BANKING
IN THE
BRITISH COMMONWEALTH

EDITED BY
R. S. SAYERS

OXFORD
AT THE CLARENDON PRESS
1952

Oxford University Press, Amen House, London E.C.4

GLASGOW NEW YORK TORONTO MELBOURNE WELLINGTON

BOMBAY CALCUTTA MADRAS KARACHI CAPE TOWN IBADAN

Geoffrey Cumberlege, Publisher to the University

PRINTED IN GREAT BRITAIN

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INTRODUCTION

THE countries whose banking systems are described in this book have two features in common. They are, or have until recently been, part of the British Commonwealth, and their banking systems have, or have had in a formative stage, close links with London. These similarities, particularly the latter, have afforded some justification for the tendency to look upon their several banking institutions as but variations on a single pattern; and reform plans from time to time have borne the stamp of standardized products designed for standardized markets. Perhaps the inclusion of these countries here, between a single pair of covers, may be thought to lend support to this view; but this book will have fallen sadly short of its authors' intent if it does not impress upon the reader that, alongside the universality of some political and financial tie with London, there is extreme diversity of historical background and even—in many respects—of the course of development during and since the British ascendancy.

The banking link with London, though related here and there to the political link, was in the main the natural outcome of the needs of a trading world which was itself centred on London and the other great markets of England. Banking services had to straddle the seas between England and its trading and political outposts: exchange and overseas remittance business is the life-blood of the sterling area. As trade pushed inland from colonial ports, the bankers had the opportunity to go with it: so appears one of the main origins of banking in 'new' countries. But even where these 'exchange banks' found a void they could fill, local competitors quickly (sometimes too quickly) appeared, particularly in the shape of 'land banks' designed to exploit the security (land) that colonists can most readily offer. In the 'older Dominions' these original overseas and local elements have been largely absorbed in great local banks, spreading over huge areas and leaning little if at all on the traditional links with the London money market. In the development of these Dominion banks an influential part has been played by immigrant Scots who brought with them familiarity (often based on actual employment)

with the well-established banking practices of their Mother Country.

Elsewhere immigrant British traders and bankers met not a void but active trade and monetary habits which, if not amounting to banking as we know it, nor to anything as coherent as a system or a money market, at least met in large measure the credit needs of a populous native community. This was the position in India, where the monetary authorities of today have to cope with a hotch-potch of European overseas banks, local banks of recent origin and European method (though often run by members of the old money-lender families), native 'banks' that are really only money-lenders, and co-operative banks. Any tendency there may be towards assimilation of these various institutions is at best slow, and it is not always clear that it should be encouraged. Meanwhile the problems of control from the centre, of the technique of monetary policy, are clearly quite different from those in countries where the banks have a substantial homogeneity and are not so very far removed from the English pattern.

A banker has two main functions: he is part of the capital market, linking lenders and borrowers, and he at the same time provides a means of payment. In linking lenders and borrowers —more precisely, acting simultaneously as a borrower and a lender—a bank is like an assurance company, a building society, and many another financial institution. What distinguishes the bank from these other financial institutions is the use of claims upon it as money for the settlement of debts. This second function is inextricably bound up with the first. Historically the banker attracted savings partly by offering ready transferability of claims (deposits), and he developed his lending partly by persuading borrowers that paper claims on himself (notes or deposits) were useful for making payments to others. In the most highly developed banking systems—particularly now that loans to governments have grown relatively to the more tricky loans to private traders—we have rather lost sight of this twofold root of the business of banking, though it occasionally crops up in the more theoretical discussions of the burden of banking costs. In less highly developed systems, however, it is to be borne constantly in mind. In a new field

the success of the banker as a provider of means of payment depends upon his success as a lender and borrower; and his success as a lender and borrower likewise depends upon his success in providing a means of payment. The two aspects of his business are interdependent.

Because of this interdependence, banking cannot be regarded as the automatic functioning of a money machine. The progress of a bank depends, more than anything else, on the relations developed between borrower and lender—whether the bank is the borrower and the customer the lender, or vice versa. Banking is thus conditioned by the general economic structure, especially in the readiness with which property, in goods, land, and other assets, lends itself to the creation of security for loans. But everywhere and all the time it is a matter of relations between people, and any discussion of banking must not be confined to balance-sheets and payment mechanics but must go behind these to the relations between banker and customer and the detailed background of their everyday business.

These editorial views on the nature of banking have determined the scope (other than geographical) of this volume. The contributors have considered the structure of banking not merely in terms of the number of banks and branches, but also in terms of such questions as, What places have banking offices and where are there none at all? and How does the local banker stand not only in relation to his head office but also in relation to the local community in which he works? Similarly, they have tried to answer the questions, What kinds of business does this bank do? and How does this reflect the local peculiarities of trading and property? And how do these banks stand in relation to other financial institutions?

The answers to these questions serve not only to portray the banking systems as these impinge on the general business life of their communities, but also as backgrounds for the discussions of central banking. There is a central bank in every one of the countries here considered except the colonial territories covered in Chapter 13—and in at least some of these colonies the establishment of a central bank has been mooted. All the central banks here reviewed are, in comparison with the great

central banks of Europe, youngsters. The oldest among them is the Commonwealth Bank of Australia, but this in its early days was neither designed nor operated as a central bank, and provides no true exception to the generalization that these central banks are foundations of the inter-war period (Pakistan and Ceylon are true exceptions). In this period there were two phases in which it was particularly fashionable to establish a central bank. In the former phase, the early nineteen-twenties, to which the South African Reserve Bank and the remodelled Commonwealth Bank of Australia belong, the fashion was rooted in the broader movement of monetary reconstruction after war-time and post-war upheavals. The new establishments (and on the Continent of Europe reconstructions of old foundations) were envisaged as part of the machinery necessary for proper working of the international gold standard. Authoritative expositions, both official and academic, of the working of the international gold standard at that time stressed the price effects, as we should say nowadays, rather than the income effects of international monetary adjustments, and they universally stressed the part to be played by national banking authorities in bringing about price adjustments through both changes in interest rates and the availability of credit. The more refined expositions further underlined the desirability of establishing central banks by showing how temporary (as opposed to fundamental) disequilibria in the balances of international payments might, by discretionary action at the centre, be prevented from causing unnecessary disturbance in domestic trade.

The idea of discretionary action, not altogether unwelcome to those of the older generation who could remember pre-1914 complaints of the hurtfulness of high Bank Rate, became more prominent as the years went by. Already in the restored gold standard years (the later twenties) the notice taken of 'offsetting operations' gave increased weight to the view that invisible hands were not enough. Consultations between central banks (despite the characteristic attempts of 'Professor Clarence Skinner' to keep them dark) provided yet further justification—and perhaps also suspicion that the central bankers of the big countries were enjoying too free a hand in the manipulation of the destinies of the world's markets.

None of the central banks in these countries was founded during this period of the restored gold standard. (The project of the Indian Reserve Bank was under debate, rather as a delayed action in post-war monetary reconstruction, but for various reasons it failed as yet to come to fruition.) The circumstances described above, however, by making the world more conscious of central banking, helped to prepare the ground for rapid developments when, after the disruption of the international standard, avowal of national independence in monetary affairs became fashionable. Canada, New Zealand, and India were, in the course of the next few years, provided with central banks, while those of other countries were endowed with new powers. Those of Pakistan and Ceylon followed after the Second World War, following the separation of Pakistan from India and the achievement of Dominion status by Ceylon; in both cases the rationale was substantially that of the thirties. Looking back, it is impossible to resist the statement that the foundation of central banks has been partly a matter of fashion. Just at present (1951), there appears to be no very pronounced fashion—whether colonies emerging into nationhood should follow the example of Ceylon appears to be an open question, a question on which it is hoped that this book will throw some light.

Even more subject to the ebb and flow of fashion has been the constitutional shaping of these central banks. In the reconstruction period after the First World War, men's views were naturally coloured by their regard for the Bank of England, a shareholder's bank without formal allegiance to any branch of government, and to the brand new Federal Reserve System, a bank-owned bank also nominally independent of the executive government. Powerful also was the desire to avoid the prodigal government inflations of continental countries where subordination of central banks to Treasury needs appeared to have played a critical part. The fashion was therefore to emphasize the 'independence' of central banks—perhaps I should say to over-emphasize it. Montagu Norman (later Lord Norman), Governor of the Bank of England almost throughout the inter-war period, when questioned by the Royal Commission reviewing Indian arrangements, stressed

the inevitable limits to this independence, but his qualifying phrases were little heeded at the time—and perhaps this was just as well! After the outbreak of monetary nationalism in the early thirties, when public opinion became much more conscious of monetary problems, there was widespread insistence on the open subjection of central bankers to government control. This reversal of views had its effect on the constitutions of the central banks set up at this time, occasioned some changes in the charters of their elder brothers, and even in those of some of the new banks themselves (e.g. the Bank of Canada) as the fashion swung farther away from the old ideal of independence. The exigencies of war finance maintained and strengthened the hold of governments, though recently there have been signs—in Australia and elsewhere—that the pendulum is turning back again, and that there are some people at least who would like to see more independence in the men who are charged with the care of the standard of value.

What use might be made of these new central banks is a question to which experience has given no simple answer—certainly it has provided no justification at all for expectations that they could develop along lines regarded as 'traditional'. The 'traditions', such as they were, had in fact no claim to veneration as long-established ways that had survived many changes of circumstance and been tried in many fires. Views on 'traditional central banking' were in fact crystallized only in the first three decades, particularly the third, of the twentieth century. In the absence of any official inquiry in Britain until 1918, public discussion was mainly in the United States after 1907 and leading up to the establishment of the Federal Reserve System in 1914. In 1918 and afterwards, central banking came into the forefront of economic discussions about post-war reconstruction, and the views then taken, in the absence of any important experience in the new American system, were perhaps unduly weighted by personal knowledge of the immediately pre-war period. The principles and practices that had ruled in 1913 were unconsciously labelled as 'normal' and 'traditional', without regard for earlier vicissitudes of monetary history. To put it in its most extreme form (perhaps a little unfairly to the men of 1920), the corner-stone was

stability of cash ratios of commercial banks who could lean, through an active market in short money and bills, on a lender of last resort operating at interest rates of its own choice. Such a simple view as this could be taken only by regarding the Bank of England (and a very recent Bank of England at that) as the pattern of central banks, for only in London were these conditions clearly established. It is true that when charters for new central banks were being formulated in detail, the drafter's eyes were often on the Federal Reserve System, but as English ideas had been one of the important elements in the formation of this system, to look at the American document was in part no more than an indirect glance at the English pattern. The new and reorganized central banks of the early inter-war period were in consequence (as will be seen in some chapters of this book) largely based on the assumption of at least a tendency to stability in cash ratios and on the possibility of establishing an active bill market; and the central banks were therefore provided with the 'traditional' weapons of the discount rate and open market operations. The scepticism with which some of the new institutions were sometimes received by the commercial bankers was perhaps rooted, though not consciously, in the feeling that the basic assumptions were grossly inconsistent with the facts.

Stability in the cash ratio was even at that time a comparative novelty in the English banking system, and here it was a freakish rather than a normal phenomenon. For the banker's art is to weigh immediate profit against liquidity (in the broadest sense), and if the availability of attractive earning assets varies from time to time, the banker will naturally be prepared to go sometimes more, sometimes less far in the sacrifice of liquidity. What gave the English banks' cash ratio an early tendency to stability was the development of the bill market. Bills of exchange, handled in the London market, were excellent earning assets, in abundant supply in a highly competitive market, in which the individual banker could participate as much or as little as he liked, without consideration of customers' goodwill. But it was not until this market's own liquidity at all times was demonstrably assured by the recognition of the Bank of England as lender of last resort that the commercial bankers could safely keep their cash ratios at all

times at an unchanged (and conventional) minimum. Thus stability in the cash ratio is the outcome not simply of the existence of a lender of last resort but also of a peculiar structure of the capital market. The power of a central bank to command an automatic response to its operations thus depends not only upon full dependence of the money market upon the central bank as lender of last resort but also upon the existence of a market offering to the individual banker indefinitely elastic supplies of a very attractive earning asset.

Even if similar conditions could have been created overnight in the countries in which new central banks were being established, a long time would have had to elapse before the local bankers' habits would be adapted to the new régime, so establishing the central banks' powers on 'conventional' lines. In some of the Dominions hopes were expressed, and some efforts were made, that a bill market might be developed. The development of such a market had been, a little earlier, part of the reform scheme in the United States but, even in the favourable environment of a great trading centre, success was never more than partial. It was not surprising that nothing effective could be done in South Africa or Australia, or that in India fusion of the diverse money market elements into a unitary and manageable market has continued to elude the efforts of the banking reformers. A close banker–customer relationship continues almost everywhere in the Commonwealth to condition the volume of earning assets, and while this is so the strength of central-banking control of commercial banks has to depend upon harmonious direct contacts rather than upon an impersonal wielding of conventional weapons.

Not that absence of a rigid stability in the cash ratio implies the absence of all influence through the liquidity factor. In the Bank Restriction period in England, those Bullionists who regarded the country bank-note issues as subject to automatic control by Bank of England issues were wrong—as the next generation freely admitted; but it was nevertheless the case that Bank of England operations, through their effect upon the general liquidity position of the country banks, had important influence upon the availability of bank credit in the country generally. In the same way, the impossibility of mechanistic control by Dominion central banks need not imply the absence

can usefully be provided by the central bank. If wisely performed it can hasten the growth of a strong and serviceable commercial banking system and at the same time give the central bankers understanding of, and influence with, the commercial bankers whose operations the central bank is in some measure intended to guide. A central bank in the west African territories might find little to do in the way of 'traditional' central banking, but it might at least help the rapid growth of commercial banking to proceed along sound lines. Also, a central bank that grows up with the commercial banks has the best chance of finding the technique most appropriate to its own environment. Even the stumbling progress of the Bank of England during the last 200 years supports this view.

To pursue any further the hints thrown out in these introductory pages would lead me into a detailed review of the position in each country. This detailed review is, of course, provided by the contributors in the following chapters, and it is my hope—and theirs—that understanding of banking problems in many countries, both inside and outside the Commonwealth, will be forwarded by bringing together their individual studies. They have been given no detailed editorial guidance, and what unity of approach there is derives largely from the fact that most of them have been in close contact with myself during the last few years. Of the eight contributors four have been associated with me in the teaching of monetary economics at the London School of Economics and two others (both now lecturing in other universities) were my pupils there. Only for the chapters on Ireland and New Zealand has it been necessary to invite other contributors. These, among others, belong to the countries of which they have written. For South Africa an exception had to be made owing to the very late withdrawal of the South African economist who had undertaken the work. Mr. Day generously stepped into the breach. At that late hour he was unable to secure direct local knowledge, but various South African bankers and others were good enough to comment on his preliminary draft. In the course of preparing his chapters on India and Pakistan, Mr. Wilson was enabled to visit those countries with the help of a substantial grant from the Houblon–Norman Fund. The Fund also enabled Mr.

Newlyn to visit some of the colonial territories in time to revise the draft of his chapter.

Finally, I must make some apology for the title of the book. I fear some people in the new Dominions and in Eire may take offence at the inclusion of the word 'British'. I have carefully considered the possibility of its omission; but there have been other 'commonwealths' and to avoid confusion it has been absolutely necessary to say 'British Commonwealth'. I can only add that no political implication is intended. The space given to each country has likewise no political implication! It depends mainly on the complexity of the picture to be drawn.

The date of completion of most of the chapters was about mid-1951 and events after that date are for the most part ignored.

Preparation of the book for the press was facilitated by the Economics Research Division of the London School of Economics. Miss M. Clarke and Miss Adamson undertook most of the typing, and Mr. D. Judd prepared the graphs. The Index is the work of Mr. James Lanner of University College, London.

1

THE AUSTRALIAN TRADING BANKS[1]

TWO main features have characterized the development of the Australian trading banks. First, the country has come to be served by a wide network of bank branches; and, second, banking business has been concentrated in the hands of a relatively small number of institutions. Indeed, it has been stated by one authority[2] that 'the emergence of a unit bank system has never been a real possibility'. Bank branches appeared quite early in the country's history, the first being established in 1827. A few local banks appeared in the eighteen-thirties, but failed to survive the depression of 1841. Subsequent attempts to found local institutions[3] were hampered by their inability to compete with the larger 'metropolitan' banks, whose branches began to follow the geographical extension of settlement in their search for business. Associated with this process of growth was the emphasis on amalgamation and concentration, which seems to have been a factor of greater importance in restricting the number of banks than failure during crisis. Numbers reached their peak before the great bank smash of 1893 when many of the weaker banks failed. Thereafter a series of amalgamations continuing into the present century resulted in the highly concentrated system which obtains today. Moreover, the several attempts made by foreign banks to extend their activities to Australia have always failed when faced with the united competition of the existing institutions. Such foreign banks as continued to maintain offices in Australia were not concerned to any significant extent with domestic business. This high degree of concentration also made possible tacit agreement on the broad lines of policy and

[1] The author desires to express his very deep appreciation to all members of the Australian banking and financial community who have assisted him with information or criticism in the following two chapters. For the interpretations which are offered, however, he alone can be held responsible.

[2] S. J. Butlin, 'Banking, Finance, Fiscal Policy', *Australia* (ed. C. Hartley Grattan, University of California Press, 1947), p. 226.

[3] But there were exceptions. One local bank founded since 1841, and still in existence, was the Ballarat Banking Company, established 1865.

the terms of business. In times of crisis, there were some breaks with this tradition, but aggressive competition between the banks by way of rate-cutting has been a rare phenomenon in Australia. Moreover, since all the large trading banks do business in several States, they are subject to Commonwealth law and this, together with the similarity of their business, has had the effect of unifying the banks into a system. Policy is decided in central offices and there is little possibility of independent and uncoordinated action by local managers. Indeed, this unifying process was going on long before Federation, since State laws, though various in content, were uniformly mild in the nature of the restrictions imposed and, from 1850 onwards, concentration was well under way.

I

Australia's first trading bank—the Bank of New South Wales—was founded in 1817 and by 1841 the country was served by some eighteen banking institutions, the head offices of most of which were in Australia though the greater part of their capital was raised in England. By 1850 five of these banks had failed and three had been absorbed by amalgamation. Of the original banks four established branches[1] and these were opened for the most part in what were to become the capitals of the several States. The growth of banking at this stage was based primarily on the prosperity of wool-growing and on the associated growth in population, which had given rise to a widespread and increasing demand for finance to meet the needs of trade. But competition for business soon led to over-expansion and a fall in the price of wool precipitated the crisis of the early eighteen-forties, when three of the weaker banks failed. Thereafter, the banks recovered slowly until the discovery of gold in 1851 encouraged further expansion and the development first of light manufactures in the sixties and later engineering enterprises provided a modest but continuing stimulus, particularly in Victoria.

Certain of these early banks were founded as partnerships, but this proved to be a cumbersome form of organization and

[1] The banks concerned were the Bank of Australasia, the Union Bank of Australia, the Bank of New South Wales, and the Commercial Banking Company of Sydney.

incorporation followed in due course, the usual method being by Act of Parliament. Both the Bank of New South Wales (1828) and the Commercial Banking Company of Sydney (1848) adopted this method. The Bank of Australasia, on the other hand, was founded as a company in 1835 under Royal Charter. Subsequently, incorporation under the new Companies Acts became the order of the day. Some of these banks were incorporated and owned in Australia and others in England with head offices in London—a distinction which has remained important to the present day.

All of these banks adopted the system of branch banking. Indeed, at no time has there been any legal restriction imposed upon the spread of banking either within a State or from one State to another, although some banks—as a matter of policy—have confined their main activities to a single State.[1] Most banks possessed and exercised the right to issue notes until 1910, when their note circulations were taxed out of existence; and they were subject in this respect to the conditions of their charters, or special acts, and to the general law, some provision being generally made for the protection of note-holders.

Throughout the nineteenth century the Australian trading banks experienced much the same vicissitudes as affected banks elsewhere. Many were founded and many failed. Others were absorbed by their stronger brethren. But it was not until the crisis of 1893 that the banking system really became involved in serious difficulties. The preceding boom had been associated with a large influx of capital, much of it on private account, and with wild speculation in land, to which a number of banks had contributed. The banks became over-extended and soon found themselves in a most vulnerable position.

The subsequent slump was occasioned chiefly by the collapse of the land boom, a serious decline in export prices, and the falling off in overseas lending which was accompanied by a withdrawal from the Australian banks of deposits originating in the United Kingdom.[2] The crisis was most severe in the States of Victoria and—to a somewhat less extent—New South

[1] For example, the Bank of Adelaide (South Australia) and the former Queensland National Bank (Queensland).

[2] It has been estimated that, in 1891, British deposits in Australian trading banks and building societies amounted to about £A45 millions.

Wales. During 1891–2 no less than forty building and financial associations in Melbourne and Sydney failed with liabilities of about £25 millions.[1] As suspension followed suspension, the depositors, even of institutions which still appeared to be solvent, began to insist on repayment immediately their deposits matured and this increased the demand upon the surviving institutions, until finally it could no longer be met.

In New South Wales the Government acted with decision. Bank notes were made a first charge on their issuers' assets and the Governor-in-Council was given power, at any bank's request, to declare its notes legal tender. The Treasury was even empowered to issue its own notes and to lend these to the banks up to half the total of current accounts locked up by the suspension of any bank. This was the traditional policy of choking a panic with cash, though most of the Sydney banks were at first unwilling to avail themselves of the Government's offer and it was only after the Commercial Banking Company of Sydney had (unnecessarily) suspended payment that the Premier was able to wring from the other leading banks the necessary applications. The notes of certain banks were then declared legal tender and their payment guaranteed for a period of about six months.

Victoria was less fortunate. There the Government did nothing. It argued that it had no funds to spare in London and refused to issue its own notes. In January 1893 the Federal Bank of Australia had closed its doors. By April the Commercial Bank of Australia was obliged to suspend payment. Then, when the National Bank of Australasia was also forced into difficulties, the Government was left with no alternative but to declare a five days' bank holiday. However, not all the banks availed themselves of this moratorium and those with head offices in Sydney or London opened as usual and, of those which suspended payment, only a few comparatively unimportant banks failed altogether. The majority reopened and were subsequently reconstructed. There then followed a slow and painful period of recovery (from 1893 to 1901) and at Federation some of these reconstructed banks were still working out their salvation.

The crisis of 1893 left behind it a state of affairs which could

[1] Here and throughout this chapter the symbol £ represents £A.

only be cured by the passage of time and careful management. At first, the banks had to concentrate on the repayment of their creditors and on regaining their feet. In most cases, reconstruction had been completed by 1900 and from then until 1914 was a period of recovery and development. Then came the First World War, when Australian bankers had their first real experience of exchange difficulties. It was then that the process of amalgamation began in earnest. Previously, the necessities of reconstruction had stood in the way of this development, but after 1917 there were twelve amalgamations or absorptions in fourteen years.

All these arrangements appear to have been entered into by both parties for their mutual advantage. With the one exception of the Australian Bank of Commerce, which was amalgamated with the Bank of New South Wales in 1931, there was no suggestion that any of the banks taken over would have been unable to carry on. The net result of these moves was to concentrate banking in Australia in the hands of nine large trading banks with a network of branches throughout the country.

Throughout the early years of Federation and up to the outbreak of war in 1914, credit policy was in the hands of the trading banks including the Commonwealth Bank from the time of its establishment. During the war period and for some time afterwards, however, credit conditions were influenced primarily by the Government's financial arrangements. Then, following the post-war transition, responsibility for credit policy once more reverted to the banks, which position continued until 1929.

Much the same state of affairs obtained in the field of foreign exchange. The greater part of Australia's international reserves were then held by the trading banks, partly in gold in Australia, and partly in gold or sterling in London. In this respect also there was little change until 1929 and except for the periods 1914 to 1925 and after 1931, sterling was equivalent to gold. Parity with sterling was regarded as normal and no permanent or serious disparity between the Australian and English currencies seems to have been considered possible. The sterling exchange rate was in some measure controlled by common action on the part of the banks and was not deter-

mined in a completely free market. With the object of preventing major movements in the exchange rate, the banks were prepared to buy and sell sterling in unlimited quantities at the ruling rates. In order to do this, the banks had to allow their London funds to fall when sterling was tending to a premium, and conversely. As long as the banks held sufficient funds in London and were willing to permit these fluctuations, they could control the exchange market. The banks had, in fact, developed a technique which enabled them, in normal times, to maintain adequate funds in London for the purpose of controlling the exchange rate and latterly Australia was kept on a gold standard, without the necessity for special shipments of gold.

The period 1919 to 1929 was, on the whole, one of increasing economic activity, and this was reflected in the business of the trading banks. Deposits rose steadily from £193·4 millions in 1919 to £302·3 millions in 1929, an increase which occurred mainly in fixed deposits, which rose from £104·5 millions to £192·1 millions. Advances, too, increased—from £161·8 millions to £267·8 millions.[1] Even the depression of the early nineteen-thirties proved only a temporary setback and it is a tribute to the strength of the Australian institutions that none of the established trading banks failed and that all weathered the storm without difficulty. Of the three failures in 1931, that of the Government Savings Bank of New South Wales was due to political rather than financial causes and an examination of the bank's position showed that its assets were ample to meet its liabilities, though it lacked sufficient liquid assets to meet the very exceptional demands made upon it.

II

Before proceeding to discuss the type of business undertaken by the Australian trading banks, it is appropriate to indicate the general character of the financial system to which they belong. This consists of the Commonwealth Bank of Australia (now the central bank and, as such, discussed in Chapter 2), the trading banks, the savings banks, the rural and agricultural banks, and a number of other financial institutions of various types.

[1] All figures are for the June quarter in the respective years.

Australia is a country in which the banking habit is at least as highly developed as elsewhere and, despite its great distances, no centre of economic importance is without its share of banking facilities. In most of the towns and cities there are branches of several of the chief trading banks and, at times there has been a tendency towards redundancy and excess capacity. The smaller centres are served by bank agencies which provide facilities once or twice a week. Throughout Australia the cheque-using habit is widespread, though by no means universal, and many people prefer to operate savings bank accounts as a convenient method of holding small savings in a form repayable on demand and earning interest. Formerly, there were nine trading banks of national importance, but further amalgamation has now reduced the number to seven. The business of these institutions (discussed elsewhere in this chapter) is carried on over a wide area through a network of branches and agencies, and authority is usually delegated to managers to accord with their status and experience. Agencies are under the control of branch managers. In 1936 the Nine Trading Banks operated 2,352 branches and 717 agencies and receiving offices. During the war years there was some rationalization of bank branches in Australia and numbers were significantly reduced, but post-war numbers have again been increasing.

In adopting a system of branch banking, Australia has followed the English practice. The general policy has been to begin with an agency, open perhaps one or two days a week, until the volume of business is sufficient to justify conversion of the agency into a branch. If, for any reason, business subsequently falls off in this area, the branch will either be closed or converted again to the status of an agency. Two results of this system may be noted here. On the one hand, the extension of branches had in the past undoubtedly led to quite an intense competition for business (by providing services) and this resulted in a certain amount of redundancy. On the other hand, the existence of branch banking assisted the process of amalgamation by tempting larger banks to take over smaller ones and thus to avoid the costs of building up business gradually in a new area.

Inter-bank clearing of cheques is effected through clearing

houses established in every capital city and in some of the larger country towns, settlements being made by means of cheques drawn on the Commonwealth Bank. This practice dates from the passing of the Commonwealth Bank Act 1924. Previously, the banks had conducted their clearings (after they had ceased to use gold for the purpose) chiefly by means of £1,000 notes. After 1924 most of these notes were replaced by deposits held with the Commonwealth Bank. In former days, each bank contributed to a pool as a guarantee against default in settlements. This arrangement is no longer in force though it survived as an anachronism until as late as 1938.[1]

As a general rule the banks act in concert in a number of matters of common concern. There is no formal association, though there is an organization known as 'The Associated Banks of Victoria', which consists of the four trading banks (previously five) having their head office or principal Australian office in Melbourne. Two banks with head offices in Sydney are also members in respect of their business in Victoria. This association has no formal constitution, nor is it registered as an association. Representatives of the several banks meet regularly each month, or oftener if necessary, to discuss matters of common interest, but decisions are not binding and the association is in no sense a controlling body. There is no association of quite the same kind in any other capital city, though in some the managers of the banks meet when necessary for discussion of local matters of common interest.

In size the Bank of New South Wales is still the largest of all the Australian trading banks, followed by the new Australia and New Zealand Bank Ltd. (the result of a merger between the Bank of Australasia and the Union Bank of Australia Ltd.). Their nearest rival is the National Bank of Australasia Ltd. (which recently absorbed the Queensland National Bank). The remaining large banks in order of importance are the Commercial Banking Company of Sydney, the Commercial Bank of Australia Ltd., and the English, Scottish, and Australian Bank Ltd. The Bank of Adelaide is smaller still.

In addition to what were the 'Nine Trading Banks' (now reduced to seven), five other banks might be mentioned, though

[1] See L. F. Giblin, *The Growth of a Central Bank* (Melbourne University Press, 1951), pp. 255–6.

they trade only on a limited scale—the Ballarat Banking Co. Ltd. (in Ballarat and the surrounding districts), the Bank of New Zealand (which has branches in Sydney and Melbourne, mainly to handle the Australian business of the Bank on behalf of its New Zealand and London branches), the Comptoir National d'Escompte de Paris (with branches in Sydney and Melbourne, the main function of which is to facilitate trade between Australia and France), the Brisbane Permanent Building and Banking Co. Ltd. (in Brisbane), and the Bank of China, with a small office in Sydney. Formerly, the Yokohama Specie Bank Ltd. had an office in Sydney, but this was closed in 1941.

For the most part facilities for the collection of small savings have been provided by the various Australian governments, though several of the former State savings banks have now been absorbed by the Commonwealth Savings Bank which operates in all the States. Only in South Australia and Victoria are State government savings banks still in existence, and in Tasmania there are two trustee savings banks. In Victoria the Commonwealth Savings Bank now holds less than one-third of savings bank deposits; in South Australia less than one-quarter; and in Tasmania rather more than one-half. In all other States it enjoys an effective monopoly of this class of business. Total savings bank deposits in Australia approximated £850 millions in August 1951. It is the practice of all the savings banks to deposit substantial amounts either with the Commonwealth Bank or the trading banks, as well as to subscribe heavily to government securities. In this way the savings banks have played an important role in the financial system as a whole by collecting and making available an aggregation of small deposits. The savings banks also invest in fixed loans (e.g. by way of mortgage).

Each of the Australian States has established some form of rural or agricultural bank, though in some cases these are no more than State government departments. In the past they have concentrated on the provision of long-term loans to home-builders and to primary producers for development purposes. More recently, there has been some extension of their activities into the trading and industrial field. This latter development has been most noticeable in the case of the Rural

Bank of New South Wales[1] which was already an institution of the first importance. Being instruments of the State governments, however, none of these banks is subject to Federal banking law and hence they escape most of the provisions of central bank control.

Life assurance companies constitute another important financial group. Most of these institutions are organized on a mutual basis, though some have a share capital which is, however, relatively small. These societies regularly receive a large income, both from premiums and from interest on investments, and these receipts are normally in excess of their immediate requirements. They rely on the banks only occasionally for overdraft accommodation, as when large investments have temporarily depleted their liquid resources. Their influence on the financial system is considerable because of the magnitude of their funds which they invest against the day when payment of life and endowment policies becomes due. Much of their investment is in government and municipal securities, though mortgages, policy loans, and equities absorb a significant proportion of their funds. They do not, as a rule, make loans repayable on demand. Holdings of government securities increased markedly during the war and the rapid post-war rise in mortgages is therefore to be regarded merely as an attempt to restore an earlier position.

Another institution which deserves our attention is the pastoral finance company. These companies provide both short-term and long-term capital for primary producers (mainly wool-growers). The greater part of their funds is provided by share and debenture capital and reserves, and their operations have had the effect of supplementing the credit facilities provided by the banks. The basis of their activities is the sale of wool, and their financial operations have been built up as a complement to this. Most of them act as agents for the buying and selling of their clients' livestock and for the sale of station properties. But they provide a variety of other services including wool-storage and the sale of station supplies.[2] There are

[1] In anticipation of the possible nationalization of the trading banks proper, the constitution of the Rural Bank was altered in 1947 to enable it to undertake a general banking business within its own State.

[2] Pastoral properties—whether sheep or cattle are run—are always known in Australia as 'stations'.

about twenty leading pastoral finance companies, including some of the largest public companies in Australia. At certain times of the year, when their customers' demands are at their maximum, these companies are accustomed to borrow on overdraft from the banks. Usually they do not seek deposits from the public though they accept them from their own pastoral clients. It is not the practice of these companies to make long-term loans, but loans repayable on demand are frequently allowed to run on for an indefinite period. Interest is usually charged on the daily balances and the rate may be varied from time to time during the currency of the loan. In this respect, these loans resemble advances made by the trading banks. Some of these companies also permit a limited number of their clients to draw orders upon them which, in many respects, are equivalent to cheques, but with the extension of banking facilities the use of these orders is diminishing.

For the rest there are the trust companies, which control quite a large volume of trust funds, the investment of which is governed by State laws, moneys being invested either in government securities or upon mortgage (some of these companies also do an executor business); building societies, which assist people to obtain homes or business premises for occupation or investment, and which accept money either on call or fixed deposit; the finance (or hire purchase) and cash order companies; and a small number of investment trusts. Finally there are, of course, the stock exchanges, the function of which is to bring together those who desire to buy or sell government or other securities. They also provide facilities for obtaining subscriptions to new issues of government securities and shares in companies.

Most of the finance required by commerce and industry has been made available in various ways by the organizations described above, but there has been, in addition, quite a large volume of private finance provided directly by individuals and indirectly by solicitors and agents on behalf of clients. A more recent development has been the establishment in Australia of finance and issuing houses on the London model. In two instances, the move came from the City of London itself. Thus, Charterhouse Australia Proprietary Ltd., a subsidiary of the

Charterhouse Investment Trust, London,[1] began operations based on Melbourne in April 1950, and Morgan Grenfell and Lazard Brothers (both of London) have jointly founded the Anglo-Australian Corporation Pty. Ltd., the activities of which are also centred on Melbourne. Operations began in October 1949. Not to be outdone by its sister city, Sydney followed in October 1950 with the establishment of Mainguard (Australia) Ltd., an Australian company with financial support from London. These houses are primarily concerned with the financing of businesses which are moderate in size but not large enough to justify public issues through the stock exchanges. In the main, these interests propose to combine with local capital and experience in the development of Australian secondary industries. They also wish to encourage the establishment in Australia of subsidiaries of British firms. The intention was to supplement rather than to compete with the activities of banks and other mortgage-lending institutions. This is an experiment which will be watched with interest and the new emphasis on specialized financial institutions is itself a reflection both of the growth and increasing maturity of the Australian capital market and of the economy as a whole.

III

The business of a trading bank is to accept deposits and to make advances. Deposits are of two kinds—fixed deposits and deposits on current account—and they represent the savings and working capital of many sections of the community. Fixed deposits are repayable at the end of the term for which they are made—3, 6, 12, or 24 months, as the case may be—and interest is paid at rates which vary according to the length of time for which moneys are fixed. Most banks are prepared to exercise a discretion in the matter of repayment and do, on occasion, allow withdrawal before maturity in consideration of payment of an appropriately lower rate of interest. In addition, rates are varied from time to time (latterly at the direction of the Commonwealth Bank) to accord with the general rise or fall in other interest rates, but the rate carried by a deposit

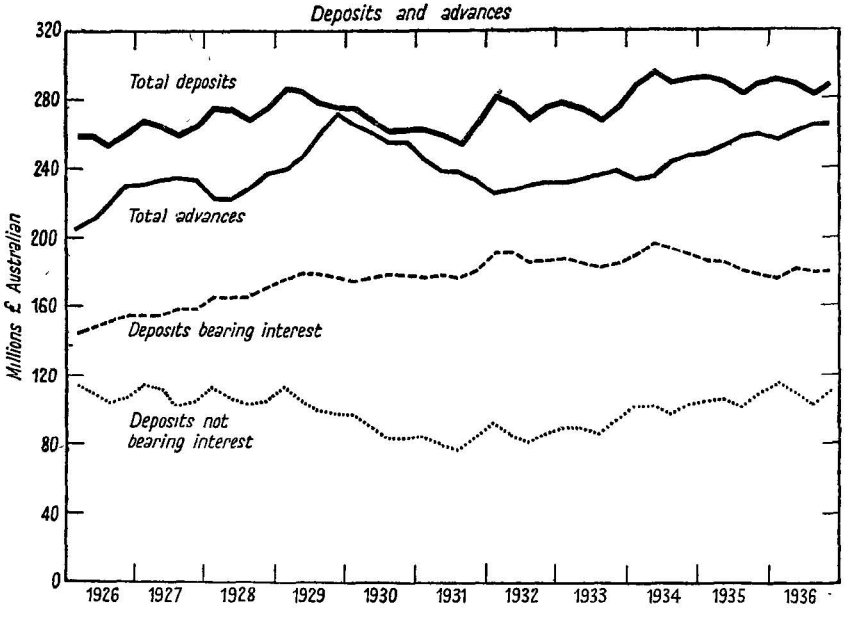
[1] This Trust draws financial support from the Prudential Assurance Co. Ltd., and two English banks—Lloyds and the Midland.

when it is lodged applies until maturity. The convenience of a fixed deposit to the customer lies in the possibility of investing money for short periods (of not less than three months), earning interest on his deposit, and receiving repayment of the capital sum on maturity. For deposits on current account the banks allow no interest but undertake to repay the money whenever called upon to do so by meeting the cheques of the customer on presentation and up to the amount of his credit balance. The convenience of a current account is that money which is not immediately required can be left with the bank and that payments can be made and received by means of cheques which the bank will pay or collect. By this means the customer can make or receive payments without the trouble or risk involved in handling cash. The banks make a fixed charge for keeping current accounts (5*s*. per half year), but this may be waived in certain cases. The banks also make a charge for the negotiation of inland cheques and bills, which is usually referred to as 'exchange' but which should be more properly described as a charge for collection. The rates vary and are affected to some extent by the time required for collection, though certain banks with branches in small and isolated centres appear to levy an additional monopoly charge, and there has been much dissatisfaction occasioned by the wide range of charges which still obtains. Partly for this reason, there have been some reductions in recent years.

Advances are made in the form of overdrafts which are strictly repayable on demand. In practice, however, many overdrafts are allowed to run on for long periods. The usual arrangement is to require the lodgement of security for overdrafts, though unsecured advances are granted occasionally. But it is fair to say that in this matter the Australian banks are much less lenient than are the English banks. It is customary to agree upon a 'limit' up to which the customer may overdraw, though interest is only charged on the daily debit balance and no other charges for keeping the account are made. Overdraft rates are not fixed for a definite period and may be altered at any time. The rates vary somewhat according to the type of account and the class of security held by the bank, and are related to the rates paid on fixed deposits. However, since 1942, the Commonwealth Bank, as central bank, has made

orders fixing maximum rates both for trading bank overdrafts and for fixed deposits.

The trading banks have also assisted in financing overseas trade in a number of ways. It is true that, under present conditions, international financial transactions are subject to exchange control, for which the Commonwealth Bank, as central



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bank, is responsible, but the trading banks act as its agents and are permitted to hold working balances of overseas funds. Through their London offices and their representatives abroad, the trading banks issue letters of credit and arrange for the presentation or issue of drafts relating to Australian export or import transactions in any commercial centre in the world, though most of these transactions still pass through London. These activities enable Australian exporters to obtain payment in Australian currency immediately goods have been shipped and enable importers to pay for imports in Australian currency. The corresponding settlements overseas are effected by the banks either in sterling or in foreign currencies.

As sub-underwriters to the Commonwealth Bank, the trading banks have at times helped to float public loans and, in pre-war days, they participated in the Exchange Mobilization Agreement, by means of which funds were provided in London to meet government commitments there.

Among the many other services which the banks provide for their customers are the safe custody of securities and valuables, the collection of interest coupons, and assistance to customers in the handling of their business affairs. In addition to normal cheque facilities they provide for the transfer of funds from one point to another within Australia and between Australia and countries overseas.

The business of banking in Australia is now concentrated in comparatively few hands, but not all of the banks are of the same size, and it is pertinent to inquire into the factors which determine the distribution of business between them. First, there are the historical factors—the obvious advantage which the first bank in a particular area has enjoyed in the attraction of business and the extent to which penetration has been assisted by amalgamation with smaller local banks. But both of these factors have now largely exhausted themselves and current relationships with the public will now be much more potent in forming the present pattern of distribution of business. Second, therefore, it is necessary to determine the degree to which there is competition for existing business. It has sometimes been asserted that the trading banks do not compete with one another, but it would be more correct to say that the trading banks do not indulge in unrestrained or cut-throat competition. In evidence before the Royal Commission on Monetary and Banking Systems in Australia (Report published in 1937), reference was made to a 'gentlemen's agreement' between the banks not to compete. Some banks acknowledged the existence of some such understanding. Others did not. In pre-war days (i.e. before direct controls were imposed), it was usual for all the trading banks to publish and quote the same rates for deposits, but it was known that in some circumstances they would compete for the deposits themselves. Rates on advances were subject to less rigid arrangements. These rates were not usually published by the banks and they varied according to the nature of the advance, the estimation of the

risk, and the value of the other business brought to the bank by the customer. But, in the general case, there were ruling rates for advances which were similar and these were probably applied by the trading banks to the greater part of their advance business. Nevertheless, this never meant that one bank would necessarily refuse an advance at a rate lower than that charged by another bank. Indeed, competition for advances did at times mean rate-cutting and the attempt to take customers away from another bank. However, the more usual form of competition was not by cutting rates but by offering other inducements to the borrower in the form of services of various kinds. In any case, now that interest rates are subject to a maximum control by the Commonwealth Bank, there is much less scope for rate-cutting. Thus, there is competition of a kind, but it is the sort we would expect from semi-monopolistic institutions, where each bank refrains from unlimited competition because it fears to spoil the market and to provoke similar competition from the other banks to the general disadvantage of them all. Yet, despite these limits to the degree of possible competition, the relative share of the total business going to a particular bank does seem to change over a period of years (quite apart from the effect of amalgamations) and one has the impression that some banks push more sturdily than others in their drive for new business.

IV

The business of the banks discussed in the previous section is reflected in the structure of their assets and liabilities. Liabilities to the public consist of notes, bills payable and other liabilities, and deposits. Latterly, central bank loans have also appeared in certain of their balance-sheets.[1] As the banks no longer issue their own notes, their liability on account of notes issued is really only nominal and the balance-sheet item is therefore in the nature of a reserve. 'Bills payable and other liabilities' includes, in the case of certain banks, a provision for contingencies and doubtful debts and, if these were deducted, the remaining liabilities under this head would be relatively small. Hence, the greater part of a trading bank's liabilities consist of deposits, either current or fixed. Of total deposits,

[1] The significance of this item will be discussed in Chapter 2.

80 per cent. are (1951) on demand. This represents a striking contrast with the position pre-war when only about 40 per cent. of total deposits were current and 60 per cent. were fixed. This development was due no doubt to the pursuit of a cheap money policy during the war and early post-war years, which latterly rendered the fixed deposit a much less attractive short-term investment. Under these conditions bank customers preferred either to hold their liquid reserves as deposits on current account or to invest in short-dated governments.

On the assets side, the most liquid item is, of course, 'Coin, Bullion, Notes and Cash with the Commonwealth Bank', in addition to which the trading banks are now obliged to hold immobilized considerable sums in Special Account with the Commonwealth Bank (releases may be made from these holdings, subject to certain conditions). In pre-war days, significant amounts of money were also lent at short-call in London but, apart from the Commonwealth Bank, such amounts are now relatively small, and the trading banks only hold working balances. The remainder of Australia's sterling funds are mobilized in the hands of the Commonwealth Bank. The bulk of the trading banks' 'Securities and Investments', which is their next line of defence, consists of Treasury Bills and government and municipal securities. The proportion of total funds now invested in this form has not changed very much since pre-war days.

The other main earning item is 'Advances and Discounts', from which most of the banks deduct a provision for bad and doubtful debts on the assets side of the balance-sheet, though certain banks make an alternative provision, as mentioned above. The greater part of this business consists of advances by way of overdraft. In 1936, when the Royal Commission investigated, bills discounted amounted to only 1 per cent. of the total and 'other items' to about ½ per cent. and, over a period of years, there had been a continuous decline in bills discounted from about £10 millions in 1926 to about £3 millions in 1936. It is understood that since the end of the Second World War, however, the bill business of certain banks has expanded to quite a significant extent. This has no doubt been associated with the partial recovery of the business in Foreign Bills in the City of London.

An interesting feature of the Australian trading banks' advance–deposit ratios is the considerable divergence from English experience which still persists. In the thirties the London Clearing Banks advance–deposit ratio approximated 40 per cent., whereas the corresponding ratio of the Nine Trading Banks in Australia usually exceeded 80 per cent. and quite frequently 90 per cent. The impact of the war has affected the trading position of the banks in both countries, but something of the same tendency still appears to operate. The London Clearing Banks advance–deposit ratio had climbed back to about 30 per cent. by 1951, while that of the 'nine' Australian trading banks has moved between 40 and 50 per cent. over recent years. This divergence was usually explained in terms of the difference in business conditions.

Some of the funds provided by Australian banks in the form of overdrafts are provided by the English banks in other forms, as, for example, loans at short call and commercial bills. Therefore, Australian banks are obliged to invest more of their funds in advances, and, because of some lack of other facilities, borrowers are compelled to rely to a greater extent for their requirements on overdrafts.[1]

Premises and other real estate represent only a very small percentage of total assets, though these assets have been written down to a figure far below their true value.

Finally, mention should be made of the banks' inner reserves. These are, in effect, the differences between the disclosed and undisclosed valuations of certain assets. They include provision for loss of advances which are doubtful and interest which may not yet have been received. In addition, these reserves include provision for the depreciation of investments and bank premises. The inner reserves have been built up over a long period. In some banks the reserves date from the eighteen-eighties and in others they were built up after the banks' recovery from the depression of 1893. In 1936 the inner reserves of all banks were said to amount to approximately

[1] *Report of the Royal Commission on Monetary and Banking Systems in Australia* (1937), para. 300, pp. 127–8. Though the divergence still obtains, it is now less marked than formerly and this must be ascribed to the rather drastic changes in Australian bank asset structure occasioned by the form and operation of war-time and post-war credit controls referred to elsewhere in this volume.

£22 millions[1] but, so far as the present writer is aware, there has been no comparable figure published since.

It is now necessary to consider the general question of liquidity and the rules which have guided the Australian banks in this connexion. In pre-war days the trading banks had much greater freedom than they have now in determining movements in their assets and liabilities and in influencing the several ratios to which reference has been made.

A uniform practice was followed in defining the content of the items deposits, advances, liquid assets, and total liabilities to the public, but there were differences in regard to 'cash'. All banks included coin, bullion, Australian notes, and deposits with the Commonwealth Bank. In addition, some included Treasury Bills, some part of their London funds, and some both. Furthermore, some banks which included London funds did not convert them into their equivalent in Australian currency. Liquid assets included cash and all other assets, except advances and landed property. Thus, government securities were treated as liquid, whether they were held in London or in Australia. Total liabilities to the public consisted almost entirely of deposits together with small amounts to cover notes and bills in circulation and balances due to other banks.

In Australia there were three ratios to which all the banks in varying degree paid some attention in making policy decisions, namely, the ratio of advances to deposits, the ratio of liquid assets to total liabilities to the public, and the ratio of cash to deposits. There was no general agreement as to the order of importance of these ratios and, as we have seen, there was some difference of practice as to what was regarded as cash. Every bank had its own opinion as to what were satisfactory ratios from the point of view of profit and liquidity and shaped its policy accordingly. Nor were these ratios ever rigidly adhered to by the banks and they were in point of fact prepared to let their ratios vary within wide limits. Nevertheless, each of the banks endeavoured to keep them within limits which were fairly well defined and lending policy was subject to rules which, while flexible, were definite enough in practice.

[1] Ibid., para. 302, p. 128.

The ratio of advances to deposits was the percentage ratio of the aggregate advances to the aggregate deposits. The liquid assets ratio was the percentage ratio of the aggregate liquid assets to the total liabilities to the public. But it was not so easy to define what the banks had in mind when they spoke of their 'cash ratio', because of the differences in practice as to what the various banks regarded as 'cash'. However, when the Royal Commission appointed to investigate monetary and banking systems in Australia reported in 1937, they defined cash as

> those items which are cash in themselves (coin, bullion, and notes) and those which will be turned readily into cash by the Commonwealth Bank (deposits with the Commonwealth Bank, treasury bills, and London funds). We have not regarded as London funds Australian Government securities held in London. . . . The London funds included as cash are taken at their value in Australian currency at the time to which they relate. It is true that no one bank uses precisely these items in calculating its cash ratio, but in our view the ratio which we have adopted is the most important indication of the liquidity of the system as a whole. It might be confusing to call the ratio either 'cash ratio' or 'liquid ratio'. The items include more than cash in the strict sense of the word, and less than the total liquid assets taken into account by the banks for purposes of their liquid assets ratio. For convenience we shall refer to it as the 'cash reserve ratio' and to the aggregate cash, treasury-bills, and London funds as 'cash reserves'.[1]

It is perhaps desirable, at this stage, to indicate the role played by London funds in determining the liquidity of the Australian banking system. First, because of the seasonality of their business, it was the practice of the banks to accumulate large sums in London during the export season and to allow them gradually to run down during the remainder of the year. Second, and from the point of view of a single bank, any increase in its London funds over and above its normal holding, without a corresponding decrease in Australian funds, tended to improve its liquid ratio and, therefore, its power to lend. Conversely, any decrease in its London funds, without a corresponding increase in Australian funds, tended to reduce its power to lend. If one bank found that its holdings of London funds were too large, or too small, it adjusted its position by

[1] *Report*, para. 170, p. 75.

selling to or buying from the other Australian banks. In either case its liquid resources would remain unchanged in amount. But, of course, for the banks as a whole it was not possible to meet the position in this way. A general increase in London funds, without a corresponding decrease in Australian assets, meant a general increase in the liquid resources of the system. It was true that no one bank would know accurately the amount of any holdings of London funds other than its own and it could not therefore be certain of the extent to which there had been an increase in funds. Nevertheless, it would be a matter of common knowledge that export values had increased and the banks, finding their own liquid resources greater, would generally be in a position to lend more. Conversely, when London funds decreased without a corresponding increase in Australian assets, they were inclined to lend less. Whenever receipts from exports were high, or government overseas borrowing increased, or imports fell off, the liquid resources of the system tended to rise, and an expansion of credit could be expected. Whenever receipts from exports were reduced, or government overseas borrowing slackened, or imports rose, the liquid resources of the system tended to fall, and a contraction of credit could be expected.

If the banks were in a position such that their cash ratios, liquid ratios, and ratios of advances to deposits were satisfactory, and a net increase (or decrease) in London funds altered them, the steps taken by the banks would tend to restore the ratios and lead to the necessary adjustments in London funds. When, for example, a rise in export values increased the banks' holdings of London funds, it simultaneously increased the Australian deposits, or reduced the level of advances, of those customers from whom the banks had bought export bills. The first effect of this was that the ratio of advances to deposits would fall, and the ratios of cash to deposits and liquid assets to liabilities would rise. If this change in the ratios were large enough, the banks would be prepared to increase their advances, thus raising the advance–deposit ratios. Any increase in advances would tend to increase deposits. Cash ratios and liquid ratios would then fall. In addition, this expansion of credit would tend to increase the aggregate money income of the country and so stimulate imports which would in due

course reduce London funds. Conversely, a net decrease in London funds, leading to a change in ratios, would tend to result in a restriction of advances and to restore London funds through a decline in imports.

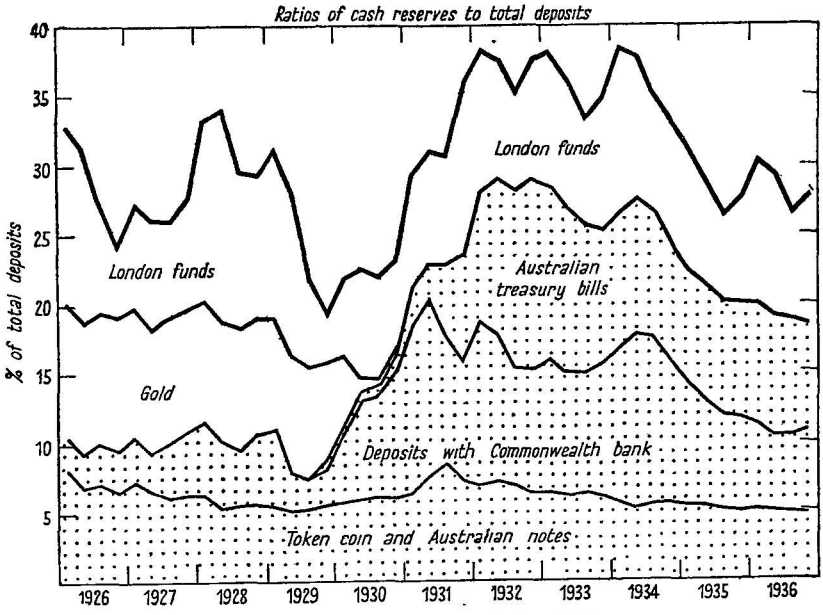
It was in this way too that the Australian banks met the strain imposed on the stability of the exchange rate by movements in London funds and maintained parity between English and Australian currency. So successful were they that, up to 1915 and from 1925 to 1928, there were only very small movements in the rate. Even during the period 1915 to 1925, when Australia and the United Kingdom were both off gold, sterling was never at a discount greater than £3. 10*s*. per cent., nor at a premium greater than £2. 10*s*. per cent. There was, however, no exact relation between an increase (or decrease) in London funds and an expansion (or contraction) of credit in Australia. The banks had no means of estimating accurately how the demand for imports would respond to the expansion or contraction of credit and, at times, it might well happen, in the case of an expansion, that the effect upon imports would be to reduce London funds to a level lower than was convenient. At other times a contraction might have the opposite effect. But in either case the movement in London funds would continue to serve as an indicator to the banks and a criterion of policy.

It is convenient now to examine the ratios which did obtain in pre-war years and to investigate the type of monetary experience which they reveal. If we consider the ratios of any one bank we find quite a wide range of fluctuation about the average, and a comparison of the ratios of different banks shows that the average ratio differed considerably as between banks, with a range of fluctuation greater for some banks than for others. But, on the whole, the ratios of all banks moved in the same direction.

The ratio of cash reserves to deposits and the advance–deposit ratio are shown for the years 1926 to 1936 in the graphs reproduced below.

In considering fluctuations in this ratio it should be borne in mind that the period covered includes years of acute disturbance and that these figures by no means give an accurate view of the limits within which the trading banks' cash reserve

ratio has varied in less disturbed times. This is illustrated by taking the years 1926, 1927, and 1928 which preceded the depression of the thirties, but which included a period of slight business recession. During these years variations were not as extreme as they were to become. For example, the cash reserve ratio then varied from 24 per cent. to 34 per cent., the



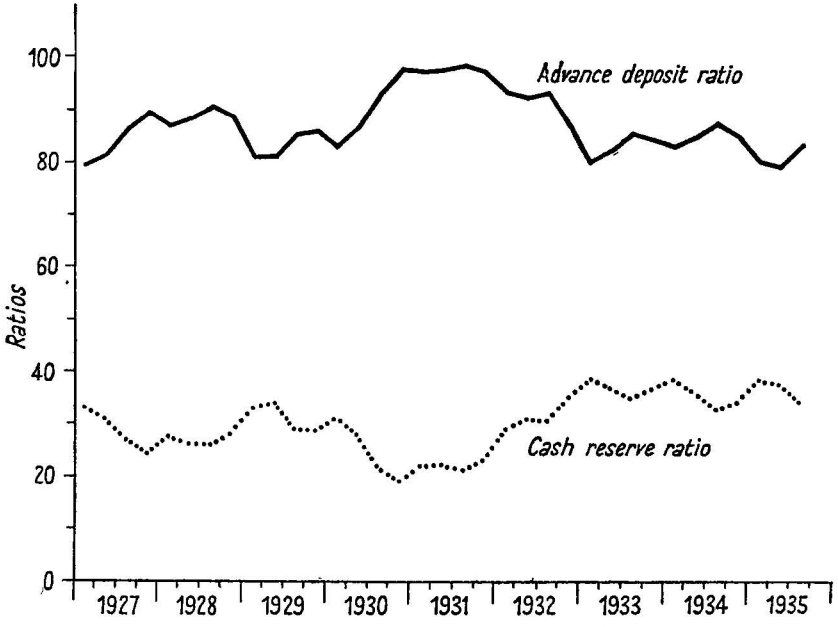
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liquid assets ratio from 30 per cent. to 41 per cent., and the advance–deposit ratio from 79 per cent. to 91 per cent. In the succeeding eight years of depression and recovery, on the other hand, the cash reserve ratio varied from 19 per cent. to 39 per cent., the liquid assets ratio from 25 per cent. to 45 per cent., and the advance–deposit ratio from 79 per cent. to 98 per cent.

There had also been evidence of a seasonal movement in banking figures for a considerable period prior to 1929. This was due quite obviously to seasonality in the production and sale of Australia's principal exports, which consisted of primary products, the chief of which were wool, wheat, and meat. As a result, the cash reserve ratios and the liquid assets ratios

were usually at their lowest point in the third quarter of the year when advances increased, deposits fell, and cash reserves tended to decline, whereas in the first quarter of the year (after the produce had been marketed) deposits reached their highest point and advances were low.



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The most variable element in the cash reserves of the trading banks in pre-depression years was the item London funds. Quarterly average figures for London funds for the years 1926 to 1928 show a fall between the first quarter and the fourth quarter of 1926 from £33 millions to £13 millions. These funds remained low throughout 1927, but rose again to £41 millions in the second quarter of 1928. There were no offsetting movements in the other constituents of the cash reserve, so that these changes were reflected in the ratios of the banks as a whole, because when London funds fell suddenly it was difficult for the banks to effect an immediate and corresponding reduction in their advances. The result was that the cash reserve ratio fell, the advance–deposit ratio rose, and the position of the banks became less liquid.

In the first half of 1929 the outlook for the future was doubt-

ful. No long-term overseas loan had been raised after January 1929, and there had already been a decline in export prices, but there was still a hope that the trend might be reversed. Much the same was thought about the rising figures of unemployment. The cash reserve ratio in the first quarter of 1929 was a little over 31 per cent., which, while not as high as in the early part of 1928, was still regarded as satisfactory. The advance–deposit ratio was 83 per cent. and this was not yet high enough to cause any apprehension. Even in the second quarter of 1929 there was only a slight deterioration in the cash reserve ratio, which fell from 31 per cent. to 28 per cent., and in the advance–deposit ratio, which rose from 83 per cent. to 87 per cent. The position of the trading banks was becoming rather less liquid, it is true, but similar movements had occurred in the past and had usually righted themselves within a few months.

However, towards the end of 1929, it was clear that Australia was entering a depression. Export prices had fallen further and the wool sales in September had opened badly. Unemployment was rising steadily. Bank deposits fell from £284 millions in the second quarter to £277 millions in the third, and, instead of the usual rise in the fourth quarter, there was a further fall to £275 millions. Meanwhile, advances rose rather more steeply than usual from £247 millions in the second quarter to £269 millions in the fourth. Trading bank holdings of government securities fell from £17 millions to £13 millions over the same period. But the chief strain was on London funds, which fell from £33 millions in the second quarter of 1929 to £18 millions in the third, with a further fall in the fourth quarter to the very low figure of £9 millions. There was also a fall in the amount of gold held—from £23 millions to £19 millions—which occurred before legislation empowering the Commonwealth Bank to acquire gold had had time to operate. The cash reserve ratio fell steadily to 19 per cent., which was clearly unsatisfactory, and the advance–deposit ratio rose to 98 per cent.

Thus the position of the banks at the end of 1929 was extremely illiquid. Deposits and cash reserves were falling, advances increasing. London funds were very low and were likely to remain low, even with the normal seasonal increase to be expected in the new year. The cash reserve ratio and the

advance–deposit ratio were both unsatisfactory and the problem with which the banks were faced was how to restore their liquidity. A number of devices were adopted with more or less success. During the latter half of 1929 the banks sold securities and reduced their holdings by £4 millions. Partly offsetting this, however, were the £1·5 millions of Treasury Bills which some of the banks had been induced to take up and, at this time, it should be emphasized that certain of the banks were extremely wary of lending to governments on the security of Treasury Bills, which were not then subject to a Commonwealth Bank undertaking to rediscount at a fixed rate and to meet them, if necessary, at maturity. Finally, throughout 1929, but especially in the latter half of the year, the banks severely restricted new lending, though they endeavoured to assist their established customers and, in particular, the primary producers.

But the depression continued to deepen. Export prices fell further during the first half of 1930 to a level 40 per cent. below that ruling in May 1928. Unemployment rose steadily until it reached 18·5 per cent. in the second quarter of 1930. Total deposits were still falling, though the contraction of fixed deposits was small. Nevertheless, there was a definite shift in the latter from the longer to the shorter terms. Advances, which had reached their maximum at £269 millions in the fourth quarter of 1929, fell in the second quarter of 1930 to £260 millions, and there was no significant change in the holding of government securities. Meanwhile, the liquid reserves of the banks had shown a net increase of some £7 millions. Between the fourth quarter of 1929 and the second quarter of 1930 London funds rose from £9 millions to £21 millions. Gold fell from about £19 millions to £3 millions, largely as a result of gold sales to the Commonwealth Bank. Treasury Bills rose from £1·5 millions to £2 millions, and deposits with the Commonwealth Bank from £8·6 millions to £18·7 millions (in virtue of gold surrendered against deposits). As a direct consequence of these changes there was an increase in the cash reserve ratio from 19 per cent. to 23 per cent., but this was still too low to be satisfactory. The advance–deposit ratio remained in the neighbourhood of 98 per cent. As is apparent from the figures, the trading banks still maintained their former cautious attitude towards Treasury Bills. They

continued to restrict new lending and were so successful that advances fell sharply. After the end of 1930 the liquidity of the banking system increased rapidly and the advance–deposit ratio was brought down to safer levels.

Much of this was due to an expansion of central bank credit on the basis of an increase in the Treasury Bill issue to £20·6 millions and, by mid-1931, the banks' cash reserve ratio stood at 31 per cent. Although London funds were still low, the banks were no longer in a position where a contraction of lending seemed necessary. Thus, Treasury Bill finance had the effect both of adding to the cash reserves of the banking system and to the deposits of the trading banks. It was in this way that the decline in deposits, continuous since 1929, was finally arrested. However, the net increase in the cash reserves of the system came not from the increased holding of Treasury Bills by the trading banks,[1] but from their increased issue by the Government to the Commonwealth Bank. A new issue of Treasury Bills could affect the liquid position of the trading banks in either of two ways. If the Commonwealth Bank retained the whole of a new issue, trading bank deposits with the central bank would be increased as the funds were expended by the Government and a proportion of these moneys were deposited with the trading banks. If, on the other hand, the Commonwealth Bank sold part of an issue to the trading banks, there would ultimately be the same net change in the aggregate of trading bank liquid assets, but the increase would be held in the form of Treasury Bills instead of in deposits with the central bank. However, the trading banks earned revenue on Treasury Bills, whereas deposits with the central bank earned nothing. In short, the holding by the trading banks of Treasury Bills represented a different and more profitable distribution of a given holding of cash or its equivalent.

In this way, the loss of London funds and of gold was offset and the banks soon removed their restrictions on new lending. But the improvement in the banking system came about much

[1] Treasury Bills had by this time assumed a new significance for the trading banks since the Commonwealth Bank had announced in June 1931 its willingness to rediscount at a fixed rate and to meet the bills, if necessary, at maturity, but while some trading banks were prepared to regard them in all respects as cash others thought of them only as 'almost the equivalent of cash'.

earlier than the general recovery in industry and trade. Hence, when from 1932 to 1934 the banks attempted to expand their advances, they found at first little response from borrowers, despite lower interest rates. Gradually, however, as recovery proceeded, more borrowers began to come forward and advance business improved. Additions to cash reserves and to deposits as a result of Treasury Bill finance almost ceased after 1932 and changes in the liquidity of the banks again became dependent on movements in London funds.

V

War-time brought great changes to the trading banks. Previously, they had enjoyed a considerable amount of freedom in the formulation of credit policy, subject only to fairly well-defined, if self-imposed, liquidity rules and (latterly) the moral leadership of the Commonwealth Bank, which by 1939 had definitely accepted the responsibilities of a central bank. War-time changes could not alter the relevance of criteria which were fundamental to the system, but there was a noticeable shift of emphasis. First, there was the impact of war finance itself, which had the effect of greatly increasing the liquid resources of the banks, so that the problem of surplus liquidity now became a matter of prime importance. Second, there was the concentration of power in the hands of the Treasury and the central bank (initially under war-time regulations and latterly under the banking legislation of 1945) which meant a considerable loss of freedom of action to the trading banks and left policy decisions to the monetary authorities. It was now the latter who decided the broad lines of credit policy, what changes in ratios could be permitted with safety, and what action should be taken if the ratios persisted in misbehaviour. Not all of this was immediately apparent and it was some years before the changes were recognized as having a degree of permanence, and this the trading banks were at all times loath to acknowledge. Nevertheless, this was the ultimate effect of war-time developments.

In the few years prior to the outbreak of war in 1939 the position of the trading banks was not without its difficulties. The value of Australian exports had fallen to low levels, while the value of imports had increased sharply, with the result that

Australian overseas funds had again fallen to uncomfortably low proportions. In consequence, there was a decline in economic activity at home and the resources of the trading banks were strained. On the one hand, there was the threat of business recession and unemployment; on the other, the paramount necessity to safeguard the balance of payments.

However, with the approach of war, there was a general increase in government expenditure to accelerate the output of war materials and supplies, and this helped to increase the amount of money available to the banks. In addition, contracts were concluded with the United Kingdom for the sale of export commodities and, in due course, this had the effect of relieving the strain on the balance of payments. These benefits were not immediately apparent and the trading banks were still short of cash in December 1939 when the first war loan was issued. This was for £12 millions, of which the trading banks subscribed £3,725,000, the remainder being taken up by the Commonwealth Bank. As this loan was spent the deposits of the trading banks increased and this combined with the other favourable factors to remove some of the tightness from the banking system. The central bank also made commodity advances and added to the liquid resources of the trading banks by purchases of government securities.

It was only after 1941 that the issue of Treasury Bills began to play the dominant role and the central bank deposits of the trading banks began to increase rapidly. As a group, the trading banks would normally have been inclined to expand their investments and advances by several times the amount of any cash they received in excess of what they regarded as their appropriate holding, and this would have increased bank deposits in the hands of the public. Unless the increased cash received by the banks was controlled, the inflationary pressure occasioned by Treasury Bill finance might thus have been multiplied several times. This problem of 'secondary inflation' was met by giving the Commonwealth Bank legal power (1) to prevent any action by the trading banks which might have added to the inflationary pressure; (2) to ensure that the trading banks did not make excessive profits as a result of the war-time expansion of credit; and (3) to co-ordinate their lending policy with other action (e.g. direct controls) taken for

the efficient prosecution of the war. The regulations giving effect to this policy were the National Security (War-time Banking Control) Regulations introduced in November 1941, and the National Security (Economic Organization) Regulations, gazetted in March 1942. The former established the basis for a fully centralized and controlled banking system which could cope with the problems of total war and the latter, in so far as they concerned the banking system, gave the central bank control over maximum interest rates for most types of lending and borrowing.[1]

Another impact of the war upon the trading banks was the rationalization of bank branches, which was partly dictated by shortage of staff but reinforced by government action. The closure of 'dispensable' branches in country towns served by more than one bank was part of a more general policy of concentration. Early in 1942 the Minister for War Organization of Industry arranged with the Commonwealth Bank to convene a conference of the Nine Trading Banks. At this time an appeal was being made to each industry to review its activities with a view to the elimination of all that was inessential in war-time and, as the Minister pointed out, the banking industry could not be exempted from such a review. It was suggested that there were many towns with several bank branches and that these towns could be adequately served by fewer banks, thus releasing manpower, buildings, and some office equipment for other purposes. The banks agreed in principle with the Minister's proposals and undertook to work out a common plan of branch closures which would be 'equitable' and on a reciprocal basis. The Bank Officers' Associations were also consulted.

In the course of a few weeks a list of over 400 branches, which it was proposed to close, was taken out by the banks. So far as towns with more than one bank were concerned, this offer was acceptable to the Government, but Ministerial approval was requested before the closure of branches in 'single-bank' towns was completed. Subsequently, the banks were asked to substitute other closures in towns with several banks

[1] Details of these controls and their impact on the structure of trading bank assets and liabilities are discussed in Chapter 2. This has been done as a matter of convenience and in order to avoid unnecessary duplication.

for those proposed in the single-bank towns. The progress of this scheme was slowed up by the reluctance of the Bank of New South Wales to co-operate owing to its doubts as to the possible success of the scheme as a means of economizing manpower. Meanwhile, the other eight banks had completed half of their proposed closures and they now made it quite clear to the Department that full implementation of the plan must depend on fulfilment by the Bank of New South Wales of its undertaking to carry out agreed closures. To expedite the process, the Government issued a special regulation under the National Security Act, authorizing the Minister to limit by order the number of branches which any named bank could maintain, or to direct a bank to close any specified branch or office. However, it was not necessary to issue any order under this regulation and there was no further trouble. The closure plan was duly completed. In total, 494 branches were closed in addition to forty-nine already closed prior to the government initiative. Closures represented about one-fifth of the previous total of branches. Bank customers were given the choice of changing their account to the bank remaining in the town or of transferring it to the nearest branch of the bank with which they had previously dealt. There was some complaint by the trading banks that the Commonwealth Bank, the savings banks, and certain State banks were not brought into the scheme, but otherwise the plan went through without noticeable friction, though there was some suspicion that war-time rationalization might well be a prelude to post-war nationalization.

With the end of the war, however, the trading banks began once again to expand the number of their branches. By 30 June 1949 the trading banks operated 2,871 branches and 978 agencies,[1] though it seems that in some towns the banks have not reopened branches rationalized during war-time. The number of branches now exceeds pre-war figures and there has been some change in the location of banking facilities. Shortage of staff has been a major problem in recent years and banking facilities now appear to be fully extended.

The impact of war-time controls and their subsequent incor-

[1] See *Commonwealth Year Book*, No. 38, 1951, p. 710.

poration in post-war legislation may well have been responsible for the further interest of certain banks in amalgamation, though there has been no overt statement to this effect. The first merger to be mooted was that of the Bank of Australasia, incorporated by Royal Charter in 1835, and the Union Bank of Australia Ltd., established in 1837. The arrangements then proposed were announced to the public early in 1947, but they had been in the air since 1941. However, these plans were interrupted when, on 16 August 1947, the then Prime Minister (Mr. J. B. Chifley) announced his Government's intention to legislate for the nationalization of the private trading banks. Proposals for the merger were therefore deferred, pending decisions (which in the event proved to be unfavourable to the Commonwealth) first by the Australian High Court in August 1948, and later by the Judicial Committee of the Privy Council in July 1949. Once that threat had been removed, work proceeded on drawing up a scheme of arrangement and amalgamation under the English Companies Act (since both these were Anglo-Australian banks, with head offices in London). The reasons given for the proposals ultimately placed before the shareholders of both banks in January 1951 were fourfold: first, it was felt that the formation of a larger and therefore even stronger bank would provide an organization capable of meeting 'the future requirements of expanding trade and industry', with a much wider spread of banking facilities than either bank could provide alone; second, it would be possible to offer to customers 'fuller technical services' in departments dealing with 'overseas business, trade inquiries, business introductions, travel facilities, economic and statistical information', since a larger institution could 'more easily carry the expense of maintaining such specialised departments', which would provide better service to existing customers and also attract new business; third, the building programmes of the two banks could be co-ordinated into a single programme and thus achieve many economies; and, finally, the character of the business carried on by the two institutions had, in fact, developed along complementary lines and there was much to be said for operating as a single unit. The paid-up capital of the new bank was to be equal to the aggregate of the paid-up capitals of the two merging banks and shareholders in the two

undertakings were to receive equal treatment.[1] Approval for the scheme was secured from both the English and Australian monetary authorities. Separate meetings of the shareholders of the two banks were held in London on 16 February 1951, and large majorities voted in favour of the change. The sanction of the English High Court was granted on 19 March 1951. The merger of these two banks into the newly formed Australia and New Zealand Bank Ltd. followed shortly afterwards and the one bank operating in Australia under a Royal Charter ceased to exist. As a result of the change a new institution, second only in size to the Bank of New South Wales itself, had been created.

Meanwhile, the proposed union of the National Bank of Australasia with the Queensland National Bank had been announced early in 1947. It was agreed to take all the steps necessary to unite the activities of these two institutions

> on such a basis as to give the proprietors of each institution equitable rights in the control of the joint business and in the benefits to be derived from the union. The proposal is based on the belief that the united strength of these two sound institutions will more adequately provide the customers of both banks with that wider and more comprehensive service demanded by modern conditions.[2]

The proposals envisaged the merging of the capital structures of the two banks and the continuance of their business as a joint business in the name of the National Bank of Australasia Ltd. The basis for exchanging National Bank for Queensland National Bank shares was decided upon by reference to 'the inherent values of assets and respective earning power of the two banks'.[3] By the exchange of one £5 fully-paid share for five £1 fully-paid shares in the National Bank, Queensland National Bank holders were to obtain shares valued in the market at £8 for their share valued before the merger announcement at £6. 10s. Holders of negotiable inscribed stock of the Queensland National Bank were not affected by the exchange of shares involved in the amalgamation. This interminable

[1] See Chairmen's Addresses at the Annual General Meetings of the Union Bank of Australia Ltd. and the Bank of Australasia, as published in the London *Financial Times*, 19 Jan. 1951, p. 7.

[2] Statement of Directors published in the Melbourne *Argus*, 28 May 1947.

[3] *Sydney Morning Herald*, 29 Mar. 1947.

stock was redeemable by the bank on notice and its liability was taken over by the National Bank and the interests of holders protected. Arrangements for the completion of the merger proceeded with the voluntary liquidation of the Queensland National Bank. As a result of these changes the nine large Australian trading banks were reduced in number to seven.

VI

There is little that need be said here about the attempt to nationalize the Australian private trading banks.[1] The occasion for the Labour Government's decision was provided by the Melbourne City Council's successful challenge in the Australian High Court to s. 48 of the Banking Act 1945, under which all government authorities could, in effect, have been required to transfer accounts held with private trading banks to the Commonwealth Bank. By a majority judgement handed down in August 1947, this section was declared *ultra vires* the Australian Constitution. The Federal Cabinet thereupon decided unanimously to nationalize the private trading banks. The reasons for this decision are not easy to disentangle and it may well have been that the alleged fear that the whole of the 1945 legislation was in danger as a result of the High Court's decision on s. 48 was little more than a pretext. Nevertheless, the case for nationalization of the private trading banks was based almost entirely on the assumption that the vital sections 18–22 of the Banking Act 1945 (incorporating the special account procedure) were now open to challenge in the High Court, though the argument depended more on evidence of trading bank hostility to this form of quantitative credit control than on the content of the High Court judgement itself.

For the purpose of giving effect to its intentions, the Government introduced a Banking Bill into the Australian House of Representatives on 15 October 1947, and this had passed both Houses by 26 November 1947. Private banks were to be prohibited from carrying on the business of banking in Australia, and the Commonwealth Bank was empowered to take over the Australian business of such banks. Provision was made for the

[1] For a fuller consideration see J. S. G. Wilson, 'The Future of Banking in Australia', *Economic Journal*, June 1949, pp. 208–18.

determination by agreement between the Commonwealth Bank and the parties concerned of the compensation payable for any property compulsorily acquired. Failing agreement, the claim could be referred to a Federal Court of Claims to be established under the legislation. Employees of private banks were to be protected in respect of continuance of employment, scales of pay, and conditions of service. Pension rights were similarly safeguarded. To meet objections to the institution of a government banking monopoly, it was to be a duty of the Commonwealth Bank to provide the community with adequate banking facilities. The Commonwealth Bank was also to be required to conduct its business without discrimination, except on grounds appropriate to 'the normal and proper conduct of banking business', and to observe, except as otherwise required by law, 'the practices and usages customary among bankers' (in particular, the rules relating to non-disclosure of the state of a customer's account).

Before this legislation could be implemented, however, it was challenged in the Australian High Court by the private trading banks and the States of Victoria, South Australia, and Western Australia. Judgement was handed down on 11 August 1948 when by a majority decision vital operative sections of the Act were declared *ultra vires* the Federal Constitution, and an injunction was granted restraining the authorities concerned from taking any further action under those sections of the Act which had, in effect, been declared invalid by the Court.

No purpose would be served by discussing the details of this judgement,[1] though the extent to which it turned on s. 92 of the Constitution (which provides, *inter alia*, that 'trade, commerce and intercourse among the States . . . shall be absolutely free') is important. By applying s. 92, the four judges concerned all held, in effect, that banking was a part of 'trade', and interference with it would therefore contravene the provisions of the Constitution.

The case then went on appeal to the Judicial Committee of the Privy Council. The appellants were the Commonwealth of Australia and others and the respondents the private trading banks and several of the Australian States. The Privy Council also granted the petition of the State governments of New

[1] A summary is available in *The Banker* (London), Sept. 1948, pp. 149–51.

South Wales and Queensland for leave to intervene in support of the Commonwealth Government. After months of argument their Lordships decided that the consolidated appeals of the several parties involved should be dismissed; and their reasons were given on 26 October 1949. There were two points at issue: first, the preliminary question of jurisdiction—whether in point of fact an appeal lay to the Privy Council without a certificate from the Australian High Court; and, second, the substantive issue—whether s. 46 of the Banking Act 1947, which empowered the Commonwealth Treasurer to prohibit the carrying on by a private bank of banking business in Australia, infringed s. 92 of the Australian Constitution. Their Lordships held that no appeal lay to them without a certificate from the High Court of Australia. That was conclusive and, in normal circumstances, they would not have given any opinion upon the many other matters argued before them, but, because it was conceivable that a certificate might yet be obtained and the case have to be re-argued and because of a certain misapprehension of two cases already decided by the Privy Council, their Lordships thought it right to state their views as to whether s. 46 of the Act did offend against s. 92 of the Constitution.

Two questions required an answer: first, was the business of banking included in the expression 'trade, commerce and intercourse'; and, second, what was the freedom guaranteed by s. 92 and was it infringed by the Act? Their Lordships held that 'the business of banking, consisting of the creation and transfer of credit, the making of loans, the purchase and disposal of investments and other kindred activities, is part of the trade commerce and intercourse of a modern society and, in so far as it is carried on by means of inter-State transactions, is within the ambit of s. 92'. The 'business of banking' being an activity of which the freedom is protected by s. 92, the next question was whether the Act offended that section. Their Lordships turned at once to the cases of *James* v. *Cowan* and *James* v. *The Commonwealth*, of which the more important, for what it decided, was *James* v. *Cowan*. James had vindicated his freedom in hard won fights through the Courts and these cases have gone down in Australian constitutional history. Let their Lordships speak:

The bearing of those decisions with their implications upon the present appeal is manifest. Let it be admitted, let it, indeed, be emphatically asserted, that the impact of s. 92 upon any legislative or executive action must depend upon the facts of the case. Yet it would be a strange anomaly if a grower of fruit could successfully challenge an unqualified power to interfere with his liberty to dispose of his produce at his will by an inter-State or intra-State transaction, but a banker could be prohibited altogether from carrying on his business both inter-State and intra-State and against the prohibition would invoke s. 92 in vain. In their Lordships' opinion there is no justification for such an anomaly.

It had been contended that an Act cannot offend against s. 92 unless it can be shown that the intention of the Legislature was to interfere in some way with inter-State trade and it was argued that in the Banking Act 1947, there was to be found no such intention. The test applied in this connexion by their Lordships was whether the Act 'not remotely or incidentally . . . but directly' restricted the inter-State business of banking. 'Beyond doubt it does since it authorises in terms the total prohibition of private banking. If so, then in the only sense in which those words can be appropriately used in this case, it is an Act which is aimed or directed at, and the purpose, object and intention of which is to restrict, inter-State trade commerce and intercourse.' But they agreed that *regulation* of trade commerce and intercourse among the States was compatible with its 'absolute freedom' and that 's. 92 is violated only when a legislative or executive act operates to restrict such trade commerce and intercourse directly and immediately as distinct from creating some indirect or consequential impediment which may fairly be regarded as remote'.[1] Within the terms of this statement of the position it would seem that the *regulation* of the activities of the trading banks will henceforth be protected against successful challenge in the Courts and that the vital provisions of the Banking Act 1945 are therefore safe.

This judgement brought to an end the Labour Party's attempt to nationalize the private trading banks in Australia. At an election shortly afterwards, the Labour Government was defeated and the new Liberal–Country Party Coalition

[1] For the detail of their Lordships' opinions, as summarized here, see *Judgment of the Lords of the Judicial Committee of the Privy Council*, delivered 26 Oct. 1949, as printed, pp. 11, 13, 14, and 15.

Government retained the structure of credit controls inherited from the war years though subsequently it repealed the Banking Act 1947, under which the nationalization of the trading banks had been attempted. It would therefore appear that some sort of stability in Australian banking arrangements has at long last been achieved. Its basis is a banking system substantially in private hands, but subject both to the regulation in a wide variety of matters of a strong government-owned central bank and to the active competition of its trading departments. It is not unreasonable to suppose that even the trading banks have become reconciled to the general character —if not always the detail—of these arrangements.

2

THE COMMONWEALTH BANK OF AUSTRALIA[1]

THE development of central banking institutions in Australia was not a sudden achievement but a matter of slow growth. The central bank evolved in its own peculiar fashion and its development was conditioned very largely by the character of the economy which it was called upon to serve. Prior to 1911 the Australian economy was served by a number of strongly entrenched trading banks, the oldest of which was the Bank of New South Wales, established in 1817. There was no central bank and no conscious co-ordination of banking policy. Even when the Commonwealth Bank was established in 1911, the only immediate effect was to set up a new trading bank under government ownership and the ultimate evolution of the Commonwealth Bank as a central bank was, as it happened, more a matter of accident than design. It was indeed as the direct result of three major crises in the country's history that the Commonwealth Bank eventually came to be recognized as the central bank of Australia. The three landmarks in the Bank's history were the First World War, the depression of the early nineteen-thirties, and the Second World War. It only completed its evolution as a central bank when it had succeeded in formulating methods of credit control appropriate to Australian conditions.

I

The name most intimately associated with the establishment of the Commonwealth Bank was that of Mr. King O'Malley.[2]

[1] This chapter was written before the appearance of the late L. F. Giblin's *The Growth of a Central Bank* (Melbourne University Press, 1951), though on certain matters it has been possible to incorporate some of the additional evidence. For a detailed account of the development of the Commonwealth Bank 1924–45, there can be no better source than Giblin's important work which was based both on a full access to the documents and the personal experience of a member of the Bank Board. He could have left no better memorial.

[2] Mr. O'Malley came to Australia from North America where he seems to have had some banking experience in the United States.

It was largely because of his efforts that the proposal for a 'national bank' was included in the fighting platform of the Australian Labour Party at its 1908 conference. Then, with the two-House majority, which Labour obtained in 1910, its realization became politically possible. The Federal Government already had power under the Commonwealth Constitution to make laws in relation to 'banking (other than State banking); also State banking extending beyond the limit of the State concerned; the incorporation of banks, and the issue of paper money', and in 1911 the Commonwealth Bank Act became law.

In the event, the Commonwealth Bank as established was not what O'Malley had hoped for. He wanted a bank which would have combined the activities of a commercial bank with those of a 'bank of issue and reserve'. It was O'Malley's purpose to break the monopoly of the trading banks and, at the same time, to introduce a 'sound and scientific' control of the currency, with the profits going to the people. The new bank was to be conducted by a board (on which were to sit representatives of both the States and the Commonwealth) 'purely as a government department, absolutely free from political control'. But these proposals were acceptable neither to the majority of the Labour Government nor to its financial advisers. The new Bank as founded was divided into two parts—a general banking department and a savings bank department—and it was implied that it might compete with the trading banks for general banking business. Some of its early supporters hoped that it would come to resemble the Bank of England—the model for central banks all over the world. From the point of view of its possible evolution as a central bank, however, the Commonwealth Bank began its life with certain peculiarities. First, there was the Bank's concern with ordinary banking business and the intention to conduct savings bank business as well. Second, the power to issue notes was not in the first instance vested in the Bank, but was retained in the hands of the Federal Treasury, the latter having obtained a virtual monopoly by imposing a 10 per cent. tax on trading bank note-issues under the Bank Notes Tax Act 1910. Third, the Bank did not raise any capital, but began operations on the basis of a temporary loan from the Federal Government.

Finally, with no shareholders or board of directors to control him, the Governor of the Bank was in a position to assume exceptionally wide powers and virtually to decide for himself the broad lines of Bank policy.

The first Governor of the Bank was Mr. (later Sir) Denison Miller. He was a man of considerable force and strength of character. At the time of his appointment he was Chief Metropolitan Inspector and personal assistant to the General Manager of the Bank of New South Wales, Australia's oldest and strongest trading bank. As was to be expected, the new Governor respected the interests of the trading banks and this policy paid handsome dividends in the form of much helpful co-operation both from the Bank of New South Wales and the other trading banks.

The Commonwealth Bank began to operate a savings bank business in 1912 and not until 1913 did it open its general banking department, the business of which consisted at first in little more than keeping the Government's account. Indeed, the early and formative years of the Bank's history were largely taken up with the special financial problems of the First World War, much of the necessary finance for which was raised by way of public war loans. As the agent of the Federal Treasury, the Commonwealth Bank supervised the floatation of all war loans issued in Australia and, after 1916, all those issued in London. The Commonwealth Bank also assisted by providing finance for various pools concerned with the marketing of primary products (e.g. wheat, wool, fruit, and meat) and acted as government agent in effecting shipments of gold abroad. There can be no doubt that as banker to a war-time government the Commonwealth Bank progressed both in experience and power far more rapidly than would otherwise have been possible and gradually it came to take the lead in all matters which required the collaboration of the banks as a whole. It was during this period, too, that the Bank undertook what must have been its first positive action as a central bank, when it took steps to safeguard the trading banks' cash position from the effects of the transfer of loan funds to government account.

In the early post-war period, the Commonwealth Bank continued to play an important part as government agent. It assisted the Government in making its deferred pay and war

gratuity arrangements and even acted as agent of the War Service Homes Commission in the purchase, erection, and sale of dwellings.

The Labour Party had lost control of Parliament in 1916 and, in an unbroken succession, governments more to the right held power until 1929. These encouraged the Commonwealth Bank to develop as a central bank along 'orthodox' lines and competition with the trading banks, although it existed, was passive in character. Thus, in 1920, an Act was passed whereby the Treasury handed over to the Bank responsibility for the note-issue. A separate Issue Department was established, though control of the note-issue was not entrusted, as was the rest of the Bank's business, to the almost unlimited discretion of the Governor. It was placed in the hands of a Notes Board, of which the Governor was a member. This proved unsatisfactory, and with the death of Sir Denison Miller in 1923 the time seemed ripe for a general reorganization of the Bank.

This task was undertaken by the Bruce–Page Government in 1924. At this stage, Australia had a government bank in passive competition with the trading banks and responsible for the note-issue, which was handled in a separate note-issue department but controlled by a Notes Board. The Government now decided to convert this bank into 'a central bank of issue' with full power to control the note-issue. The alleged shortage of notes was remedied by allowing the Bank to issue notes against assets held in London. These included cash and securities. The Bank was nevertheless still required to hold gold coin and bullion to a value of not less than 25 per cent. of the notes issued. It was also hoped to free control of the Bank from any suggestion of political pressure by placing its affairs in the hands of a Board of Directors and to provide the Bank with power sufficient to control banking policy in the interests of the whole community.

In introducing his Bill into the House of Representatives on 13 June 1924, the then Federal Treasurer (the Hon. Earle Page) emphasized the importance of five major changes. First, management of the Bank was to be placed in the hands of a Board of Directors with long overlapping terms of office. It was to control both the note-issue and the general banking business of the Bank. The Directors were to be eight in num-

ber and were to include the Bank Governor, the Secretary to the Commonwealth Treasury, and 'six other persons who are or have been actively engaged in agriculture, commerce, finance or industry'. In this way it was hoped that the Board might combine practical experience with representation of various interests in the economy as a whole. Originally, the Bill proposed the appointment to the Board of two Directors, with rather special powers, 'because of their knowledge of currency matters', but this provision never became law. In effect, however, it was revived in 1935, when an economist (Professor L. F. Giblin) was appointed to the Board. On his retirement, in 1942, Professor Giblin was succeeded by another economist (Dr. H. C. Coombs), who remained until the abolition of the Commonwealth Bank Board in 1945. Dr. Coombs was later to become Governor of the Commonwealth Bank. In the second place, the Commonwealth Bank was encouraged under the 1924 Act to strengthen its position by raising some capital. But the change was less than it seemed, because all that took place was a transfer by the Bank of £4 millions to capital account from its existing Reserve and Redemption Funds. The Redemption Fund was abolished. Possibly, this change in form rendered the balance-sheet more acceptable in orthodox financial circles, but in all material respects the situation remained unaltered. Thirdly, it was provided in the 1924 Act that, after a date to be fixed by proclamation, the Bank should be empowered to 'fix and publish from time to time the rates at which the Bank will discount and re-discount bills of exchange'. According to the then Federal Treasurer, this was 'one of the most important functions of a central bank'. In making this statement, it was quite obvious that the Treasurer's conception of central banking was largely based on British experience and there was little appreciation of the rather special characteristics of the Australian economy, which rendered inappropriate the instruments of credit control developed by the Bank of England for use in a world financial centre. As events turned out and in the persistent absence of a bill market in the accepted sense, the need for publishing a rate of re-discount never arose and the relevant section of the Act was not therefore proclaimed to be operative. Fourth, the banks were to be required to settle clearing balances by cheques drawn upon

and paid into the Commonwealth Bank. There was to be 'no compulsion as to the amount kept . . . with the Commonwealth Bank', but it was apparent that the Treasurer hoped that the banks would come to deposit practically all their reserves with the central bank. This section likewise was never proclaimed to be operative and, although the trading banks did as a matter of convenience settle their clearings through their account at the Commonwealth Bank, their deposits with the Bank remained comparatively small and could not be said to represent their cash reserves. Fifthly, 'all banks were required to furnish to the Treasurer statistics of quarterly averages of their liabilities and assets within Australia, on a basis similar to that used previously in furnishing statistics to State authorities'. Another provision of the 1924 Act empowered the Bank to set up a board of advice in London. This was never established.[1]

It would seem therefore that the 1924 Act was not an unqualified success. Its best features were probably the setting up of a Board of Directors to take the place of autocratic control by a Governor and the handing over to the Bank of control over the note-issue. The requirement that additional bank statistics be compiled and published was also a step in the right direction. On the other hand, it was foolish in the extreme to attempt to establish in Australia and without modification institutions which had been developed in a totally different environment.

During the years which followed the passage of the 1924 Act, the Commonwealth Bank steadily developed its general banking functions. So far as the development of central banking was concerned the period was one of hesitation. In 1925 a Rural Credits Department was established within the Commonwealth Bank for the purpose of financing and encouraging the co-operative marketing of primary products. Advances were not to be made to individuals and no advance was to be made for a period of more than twelve months. Its funds were to be derived from Treasury loans (outstanding loans were not to exceed £A3 millions at any one time), or from advances made to the Department by the Bank itself. In addition, 25 per cent. of the net annual profits of the Note Issue Department were to be made available, until the total amount from this

[1] For details see Giblin, op. cit., pp. 37–38.

source reached £A2 millions. Provision was also made for the issue of debentures, though none has ever been issued. Up to the outbreak of war in 1939 and within its restricted field, the Department conducted a business of modest proportions and in this way the Bank itself was kept in touch both with rural conditions and the problems of rural credit. During the war years, however, its activities were expanded and it came to play a rather more important part in meeting the demand for rural credit.[1] The only other change which calls for comment prior to 1929 concerned the legal operation of the Commonwealth Bank and the Commonwealth Savings Bank. According to Jauncey[2] this was the chief result of Sir Ernest Harvey's[3] visit to Australia in 1927. But again the change was less than it seemed. The legislation provided that the Savings Bank should be managed by a Commission composed of a Chief Commissioner and two others, but until its appointment which should only be 'upon a resolution passed by both Houses of Parliament approving such appointment', the Savings Bank would continue to be managed by the Commonwealth Bank Board. The Commission was never appointed and to all intents and purposes the Commonwealth Bank and the Commonwealth Savings Bank remained the same institution.

Indeed, all that Sir Ernest Harvey's visit really seems to have achieved was to stimulate discussion about central banking. The Commonwealth Bank Board itself appears to have been anxious to establish a 'central reserve banking system' in Australia,[4] but realized that it could not be done merely by transplanting British institutions and expecting them to thrive under Australian conditions. The Commonwealth Bank also seems to have left it to the trading banks to give the lead and they appeared to be quite content to allow things to remain as they were. It was no surprise therefore when the Directors of the Commonwealth Bank reported on 5 July 1929 that 'the establishment of the Central Reserve Banking System in Australia still remains an open question'.

[1] See Giblin, op. cit., pp. 57–60.

[2] See *Australia's Government Bank* (London, 1933), p. 166.

[3] Sir Ernest Harvey was at that time the Comptroller of the Bank of England.

[4] The responsibility for this advocacy appears to have been primarily that of the Board's very forceful Chairman (Sir Robert Gibson). See Giblin, op. cit., pp. 35–36.

But with the crisis conditions which supervened in the second half of 1929 the evolution of the Commonwealth Bank as a central bank took a quick step forward. The depression of the early nineteen-thirties affected Australia at least as much as any other country. It also saw the return of the Labour Party to the Treasury benches, though without a Senate majority. It was not unexpected therefore that the Labour Party would propose 'unorthodox' measures and that the non-Labour Senate majority would oppose them. In addition, Sir Robert Gibson, as Chairman of the Commonwealth Bank Board, bitterly opposed what he regarded as political pressure. The Bank Board at that time was composed of persons appointed by previous non-Labour governments and, while prepared to assist the Labour Government so long as it countenanced 'orthodox' measures, this Board tended to aline itself with the Senate majority in opposition to any hint of Labour 'radicalism'.

However, the magnitude of the crisis was such that the Commonwealth Bank, as government banker, was naturally called upon to play an important part in meeting it and gradually the Bank developed qualities of leadership which at first had been seriously lacking. In 1929, there were two sets of factors operating to the disadvantage of the Australian balance of payments. These were, first, a decline in the prices of Australia's staple exports, and, second, the unwillingness of London to continue lending to Australian governments. As a result severe strains were set up and considerable pressure on the exchange rate began to develop. By the end of the year the Australian exchange had been forced beyond the gold export point and, in order to meet the demands for funds in London (particularly from governments with debts to service there), an Act was passed on 28 November 1929 giving the Commonwealth Bank power to secure control over such gold as was available in Australia and, in particular, the comparatively large stocks held by the trading banks. In addition the Act provided for the licensing and prohibition of the export of gold, so that virtually all gold exported would be on government account. Under this legislation the Commonwealth Bank acquired £A12 millions in gold from the trading banks, giving them in exchange deposits with itself. Since that time, the bulk

of trading bank cash reserves in Australia have been held in that form.

Despite continued gold exports it was impossible (at the low price which most of the trading banks and the Commonwealth Bank were anxious to maintain) to provide London funds in quantities sufficient to meet the interest liabilities on government debt held overseas. In an attempt to meet this situation the Commonwealth Bank with the co-operation of the trading banks took steps to form an exchange pool for the purpose of providing as a first charge on the country's exchange resources the overseas interest due by Australian governments. This Mobilization Agreement, as it was called, was brought into operation in September 1930 and remained in existence, with some modifications, until just prior to the outbreak of war in 1939. In addition the Commonwealth Bank Act was amended to permit a reduction in the statutory limit of the gold reserve from 25 per cent. to 15 per cent., but with the proviso that it would be restored to 25 per cent. in three steps over a period of not more than four years. This restoration was duly effected, though the 25 per cent. gold reserve became a gold and sterling reserve in the process. However, the Commonwealth Bank was still not in control of the situation. Indeed, its whole attitude was most unrealistic. The Commonwealth Bank obviously did not enjoy paying a high price for London funds, but market forces were too strong for it. In January 1931 there had occurred the spectacular movement of the exchange rate from £A109 = £E100 to a peak of £A130 = £E100. Initially, this movement took place in an outside market, but it was followed and soon overtaken by the Bank of New South Wales. The Commonwealth Bank and the other trading banks were then forced to adjust their own rates to bring them into line with the new market rate. The next variation in the exchange rate, however, was the result of Commonwealth Bank initiative. Towards the end of 1931 it conferred with the trading banks with the object of stabilizing the exchange position, but it failed to secure their agreement to its proposals. It nevertheless decided to vary the exchange rate downwards and to peg it at £A125 = £E100. Commonwealth Bank responsibility for the exchange rate was henceforth generally accepted and unilateral action on the part of individual trading banks never occurred again.

It was during this period, too, that increasing resort was made by governments to short-term borrowing from the banks on Treasury Bills. Before this it had been the practice of Australian governments to secure short-term accommodation in the form of a bank overdraft. It is true that there had been occasional issues of Treasury Bills, but these had always been redeemed at maturity. However, in October 1929 the Commonwealth Government issued Treasury Bills which were renewed instead of being redeemed. The reason for the change was the unwillingness of the banks, including the Commonwealth Bank, to continue overdraft accommodation and the inability of governments to raise money by long-term borrowing either internally or overseas. The end of 1929 therefore witnessed the beginning of a permanent issue of bills. With growing government deficits, issues of Treasury Bills increased rapidly. The amount outstanding in December 1929 was only £A2·5 millions, but in less than three years this had climbed to over £A50 millions.

At first, Treasury Bills merely represented to the trading banks which held them short-term government securities of no special liquidity beyond their three months' currency, though even then there were facilities (as distinct from a guarantee) for re-discount with the Commonwealth Bank. Then, in June 1931, arrangements were made which considerably increased the attractiveness to the trading banks of the Treasury Bill as a liquid asset. The Commonwealth Bank undertook to meet the bills at maturity, if necessary, and to re-discount them at a rate differing not more than ¼ per cent. per annum from the rate at which they were issued. Resort to Treasury Bill finance had important consequences for the Australian financial structure. Apart from a probably unintentional 'reflationary' effect, the trading banks discovered a new type of investment which was both liquid and profitable.

From the trading banks' point of view, Treasury bills, being liquid, were much more attractive than Government overdrafts had been. While the banks did not rediscount many Treasury bills with the Commonwealth Bank, the fact that they could do so at any time enabled the banks to treat Treasury bills as the equivalent of cash. But this was not fully realised for some time. Treasury bills were used at first only as an expedient, no other means of government financing being available.

Later, however, the trading banks recognising that Treasury bills provided a profitable outlet for the employment of secondary reserves eagerly absorbed all the bills that were offered them.[1]

In addition, the regular issue of Treasury Bills helped to compensate for the absence of a bill market in Australia by providing a type of security capable of absorbing banking funds for short periods.

Nevertheless, the Commonwealth Bank was greatly disturbed by the continuing resort to Treasury Bill finance which occurred as a by-product of the depression. It indicated that the resources of the loan market should be tapped at the earliest possible date and emphasized the desirability of funding at least some of the internal floating debt.[2] By September 1933 the Bank had persuaded the Loan Council[3] (which consists of the Prime Minister of the Commonwealth and the several State Premiers) to agree that future loan expenditure should be financed by loans raised on the market and that there should be a gradual funding of Treasury Bills by the same means 'as and when conditions permit'. But conditions did not permit and reduction of the floating debt was long delayed. Seasonal lags in revenue continued to be financed by this means. The guarantee to re-discount bills at a fixed rate and to repay them upon maturity was also regarded as an emergency measure and was now withdrawn though their liquidity was maintained by the Commonwealth Bank's undertaking to re-discount such bills 'at a rate to be quoted to holders from time to time'.

The method of issuing bills in Australia is of some interest.

[1] W. R. MacLaurin, *Economic Planning in Australia, 1929–1936* (London, 1937), p. 124.

[2] The 'funding controversy' which began to rage about this time is ably covered by Plumptre, *Central Banking in the British Dominions* (Toronto, 1940), pp. 321–4. See also MacLaurin, op. cit., pp. 130–2; and Copland and Janes, *Cross Currents of Australian Finance* (Sydney, 1936), pp. 303 ff.

[3] The Commonwealth Bank acted as adviser to the Loan Council in connexion with all loan finance. It was consulted by the Council as to the amount and terms of loans and the time of issue, though the Bank's advice was not always taken. In addition, the Loan Council looked to the Commonwealth Bank to underwrite government loans in Australia and the Bank frequently proposed limits of underwriting. Usually, however, the limits were extended whenever necessary. On the whole, the Bank exercised a most important influence in regulating public long-term borrowing and in that way added to its prestige as a central bank.

Apart from its one experiment in selling bills to the public (discussed below), it has been the practice of the Commonwealth Bank to take up the whole of each issue sponsored by the Loan Council, the Bank itself determining the rate of discount. The Bank then kept such part of each issue as it thought fit and distributed the remainder among the trading banks, usually allocating the bills among the banks more or less in proportion to size, or, alternatively, in proportion to the volume of deposits held with the central bank. But there have been exceptions to this procedure and the Commonwealth Bank was not bound by any rules in the distribution of bills.[1]

The Commonwealth Bank experiment in selling Treasury Bills to the public followed discussion with the trading banks, after which it announced its offer of £A1 million from its own holdings. Tenders were called to close on 12 March 1936, the rate of discount being fixed by the Commonwealth Bank at 1¾ per cent. per annum, which was ¼ per cent. per annum above the trading bank's rate for three months' fixed deposits. As money conditions were becoming tight and in order to protect both its fixed deposits and its cash reserves, the Bank of New South Wales forestalled this move by raising its own rate on three months' fixed deposits to exceed by ¼ per cent. per annum, the rate on the Treasury Bills on offer from the Commonwealth Bank. The Bank of Adelaide followed its example a day later. The Commonwealth Bank, *moreover, failed to in*duce these banks to revert to their previous rate, and both it and the other trading banks were then forced to bring their own three months' fixed deposit rate into line. In the result, only £A315,000 of Treasury Bills were sold to the public and the issue was considered to be a failure. No further experiments of this kind were attempted. This experience was doubly unfortunate because the Commonwealth Bank had already begun to take the lead in initiating variations in interest rates, but its developing leadership was rather rudely shaken by the events just described. Complete control over the interest rate structure did not come until after the outbreak of the Second World War.

Open market operations of a kind had been undertaken over a period of years. Initially, sales of securities had been made

[1] See Giblin, op. cit., pp. 186–7.

as a means of reducing the note circulation, and the policy of selling securities for this purpose had been formally adopted by the Bank Board as early as January 1926.[1] Open market operations for the purpose of maintaining trading bank liquidity were reported in 1935, but it is clear that 'up to 1936 deliberate central bank operations were relatively small, and somewhat inconsistent, so that no definite policy is indicated by them'.[2] Moreover, the Bank seems to have been more concerned to offset the effects on interest rates of sales of securities by the trading banks than with liquidity considerations as such. It was only with the operations of 1937, in preparation for a threatened recession, and of 1938 and 1939, in order to offset a recession, that 'a deliberate and determined policy' was indicated.[3] In any case, from the point of view of influencing the size of trading bank cash reserves, which is the traditional purpose of open market operations, their scope was limited. The market for government securities was too narrow and any extensive operations would noticeably have affected the prices of government stocks and thereby rates of interest. As a primary means of credit control, open market operations were therefore unlikely to be appropriate under Australian conditions.

Thus the position of the Commonwealth Bank was still not strong, and, in its representations before the Australian Royal Commission on Monetary and Banking Systems in 1936, the Bank requested that its powers be extended (*a*) to give it the right to call upon the overseas funds of the Australian banking system; and (*b*) to require the trading banks to maintain with the central bank not less than a fixed percentage of their liabilities to the public. In this the Royal Commission was sympathetic and recommended the granting of an even wider array of powers. However, before a tardy Government could come to a decision, the advent of the Second World War virtually forced its hand.

II

As one would expect, the impact of modern war on the Australian banking structure necessitated the acceptance by the

[1] See Giblin, op. cit., p. 29.
[2] Ibid., p. 183.
[3] Ibid., pp. 183, 246–7, and 250.

Commonwealth Bank, as government banker, of responsibilities considerably greater than any previously envisaged, and it was during this period that a fully fledged system of central banking was developed. By 1945 the Commonwealth Bank had acquired all the legal powers necessary to complete control over the trading banks. This did not come immediately, however, since there was little need for restrictive action in the domestic field during the early stages of the transition from peace to war, when central bank policy remained somewhat passive. Credit conditions were tight and the level of unemployment relatively high. In these circumstances, it was appropriate that the Government should borrow from the banking system to cover its budgetary deficit. But as soon as the unemployed had been absorbed, the problem became one of effecting transfers from the civilian sectors of the economy to war industries and the Services; the task of balancing the budget became increasingly difficult and action to regulate and control the credit situation became imperative. It is against this background that we now proceed to discuss the developments of the war years and, in particular, their significance in the banking field.

Loan Policy and Interest Rate Structure

Treasury Bill finance, with which it is convenient to begin our discussion, was increased greatly in importance by the war as a means of raising moneys for government expenditure. In this connexion it became both a method of short-term borrowing in advance of taxation and loan receipts and the recognized means of financing war-time budget deficits—both Commonwealth and State. Outstanding Treasury Bills stood at slightly more than £A54 millions in September 1939. The large-scale war-time expansion of credit did not really begin until two years later when the Commonwealth Government began to rely on Treasury Bills discounted with the Commonwealth Bank for an increasing part of its war finance. The turnover of Treasury Bills grew in proportion and the total issued rose from £A68 millions in September 1941 to £A165 millions in September 1942 and £A351 millions in September 1943, reaching a peak of £A429 millions in April 1944. By Septem-

ber 1945 the volume of outstanding Treasury Bills had fallen to £A361 millions, the bulk of which was held by the Commonwealth Bank and the Commonwealth Savings Bank.

Critics of the Government's war finance feared that the rapid growth in Treasury Bill issues would lead to unmanageable inflation, but it was the policy of the Commonwealth Bank always to guard against such an eventuality and to exert pressure, whenever necessary, in order to limit Treasury Bill issues to a minimum. Except latterly, funding or redemption was out of the question, but the Commonwealth Bank attempted to meet the situation by assisting the Government to raise as much of its finance as possible by way of public loan, though the extent to which long-term borrowings were practicable depended ultimately on the attitude of the public itself and the nature of its liquidity preferences. The central bank also applied a persistent downward pressure on the Treasury Bill discount rate which in 1939 stood at 1¾ per cent. per annum, a rate which had been fixed in January 1935. Subsequently, reductions were made to 1½ per cent. per annum in May 1940, 1¼ per cent. per annum in November 1943, 1 per cent. per annum in March 1945, and ¾ per cent. per annum in May 1949, initially with the object of 'easing the burden of interest on the war debt', and more recently to accord with the Government's post-war cheap money policy. However, in so far as this payment was made to the Commonwealth Bank itself, it was virtually a transfer of moneys from one government pocket to another.

It was also necessary to maintain consistency between the Treasury Bill rate and the other rates in the market. At the outbreak of war, for example, the three months' fixed deposit rate stood at 2 per cent. per annum. This rate had been fixed in March 1936 following the Commonwealth Bank's ill-fated experiment in selling Treasury Bills to the public. Formerly, the three months' fixed deposit rate had been lower than that on Treasury Bills and, despite some degree of financial stringency, there was reason to believe that the 1939 position was somewhat artificial. By January 1940, however, the two rates had been moved back to equality, and, after March 1942 the three months' fixed deposit rate was again below the Treasury Bill rate. It was moved back to equality in November 1943,

but was reduced to a lower level once more in January 1944. In general, a lower rate on three months' fixed deposits was to be expected because both securities were of a three months' currency and market consistency would seem to postulate that the rates at which the banks borrowed from the public for this term should be below the corresponding lending rate. In addition, it should be observed that in Australia only the banks normally hold Treasury Bills.

So far as bank rates of interest were concerned the central bank was obliged at first to depend more on leadership than upon its legal powers to enforce interest rate reductions. Indeed, the first action to control bank rates of interest was taken towards the end of 1939 under the National Security (Capital Issues) Regulations. Under these provisions, which also regulated non-bank lending, banks were not permitted to charge rates of interest on loans in excess of the rate current for similar loans on 31 August 1939 without the approval of the Commonwealth Treasurer. The next step was an extension of the low-rate policy to bank fixed deposit rates. These were reduced by $\frac{1}{4}$ per cent. per annum on 24 January 1940 and by a further $\frac{1}{4}$ per cent. per annum on 28 May of the same year. Again, as from 22 September 1941, rates in respect of fixed deposits for 6, 12, and 24 months were reduced by $\frac{1}{4}$ per cent. per annum, the three months' rate remaining unchanged. The major object of this policy was to render fixed deposits relatively less attractive in order to increase the eligibility of government loans as a public investment. In this case the power of the central bank to reduce the rates in question was not a formal one but derived from a developing central bank leadership. Further, as from 1 July 1940, trading bank overdraft rates higher than $5\frac{1}{2}$ per cent. per annum were reduced $\frac{1}{4}$ per cent. per annum to accord with the views of the central bank, which reduced its own overdraft rates in its Rural Credits Department by a similar amount. Subsequently, and following a conference between the Commonwealth Bank and the trading banks, the latter decided to effect a second reduction of $\frac{1}{8}$ per cent. per annum in overdraft rates in excess of 5 per cent. current on 1 January 1942. In announcing this change, 'the banks stated that the rates would be further reviewed from time to time with the object of passing on to borrowers any benefits accruing to

the banks from reductions in deposit rates'.[1] Meanwhile, there had been a progressive fall in yields of government securities.

Up to this stage, downward movements in interest rates had appeared to lack co-ordination and had come piecemeal, but with the gazettal of the National Security (Economic Organization) Regulations[2] on 19 February 1942, provision was made for a more general control. The principal order under the regulations was made on 13 March 1942. It was followed by four amendments—on 12 January 1944, 9 August 1944, 24 November 1945, and 19 December 1946—the object of which was to bring under control and to incorporate in a self-consistent interest rate structure the lending and borrowing rates of trading banks, savings banks, building and co-operative societies, and life insurance companies. In the result, and with the exception of savings-bank rates on deposits up to £A500, there was a steady reduction of rates paid on both deposits and advances. Gradually, fixed deposit rates were brought down, first to equality with, and latterly below rates paid by savings banks. The tendency was then for the investor of moneys up to £A1,000 to keep these on deposit with a savings bank which would in its turn be a substantial contributor to new issues of government securities. For amounts in excess of £A1,000 bank deposits (of whatever kind) were so manifestly a poor investment (as judged by the rate of return) that there must have been every incentive for the small investor to seek a more profitable outlet in government securities. Nevertheless, it is probable that many still preferred liquidity to a higher rate of return. So far as the fixed deposits of business were concerned, the reduced rates may have resulted in the fixing of deposits for the maximum period (viz. 24 months), but apart from that it is unlikely that the overall investment position was much affected. Indeed, the reduction of August 1944 of ½ per cent. per annum in the 3 and 6 months' deposit rates, while the 12 and 24 months' rates were only reduced ¼ per cent. per annum may be interpreted as encouraging such a movement. Moreover, fixed deposit investment of business reserves was probably higher than the recorded aggregate increase in inter-

[1] *Commonwealth Bank Statistical Bulletin*, Jan. 1942, p. 37.

[2] After Dec. 1946 the National Security Act ceased to have effect and regulations were issued under the Defence (Transitional Provisions) Act.

est-bearing deposits, as it is likely that withdrawals for investment in Commonwealth loans were made primarily from private fixed deposit holdings. That this was probably the case was reflected in the next act of policy when 3 and 6 months' rates were left unaltered, 12 and 24 months' rates reduced a further ¼ per cent. per annum as from 1 December 1945, and deposits of over £A10,000 further penalized by an outright reduction to 1 per cent. per annum or less (depending on the term for which the deposits were fixed). Although the object of these arrangements was to force more moneys into Commonwealth loans, in practice the effect was probably that amounts in excess of £A10,000 were lodged for twelve months only. There could be no formal objection to this, but in so far as it became the practice, the intentions of the change in policy remained unrealized. Hence the attempt made in the Security Loan, which opened on 12 March 1946, to attract short-term investment moneys by offering securities maturing in three years and carrying interest at 2 per cent. per annum. It was hoped that these securities would absorb large sums being held for plant or stock replacement and that business might be persuaded to keep its reserves in that form in the future.

Consistency also demanded a further reduction in trading bank overdraft rates. A maximum rate of 5 per cent. per annum had been ordered in March 1942, and this was subsequently reduced in August 1944 to 4¾ per cent. per annum, so that throughout this period the twenty-four months' fixed deposit rate remained consistently 3 per cent. per annum lower than the rate on trading bank overdrafts. This relationship was not varied until November 1945 when the radical changes in fixed deposit rates referred to above were implemented, but the maximum trading bank overdraft rate was left undisturbed. However, the old relationship was restored in part in December 1946 when the maximum trading bank overdraft rate was reduced to 4½ per cent. per annum, the twenty-four months' fixed deposit rate up to £A10,000 then standing at 1½ per cent. per annum. Indeed, the Governor of the Commonwealth Bank stated at the time that this reduction was 'linked with the reduction in deposit rates' made twelve months previously and also with the reduction in the long-term bond rate which had just been announced. At the same time the Bank's own margin

had been consistently narrower. The Commonwealth Bank overdraft rate in its general banking department was fixed at 4¼ per cent. per annum in November 1934 and had remained unchanged throughout the years, though in July 1940 the rate for municipal and other semi-governmental advances had been reduced to 4 per cent. per annum.

Savings-bank rates were varied so that every encouragement was given to the accumulation of small savings. The Commonwealth Savings Bank rate up to a limit of £A500 was 2 per cent. per annum and this had ruled since January 1935. After March 1942 the maximum rate which the Victorian Government Savings Bank could allow on such deposits was also 2 per cent. per annum. Other savings banks were permitted to pay up to ¼ per cent. per annum higher. For balances over £A500, however (with a maximum of £A1,000), the rates allowed were progressively reduced, again with the object of encouraging the diversion of idle balances to investment in Commonwealth loans. In all instances the higher rate applicable to the first £A500 was paid on the full balance of Friendly and other Society accounts, but, by arrangements between the banks, maximum rates were not allowed on balances in excess of £A2,000.

As indicated above, war-time changes in the Australian interest rate structure had as one of their objects an increase in the relative attractiveness to the general public of Commonwealth Government securities. As central bank, the Commonwealth Bank was also charged with responsibility for loan issues and it was the duty of the Bank to decide (together with the Treasury) what amounts the public might reasonably be asked to subscribe, the terms of each issue, and also the timing of loan floatations. In this connexion, war-time loan policy seemed to go through three phases, though this somewhat arbitrary division must be accepted with caution.

The first phase covered the period of relatively small loans, floated at rates of interest which reflected the financial stringency of the market. At this stage timing was rather a delicate matter and the state of the market was an important influence. Indeed, general economic and market conditions were reflected in the fact that no public loans were floated at all in Australia during the six months preceding December 1939,

and the Government was tided over until the time was propitious for the next public issue by two private loans from the banking system. These were issued at par and amounted to £A12 millions. The rate was $3\frac{1}{2}$ per cent. per annum. By March 1940 it was felt that market conditions were at last sufficiently favourable for a public floatation to be attempted and £A18 millions was sought at par with interest at $3\frac{3}{8}$ per cent. per annum for five years, or $3\frac{5}{8}$ per cent. for ten to sixteen years. This was followed by two more loans for £A20 millions and £A28 millions respectively in May and November 1940, the interest rates having been reduced to $2\frac{3}{4}$ per cent. per annum for the short and $3\frac{1}{4}$ per cent. per annum for the longer term. Meanwhile, the Government by arrangement with the stock exchanges had introduced in June 1940 the fixing of minimum bond prices as an emergency war measure. This put a floor under the market and prepared the way for a further reduction in the short-term rate to $2\frac{1}{2}$ per cent. per annum which, together with the long-term rate of $3\frac{1}{4}$ per cent. per annum, was maintained without variation until March 1946. To the middle of 1942 four more loans were issued, but the amounts sought by way of new money were moderate.

The second phase witnessed the issue of progressively larger loans, the object of which was to siphon off as much of the current excess of liquidity as possible. It was primarily the magnitude of this increase in liquidity which enabled the Commonwealth Treasury and the Bank virtually to ignore market nervousness and to continue the raising of loans at low rates of interest even during the darkest days of the war. Latterly, prices for stocks and shares were pegged and were thus prevented from reflecting supply and demand conditions, but by then the availability of liquid resources was such that loans could be raised with little difficulty. Indeed, loan-raising appeared to become rather an automatic procedure. Timing of issues became less important than formerly. Terms were similar to those on previous loans and the only question for decision appeared to be the amount to be sought from the public. Most of these loans sought more than £A100 millions at a time, but all went well until September 1944 when the Second Victory Loan lagged rather badly and the closing date had to be extended. There was a relative recovery when the Third

Victory Loan for £A100 millions was launched in March 1945; but the transition to the third phase had begun.

In the third phase, therefore, loan-raising had again become more difficult. This seems to have been directly due to the easing of the war situation. With the approach to peace, and in even greater degree when peace had been won, the liquidity preferences of the community rose sharply, presumably in anticipation of peace-time spending. It was during this period that the Commonwealth floated its £A85 millions Fourth Victory Loan of September 1945. Again, the loan lagged very badly and it was only after an extension of time that it was finally over-subscribed. The poor response to this loan was also indicated by the low number of subscribers—259,507—which contrasted with over 420,000 subscribers to each of the two previous loans of £A112·5 millions and £A100 millions respectively. There was a significant change in loan terms when the second post-war loan for £A70 millions opened in March 1946. The long rate remained at 3¼ per cent. per annum, but the currency of the loan was altered from 5–16 years to 9–12 years and the rate on short-term securities was reduced to 2 per cent. per annum for a three-year currency (instead of 4–5 years as previously). The significance of the short-term arrangements has been discussed already. In general, the intention was to encourage investment for the longer period, since the Government now had to wait longer for its first opportunity to convert and there was less risk of a further reduction in interest rates in the near future. These arrangements were preceded by central bank permission to the trading banks (under the terms of the Banking Act 1945) to take up larger quantities of Commonwealth loan securities, so that the demand for bonds would be sustained at a time when industry wished to cash some of its 'reconstruction reserves' held in bonds during the war period. It is apparent, therefore, that both the Treasury and the central bank were anxious to avoid any repetition of the near failure of the Fourth Victory Loan, especially at a time when the Government's critics had argued that the success of the loan was the crucial test of the wisdom of the Government's low interest rate policy. As it happened, both this and the two following loans were successful, though the amounts were now smaller. More-

over, in April 1947 it was possible to reduce the long-term rate still further to $3\frac{1}{8}$ per cent. per annum. It was found, too, that practically all the money subscribed in recent loans had been invested in long-term securities and the Government decided in its next loan to offer no short-term securities at all. About the same time the fixing of minimum prices for the sale of Commonwealth bonds was discontinued and the third phase of war-time loan floatation had come to an end.

Thus, despite the early vagaries of the market and the subsequently high level of the community's liquidity preferences, the Commonwealth Bank was generally able to secure the loan finance for which the Government asked. It achieved this at low rates of interest and at a cost per cent. said to be the lowest in the world. Short of an absolute rise in the rates of interest offered on Commonwealth securities, it would have been difficult to have raised more.

War-time Control of the Trading Banks

The first of the war-time financial controls to be imposed related to capital issues. This control was established by the Menzies Government in 1939. Initially, the control was merely calculated to curb the more extravagant types of civilian investment, but gradually it became more exacting, almost amounting to a prohibition upon investment for any purpose not associated directly or indirectly with the prosecution of the war. Nevertheless, there were two gaps which tended to impair the effectiveness of this control. First, there were the undistributed profits of companies, and, second, trading bank loans. Obviously, if new capital issues were restricted and a business wished to extend its operations, either undistributed profits might be tapped to finance the proposed extension or additional bank accommodation could be sought for the purpose. If, therefore, there was a case for the control of new capital issues in war-time, it was also appropriate that there should be some central bank oversight of trading bank lending. It was with this in mind that the Menzies Government early adopted an informal kind of control, giving the banks general advice as to which industries should or should not be encouraged, leaving it to the banks to see that their lending policy conformed with the general needs of the war situation.

Following a series of conferences with the banks, this arrangement was later formalized by the Fadden Government which secured from the trading banks a written agreement.[1] It was also intended by this means to make the control more effective. It is important to emphasize, however, that this agreement was regarded by the trading banks as a war-time measure only. Its objects were to ensure that additions to trading bank funds as a result of war conditions were not used to make excess profits or to expand advances in any way contrary to the national interest. The plan was to be administered by the Commonwealth Bank.

But the new scheme had scarcely been formulated when the Fadden Government was forced to resign and the Curtin Labour Government, which followed, proceeded to gazette the National Security (War-time Banking Control) Regulations to come into operation on 26 November 1941. In this way, the voluntary agreement was replaced by compulsion and the final decisions were to be in the hands of the Treasurer, though the administration of the regulations was left with the Commonwealth Bank as central bank.

The difference in emphasis will be apparent from a brief comparison. Under the Fadden scheme it was agreed that the trading banks would not make new advances or grant increases in existing advances except in accordance with the policy laid down by the Commonwealth Bank from time to time. To ensure conformity with that policy the trading banks would supply the Commonwealth Bank with a monthly analysis of new and increased advances in a form approved by the latter. In addition, before purchasing or subscribing to government or semi-government loans, the trading banks were to obtain the concurrence of the Commonwealth Bank. The regulations, on the other hand, required a trading bank in making advances to 'comply with the policy laid down by the Commonwealth Bank from time to time' and a trading bank had to obtain the prior consent of the Commonwealth Bank to purchase or subscribe to government, semi-governmental, or municipal loans, or any stock-exchange securities in Australia. This ensured effective control not only over trading bank lending, but over

[1] Published as Table 4 of Mr. Fadden's 1941–2 *Budget Speech*, as printed, p. 22. The story behind this agreement is told by Giblin, op. cit., pp. 281–5.

alternative forms of investment as well. Under both schemes, the 'surplus investible funds' of the trading banks were to be placed in special deposit accounts with the Commonwealth Bank, but there were important differences. The rate of interest to be paid on these deposits within the terms of the agreement was to be fixed by the Commonwealth Bank at a level which would prevent the trading banks from making 'excess profits out of war conditions'. Surplus investible funds were defined as 'all funds over and above those necessary to enable the banks to meet the overdraft requirements of the public in accordance with the advance policy laid down by the Commonwealth Bank and those funds necessary for the protection of their depositors'. The trading banks were to advise the Commonwealth Bank periodically what funds became available and the Commonwealth Bank was then to decide the total amount of deposits required. The special war-time deposits were to be initially for a term of six months, but would be renewed as they matured unless in the opinion of the Commonwealth Bank the deposits were necessary to the trading banks for the purposes outlined in the agreement. In the regulations, on the other hand, the definition of surplus investible funds was less flexible. These were there described as the amount by which each trading bank's total assets in Australia at any time exceeded the average of its total assets in Australia at the weekly balancing days in the month of August 1939. A trading bank was not to withdraw any sum from its special account, except with the consent of the Commonwealth Bank, and the latter was to pay interest to each trading bank on its special account deposits at a rate determined from time to time by the central bank, but not exceeding whatever rate was fixed by the Treasurer. Finally, under the agreement, the banks were to supply the Commonwealth Bank 'with such certificates from the Commonwealth Commissioner of Taxation as will enable that Bank to satisfy itself that the undertaking . . . regarding profits is being observed'. The regulations, however, required that annual balance-sheets and profit and loss accounts be prepared in a special form and that profit and loss figures be forwarded to the Treasurer, through the Commonwealth Bank. In addition, every trading bank was obliged to 'furnish to the Treasurer, through the Commonwealth Bank, such statements in

respect of its business as the Treasurer directs and to the Commonwealth Bank such statements in respect of its business as the Bank directs, provided that such statements did not disclose particulars of the accounts of any individual customer'. Similar provisions applied to 'every person or corporation which accepts deposits of money'. Moreover, power was given to the Auditor-General to 'investigate periodically, and at any other time when so directed by the Treasurer, the books, accounts and transactions of every trading bank', and he was required to 'furnish to the Treasurer and to the Commonwealth Bank such reports upon the affairs of each bank as are directed by the Treasurer'. Of course, exemptions from the regulations could be granted by the Treasurer, either wholly or in part, and a number of orders were made with this effect. It is sufficiently apparent, however, that the terms of these regulations were much more stringent than those of the voluntary agreement and this enabled the central bank to increase greatly the effectiveness of its credit controls. These must now be considered in greater detail.

In September 1939 the Commonwealth Bank still lacked the powers of a fully developed central bank. It was in a position to state its views to the Government on the major financial questions of the day and could expect that due consideration would be given to them. In its relations with the trading banks it could claim a certain amount of moral leadership and was generally regarded by them as the central bank. Hence, the bank had come to occupy a position of substantial influence and could, within limits, regulate the quantity of money available to the community. Legally, however, its position was still not strong. Fortunately for the Bank, mobilization for war in Australia was gradual, and any lack of legal authority to carry out central banking functions was therefore not acutely felt in the early stages. It was only when government expenditure began to grow with increasing rapidity and the problem of excess liquidity came to require attention that the inadequacy of the Bank's powers was recognized.

At first, Bank policy was largely passive. In 1939 credit conditions were tight and unemployment was at relatively high levels. At this stage, then, an expansion of credit was favoured. Trading bank advances rose and business began to boom. But

as supplies of productive factors became increasingly inelastic it was necessary to become more selective in advance policy. As a result an attempt was made to stabilize at current levels the loans being made to private industry and the probability of contraction was indicated as soon as governmental employers chose to enter the field of war production. Moreover, because the central bank was also a trading bank, there was inevitably a shift in business from the private trading banks to the Commonwealth Bank, which was in a favoured position to secure much of the new business on government account. Nevertheless, there were other factors to explain the limited rise in trading bank business. A high level of government spending meant an increase in public holdings of liquid resources and the repayment of many advances outstanding in trading bank ledgers. At the same time, there was a corresponding increase in trading bank deposits with the central bank. These were regarded by the trading banks as the equivalent of cash and, on the basis of their expanded cash resources, it was possible for a secondary credit inflation to occur. The danger of this may have been exaggerated, but, as rates of taxation were progressively increased, there were many individuals who would not have scrupled to borrow against the security of their assets in order to maintain living standards at accustomed levels. Likewise, business firms were prepared to borrow finance for the purpose of taking advantage of the lucrative business offering. Furthermore, because he would be anxious to avert any 'dislocation' to his customer's business, the trading banker himself might well be drawn into this vicious circle of secondary inflation. It was therefore necessary to discourage such activities. The central bank provided the leadership and the trading banks 'co-operated in maintaining an advance policy in conformity with general economic policy'.[1]

However, as soon as the war effort grew to sufficient magnitude and competition for scarce resources began to hamper its further intensification, it became necessary to sterilize this increase in trading bank cash. In that way it was possible to exercise a general control over the quantity of credit. It was at this stage that Mr. A. W. Fadden, as Commonwealth Treasurer, published the voluntary agreement of the trading banks

[1] Commonwealth Bank *Directors' Report*, 17 Sept. 1940.

to accept central bank instructions both as to the amount and content of their lending programme. Although the agreement approved by Mr. Fadden never actually came into operation, the main features of the control there proposed were accepted by the succeeding Labour Government, and the original plan was therefore significant as the first recognition by an Australian Government and its advisers of the inadequacy in the Australian environment of the type of quantitative control appropriate under British conditions. It had always been relatively easy (given the will to do so) to increase the flow of money and credit within the Australian economy simply by running a budget deficit and securing the necessary funds either on overdraft or by a new issue of Treasury Bills (alternatively the Commonwealth Bank could take up an issue of longer-dated government securities). 'Open market operations' were a theoretical possibility, but were rarely used for the purpose primarily because of the narrowness of the security market. The difficulty has rarely been how to expand credit, but how to control such an expansion once it got under way. In theory, redemption of government borrowings was a possible means of credit contraction, but governments are not usually very accommodating in these matters. Nor could the Commonwealth Bank expect very much—except loss of business—from a curtailment of its trading activities in the hope that the trading banks would follow its example. Furthermore, without a developed bill market, there was little scope for discount policy. Thus, neither central bank leadership nor the methods of control traditional in Britain seemed to be sufficiently effective under Australian conditions. Indeed, this much had been recognized by the Royal Commission which investigated these matters and reported in 1937. It was seen there that some system of varying the deposits which the trading banks should be required to keep with the central bank would be an appropriate means of control and, with safeguards, the Commission was prepared to recommend along these lines.[1] Thus, both the Fadden Plan and the Labour Government's War-time Banking Control Regulations might be regarded as a development of the Commission's proposal.

'Surplus investible funds' had been defined in the regula-

[1] See *Report*, para. 589.

tions as the increase in trading bank assets in Australia as compared with August 1939, but the initial lodgements in special account absorbed only part of the past increase. From August 1939 to the commencement of the regulations in November 1941, trading bank deposits had increased by £A55 millions. Of this amount the Commonwealth Bank required only £A20 millions to be lodged in special account, the remainder being left with the banks in order to make due allowance for their low liquidity at the outbreak of war. These initial lodgements in 1941 and early 1942 came mainly from trading bank drawings on their free deposits with the Commonwealth Bank, but partly from proceeds of sales by the trading banks to the Commonwealth Bank of Commonwealth government securities and Treasury Bills. Thereafter, it was generally the practice of the Commonwealth Bank to direct the trading banks to lodge in their special accounts each month an amount equal to the increase in their total assets in Australia during the preceding month. These lodgements were made entirely by the trading banks' drawing on their free deposits with the Commonwealth Bank. Interest was allowed on these accounts at a rate of $\frac{3}{4}$ per cent. per annum. Moneys held in special account by the Commonwealth Bank were 'available as required to meet withdrawals by depositors with the trading banks', but were 'frozen as against investment by the trading banks themselves'. Meanwhile, according to the Treasurer, the moneys were 'temporarily invested by the Commonwealth Bank for war purposes mainly in treasury-bills'. Provision had been made in the regulations for withdrawals from these special accounts, subject to the consent of the Bank, but only a few applications were received, as a lodgement was not requested when it was known that a rise in assets would be followed by an early fall. Nevertheless, some withdrawals from special account were made during the operations of the regulations, when the banks found it necessary to augment their cash holdings. These arrangements ensured the requisite degree of elasticity in the new system and rendered the control both simple and effective. On the whole, this quantitative control over credit worked well and the central bank at all times maintained harmonious relations with the trading banks. More important still, valuable experience was gained of a type of central bank control eminently suited to Australian conditions.

The impact of the Commonwealth Bank's controls over bank lending and investment in modifying the structure of trading bank assets and liabilities deserves detailed attention. A general picture of the position as it developed is given in the graphs which appear below. The predominant feature was the steady rise in trading bank deposits[1] from £A318 millions in June 1939 to £A582·5 millions in June 1945, an expansion of approximately 83 per cent. This increase was a direct result of war-time credit expansion due, first, to the necessity to bring the economy to a state of full employment and, second, to the inability of taxation and loan policy to cover the rise in war expenditure. But it is certain that the increase would have been more marked had it not been for the quantitative credit controls imposed on the trading banks. One feature of the rise in deposits was the buoyancy of interest-bearing deposits, which —over the reference period—rose from £A200·9 millions to £A224 millions, or by 11·5 per cent., and despite a progressive reduction in rates of interest.[2]

The most important factor in the creation of bank deposits was the rate of government expenditure, first, because it comprised an overwhelming proportion of total expenditure for purposes other than personal consumption, and, second, government spending for war purposes was considered so vital that there was no question of any 'inadequacy of finance'. To the extent that the Government could not pay its way with moneys extracted from the pockets of the public, it created new money for the purpose by borrowing from the banking system (mainly from the central bank). But the release of resources for war production was achieved mainly by means of consumer and producer rationing. Competitive price increases were only permitted to operate to a limited extent since price increases were themselves controlled. The situation which was created was therefore one in which the public was unable to spend the whole of its net money income and a large part of the savings required to finance the government deficit were thus the product of involuntary saving.

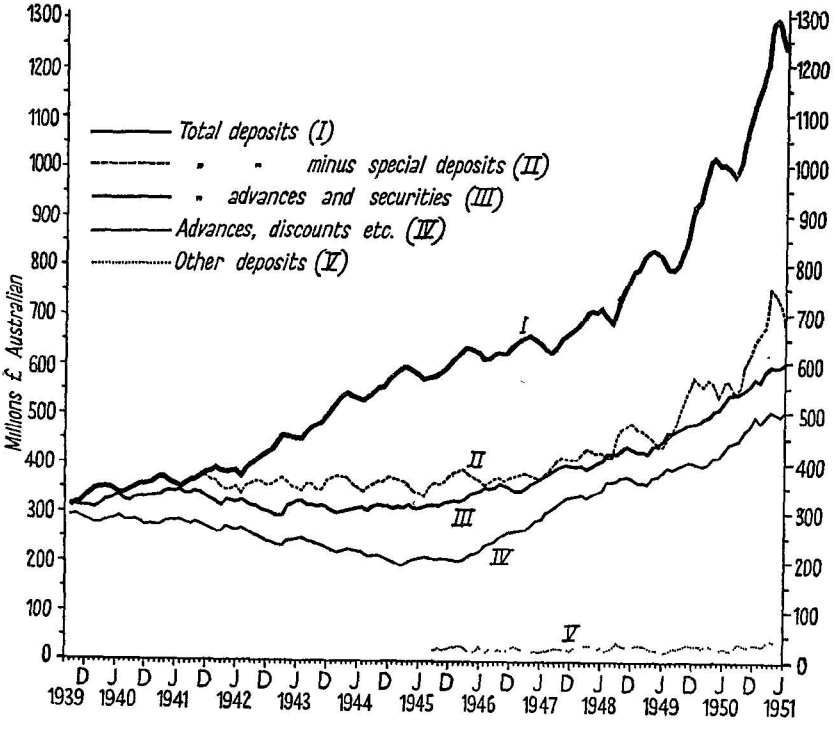
In these circumstances the main determinant of the rate of

[1] Figures quoted are for the Nine Trading Banks only.

[2] For twenty-four months' fixed deposits there was a reduction over this period from 3 per cent. to 1¾ per cent. per annum.

growth of deposits (apart from fiscal measures) was the form in which the public elected to hold its savings—bank deposits, government bonds, War Savings Certificates, or notes and coin. Given the amount of the government deficit and the size of the country's adverse balance of overseas payments (if any),

GRAPH A



NINE TRADING BANKS

the movement of bank deposits would depend upon the distribution of the Government's security sales between the public and the banks, which distribution was very largely determined by the public itself. If the public insisted on holding a large part of its unspent income in the liquid form of bank deposits (repayment of advances might also be included), or as notes and coin, the banking system itself would be obliged to create the finance required by the Government. But, if the public was willing to hold a large part of its increased savings in less liquid form (government bonds or Savings Certificates), then the in-

crease in bank deposits would be relatively small. Naturally, the Government sought to influence this choice. War loan drives and similar appeals aimed both to stimulate voluntary saving and to induce the public to invest their savings in the less liquid forms. But, because the structure of war-time controls virtually compelled the public to save in any case, the second objective was relatively the more important.

The progressive increase in total deposits is indicated by Curve I of Graph A. Within this aggregate, deposits bearing interest remained relatively stable, so that the rate of increase in total deposits was mainly due to the rapid rise in deposits held on current account. As a result, the ratio of deposits not bearing interest to total deposits moved progressively upwards throughout the war period, though it was subject to a regular seasonal movement, reaching its peak about April of each year. This seasonal movement was directly related to a similar movement in total deposits and was due to payments for primary products made direct to growers in Australia. The subsequent annual decline was accentuated by heavy taxation payments which often fell due in this part of the year.

The 'surplus investible funds' of the trading banks, which were frozen in special accounts with the Commonwealth Bank, are indicated by the divergence of Curves I and II. Total deposits minus 'surplus investible funds'—Curve II—remained comparatively stable during the war years, as one would expect. On the other hand, as long as inflationary methods of finance were employed, there was a progressive increase in the percentage of total deposits which were immobilized in special accounts. But, latterly, this ratio achieved a greater degree of stability largely due to the successful efforts of the Treasurer to prevent any further net increase in Treasury Bills issued. In addition, the policy of immobilizing surplus investible funds was applied with rather less rigour once the war-time peak in spending was passed.

From the point of view of the future, war-time changes in the composition of trading bank earning assets were equally significant. As deposits continued to rise, advances steadily fell. This was again in the nature of war finance. The Government could only obtain control of resources either by outbidding the private purchaser or by exercising its priorities,

and it preferred to employ the latter method as much as possible. Advances were restricted in the first instance by means of the increasingly selective policy of the banks themselves (under central bank leadership) and after November 1941 by the more direct control exercised through the Commonwealth Bank under powers conferred by the War-time Banking Control Regulations. The trading banks were specifically enjoined to lend only for purposes essential to the war effort. This produced, for example, a steady reduction in advances to the building and retail trades and for hire purchase and property deals.

Meanwhile, satisfactory prices for most primary products and the effects of credit expansion in increasing liquidity all round had reduced existing overdrafts at a time when other lending outlets had been closed by the Government's policy of concentrating on essential types of production only. The war brought relative prosperity to a number of producers, notably farmers, pastoralists, and certain small manufacturing businesses. This helped to liquidate many overdrafts, which had previously seemed doubtful, if not actually bad. On the other hand, the marked contraction of civilian industry, as a result of 'rationalization' (or even outright prohibition) of certain types of production, was responsible for heavy repayments of a variety of trade advances, as stocks in the hands of manufacturers, wholesalers, and retailers were allowed to run down and were not replaced. Moreover, much of the new business arising from expanded war production was undertaken by the trading sections of the central bank, which provided the necessary finance for a wide range of war-time activities. Even within the private sector of the war economy, a system of progress payments on government contracts and, through the main contractors, on sub-contracts also, substantially reduced the demands which would otherwise have been made on the trading banks. In addition, some of the finance for fixed capital extensions was provided by the Government. For all these reasons, the demand for trading bank advances tended to shrink. The Government had replaced individuals as the main borrower from the banking system and it satisfied its short-term demands from the resources of the Commonwealth Bank.

The fall in trading bank advances beginning in 1941 and

continuing until after the end of the war is indicated by Curve IV of the graph. The ratio of trading bank advances to deposits fell from more than 91·7 per cent. in June 1939 to the low level of just below 35·7 per cent. in June 1945. This ratio was also subject to a seasonal movement with peaks about July of each year, though there was a tendency to move away from this position in 1944 and again in 1946. The troughs occurred almost uniformly in December, with troughs also in March for 1945 and 1946. These movements were less pronounced than those affecting deposits and, in addition to the seasonal effect of export receipts, were also associated with the impact of government financial arrangements. As a rough generalization, when deposits went up, advances fell and for the same reasons. When the private sector became less liquid, trading bank advances increased, but only slightly because of the strictness of the controls.

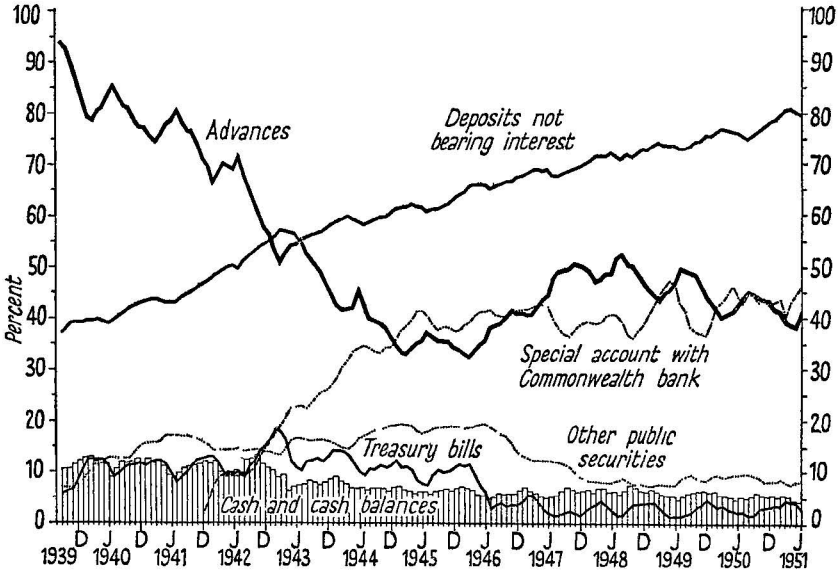
Within the total of bank investments there was a diversion of funds from advances to holdings of government securities and Treasury Bills. In point of fact, during the first two years of the war, the trading banks supplied about one-third of the Government's borrowing requirements. Thereafter, the Government made strenuous efforts to induce the public to invest in war loans and, under the terms of the War-time Banking Control Regulations, trading bank loan transactions were limited by the provision requiring prior permission from the Commonwealth Bank. But to compensate for the fall in their advances, the trading banks were allowed to purchase government securities to an extent sufficient to maintain the sum of their advances and security holdings in approximate stability. Purchases of government securities were made from the Commonwealth Bank or the Commonwealth Savings Bank and, in that way, full control over the credit mechanism was effectively maintained. As a percentage of total deposits, securities showed a marked increase but did not seem to be subject to any regular seasonal fluctuation.

Between June 1939 and June 1945 trading bank advances fell from £A291·7 millions to £A207·9 millions, or by £A83·8 millions. Meanwhile, trading bank holdings of government and municipal securities increased from £A22·1 millions to £A104·3 millions, or by £A82·2 millions, almost an exact

offset to the fall in advances. In June 1939 the ratio of government securities to deposits was approximately 7 per cent. By September 1941 this ratio had risen to 17 per cent. It differed little from this level in June 1945 when it stood at 17·9 per cent.

All these changes necessarily had their effects on liquidity ratios, though quite obviously pre-war criteria could no longer

GRAPH B



NINE TRADING BANKS
Ratio of Assets and Liabilities to Total Deposits

be applied. In June 1939 trading bank cash stood at £A28·6 millions. Treasury Bill holdings amounted to £A23·9 millions, giving a total of £A52·5 millions. Total deposits were then £A318·0 millions and the liquidity ratio approximated 16·5 per cent. By September 1941 cash and Treasury Bills totalled £A79·5 millions, deposits £A366·5 millions, and the ratio had risen to almost 21·7 per cent. By June 1945, however, when deposits stood at £A582·5 millions, cash and Treasury Bills had only been allowed to rise to £A83·0 millions and the ratio was down to 14·25 per cent. The cash ratio (cash–deposits) moved in a similar fashion, the corresponding figures being

9 per cent., 11·3 per cent., and 6·3 per cent. But these levels were a by-product of war finance and were largely artificial.

It should also be observed that both the cash ratio and the ratio of Treasury Bills to deposits showed a degree of seasonality of movement. The cash ratio tended to move to a peak in January or February of each year and to fall to a minimum about June. Actually, the peaks were more regular than the minima. Indeed, in several years there was a double set of troughs (one occurring in April) and the June troughs sometimes varied a little either way. It was noticeable, too, that the downward trend in the cash ratio seemed to have the effect of damping the amplitude of the seasonal movement. The Treasury Bill ratio had peaks, which varied somewhat from year to year, occurring in March to April in 1940 and 1941 and moving back to January–February for subsequent years. The troughs occurred almost uniformly in July. Nevertheless, the seasonal movements of the cash and Treasury Bill ratios seemed to show a fairly high degree of positive correlation. This may have been due to the inverse correlation which obtained between the Treasury Bill ratio and the advance–deposit ratio. The Treasury Bill ratio tended to rise to its peak shortly after the advance–deposit ratio had fallen to its minimum, whereas the peaks of the advance–deposit ratio occurred about the same month in each year as the minima of the Treasury Bill percentage of total deposits.

However, it is not wise to attach too much importance to changes in these ratios, because the special account procedure had largely transformed traditional concepts of liquidity. Its primary function was to prevent a secondary inflation, and although these surplus investible funds were frozen against use as part of the credit base, they nevertheless constituted a strong reserve against the demands of depositors since the central bank could in appropriate circumstances release a proportion of these funds and thereby augment trading bank cash directly. Indeed, by June 1945 these special war-time deposits constituted over 41·5 per cent. of total deposits and had become the trading banks' largest single asset.

We turn now to consider qualitative credit controls in Australia imposed for the first time during the war years. At all times a certain proportion of current production is financed by

bank loans. These are liquidated as the product is sold and renewed as more production is undertaken. As one means of implementing war-time transfers of resources, it therefore became necessary to curtail loans demanded for purposes of inessential civilian production and to select in their place advances to industry for war purposes.

The first indication that this type of policy was being implemented was given by the Commonwealth Bank Board in 1940, when it referred to the co-operation of the trading banks 'in maintaining an advance policy in conformity with general economic policy'. But, as early as October 1939, the National Security (Capital Issues) Regulations had been gazetted, with the object of conserving resources and directing them into channels which served the national interest. At first the trading banks were excepted from the operation of these regulations. However, developments early in 1940 necessitated the imposition of a stricter control and the Capital Issues Advisory Board, upon which the Commonwealth Bank was represented, formulated a general tightening up of the control over the capital market. To make this plan fully effective, it was necessary that the trading banks adopt a similar policy and apply the same rules to applications by customers for new or increased overdraft facilities. At the direction of the Commonwealth Treasurer, the Capital Issues Advisory Board therefore entered into discussions with the trading banks and advised them of its policy. It was suggested that, in future, they should be more cautious with applications for new or increased advances which might damage the economic stability of the country. Only advances required for expansion in essential industries were to be encouraged. As a result, proposals to start or expand retail businesses, chain stores, hire-purchase financing, and amusement companies were to be discouraged and applications of a purely speculative nature declined. The Capital Issues Advisory Board arranged to inform the banks of any changes in its policy from time to time and also to supply for their guidance particulars of applications refused by the Treasurer under the Capital Issues Regulations. It was suggested that the banks should discuss doubtful cases with the Capital Issues Advisory Board. The trading banks agreed to co-operate in applying this policy, but preferred that all discussions with them should be

conducted through the Commonwealth Bank and that procedure was accordingly followed for about twelve months. On the whole this voluntary arrangement worked fairly well until June 1941 when it was found necessary to supply the banks with more definite guidance in the form of a schedule, setting out the Commonwealth Bank's attitude to different types of advances. This schedule was accompanied by a list of recent applications refused under the Capital Issues Regulations. From then on all the trading banks were informed of advices given by the Commonwealth Bank in connexion with doubtful cases submitted to it, though without disclosing the names of the parties concerned. Special advices were also given regarding particular types of advances of an essential nature which could be granted without restriction.

This voluntary co-operation of the trading banks continued until the introduction of the War-time Banking Control Regulations in November 1941. The Commonwealth Bank then laid down a definite set of rules to be followed by the trading banks in making advances to the public. To a certain extent this control was a continuation of the earlier arrangements, though there were a number of extensions. In general, it was designed to assist in the diversion of resources from inessential enterprises to those concerned directly with the prosecution of the war. The trading banks administered the rules themselves, though under the general supervision of the central bank, to which they also referred any doubtful cases that might arise. In brief, the banks were informed that accommodation for retailers, wholesalers, and manufacturers of goods for civil consumption was, in future, to be definitely limited. As a general rule, finance was not to be granted for any new investment which could not be regarded as essential to the war effort. Taxation and dividends were not to be paid by drawing on overdrafts, unless extenuating circumstances existed. Advances to take up Commonwealth loans were discouraged. Applications from primary producers were to be treated on their merits and, for the rest, the Commonwealth Bank requested that existing limits be reviewed and reduced limits recorded wherever possible, with a view to ensuring the restriction of all activities which made no direct contribution to the effective prosecution of the war. In particular, the central bank was

anxious to avoid the granting of limits of any magnitude on terms which would permit the borrower to use his overdraft at will. Loans had to be made for specific purposes and within the broad terms of the policy laid down from time to time by the central bank. So that the whole field of banking would be covered, the Commonwealth Bank also sought and readily obtained the co-operation of those banks not listed in the regulations, viz. the State banks and the savings banks.

The advance policy laid down by the Commonwealth Bank under the War-time Banking Control Regulations in November 1941 was amended and supplemented during the succeeding three and half years to accord with changing circumstances. Furthermore, answers to specific questions submitted by the individual banks to the Commonwealth Bank were circulated for the information and guidance of all the banks concerned. This ensured consistency and flexibility in the operation of the control and both the central bank and the trading banks seem to have been satisfied with the working of these arrangements. Thus, with the end of the war in Europe and the transference of large numbers of the Allied Forces to the Pacific area, modifications were required in the shape of Australia's war effort and advance policy was adjusted in sympathy. Moreover, during the years of intensive war production, house-building and the supply of other essential civilian goods had had to be sacrificed and a huge backlog demand had accumulated. Australia's main efforts still had to be directed to the war against Japan, but with the gradual release of men from the Services and the falling off in the production of munitions and other war supplies, it was possible to recommence production of certain civilian goods and thus to assist in overcoming the shortages. Advance policy was therefore recast to provide for a gradual reconversion from war to civilian production and the revised policy was forwarded to the banks in July 1945.

The War-time Banking Control Regulations were repealed in August 1945, but the banks were still required to observe the advance policy of the Commonwealth Bank under the terms of the Banking Act 1945. However, with the termination of hostilities against Japan, greater emphasis was now placed on the need for a speedy but balanced reconversion to peacetime production and central bank administration of advance

policy became progressively less restrictive. Again, the Commonwealth Bank was enabled to gain valuable experience in a form of credit control, which appeared to be suited to Australian conditions.

Exchange Control

On 28 August 1939 the Commonwealth Government imposed exchange control. Approved transactions were required to be completed through banking channels (i.e. through the Commonwealth Bank or the trading banks, which were appointed its agents for exchange control purposes). The free export of gold and of Australian and foreign currency notes was also prohibited and regulations were gazetted requiring all gold to be sold to the Commonwealth Bank. The first step in exchange control was to restrict sales of sterling and foreign exchange to trade dealings and other payments approved by the Commonwealth Bank. The second was the introduction of a licensing system for all exports (with certain minor exceptions) so as to mobilize within the Australian banking system all overseas funds accumulated as proceeds of exports and to ensure that the proceeds of exports to certain foreign countries were received in required currencies. The export licensing system was administered by the Department of Trade and Customs.

There were three main reasons for the imposition of these controls. First, there had been a serious drain on the London funds available to the Australian banking system during the years 1937–9 and, with the outbreak of war, it was necessary to guard against the further embarrassment of a flight of capital. Secondly, it was realized that in the event of a fall in exports at a time when imports would be rising (e.g. of machine tools and equipment) and with overseas defence expenditures also increasing, Australia's exchange resources would have to be applied with economy. Thirdly, prevention of the export of capital was part of the Government's technique for ensuring that Australia's resources would be available for the successful prosecution of the war.

Various other complementary controls were also operated in order to prevent major leakages. Thus export licensing was supplemented by national control of all foreign securities in

Australian hands and by a control over the transfer abroad of any securities held in Australia. In granting consent for dealings in foreign securities, Treasury policy was usually to require that the foreign currency proceeds be received into the Australian banking system and all dealings for which a consent had been granted were then followed up for evidence of completion. Genuine arbitrage operations between London and Australia were permitted, but only between strictly defined limits. Mobilization of foreign securities was undertaken initially to prevent outward movements of funds, but in order to supplement the nation's holding of scarce currencies, the regulations provided further that privately held overseas securities and foreign currency might be acquired by the Federal Treasurer, subject to the full protection of mortgage rights. Payment was to be made by the Treasurer at not less than the market value, or (in cases of dispute) the value as determined in an action for compensation. Under these arrangements orders were issued calling upon the owners of specified United States and Canadian dollar securities to realize on their holdings and to make the dollar proceeds available for the use of the Commonwealth Government by lodging these sums to the credit of the Commonwealth Bank in New York against payment in Australia on a telegraphic transfer basis. In all this it was the duty of the Commonwealth Bank to administer the controls imposed, to handle the returns required, and to classify the information so provided. On matters of policy the Commonwealth Treasurer was responsible.

One of the more important sections of exchange control was undoubtedly the so-called 'monetary control'. This was supplemented from 1 December 1939 by a system of import licensing administered by the Department of Trade and Customs. From the point of view of the development of the Commonwealth Bank as a central bank, the imposition of the monetary control was of considerable significance. It gave the Bank increased standing with the trading banks and was the means of its acquiring useful experience in the administration of a very delicate mechanism. A department was set up within the Bank known as the Exchange Control, which, in effect, acted for the Treasury, although it was staffed by the Bank. Meanwhile, the trading banks had been appointed agents of

the Commonwealth Bank in the administration of the regulations and they were issued from time to time with instructions setting out which transactions were not permitted, which were permissible without reference, and which should be referred to the Commonwealth Bank for approval. These arrangements worked smoothly and efficiently and, at all times, the trading banks co-operated fully.

The first few months of the control were the most difficult. It was introduced at a time when it was necessary both to protect Australian holdings of funds in London and to conserve dollars and other scarce currencies. The primary objective was to prevent any unnecessary movement of funds away from Australia and particularly to the United States. Indeed, in the very early stages, any transaction even remotely resembling a movement of capital funds was refused. This placed upon the Commonwealth Bank the onerous duty of deciding which were normal trade remittances and which were in the nature of an attempt to transfer funds out of the country. Prior to the introduction of import licensing on 1 December 1939 there was the further difficulty of distinguishing 'essential' imports from 'luxuries'. As the Bank lacked the necessary technical knowledge, the Department of Trade and Customs provided unofficial assistance, though, during a period when the formulation of policies and procedures was entirely without precedent in the history of Australian banking, it will be appreciated that applications for exchange to pay for imports had to be dealt with in rather an experimental manner. When import licensing was introduced under the administration of the Department of Trade and Customs, some of the early problems of exchange control were eliminated. It was never officially admitted, but the grant of a licence was always regarded as tantamount to a grant of exchange to pay for the goods to be imported and the monetary control then resolved itself into a determination of the appropriate currency and the form of payment.[1]

'So far as non-sterling transactions were concerned, Australian restrictions were undertaken in fulfilment of her obligations as a unit of the sterling area, which shared a common pool. The restrictions applied, more particularly, to the scarce

[1] The official position on this matter is still reserved.

or 'hard' currencies—United States and Canadian dollars, and Swiss francs. In addition, the Australian control was vitally concerned with the maintenance of a satisfactory level of London funds. Australian policy therefore fell into two sections: the first related to non-sterling transactions, where policy tended to follow United Kingdom decisions; the second concerned transactions with other parts of the sterling area, in which case policy was influenced almost entirely by the existing and prospective level of London funds. In the early months of the control, restrictions on sterling area transactions were similar to those applied to non-sterling transactions. Capital transfers were refused outright, though income payments were allowed freely. Then, the non-sterling restrictions were intensified and sustenance payments, and profit and royalty transfers severely curtailed. Sterling restrictions remained as before. The level of Australia's London funds improved during 1940, but it was not until 1941 that the Commonwealth Bank gave serious consideration to a relaxation of the ban on capital movements. However, the entry of Japan into the war in December 1941 postponed any positive action until after the benefits of United States active participation in the conflict became noticeable. Only then was it possible to ease gradually the restrictions on capital movements. Initially, only transfers of capital by persons moving to other parts of the sterling area were allowed. Later, withdrawals by non-residents generally were permitted and, finally, the only remaining restrictions applied to investments abroad by Australian residents.

After the early difficulties had been countered, the Control settled down to routine operation and the problems became fewer and less complicated. Latterly, as the war moved to a successful conclusion, restrictions were gradually relaxed. Eventually, a stage was reached when only enemy countries were excluded from the resumption of financial dealings. It was during these final months of active hostilities that administration of the control again became difficult. New arrangements had to be made with the liberated countries and these were sometimes very complicated. But apart from these periods of transition and adjustment, the Control operated smoothly and with a high degree of efficiency. After the end of the war, exchange control was operated primarily with the object of

economizing the use of hard currencies (particularly dollar currencies).

III

On 9 March 1945 the Federal Treasurer (Mr. J. B. Chifley) introduced into the Australian House of Representatives two Bills—the Commonwealth Bank Bill and the Banking Bill—the purpose of which was to modify considerably the structure of the Australian banking system as it had existed pre-war. The all-inclusive and even radical character of these measures resulted in much controversy. Indeed, the public debate commenced months before the Bills were introduced into the House and there were repeated probings in the Federal Parliament to establish the character of the proposed changes. At the same time there began a series of related propaganda campaigns which aimed at preventing the passage of the proposed legislation. Alternatively, it was hoped that by mobilizing public opinion against the proposals and by attempting to bring pressure to bear on parliamentarians of all parties substantial modifications might be forced upon the Government. Meanwhile, the Government itself had refused to show its hand until the details were completed and the new scheme could be judged as a whole.

One of the most obvious purposes of the Commonwealth Bank Bill was to strengthen the central banking functions of the Commonwealth Bank and to ensure that the financial policy of the Bank should be in harmony with the main decisions of government policy. At the same time, however, it was proposed to expand the Bank's ordinary banking business by active competition with the trading banks, conducted in a department the accounts of which would be kept separate from those of the central bank proper. The Commonwealth Savings Bank, the Rural Credits Department, and the Mortgage Bank Department (set up in 1943) were also to be continued under the general management of the Governor of the Bank and two new activities were added. These were the provision of finance to assist in the development of small industries through an Industrial Finance Department[1] and arrangements for the provision of housing loans on credit foncier terms.

[1] There is little that need be said about the operations of the Industrial Finance Department. It has undoubtedly provided useful supplementary facilities

The most effective arguments put forward to support the Government view that the Commonwealth Bank should be further strengthened as a central bank so as to control effectively the operations of the trading banks, while at the same time serving as an instrument of government financial policy, were drawn from the history of the Bank during the years of depression in the thirties. It was recalled in the Treasurer's Second Reading Speech that 'the necessities of the economic situation in Australia [i.e. in 1929–33] produced a central bank. But it did not fully measure up to its responsibilities. In the opinion of the Government, the Commonwealth Bank and the banking system should have done more to mitigate the distress of the depression years.' However, the Federal Treasurer evidently believed that his trump card was the Report of the Royal Commission appointed to inquire into the monetary and banking systems of Australia (1937): 'The commission . . . recognized that the Commonwealth Bank had developed into a central bank. But the commission believed that certain extensions of the powers and functions of the bank were required to enable it to carry out its responsibilities.' Nevertheless, it is fair comment that the Treasurer was more than a little inclined to exploit the Banking Commission's Report and, at times, to give an interpretation decidedly more favourable to his own case than the Commission could possibly have intended.

One of the most controversial aspects of the Commonwealth Bank Bill was that which provided for differences of opinion between the Government and the Bank on questions of policy. The Bank was required to inform the Federal Treasurer from time to time of its monetary and banking policy and, in the event of any difference of opinion which it was impossible to resolve by discussion, the Treasurer might inform the Bank that the Government would itself accept responsibility for the Bank's adoption of a policy in accord with government opinion. The Bank would then be required to give effect to that policy. According to the Government, this provision gave practical effect to the views of the Banking Commission as expressed in

and by 30 June 1950 its loans exceeded £A20 millions. The majority of these were made on either overdraft or hire-purchase terms, though a number of fixed loans had been granted and underwritings of public share issues had been accepted.

its report, but critics of the new proposal contended that, with the abolition of the Bank Board, which was also provided for in the Bill, the power given to the Treasurer of the day was open to abuse. It was also pointed out that, while members of a Bank Board could resign if they disapproved of particular aspects of policy and, in that way, focus public attention on the particular point at issue, it would be less easy for a Bank Governor to resign from a position of full-time employment. It was recognized that in the final analysis the views of a government with a parliamentary majority must prevail, because, whatever the law, it is open to such a government to amend it by legislation. But what the critics maintained was the likelihood of more considered action with a Bank Board than might possibly be the case under the new provisions. On the other hand, it was argued that no responsible Treasurer was really likely to abuse his powers in view of the necessity for him to justify his actions before the electorate. The Treasurer might also be expected to receive the opinion of the Governor with respect and, in the framing of the general lines of policy, the Governor's influence would presumably be quite considerable.

Nevertheless, and for the protection of the management of the Bank itself, some critics suggested that any overriding instruction given by the Treasurer should be made in writing, so that its terms would be beyond dispute and, if necessary, available for future reference. In a sense, there was now a substitute for the Bank Board in the form of an Advisory Council presided over by the Governor. Its duties were to tender advice on monetary and banking policy and on such other matters as might be referred to it by the Governor, but it was not to be concerned with ordinary matters of administration. To a certain extent, the Council replaced the Bank Board, but it lacked the executive authority of the latter and its freedom of public statement. It is true that in technical capacity the Council was of much higher quality than was the old Commonwealth Bank Board, but it was a pity that this competence was not combined with some representation of the country's major economic interests, the opinions of which (in the judgement of the present writer) should be heard on any body which is associated with the framing of central bank policy.

Much was done to meet these objections, when the Liberal–

Country Party Coalition Government (which came to power in 1949), introduced legislative proposals on 16 March 1950, the purpose of which was to provide *inter alia* for the establishment of a new Commonwealth Bank Board to determine the policy of the Bank and of the Commonwealth Savings Bank. This Board was to consist of ten members with the Bank Governor as chairman and the Deputy Governor as deputy chairman. The Secretary to the Treasury was to be a member but, of the remaining seven others, at least five were not to be members of the Bank nor of the Commonwealth Public Service. Subject to the Board, the Governor was to manage the Bank. It also provided that, in the event of a difference of opinion upon a matter of monetary and banking policy, the Government would determine the policy to be adopted by the Bank, but the Treasurer was to have a statement of that policy laid before each House of Parliament within fifteen sitting days. However, the Menzies' Government lacked a majority in the Senate, which was dominated by the Labour Party, opposed in principle to a Bank Board. The Bill was held up in the Senate by a variety of delaying tactics, including its reference to a Select Committee. The Government countered this move by introducing a second bill, identical with the first, and when this met a similar fate, the Prime Minister sought and was granted a double dissolution (in terms of the Commonwealth Constitution). This was followed by elections in April 1951 to both Houses (including the whole of the Senate, only half of which normally retires every three years). The Liberal–Country Party Government was returned with majorities in both Houses. By July, the Bill, which was resubmitted immediately, had passed through all stages and become law. Appointments to the new Board were made shortly afterwards. Several members of the former Advisory Council were reappointed, and of the non-official members chief emphasis was placed on representatives of the primary industries. The manufacturing industries were directly represented by only one member and the trade unions not at all.

An important section of the 1945 legislation embodied formal recognition of the Commonwealth Bank as central bank. In practice the Commonwealth Bank had acted as central bank for some time. This state of affairs was now given statutory

recognition. The Bank was to continue to act as banker and financial agent to the Commonwealth and was granted general powers to regulate the note-issue, to receive money on deposit, to borrow and to lend money, to discount and rediscount bills, to buy and sell securities, to deal in foreign currency and in gold, to establish credits and to give guarantees, to issue bills and drafts, to effect transfers of money and to underwrite loans.

New capital provisions were another feature of the 1945 Act. For purposes of central banking the capital of the Commonwealth Bank was now to consist of £A4 millions to be transferred from existing capital plus such other amounts as may be transferred to capital account from a Commonwealth Bank Reserve Fund to be established. Separate and additional provision was made for the capital requirements of the general banking division, rural credits, the mortgage bank department, and industrial finance.[1]

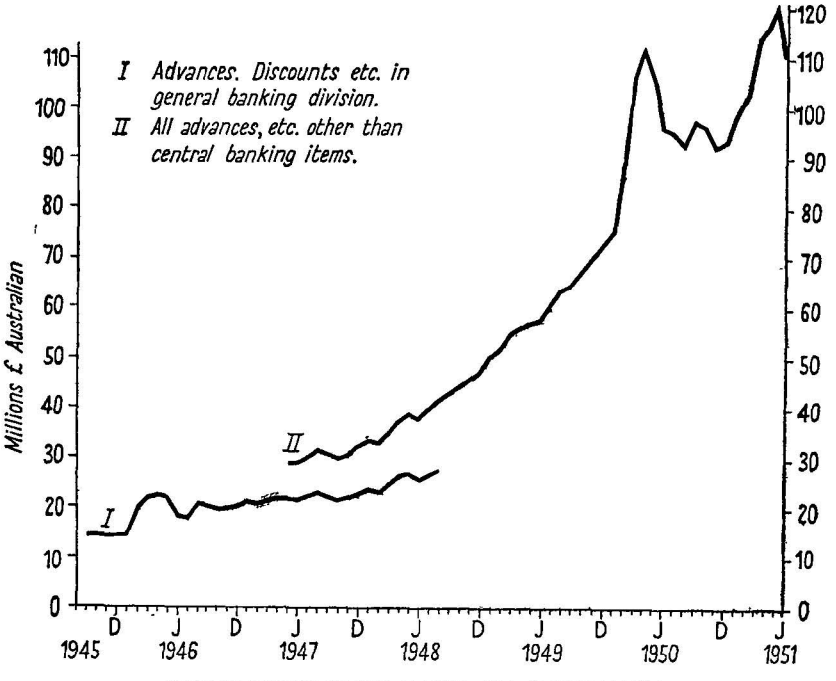
It may seem surprising to many that the Commonwealth Bank, now a central bank, should continue to carry on a general banking business, since it is unusual for a central bank to engage in large-scale trading activities. Even more strange was the direction contained in the 1945 legislation that the Bank 'develop and expand its general banking business'. Indeed, under the new provisions, the Bank, through its general banking division, 'shall not refuse to conduct banking business for any person, by reason only of the fact that to conduct that business would have the effect of taking away business from another bank'. Apart from important advantages in staffing the trading and central banking sections of the Bank, it has sometimes been argued in Australia that Commonwealth Bank competition with the trading banks is a useful supplement to its central banking powers.[2] One might think that latterly this argument would have lost much of its force with the imposition of strict controls over trading bank activities, but chief emphasis seems now to be placed on the possibility of direct credit expansion through the Bank's trading departments in

[1] Under the 1951 amending Act provision was made for an increase of capital in the Commonwealth Bank's trading departments. The maximum increase was set at £A5 millions spread over five years and it was to be derived from the profits of the Bank and from profits arising out of the issue of Australian notes.

[2] See, for example, *Report* of Royal Commission which investigated banking in Australia (1937), para. 577, p. 224.

the event of recession. As for a possible clash between its trading interests and its central bank responsibilities, the Bank would presumably be bound to place national considerations above those of immediate profit. Indeed, there are already signs that this philosophy is being increasingly favoured within the Bank itself. Yet this is not an easy thing to do. A central

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bank must lose something in objectivity when it is a question of deciding advance policy for one or other of its own trading departments. In theory, one might argue that the system should work as well here as outside. In practice, it rarely does. For the rest, the Bank would probably maintain the view that the fields in which it has expanded its activities—e.g. industrial finance and housing loans—are those which were previously catered for somewhat inadequately and that the case for expansion of these facilities was therefore strong. Be that as it may, the provision of additional facilities during a period of infla-

tionary strain (such as that which has obtained during the post-war period) would appear to run counter to the damping process which has been attempted elsewhere. In addition, the trading banks still resent what they regard as the privileged competitive position of the trading sections of the Commonwealth Bank and, in particular, the fact that the special account procedure is not applied by the Bank to its own trading departments. In these circumstances it is difficult to ensure the whole-hearted co-operation of the trading banks in implementing central bank credit policy. That so much has in fact been achieved says a good deal for the personalities on both sides, since it cannot be wholly ascribed to the existence of powers of compulsion to be used in the event of intransigence. No central banking system could survive on that basis alone. Despite the arguments which may be voiced in favour of the present system, there would still seem to be some wisdom in setting up an entirely separate government trading institution to which the general rules of credit policy could be applied openly. There would then be no basis for misunderstanding.

Under the note-issue provisions of the Commonwealth Bank Act 1945, Australian notes now became the only currency notes which might be legally issued and circulated in Australia and the Bank Notes Tax Act 1910 (which taxed out of existence the notes of the trading banks) was repealed as unnecessary. The most important change, however, related to the note-issue reserve. As Australian notes were no longer convertible into gold it was held that there was no need for any direct relationship between the note-issue and Australian overseas funds and/or gold. The Government held the practical view that it was essential that the Commonwealth Bank should issue sufficient notes to meet the day-to-day requirements of the public and that, under modern conditions, more emphasis should be placed on control over the credit base of the trading banks, the main constituent of which was now deposits with the central bank. What the Government may not perhaps have recognized, however, was the necessity for the Commonwealth Bank also to regulate its own credit policy along sound lines. Granted that condition, there was no inherent danger in the new position, since the note-issue is, in reality, only the small change of the credit structure.

In general, the objective of the Banking Bill, which was a cognate measure, was to continue in operation the war-time controls over the trading banks. Thus, the business of banking in Australia could only be carried on by corporations specifically authorized to do so, though exemptions might be granted to pastoral companies, travel agencies, and other firms that normally conduct certain banking transactions for their customers in conjunction with their main business.

For the purpose of 'protecting depositors', it was further provided in the Banking Act 1945 that the Commonwealth Bank may at any time obtain information regarding the financial stability of a trading bank and, should a trading bank fail to supply information sought by the Commonwealth Bank, the latter was now empowered to appoint one of its officers to investigate the affairs of the bank in question. On the other hand, if a trading bank found that it was unlikely to be able to meet its obligations or was about to suspend payment, it was required immediately to inform the Commonwealth Bank which might then investigate its affairs, and, if necessary, assume control of and carry on its business. Indeed, the Commonwealth Bank can now take such action on its own initiative. Once having assumed control of a trading bank, the Commonwealth Bank must then remain in control until the deposits with that bank have been repaid or suitable provision has been made for repayment. Trading banks must also hold in Australia tangible assets of a value not less than the total amount of their deposit liabilities.

One of the main functions of a central bank is to regulate the volume of credit so that it may assist in the damping of cyclical fluctuations. To do this the central bank must be able to control the availability of trading bank cash (which includes deposits at the central bank), since this is the basis of bank lending. Australia developed her own technique of immobilizing the war-time increase in trading bank cash reserves and it was now proposed to continue this control (under powers contained in the Banking Act 1945) so that the war-time accumulation of bank funds could not be used as the basis of an inflationary post-war expansion of trading bank advances and investments. Under the Act the Commonwealth Bank was now empowered to require each trading bank to lodge in special account such

sums as the central bank might consider to be necessary in the light of current credit conditions. However, as an upper limit, the Commonwealth Bank might not require the lodgement of an amount which would cause the balance in a bank's special account to exceed the amounts transferred from its war-time special account, plus any increase in the bank's assets following the commencement of the appropriate provisions of the Banking Act 1945. Withdrawals from these special accounts might be permitted, though (possibly) subject to conditions, and, in point of fact, substantial withdrawals have already been allowed under these provisions (e.g. during the early months of the financial year 1947–8 and again in mid-1949), 'to meet the liquidity requirements of the banks'. Interest is paid to each bank semi-annually on the daily balance of its special account at a rate not exceeding 17*s.* 6*d.* per cent. per annum, to be determined from time to time by the Commonwealth Bank, with the approval of the Federal Treasurer.

After the war it was realized that the re-establishment and expansion of peace-time industry would require some increase in bank advances and that it would be necessary to leave sufficient liquid funds with the banking system for the purpose. Accordingly, for the three years to July 1948, only about 45 per cent. of the increase in trading bank assets was in fact called to special account. In addition, the banks held at the end of the war substantial amounts of government securities, a large part of which had been bought during the war years at a time when their advances were falling. By limiting the releases it was prepared to make from special account, the central bank could require the trading banks to meet a large part of their increased demand for liquid resources by selling government securities and, as advances began to increase rapidly after 1945, this was insisted upon. But the rate of growth of the advances of different banks was very uneven, and by mid-1947 the security holdings of certain banks were reduced to a low level. This was followed by requests to the central bank for releases from their special accounts. However, the central bank took the view that any further relaxation to enable the banks to continue a rapid expansion of advances would have defeated the purpose for which the special account procedure had been instituted. Nevertheless, it was felt that to have forced these

banks into a situation in which they could not have met the new requirements of their customers would have been too drastic. It was also recognized that credit controls must be administered with reasonable flexibility. First, it was appreciated that 'current demands on a bank for advances are frequently the result of decisions made many months earlier, so that a change in policy takes a considerable period to become fully effective'; and, second, that 'a rigid limitation of funds may involve the refusal of legitimate finance for an eminently desirable purpose'. Instead of permitting further releases from special account (upon which the trading banks were allowed ½ per cent. per annum), flexibility was provided by granting to the banks in question short-period central bank loans at a rate of 3½ per cent. per annum, which placed these banks on the same footing as those which were still able to sell government securities, though these new arrangements were primarily designed to discourage any tendency for the banks to rely on this source of finance. The intention was merely to provide a breathing space such that these banks could continue to meet the essential requirements of their customers while adjustments in their advance policy were being effected. It was emphasized that central bank loans were intended as a strictly temporary source of finance for the sole purpose of providing 'an essential element of flexibility' but that it would be 'normal policy to provide for the growing requirements of the economy for finance by releases from special account on a scale sufficient to support an appropriate level of bank investments', and the banks would be expected to adjust their operations over a period to conform with this general level.[1] For the formulation of this policy, the central bank was, of course, fully responsible, but it has become the practice to consult with the trading banks before making major policy changes, and co-operation appears to have been close even when the trading banks have disagreed with the details of the control.

Latterly, the Commonwealth Bank appears to have adopted the so-called S.A.C.T. ratio (i.e. the combined total of Special Accounts, Cash, and Treasury Bills as a ratio to deposits) as a rough working rule in determining what proportion of the in-

[1] For a discussion of Commonwealth Bank advance policy post-war see the Bank Governor's *Annual Report*, 30 Aug. 1949, pp. 30–33.

crease in deposits should be called to Special Account. There is some evidence to suggest that this ratio was gradually raised to about 50 per cent., at which figure the Bank has sought stability for the system as a whole. In the result, some part of the increase in trading bank deposits has been left free. However, the ratio has on occasion been allowed to vary as between banks (in the event of their having special commitments) and the chief complaint has related to the uncertainty of Commowealth Bank action. It is understood that this is now being overcome by fuller consultation with the trading banks.

Another continuation of war-time powers under the 1945 legislation related to the direction of lending. Where the Commonwealth Bank is satisfied that it is necessary or expedient to do so in the public interest, it may determine the policy to be followed by the trading banks in relation to advances and the Commonwealth Bank may give directions, with which each bank must comply, as to the classes of purposes for which trading bank advances may or may not be made. However, the Commonwealth Bank may not 'make any determination or give any direction with respect to an advance made, or proposed to be made, to any particular person'. This control over the direction of lending was regarded not only as an essential continuing power in the post-war transition period but also the means of checking an unbalanced expansion of credit resulting in sectional inflation and distortions in the structure of production. Supplementing this power to control the direction in which credit is granted, the Commonwealth Bank was also required to control other forms of trading bank investment. Thus, except with the consent in writing of the Commonwealth Bank, a trading bank may not purchase or subscribe to securities of the Commonwealth or of a State, securities of any local governing body in Australia, or securities listed on the Stock Exchange.

In accordance with these responsibilities, the Commonwealth Bank has issued to the trading banks from time to time 'policy directions relating to advances in various classes and for various purposes'. These advices have been reviewed on frequent occasions in the light of current economic conditions and the experience of the banks in carrying out the policy

required. In general terms this has been

designed to ensure that bank finance available was used for the most important purposes and that advance policy did not add unnecessarily to the existing inflationary pressure on resources. In particular, it emphasised that long-term capital for development and new enterprises should be obtained as far as practicable from outside the banking system, that the inflation of capital values should not be encouraged by lending on optimistic valuations, that current expenditure beyond current income should not be facilitated, and that primary producers should be encouraged to take advantage of their currently high incomes to increase their equities in their properties by the reduction of their overdrafts and other debts.[1]

Within this broad framework, credit policy was made increasingly selective in an attempt to curb the rising inflationary pressure.

In May 1949,[2] and again in November 1950,[3] when advance policy was under review, changes were only made after detailed consultation with the trading banks. The central bank continued to be 'solely and fully responsible for the content of this policy', but it was felt that 'such consultation can ensure that the wide contacts and detailed experience of trading banks play their appropriate part in the formulation of policy in relation to the distribution of credit'. In addition, the central bank decided, though not without some hesitation, to make its advance policy public. 'The Bank is anxious that its policy in matters of such concern to the community should be widely known and understood. There is, however, a danger that publication may lead to undue importance being attached to changes and thus militate against flexibility in a policy which must be sensitively adjusted to changing economic conditions.'[4] One can appreciate the reasons for this hesitancy, yet it would seem that by taking the public into its confidence a central bank stands to gain more than it could lose and this experiment in publicity should be commended.

On the question of interest rates, it was the Government's view that their control would be just as important in the post-war period as during the war years and that a low rate of interest

[1] Bank Governor's *Annual Report*, 30 Aug. 1949, p. 32.
[2] For details see Commonwealth Bank, *Statistical Bulletin*, May 1949, p. 67.
[3] See ibid., Dec. 1950–Jan. 1951, p. 47.
[4] Bank Governor's *Annual Report*, 20 Aug. 1949, p. 33.

would encourage the maintenance of a high level of economic activity and employment. For this reason the Commonwealth Bank was empowered, subject to the Treasurer's approval, to make regulations to control rates of interest payable to or by banks, or to or by persons in the course of any banking business carried on by them, or rates of discount chargeable by banks or by other persons in the course of any banking business carried on by them. Regulations may also be made providing that no interest is to be paid on demand deposits (except savings-bank deposits and then only up to a certain specified amount).

Finally, it is necessary to consider the arrangements for the mobilization of overseas funds. The Royal Commission on Banking had felt it desirable that the Commonwealth Bank be provided with sufficient overseas funds, not merely to provide for the debt service of Australian Governments but also to assist the central bank in the performance of its necessary functions. This was in 1937. Before their recommendations could be acted upon, however, the proximity of war necessitated the imposition of exchange control. The Government hoped that after the post-war 'transition period' was over this control would no longer be necessary, but because overseas resources may not always be sufficient to meet normal exchange requirements it nevertheless provided in the Banking Act 1945 for the future use of exchange control in the event of an emergency. Under more normal conditions, it is anticipated that less stringent arrangements will suffice and the Act also empowers the Commonwealth Bank to buy whatever proportion it may need of any foreign currency which the trading banks accumulate abroad as a result of their Australian business after the commencement of the Act. In exercising this right, however, the Commonwealth Bank must take the same proportion from each bank and it must make allowance for any blocked balances which the banks may hold. The price at which transactions in sterling are to be effected is to be a matter for agreement between the Commonwealth Bank and the trading banks or, in default of agreement, as determined in an action for compensation. Special provisions ensure that the trading banks will have sufficient foreign currency available to meet all their normal business requirements. The gold provisions in the Act are similar to those which operated during the war years. Thus,

the consent of the Commonwealth Bank may be required for the taking or sending of gold out of Australia, and any person who has gold in his possession or under his control may be required to deliver it to the Commonwealth Bank or to some other prescribed authority such as a Mint. Naturally, provision is made for the use of gold for professional or trade purposes. The Commonwealth Bank will pay for gold delivered to it at a price fixed and published by itself, though the seller may (if dissatisfied) have the price determined in an action for compensation against the Commonwealth Bank. Since these provisions may not be required as a permanent feature of central bank control, they may be brought into operation (or suspended) wholly or in part by proclamation.

Under the 1945 legislation the Commonwealth Bank has been given a wide range of powers to control the supply and distribution of bank credit in Australia, though the high level of liquidity inherited from the war years and the subsequent import of inflationary influences from abroad has necessarily qualified the completeness of its control to date. Furthermore, the maintenance of cheap money during the early post-war period[1] must have accentuated the impact of inflation, despite the tightness of the controls operated by the central bank.

Trading Bank Reactions

There is a feeling among trading bankers in Australia that the powers accorded the central bank in 1945 are too wide. This nervousness was undoubtedly accentuated by the unsuccessful attempt to nationalize the private trading banks (referred to elsewhere in this volume). In addition, trading bankers have been extremely critical of the operation of credit control during the post-war years. Not all of these criticisms have been entirely fair, but at least they should be brought to the reader's attention. For example, trading bankers have argued that the

[1] At its meeting in Aug. 1951 the Australian Loan Council decided to raise the interest rate on new government loans from $3\frac{1}{8}$ per cent. to $3\frac{1}{4}$ per cent. This was followed by the announcement by the Federal Treasurer that as from 11 Sept. 1951 the maximum rate at which loans might be made to semi-government and local authorities would be raised from $3\frac{1}{2}$ per cent. for loans guaranteed by State governments and $3\frac{5}{8}$ per cent. for non-guaranteed loans to an over-all $4\frac{1}{8}$ per cent. The maximum rate on loans raised by building societies guaranteed by State governments was increased at the same time from $3\frac{7}{8}$ per cent. to $4\frac{1}{2}$ per cent. per annum.

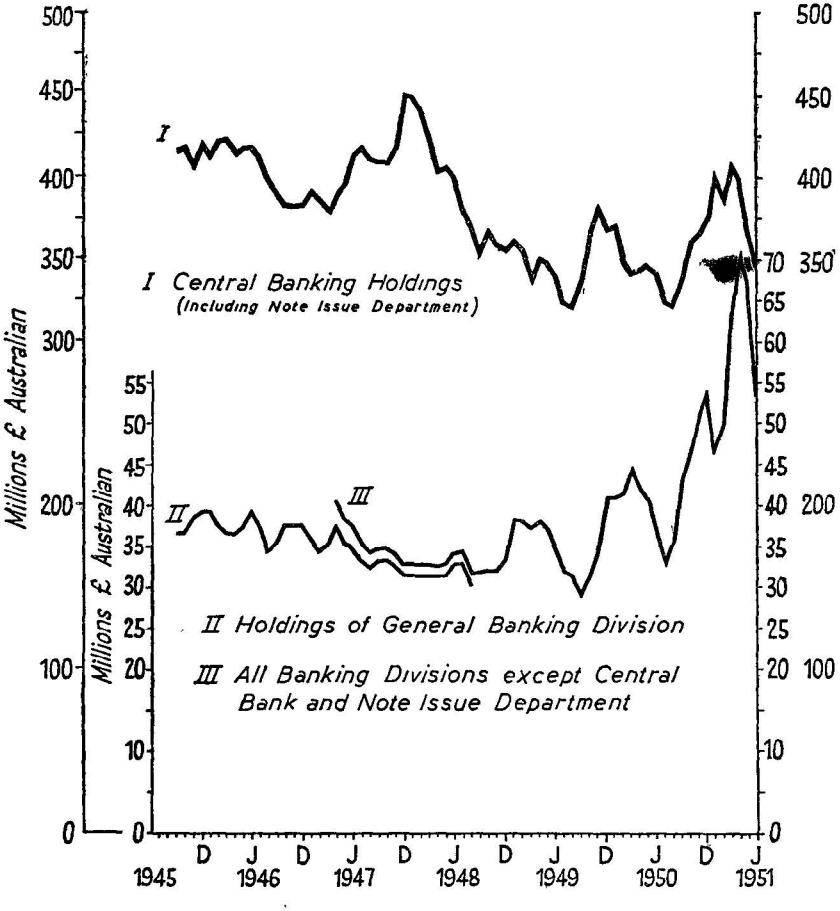
fault lies with the emphasis on compulsion, which has hindered the development of 'classical' central bank techniques. They allow that Australian conditions impose severe limitations upon the use of such techniques and that, despite the marked growth in the magnitude and quality of the bond market in recent years, open market operations on the scale that would be required to prevent a secondary credit expansion based on a substantial initial change in cash reserves would be impracticable. The more open-minded of them would agree that the central bank should be equipped with reserve compulsive powers, but even so they doubt whether these should be exercised at any time on the basis of a month-to-month control. They claim that there is a danger that the existing controls will tend to promote rigidity, particularly as the several banks differ widely in the structure of their business and their policies of development. More specifically, the tendency to confuse 'monetary' with 'profit' control is deprecated. This is said to introduce an element of uncertainty and to militate against smooth operation. There may well be something in this view, yet it could still be argued that sometimes the most effective way of implementing particular types of action is to exert an influence on profits. In any case, the Commonwealth Bank has not been concerned merely to hold profits within a ceiling. There have been times when it has facilitated adjustments in the distribution of trading bank earning assets in order to prevent profits from falling.[1] Again, the control over trading bank investment in government securities is regarded as both unnecessary and unwise, since it hinders the natural development of the market and impairs the banks' second line reserve of liquid assets. The trading banks also doubt whether qualitative control through advance directives can be operated effectively in practice. Quite apart from the difficulty of defining the purpose of an advance, it is objected that decisions of this kind are taken outside the market and that the costs of misjudgement may be heavy. The criticism is not apparently of the need for guidance of a general character, but the reduction of directives to 'formal' and detailed terms.

However, it may be that too much importance has been attached to this charge of 'over-formalization'. It could be

[1] See, for example, Giblin, op. cit., pp. 319–23.

argued that an advance policy stated in more general terms would fail to provide any true guidance at all and there is something to be said for specific guidance in chosen matters.

GRAPH D



COMMONWEALTH BANK OF AUSTRALIA
Holdings of Investments and other Securities

Nor should it be forgotten that the interpretation of policy is very largely the responsibility of the trading banks themselves. They may, of course, ask the Commonwealth Bank for advice and, in certain cases, must, but the degree of compulsion is not unduly burdensome. Indeed, co-operation in implementing a

general policy comes nearer the aim of the central bank. There is, nevertheless, one consequence of the control over advances which genuinely worries the trading bankers. During the course of the post-war inflation, the central bank has requested the adoption of an increasingly selective advance policy. In particular, it felt that finance for capital expenditure and permanent non-fluctuating working requirements should be obtained from outside the banking system. Trading bankers have argued that, if this policy is persisted in for any length of time, it will seriously weaken central bank control besides encouraging greater credit instability in time of recession. The trend towards split borrowing by business firms from banks, other financial institutions, and private persons is already noticeable and, in this way, the insurance companies, for example, have increased their business loans considerably. In a certain sense, they have become 'bankers'. Yet they are not subject to central bank control.[1] Naturally, the trading banker resents this loss of business, especially when he feels that little has been gained in any over-all sense.

What, on a balance of considerations, should our final judgement be? It must be recognized that banking today is an activity so vital to the welfare of the community that, in the view of the present writer, effective control is not possible without wide powers. Moreover, it may be argued that in Australia the method of control adopted is eminently suited to local conditions, since the narrowness of the security market (despite its expansion since 1939) and the relative immaturity of financial institutions do not permit the effective use of the sophisticated methods of credit control worked out for the more mature economies of the United Kingdom and the United States. Thus, open market operations have been little used in Australia as the primary means of influencing the cash base and there is no mechanism, such as the London Money Market, through the delicate operation of which it is possible to implement changes in the structure of interest rates. In these circumstances, central bank leadership was likely to be slow and difficult, and the

[1] They have been subject to the capital issues control, but this may be held to have less permanence than controls operated by the central bank. It has already been discontinued once since the war and had to be reimposed.

forces of tradition less persuasive than powers of compulsion. Furthermore, the vulnerability of Australia as an open economy may now be safeguarded to a certain extent by appropriate central bank action. Australian prosperity has always been dependent on conditions overseas and it was hoped to

GRAPH E



COMMONWEALTH BANK OF AUSTRALIA

Overseas Funds

overcome some of the disadvantages of this position by resorting to central bank measures designed to cushion Australia's domestic economy against external shocks.

Post-war experience would suggest, however, that much has yet to be learnt before it will be possible to control adequately the types of inflationary pressures which have affected the Australian economy in recent years. It is true that some of the most powerful factors have been very largely outside domestic

control. Export prices and export incomes rose progressively. Recurrent rumours that the Australian £ was about to be revalued prompted importers to delay payments and overseas buyers of Australian exports either to pay in advance or to transfer funds to Australia in anticipation of early purchases. In addition there was the movement of a certain amount of 'hot money' to Australia as a pure speculation. Further, there has been a heavy capital inflow since the end of the Second World War for permanent investment in Australian industry. All this has meant considerable additions to Australia's overseas funds and a consequent appreciable net increase in the liquid assets and deposits of the banking system. This presented the central bank with a formidable problem, complicated still more by the Government's insistence on an ambitious policy of immigration and development. Without the operation of credit control, the situation must have been much worse. Nevertheless, Australian experience has served to underline the limitations of credit policy in an open economy and must qualify considerably the faith placed in the 1945 legislation.

3

COMMERCIAL BANKING IN CANADA

I

THE DEVELOPMENT OF THE CHARTERED BANKING SYSTEM

1. *Introduction*

A. *The Canadian Financial Institutions*

As a glance at Tables 1, 2, and 3 indicates, the Canadian monetary system has developed along traditional lines. The money supply consists in notes, practically all of which have been issued by the central bank, and bank deposits. Notes in circulation form about one-quarter of the total money supply and bank deposits the remainder.[1]

TABLE 1

*Canadian Money Supply, 31 December 1950**

$ millions

Currency outside banks:			
Notes		1,136	
Coin		78	
			1,214
Active bank deposits:			
Chartered banks:			
Demand	2,770		
Active notice	697		
Other†	413		
	3,880		
Deduct float	450		
		3,430	
Bank of Canada 'Other Deposits'		207	
			3,637
TOTAL			4,851

* For a definition of the terms used in this table see the Appendix to this chapter.

† Excluding Dominion Government Accounts.

Source: Bank of Canada, *Statistical Summary*, Jan. 1951.

[1] For an official Canadian discussion of 'the supply of money' see the Appendix to this chapter.

There is a well-established central bank—the Bank of Canada—which fulfils the usual duties of such an institution. It now has a monopoly of the country's note-issue,[1] it acts as the Government's banker and its other liabilities consist predominantly of the cash reserves of the commercial banking system. Its assets before the recent war consisted of the country's gold and foreign exchange reserves and sufficient government securities to offset its liabilities. Today the country's gold holdings have been taken over by a direct government agency—the Foreign Exchange Control Board—and the only foreign exchange holdings of the bank consist of funds held for the account of this institution.

TABLE 2

Bank of Canada—Balance-sheet

31 December 1949 ($ millions)

LIABILITIES		
Notes		1,307
Deposits:		
Government of Canada	51	
Chartered banks	542	
Other	127	
		720
Liabilities payable in foreign currencies		80
		2,107
ASSETS		
Foreign exchange at market value		74
Investments		2,015
Other assets (net)		18
		2,107

Source: Bank of Canada, *Annual Report* to Minister of Finance and Statement of Accounts for the year 1949.

The commercial banking system of the country is dominated by the ten chartered banks (so called because they all operate under Dominion government charters). Three of these

[1] Canadian bank-note currency is issued in dollar denominations with coinage in cent denominations. At present the rate of exchange is $C1.10½ = $US1.00 and £1 = $C3.10¾. Bank of Canada notes are issued in denominations of $1, $2, $5, $10, $20, $50, $100, and $1,000. Subsidiary coinage with limited legal tender privileges are issued by the Royal Canadian mint in units of £1, £5, £10, £25, £50, $1.00.

banks have more than 500 branches each[1] and conduct a nation-wide business. Four of them have over 100 branches each and conduct business in all parts of the country. Two banks with more than one hundred branches each limit their activities to the French-speaking areas. Barclays Bank (Canada) has three branches only and its business tends to be dominated by international financial transactions.[2] All these banks are members of local and provincial clearing houses and there is a final central clearing with the Bank of Canada in Ottawa.

In addition, the Montreal City and District Savings Bank, which is incorporated by the Dominion Government under the Quebec Savings Bank Act, carries on an active business in and near Montreal. While its activities consist primarily of an active savings and personal business, it does carry a limited number of accounts of commercial institutions in the City of Montreal. These are primarily small shopkeepers.

All the Canadian banks, with the exception of Barclays (Canada) are almost entirely owned by residents, having originally been formed by small groups of local merchants. Some of their securities are owned abroad, but in all cases their head offices are within the Dominion and with the one exception they are controlled by Canadians. In fact the diffuse ownership of their stock has led to effective control being vested in the senior employees of the institutions, who in practically all cases have risen to their present positions within the confines of their own institutions. Despite the fact that most of the

[1] Including sub-agencies.

[2] *At 31 Dec. 1947*

Bank	*No. of branches*	*Deposits $ millions*
Royal Bank of Canada	659	1,956
Bank of Montreal	473	1,763
Canadian Bank of Commerce	496	1,304
Bank of Nova Scotia	313	626
Imperial Bank of Canada	179	383
Bank of Toronto	200	347
Dominion Bank	132	326
Banque Canadienne Nationale	225	365
Provincial Bank of Canada	131	136
Montreal City and District Savings Bank	?	148
Barclays Bank (Canada)	3	31

banks were formed by groups of merchants, they were established solely as financial institutions. Canadian banking has never had direct connexions with other commercial activities and at no time have any banks been predominantly engaged in financing any one field of activity.

TABLE 3

Chartered Banks—Consolidated Balance-Sheet

31 December 1949 (*$ millions*)

DEPOSITS:			
Payable in Canada			7,348
Payable elsewhere			730
			8,078
ASSETS:			
Bank of Canada			
Deposits	542		
Notes	211		
		753	
Short-term securities	1,016		
Foreign securities	242		
Other securities	3,087		
		4,345	
Loans			
In Canada	2,404		
Elsewhere	281		
		2,685	
Other assets (net)			295
			8,078

Source: *Canadian Statistical Review*, Feb. 1950, p. 115.

Thus the Canadian branch banking system has been built up along lines remarkably similar to its English counterpart.[1] The most striking difference in practice between the two countries arises from the fact that there is no 'money market' in Canada and practically no commercial bills. The Canadian banks make their liquid investments in Treasury Bills purchased directly from the Bank of Canada who also deal in such securities directly with other institutional investors. Also the banks are able to borrow directly from the central bank and on a few occasions have done so on a small scale. One minor difference in practice arises from the fact that Canadian banks practically never grant overdraft facilities. Almost all extension

[1] This similarity probably arises from the fact that both groups of institutions have been to a large extent created by the activities of Scottish emigrés.

TABLE 4. *Consolidated Monthly Return of the Chartered Banks for 31 December 1950*

	$ *millions*		
Government deposits:			
By Dominion Government	339		
Provincial Governments	161		
		500	
Public deposits payable in Canada:			
On demand	2,770		
After notice or on fixed day	4,558		
In foreign currencies	101		
		7,429	
Deposits payable to banks and correspondents:			
In Canada	117		
Elsewhere	187		
		304	
Deposits elsewhere than in Canada		633	
			8,866
Acceptances and letters of credit			258
Other liabilities to public			10
Reserves			198
Paid-up capital and surplus, &c.			164
			9,478
Cash reserves:			
Deposits with Bank of Canada		579	
Notes of Bank of Canada		231	
			810
Other quick assets:			
Coin		16	
Notes of and cheques on other banks		450	
Government bank-notes other than Canadian		40	
Deposits with other Canadian banks		1	
Deposits with non-Canadian banks		259	
			766
Securities:			
Dominion Government short-term*		823	
Other Dominion Government		2,256	
Provincial Government short-term*		117	
Other Provincial Government		299	
Canadian Municipal		194	
Public securities, other than Canadian		193	
Other securities		405	
			4,287
Loans:			
Call and short loans in Canada†		134	
Call and short loans elsewhere†		100	
Current loans in Canada		2,651	
Current loans elsewhere		247	
Provincial Governments		41	
To Municipalities		84	
Non-current		1	
			3,258
Bank premises, &c.			106
Acceptances and letters of credit			258
Other			11

* Securities maturing within two years. † Call loans and loans maturing within thirty days. *Source*: The *Canada Gazette*, 3 Feb. 1951.

of bank credit takes the form of the creation of deposit against fixed loans.

Table 4 shows in more detail the business of the chartered banks. From this it can be seen that the Canadian banks carry a surprisingly large proportion of notice deposits. Even when allowance is made for the number of these accounts which are in fact used as if they were current accounts, more than half the public deposits payable in Canada held on the books of the Canadian chartered banks are savings and deposit accounts.

A glance at the assets side of this consolidated balance-sheet indicates the effect of the absence of any money market in Canada. The liquid assets of the Canadian banks, other than cash reserves, consist almost entirely of notes of, cheques on, and deposits with other banks. Even so, the total of these items is less than the total cash held by the banking system and the cash reserve ratio is less than 10 per cent. of deposits. Even the short-term government securities held by the banking system amount to less than 10 per cent. of total deposits and the definition of short-term security for the Canadian banking system extends up to two years. The main source of bank investment today consists of government securities which are almost one-third larger than investments in loans and advances.

The Canadian deposits held by the chartered banks are analysed in more detail in Table 5.

TABLE 5. *Chartered Banks*

Annual Classification of Public Demand and Notice Deposits in Canada at 30 September 1950

Size of deposits	*Demand*		*Notice*		*Total*	
	Number ('000)	*Amount $ millions*	*Number ('000)*	*Amount $ millions*	*Number ('000)*	*Amount $ millions*
$1,000 or less	827	180	6,170	994	6,994	1,174
$1,000 to $5,000	158	347	817	1,730	975	2,077
$5,000 to $25,000	48	478	131	1,099	179	1,577
$25,000 to $100,000	10	456	7	286	17	742
Over $100,000	3	1,379	1	463	4	1,842
Adjustment	—	−131	—	10	—	−121
TOTAL	1,043	2,709	7,126	4,582	8,169	7,291

Source: Bank of Canada, *Statistical Summary*, Dec. 1950.

It will be seen that the majority of the deposits are of sums less than $1,000 and that such accounts provide the great bulk of the notice deposits in number, and a considerable part of the total amount held on such account. Even so, more than half the total volume of notice deposits is held in accounts of between $1,000 and $25,000. While the largest number of demand deposits are for less than $1,000, more than half the total volume is held in amounts of over $100,000. In general it might be said that practically all the commercial and business accounts are held in the form of demand deposits and a large number of active banking accounts of salaried and professional people who are paid by cheque are in the form of such accounts. Notice deposits consist primarily of the liquid savings of those who receive their income in the form of cash payments such as wage-earners and the savings accounts of professional people and salary earners. It is quite common for members of the latter group to have two accounts, one a current or demand account, and the other a savings or notice account. It is also fairly common for Canadians to try to use their savings account as fully as possible. As can be seen by a comparison with Table 7, the average interest paid on such accounts was about 1¼ per cent. Consequently there is a tendency for a conflict to develop between the depositor and the bank manager, the depositor wishing to hold as much as possible in his savings account and as a result to use it to the maximum, while the bank manager tries to limit the total of such accounts and the consequent demands on them as much as possible, though he does not wish to discourage his customers so much that they will transfer their business to another 'friendlier' bank.

Table 6 shows the last annual classification of bank loans in Canada. From this it can be seen that bank lending to private individuals accounted for under 20 per cent. of the total outstanding and of this more than half was backed by collateral in the form of stocks and bonds. Less than 15 per cent. was lent to financial institutions to provide bank finance for security and similar transactions and to government and other public services. The major recipients of assistance from the banks were industrial and commercial borrowers (including agriculture); they accounted for almost 70 per cent. of the total loans

TABLE 6

Chartered Banks

Annual Classification of Loans in Canada at 30 September 1950

Borrowers	*Amount $ millions*	*Per cent. of total*
I. Government and other public services:		
1. Provincial Governments	24	
2. Municipal Governments	91	
3. Religious, education, &c., institutions	33	
	148	5·8
II. Financial:		
1. Investment dealers, &c. (call and short)	101	
2. Trust, loan, mortgage, &c., institutions	86	
	187	7·2
III. Personal:		
1. On the security of stocks and bonds	244	
2. Other	218	
	462	18·0
IV. Agricultural, industrial, commercial:		
1. Farmers	256	
2. Industry	585	
(*a*) Chemical and rubber products	(29)	
(*b*) Electrical apparatus and supplies	(14)	
(*c*) Food, beverages, and tobacco	(123)	
(*d*) Forest products	(76)	
(*e*) Furniture	(16)	
(*f*) Iron and steel products	(54)	
(*g*) Mining and mine products	(26)	
(*h*) Petroleum products	(23)	
(*i*) Textiles, leather, and clothing	(139)	
(*j*) Transportation equipment	(30)	
(*k*) Other products	(55)	
3. Public utilities, transportation, &c.	54	
4. Construction contractors	123	
5. Grain dealers and exporters	93	
6. Instalment finance companies	96	
7. Merchandises	436	
8. Other business	135	
	1,778	69·0
TOTAL	2,575	100·0

outstanding. Within this classification almost one-third went to provide finance for industry and slightly over one-third went to provide working capital for merchants and instalment finance (hire purchase) companies. From this it is apparent that Canadian bankers are still imbued with 'orthodox' traditions in the consideration of their loan activities.

TABLE 7

Current Operating Expenses and Earnings of Canadian Chartered Banks

(*Financial Years Ending in 1950*)

$ *millions*

Current operating earnings:	
1. Interest and discount on loans	125
2. Interest dividends and trading profit on securities	101
3. Exchange commissions, &c., and other	56
	282
Current operating expenses:	
1. Interest on deposits	58
2. Remuneration to employees	102
3. Provision for taxes	21
4. Contribution to pension funds	11
5. Provision for depreciation of premises	7
6. All other	38
	237

Table 7 shows the effect of all these transactions on the income and expenditure account of the banking system. Slightly less than half the total income of the banks comes from their loan activities while, on the other hand, less than one-quarter comes from the service charges which they make, the remainder being made up by income derived from their investment portfolios. On the expenditure side, almost half of their total outgoings are for payments to their staff, including contributions to pension funds, the total payments to staff being more than twice as great as interest paid on deposits.

It is extremely difficult to obtain any information regarding the level of interest charged on particular loans. In some cases this is determined, in part, by negotiation between the branch manager and the customer, but if the total income from this source is compared with the total of loans outstanding it can

be seen that loan income amounted to almost 6 per cent. of the value of loans outstanding. This gives some indication of the level of charges which by British standards in 1951 appears to be fairly high.

While as Table 3 indicates the business of Canadian banks is dominated by activities within the Dominion, all the larger banks do a considerable foreign business. They have branches in the larger financial markets. In recent years the development of security markets in Canada has limited the importance of these branches as they were originally established in order to handle the technical arrangements arising out of foreign capital investment in Canada and to arrange for the investment of the overseas reserves of the monetary system. However, the Canadian banks also conduct a considerable amount of real foreign business. In some of the Caribbean islands they dominate the financial scene and in others vie with Barclays (D.C. & O.) for predominance.

In addition to these key institutions there are two Provincial savings banks[1] both of which have a number of branches and do a small amount of personal business. Also there are about 400 *Caisses Populaires* in the Province of Quebec, which are small independent co-operative savings banks and credit bodies which with a few exceptions are all rural organizations.

The Canadian banks have never been allowed to engage actively in mortgage operations. Since Canada was predominantly an agricultural country there was a pressing need for rural development capital. This need has been met by a group of trust and loan companies which have been financed from a variety of sources. They have issued securities both within Canada and abroad, have accepted long-term deposits from the public, and have managed and invested numerous Canadian estates. In 1939 their assets amounted to $427 millions.

The other largest financial institutions are the insurance companies. Foreign insurance companies have always conducted an active business in Canada. However, since the early days there have been a number of local companies. Today some of these organizations have reached considerable size and their activities have spread throughout the world. In fact one firm—the Sun Life—is one of the biggest international insti-

[1] Ontario and Alberta.

tutions. Their activities have largely contributed to the development of Canadian security markets as well as providing a considerable source of private finance, as can be seen from Table 8.

TABLE 8

Canadian Life Insurance Statistics, 1946

$ millions

CANADIAN COMPANIES:		
Domestic insurance liabilities	2,010	
Foreign insurance liabilities	1,485	
Total		3,495
Assets:		
Mortgage loans, &c.	302	
Securities	3,002	
Other assets	355	
Total		3,659
FOREIGN COMPANIES:		
Liabilities		763
Assets:		
Mortgage loans, &c.	12	
Securities	791	
Total		803

Source: *The Canada Year Book, 1948–49*, pp. 1075–6.

The only other important financial agencies are the security dealers who have continuously engaged in a large volume of business in connexion with the capital inflow and the development of domestic security markets. In Canadian companies, dealing, jobbing, and underwriting are all conducted by the same firm. However, they have tended to limit their activities to trading. Investment banking as in the United States or direct investment in securities as conducted by some of the London merchant banks and investment trusts has been left to the insurance and trust and loan companies.

There are well-organized security markets for dealing in industrial securities in Toronto and Montreal and smaller or specialized markets in the other large cities. There are, however, no organized markets for dealing in government securities. On the other hand, all the large security dealers publish daily information on the prices at which they are prepared to buy and sell such securities. With the presence of several large dealers and the publicity given to their offers the Canadian investor can obtain service similar to that obtained with the

presence of a formal organized market. The combination of jobbing and underwriting in individual firms means that the large dealers can almost always supply or absorb any particular government security offered to them without great difficulty. The only cases where difficulties might arise are in connexion with the transactions of the large insurance companies. In such cases the transactions are frequently individually arranged between the large institutions and the security dealers. In these circumstances the banks frequently buy or sell government securities in considerable amounts in order to contribute to the stability of the 'market'.

B. *Banking Legislation*

In Canada the problem of which authority within the federation shall control the banking system was settled clearly under the Dominion's constitution. Section 9 (15) of the British North America Act reserves the regulation of 'banking, incorporation of banks, and the issue of paper money' exclusively to the Dominion Government. The central government has successfully challenged every attempt of the provincial authorities to intervene in this field.[1] There are two Acts which are significant for our purposes: the Bank of Canada Act and the Bank Act. Both of these Acts are traditionally passed for ten-year periods only and expire simultaneously. They provide an opportunity for parliamentary review of the country's financial institutions but also ensure that those engaged in this business will, except in cases of emergency, only be subject to changes in the legal rules governing their business at fairly long intervals and after considerable public inquiry.

The Bank of Canada Act provides for the establishment of a completely nationalized central bank which is administered by an independent, but government-appointed, board of directors. The Bank is now given a monopoly of the note-issue with no reserve requirements. It has power to make loans to banks and to the Dominion and Provincial governments but not to private individuals or firms. It is also free to discount trade and Treasury Bills and to buy and sell securities. Originally it

[1] For instance the numerous attempts of the Social Credit Government in Alberta to implement some of their election pledges in connexion with financial questions.

was called upon to hold the gold and foreign exchange reserves of the commercial banking system, but in 1940 these were handed over to the Foreign Exchange Control Board. Its power to create deposit liabilities is limited to deposits of the other banks, governments, and official agencies.

The Bank Act provides that the term 'bank' can only be used by corporations chartered by the Government under the conditions laid down in it. The chief limitation provided on incorporation is that each institution must have a minimum subscribed capital of $500,000 of which at least $250,000 must be paid up. Once chartered, a bank is free to conduct business anywhere in the country, provided it abides by the provisions of the Act. The most important positive requirement is that it must maintain a cash reserve in the form of deposits with or notes of the Bank of Canada equal to at least 5 per cent. of its total liabilities (the conventional Canadian ratio is 9–10 per cent.). Each bank must also be prepared to make a detailed report on its operations (but not on the private business of any customer) to the Bank of Canada and is subject to inspection by the Inspector-General of Banks—a government officer. The chief negative requirement is the specific prohibition against the granting of loans directly against or on the security of a mortgage, with certain limited exceptions. On the other hand, the Act permits banks to grant loans against warehouse receipts or the security of standing crops. In such cases the bank becomes an absolutely preferred creditor in so far as the pledged assets provide security. For a developing, raw-material-producing country such as Canada this form of bank lending has proved more useful both for the banks and the industrial community than trade bills which are more adapted to a merchanting community like London. In fact loans made against such security are very much akin to some of the present-day London discounting of inland trade bills. Prior to 1935 the banks also had power, subject to certain limitations, to issue notes. This privilege continued after 1935, but the limitations on it were increased until it was extinguished in 1950.

These institutions operating under the legal framework outlined here have provided the Dominion of Canada with the financial services which it is the purpose of this chapter and the next to examine in further detail.

II. *Early History*

A. *Prior to 1900*

Prior to 1800 the only 'banking' done in British North America was merely an extension of the commercial credit activities of the local merchants. The only real financial operations arose in connexion with overseas trade and were carried out in London or, less frequently, in Boston or New York.

The Bank of Montreal was established as the first real bank in 1817. Its founders looked to the issue of bank-notes against loans as their chief source of income. By 1832 seven banks had been established under private charters. When the colonies confederated in 1867 to form Canada there were twenty-eight banks in existence.

The years immediately following Confederation saw a failure to realize the high hopes held by the architects of Canada and progress was slow. However, there was some expansion of the financial system. The total monetary liabilities of the chartered banks rose from $65 millions in 1870 to $350 millions in 1900. More important for the development of the Canadian structure was the development of the banking and cheque habit. The first Canadian bankers had expected that their major liability would be in the form of notes. By 1900 notes accounted for only about 13 per cent. of total bank liabilities. Originally banking had been considered to be almost entirely a direct loan business. It was considered proper for the volume of loans to be equal to the total of notes plus deposits, with the subscribed capital offsetting the other bank assets (this was the situation in 1870 and 1880). However, in the later years of the century the banks began to invest in government securities which were becoming more plentiful as a result of the early development programmes (the Canadian public debt rose from $115 millions in 1870 to $345 millions in 1900). By 1900 the total of bank-note and deposit liabilities exceeded the banks' loans by $70 millions.

This period also saw the firm establishment of the trust and loan companies as a source of agricultural finance. These companies, whose assets had only totalled $3 millions in 1867 had investments of $150 millions by 1900. This meant that the total of their loans was equal to about half the comparable figure for the banks.

B. *1900–13*

The opening years of the present century up to the outbreak of the Kaiser's War covered the most important period of Canadian development. The stream of European immigrants which had been flowing to the United States turned northwards and the prairies were settled. This was only possible after there had been heavy developmental expenditure, particularly in transcontinental railways with a well-developed network of branch lines. This railroad investment provided a market for the rapidly expanding iron, steel, and machinery industry. All these activities created a basis for the first real industrialization of Canada. This rapid expansion was only possible because foreign (chiefly British) industrialists were willing to provide the finance necessary for the investment involved. By 1900 $1,200 millions of foreign capital had been invested in the country, while in the years 1900–14 there was an inflow of $2,500 millions. The level of annual capital imports rose from $30 millions in 1900 to $100 millions in 1905 and to $200 millions by 1910; in 1913 this figure reached $400 millions.

This rapid expansion of business activity created many problems for the banks. Their rapid development during this period led to the general pattern of their activities being established which still exists today. For instance, the number of branches operating increased from 700 in 1900 to 3,000 in 1913 (despite the fact that the country's population only increased from 5·3 millions to 7·6 millions), while in the following thirty-five years the number of branches hardly changed. The volume of business almost kept pace with this rapid physical expansion which was more the result of the geographical expansion of the country than its commercial development. The total deposit liabilities rose from $300 millions to $1,125 millions, while bank loans increased about fourfold from $280 millions to $1,100 millions. During these years the banks were called on to subscribe to very few government securities, which found a ready market overseas.

The Dominion's overseas accounts produced many problems for the banks. In the first place there were many purely technical questions which the banks had to face. Between 1900 and 1913 Canadians received $4,700 millions in sterling, while they made similar payments of only $2,850 millions. There-

fore the Canadian banking system acquired $1,850 millions in sterling which with receipts of $400 millions in 'other' currencies meant that they had to dispose of $2,250 millions of foreign exchange. On the other hand, Canadians made payments of $3,800 millions to the United States while they received only $2,250 millions. These net dollar payments of $1,550 millions plus 'other' currency payments of $600 millions took up $2,150 millions of the banks' receipts, leaving them with about $100 millions which provided the increase in their cash reserves. Naturally, the conduct of these conversion operations meant that the Canadian banks had to establish the relatively large foreign-exchange branches with their widespread overseas connexions and branches, which have been such striking features of the Head Office organizations of Canadian banks. While most of these operations were originally completed in the London market, the banks soon found it convenient to open branches in other centres, particularly New York. This tendency was strengthened by the numerous direct financial relations between Canadian and United States concerns. For these reasons direct international connexions were established even when Canada was a 'sterling area' country. Thus the institutional reasons which kept so many countries in the sterling area during the nineteen-thirties were not applicable in the Canadian case.

The capital inflow brought a number of other technical problems to these departments and their subsidiary agencies. In many cases the banks were the only institutions available to arrange for the floatation of overseas securities. These arrangements sometimes went so far as to involve the banks in making loans to industry for capital development, these loans being subsequently repaid out of the proceeds of securities marketed by the banks on the basis of the assets created by the issuing companies out of the proceeds of the bank loans.

Because the capital inflow increased rather erratically while the accompanying current account deficit rose steadily the banks provided an equilibrating agency. In years of large capital inflow their foreign reserves were allowed to increase, while in years when the capital inflow fell off or only increased slightly these reserves were run down. This development tended to increase the importance of the position of foreign

reserves for the Canadian banking system. They continued to be of primary importance to the banks until conditions changed in the nineteen-thirties and they were taken over first by the Bank of Canada and later by the Government. Today the foreign reserve position provides no worries for the bank managers but only for the Minister of Finance. Like his British counterpart, he tends to build his budget policy on the foundation of the requirements of overseas finance.

The Canadian experience during this period provides one of the classic cases in the study of international adjustments, and the banks played their full role in the story. Prior to 1900 Canada had been a 'mature debtor' with an annual export surplus of $10 millions: after the turn of the century this position was reversed and in the period covered here the country had an import balance of $1,300 millions. In this process either before or after a Canadian company floated an overseas security issue it received a Canadian deposit against an advance from the bank or the surrender of the foreign exchange proceeds. Either immediately or eventually the bank received a countervailing addition to its overseas assets. However, due to the expansion of deposits arising from this process there was need for an increase in bank cash and part of the foreign balances were used to purchase gold for import. During these years there was an inflow of $123 millions of monetary gold.

The increase in bank deposits and their expenditure largely on capital investment led to a rapid increase in Canadian incomes. This was followed by a rise in domestic prices and improvement in the terms of trade. As might be expected, this resulted in a more active encouragement of imports than of exports. It should not be ignored that the Canadian capital development was based on the development of export resources. However, the price movements provided a more immediate stimulus to import demands, consequently an import surplus soon developed. The relevant indexes are shown in Table 9.

Throughout these years the other financial institutions expanded rapidly. In many cases they made foreign security issues which provided them with funds enabling them to make direct loans in Canada for the development of agricultural production. Between 1900 and 1913 the liabilities of the trust and loan companies increased from $150 millions to $480 millions.

TABLE 9

Canadian Index Numbers (1900 = 100)

	1905	1910	1913
Population	113	132	144
Bank deposits	170	300	375
Wage rates	113	134	149
Domestic prices	121	146	162
Import prices	98	105	114
Export prices	108	126	134
Terms of trade	110	120	117

C. *The War and Post-war*

Canada's participation in the Kaiser's War was, to a large extent, financed by government borrowing. The national debt increased from $315 millions in 1913 to $1,575 millions at the end of 1919—a small increase in terms of present-day magnitudes but large for a young and newly developed country. Of this increase a small part ($200 millions) was purchased directly by the banks. A further considerable proportion was financed by bank loans, which increased from $1,100 millions to $1,550 millions. This rise in bank assets, plus an enlargement of bank cash as a result of operations under the Finance Act[1] and an increase in overseas balances as a result of allied purchases in Canada, led to an increase in bank deposits from $1,125 millions to $2,200 millions and a doubling of the note issue to a figure of $220 millions.

These changes directly reflected the war-time financial developments which had as their more indirect result the general inflationary situation with which the war ended. The wholesale price index increased by a little over 100 per cent. in the years 1914–19. However, perhaps more important for the future development of banking institutions was that the banks emerged from the war with security holdings as a significant element in their balance-sheets. Their holdings of all types of securities increased from $30 millions in 1913 to $470 millions in 1919. Simultaneously, the ratio of loans to deposit and note liabilities fell from 90 per cent. to 75 per cent., while the cash ratio rose from 11 per cent. to 15 per cent. and the security ratio from 1 per cent. to 20 per cent.

[1] See below, pp. 124–5.

The war was followed by the immediate post-war boom and recession, then the prosperity of the twenties and the depression of the thirties. In Canada these movements were quite wide, due to the dependence of the economy on foreign trade. Exports which totalled $1,300 millions in 1920 fell to $800 millions in 1921. By 1928 they had risen to $1,400 millions and then they fell steadily to $500 millions in 1932. These movements were reflected in the movements of the national income, which fell from $5,500 millions in 1920 to $4,200 millions in 1921. It then rose steadily until it reached a peak of $6,300 millions in 1928 before collapsing to $3,400 millions by 1932.

These movements occurred with only minor changes in the banking system. In 1930 the totals of loan and deposit liabilities were practically the same as they had been in 1920. There had been a slight decline in the issue of bank-notes from $230 millions to $160 millions. The cash holdings of the banks fell, however, from $365 millions to $230 millions. This involved a fall in the reserve ratio from 14 per cent. to 9 per cent. After having fluctuated considerably in the previous history of Canadian banking this figure was destined to remain very close to 9 per cent. for the next twenty years. The only other significant change was a further increase in investments from $330 millions to $500 millions.

While there were relatively few changes in the position of the banks during this period, the other financial institutions expanded rapidly. The prosperous markets for agricultural exports seemed to offer opportunities for rural expansion, and the cities experienced a considerable building boom. The trust and loan companies participated fully in this expansion and their willingness to make loans contributed in part to the rise in the price of agricultural properties. In the period 1920–31 the total amount of mortgage and other credit outstanding probably increased by about two-thirds. This expansion was much greater than in other fields of investment and in excess of the true potentialities of Canadian agriculture.

III. *Conclusion*

By 1930 the structure of the Canadian banking system had become firmly established. The widespread branch system

operating on a 9 per cent. cash reserve ratio with a considerable volume of overseas business was to remain unchanged until the present day. As yet there was no effective government intervention to influence financial policy. Provided the banks met the rather stern administrative requirements of the Bank Act they were completely free of government interference or control and almost immune from influence. The fact that a large proportion of their reserves were invested overseas meant that, if anything, they were more subject to the influence of overseas financial markets than to the requirements of domestic economic needs. In fact Canada was a typical 'gold standard' country. The next twenty years were to see changes in the economic background and the development of instruments which were to 'nationalize' the Canadian banking system in terms of making it subject to government influence and control, if not in terms of ownership.

Appendix to Chapter 3

MONEY SUPPLY AND RELATED BANK ASSETS

The following is an excerpt from Appendix B of the Bank of Canada *Annual Report* for 1947:

In measuring the volume of money one must decide which categories of bank deposits should be classed as 'money' and which, by their nature, should be regarded more appropriately as part of the public's other liquid asset holdings such as Government bonds. Generally, it has been satisfactory to classify bank deposits as 'money' if cheques may be drawn against them. In other countries this criterion has seemed to work fairly well because cheques may not be drawn against savings deposits. In Canada, however, cheques are, in practice, drawn freely against savings deposits and this has always posed an awkward problem when trying to assemble volume of money statistics. To omit all savings deposits of chartered banks would ignore the obvious fact that for many people a savings account is an active chequing account which is very similar to a current deposit. On the other hand we know from available information that of the total amount on deposit in savings accounts in Canada, much the larger part is, in practice, inactive. Chartered banks pay interest on the minimum quarterly balances in personal savings accounts, i.e. on the sum which has been left undisturbed for the quarterly period; from the amount of interest which is actually paid on this basis as compared with the nominal rate of interest, it is apparent that the aggregate minimum quarterly balances in personal savings accounts are about five-sixths of the total of such deposits at the present time.

It is therefore felt that a more realistic picture of monetary developments in Canada—and one more comparable with the usual presentation of similar statistics in other countries—is obtained by omitting the minimum quarterly balances in personal savings deposits and non-personal notice deposits, from volume of money statistics. It has seemed preferable to exclude these deposits from the volume of money on the basis that they are inactive in practice rather than to include them on the grounds that they are potentially active because cheques may be issued against them.

The published returns of Canadian chartered banks include among Assets 'Cheques on Other Banks' which represents the amount of cheques which have been credited to the deposit account of the payee but not yet cleared against the deposit account of the drawer. To the extent of such items in 'float' there is therefore duplication in the figures of bank deposits. In the table contained in this Appendix we have deducted 'Cheques on Other Banks' from the figure of chartered bank deposits, in order to eliminate this duplication. A similar deduction is made in the United States in calculating their commercial banks' 'Demand Deposits Adjusted'.

Government deposits are given different treatment in different countries so far as volume of money statistics are concerned. In various countries including the United States the most commonly used figure of bank deposits excludes Government deposits. On the whole it appears preferable to exclude Dominion Government deposits from the volume of money.

4

THE BANK OF CANADA

I. INTRODUCTION

1. *The Background*

As indicated in Chapter 3, the Canadian chartered banking system had become well established by 1930 as a typical branch banking system. It had developed all the technical instruments required to provide the country with adequate banking services. Yet there was no central agency designed to influence the country's financial climate. The general level of credit available was more a result of the state of the banking system's foreign reserves than of any direct internal considerations. Under the political conditions existing in the nineteen-thirties this situation was not considered satisfactory. The extreme severity with which the depression struck Canada gave strength to the claims of those who felt that such an institution was necessary. Fortunately, the development of financial institutions had provided instruments which a central bank operating almost on traditional 'Bank of England' lines could use to control the banking system. Before reviewing the development of the Bank of Canada it is desirable to pause and examine the conditions which are prerequisite for the operation of a central bank and the extent of their development in Canada.

2. *Conditions for the Successful Operation of a Central Bank*

The first condition which is essential for the successful operation of a central bank is that the commercial banks must operate with a reasonably constant ratio between some asset or assets and the volume of deposit and note liabilities. Traditionally, as in England, the assets on which this ratio is based are the deposits with and notes of the central bank held by the commercial banks. In other cases it has been between such central bank assets plus foreign reserves (e.g. Australia and South Africa). It is immaterial what assets are kept in such a constant ratio. It is sufficient that some assets are maintained

as a constant fraction of deposit liabilities and that if this ratio changes for any reason the banks take active steps to alter the volume of either (or both) the particular assets or deposits.

The second essential condition is that the central bank by its own action can alter the volume of the particular assets used in maintaining this ratio. If such a ratio is maintained it is possible for the central bank to forecast changes in the level of deposits from known changes in the central bank cash or other relevant assets held by the banks. Only if the central bank can alter the volume of this particular asset or group of assets can it influence the action of the commercial banks. It is this requirement which usually renders central banks impotent in undeveloped economies. In such cases the commercial banks usually maintain a ratio based on foreign reserves and, perhaps, central bank cash. If the central bank cannot control the volume of foreign reserves (as it usually cannot) it is not in a position to determine the action of the private institutions.

It is most unusual, if not unknown, for a central bank to be able to alter the 'reserve' asset at will. In the cases where the most satisfactory ratio for purposes of control (between cash and deposits) is maintained, the central bank can only alter the cash reserves of the banking system by buying and selling some one or group of its own assets. Usually government securities (including short-term Treasury Bills) are used in such operations. If the central bank is to engage in such operations successfully there must be adequate markets for the securities traded. It is not satisfactory if every significant group of transactions by the central bank leads to a considerable alternation in the prices of the relevant securities. Therefore if the central bank is to engage successfully in 'open market operations' there must be a well-developed capital market in which the activities of the central bank play only a minor role.

Before such adequate capital markets can develop there are certain conditions which must be met. In the first place there must be a relatively constant flow of funds of considerable volume for investment. Only from such a source can the demand side of the market be supplied and can it have a realistic existence. Second, there must be a large volume of business in existing securities. If the chief business consists primarily of accumulation of private funds by intermediaries and purchase

of new securities by private investors and such intermediaries (this class of business typified the Edmonton market in oil securities during most of the nineteen-thirties), any significant transactions in existing securities will lead to large price movements. Third, to ensure stability there must be a considerable volume of short-term lending and borrowing. The existence of borrowers and lenders engaged in such transactions ensures the existence of operators who are in possession of liquid assets and who will be prepared to move into the medium or long-term markets if the prices of such securities fall unduly. Conversely, if their prices rise unduly there are opportunities for investors to invest their money for short periods until the market returns to more 'normal' levels. Fourth, a satisfactory capital market must be dependent on domestic sources of funds. If it is based on foreign investors it will be subject to severe crises whenever the inflow of foreign funds diminishes, in fact any slight 'recessions' will frighten the foreign investors and convert such 'recessions' into 'crises'. Conversely the fact that such markets tend to be 'marginal' and 'speculative' markets for the foreign investors will tend to accentuate any 'booms' which may develop. On the other hand, if the market is based on domestic sources of funds and if the lenders in this market are also willing to invest abroad, the existence of such capital exports will give stability to the market. Any tendency for domestic prices to rise will encourage capital export and any declines will encourage investors to lend in the internal market, thus maintaining prices. Fifth, the existence of well-established institutions will give an element of 'credit-worthiness' to the market, and this is a further source of stability in times of possible crisis. Sixth, some source of 'final credit' will lead to a knowledge that in times of crisis holders of some securities, at least, will be able to sell them and obtain funds to meet their commitments or to purchase the securities of other investors who are in difficulties. Such a condition will discourage the development of speculative crises and ensure greater stability (cf. the position of the Bank of England as a 'lender of last resort'). These requirements are essential if there is to be the price stability which is essential for successful central bank operation in the market.

Finally, if the central bank wishes to control the private insti-

tutions they must be both willing and accustomed to having their assets influenced by some central institution. If they are able and desire to take action to offset the influence of the central bank that body's activities are made more difficult. This element of not only reacting directly to the actions of the Bank of England but also being willing to act on a 'hint from headquarters' has contributed markedly to the success of the London markets. Conversely, in the U.S.A. the ability of and the willingness of the member banks to borrow from or repay loans to the Reserve Banks has markedly increased the difficulties of these institutions in their attempts to alter cash reserves by 'open market' action.

3. *The Canadian Situation in 1935*

(*a*) *The Finance Act*

Almost by accident the Canadian banks were accustomed, by 1935, to depend on government sources for a considerable portion of their cash reserves. Even in the period 1900–14 the Canadian banks considered their 'final reserves' to be their holdings of both gold and Dominion notes. These notes were issued by the Federal Government and consisted partly of an issue against which a gold reserve was maintained and partly of a fiduciary issue. At this period the discussions of banking policy in North America were centred on the desirability of an 'elastic' currency system which should be designed to enable the banks to 'meet the legitimate needs of trade'. During 1914 the Dominion's finances were directed by a Minister of Finance who had a long and distinguished career as a commercial banker and who was a firm believer in the 'legitimate needs of trade' theories of banking. When the bankers and the Government realized in August 1914 that an outbreak of war might precipitate a 'run' on the banks the Government was prepared to take action to enable them to meet this exigency without embarrassment. At the same time it was thought that the mobilization for war would involve heavy government expenditure and expansion by munitions and similar industries. In the first stages, at least, the banks would be called upon to finance this increased expenditure.

In order to enable the banks to meet these demands on their

resources, the Government passed the Finance Act. Under this Act the banks were permitted to borrow Dominion notes from the Department of Finance. They were allowed to include these borrowed notes in their cash holdings for the purpose of determining their reserves. The only requirement was that they should lodge Dominion government securities with the Department as security for their note borrowings. The interest paid on these loans was always less than the prevailing market rate for securities eligible for deposit. The Department of Finance, in turn, was empowered to issue additional fiduciary notes backed by the securities lodged by the banks. In this manner the country was ensured of an elastic supply of currency. However, there were few opportunities open to the Treasury Board (the agency of the Department responsible for these operations) to 'manage' the supply of currency.

The banks immediately availed themselves of the privileges open to them under this Act. In 1914 they borrowed only $12 millions to meet the immediate needs. The increase in their foreign reserves resulting from Allied expenditure in Canada enabled the banks to allow these loans to decline to $3 millions in 1916. However, the financial needs of the late war and post-war boom in Canada required the banks to increase their borrowings until they reached the peak figure of $124 millions in 1920. By 1925 they had declined to $21 millions. The prosperity of the later nineteen-twenties induced the banks again to increase their borrowings to $111 millions and in the ensuing depression they fell off to $19 millions by 1931. In 1934 prior to the establishment of the Bank of Canada they had risen again to $39 millions, having reached $46 millions in 1933.

Thus it can be seen that Canada had an 'elastic' currency system. However, there was no control over its 'elasticity'. In fact the system was so designed that the cash reserves of the banking system were allowed to increase freely in times of boom and contract in times of depression! The important point to be emphasized is that by 1935 the country's bankers were dependent on government sources for an important portion of their cash reserves. Further, they were on terms of intimate co-operation with the Treasury Board. It took only a little tactful management to persuade them to transfer these

co-operative sentiments to the newly established central bank. One principle that has always dominated the attitude of the Dominion Government (and the Bank of Canada) has been tact. No financial action has ever been taken without consulting and, if necessary, pacifying the country's bankers.[1] Conversely, the bankers have never attempted to obstruct the Government's policy or engage in 'strike action'.

(*b*) *The Development of Capital Markets*

Prior to the Kaiser's War, Canada, like most undeveloped and dependent economies, did not have an adequate capital market. For purposes of central bank control it is usually the market for bonds, rather than all types of securities, which is significant. By the nature of its responsibilities such an institution is practically required to deal only in the less speculative securities. In fact it usually limits its holdings to bonds issued by its own government or its dependent territories. It was the bond section of the Canadian capital market which was least developed prior to 1914. Whereas in the years 1911–14 the total sales in Canada of newly issued bonds averaged only $40 millions per year, $220 millions per year were sold in the United Kingdom and $40 millions in the United States. Thus 85 per cent. of the country's requirements of this type of capital had to be obtained abroad. During the war the situation altered considerably. There was a slight decline in the volume of overseas sales which averaged $230 millions per year between 1915 and 1919. On the other hand, the volume of domestic sales increased rapidly until they reached a peak of $725 in 1918, averaging $440 millions in these five years. In the post-war period this trend continued. In the years 1920–35, with the exception of 1931 when total transactions reached $1,100 millions, the sales of newly issued bonds on the Canadian market were between $300 millions and $400 millions, while overseas sales declined slightly to $200 millions. This continued addition to the stock of domestically held securities and

[1] Certain actions such as the introduction of exchange control in 1939 provide an obvious exception to this general statement. However, even in this case, as soon as it was possible, there was close and friendly co-operation between the Foreign Exchange Control Board and representatives of the banks in working out the administrative arrangements and in the early numerous amendments to the Foreign Exchange Order and the Board's regulations and instructions.

the growth of financial institutions such as security dealers and insurance companies with a large Canadian and foreign business furthered the development of an active and stable market in outstanding securities. The change in the country's overseas capital accounts also furthered the development of the Canadian securities market. Between 1919 and 1931 there was a continuation of the net capital inflow. After 1931 Canada reached the position of a 'mature' debtor and a net capital outflow developed. These overall movements were reflected in security transactions. The foreign sales of securities never reached their pre-1913 levels, but until 1929 net sales of securities were between $100 and $150 millions per annum. After jumping to $300 millions in 1930 the picture changed and until the outbreak of the Second World War net purchases of securities (including redemptions) exceeded sales in every year. These payments were predominantly repayments, but there was a considerable volume of foreign lending by Canadians, particularly investment in South and Central American utility and transport companies. This change further strengthened the Canadian bond market and made it a more suitable field for central bank operations. In fact, by 1935 the Canadian capital market had become an 'adequate' one in the sense referred to above.

(*c*) *The Canadian Banking Situation*

Prior to 1930 the Canadian banks tended to consider their holdings of cash and their foreign reserves as their liquid assets. We have already seen how they were, in part, dependent on an official source for their supply of cash. So long as Canadian security markets were not well developed they were forced, for their other liquid resources, to depend on investments acquired in foreign markets. Even after the Canadian markets had developed to a position where they might have provided adequate liquidity the banks continued their practice of foreign investment. The large volume of exchange business gave an additional usefulness to these reserves beyond their purely 'liquid' attributes and diminished any tendency which the banks might have had to turn their attention to the Canadian markets. So long as Canada and the countries where the important markets were located (London and New York) were

on the gold standard, investments in them were as liquid in Canadian terms as they were in foreign terms. However, the final abandonment of the gold standard by Canada in 1931 and the British departure from gold in 1931 removed this element of liquidity. In future, no matter how liquid their investments might be in foreign markets, the banks were faced with the possibility of loss on conversion of their assets into Canadian funds. This risk was increased by the fact that the only times when they would have to call on such assets would be times of difficulty in Canada when Canadians were attempting to convert their deposits into cash or calling on the banks for extended credit. Given the nature of the Canadian economy, such a situation would be most likely to arise when the country's export trades were depressed. Such a situation would be one where, with a free foreign exchange market, the Canadian dollar would be depressed. As a result the banks were forced to turn to the Canadian markets for their source of liquidity. Consequently their foreign loans declined from approximately $500 millions in 1930 to about $250 millions in the period up to 1935 and to $200 millions in that year. This drift was most marked in the volume of their foreign call loans which had been between $200 millions and $300 millions prior to 1930 and which declined to approximately $100 millions in 1930–4 and to only $50 millions in 1935.

It might be noted that such a change was either not open to or not required by the banking institutions of the other Commonwealth countries. Canadian banks were required to engage in both the London and New York markets. A large part of their foreign exchange business consisted of converting the country's net sterling income into United States dollars in order to meet the continuous trading deficit with that country. In such circumstances once the pound and the United States dollar ceased to be exchangeable at a fixed rate, the banking institutions were faced with the alternative of limiting their activities to one market and trying to maintain parity between the Canadian dollar and the currency in which their investments were made or of maintaining 'balanced books' in all currencies, with the inevitable result that the Canadian dollar tended to fluctuate between the two major currencies while following a somewhat independent path against both of them.

The first alternative would have made Canada a full member of either the sterling or dollar area. It would have meant that the banks were open to a loss if they should be unable to hold the Canadian dollar stable against the particular 'key currency' chosen. Also in the Canadian case it would have meant losing a part of the Canadian foreign exchange business to the foreign correspondents of the Canadian banks. The second alternative protected the position of the Canadian banks and also allowed them to retain the major part of the financial business arising out of Canada's trade. It was also in line with the general political desires of the Canadian Government whose Prime Minister was in many ways a financial nationalist despite his Imperialist protestations. Such alternative courses were not open to the other Commonwealth countries. In some cases, such as Australia, practically all financial relations were with the United Kingdom or other sterling area countries and therefore the problem of being forced to choose between stabilization against one of two currencies or independence never arose. In other cases, such as Malaya, there were no satisfactory domestic capital markets and therefore stability against one currency had to be chosen; in these cases membership in the sterling area was the obvious choice.

This action of the Canadian banks in following a course of financial independence and transferring their liquid investments to Canada had two important results. It meant that they were completely dependent on Canadian financial conditions in the determination of their policies. Thus they were more subject to official influences when these were exerted. They were also in a position where they would be more affected by the action of a central bank, if it were in existence, than when they were also dependent on the conditions in foreign capital markets. On the other hand, their increased interest in the Canadian capital market obviously increased the volume of business conducted in that market. It tended most of all to increase the volume of short-term business and therefore the liquidity of the market. Finally, it gave an increased air of respectability and therefore of 'credit worthiness' to the market. The changes in the market resulting from this change in bank policy provided the last development required to make the market really 'adequate'.

All these developments would have been of limited value if the banks had continued in their pre-war practice of allowing their cash reserve ratio to fluctuate. However, by 1930, as we have seen, they had settled down to a 9 per cent. cash reserve. Since then they have followed this practice in the 'best British tradition'. Therefore once a central bank was established and able to buy and sell securities conveniently it was able to alter the cash reserves of the banking system. The adoption of a stable cash reserve ratio meant that such alterations would directly influence the volume of bank deposits. That is, a central bank would be able to influence the country's money supply.

The developments between 1930 and 1935 brought the Canadian banks under domestic influences and finally created an adequate capital market. Therefore the Canadian chartered banks were open to central bank control and there was a field available for the bank to manœuvre in. The time was ripe for the establishment of a central bank.

II. THE ESTABLISHMENT OF THE BANK OF CANADA

1. *The Background*

Even if the situation was ripe for the establishment of a central bank, it did not necessarily follow that one would be created. In fact it is impossible to give any clear and simple outline of the forces which actually led to its creation. In many respects it is true to say that it was created because it was 'the thing to do'. The economic experts of the League of Nations were encouraging all countries to establish central banks. Consultation between central bankers was becoming one of the recognized methods of international co-operation. Finally, Canada had been faced with serious economic problems and it was felt that a central bank 'could do no harm'.

Certainly the Bank of Canada was not created in order to carry out a vendetta against the private bankers, as was partly the reason for the establishment of the Commonwealth Bank of Australia. The Prime Minister was one of Canada's outstanding industrialists and a firm believer in orthodox approaches to economic problems. The Minister of Finance was likewise a conservative financier. Even the 'stormy petrel' of

the Canadian cabinet—the Minister of Trade and Commerce —was a devoted exponent of private capitalism. His frequently colourful activities were all designed to foster free enterprise competition and to obstruct monopolistic combinations in the best Marshallian traditions. In fact the Canadian Conservative Government was dominated by 'Gladstonian Liberals' (with the qualification that they were protectionists). Even the Liberal opposition were 'Lloyd George Liberals'. The small 'Socialist' and 'Easy Money' minority was hopelessly divided and exerted very little influence over government policy.

On the other hand, the chartered banking system had not followed policies which would inevitably create violent oscillations in the volume of credit as was the case in South Africa prior to the creation of the Reserve Bank as a guardian of the national economy. Despite the potentially volatile structure of the banking system based on the Finance Act and the extremely cyclical effect of international influence on Canadian exports and hence on the entire Canadian economy, the banks had reacted with commendable conservatism. Table 1 indicates that

TABLE 1

Canadian Banking Statistics, 1926–35

(*Average of Month-End Figures*)

$ *millions*

	1926	*1929*	*1932*	*1935*
Notes	169	178	132	126
Canadian deposits	2,003	2,419	2,010	2,128
Cash reserves	197	212	186	216
Loans in Canada	1,161	1,722	1,304	1,045
Securities	533	499	696	1,044

Source: Bank of Canada, *Statistical Summary*.

there was some fluctuation in the activities of the Canadian banks. However, when these movements are compared with the extreme changes which occurred in the underlying economic conditions arising from variations in the export income of the country already indicated it is obvious that the banks were not following an independent 'boom and bust' policy which required regulation.

Neither did the Government lack a satisfactory financial

agent as had been the case prior to the adoption of the United States Sub-Treasury system. The Bank of Montreal had long acted as the Government's banker. It was a thoroughly sound and reputable institution. It had developed a widespread system of Canadian and overseas branches which gave the Government all the facilities it required. Finally, its position as the oldest of the Canadian banks and its traditional 'right' to be the Government's banker prevented any feelings of opposition or jealousy being felt by the other institutions.

It was true, however, that Canadian economic conditions were not satisfactory. In an article appearing in the *Journal of Political Economy*[1] in 1932, Professor C. A. Curtis centred his attention on the need for some agency to intervene in the foreign exchange markets to eliminate the short-term fluctuations in the value of the Canadian dollar. He also drew attention to the basic weaknesses of the system arising out of the operation of the Finance Act. This article gave the final incentive to the Canadian Government to adopt the typical Canadian reaction when faced with a difficult problem. They appointed a Royal Commission to investigate it. Lord MacMillan, who had only recently completed his work on a similar British commission, was appointed Chairman. The 'Canadian MacMillan Report', like its English predecessor, was a masterly review of the Canadian financial system. Among other recommendations, it advocated the establishment of a central bank. Its reasoning followed the typical orthodox lines. The authors indicated that a Canadian central bank could establish an effective and influential short-term money market despite the repeated disappointments which had followed previous attempts to do this in other countries which did not have international financial centres. It is perhaps fair to say that the history contained in the report is more valuable than the logic behind its recommendations. In fact the minority report of one of its members opposing the creation of a central bank now appears more consistent with the facts of the report than the majority view.

2. *Constitution of the Bank*

The original Bank of Canada Act envisaged the creation of a 'traditional' type of central bank. The new institution was

[1] 'The Canadian Monetary Situation', xl. 314–37.

intended to be an independent bankers' and government bank. It was expected that any influence it might exert on the financial system would be primarily through the short-term financial markets.

The Bank was to be a privately-owned corporation with an authorized capital of $5 millions. In order to preserve its independence it was provided that no individual could hold more than $2,500 of the Bank's capital.[1] In addition the chartered banks were prohibited from purchasing shares.

It was intended that the bank should have a monopoly of the country's note-issue. However, in order to cause as little inconvenience as possible to the chartered banks, who still had the right to issue notes of $5 denomination and over, they were only required to withdraw part of their outstanding issues by 1945.[2] In the 1944 amendment to the Bank Act they were called on to withdraw as many as possible of their outstanding notes by 1950. At the end of that year they would be required to make a payment to the Bank of Canada equal to their outstanding note-issue and the Bank would assume liability for the outstanding notes.[3]

The Bank of Canada was given the power to make loans with a maturity not exceeding ninety days to and hold deposits for the Dominion Government, Canadian Provincial and foreign governments, Canadian chartered banks and foreign central and private banks, and official agencies of Canadian and foreign governments.[4] In the best orthodox traditions it was prohibited from engaging in similar transactions with private individuals and firms.

It was authorized to buy and sell Dominion and Provincial securities with a maturity of less than two years without restriction. Securities with a longer tenure could only be held up to an amount equal to three times the Bank's paid-up capital.

[1] Due to the over-subscription of the capital issue no share allotments were made in excess of $1,500.

[2] They were required to reduce their note-issue to an amount equal to not more than 25 per cent. of their paid-up capital on 11 March 1935. This meant a reduction from $125 millions to not more than $48 millions. In fact by 1945 the total issue had fallen to $29 millions.

[3] This provision was made to allow for the notes which might not be presented to a bank by their holders prior to the final date.

[4] e.g. the Canadian Commodity Prices Stabilization Corporation, or the British Overseas Food Corporation.

It could also hold without limit securities with a maturity of less than six months, issued by the governments of the United Kingdom, British Dominions, the United States, and France. For securities of the United Kingdom and the United States with a maturity in excess of six months its holdings were limited to an amount equal to one-half its paid-up capital.

It was empowered to buy, sell, and rediscount bills whether drawn by Canadian residents or non-residents, with a maturity not exceeding ninety days, provided that they were endorsed by a chartered bank. For such bills, intended to finance primary production, the date of maturity could be 180 days.

It was also authorized to deal in and hold foreign exchange and bullion.

It was prohibited from engaging in any other business, purchasing the shares of banks (other than the Bank for International Settlements), making unsecured loans, paying interest on deposits, or lending on the security of real estate.

The Bank was required to hold a reserve in gold and foreign exchange equal to at least one-quarter of its notes and deposit liabilities. The chartered banks in turn were required to hold reserves in the form of notes of or deposits at the Bank of Canada equal to at least 5 per cent. of their deposit liabilities. In order to facilitate these requirements the chartered banks were required to surrender their Canadian gold holdings to the Bank of Canada, against payment.

3. *Amendments to the Constitution*

By the Bank of Canada Amendment Act, 1936, the Bank was given power to hold Dominion and Provincial government securities with a maturity in excess of two years up to an amount equal to one-half of its outstanding notes. It was provided, however, that its holdings of such securities with a maturity in excess of ten years should be limited to an amount equal to three times its paid-up capital. Under the Amendment Act of 1938 this latter figure was changed to five times the paid-up capital and reserve fund.[1] Under this Act the limit on the Bank's holding of longer-term United Kingdom and

[1] Due to the reduction of the capital of the Bank from $10,100,000 to $5,000,000 this increase was not as great as appears at first glance. At the end of 1950 the Bank's reserve fund stood at $10,050,000.

United States securities was raised to one-half its paid-up capital and reserve fund.

By the 1936 Act the maturity of all bills eligible for purchase or rediscount by the Bank was extended to 190 days.

The Acts of 1936 and 1938 also served to nationalize the Bank of Canada. In the first of these the new Liberal Government implemented its election promise to nationalize the Bank by raising its capital to $10,100,000 through the sale of an additional $5,100,000 of new shares to the Minister of Finance. In 1938 it renationalized the Bank by authorizing the redemption by it of all the shares held by the public at a premium of 18·4 per cent. and the issue of $5,000,000 new shares to the Minister of Finance to replace the $5,100,000 held by him.

4. *Minor Points*

Since 1938 the eleven Directors of the Bank have been appointed by the Minister of Finance. They in turn appoint the Governor and Deputy Governor, subject to the approval of the Governor-in-Council, and other officers. These two senior officers are members of the Board of Directors, as is the Deputy Minister of Finance (without a vote).

The Bank is authorized to pay an annual dividend of 4½ per cent. to the Minister of Finance. Of the remainder of its profit, one-tenth was to be appropriated to a Rest Fund and nine-tenths to be transferred to the Dominion's Consolidated Revenue Fund. As soon as the Rest Fund amounted to more than twice the paid-up capital, the entire residue of profit is to be placed in the Consolidated Revenue Fund. This point was reached in 1945.

5. *Summary*

The original Act was obviously designed in the orthodox traditions, based on the experience of the Bank of England. Yet it was given powers which were later extended to enable it to exert its major influence on the monetary system by intervention in the long-term security markets. There has never been a market for short-term commercial paper in Canada. Therefore the significant powers possessed by the Bank were those which enabled it to deal in government securities and

foreign exchange. As will be seen later, these have proved adequate for its requirements.

III. THE BANK OF CANADA'S FIRST DECADE

On 11 March 1935 the Bank commenced business. It was fortunate in the timing of its inauguration. Canadian exports had touched their inter-war nadir in 1932, and the national income did so in 1933. Despite the mild recession following 1937 the Bank of Canada's first years were a period of economic advance but not of extreme inflation. Therefore it had time to gather its personnel and establish its position within the general government and financial structure before it had to face its first major problems. These arose with the outbreak of war in 1939.

Between 1935 and 1938 the average daily figures for the chartered banks showed a rise in cash reserves from $213 millions to $258 millions. This increase was largely brought about by Bank of Canada action. Its security holdings rose by $36 millions to a total of $186 millions at the end of 1938. It is hard to say, even now, whether its first actions were designed to foster a movement out of the depression or to provide a legitimate financial basis for expanding trade. It is probable that both these concepts influenced the senior staff of the new institution. However, it is true that they were not called on to make any bold financial steps during this period.

Instead they were able to move circumspectly in the establishment of their moral authority. Branches of the Bank were established in each of the provincial capitals (with the exception of Quebec where the branch was established in the financial centre, Montreal, instead of the political capital, Quebec City). Of these, the Montreal and Toronto branches were the most important. From the first, the Bank entered the security markets. Frequently it did little more than 'dabble' in the markets. Yet the local representatives of the Bank's securities department soon became influential as disinterested individuals at the centre of these rather loosely organized exchanges. At the same time the Bank entered the foreign exchange markets. From the end of 1935 until 31 December 1938 its holdings of foreign exchange rose by only $20 millions to $28 millions, yet the Bank did intervene in the market almost every

day. This was done primarily to reduce the short-run fluctuations in the external value of the Canadian dollar. Thus the Bank's officers obtained a position of trust and respect which was to stand them in good stead when exchange control was introduced in 1939. At the same time the Governor of the Bank, Mr. Graham Towers, took steps to make the Bank a centre of economic and financial investigation. He gathered an outstanding team of young men and women in the Research Department and allowed them an unusually free hand.[1] The fact that this department was (and still is) raided on many occasions to provide economists for temporary assignment to other agencies has been a potent factor in strengthening the position of the Bank as a source of advice for all government departments.

Thus, prior to 1939, the Bank had done little more than take steps to establish its position as the central government financial agency. The outbreak of war brought two groups of problems. The first was the control of foreign exchange and the second was the organization of war finance.

The first of these was met with extreme rapidity and surprising finality. The first fortnight of war produced a steady decline in the foreign exchange value of the Canadian dollar from near 'parity' with its United States namesake to a discount of 10 per cent. on 15 September. On that date the rate of exchange against the United States dollar and the pound was fixed on the basis of the existing discount. At the same time a complete system of exchange control was introduced. This was administered by the Foreign Exchange Control Board which was technically responsible to the Minister of Finance. In fact the Governor of the Bank of Canada was Chairman of the Board and the senior administrative officers also held comparable positions in the Bank simultaneously.

From its inception, the Canadian exchange control was of a surprisingly complete nature. After 16 September all payments to non-residents required formal approval by the Board and all receipts from non-residents had to be surrendered to

[1] The author trusts that his close association with this group from 1941 to 1946 and the generous treatment he received as an employee of the Bank has not detracted from the objectivity of his views.

the Board.[1] The chartered banks were appointed agents of the Board and were the institutions which actually purchased and sold foreign exchange on its behalf. They were also given authority to approve the payment of funds to non-residents in most of the circumstances where the Board itself would have permitted the transfer. In practice the Foreign Exchange Control Board has always approved practically all payments on current account which were otherwise legal, while prohibiting most transfers on capital account. The restrictions on 'luxury' imports introduced in 1940 and again in 1947 were administered by agencies other than the Board. Its sole duty was to advise on the degree of restriction which was advisable and to ensure that no prohibited payments were made. In April 1940 all residents were ordered to surrender any gold and foreign exchange which they had held on 15 September 1939. Under these Orders the Bank of Canada surrendered its gold and foreign exchange and the chartered banks their foreign exchange. This marked the end of any foreign exchange reserve for the Canadian monetary structure. In essence this system of exchange control is still in operation, although numerous relaxations of the restrictions on capital payments have been introduced and since 1 January 1942 there have been no restrictions on payments to the sterling area. The Foreign Exchange Control Act of 1946 provided a new legal basis for the operation of this control and relieved the Bank of Canada of its reserve requirements. On the expiry of this Act in 1949 it was renewed for a further two years. Under these Acts the Bank of Canada was required to provide the necessary staff, premises, office supplies, and equipment for their administration.[2]

The problems of internal finance could not be met in as forthright a manner as their external counterparts. In many respects Canada entered the war on a 'limited liability' basis. It was thought that her primary contribution would be the production of goods for sale to her allies. It was realized that this would produce some shortage of supplies for export to the United States and an increase in imports from this major source of Canadian foreign requirements. It was also realized

[1] It should be noted that the British exchange control did not insist on this latter point until June 1940.

[2] Late in 1951 foreign exchange control was abolished.

that Britain could not pay for these supplies from current exports. Instead she was called upon to surrender the major part of her Canadian investments. It was not until 1941 that Canada lent any significant sums to the United Kingdom and not until 1942 that she agreed to give assistance on the basis of 'Mutual Aid'. This policy was bound to produce an external crisis and therefore the need for exchange control was obvious. Internally this outlook produced a 'business as usual' attitude.

There were unemployed resources in Canada and the Bank felt that the first aim of financial policy should be to bring them into employment. It was felt that a reasonable dose of inflation would do this and would also assist in the transfer of factors which the development of war production would require. Therefore the early stages of war finance appear now to have been almost gay. The first step was to raise $200 millions by the sale of securities to the banks in October 1939. This operation enabled the Government to redeem some of its securities held by individuals and non-banking corporations. It was not until January 1940 that the first issue of $200 millions of war loan was offered for public subscription. Of this only $132 millions represented cash subscription, the remainder merely involving the conversion of existing securities. In September 1940 a further issue realized $113 millions. With a budget deficit of $377 millions these operations obviously involved further borrowing from the banking system. This contributed to the desired inflationary effect.

By the middle of 1941 shortages of many commodities other than United States dollars were developing. Inflation, instead of being an instrument for the transfer of resources, was becoming a danger to the war effort. At the same time Canada was switching from a 'limited liability' to an 'all-out' war effort. The annual war expenditure of $118 millions for 1939–40 and $752 millions for 1940–1 rose to $1,340 millions for 1941–2 and was destined to reach a peak of $4,587 millions in 1943–4. With a gross national product at factor cost of $9,100 millions in 1943 this level of expenditure produced many problems. Despite considerable increases in taxation it proved impossible to cover more than approximately half the expenditure from revenue. The rest had to be borrowed. It fell to the Bank of Canada to supplement the Government's

taxation by borrowing a maximum from the public and a minimum from the banks.

For this purpose the National War Finance Committee was organized on a basis similar to that of the Foreign Exchange Control Board. It organized 'Victory Loan' campaigns and the sale of War Savings Certificates. Largely as a result of its activities the sales of government securities to Canadian investors other than banks reached slightly more than $2,000 millions in each of the years 1943–5.

Despite attempts to borrow as much as possible from the public, the Government was forced to find part of its finance from the banking system. To assist the Bank to retain some control over the chartered banks, $820 millions of a new security, Deposit Certificates, were issued to the chartered banks in 1943. These were non-transferable six-month notes for issue only to the banks and carrying a rate of $\frac{3}{4}$ per cent. In 1945 the amount of them outstanding reached a maximum of $1,000 millions. From the end of 1941 until the end of 1945 the chartered banks total holdings of government securities rose by $2,340 millions to $3,506 millions. This increase in their assets was the prime factor which led to an increase in the volume of net deposits from $3,191 millions to $5,739 millions. $850 millions of this increase was represented by an increase in balances held by the Dominion Government. The total money supply in the community almost doubled during these four years, as shown in Table 2, and the public's holdings of liquid assets increased by more than 125 per cent.

To enable this rise to take place the Bank of Canada was forced to increase its holdings of government securities from $605 millions to $1,842 millions. This action provided the basis for the increase in the currency issued and for the rise in the chartered banks' reserves from an average of $313 millions in 1941 to $603 millions in 1945.

It is difficult to assess the war-time record of the Canadian financial system. The monetary supply was allowed to increase considerably as has been seen and the economy emerged from the war in an extremely liquid position. The liquid assets of the public totalling $6,209 millions at the end of 1939 had been only slightly in excess of the gross national income at market prices of $5,600 millions in that year. The total of

$17,162 millions at the end of 1945 equalled almost 150 per cent. of the national income of $11,750 millions. At the same time the combination of the Government's price control, taxation policies, and war savings campaigns had restricted the rise in prices to approximately 30 per cent. for most of the signi-

TABLE 2

Liquid Assets of the Public, 1941–5*

	31 December	
	1941	1945
Currency held by public	492	1,055
Demand deposits at chartered banks†	1,268	2,063
Active notice deposits at chartered banks‡	236	474
Other deposits	103	202
	2,099	3,794
Less inter-bank items	198	280
Total money supply	1,901	3,514
Inactive notice deposits‡	1,433	2,391
Government securities held by public	4,071	11,257
	7,405	17,162

* Assets held by non-banking institutions.

† Excluding Dominion government accounts.

‡ Notice deposits broken down into estimated minimum quarterly balances (inactive) and the remainder (active).

Source: Bank of Canada, *Annual Report*, 1949.

ficant indexes. The high degree of liquidity was to enable a large part of the pent-up demand of the war years to become effective in the post-war period. In this way the problems arising as a result of war finance were to prove more serious, in some respects, than the war-time problems themselves. It can be said therefore that the system of war finance allowed a number of difficulties to develop. On the other hand, the Canadian record compares favourably with that of practically all the other members of the war-time alliance. The official view was perhaps best expressed by the Bank of Canada in its report for 1945:[1]

Although Dominion Government disbursements between August 31st, 1939, and December 30th, 1944, have been nearly $20 billions,

[1] p. 12.

about one-half of this total has been covered by taxes and other revenues. Moreover, through Victory Loan and other campaigns specifically directed toward the second objective, it has been possible to cover two-thirds of the Government's over-all borrowing by means of bonds sold to and retained by non-banking investors.

The remaining one-sixth of the Government's total requirements has been financed to a considerable extent by the chartered banks, which has involved a substantial increase in their holdings of Government securities, and consequently in the volume of savings and demand deposits of the public with the banks. This increase in deposit liabilities has in turn given rise to a need on the part of the chartered banks for larger cash reserves. The policy of the Bank of Canada—implemented through its purchase of Government securities in the market—has been to keep pace with these necessities, without trying to bring about expansion of credit for purposes unrelated to war needs.

IV. THE AMENDMENTS OF 1944

In the later years of the war attention was turned to the problems of post-war reconstruction. In practically all countries there was a tendency to feel that the decline in the demand for armaments would create serious employment problems. This view was widely held in Canada.[1] Therefore policies were adopted to ensure, in so far as was considered possible, that the financial system of the country would be able to assist in the maintenance of full employment.

The first step was taken on 8 February 1944 when the Bank's rediscount rate was lowered from 2½ per cent. to 1½ per cent. Due to the absence of any bill market in Canada this step was relatively insignificant by itself. The only borrowings by the chartered banks from the Bank of Canada have been very small and for quite short periods on rare occasions. Yet it was felt that this change would demonstrate the Bank's belief in

[1] e.g. the following excerpt from the Bank of Canada's *Annual Report* for 1945 (p. 10): 'Looking to the future, however, there is no reason for complacency. Most of our real problems of post-war adjustment are still ahead. The backlog of demand will not be large in relation to productive capacity when industry has been fully reconverted and inventories built up to normal levels. When the time lag involved in demobilization is over, government expenditures will fall rapidly. Nor will our foreign lending to finance the purchase of Canadian goods remain indefinitely at the present level. The prevailing optimism on the North American continent is dangerous if it diverts attention from the problems which have to be faced.'

the desirability of low interest rates in the post-war period, as an incentive to investment, which it was thought would require encouragement.

It was in this atmosphere that the legislative programme of 1944 was carried out. It had for some time been thought that, while large corporations could obtain long-term capital with relative ease, the position of the individual producer or small corporation was not so easy. Therefore the Farm Improvement Loans Act was passed and Section 88 of the Bank Act was amended. These changes authorized the chartered banks to make loans on the security of mortgages of real property and equipment for the purpose of financing the improvement or development of farms. To protect the position of the banks, the Minister of Finance was instructed to guarantee them against loss on these loans up to an amount equal to 10 per cent. of the total of such advances. Section 88 was also amended to enable the banks to make advances against the security of fishing vessels. Partly as a result of these changes bank loans to farmers rose from $50 millions at 31 October 1943 to $256 millions at 30 September 1950.

The other major legislation carried through was the Industrial Development Bank Act. This Act incorporated the Industrial Development Bank with a capital of $25 millions to be subscribed by the Bank of Canada. In addition it was authorized to borrow a further amount equal to three times its capital and reserve fund. The Bank was instructed to make or guarantee loans in those cases where in its opinion '. . . credit or financial resources would not otherwise be available on reasonable terms and conditions to a person engaged in or about to engage in an industrial enterprise in Canada'. It was provided, however, that there should be a limit of $15 millions imposed on the total of loans or guarantees in excess of $200,000 each. By the end of 1950 this institution had made loans totalling $22 millions and entered into guarantees of $3 millions. It was also committed to further loans to a total of $10 millions. Of all these, $14 millions, or 26 per cent., were for advances in excess of $200,000 each. On the other hand, 204, or 45 per cent., of its commitments were for amounts between $5,000 and $25,000.

These changes were intended to fill the Canadian 'Mac-

Millan Gap'. It must also be admitted that they could be, and were, interpreted by the chartered banks as an encouragement to look less severely on investments which were in fact intended to finance fixed capital investment.

The other changes in the banking legislation, aside from the provision for the retirement of chartered bank notes by 1 January 1950, were of a quite minor nature.

V. THE POST-WAR PERIOD

In reviewing the financial developments in Canada during the years since 1945, it is convenient to divide the problems which had to be faced into two categories: external and internal. It is probably more dangerous to do so for this period than for any other. The two groups of difficulties which had to be faced were more closely inter-related during these years than at any other time. Yet, for purposes of exposition, to do so tends to assist in the delineation of a clear picture of post-war events.

Primarily because of the large volume of United States purchases during the latter years of the war, Canada entered the post-war period with a large volume of hard currency reserves. At the end of 1945 these exceeded $1,500 millions in value. This provided an atmosphere of confidence if not of complacency. When the United States price controls lapsed on 1 July 1946, the authorities felt that the volume of their reserves provided sufficient security to permit them to take protective action to offset effects of the contemplated rise in import prices. The Canadian dollar was revalued on 6 July and a new rate was fixed at $1·00 Canadian = $1·00 United States.

At the same time Canada entered on a considerable programme of capital assistance to Europe. Post-war loans rose from $105 millions in 1945 to $750 millions in 1946. It is true that direct aid fell from $960 millions to $100 millions. However, exports also fell by $1,080 millions to $2,393 millions, while there was a simultaneous rise of $380 millions to $1,822 millions in imports. In 1947 the position continued to deteriorate. The net current account balance fell from $460 millions to $85 millions, while all other transactions except the changes in reserves called for net payments in excess of $800 millions. The result was a fall in the foreign exchange reserves to $502

millions at the end of 1947. This called for firm action on the part of the Canadian authorities and as a result the programme of foreign loans was drastically curtailed and a series of import restrictions was imposed.

The situation steadily improved thereafter and by 1 January 1950 all the import restrictions had been removed. The immediate effect of the Government's action was to improve the balance of payments position and there was a current account surplus of $470 millions in 1948. The growing inflationary pressure tended to reduce this until 1950 showed a deficit provisionally estimated at $316 millions. However, a large part of the internal development which is referred to below was financed by United States capital and as a consequence the inflow of capital rose to almost $950 millions in 1950. As a result the foreign reserves increased steadily until they touched a post-war peak of $1,790 at the end of September 1950.

The general deterioration of the current account of the balance of payments was largely responsible in influencing the Canadian authorities to follow the rest of the world in the devaluation of September 1949. It was also felt that it was necessary to take this step if Canada were to retain its competitive position in the United States market. As a result the Canadian dollar was revalued to $1·00 United States = $1·10 Canadian on 20 September. Shortly thereafter, rumours began to develop that there was a possibility of a reverse movement in the exchange rate. Given the underlying conditions, there appears to have been little ground for this speculation. Yet it resulted in an inward movement of funds of considerable proportions. The Report of the Foreign Exchange Control Board for 1950[1] sums up the action taken:

> During the third quarter of 1950 it became apparent that private capital was flowing into Canada at an excessive rate and was exercising an inflationary influence in Canada at a time when inflationary pressures were already causing concern. Moreover, the inflows were bringing about a substantial and involuntary increase in Canada's gross foreign debt and annual service charges, without any corresponding increase in its productive resources or ability to export. In considering action appropriate to check the inflow the Government reviewed the possibility of moving the par value of the Canadian dollar to a new and higher fixed

[1] pp. 141–5.

level but concluded that under the conditions then existing it was impossible to determine in advance with any reasonable assurance what new level would be appropriate. It therefore decided that the rate of exchange should be left to be determined by market forces.

After consultation with the International Monetary Fund, the Government accordingly cancelled, effective October 1, the official rates of exchange which came into effect on September 20, 1949, and did not prescribe any new official fixed rates of exchange.

The internal problems were equally difficult. Despite the expectations of the late war years, the Bank of Canada has faced only one problem—inflation. Since 1945 Canadian development has been more rapid than could have been foreseen. The population is estimated to have increased by over a million between the end of 1945 and 1949. This is equal to the increase in the preceding nine years. In every year after 1945 immigration was higher than at any time since 1930 and reached a peak of 125,000 in 1948. The development of the country's natural resources, particularly oil and iron ore, was quite unexpected. It is now confidently hoped that petroleum production will reach an annual value of $100 millions compared to a wartime level of about $15 millions. It also appears probable that the Quebec–Labrador iron ore field will replace the rapidly disappearing Messabi range as North America's primary source of ore. Given this background it is easy to realize why the period 1946–50 saw an unprecedented level of investment in Canada. In the first of these years domestic investment amounted to 16 per cent. of national expenditure. This proportion rose to 22 per cent. in 1947 and 1948, fell to 19 per cent. in 1949, and rose again to 22 per cent. in 1950. In addition there was net foreign investment in every year except 1950. At the same time the Canadian economy was subject to the pressures arising from the steady rise in foreign prices. Against this background the efficacy of the fiscal and financial controls can be judged from the fact that it is estimated that the real national income rose by 12 per cent. during these years while the money national income rose by 46 per cent. In other words the general level of prices rose by only about 30 per cent. This increase is by no means excessive when compared to price changes in the rest of the world during the period.

The Bank of Canada was faced with a dual task. It was part

of government policy to encourage this expansion. Therefore it had to ensure that nothing was done to restrain it. At the same time it had to take every step possible to retain monetary stability. The general attitude prevailing at the end of the war encouraged the banking system to be generous and adopt the type of policy indicated by the amendments to the Bank Act. In 1946 this attitude was encouraged by the Bank of Canada when it took steps to increase the cash reserves of the banking system by $58 millions. While the Bank took this step it reached an agreement under which the chartered banks promised that their holdings of government securities, other than short-term issues, would not exceed 90 per cent. of their savings accounts. As a result of all these factors the banks were encouraged to increase their loans and non-government investments. These rose by $472 millions to $2,297 millions, their holdings of government securities, other than Deposit Certificates, only increased by $61 millions. As a result of all these changes the community's money supply rose by $482 millions to $3,996 millions.[1]

1947 saw the first serious signs of strain developing in the system of financial control. The Bank took steps to contain the inflationary pressures, which reflected themselves in the foreign exchange crisis already mentioned. It brought about a decrease in the cash reserves of the chartered banks of $22 millions. At the same time it redeemed the remaining $490 millions of Deposit Certificates, and largely as a result of redemptions there was a decline of $170 millions in the chartered banks holdings of other securities. As a result of these changes they were able to experience a record increase of $461 millions in their loans. The Governor of the Bank felt it necessary to speak in rather guarded terms of this increase in bank finance of private industry in a year when the money supply had been reduced largely as a result of central bank action by £52 millions.

During 1948 the Bank made the position of the chartered banks slightly easier by allowing their cash reserves to increase by $18 millions. At the same time it reached an agreement with them early in the year that they would refrain from purchasing corporate securities and limit their assistance by way of loans for the financing of fixed capital investment. It thus

[1] For the meaning of 'money supply' see pp. 119–20.

brought the banks back to a more 'orthodox' view of their role in the financial system. While the money supply increased by $390 millions during the year, the Bank could feel that a large proportion of this rise was required to meet 'the legitimate needs of trade'. It was a corollary of the inflation arising from forces in the non-banking sector of the economy rather than an immediate source of such strain.

1949 was a year of relative quiet on the Canadian financial scene. The Bank increased the chartered banks' cash reserves by $15 millions and this produced a small increase in the money supply.

In 1950 the Bank had to face the necessity of ensuring that the large increase in foreign reserves could be financed and of enabling the first steps to be taken in the implementation of the defence programme. To permit this it allowed the chartered bank reserves to rise by $56 millions, and bank deposits increased by $567 millions. At the same time the Bank gave notice of its desires by raising its advance rate from 1½ per cent. to 2 per cent. on 17 October. As already indicated changes in this charge are much more 'hints from headquarters' than significant alterations in any individual's costs. It was on this note of concern regarding the possible future difficulties in the financial field that the Bank entered the era of active rearmament.

Certain conclusions can be drawn from this brief survey of post-war developments on the Canadian financial scene. The first of these is that the economy is still substantially subject to external influences. The need to aim at equilibrium in its balance of payments continues to be great. Internally the financial system is still largely subject to, rather than the controller of, the basic economic conditions. Yet the instruments of central influence are much stronger than they were before 1938.

The Bank of Canada has been able to restrain the forces of inflation by controlling the volume of cash reserves held by the chartered banks. Yet it has achieved almost as much by being able to persuade them to adjust their policies to the national requirements. At the same time the Foreign Exchange Control Board has been able to insulate the economy from the more severe effects arising from changes in the country's foreign accounts. It is this latter development which perhaps most

clearly differentiates the post-war picture from that which existed prior to 1939.

VI. CONCLUSION

From all this there emerges a picture of a closely integrated financial system extending across the 4,500 miles of Canada. It is a structure marked by the administrative integration inherent in the branch organization of the chartered banks. As the central co-ordinator, the Bank of Canada fills an unquestioned place. Its position arises not only from its ability to take unopposed administrative action but also from the moral authority which it is able to assert. One must go to the physically much more compact area of the United Kingdom to find a structure which is comparable in its integration and sense of responsibility while retaining the essential flexibility required of a modern monetary system.

BIBLIOGRAPHICAL NOTE

Footnote references have purposely been kept to a minimum in these chapters. Practically all the information has been obtained from the following sources.

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5

THE BUSINESS OF BANKING IN INDIA[1]

To present a generalized picture of banking business in India is, indeed, a most difficult task. There are, it is true, certain broad categories within which banking institutions can be grouped, but there is nevertheless much diversity of practice even as between similar institutions. In general terms there are two main sectors: that which concerns itself with commercial banking, as that term is commonly understood in Western countries; and that which derives from indigenous practice, with a tradition going back many hundreds of years. These two sectors are not wholly unconnected with each other, but at all times the links are somewhat tenuous and there is in no sense complete integration into a single system. Within the commercial banking sector, where institutions are substantially 'Western' in conception, English and Scottish influences are clearly present and similarities with American experience exist. But to these must be added the effects of indigenous factors which have increased the degree of diversity in internal arrangements.

Emphasizing the dichotomy referred to above is the restricted use made of the cheque as such. In any extensive sense the banking habit is as yet relatively undeveloped, and the banks, as it were, only cater for the 'marginal' needs of the population as a whole. The cheque is, of course, supplemented in a very important way by the use of indigenous credit instruments, but it remains true that for much of the rural population, which is largely illiterate, organized banking arrangements scarcely exist. The effect of this is, first, a relatively restricted

[1] The author desires to express his appreciation to the Trustees of the Houblon–Norman Fund for their generosity in making possible his visit to India and Pakistan in March and April 1950. Without this assistance much of the material upon which the three following chapters are based could not have been assembled. He would also wish to emphasize his indebtedness to the many persons—bankers, civil servants, and others—who by their unfailing patience and courtesy helped to ease the difficulties of his inquiry and to save him from the grosser errors of description. For such inaccuracies and omissions as remain, and for particular interpretations of the facts, he alone can be held responsible.

use of bank credit; second, the direct employment of cash (i.e. notes and coin) for the majority of monetary transactions; and, third, and even more obviously beyond the influence of banking institutions, a host of transactions which are consummated in kind, i.e. in non-monetary terms. Superimposed on this is the hoarding habit,[1] which appears to provide an almost bottomless pit for the absorption of gold and silver. This is the background against which to view the business of banking in India.

1. *The Commercial Banks*[2]

It is appropriate to begin our analysis with a consideration of the commercial banking structure. The commercial banks may be divided into two main groups: the Exchange Banks and the Indian Joint Stock Banks, both 'scheduled' and 'non-scheduled'.

The *Exchange Banks* constitute the oldest and most homogeneous group of banks in India. They are strong and with a long record of service. In times of uncertainty their very presence has contributed to confidence and the maintenance of stability. For the most part they have been foreign (i.e. non-Indian) in origin and their methods are primarily derived from British and particularly Scottish experience. At times, and in certain quarters, these banks have been regarded with some suspicion, but their strength in periods of crisis appears more recently to have created a new respect, and by the Indian depositor and the authorities alike every confidence is now placed

[1] The reasons for the strength of the hoarding habit in India are many. One might mention the love of display; the association of wealth and status with possession of the precious metals and jewels; the frequency of crises both in agriculture and in industry; the uncertainties arising from radical changes in the direction of government policy; and—not least important—the appreciation of bullion values in relation to almost every other store of value.

[2] Unless otherwise indicated the rates of interest quoted in this study as applying to the various types of bank business are those which obtained during the 1949–50 season. Too much attention should not therefore be paid to the absolute level of the rates. More importance should be attached to relations between the several rates quoted. It should also be observed that in the following (1950–1) season, the tightness of the money markets in India (and particularly in Bombay) was unprecedented. Not only were rates driven much higher than had previously obtained, but the heavy seasonal demand for money commenced earlier and lasted longer than was usual. In addition to normal seasonal requirements, money was sought in large amounts to finance stock-piling. A summary of the 1950–1 position may be found in Reserve Bank of India, *Annual Report*, Aug. 1951, pp. 17–18.

in their ability and willingness to meet fully their responsibilities to the public. They are not confined in their activities to India (and Pakistan) alone, but this is one of their most important spheres of operation. In terms of deposits the bulk is held by Lloyds Bank,[1] the National Bank of India, the Chartered Bank of India, Australia, and China, and the Mercantile Bank of India—in that order; while, in discounts and advances, the Chartered and National do a business of approximately equal size, followed by Lloyds, the Mercantile, and the Hong-Kong and Shanghai Banking Corporation. There are a number of smaller institutions—mainly British, Dutch, and American. Within India, the offices of these banks are concentrated mainly in Bombay and Calcutta, with minor concentrations in Delhi, Madras, and Kanpur. The exchange banks specialize in the finance of foreign trade, in which they still have a near-monopoly of the better class business. They also play some part in the financing of internal trade, in order to assist the movement of goods between up-country (or 'mofussil') centres and the ports. So far as their general banking business is concerned this is related as far as possible to the auxiliary financing of the export and import trades. In 1939 nineteen exchange banks incorporated outside India were operating in the country. This has since been reduced to fifteen due to amalgamation, the closure of Japanese banks at the outbreak of war, and the failure—more recently—of an Indian exchange bank.

In general, the financing of India's foreign trade, which is the main function of the exchange banks, can be broken down into two operations: (*a*) the finance of the import or export of goods to and from Indian ports; and (*b*) the finance of the movement of goods between the ports and up-country centres.

To provide cover for the export of goods it is customary for the Indian exporter to insist on having a credit opened by his buyer through a bank in London. He usually asks for an irrevocable credit, which protects him while he is arranging the shipment. When the credit is opened, the Indian exporter is advised by the branch or correspondent in India of the London bank which has made the arrangements. Then, when the bills of lading are ready, the exporter draws a bill of exchange under

[1] Although its business interests in the Orient are extensive, its main sphere of activity is, of course, in England.

the credit (supported by the usual documents—viz. bill of lading, invoice, and insurance policy) and negotiates it with his banker in India. In most cases the documents are delivered to the overseas importer through a London bank against acceptance and only in a small proportion of cases are bills drawn subject to the condition of payment before the delivery of documents. Bills are usually drawn up to ninety days after sight, but there are no fixed rules. When these bills are sent by the negotiating bank to the bank which has established the credit, they are presented for acceptance, endorsed by the exchange bank concerned, and discounted in the London Money Market. In this way, a regular turnover of funds is ensured. Bills would normally only be held to maturity if the banks were highly liquid.

Formerly, imports were financed in much the same manner, though some bills were treated more favourably than others. For example, where the importing firm had good London connexions, documentary bills were drawn by the London exporting houses on the London offices of the exchange banks, which accepted the bills before returning them to their drawers. The latter could then discount them in the London Money Market. The relevant documents were sent to a branch of an exchange bank in India for collection of the proceeds of the goods on sale by the Indian offices of the exporting firms and cover was remitted to London at or before the maturity date of the bills. This procedure was employed a great deal in the days of imported British piece-goods, but such imports are now practically non-existent and the London acceptance is much less in vogue than formerly. Imports into India are nowadays more generally covered by sight or usance bills under credits established from India and available in the exporting country. A usance of thirty days is a popular one as that period allows sufficient time to cover the interval between the receipt of shipping documents by airmail and the arrival of the vessel carrying the relevant cargo.[1] The usual procedure is for the

[1] Restricted imports in recent years have, however, tended to result in prompter payment for goods arriving in India from overseas, and credits calling for usance bills, which are more expensive for the opener, have not been asked for as frequently. Payments for imports—and exports—may then be made by direct 'clean' remittances (i.e. no documents attached) either by demand drafts or, more usually, by telegraphic transfer.

bill to be discounted by the exporter at, say, the London office of an exchange bank against letters of request and hypothecation, as a result of which the exchange bank becomes a holder for value. The bill is then sent to the appropriate Indian office of that exchange bank for presentation to the drawees for acceptance in the case of a usance bill (in which event the bill is held in the portfolio of the bank's Indian office), or payment in the case of a sight bill. Furthermore, the importer will frequently accept a bill and then apply to the bank for the delivery of the goods before payment (against the security of trust receipts). The bills of lading and other documents are then handed over to the importers who are now in a position to obtain possession of the goods as trustees for the exchange bank. The goods are stored in 'godowns' and the bill is met when the goods are sold. It is important to note here that control over the goods only passes to the importer when there is an agreement to hypothecate. With firms of less standing, the goods are pledged to the bank and possession and control remains with the bank and the latter releases the goods from its godown for sale, the receipts being set off against the importer's indebtedness. However, since the firms accepted as customers by the exchange banks are restricted to those of good standing, hypothecation is the more usual procedure.

In addition to the financing of exports and imports through the ports, the exchange banks also finance the movement of goods between the ports and up-country centres, in the more important of which they have branches. In such cases it is possible for the exporter or importer to finance both movement to or from the ports and to or from the party overseas by what amounts to a single transaction. For example, for goods imported by a firm in Delhi an import bill will be drawn by the foreign exporter and forwarded to the Delhi branch of an exchange bank. On its due date and by arrangement with the drawee, the bill will be retired to a loan account in the name of the importer and the relevant goods will be stored either at the port or brought to Delhi and stored in the bank's godown. The bank then remits the full amount of the bill to its London office. Meanwhile, the importer will have signed a promissory note and a letter of lien to cover the maximum amount the bank is prepared to advance to him at any one time. In this

advancing against goods in godown, the bank will of course require a margin of security and will normally only be prepared to advance up to 85 per cent. of the value of the goods in question. The indebtedness of the importer will then be progressively reduced as the goods are taken out of the godown and sold.

Similarly with exports. The Indian exporter draws a bill on his overseas customer under a credit opened by the latter and negotiates this bill through the Delhi branch of the exchange bank concerned.[1] In effect, loans are made by the bank (in this case) up to 75 per cent. of value against shipment under a confirmed letter of credit and against a signed order for the goods and the railway receipt. The goods are then sent down to the port under lien to the bank and kept there until a shipment is accumulated. At this stage the goods are under the control of a clearing agent who obtains the bill of lading on behalf of the bank. When the bill of lading is received from the clearing agents, the bank will usually purchase the bill and pay the exporter the balance due to him, namely, 25 per cent. The bill and supporting documents are then forwarded to the overseas office of the bank for presentation to the importer. In some cases, however, the letter of credit only authorizes a payment of, say, 75 per cent. of *invoice value*. In this event the exporter has to wait until the goods reach the importer in London and have been examined and approved. Only then will the balance of 25 per cent. be remitted to the exporter—either by way of bank draft or telegraphic transfer.

It is important to observe at this stage, however, that although the exchange banks concentrate mainly on bill finance, their business is not confined to this activity. Indeed, all of them do quite a big advance business.[2] Some of this is of a general character. In some up-country centres, for example, loans are made against the pledge of gold, silver, and ornaments, which

[1] Sometimes, it should be observed, the exchange banks finance export trade, by means of documentary bills, at some distance from their branches. For example, in South India, where not all the exchange banks have branches on the west coast, the Madras offices of such banks deal in bills covering shipments of coffee, tea, spices, copra, and coir exported through Cochin.

[2] The mechanism of such finance is substantially similar to that of the Indian joint stock banks and it can be elaborated most conveniently in that context. The exchange banks also accept fixed deposits and some of them do a savings bank business (e.g. Lloyds and—in Delhi—the Mercantile Bank of India).

are held in the bank's strongroom. More frequently, advances are made to local manufacturers and merchants, usually, however, with a view to obtaining their exchange business as well.[1] Indeed, it would seem that the bulk of exchange bank loans is fairly directly related to their main business of financing the country's foreign trade.

The statistical breakdown of exchange bank loans in June 1949 was as follows: commerce 49 per cent., industry 31 per cent., agriculture 8 per cent., professional 6 per cent., and unclassified 6 per cent. The jute industry was the principal industrial borrower and the exchange banks supplied 40 per cent. of the total credit extended to this industry by the scheduled banks as a whole. Exchange bank advances to coal, engineering, and public utilities represented 48 per cent., 43 per cent., and 55 per cent. respectively of total scheduled bank advances to these industries. Half the commercial advances went to the wholesale trade in non-agricultural commodities and about one-fifth to that in agricultural commodities. Agricultural advances were almost entirely against commercial crops and represented about two-thirds of the aggregate agricultural advances of all scheduled banks. The total advances of fifteen exchange banks at the end of June 1949 amounted to Rs. 122 crores.[2]

Of all the 'Indian' banks, as the non-exchange commercial banks are usually called, the Imperial Bank of India is the largest and most powerful. It was constituted in 1921 as a semi-

[1] Thus, the exchange banks make advances against local textile production (to finance the raw cotton purchases of the mills), to jute mills, and to tea gardens. The usual procedure is to advance either against hypothecation of stocks, or (as in the case of tea gardens) against the hypothecation of the crop (up to 75 per cent. of the value of the crop). In financing the movement of the tea crop it is also usual to take as collateral the guarantee of the broker who deals with the sale of the crop at the auction, since it is mainly his responsibility to see that railments to Calcutta are duly made and that the tea is properly disposed of. Sometimes an exchange bank may even take a floating charge over the assets of an industrial company. This occurs usually when money is tight and industry requires longer credits. The margin up to which advances are allowed is normally of the order of 25 per cent., but in the case of very sound concerns it may be as high as 50 per cent. In Calcutta certain of the exchange banks hold coal accounts and this trade likewise has required accommodation from time to time. Almost all of these advances are seasonal in character and self-liquidating.

[2] See 'Surveys of Bank Advances', *Reserve Bank of India Bulletin*, May 1951, p. 318. Note: 1 lakh = 100,000. 1 crore = 100 lakhs = 10,000,000. At current rates of exchange, Rs. 1 crore = £750,000 approx.

public institution by amalgamating the three Presidency banks and fulfilled the functions of an interim central bank until 1935. It has a network of branches and pay offices covering every town of commercial importance in India, and in December 1950 held total deposits of Rs. 231·6 crores. It is administered through three Local Boards at Calcutta, Bombay, and Madras, the power of general superintendence being vested in a Central Board. As agent of the Reserve Bank for government transactions, it still retains a part of its former official functions[1] and, since 1934, when the Reserve Bank was established, it has conducted a general banking and foreign exchange business similar to the other commercial banks. It retains its prominent position in the money market, where it remains an 'intermediate' lender of last resort.[2]

The connexion with the Government and the Reserve Bank has meant the assumption by the Imperial Bank of a number of special responsibilities, and this has necessitated certain restrictions on its business. Nevertheless, this connexion has also given the institution a special status and conferred on it several direct and indirect benefits. The role envisaged by the Rural Banking Enquiry Committee (reporting in 1950) for the Imperial Bank was that of an auxiliary to the Reserve Bank. The Committee was aware that there had been considerable criticism of the privileges afforded to the Imperial Bank and also of its policy towards other banks. This, the Committee held, was 'partly political, being a carry-over from the past, but it also expresses the genuine apprehensions of the commercial and banking interests in the country towards the working of the institution as organised at present'. It agreed that

> it is wrong in principle and against the long-term interests of the country that Government cash work and currency chests, with all the prestige and other benefits they carry, should be entrusted to a single commercial bank, thereby creating a powerful private monopoly, which can disregard the interests of the public, or jeopardize the working of other banks.

[1] Discussed elsewhere in chapter on 'The Rise of Central Banking in India'.

[2] The Indian commercial banks have generally preferred not to rediscount bills or borrow directly from the Reserve Bank, which is, of course, the ultimate lender of last resort, but have usually satisfied their requirements for finance by borrowing against government securities from the Imperial Bank of India, which therefore constitutes an 'intermediate' lender of last resort. This phenomenon is discussed in greater detail in the following chapter.

Either the monopoly should be strictly regulated by the State, or the Bank should be deprived of the cash work and other special privileges it enjoys at present. The present unsatisfactory position arises largely from the fact that some of the powers given to Government by the Imperial Bank of India Act, 1920, were allowed to lapse in 1934. The Imperial Bank has continued to enjoy most of the benefits it used to get prior to the inauguration of the Reserve Bank. . . .

The Committee therefore recommended that powers to regulate the policy and working of the Bank should now be resumed by the Government, though there should not be 'any interference from Government in its day-to-day working'.

It had also been maintained before the Committee that the Imperial Bank was placed in a stronger competitive position than other banks since it was able to work with extremely fine balances at its branches and to make substantial savings in the cost of remittances. Further, the Bank was alleged to discriminate between its own customers and other banks in the matter of remittances. As a remedy it was suggested that the Imperial Bank should be divested of its commercial activities. But the Committee felt that it was

necessary, in the interests of the country, that the Imperial Bank should continue to retain its commercial activities, and . . . that the existing restrictions on its business are quite sufficient. As regards the facility for free transfer of funds through currency chests, however, we suggest that steps should [be] taken to see that the Imperial Bank is not the chief beneficiary under the arrangements. Several services have to be performed by the Bank because it holds custody of currency chest balances, and it is no doubt entitled to claim fair compensation for these services, but we do not consider that it can be permitted to make any undue profits, or derive a competitive advantage over other banks by reason of the fact that it holds custody of the national stocks of currency.

The Committee recommended 'the cheapening of the rates for remittance of funds for banks through treasuries and branches of the Imperial Bank', but that this should be based on a detailed analysis of the costs and off-setting benefits involved.

Finally, it was argued in evidence that the working of such 'a highly centralised institution' tended to be 'impersonal' and that the Imperial Bank was 'unlikely to interest itself in the opening up of the less-developed areas'. But the Committee

[1] *Report*, pp. 95–96.

did not consider 'the emergence of provincialism in commercial banking . . . a desirable development. There is no reason why an institution of the type of the Imperial Bank, with its large resources, should not be able to assist the development of less-developed areas to the same extent as any provincial bank.' Indeed, it was felt that 'so long as there is scope for expansion, and the Imperial Bank is assured that its overheads will be covered, the country has . . . a right to require the Bank to extend its network of branches'. Nor did discussions with the Bank suggest that it was averse to opening new branches on this basis. The Committee therefore recommended that

> the Imperial Bank and the Reserve Bank should jointly investigate the possibilities of increasing the number of branches of the Imperial Bank to cover as many centres as possible. Further, in order to introduce an element of regionalisation, the Bank may be asked to establish one or two additional Local Head Offices so that the various regional interests are more fully represented on its Local and Central Boards.[1]

Before proceeding to discuss the business of the *Indian Joint Stock Banks* it is desirable to emphasize certain of their characteristics. First, there is the question of size. The joint stock banks range with an almost regular gradation from institutions which are large and powerful to units which scarcely justify the description of 'bank'. Even the requirement that only those banks with a paid-up capital and reserves of Rs. 5 lakhs or more can be 'scheduled' fails to provide the hall-mark of security, as this is far too small a capital upon which to base sound banking. Altogether, as at June 1949, there were 101 scheduled banks out of a total of something more than 600 banks submitting returns to the Reserve Bank. How many non-scheduled banks were beyond the pale there is no means of estimating. In these circumstances it is difficult to fix the line of demarcation between truly large banks and those of medium size, and any such division would be of an arbitrary character.

Apart from the Imperial Bank (which is in a special category), the biggest bank is undoubtedly the Central Bank of India with total deposits in December 1949 of about Rs. 120 crores.[2] Then we have a cluster of somewhat smaller but still

[1] See ibid., pp. 97–98.

[2] The comparable figure for the Imperial Bank—i.e. as at 31 Dec. 1949—was Rs. 260 crores.

large banks in the Bank of India (Rs. 60 crores), the Punjab National Bank (Rs. 42 crores), the Bank of Boroda (Rs. 34 crores), the United Commercial Bank (Rs. 30 crores), and the Allahabad Bank (Rs. 28 crores). But immediately below these in order of size will be found banks which are almost as big and so we can continue throughout the list.

Second, and there is little that is remarkable in this, is the variation in emphasis as to the types of business most favoured by the several larger banks,[1] in addition to which there are, of course, differences of a regional character in the type of business undertaken. It is most noticeable, too, that banks with a regionalized branch development, such as the Bengali and South Indian banks, have a point of view which is quite distinct from that of their larger brethren. They believe, for example, in the importance of retaining small banks in the banking structure. Both these groups maintain that, with their knowledge of local trades and industries, they can give their customers better service than can the larger banks. With their greater personal knowledge of their customers and their affairs they can accept business which to the larger institutions may seem to be too risky and beyond their province.[2] Indeed, it has been argued that the existence of small banking institutions has had the effect of introducing the banking habit to those who live outside the cities, that 'an extensive country like ours requires local unit banks', and that the organization of banking in India should be modelled on United States rather than British experience.[3]

As against this it has been argued that the importance of retaining small units in the banking structure is diminishing and, in point of fact, the desirability of amalgamation of the smaller banks is increasingly being stressed. Indeed, this has been the view of the Reserve Bank itself and it has indicated its willingness

[1] For example, the Central Bank of India favours an ambitious policy with a wide spread of business and branches, whereas the Bank of India is very much more of an urban bank with a somewhat conservative outlook.

[2] The importance of knowledge of local conditions may nevertheless be overemphasized, as the absence of a comprehensive understanding of external factors may well lead to costly errors of judgement.

[3] See, for example, the Chairman's Address, 35th Annual General Meeting (1949) of the Comilla Banking Corporation Ltd. In the same speech the gradual introduction of a deposit insurance scheme was suggested, framed along American lines.

to offer assistance in the required direction. Already, it has been successful in bringing to fruition the amalgamation of four of the medium-sized Bengali banks.

Third, it is pertinent to emphasize the distribution of branches. Thus, in February 1950 there were 2,923 scheduled bank branches in India spread over some 1,350 cities and towns, with a heavy concentration in the larger centres. Indeed, as many as 800 were situated in thirteen principal towns. In other words, 27 per cent. of the scheduled banks' offices were located in 1 per cent. of the towns having banking facilities and this over-concentration in a relatively few centres has led to much unnecessary overlapping and to a good deal of unhealthy competition both for deposits and advances. According to one leading banker:

> The urban areas could very well be served with half the number of existing branches—say 1,500—others could be shifted to the rural areas. A planned programme of closing their redundant offices in towns and reopening these in rural areas will not adversely affect the profits of the banks, while the economic condition of the countryside will improve.[1]

Nevertheless, such a programme would not be without its difficulties. Village life in India is quite different from that of the towns, and the banker would have to adjust to a completely new environment. The distances are great and communications poor. Deposits may not be easy to attract. When account is taken of the complications of Hindu joint family ownership, illiteracy, and the play of communal politics, the risks of lending are likely to be much greater. In all these circumstances, rural branches would tend to be expensive to run and the bankers' conservatism would appear to be justified.

This was one of the problems considered by the Rural Banking Enquiry Committee.[2] They found that high operating costs in relation to the earning capacity of rural and semi-urban branches had been accentuated by the general increase in costs and

> if the present trend continues, it is feared that many banks may be forced to close a number of their uneconomic branches; in fact, the process of rationalisation of branches . . . has already begun. . . . If banks are to be

[1] Mr. Lala Yodhraj in Chairman's Speech, Punjab National Bank Ltd., Delhi, for year ended 31 Dec. 1949, as printed, p. 11.

[2] *Report*, pp. 59–60.

encouraged to expand their operations to outlying areas, steps will have to be taken to assist them in overcoming this handicap. . . . One of the factors which has added to the difficulties of banks in this respect . . . is the extension of Shops and Establishment Acts and of awards of Industrial Tribunals to branches of banks in the mofussil. Small branches have necessarily to be run on the basis of minimum staff and compliance with the requirements of these acts, which binds them to certain fixed hours of working and necessitates the maintenance of a number of additional records and registers, adds considerably to their work. . . . Work at the smaller branches is of an intermittent character, there being heavy work during certain seasons and little work during other periods, and unless a certain amount of elasticity and informality is permitted in the case of such branches, it would be difficult to run them and popularise banking among rural people. The enforcement of awards of Industrial Tribunals is likely to result in salary scales, fixed largely with reference to conditions obtaining in large urban centres, being made applicable to the smaller branches and will thus make the maintenance of such branches unremunerative for banks.

To meet this situation the Committee recommended that offices of banks situated in towns of less than 50,000 should be exempted from the Shops and Establishment Acts and from the awards of industrial tribunals.[1]

Other measures which were suggested as likely to stimulate the expansion of sound banking included the provision of less expensive remittance facilities by the Reserve Bank and its agents; better facilities for the conversion and exchange of notes and coin; facilities for banks to keep their iron safes and chests for safe custody in the strongrooms of treasuries and sub-treasuries; and the establishment of a Warehousing Development Board with funds contributed by the Central and State governments and the Reserve Bank to be made available either by way of loan or subsidy to banks or co-operative institutions. It was suggested that banking companies should be permitted to form subsidiaries for the purpose of constructing and running warehouses and that the certificates issued by

[1] An All India Industrial Tribunal (Bank Disputes) had been appointed in June 1949 to adjudicate on industrial disputes relating to banking companies having branches or other establishments in more than one State. The intention was to obviate the possibility of divergent and conflicting awards. The award of the Tribunal was published in Aug. 1950 and granted considerable improvements in scales of pay, hours, and working conditions. See *Reserve Bank of India Bulletin*, Oct. 1950, pp. 726–31.

them should be recognized, as an experimental measure, as valid warehouse receipts by the Reserve Bank.[1]

Most of the activities of the Indian commercial banks follow a fairly uniform pattern though there are, of course, numerous differences of detail. All the larger banks accept deposits both on current account and as fixed deposits.[2] Some banks accept money at call. Most banks keep savings-bank accounts, the exceptions being the majority of the exchange banks. Many banks pay interest on such current accounts as maintain the required minimum balance, usually at ¼ per cent. per annum, though some of the smaller banks pay more. In the case of the exchange banks interest at ¼ per cent. is paid on the minimum monthly balance provided an amount of between Rs. 25,000 and Rs. 1 lakh is maintained and interest is not less than Rs. 10 per half-year. It is common, however, to make incidental charges for keeping the account. Fixed deposits are accepted repayable at the end of the term for which they are fixed (this usually varies between one month and twelve) and interest is paid at rates which (usually) rise with the length of time for which the money has been placed with the bank.[3] The smaller banks frequently pay higher rates than the larger institutions in an effort to attract badly needed deposits. They charge correspondingly higher rates on their advances. Sometimes the distinction is made between short-term deposits and fixed deposits. Generally speaking, money deposited for less than six months is regarded as 'short-term' money, but in a strict sense all money available to the banks for a definite term is technically a fixed deposit. 'House money'—a term used in Bombay and Calcutta—is also accepted by certain banks. This

[1] See *Report of Rural Banking Enquiry Committee* (1950), pp. 60–65.

[2] Some small banks only accept fixed deposits and do not hold current accounts at all. In the case of scheduled banks there is a marked preponderance of demand deposits, while for non-scheduled banks time deposits greatly exceed those available on demand. Apart from this structural difference, the ratios of demand and time deposits vary regionally. Thus, scheduled banks in the Bombay and Calcutta areas have a ratio of demand to total deposits (about 70 per cent.) which is much higher than that for Delhi and Kanpur (slightly over 50 per cent.) or Madras (about 40 per cent.). See Reserve Bank of India, *Annual Report on the Trend and Progress of Banking in India*, period ended 31 Dec. 1949.

[3] It often happens during the busy season that a bank will be prepared to pay more for money at three months than at six months, because the period of stringency will only last three months and the bank expects to have ample funds thereafter.

is call money available from business houses and private individuals of standing and represents their surplus cash. It is placed with the banks through finance brokers and it usually attracts a rate of interest ¼ to ½ per cent. higher than that on call money proper which is usually only available from day to day. Strictly speaking, house money is also at call, but in practice it tends to be 'weekly money' (i.e. up to 10 days) and for this reason attracts the higher rate. Savings-bank accounts in India are really deposit accounts, subject to limited drawings by cheque. Practice varies, but the general rule is only to allow encashment of cheques once or twice a week within prescribed limits. Interest was formerly allowed on daily balances, but in most cases it is now calculated on the basis of the minimum monthly balance.

On the other side of the balance-sheet, advance business takes pride of place, though there are a number of other earning items, including investments and the discount of bills. Investment policy is much the same as that followed by banks elsewhere[1] but advances and discounts require more detailed discussion.

It is perhaps not surprising that business done by way of loans, cash credits, and overdrafts should be vastly more important than the volume of bills discounted. Bills discounted now represent no more than 3 to 4 per cent. of total accommodation granted by the banks.[2] This is said to be due to the less expensive character and more convenient form of borrowing by way of overdraft or cash credit. The bulk of the advance business—68 per cent.—is done by the Indian scheduled banks. The exchange banks are responsible for 25 per cent. of the business, and the non-scheduled banks for 7 per cent. Scheduled bank advances and bills discounted represent between 45 and 50 per cent. of total deposits, which compares with 55 to 60 per cent. for investments. (For non-scheduled banks the advance–deposit ratio approximates to 75 per cent.

[1] The bulk of bank investments are held in the form of Government of India and Provincial Loans—including Treasury Bills—and Trustee securities, with small holdings only of approved industrial shares, debentures, and bonds. Certain foreign securities are also held. The demand for Treasury Bills and short-term governments will be heaviest during the slack season.

[2] See Reserve Bank of India, *Annual Report of the Trend and Progress of Banking in India* (for period ended 31 Dec. 1949), p. 48.

and the investment ratio is slightly over 30 per cent.) Nearly half the total of scheduled bank advances are for commercial purposes and about one-third go to industry. Production credit for agriculture is small. Personal and professional advances constitute about one-tenth of the total, though in part these are used for business. Of the aggregate advances of all commercial banks, something like 87 per cent. are secured, the most popular form of security being bullion, including gold and silver ornaments. About a quarter of unsecured advances are made against 'clean' bills (i.e. no documents attached) and, in part, represent the finance of trade. Advances of a highly liquid nature such as those against merchandise and documentary bills constitute nearly half of total advances, those against government securities and readily marketable shares nearly a quarter, and those against real estate 6 per cent. Less than 1 per cent. of total advances was classified as bad and doubtful debts. The cotton industry is the largest single industrial borrower, and, together with jute and sugar, absorbs half the industrial finance provided by the banks. The credit extended to basic industries, such as engineering, coal, cement, and public utilities, appears to be quite small.

Among the non-scheduled banks, loans for consumption predominate. The amounts advanced to 'personal' borrowers and against the security of bullion are relatively much higher than in the case of scheduled banks. Advances against merchandise amount to about 21 per cent. of total advances, as against 42 per cent. for scheduled banks. Advances against real estate are nearly four times those of the scheduled banks and this is particularly true of the smaller non-scheduled banks.[1]

Advances are made in several different ways and for a number of purposes, though in general practice is based on British experience. Such an influence is most apparent in loan and overdraft procedure. The former relates to the loan against appropriate security of a fixed amount, which is shown in a separate loan account (the relevant moneys being transferred for operation to a current account) and indebtedness is reduced by instalments until the loan is paid off. Strictly speak-

[1] See 'Surveys of Bank Advances', *Reserve Bank of India Bulletin*, May 1951, pp. 311–35.

ing, the loan is repayable on demand, but in practice it is for an agreed term. In no circumstances can the satisfied portion of the debt be revived. The overdraft, on the other hand, represents a drawing up to an agreed limit, often upon the personal security of the borrower (sometimes against government securities, or stocks and shares) and, provided the limit is not exceeded, the debt can be revived. This form of lending is regarded as strictly of a temporary character, though it is not uncommon for an overdraft arrangement against shares to stand for a long period. The cash credit may be described as a special kind of overdraft. It is an advance made in overdraft form to joint stock companies, firms, or individuals to finance the holding of stocks. Such advances are made theoretically on demand, but in practice the cash credit is allowed to run for six or twelve months. The object is to provide working capital on a seasonal basis. Formerly, it was common to require a minimum interest clause, but this has now died out. In attempting to distinguish between cash credits and overdrafts, it would seem that the *purpose* of the loan is all-important, since the form of lending is the same. If the advance is against a pledge or hypothecation of goods, it is a cash credit. Sometimes the banks keep overdrafts and cash credits in separate ledgers, but this practice is by no means universal. Indeed, the accounting arrangements even vary as between different branches of the same bank.

Special mention should be made at this stage of joint and several loans, which are a feature of Indian banking. In Bombay these are also referred to in some quarters as 'Marwari loans', because the chief borrowers are Marwari merchants. These are demand loans for which security is taken on two signatures in promissory note form. In point of fact it is customary to allow such accommodation to run on (if it is required) for a period of months. Certain of these promissory notes state that they are repayable on demand, and are for a period of not longer than two months. Others are merely repayable on demand, but the bank concerned may agree with the borrower that the loan will not be called within a period noted in pencil on the document. One reason for this arrangement may be the avoidance of *ad valorem* stamp duty, since a demand promissory note only attracts a fixed duty of 4 annas.

Of greater importance, however, is the fact that such an arrangement is less binding on the bank and, if market reports of the borrower's business standing are unfavourable and the bank has reason to feel uneasy about the soundness of his position, there is nothing to prevent the bank from demanding immediate repayment. On the other hand, elasticity can be provided by successive renewals of the accommodation, though one leading bank will permit not more than five renewals, while the Imperial Bank clears out its joint and several loans once a year on 30 September, even when a new loan on the same basis might very well be made the next day. In addition, all joint and several borrowers are restricted by 'limits' to the accommodation they can seek in this way from an individual bank, though—at the height of the season—these limits may sometimes be exceeded. When a loan is to be arranged or renewed, the bank is frequently approached by a broker acting on behalf of the borrowing merchants and, to a certain extent, the bank depends on the reports given by the brokers regarding the standing, worth, and respectability of intending borrowers, but the banks also have their own special departments which make inquiries quite independently. Nor is there anything to prevent borrowers from approaching the bank direct. In this case the bank would depend entirely on its own inquiries and, if satisfied, would make the loan in the ordinary way. It will be apparent that the joint and several loan is a most convenient means of providing seasonal finance to merchants and traders and it is much used in India.

In Calcutta the banks normally provide finance to the jute trade against jute delivery orders. These orders are issued after receiving payment and are in the form of a request from a 'managing agent'[1] to the manager of a jute mill to deliver specified bags, or bales of cloth, under a numbered contract, to a specified person, the goods being held insured under a

[1] The original purpose of the managing agency system, which is peculiar to India, was to mobilize capital for industrial development at a time when there was no organized capital market in the country. In addition to capital, the managing agents possessed the necessary know-how and this led to their provision of specialist management services to companies they had helped to establish and in which they retained a share interest. Many of these agency firms also possess extensive trading interests. See P. S. Lokanathan, *Industrial Organisation in India* (London, 1935), and S. K. Basu, *Industrial Finance in India*, 2nd edn. (Calcutta, 1950), pp. 143–69.

mill policy until a specified date. These orders are transferable by endorsement and frequently pass from one hand to another. Usually, the banks are quite keen to advance against approved orders, but some are rejected because of a doubt as to whether the mill will be able to deliver. Indeed, it is not unknown for such orders to be issued by mills purely as an accommodation transaction and with no delivery contemplated. In this event the bank must know its customer very well and there have been cases of banks becoming involved in losses as a result of holding fictitious orders. These advances are usually made at 4–5 per cent. against margins of 25–30 per cent. The business is subject to a monthly settlement, though in practice the advance usually runs on, because orders which are retired are replaced by new ones each month. Latterly, this type of business has declined somewhat, because of government requisitioning of stocks and the resort to bilateral trade deals. The jute trade in up-country centres has in the past been financed more by a movement of currency than through banking channels, but this aspect is discussed in our chapter on 'Money and Banking in Pakistan'.

Finally, under the heading of loans and advances, reference must be made to the 'demand hundi', or inland bill of exchange.[1] This is not regarded as a true 'hundi' (discussed below) and statistically is an 'advance', though the document is drawn in bill of exchange form (usually, but not always, in the vernacular). Frequently, these demand hundis are drawn by a branch on another office of the same firm (e.g. on its Bombay or Calcutta office), but they may also be drawn on an indigenous banker, when they approximate to a cheque, though there is no stamp duty. They are used primarily to finance trade between 'mofussil' (or up-country) centres and the ports.[2] In this category, too, we might include government bills, in payment for goods supplied. On the whole, these are not favoured by the banks, because of slowness in payment, but some banks advance against government timber bills, as these are met more promptly. For good customers, most banks

[1] These instruments are also called 'demand drafts', or D/Ds.

[2] The usual procedure is to draw sight bills to finance the movement of a crop from up-country centres to the port and then to secure cash credit accommodation to cover the holding of stocks on arrival.

are prepared to accept these instruments for collection and they may even be discounted, when the collection (or discounting) charge depends on the distance the goods have to travel (i.e. the period for which accommodation is required). In effect, the demand hundi is virtually an 'interest bill', though they are never referred to as such. If the bill is not met on presentation, interest runs on at the same rate. Usually, there are no supporting documents, as the name of the drawer is sufficiently well known.[1] Where the name is not good enough, it is the practice to require the bill to be supported by railway receipts or by a bill of lading.[2] A somewhat similar procedure is followed in opening an inland Letter of Credit. Such a credit might be opened to finance the purchase of piece-goods in an up-country centre. These are bought up as the goods come into the market and finance is required until a shipment can be accumulated. Meanwhile, the buyer draws inland bills under his Letter of Credit against the railway receipts for goods already dispatched to the port.

Bill finance proper relates to (*a*) the internal finance of trade by means of the usance 'hundi'; and (*b*) foreign exchange business. The true 'hundi', which is also called a 'poorja' in Bombay and Calcutta, is usually made out in English in printed promissory note form[3] and is made payable so many days after date. Usually, days of grace are allowed, but if the hundi is made 'khara', it is without days of grace. Usance hundis carry a stamp duty of 2 annas per Rs. 1,000, irrespective of the usance. A hundi will be made by a small merchant, trader, manufacturer, or shopkeeper, in favour of a Multani banker, who thereby becomes the lender and the maker a borrower, at a rate of interest which in Bombay and Calcutta (e.g. during

[1] These are known as 'clean' or unsecured bills—i.e. 'clean' of documents.

[2] In the case of the Allahabad Bank, which does a big business in financing the movement and storage of agricultural produce, the movement of goods is financed by demand hundis, and the parties are guaranteed by the Bank's 'Treasurer'. He is a wealthy Indian property owner who is engaged in business on his own account and has special knowledge of up-country conditions. He acts only for the Allahabad Bank. The arrangement is based on a family connexion of long standing. The finance to carry goods *in store* is provided by way of overdraft or cash credit, and the security is invariably an actual pledge of stocks under the Bank's lock and key.

[3] It is common practice to have printed on top of the hundi the likeness of a goddess (or god) to bring good luck. Usually, the likeness is that of Laxmi, Goddess of Wealth.

the 1949–50 season) varies between 7½ and 9 per cent. per annum, but may be as low as 6 per cent. per annum. In Madras there is a flat rate of 12 per cent. per annum. The loan between the Multani banker and the borrower[1] is arranged by a loan broker who is paid a brokerage by the borrower for his services. Brokerage commonly amounts to $\frac{1}{32}$ per cent. Usually, the Multani banker then endorses the hundi[2] and, by arrangement through a hundi broker, discounts it with a scheduled bank at 3 to 4 per cent. per annum. The function of the hundi broker is to bring the Multani banker and the joint stock bank together and he is paid a brokerage for his services.[3] The broker introduces the Multani shroff to the bank and obtains for him the 'limits' up to which the bank will be prepared to discount his hundis,[4] but, once the arrangement has been made, the Multani deals direct with the bank. (Usually, he will have limits with several banks.)[5] In this way the Multani banker acts as an intermediary between the joint stock banks and the small trader, about whose credit-worthiness the banks will not usually have any detailed information. In effect the Multani guarantees the transaction and his guarantee is important, because frequently no value will have been received and the transaction will have been of an 'accommodation' character only. The scheduled banks may not be able to distinguish such transactions, but the Multani, who knows intimately the business connexions of his clients, will be in a position to identify the finance hundi (as, for example, when the businesses of the maker and lender are different and it is unlikely that any payment for goods is involved). Indeed, it is quite usual for hundi finance to be employed by those who would have difficulty in

[1] Sometimes hundis are drawn by merchants on a branch of their own firm or on a corresponding firm up-country, the proceeds of discounting to be divided between them.

[2] The endorsing 'shroff' becomes in this way the link between indigenous banking and commercial banking proper.

[3] By the Multani, following the rule that brokerage is paid by the borrower.

[4] The Multani may not wish to discount all hundis that come into his hands and those which he holds are known as 'box bills', because he keeps them in his safe-box. Sometimes he holds these to maturity, but more commonly he holds them for portion only of their currency, discounting with a bank when he desires increased liquidity.

[5] In fixing these limits, the banks follow the usual criteria, such as the integrity of the firm, the size of the firm's resources, and its known limits with other banks.

securing joint and several loans. But all this has been accepted practice and the system has worked well for centuries. It was almost unknown for a Multani banker (or 'shroff') to fail in meeting his obligations.[1] If necessary, he would receive assistance from his fellow shroffs, because in the event of failure the credit standing of the whole community would be damaged. Latterly, however, this tradition of credit-worthiness has suffered some reverses. The solidarity of the community has been undermined, partly by losses arising out of partition, partly by reason of the claims imposed upon estates by the Hindu system of joint family ownership, and partly by the entry into the field of persons whose ethical code is less reliable. In these circumstances the banks have tended to revise the limits they are prepared to offer for this class of business and these have now been fixed at levels which are fairly low.

Only four or five of the scheduled banks discount the true hundi (though almost all deal in demand hundis). Of this small group the Imperial Bank of India does by far the largest business, with the Bank of India and the Central Bank of India doing the bulk of the remainder. The residue falls to the Bank of Baroda and (to a much smaller extent) the Hyderabad State Bank. Opinions differ as to whether the hundi is used as much as before the war. It is known that the number of Multanis in Bombay has increased, but this is no doubt due to their migration from centres now in Pakistan. The probability is that any increase in the monetary value of hundi business has been much less than the rise in prices. Nevertheless, the hundi still remains a highly important means of financing the internal trade of India.[2]

In addition to their hundi business, which constitutes internal bill finance, almost all the Indian banks now conduct a business in foreign bills. This is done in emulation of the exchange banks and, apart from its profitability, this activity would also appear to have a certain prestige value. In general, the Indian banks only undertake the smaller types of transactions and the bulk of the exchange business is still left to the

[1] Sometimes, however, a hundi might be renewed, such renewals being arranged through a broker.

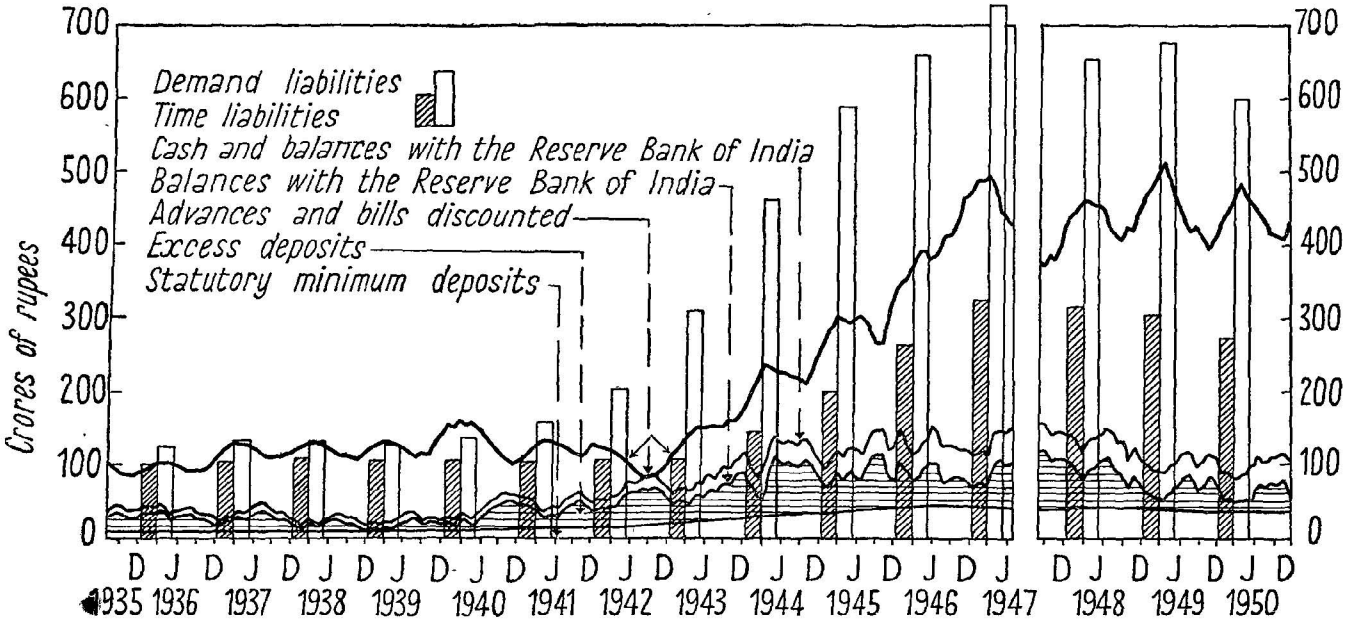
[2] It should not be forgotten that the other indigenous bankers also do a hundi discounting business and thus supplement the ordinary arrangements of bank discounting.

exchange banks. No Indian bank has yet been admitted to membership of the Exchange Banks' Association in Bombay, Calcutta, or Madras, though they are obliged to follow the rates and terms laid down by the Association. Quantitatively, the work of the Indian banks in this field is not unimportant, but it represents only a small part of their total bill business. At the same time their exchange business is expanding and they may in time present a more serious challenge to the exchange banks. The mechanism of such finance is substantially similar to that employed by the exchange banks and requires no further elaboration. There has, in the past, been considerable criticism of the monopolistic position of the exchange banks in this field,[1] and the authorities have actively encouraged the Indian banks to expand their business in foreign bills. This would seem to be the chief alternative to the establishment of Indian exchange banks, which up to date have not made a very successful début. Indeed, the Government has recently persuaded the Bank of India to establish Japanese branches in Tokyo and Osaka in order to secure for an Indian bank a reasonable share of a growing business. This was followed by the opening of a branch in Singapore. Furthermore, it required these branches to be managed by Indians, though the Bank's London manager was seconded to Tokyo to establish the first branch and remained as an 'observer' until the technicalities were thoroughly understood by the staff. By this means it is intended to build on existing experience and to encourage an understanding of a form of business in which there are many pitfalls for the unwary. Nevertheless, it will be many years before the entrenched position of the exchange banks will be seriously threatened and, in any case, there is much to be said for specialization in the field of finance, when the volume of transactions warrants it.

It remains to consider recent trends in the commercial banking field.[2] In any discussion of the development of Indian banking since 1939 it is advisable to trace briefly the results of

[1] See, for example, S. G. Panandikar, *Banking in India*, 6th edn. (Bombay, 1948), pp. 190 ff. However, many of the author's criticisms are no longer applicable since the Reserve Bank now has full power to regulate such activities.

[2] All statistics quoted below have been abstracted from publications of the Reserve Bank of India and no attempt has been made to give the detailed refer-


Crores of rupees
700
600
500
400
300
200
100
0
Demand liabilities
Time liabilities
Cash and balances with the Reserve Bank of India
Balances with the Reserve Bank of India
Advances and bills discounted
Excess deposits
Statutory minimum deposits
D J D J D J

the financial policy followed by the Central Government during the Second World War. During this period the Government was primarily concerned with the financing of a deficit which rose to a peak of nearly Rs. 190 crores in 1943–4 (total deficits 1939–40 to 1944–5 amounted to over Rs. 480 crores) and this was accompanied by a rapid increase in the floating debt. Total interest-bearing obligations (including unfunded debt and deposits) rose progressively from about Rs. 1,200

Treasury Bills and Ways and Means Advances

(*in crores of rupees*)

1939–40	54·70
1940–1	84·90
1941–2	136·98
1942–3	264·70
1943–4	110·61
1944–5	86·70
1945–6	83·33
1946–7	79·20
1947–8	86·84
1948–9	373·33

crores in 1939–40 to over Rs. 1,850 crores in 1944–5 (by 1948–9 it had reached a figure of over Rs. 2,400 crores). These developments were reflected both in a growth of commercial bank liquidity and in notes in circulation. Cash in hand and balances with the Reserve Bank for the scheduled banks increased from just over Rs. 20 crores in 1939 to nearly Rs. 120 crores in 1945 (there has since been a fall below Rs. 100 crores). Notes in circulation rose from Rs. 225 crores in December 1939 to nearly Rs. 1,140 crores in June 1945.

The development and growth of joint stock banking in India was greatly accelerated during the Second World War, particularly after the middle of 1942. There was a substantial increase both in the number of banks and in the volume of their resources. Significant changes also occurred in the distribution of bank assets. Thus, in 1935, there were only fifty

ences. Where the evidence was conflicting or incomplete the writer has interpreted the figures in terms of trends and has only attempted to give the general picture.

scheduled banks—i.e. banks with paid-up capital and reserves of Rs. 5 lakhs and over. By August 1940 this figure had increased to fifty-nine. No appreciable change took place until 1943 when sixty-four banks were scheduled. Thereafter, however, the growth was almost continuous and by August 1949 101 banks had been scheduled. Subsequently, there has been a small decline and the figure for June 1951 stood at ninety-five. Not all of these, of course, were new banks. Many were banks whose paid-up capital and reserves had now risen to and above the required Rs. 5 lakhs. On the other hand, non-scheduled banks reporting to the Reserve Bank have declined since 1940.[1] Since the movement upwards of the non-scheduled banks into the scheduled category is not sufficiently large to account for the apparent fall in the numbers of the former, it may well have been due to the incidence of bank failures. But the figures fluctuate so violently from year to year that it is difficult to draw any sound conclusions. Nevertheless, there was a significant growth in the number of branches and pay offices from 1940 to 1947 (when partition interfered with the comparability of statistics). Offices of the scheduled banks appeared to have more than doubled and, indeed, to have approached treble their pre-war figures, exceeding (in 1947) 3,500, as compared with about 1,350 in 1940. For the non-scheduled banks, absolute figures must be treated with more caution, but the trend appears to have been upwards at least until 1945 and their number likewise seems to have more than doubled. So that, by 1948, and including the co-operative banks, India was apparently served by a network of bank branches in excess of 5,000. This does not, of course, include the offices of money-lenders and indigenous bankers.

There was also a considerable increase in bank resources during the war years. This went hand in hand with the marked increase in the size of the currency circulation. Immediately pre-war, the note circulation approximated Rs. 180 crores. This rose progressively throughout the war and post-war period to exceed Rs. 1,300 crores by June 1948.[2] In addition,

[1] See Reserve Bank of India, *Statistical Tables Relating to Banks in India*, 1941–9.

[2] In round figures, the growth was as follows (in crores of rupees): 1940 235; 1941 260; 1942 447; 1943 732; 1944 931; 1945 1,137; 1946 1,237; 1947 1,224; 1948 1,320; 1949 1,154; 1950 1,169.

there was a considerable absorption of small coin. This increase in the currency circulation was reflected in a related—though not proportionate[1]—rise in bank deposits. In December 1939 the demand and time liabilities of the scheduled banks amounted to Rs. 252 crores. By June 1945 this figure had risen to Rs. 868 crores[2] and the rise in demand deposits during the war years was greater than that in time deposits, because of the high liquidity preferences of depositors and (subject to the seasonal fluctuation) the persistent fall in the rate of interest offered on time deposits. For December 1939 the demand liabilities for the scheduled banks stood at Rs. 147 crores and time liabilities at Rs. 105 crores, but, by June 1945 the respective totals were Rs. 629 crores and Rs. 239 crores, most of the growth in the latter taking place after 1943. Similar trends applied to the non-scheduled banks, though the normal relationship between demand and time liabilities (based on scheduled bank experience) tends to be reversed. Thus, in 1939, demand liabilities amounted to Rs. 4,87 lakhs and time liabilities to Rs. 11,09 lakhs. By 1945 the position had altered drastically and the respective totals were now Rs. 33,92 lakhs and Rs. 39,72 lakhs (indeed, in 1943, demand liabilities at Rs. 17,52 lakhs actually exceeded time deposits of Rs. 17,27 lakhs, though the latter's position was soon restored). Both relatively and absolutely, the demand liabilities of the scheduled and non-scheduled banks together increased much more than their time liabilities.

On the assets side there were significant changes in the distribution of resources. The most notable feature was the high degree of liquidity which was maintained. There were two reasons for this: first, the banks were obliged to maintain a highly liquid position because there was a certain amount of apprehension that, as a result of war developments, there might be a withdrawal of deposits; and, second, avenues for the profitable employment of funds in trade and industry were limited during the war period, with the Government providing

[1] That is to say, many transactions were effected on a cash basis outside the banking system. This reflects the restricted growth of the banking habit in India.

[2] The figures for total deposits for June 1946, 1947, and 1948 exceeded Rs. 1,000 crores. By June 1949 the total had fallen to approximately Rs. 875 crores.

the bulk of the finance required for the execution of war contracts. Hence, the investment of an increasing proportion of their funds in government securities. At the same time the cash ratio was maintained at a relatively high level. The high degree of bank liquidity is also evidenced by the excess of bank deposits with the Reserve Bank over the required statutory minimum (see Graph facing p. 173).

Comparative Bank Ratios for Years 1939–49

1. *Cash and Cash Balances*; 2. *Investments (including Government Securities)*; 3. *Loans, Advances, Bills Discounted and Purchased—as Percentages of Total Deposits*

	Imperial Bank			*Other Indian scheduled banks*			*Non-scheduled banks (with paid-up capital and reserves of Rs. 1 lakh and over)*		
Year	*1* %	*2* %	*3* %	*1* %	*2* %	*3* %	*1* %	*2* %	*3* %
1939	12·6	43·3	55·0	17·2	38·9	56·1	12·2	28·2	86·9
1940	25·9	50·6	33·6	23·6	40·0	46·1	18·4	25·5	72·0
1941	14·0	59·1	35·7	18·8	45·4	48·6	20·7	28·9	72·7
1942	14·1	71·2	20·7	23·1	53·7	32·0	28·0	28·7	60·5
1943	24·9	60·7	18·9	23·9	51·4	33·6	32·4	24·9	55·8
1944	11·9	62·5	29·5	20·6	53·2	36·2	35·7	25·0	50·6
1945	16·0	59·4	28·1	19·6	51·4	40·8	31·4	30·2	50·0
1946	15·6	56·9	34·7	19·1	44·2	50·1	26·8	34·2	54·5
1947	15·0	57·3	31·1	19·6	46·0	46·5	20·8	33·0	64·9
1948	15·6	57·5	35·0	19·4	47·0	46·7	17·6	33·2	67·9
1949	26·7	42·7	36·7	15·7	47·5	42·5	17·1	33·1	70·8

Source: Reserve Bank of India, *Statistical Tables Relating to Banks in India*, 1939–49.

The other important change affected the assets item 'advances and bills discounted'. Before the war total advances of the scheduled banks (including bills discounted) moved in the region of 50 per cent. of deposits. By 1943 this ratio had fallen to about 25 per cent. Thereafter there was a marked improvement in absolute terms and, at the end of the war, the proportion had risen to about 33 per cent. However, the relative fall in war-time advances was offset by a rapid growth in bank holdings of investments and it is noticeable that when the ratio

of advances to deposits fell, that of investments to deposits rose.

For the non-scheduled banks, however, the major changes were confined to the cash– and advance–deposit ratios. The investment ratio changed little during the war years. As a result the fall in the advance ratio to 1945 was accompanied by a rising cash reserve ratio. Subsequently, the recovery in the advance–deposit ratio was accommodated by a fall in cash reserves—relative and absolute.

II. *The Indigenous Lenders*

Joint stock banking in India is concerned primarily with an urban demand. Nevertheless, in the cities and towns, there also exist indigenous institutions which cater for the many small manufacturers and traders. These may borrow by way of mortgage loans on house or other property or by means of hundis. A good deal of business is also derived from up-country trade and it has been estimated that the indigenous bankers finance nearly 90 per cent. of India's internal trade. But it is in the rural areas that the indigenous institutions find most scope for their activities. India is primarily an agricultural country and her social life is based on the village community. It is in the villages, therefore, that the indigenous institutions make their greatest contribution.

It is difficult to give a tidy picture of the indigenous credit structure, but at the cost of some omission of detail it will serve our purpose best if we concentrate on two broad categories—the indigenous bankers and the money-lenders.

It should be remarked at the outset that the indigenous banking and money-lending groups merge one into the other. If one may generalize the position, the indigenous banker supplements his resources by accepting deposits from the public, whereas the money-lender trades primarily on his own capital. At the same time, the latter may raise additional funds by borrowing from other institutional lenders. Thus, the rural money-lender may borrow from urban money-lenders and the urban money-lender in turn from indigenous bankers, merchants, and traders, and even from co-operative banks and societies.

Indigenous bankers[1] comprise a heterogenous group of people who generally combine banking with other forms of business. They range in size from firms which are little more than petty money-lenders to substantial shroffs, who carry on a large and specialized business which at times exceeds that of some of the scheduled banks. It has not been their practice to publish balance-sheets, and they are disinclined to introduce modern methods into their business, which has been carried on for centuries in accordance with an established tradition. Indeed, those who undertake this type of business will usually be found to belong to certain castes or communities, such as the Multanis, Marwaris, Natukottai Chettis, or the Kalladkurchi Brahmins.

The *Multanis* derive their funds mainly from their own resources. Their headquarters was formerly at Shikarpur, but they have now spread all over India, concentrating their activities in the cities and towns. They borrow from certain of the joint stock banks, which they regard as the appropriate source of their marginal finance. In addition, the Bombay and Ahmedabad shroffs lend money among themselves at a comparatively low rate of interest—4½ to 6 per cent. in Bombay and not more than 6 per cent. in Ahmedabad. The Multani restricts himself to his banking business (primarily a hundi business) and regards himself as prohibited by convention from accepting the risks of trade, which would multiply his lending risks.

The *Marwari*, on the other hand, is not so inhibited. He is a merchant banker. He deals as a merchant, lends money, and also does a hundi business. Usually he lends against goods by way of pledge supported by a demand promissory note or a usance hundi. He may even accept a mortgage, either as primary or collateral security. The Marwari bankers prefer to rely on funds from their own community, which are available at a rate of from 4 to 7 per cent., but they also accept deposits and the popularity of the 'Marwari loan' (borrowing on two names) in both Bombay and Calcutta suggests a growing dependence on bank finance to cover marginal needs in the busy season.

[1] For a detailed analysis of the origins and methods of the indigenous bankers see L. C. Jain, *Indigenous Banking in India* (London, 1929).

The *Chettiars*—in their hey-day[1]—used to accept deposits in quite considerable amounts from non-Chettiars, mostly in the form of fixed deposits for 3, 6, or 12 months, either at a fixed rate of interest or at a fluctuating monthly rate of an anna or two below the current Chettiar rate (the rate being quoted at so many annas per month). Current account deposits were accepted from traders and shopkeepers and there was also a certain amount of inter-Chettiar borrowing both in the form of fixed deposits and call money in addition to some borrowing by way of loan or overdraft from the joint stock banks.[2] On the lending side the Chettiars advanced both on the basis of hundis and on the pledge or hypothecation of goods. Loans were also given on personal security and sometimes two or three Chettiar firms would join together to give such a loan where the amount was beyond the resources of any one or there was a desire to spread the risk. It is worthy of note that not all Chettiars were lenders of money. Some were merchants pure and simple and it was quite common for Chettiar merchants to borrow from the Multanis and not from their own community.

The *Kalladkurchi Brahmins* accept fixed deposits at 6 to 8 per cent. and current deposits at 5 to 7 per cent. They also borrow to an extent roughly equal to their own capital.

The fact that indigenous bankers are drawn from banking castes or communities accounts for the influence of tradition on their methods. The indigenous banker is brought up to his calling. Generally speaking, he receives no special banking education. He draws on the experience of the past, either his

[1] Much of the Chettiars' business was in Burma and South-east Asia generally and, with recent political changes in these areas, they have lost heavily. As a result, they are unlikely to regain their former importance. In any case, their business in South India was never as significant as their activities overseas, where, as a result of lending on the mortgage of land and of foreclosing when their clients could not repay the loan, they succeeded in acquiring huge blocks of some of the best rice land in South-east Asia.

[2] In their hey-day a Chettiar loan normally granted by the banks for a period of three months against demand promissory notes was paid as promptly on its due date as a Multani hundi, and the fact that the Chettiar was charged ½ to 1 per cent. more than the Multani was not due so much to differences in the degree of credit-worthiness of their respective communities as to the fact that the Multani dealt with the Bombay banks and the Chettiars with Madras or Rangoon banks. In other words, the differential was primarily due to the nature of the markets in which the bulk of their business was done. Rates higher than Bombay still obtain in the Madras money market, though the Chettiar has virtually disappeared from the scene.

own, or that of his firm. From the point of view of the borrower his chief virtue is the absence of formalities and delays. His accounts are kept in a simple and economical way, but are accurate and—for his purposes—quite adequate. His establishment is not elaborate and therefore his overhead costs are low. A typical firm would occupy a large airy room with the staff sitting cross-legged on grass mats. The first person to be met is a clerk, who sits in front of and to the left of the banker, using a floor-level lectern to support the book in which he enters the transactions. The banker (either alone or with his partner) sits behind a cash-box (or till), which is the symbol of his trade and is handed on from generation to generation and he is flanked one on each side by his safes. After the entry of the transaction by his clerk, the banker proceeds to make the loan, or accept the deposit, personally.

Besides this informality, the indigenous banker is accessible. His lending policy is flexible and though he may appear to take more risks than his joint stock counterpart, his closer personal knowledge of his customer to a large extent offers a measure of protection not available to larger institutions. The joint stock banks, on the other hand, investigate the nature of the security much more closely and, in any case, their managers cannot have the same margin of discretion as the small man. The indigenous banker may also be able to offer special facilities to his customer. For example, most street markets are open in the evening (until 10 p.m.) and, when these close for the day, the indigenous banker will be prepared to offer safe custody facilities by accepting overnight deposits and will pay interest on the money (which may not, in fact, be withdrawn for some days). Again, goods may be under pledge to the banker and it is desired to get them to the railway station for transport to their market at an hour when the joint stock banks are still closed. The indigenous banker, however, will be prepared to open up at 6 a.m., get the goods out of the godown and to the railway yards by 8 a.m. Because of these facilities, even quite large firms keep accounts with the small indigenous bankers.[1]

[1] Though, in time, the indigenous banker is likely to lose these competitive advantages due to the extension of restrictions on hours. e.g. in Madras State, the Shop Assistants Act now applies to a much wider area and the indigenous banker has had to conform to the new regulations.

Even when he is not a merchant himself, the indigenous banker is primarily concerned with the finance of trade. As a general rule it is not practicable for him to establish direct business relations with the agriculturist, though indirectly he may finance even agriculture by making funds available to local 'sowkars' (or money-lenders). It is true that in pre-war Burma (and elsewhere in South-east Asia) most of the Chettiar loans were made to agriculture and one feature of their system of finance was to send clerks out into the villages to deal with local borrowers. Indigenous bankers do, of course, lend to grain merchants and may advance to agriculturists who have ready access to the towns, but assistance to agriculture is largely indirect by financing the trade derived from it. In financing the trader and small industrialist, the indigenous banker does a good deal of general banking business similar to that undertaken by the joint stock banks. Thus, he receives call money, short-term deposits, and fixed deposits, keeps current accounts, makes payments to the account holder personally, and honours his written orders conveyed by letter. He does not normally allow cheques to be drawn on customers' accounts. It is true that some indigenous bankers do issue cheque books, but such cheques would only have a limited local circulation. The indigenous banker gives advances both on the basis of security and on personal credit. He discounts hundis and accepts bills for collection, and provides hundis or drafts for purposes of private or trade remittance. So that he carries on a very large amount of inland exchange business through a network of offices and agencies, being in many an up-country centre the only agency for the transmission of funds.[1]

The credit facilities of the agriculturist were formerly provided almost entirely by the village 'sowkar' or 'bania'. The Indian peasant, or 'ryot', was the chief customer of the village money-lender. These small farmers had little credit to offer and no joint stock bank, even if it had a branch nearby, would be willing to lend. Where liquidity is the main consideration, the small landholder with his crop only ready for harvest after about eight months could scarcely expect to borrow from the commercial banks. In any event, a joint stock bank is a rare

[1] Where hundis are used for remittance purposes, transfers are effected at highly competitive rates.

phenomenon in rural India. The money-lender had for long been an indispensable adjunct to village life and his importance might be judged by the fact that the vast majority of Indians live in the villages.[1]

Money-lenders may be classified broadly into two groups: (*a*) the professional money-lenders, both rural and urban, and including itinerants; and (*b*) various non-professional money-lenders, such as landowners and the larger agriculturists, merchants and traders, and such persons—pleaders, pensioners, priests, and widows—who lent out their surplus cash to those in need of assistance. There was also a certain amount of petty money-lending, based on friendship and usually without interest, among members of the same caste or tribe.

The methods of business and system of accounts of the village money-lender were simple, though infinitely diverse and varying with the idiosyncrasies of the individual money-lender, the circumstances of the debtor, the nature of the security, even the locality. As a rule, loans were given on the basis of mutual trust and often without a document or even a witness. But when the amounts were large, or the transaction represented the renewal of an old loan, promissory notes might be taken. Loans might also be made on the security of mortgages of land, houses, and ornaments, and on rare occasions of cattle. For current agricultural needs, the money-lender usually accepted personal security, on the understanding—express or implied—that the produce would be sold to or through him. This was not surprising, because the bania or sowkar frequently started as a shopkeeper and became accustomed to lend on a paddy basis (the maund of rice was his unit of account). He bought and sold on credit, but he neither borrowed nor lent money, and even today much village 'finance' continues to be made available in kind. However, this system was open to abuses, especially when the creditor fixed the price at which he bought the crop and deducted charges for various 'services'. In addition, weights and measures were most unreliable and much cheating went on. Moreover, the money-lender was not interested in the purpose for which

[1] For a recent study of Indian village life see *Bhuval—Socio-Economic Survey of a Village* (Indian Society of Agricultural Economics), by V. and S. Shah (Bombay, 1949).

money was borrowed, nor in the manner in which it was spent. The borrower was rarely pressed for repayment and at compound interest the debt frequently accumulated at an alarming rate. The accounts kept were often most inadequate and the smaller money-lenders kept nothing more than a scrap notebook in which they jotted down a few details,[1] or a loose bundle of bonds or decrees on the back of which entries were made of the amounts paid by the borrowers. Only the more substantial money-lenders maintained both a daybook and a ledger.

It became a matter for general comment that, although most accommodating in providing finance for all purposes,[2] relations between the money-lender and the villager steadily deteriorated over the years. Formerly, the money-lender was restrained by various conventions and by public opinion, but with the introduction of Western legal arrangements the tendency was for these restraints to weaken and for the letter of the law to be enforced. In this respect, the appalling illiteracy of the peasant played right into the hands of the man on whom he so vitally depended for his finance. But the balance of blame was by no means all on one side. It was not unknown, for instance, for a ryot to hypothecate a crop to one person and to sell it quietly to another. The money-lender retaliated by taking bonds for larger amounts than had actually been lent[3] and he regarded this merely as a regulation of his dealings such that he indemnified himself against risk of loss. It is true that he charged usurious rates of interest, but there were often wide discrepancies between the rate of interest stipulated in the contract and that which was finally realized.[4]

The methods of business of the urban money-lender were almost the same as those of the man operating in the villages,

[1] Indeed, it is said that money-lending widows often kept no record whatsoever of the transactions they entered into and depended instead on a prodigiously accurate memory, see L. C. Jain, op. cit., pp. 66–67.

[2] Marriage and funeral loans were probably the most important of the non-productive types of borrowing, but 'each social and religious occasion is celebrated with pomp and splendour as required by the rules of the caste'. V. and S. Shah, op. cit., p. 111.

[3] Other malpractices included demands for advance interest, requiring a 'present' before doing business, taking a thumb impression on blank paper with a view to inserting an arbitrary amount at a later date if the debtor became irregular in payment of interest, and general manipulation of the account to the disadvantage of the debtor.

[4] See *Central Banking Enquiry Committee Report*, 1931, vol. i, Part I, p. 82.

except that the urban money-lender often advanced on hundis and his operations were on a larger scale. He, too, was accustomed to combine the business of money-lending with ordinary trading.

The itinerant money-lenders, on the other hand, only provided credit for persons who could not obtain it elsewhere. The Pathans (or Kabulis) were probably most well known, though there were also the Rohillas and, in certain areas, cattle dealers. The Pathan money-lender was found in almost all parts of India and his business was confined more to particular classes of people than to areas. His clientele consisted primarily of the poor—the mill labourers, menial servants, and low-paid clerks—though sometimes men of better position fell into his hands. Advances were usually within the range Rs. 5 to Rs. 50, and either promissory notes, or signatures and thumb impressions in 'khata' books, were the most common forms of acknowledgement obtained from the debtors. In cases of default, the money-lender used force and intimidation and seldom resorted to the law courts. Actual cases of violence may not have been many, but the methods employed were such as to keep the borrower in a state of perpetual fear. Since partition, it is said that the Pathan has become very much less common. In any case, as an alien, his movements are now somewhat restricted. Evidence of his activities can still be found, however, and he has been seen in recent years in the villages, more particularly in the vicinity of Bombay. But it would seem that he has very largely been driven underground and his operations are no longer on any scale.

Over a period of years, various attempts were made to regulate the activities of the professional money-lenders and to restrict the worst abuses. But ignorance of the law, illiteracy, and the ease with which loans could be had from this source rendered much of this legislation inoperative. Latterly, however, the legislative requirements have been made much more stringent and, even more important, the nature of these provisions has become more widely known. The effect has been the virtual disappearance of the professional money-lender from many areas. Taking into account the risks involved, it has no longer seemed worth while to operate under the new provisions. Thus, the money-lender or pawnbroker must now secure a

licence; interest is restricted to $9\frac{3}{8}$ per cent. on small loans (up to Rs. 25) and $6\frac{1}{4}$ per cent. on larger loans; other permitted charges are strictly regulated; a pawn ticket must be provided; proper books of account must be kept (either in English or some other specified language); and rules have been laid down to ensure that auctions of pledges are properly conducted. Penalties are provided for contravention of the Acts and the pawnbroker may suffer fine, imprisonment, or loss of his licence. Rather than face the difficulties of life under these conditions, the money-lender has changed his calling and become a merchant or trader, though he probably still carries on an illicit money-lending business on a restricted scale.

The decline in the importance of the professional money-lender has had two effects. First, a vacuum has been created which existing institutions have not been able to fill and there is in consequence a great dearth of credit in the villages. It has been estimated that the co-operatives only cater for from 5 to 10 per cent. of the financial requirements of the rural areas and, even where their services are available, they are not nearly so ready to lend. They investigate the ryot's affairs more closely than did the sowkar; they require security and adequate arrangements for repayment, whereas the sowkar used to lend with no questions asked and repayment was often not insisted upon, provided the interest was duly met. As a result, the villager today finds borrowing difficult and suffers much inconvenience. In many cases, he would like to borrow more if he could. For the poorer man, difficulty in securing accommodation may, in part, be a reflection of lack of credit-worthiness, especially now that the sources of easy credit are drying up. This may well have been so even if his debt position had improved, as is so often assumed, in consequence of war-time inflation and high prices. But such evidence as we have indicates that, so far as there was an improvement in the incidence of rural indebtedness during the war years, the poorer man gained relatively little and, indeed, in many cases his indebtedness increased. Though there have been over-all reductions in debt of quite significant proportions, those who gained most seem to have been the larger landowners.[1] Latterly, costs have

[1] See two statistical studies, B. V. N. Naidu, *Report of the Economist for Enquiry into Rural Indebtedness* (Madras, 1946), in which the debt position in 1939

tended to overtake prices and the opportunity for further debt reduction has disappeared. Indeed, the trend now seems to have been reversed and the creation of new debt appears to be on the increase. However, much of the new debt is described as 'productive' (i.e. money has been used either for the acquisition of land or its improvement) and less new lending appears to be finding its way into consumption loans, which expenditures can now often be financed out of income.[1]

Second, and because of the villager's insistent demand for accommodation, the non-professional money-lending groups, which have always operated to some extent, are increasing in importance. Thus, it is not uncommon—even in villages where co-operatives exist—for the larger landowners and wealthier ryots to lend to the poorer members of their community, frequently at high rates of interest which the borrowers are quite prepared to pay. Moreover, the agricultural money-lender is often more grasping than his professional counterpart. He usually lends seed against the security of future crops, or cash against the security of land, and he is quick to seize the opportunity to foreclose. But the evidence is conflicting and it is sometimes said that, being agriculturists themselves, these lenders 'are more considerate than the former professional moneylenders in their dealings with the farmers'.[2] In addition there are the merchants and traders and miscellaneous moneylenders who still carry on an ancillary lending business, which is not unimportant.

III. *Co-operative Banking*

Supplementing the work of the indigenous institutions are the several species of co-operative banks. These provide, first, one of the two main links (the other being the endorsing shroff) between the sophisticated institutions of the central money

and 1945 is compared, and D. R. Gadgil for the Bombay Provincial Co-operative Institute, *Effects of War on Economic Position, with Special Reference to Indebtedness of Members of Co-operative Societies in Bombay Province during 1939–40 and 1943–4* (unpublished).

[1] See Reserve Bank of India, Agricultural Credit Department, Bombay, *Glimpses of Co-operation in Bombay* (Bombay, 1950), '. . . the steep rise in agricultural prices during the war years has not resulted in any substantial increase in the savings of the agriculturalist . . . once he cleared away his debts, [he] reverted to his improvident habits and frittered away his savings' (p. 89).

[2] See V. and S. Shah, op. cit., p. 78.

market and the credit needs of both the rural village and the smaller artisans of the towns. Attempts have been made in recent years—by formalizing relations between the provincial co-operative banks and the Reserve Bank—to strengthen this link, but (as we shall find in our succeeding chapter) the integration is not yet by any means complete. Second, it was intended that the primary co-operative societies should provide credit facilities in direct competition with and as an alternative to the money-lender. In this context it is also appropriate to consider the chit funds and nidhis of South India, which provide a semi-indigenous form of co-operative banking.

The main function of the agricultural co-operative societies has been to supply rural credit and to educate the farmer in the practices of co-operation and thrift. More recently, there has been a shift of emphasis to the multi-purpose potentialities of co-operation, such as the development of marketing[1] and procurement facilities. This has been the chief effect of the recent war.[2] From the depression of the early thirties to the outbreak of war in 1939, the progress of the movement was rather discouraging when compared with the pre-depression period. During the war, however, the position improved, as was reflected in the increase of working capital from Rs. 106 crores in 1938–9 to nearly Rs. 164 crores in 1945–6. But this increase in working capital, substantial though it appeared to be, was not in proportion to the war-time inflation, due perhaps to the societies' own disinclination to augment funds unduly at a time when the demands of borrowers were decreasing. Another not unimportant reason may well have been that, once the farmer cleared his more burdensome debts out of his increased war-time earnings, he lacked the incentive to save further and soon lapsed into his traditional habits of improvidence. As a result, a unique opportunity was lost in not augmenting working capital by an expansion of members' deposits.

[1] Marketing arrangements have for long been a cause of considerable discontent, as a result of unfair quotations and faulty weights and measures. The co-operatives, when they have gone into this field, have insisted, in the interests of the producer, on public auctions and properly inspected weights and measures and have been successful in eliminating at least the major abuses.

[2] See Reserve Bank of India, *Review of the Co-operative Movement in India*, 1939–46 (Bombay, 1948) and 1946–8 (Bombay, 1950).

Since the war, there has been some increase in advances to agriculture due substantially to the rise in working costs and the demand for improvement loans. Indeed, the Rural Banking Enquiry Committee, which reported in 1950, refers to the experience of considerable financial stringency in rural areas and states that 'the co-operative institutions are now faced with large demands for funds which they are unable to provide'. Further, as a result of the compulsory scaling down of agricultural debt and the fixing of instalments in which the adjusted debts are to be repaid, 'the normal sources of finance have dried up' and the problem of making adequate provision for the needs of the adjusted debtors and other credit-worthy agriculturists has become urgent.

The legislative basis for the development of co-operative banking was provided by the various provincial Co-operative Societies Acts, dating from 1904. The foundations of the system are the village or 'primary' societies, which are generally linked with 'central banks'. These, in turn, are affiliated with the provincial banks. A village credit society can be formed by the association of a minimum of ten members, who then apply for registration. Where the majority are agriculturists and the object is 'the creation of funds to be lent to its members', the liability of members is unlimited. The internal resources are derived from entrance fees, members' deposits, and surplus assets held in reserve. External assistance is obtained from 'central' and provincial banks, and the Government. Accommodation is also available, under certain conditions, from the Reserve Bank of India. These funds are then lent out to members at moderate rates for current and short-term purposes. The uses to which loans are put should be strictly productive, but loans for non-productive purposes, which are 'necessary and unavoidable' (e.g. marriage loans) may also have to be granted from time to time (though with due care) to prevent a member seeking accommodation elsewhere at usurious rates of interest. The period of repayment depends, among other things, upon the purpose for which a loan has been granted and may vary from three months to three years.

Reference has already been made to the federated structure of the co-operative system. There are good reasons for the institution of this form of organization. A number of scattered

village banks working independently could only achieve rather limited results. More capital was required than could be raised from local sources and some form of federation was therefore seen to be necessary, not only for the purpose of securing access to larger amounts of capital but also for the spreading of risks. With this object in mind, village banks were grouped under 'central banks', which were better placed for the attraction of deposits from the public. They covered a larger area and were able to contact urban dwellers with whom the banking habit was more developed. Furthermore, the liability of the central banks was limited and the management was in more capable hands. It was natural, therefore, that they should attract deposits more easily from the middle classes. The village societies were, of course, members of the central banks, but the bulk of the latter's deposits came from private individuals, who placed money on deposit for fixed periods. These moneys were then usually lent short-term to the primary societies, though latterly some of the central banks have undertaken a commercial banking business as a means of employing surplus funds. However, commercial banking strictly lies outside the sphere of the co-operatives and, while certain authorities are in favour of its extension, it is frowned on by the Reserve Bank itself and lending funds to village societies is regarded as the main function. But such lending might lead to embarrassing situations. Money might have been lent to one village and would not therefore be available to another. In these circumstances, co-ordination of provincial finance and supervision of the central banks themselves became necessary if money was to be obtained on reasonable terms. This co-ordination was supplied by what were called provincial or 'apex' banks.[1] In this way, a federal structure was provided, though it was not always availed of.

An attempt to meet the long-term requirements of agriculturists has been made by the establishment of land mortgage banks, but such banks are few in number and of comparatively small resources, except in Madras. Indeed, the real beginning of land mortgage banking in India came with the setting up of a Central Land Mortgage Bank in Madras in 1929. Then, in

[1] In districts where there were no central banks, a provincial co-operative bank would provide the necessary facilities for the village societies.

order to centralize the issue of debentures and co-ordinate the work of primary banks in the province, Bombay followed with a central institution in 1936, though as early as 1926, when proposals for the creation of a land mortgage organization were first put forward, the Bombay Provincial Co-operative Bank had functioned (at the request of the Government) as a temporary land mortgage bank and it had financed local land mortgage banks on the basis of additional issues of debentures. Some of these mortgage loans are still outstanding. Land mortgage banking has also made appreciable progress in Mysore. In other areas, however, the technique of land mortgage banking was either imperfect or hardly developed at all. Much the same position holds good today. In the past, advances have been mostly for the reduction of old debts and, with the heavy repayments of the war years, the lending activities of land mortgage banks declined. More recently, there has been a reversal of this declining trend in advances and fresh loans are now being made on a large scale, usually at $4\frac{1}{2}$ to 5 per cent. per annum for improvement purposes, including the purchase of machinery.

In addition, there are non-agricultural societes called 'urban' banks. These cater for the needs of small traders, artisans, their employees, and government servants. This branch of the movement caters for a much smaller population than the agricultural societies, but from the point of view of working capital and the amount of business turnover it has definitely reached larger proportions. Moreover, the urban movement was little affected by the depression of the thirties (which dealt the agricultural societies such a cruel blow) since the fall in urban money incomes was not as drastic as in rural incomes and, indeed, the fixed income classes of the towns even benefited as a result of the appreciation in the value of their money. The standards of efficiency have been higher in urban societies since their larger resources enabled them in a number of cases to employ a full-time trained staff, and they are organized on the basis of limited liability with a fairly wide area of operation (generally extending to the whole of a town). Their principal functions are to promote thrift by attracting deposits from both members and non-members and to advance loans either on personal security or by way of pledge. For the most part

their own resources have proved to be adequate and they borrow only occasionally from the central banks.

It is important to emphasize, however, that the federal structure of co-operatives, which exists today, did not obtain from the beginning, and it is instructive to consider how it was evolved. In this connexion Bombay provides us with a useful case study. In its early stages the principal activity of the co-operative movement was the formation of rural credit societies. However, it was soon found that these societies could not themselves raise the funds necessary for their normal operations and, in the early stages, had to depend on small loans from the Government. In order to overcome this difficulty, the then Registrar of Co-operative Societies in Bombay suggested in 1906 that an urban co-operative credit society be established for the purpose of providing capital for rural societies. This led to the idea of a 'central bank', the principal object of which would be to provide finance to co-operative societies and, after considerable discussion, the Bombay Central Co-operative Bank was established in October 1911 as an urban co-operative credit society. It was subject to the oversight of the Registrar of Co-operative Societies and required to maintain in liquid resources a specified amount against its demand liabilities and to invest its surplus funds in government securities or in banks approved by the Government. Provision was made for the raising of limited funds by way of debentures, the interest on which was guaranteed by the Government. The bank commenced operations by taking over loans granted to other societies in various Bombay districts. Soon afterwards, existing urban societies elsewhere in the Presidency were gradually transformed into central banks in response to the desire of various districts to be served by their own local banks. Meanwhile, the Bombay Central Bank had come to use the new 'guaranteeing unions of primary societies' as its responsible local agents.

In 1920, however, it was laid down that there should be only one financing agency in any one tract and steps were taken to eliminate the overlapping of operations and to restrict the direct relations of the Bombay Central Bank with primary agricultural societies. Hence, as central banks came to be established in the various districts, the Bombay Bank's busi-

ness in these areas was transferred to them and its name was altered in 1924 to that of the Bombay Provincial Co-operative Bank 'to denote that the Bank's primary function would be to serve as an apex bank balancing the surpluses and deficiencies in the resources of its affiliated banks'.[1] Nevertheless, the bank continued its direct relations with primary societies in the few districts where, for various reasons, local banks preferred not to operate. Wherever this gap in the federal structure existed and when the level of business warranted it, the bank opened branches.

An important part of the work of an 'apex' bank is to serve as a 'balancing centre' for its province. This requires the bank to keep its funds liquid so that it can meet withdrawals at short notice or on demand. Thus, it accepts fixed deposits from co-operative institutions at a slightly higher rate than that offered to individuals (the rate depending on conditions in the money market), and it is prepared to go to the assistance of member banks in times of crisis by providing funds to meet local withdrawals of deposits. Another important class of depositor consists of public bodies—local boards, municipalities, and school boards—which deposit substantial sums with branches of the bank.

In addition, the apex bank is in a position to borrow from the central money market and thus link the rural societies indirectly with the main sources of credit. Thus, the Bombay Bank has cash credit arrangements with the Reserve Bank, the Imperial Bank, the Chartered Bank, and the Bank of India against government securities. Furthermore, it is in a position to secure call money from the scheduled banks at current rates of interest. When advance facilities were offered by the Reserve Bank for financing seasonal agricultural operations and the marketing of crops, the Bombay Bank was the first provincial co-operative bank in India to make the necessary arrangements. These advances are allowed for fixed periods on the security of bills or promissory notes of central banks, with a reduced rate of interest on advances for the marketing of crops. Credit limits have been sanctioned under this scheme for those

[1] See R. G. Saraiya, 'A Short History of the Bombay Provincial Co-operative Bank, Ltd.' (accompanying the *Administration Report* for the year 1947–8), pp. 1–16.

central co-operative banks prepared to agree to the terms prescribed by the Reserve Bank of India. The Madras Provincial Co-operative Bank has also availed itself of these facilities, but, whereas the Reserve Bank has wished to limit its advances to A- and B-class central banks, the Madras Bank has felt unable to distinguish between the weaker and the stronger banks and has extended its help to all at the reduced rate of $2\frac{1}{2}$ per cent. Since the liability to repay has been undertaken by the provincial bank, the Madras Bank has argued that the Reserve Bank should grant accommodation with reference to the *purpose* of the loan rather than on the basis of a classification of central co-operative banks.

District central banks are usually affiliated with the provincial bank. Overdraft accommodation is allowed to them on special terms against government securities. Similar facilities have been allowed to urban banks and, indirectly, the provincial banks provide fluid resources for the movement as a whole. As well as serving as a balancing centre for affiliated banks, the provincial bank will also function as a clearing house for them, and in some cases link these clearings with those of the commercial banks themselves.

Another condition of developing bank activity is the provision of remittance facilities. In earlier years, the banks used to avail themselves of the free remittance arrangements through the Treasury, but after 1940 the privilege of free transfer was withdrawn from co-operative societies and charges were fixed at rates half those for the general public. However, the Bombay Provincial Bank has since entered into arrangements with the Reserve Bank to permit its branches and approved central banks to send to Bombay remittances of Rs. 5,000, or its multiple, once a week free of charge and other remittances at $\frac{1}{64}$ per cent. As a condition of the arrangement, the Bombay Bank has to keep balances with the Reserve Bank of India to the extent of $2\frac{1}{2}$ per cent. of its demand liabilities and 1 per cent. of time liabilities and the benefit is passed on to central banks without their having to maintain corresponding minimum balances with the provincial bank. For the rest, remittance facilities are provided mainly by treasuries and sub-treasuries, branches of the Imperial Bank and, to some extent, by the post offices. More recently, the Central Board of the

Reserve Bank approved the Rural Banking Enquiry Committee's proposals for an extension of remittance facilities at reduced rates.

One feature of co-operative banking which cannot be overemphasized relates to the risks involved. Everywhere in India the proportion of arrears went up considerably during the period of agricultural depression in the thirties. With the wartime and post-war increases in the prices of agricultural products, there has been a marked improvement in the position, though it has been somewhat uneven. Even where co-operation is relatively strong and well-organized (as in Bombay) arrears are a constant danger, especially in areas subject to a partial or complete failure of the crop due to either insufficient or excessive rains. An attempt has been made to avoid bank losses by employing provincial bank inspectors to scrutinize the applications for loans and credits, to check statements of the position of bank clients, to stimulate recoveries, and generally to inspect the work of affiliated societies. But ordinary banking prudence cannot provide cover against the contingencies of famine conditions. Large parts of India are unfortunately liable to famine and, in these circumstances, it becomes necessary both to extend the period of repayments and to make arrangements to provide fresh finance for fodder, maintenance, and rehabilitation. Such finance is usually allowed at specially reduced rates of interest. Again, with the introduction of Agricultural Debtors' Relief Acts—or similar legislation—the risks of providing finance to persons whose prior debts have to be scaled down to enable them to repay out of current income were great, and governments have had to offer conditional guarantees to enable the banks to enter this field. In areas where co-operation is less developed and less well organized the risks are even greater.

Bengal offers an appropriate contrast. It is true that this area suffered considerably from the disturbances of partition, but—even allowing for that—it does not present a very happy picture. Thus, a recent report[1] indicates that while the working of the Bengal Provincial Co-operative Bank was 'on the whole satisfactory', twenty-two out of thirty-nine central banks

[1] Government of West Bengal, *Annual Administrative Report of the Co-operative Directorate* (for the year 1946–7).

were in difficulties. Indeed, most of these banks only appear to have survived as a result of the profits of a 'side-business in controlled commodities'. Referring to the primary rural credit societies, the report states that

> the general position . . . showed no improvement, as these societies continued to suffer from the old handicap of huge overdue loans and the stagnation caused thereby. The old credit societies which are still in heavy debts [*sic*] to their financing banks, are practically in a state of voluntary liquidation and have ceased to function as living organisations for catering to the needs of the rural population.

When account is taken of the riskiness of some of this lending, the rates of interest charged will be found most reasonable. Thus, at the beginning of the 1948–9 year the usual rate charged by the Bombay Provincial Co-operative Bank to societies with no arrears was 4½ per cent., to societies with arrears from 5 to 5½ per cent. Then, to enable the primary co-operative societies to advance funds to their members at 6¼ per cent. the Provincial Bank reduced the rate on short-term agricultural loans to 4 per cent. per annum, with effect from 1 January 1949 provided the primary society was not in arrears to the Bank. Otherwise interest was charged at 4½ per cent. In Madras the structure of rates appears to have been similar. Thus, for 1947–8 the usual rates for loans from the Provincial Bank was given at 3 per cent., from central banks and banking unions at 4½ per cent., and from agricultural credit societies at 6¼ per cent. The rates for West Bengal, as one might expect, were rather higher. The lending rates of the Bengal Provincial Co-operative Bank ranged from 4 to 6½ per cent.; those of the various central banks and banking unions were given as from 6½ to 12½ per cent.; and the host of agricultural societies did a lending business at anywhere between 9⅜ and 15⅝ per cent. The rates of non-agricultural credit societies appear to have ranged from 6 to 12½ per cent. For 1947–8 the rates for the East Punjab were given as from 2 to 10½ per cent. for central banks and banking unions and from 6 to 12½ per cent. for agricultural credit societies.

In addition to the provision of credit, the co-operative movement has for many years also concerned itself with 'multi-purpose' activities. Thus, the selling of agricultural produce on a commission basis as the agent of members of societies and

the supply to them of agricultural requisites such as manures, fertilizers, and improved implements was initially done through shops run jointly by the societies and their provincial bank. Later, when their successful working had been demonstrated over a number of years, these shops were transferred to newly registered co-operative purchase and sale unions or societies. These activities also enabled the co-operatives to undertake educational work of a practical nature—by the introduction of new varieties of seed, manures, fertilizers, and implements. Indeed, in many ways, this is likely to be their most important contribution. Nor was this work divorced from the more obvious function of providing credit, since at all these shops it became necessary to make advances against agricultural produce pending sale or delivery, or against supplies sent for disposal on consignment account.

The linking of the marketing and supply functions with the provision of credit has not always stemmed from the initial establishment of shops and, in recent years, more has been done by extending the functions of the credit societies into the sphere of non-credit business. In both Madras and Bombay existing rural credit societies are being converted into multi-purpose societies. However, the most important developments in multi-purpose activities have taken place in Uttar Pradesh (the United Provinces) under the Development Co-ordination Plan which came into operation in April 1947, the main purpose being to increase the production of food and cloth.[1]

These developments are undoubtedly in the right direction. Nevertheless, it should be emphasized that, in many cases, losses on the provision of credit through co-operatives have only been made good either by means of direct government subsidies, the profits derived from government-sponsored distribution schemes,[2] or the profits derived from non-credit activities. Indeed, in West Bengal, it is thought that the only way in which the moribund credit societies can be rescued is 'to

[1] See *Review of the Co-operative Movement in India*, 1946–8 (Bombay, 1950), pp. 8–11.

[2] Governments also assist by making loans, guaranteeing principal and/or interest of debentures issued by co-operative institutions, allowing special concessions and privileges (such as exemption from taxes), and by supplying personnel entirely or partly free of charge to various co-operative institutions which could not otherwise afford to employ them.

place these societies in the way of additional income by their reconstruction on a multi-purpose basis'. Even in Madras, where the movement is reported to be strong, some critics assert that 'there is a lot of window-dressing' and, except for the considerable support given by the Government and certain institutions, the co-operative movement would have languished.

In terms of aggregate statistics, the growth of the co-operative movement in India looks quite impressive. The depression of the early thirties failed to check either the increase in numbers of societies or of members, while the statistical impact of partition, though noticeable in terms of the number of societies, merely checked the growth in members. In both cases the upward trend has been resumed since 1947.

However, more interest will probably attach to the regional position.[1] The strongest areas in terms of *societies* (numbers of societies per 100,000 inhabitants are given in brackets) are the East Punjab (112·4), Hyderabad (108·8), West Bengal (59·5), Uttar Pradesh (51·2), Madhya Pradesh (Central Provinces) and Berar (43·7), Bombay (40·3), Orissa (36·3), and Madras (35·3). However, on the basis of numbers of *members* per 1,000 inhabitants (for those areas with a total number of primary society members exceeding 0·5 million), the order is slightly different. Thus, Hyderabad leads with 85·5, followed by Bombay (62·4), East Punjab (55·4), Madras (47·7), West Bengal (30·2), and Uttar Pradesh (20·3). Again, in terms of *working capital* for all areas exceeding a total of Rs. 5 crores, the order based on annas of working capital per head of working population[2]—a vital test—gives Bombay (317·3) the lead with a wide margin, followed by Madras (171·3), East Punjab (127·4), West Bengal (100·9), Hyderabad (63·0), Madhya Pradesh and Berar (57·3), and Uttar Pradesh (19·3). Mysore, which does not feature in our previous lists, has a total working capital of over Rs. 4 crores, with a per capita average of 82·6 annas.

In many respects these figures reflect good progress and, in the judgement of the Rural Banking Enquiry Committee,

[1] All figures quoted are for the year 1947–8. See Reserve Bank of India, *Statistical Statements relating to the Co-operative Movement in India for the year 1947–8* (Bombay, 1950).

[2] 16 annas = R. 1.

reporting in 1950, the structure of rural credit societies 'taken as a whole' was 'impressive' and

> owing to the changes brought about by the war, improved in certain respects, particularly in the reduction of overdues, which stood at about 47 per cent in 1938–39. Their ability to attract deposits and stimulate thrift has, however, continued to be low, deposits at present being only Rs. 3·04 crores. Fresh advances during 1947–48 were of the order of Rs. 10 crores, as compared with Rs. 6·7 crores for agricultural credit societies for all India in 1938–39.[1]

Nevertheless, this improvement has,

> by and large, been confined to the provinces of Madras and Bombay and outside these two provinces the condition of agricultural credit societies leaves much to be desired. . . . Their difficulties may be ascribed chiefly to overlending to members with inadequate attention to repaying capacity, with the result that much of the finance has remained frozen.[2]

It is only fair to point out, however, that the position of societies in the East Punjab and West Bengal must have been greatly prejudiced by the disturbances arising out of partition. Bombay and Madras have always been in the forefront and the Punjab (before partition) was also very active. Bengal, on the other hand, despite its apparent statistical strength, has remained weak. In Uttar Pradesh, progress has been recent and the present position is regarded as 'generally satisfactory'.

In attempting to appraise the value of the work done by co-operatives in India it is necessary to emphasize the major difficulties that have had to be faced. These have been due as much as anything to fundamental psychological factors. The Indian is not, on the whole, a good co-operator. He is too much of an individualist and resents any intrusion into his privacy. The restrictive rules of the village society are to him irksome and it is doubtful whether the co-operative movement has yet presented an acceptable alternative to the money-lender for whose services there is still a demand. Only slowly will this resistance be broken down.

Nevertheless, the movement has an asset which cannot enter directly into any balance-sheet. This is the enthusiasm of its leaders. The Reserve Bank itself has fostered the growth of the

[1] Note—all figures in the quotation refer to agricultural credit societies only.
[2] *Report of the Rural Banking Enquiry Committee* (New Delhi, 1950), p. 20.

spirit of co-operation; in the provinces, a number of notable men have given life-long service as Registrars of Co-operatives; and the leading provincial banks have worked hard to spread knowledge and enthusiasm through educational programmes, both by propagating the principles of co-operation in the villages and by serving as the training ground for the employees of urban and central banks. While this enthusiasm remains, the co-operative movement may yet provide the answer to India's needs in the rural field.

No account of co-operative banking would be complete without passing reference to the chit funds and nidhis of South India. These constitute a semi-indigenous form of co-operative banking and are a most interesting (if dying) institution.

To establish a *chit fund*, or 'kurie', a number of people must agree to trust one of their members (the 'foreman' or stakeholder) with a fixed number of periodical deposits. The total sum of the collections on each occasion is then advanced as a loan to one of the members against security (usually a signed promissory note must be supported by the deposit of title deeds, bullion, stock exchange securities, a life insurance policy, fixed deposit receipt, or by a surety). Repayment of the advance must be made in a fixed number of equal instalments spread over the duration of the 'chit', so that within a given period the sum borrowed and the accrued interest will have been fully covered. Different chit funds differ as to the original articles of agreement, the number of fixed deposits, the amount of each deposit, the interval between each deposit, and the duration of the transaction, but the essential features are the same.

Where there are several persons desirous of securing a loan on a particular occasion, an auction[1] is held (at which members who are not in need of the loan may also bid in order to prevent the actual borrower from securing the loan at too low a rate of interest). The person who offers to pay the highest amount in advance interest gets the loan. Interest, paid in advance, is then distributed amongst the subscribers. But the loan will only be issued by the 'foreman' on approved security and, under no circumstances, is the loan made unless the

[1] An alternative form is the prize chit, where a fixed prize is drawn by lot and the balance is disposed of by auction.

security offered is considered to be first class. For his services, the foreman usually receives a commission, but there may be other privileges, such as the 'side auction', where the foreman has the option of taking up the loan himself and then re-lending the money to a member of the chit fund at a higher rate of interest (possibly for an extra 2 per cent.). The foreman is usually fully liable to every subscriber for the repayment of the whole sum deposited, with accrued interest, and his duties are onerous. For this reason it is not uncommon for banks to manage chits.

Chit funds may be either rural or urban, the urban funds being more highly organized. The latter accept and pay interest on monthly deposits against which it is only possible to draw by way of loan. The deposit rate approximates 4 per cent. and the rate on withdrawals is 6 per cent. Money can also be borrowed against fixed assets, and these funds employ a trained valuing staff for the purpose. The funds will advance up to 50–60 per cent. of value at a rate of $7\frac{1}{2}$ per cent. There is no auctioning of moneys to the borrowers, as with the rural funds, and the organization clearly resembles that of a commercial bank. Indeed, in certain cases, such funds have become scheduled banks.

Nidhis[1] were originally started about the middle of last century in the Madras Presidency as mutual loan societies, but in the course of time they have developed as semi-banking institutions. They are registered under the Indian Companies Act, a few of them as banks. They receive deposits in monthly instalments, either in the usual form, or as withdrawable share capital. The receipt of deposits is seldom, however, a primary function and funds come mainly from share capital. They exist to promote savings, to offer debt relief to members, to reduce usurious rates of interest, and to accumulate a fund for special loans on good security to members. Sometimes loans are given to outsiders, if and when the nidhis have surplus funds. Usually rates of interest are low ($6\frac{1}{4}$ per cent. would be a representative rate), but high rates are charged on amounts overdue and these are said to yield a large proportion of their profits. There are thus certain similarities between the chit funds and

[1] See *Central Banking Enquiry Committee Report*, 1931, vol. i, Part I, pp. 197–200.

the nidhis and, indeed, the latter would appear to be a more sophisticated version of the former. But whereas the chit fund is a rather loose organization frequently of an *ad hoc* character and offering loans in cash or kind, the nidhi is only concerned with cash transactions and its affairs are organized on a more or less permanent basis.

Without doubt, these semi-indigenous forms of co-operative banking have grown up to meet a legitimate demand for credit facilities in areas where no true alternative existed. In particular they provide for organized saving and for lump sum expenditure. But while many of these funds are well managed, the system is open to abuse and there are numerous instances of fraud. The system depends upon the honesty and sense of responsibility of the parties and promptness of repayment, in the absence of which many of these funds end up in confusion. Registration and effective control have been suggested as a remedy, but without the development of a sense of responsibility no institution can be made to work. The *ad hoc* type of arrangement has been on the decline in recent years, the peasant preferring to go to a money-lender, but, in so far as only the more permanent and well-organized funds survive, the risk of abuse will be greatly diminished.

IV. *The Nature of the Money Market*

So far, we have discussed the structure of Indian banking in terms of its two main sectors—the commercial banks and the indigenous institutions. Little has been said about the relations between the two. In certain respects these two sectors are relatively distinct, but there is, of course, some degree of connexion between the several types of activity which we have described, and these links have been forged most obviously in the money markets of India's main commercial and financial centres. In this context it is appropriate to concentrate on the financial organization of the two main centres—Bombay and Calcutta. Calcutta is still by far the larger, but Bombay has grown steadily in importance. Both are centres of industry and commerce with developed stock exchanges.[1] Both are major

[1] There are two stock exchanges in Bombay (only one of which—the Native Share and Stockbrokers' Association—is important) and two in Calcutta (though

ports. Bombay possesses two leading markets in bullion and cotton, while Calcutta deals in considerable quantities of jute.

Madras is much less highly developed than the other two and tends to follow the lead of Calcutta, though it also has connexions with Bombay. Banking in Madras is rather 'mofussil' (i.e. provincial) by comparison with the main money markets and interest rates are relatively higher and less competitive. The call money market is scarcely a market in the true sense and inter-bank lending is arranged by direct contact. Nor can Madras be strictly described as a 'centre', since much of its business is done on an agency or branch basis for firms in Bombay and Calcutta, and the volume of transactions does not permit of that degree of specialization which is a characteristic of the more developed markets.

In essence, a money market is a place where the borrowers and lenders of short-term funds are brought together. It is usual in India to think of the money market as being undeveloped. In a sense, this is no doubt true, since there is still scope for much further development. But it is surely erroneous to describe this lack of development as mainly due to the absence of a discount market. A money market must be a product of its environment, and simply because certain markets have been built up on the basis of particular classes of business is no reason for believing that all money markets must follow the same pattern. Even in the absence of a discount market, there may still be in evidence a system of organized relationships and a specialization of function, similar to—though not identical with—those characteristic of money markets elsewhere. By such criteria, it may well be claimed that, in certain

again interest centres on only one—the Calcutta Stock Exchange Association). There is one each in Madras, Delhi, Ahmedabad, Kanpur, and three or four smaller places. The three most important are those of Bombay, Calcutta, and Madras. The Bombay and Ahmedabad exchanges are private associations. All the others are incorporated as limited liability companies. In Bombay and Madras forward transactions are permitted with fortnightly settlements. In Calcutta, with the exception of one security on an experimental basis, trade is on a cash basis. However, the fact that settlement may be delayed a few days gives considerable scope for transactions of a forward character. The rules regarding membership and trading are fairly uniform, being based mainly on those of the Bombay Stock Exchange. Membership is usually restricted. In no Indian stock exchange is there a formal distinction between jobbers and brokers as in London. Nevertheless, a few members (more particularly in Bombay and Calcutta) have come to specialize in jobbing transactions.

respects, the main Indian money markets are more highly developed than those in existence in all but the most mature financial centres. It would seem more appropriate, therefore, to seek the weakness in the Indian market organization in the looseness of its arrangements and its lack of integration rather than in the presence or absence of this or that form of activity.

Indian money markets may be divided into two main sectors. On the one hand, we have the 'central money market', which includes (apart from the Reserve Bank) the exchange banks, the Imperial Bank, and the other Indian commercial banks; and, on the other, we have the indigenous market, which consists of a group of bazaar markets, each with different business practices and a different structure of rates. Within both these two main divisions quite a high degree of specialization has developed, including the provision of facilities for the flow of funds within and between them. The chief weakness lies in the links between the main sectors. Until these are strengthened further integration will be difficult.

The types of business conducted by the commercial banks have already been described in some detail, but for purposes of perspective and in order to give a clearer picture of the operations of the central money market, the extent to which markets may be said to exist for call money and bills must be considered further.

The call money market is restricted almost entirely to dealings between banks, though other institutions and even individuals do sometimes come into the market as lenders. This market is fairly active in Bombay, but rather less so in Calcutta, and in Madras it scarcely exists at all on an organized basis. In all three centres, the exchange banks are the chief borrowers, because of the nature of their business. Their investments are highly liquid and include a large bill portfolio, and they are therefore able to work with a comparatively small cash base. This means, however, that they may often be in need of funds for a day or so, when bills offering exceed their bill maturities. Temporary stringencies of this kind are therefore tided over by borrowing money at call or short notice. In addition, such borrowings are the means of mobilizing funds and employing economically such money as is available at the height of the busy season. In a very real sense, the exchange banks lie at the

centre of the money market in India. Nevertheless, some of the Indian banks are also known to borrow in the market. Normally, they maintain fairly large cash reserves and are not in need of call money, but 'window-dressing' is common and they may therefore go into the market for this purpose. In addition, it is thought that the statutory provision for the maintenance of minimum balances with the Reserve Bank has served to increase the periodic demand for call money in recent years. Any failure to maintain the required minimum is liable to incur heavy penalties and the banks will therefore prefer to borrow money cheaply at call to tide them over any temporary threat to their position.[1]

Inter-bank call money is usually arranged through brokers, but temporary funds may be obtained by approaching other banks directly. Very few banks—mostly the exchange banks—can obtain 'clean' call money (i.e. without collateral security) and, where money is lent against government securities or Treasury Bills, the transaction becomes in effect a collateral loan. Obviously, the rate for inter-bank call money will vary with the state of the market and be higher in the busy season than when business is slack. Thus, there tends to be a decline in demand (and in rates) in May or June, with a rise again in November or December. The influence of seasonal demand is paramount, but short-term factors may result in day to day fluctuations. Thus, heavy Treasury Bill maturities may cause funds to be in surplus for a day or so and depress the rate, or a heavy demand for funds to finance speculative dealings on the Stock Exchange, or bullion and commodity markets, may drive the rate up. In the main centres, therefore, the call money market is both developed and sensitive to changes in the conditions of over-all liquidity.

The bill market, on the other hand, is a much more dependent phenomenon. All the principal banks in India and, in particular, the exchange banks, discount approved bills, and there is a degree of specialization in the types of bills dealt in (as has already been indicated), but there is no true market in India for further dealings in these bills. Either bills dis-

[1] See B. C. Ghose, *A Study of the Indian Money Market* (Calcutta, 1943), pp. 203–4. Nevertheless, the scheduled banks as a whole normally keep their central bank deposits well above the statutory limit.

counted are carried in bank portfolios until maturity, or—as with export bills—they are rediscounted by the exchange banks in the London market, which procedure serves the interests of economy. Rediscount facilities exist both at the Imperial Bank and the Reserve Bank, but this is more in the nature of last resort accommodation. Little use has been made of Reserve Bank facilities, but the Imperial Bank (for reasons elaborated in our chapter on 'The Rise of Central Banking in India') has served and continues to serve as a kind of 'intermediate' lender of last resort. The bill market is therefore 'dependent' in two senses: (*a*) on London; and (*b*) on a direct relationship with the lenders of last resort. These arrangements are not without merit in so far as they result in economies which would not otherwise be available under Indian conditions. There is really no very strong case for the establishment of discount houses on the London model. The difficulties which arise are due rather to the somewhat narrow criteria on which approval for rediscounting is based and the remedy must be sought in widening the range of eligibility.[1]

Treasury Bills deserve separate mention. These are short-term government securities, issued for meeting government requirements for supplementary finance, usually with a currency of three months.[2] Being rediscountable at the Reserve Bank and generally issued during the slack season, they provide an ideal form of investment for the surplus funds of the banks. Government of India Treasury Bills, which constitute the bulk of those available, are issued weekly by public tender through the Reserve Bank. In addition to Treasury Bills sold by open tender, 'intermediate' Treasury Bills are sold from time to time, generally to the State governments which have surplus funds. Tenders are confined for the most part to a few large banks.[3] Sometimes the Reserve Bank may have to inter-

[1] One difficulty in extending the range of eligibility is the variety of banking practice which obtains, and it has been suggested that standardization of forms and practice would do much to encourage the rediscounting institutions to adopt a more liberal attitude. It may well be that the extensive inspections of banks now being undertaken by the Reserve Bank will enable that institution gradually to bring banking practice more into line with its requirements.

[2] Some of the Provincial governments have issued Treasury Bills of longer currency.

[3] It has been estimated that between 90 and 95 per cent. of the Treasury Bills sold to the public by tender and through the tap is taken up by the commercial

vene by purchasing bills on its own account to ensure a successful placement. To a certain extent, it is true, private individuals and institutions other than banks also tender for Treasury Bills, but the amount tendered for on their own account is very small. More usually they prefer to purchase Treasury Bills through their bankers.

We have already described the business done by way of the rediscount of hundis. It is sufficient to recall here that approved shroffs have limits at certain of the larger banks for the provision of this form of accommodation and that it is the endorsing shroff who provides the link between the central money market and the indigenous markets (described below). The link is, indeed, somewhat tenuous and it is here that the lack of integration which is the chief characteristic of the money markets of India is most in evidence. Only the better class of hundi is taken to the banks and the relation of this rate of rediscount to those charged in the bazaar markets proper is somewhat indirect.

No account of the money market structure would be complete without a passing mention of the stockbrokers. Both in Bombay and Calcutta these constitute one of the most important classes of borrower. Their marginal finance is derived by way of overdraft accommodation from the banks against the security of stocks and shares under blank transfer deeds. Advances are permitted only up to a certain percentage of the value of the securities deposited and, in recent years, these requirements have had to be made more stringent in order to curb the tendency to speculate.[1] In the past, some of the less

banks of which the share of the Imperial Bank would be from 40 to 45 per cent. (A considerable amount of money is also now obtained from the banks by the Government on the basis of Treasury Deposit Receipts, interest on which is paid at rates of 1 per cent. for six months, 1¼ per cent. for nine months, and 1½ per cent. for twelve months.) Many of the smaller banks, however, do not hold Treasury Bills because (as is the case with the Bengali banks in Calcutta) they are accustomed to attract deposits at relatively high rates of interest and they are therefore obliged to invest even their temporarily surplus funds in securities which (consistent with maximum safety) yield the highest return. This condition is satisfied by longer-dated government securities yielding 3 to 3½ per cent. per annum. (See B. C. Ghose, op. cit., pp. 207 and 210.)

[1] The most usual margin taken by banks against stock exchange securities is 50 per cent., but the Indian banks have frequently been much more generous in an attempt to attract business. Hence the number of failures which have afflicted some of the smaller banks in India.

cautious banks have incurred heavy losses by becoming over-extended in this direction.

Since the degree of integration has been taken as our chief criterion of the extent of development of the Indian money market, it is appropriate at this stage to direct our attention to those specialists who maintain contact between the several parts. These are the various kinds of brokers. The most general type is the 'finance broker', who may combine exchange, deposit, and share broking. It is more common, however (especially in Bombay), for exchange and deposit broking to be separated and for specialists to operate. Indeed, deposit broking probably reaches a degree of specialization which is to be found nowhere else. For example, inter-bank lending is arranged by these brokers and 'house money'—surplus cash available from business houses and private individuals of standing—is placed with the banks which as borrowers pay the brokerage. Even fixed deposits may be made through the agency of a deposit broker. Again, there are instances of recourse to a broker in the lending field. Thus the renewal of joint and several loans to merchants (referred to above) may be arranged through a broker. The bank may lack the special knowledge of a customer's current position to deal direct and may therefore depend in part upon the specialist advice of its broker. Where necessary, it may use more than one and there are many instances of a bank being able to contract out of losses as a result of a timely hint from contacts such as these. Not only do these brokers serve to bring the two sides of the market together but they help to keep it healthy. Much the same facilities exist for the rediscount of hundis. When the Multani wishes to rediscount with a commercial bank, the facilities are usually arranged by a hundi broker. In other cases the banks employ their own specialists for the purpose (e.g. the Allahabad Bank). Exchange transactions are arranged by exchange brokers, bullion purchases and sales by bullion brokers, and so on. The net result is a high degree of integration in the central money market and the establishment of a system of connexions with parties and types of business far removed from the direct knowledge of the banks which provide the ultimate accommodation. So that, within their own spheres of influence, the major Indian money markets, far

from being under-developed as is so often assumed, provide ample evidence of a system of relationships quite as sophisticated as any found elsewhere.

The bazaar sections of the Indian money market also demonstrate a high degree of organization. In general the indigenous sector can be subdivided into three main groups—Marwaris, Multanis, and Gujeratis[1]—representing separate communities each with its own way of doing business. Nevertheless, some degree of homogeneity is secured, partly through the operations of the borrowers and partly as a result of the somewhat tenuous connexion with the commercial banks and other lenders. A large proportion of the resources of these indigenous banking groups is contributed from within their own communities[2] and a measure of financial independence is the result. Indeed, it is this phenomenon which, together with the riskiness of the business undertaken, stands in the way of a more completely integrated system.

In these markets, usance or 'muddati' hundis are the accepted credit instrument.[3] Usually, they are drawn for a period of ninety days, but shorter usances are not uncommon. Frequently, the usance hundi is unaccompanied by any document of title to goods and, in these circumstances, may well be of an 'accommodation' character only, but, as money is lent primarily on the personal credit and standing of the borrowers, this is not regarded as a serious defect. However, the Multanis do not lend for speculative purposes and deal only with genuine traders. The Marwaris have no such inhibitions and even en-

[1] And in Calcutta, Bengalis.

[2] Multani and Bengali bankers do not accept deposits, but some of the Marwaris do, and 'in such cases, the proportion of borrowed to owned funds is usually in the ratio of 2:1'. In addition, the indigenous banker may supplement his resources either by discounting hundis, or borrowing from other bankers. Hundis may be discounted with private traders, or other indigenous bankers, as well as with the commercial banks. Indeed, it is not uncommon for private merchants to seek hundis as an outlet for their surplus funds, as also do indigenous bankers themselves when purchasing the hundis of other bankers. Multanis do not borrow from another banker for more than one day (except by way of the rediscounting of hundis with the commercial banks) and will not go outside their own community. The Marwari (and Bengali), on the other hand, is quite prepared to do both. However, the Bikanir Marwaris, by convention, borrow from each other for a period of three days only. (See B. C. Ghose, op. cit., pp. 229–31.)

[3] Though it was only after 1936 or 1937 that the Multanis began to operate on an appreciable scale in Calcutta and popularized the use of the usance hundi in that centre. Ibid., p. 231.

gage in speculation themselves. Rates of interest vary a good deal and certain merchants of standing are said to be able to borrow at between 3 and 5 per cent., but the more usual rate is 7 to 8 per cent. from Multanis, an average of 9 per cent. from the Marwaris, and anything from 9 to 15 per cent. from a Bengali.

The second main function of the indigenous banker is concerned with the collection of 'darshani' hundis. The usance hundi is the instrument generally in use for borrowing money, whereas the 'darshani' hundi, or demand draft, is employed mainly for the collection of trade accounts or the remittance of funds. Two main types of transaction are involved. First, these hundis may have been drawn by merchants for goods supplied to traders in other centres. Supporting documents, such as railway or steamer receipts, may or may not be attached. Collection[1] of what is essentially a demand bill is effected through the agency of an indigenous banker. Second, such hundis may be drawn for the purpose of remitting funds from one centre to another. Thus, an established merchant operating in several centres may draw a hundi in one centre on his office elsewhere, discount it with an indigenous banker, who sends it for collection to the centre on which it has been drawn. Traders' remittances through the banking system are always subject to a charge, but this is not invariably the case with the indigenous banker. It depends on the urgency of the need for funds. For example, in the busy season, frequently the shroff who is arranging the remittance will himself pay a commission to the party on whose behalf the funds are being transferred. In the slack season, either funds will be remitted without payment on either side, or a commission will be paid by the party requiring the transfer. When a commission is paid the rate varies from $\frac{1}{4}$ to $\frac{1}{2}$ per cent.

Both in the central money markets and in the indigenous sectors different rates of interest will apply to the several types of business, mainly because of different degrees of risk. But, in addition to this phenomenon, it is not uncommon to find

[1] The procedure of collection is described by B. C. Ghose, op. cit., pp. 233–6. Normally, one day's grace is allowed and, if the hundi is not paid, penalty rates are imposed. If the hundi is not paid by the sixth day the matter is taken up by a Darshani Hundi Committee, which certifies the fact of non-payment and takes disciplinary action by imposing further penalties.

that the rates in different centres diverge significantly. For our purpose it will be sufficient to analyse the comparative position as it obtains in Bombay and Calcutta. In a fully integrated system one would expect the rates in these centres to be approximately equal, since any tendency for rates to be higher in one should be met by an inflow of funds to take advantage of it and this would have the effect of reducing the disparity. But, in India, there are significant, if not considerable, divergences and it is therefore necessary to inquire into the possible causes. Some of these differences are rather puzzling. For example, both advance and bazaar rates in Calcutta tend to be higher than in Bombay, whereas with short-term money rates the position is sometimes reversed.[1]

The impression that lower average short rates rule in Calcutta appears to be partly a matter of statistical accident. Call money rates in Calcutta are governed by the Exchange Banks Association who agree to quote a relatively low rate. It is this rate which appears in the *Reserve Bank of India Bulletin* statistics.[2] In actual fact, where the demand for finance exceeds moderate figures, money must be borrowed from banks outside the Association. Thus, at a time when the rate fixed by the Association is ½ per cent., a borrower might have to pay 1 per cent. or even 1¼ per cent. for a proportion of his money, and this rate would equal—or even slightly exceed—that quoted in Bombay, where it seems that the published rates relate to an averaging of rates for both the exchange banks and the larger Indian banks. It may sometimes happen that the Bombay banks have to borrow in Calcutta, but, on the whole, Bombay is said to be the easier market even for short funds. The same considerations may also help to explain the published differences in three and six months' deposit rates. That some importance should be attached to this part of the explanation is borne out by the fact that for the larger scheduled

[1] See 'Money Rates in India Since 1935–36', Reserve Bank of India, *Report on Currency and Finance, 1948–49*, pp. 200–1.

[2] The position is so fluid that it is difficult to indicate an appropriate range of movement as typical. For the evidence see Table, 'Short-term Money Rates', published monthly in the *Reserve Bank of India Bulletin*. If the rates paid on fixed deposits by the small banks were included, the range of deposit rates in Calcutta would (in the judgement of the writer) be wider than in Bombay. These are not included by the Reserve Bank.

banks as a whole[1] the differences between Bombay and Calcutta are rather less marked than would appear from the *Bulletin* figures. If this is not the whole story, we must look for institutional reasons to explain the discrepancy. Thus, it is possible that there is more 'house money' available in Calcutta, where leading firms of managing agents are well established. They may well have temporarily free funds of some magnitude which are lent in the market. But, as against this, there is the textile industry in Bombay which is said to hold a lot of money in that centre. It may, therefore, be more useful to seek an explanation, not on the supply side, but in terms of demand conditions. There is reason to believe that the Bombay money market as a whole is better organized than that of Calcutta and it follows that funds are utilized more fully. There are more specialists to seek out the money available and to place it in the hands of those who can use it to advantage. The demand for funds may be increased in this way and the rates paid for short money pushed to a higher level. Likewise, more money appears to drain through to the indigenous sector in Bombay than in Calcutta (by means of the discount of hundis) and this may have the effect of increasing the demand and the cost of call money in Bombay and of reducing the supply and hence of raising rates in the *bazaar* markets of Calcutta.

In Bombay the range of advance rates is approximately 2 to 5 per cent. with the bulk of the business probably being done at 3 to 4 per cent. In Calcutta, the comparable range seems to be 3 to 6 per cent., though some of the small banks may do business up to 8 or 9 per cent. Most of the business seems to be done at 3 to 5 per cent. So that, for many transactions, the effective rates are not greatly different, but the spread of rates over the whole field is undoubtedly greater in Calcutta and the average rate significantly higher. Much the same is true of bazaar rates. Thus, between 1945 and 1949, the lowest bazaar rate reported in Bombay seems to have been $4\frac{1}{2}$ per cent., and the highest $8\frac{1}{4}$ per cent., with $7\frac{1}{2}$ per cent. the more usual upper limit. In Calcutta the rate never fell below 6 per cent. and the maximum was as high as 15 per cent., though 10 per cent. would appear to have been more common (over a number of

[1] See Table 17, Reserve Bank of India, *Statistical Tables relating to Bank in India*, 1949. Provision of information on this basis is quite a recent innovation.

seasons).[1] By way of qualification, however, it should be added that the Calcutta rate is more volatile and an average of all the rates which have ruled over a period would tend to be rather less different from the average ruling in Bombay than a range based on extreme movements would indicate.

It is not particularly difficult to discover reasons for the tendency of advance rates to be higher in Calcutta than in Bombay. In general, relatively higher rates in Calcutta can be analysed in terms of the respective importance of supply and demand factors. In the first place, Bombay is a more important banking centre with larger banks and a greater concentration of head offices.[2] Funds are in greater supply in Bombay because bank reserves are held at the head offices and the larger the institution the larger the reserves, in addition to which the Reserve Bank itself has its head office there and, partly for this reason, open market operations tend to be concentrated in Bombay rather than in Calcutta (or Madras), so that there are greater facilities for the liquidation of securities at short notice. Not only is there still a large number of small banks in Calcutta, which are forced to pay higher rates in order to attract deposits and which charge correspondingly higher rates on advances (many of which constitute the more risky types of business), but the supply of money to the bazaar markets (where the divergence is even more marked) is probably rather restricted, since the Bengali is not a natural lender and prefers to put his money into government securities or land, where he judges the security of his investment to be greater (though it is true the bulk of the lenders in the Calcutta bazaars are non-Bengali). An additional factor on the supply side is probably the relative weakness of the contacts between the indigenous and central money markets in Calcutta, where the rediscounting of hundis with the banks is not perhaps so highly developed as in Bombay. Since the link between the two sectors is the discounting shroff, the flow of funds between the two would tend to be less strong and a plentiful supply of 'short' funds in the central market may have very little influence at the

[1] Loc. cit., *Report on Currency and Finance, 1948–9.*

[2] Not only are institutions bigger but the volume of business now appears to be larger in Bombay as indicated by clearing house returns—see *Reserve Bank of India Bulletins.*

fringe and in the bazaars, where the rates rise steeply in times of stringency.

On the demand side also, there is reason to expect higher rates in Calcutta. The volume of trade is greater there and the demand for finance is highly concentrated because of the larger number of important commodities dealt in and the overlapping of seasons.[1] Jute, tea, and coal in particular absorb quite a lot of money. It is this which helps to explain the extremes to which interest rates can rise in Calcutta, though there are other, more psychological factors as well. It is also said that the emphasis on exports may help to explain the higher rates which obtain in Calcutta. Bombay, on the other hand, is primarily an import centre. It is argued that money is tied up longer in the export trade (particularly when goods are exported to Eastern countries), while import finance is said to liquidate itself fairly quickly.[2] However, since most of the export bills are discounted in the London Money Market shortly after they have been drawn, this part of the explanation should be accepted with reserve. Indeed, the psychological factor would appear to be much more important. There are, for example, temperamental differences. The standard of business morality is higher in Bombay, and, in general, the businessman there is more level-headed and less liable to gamble. It is sometimes said that the yields are higher in Calcutta and that business can afford to pay more, but one has the impression that much of this 'profit' derives either from racketeering or from speculation, the prevalence of both of which is a function of the ignorance of conditions which is so general in Calcutta markets. In short, much of the marginal demand for finance (which produces the extreme quotations) is absorbed in 'fake' business. The high yields when they are obtained (which is not infrequently) must then be related to the heavy risks which are accepted by these businessmen and (for that matter)

[1] It is possible that the wider range of activity is reflected in diseconomies of organization and increased overheads with consequently higher costs in the provision of finance, but it would be difficult to estimate the importance of this factor.

[2] Nevertheless, as has been pointed out to the writer, imports are largely financed by means of advance bills in London or by payments against confirmed credits opened in favour of the English consignor of the goods. Bills are often at sixty days sight and, therefore, to that extent payments for imports may well be tied up for sixty days.

by some of the smaller banks, which provide them with the funds.

On the basis of this analysis it is not nearly so difficult to understand the structure of rates which obtains in India. Where rates are high there is not the same incentive as in a more integrated system to transfer funds from centres (or sectors) where they are low. Frequently, the channels of communication are clogged or inadequate and the costs of transfer are too great. Moreover, costs must be measured in terms of convenience as well as in terms of money.[1] For example, banks in Bombay may have funds to spare for a short period, but, in view of the costs involved and the uncertainty as to when they will need the funds themselves, they would be loath to transfer them to Calcutta to take advantage of higher rates there, so that although there is a movement of funds between the two centres, it is not nearly as general as might be supposed from first considerations alone. Moreover, it must be remembered that for similar classes of business the rates in the two centres are not greatly different and for those types of business for which high rates may be charged there are related risks, which the larger and better managed banks would be unwilling to accept.

In general, it is possible to sum up the position in India as a whole in much the same terms. For highly organized banking institutions doing substantially the same types of business, interest and other charges are not greatly dissimilar, differences being primarily due to costs of transfer of funds and to variations in the degree of risk. By the same token, however, those markets which are not integrated with the more highly organized sections of the money market assume local characteristics and charges are governed by particular considerations of supply and demand. The range of business done also varies more and the interest rate structure at the margin or 'fringe' is governed by the somewhat restricted supply of finance for special purposes. This applies most obviously in the bazaar markets, but it is also apparent in the business done by certain of the smaller

[1] Except for remittances effected by way of free transfers through the Reserve Bank, the banks usually have to pay 'exchange' on the remittance of funds from one place to another. For example, large amounts are still remitted through the Imperial Bank, which charges 'exchange' for its services. Such costs must obviously affect the mobility of funds.

banks. The funds available are restricted either to those from a specific trading community or (as in the case of the smaller banks) to those who seek a high rate of return and are prepared to accept the consequential risks of loss. Charges to the borrower are correspondingly higher. His will usually be a risky type of business, for the finance of which the larger concerns with more conservative policies and (it should be added) less local knowledge will generally be unwilling to lend. Thus, functional specialization does exist and many of these local and specialized markets are highly developed within their own sphere of activity. Where the development has been less complete is in the establishment of conventional relationships *between* markets or groups of markets. In other words, the system is not fully integrated. Funds do flow both from one market to another and between similar markets in different centres, but the channels of communication are inadequate.

In meeting these difficulties there are two main possibilities. First, within (and, indeed, between) markets, there is scope for the greater use of the services of the broker, who by reason of his special knowledge both brings together borrower and lender and is in a position to 'guarantee' the parties. For the most economical employment of such specialists, a large volume of transactions is essential and the smaller centres operate under a disadvantage. Nevertheless, this difficulty should not be insuperable and firms in Bombay and Calcutta might develop the system of working through agents and representatives as they do to a certain extent already in the indigenous sector. Second, there is need of improved remittance facilities. Both the commercial banks and the indigenous bankers already operate systems for the transfer of funds and a degree of mobility has been achieved. If, however, such transfers are to be effected with the greatest economy and expedition, there must be some generally accepted medium. The basis for a developed remittance system already exists and, in time, it should be possible to extend it by accelerating the growth of branch banking, reducing remittance charges still further, and encouraging more of the indigenous bankers to keep accounts with either the commercial banks or the Reserve Bank. Indeed, before fuller integration of the system as a whole can be achieved, the link between the commercial

banks and the indigenous institutions must be considerably strengthened. This will require more knowledge and less suspicion (on both sides) of the methods of the other and a considerable amount of education. Once methods are disclosed and understood, the acceptance of a common code of conduct, and its strict observance, would provide the mutual trust and understanding which alone can be the basis of true integration. There is much that is good in indigenous practice and, if both sides are willing, it should not be impossible over the years to effect a graft which will provide the vigour needed for further development.

6

THE RISE OF CENTRAL BANKING IN INDIA

I

CENTRAL banking is a comparatively recent innovation in the Indian economy. Indeed, commercial banking in India may itself be said to date only from the middle of the nineteenth century, though at first even these institutions were restricted in their business to a relatively narrow sector of the economy and primarily served the needs of Indo-European trade. The everyday requirements of the bulk of the population were met by the long-established indigenous bankers with whom the 'exchange banks' had little direct contact. Nor was there any real effort made to develop and encourage the wider use of bank credit, and, throughout the years prior to the First World War, almost all the emphasis was on currency problems and the development of a national banking system was virtually ignored. There were suggestions that a central bank should be set up, but nothing came of them. It is true that Keynes, who was a member of the Chamberlain Commission of 1913, actually prepared a draft constitution for such an institution, but the First World War intervened and his proposals were shelved. Prior to this there had been two developments of major importance. One was the more or less accidental establishment of the gold exchange standard under which the rupee became convertible into international currency at an approximately stable rate; and the other was a significant expansion in the activities of the commercial banks themselves.

After the First World War there was the natural desire for a quick return to 'normal' conditions, but in addition, the experiences of war had hastened progress in the direction of a unified monetary control. On the one hand, the war had brought closer together the Government and the Presidency Banks,[1] which had been founded by the East India merchants, and had also increased co-operation between the Presidency

[1] The Bank of Bengal was established in 1806, the Bank of Bombay in 1840, and the Bank of Madras in 1843.

Banks themselves. On the other hand, the impact of war had served to emphasize the extent to which India was dependent for industrial products on the countries with whom she had traded pre-war and from whom she was now cut off. This strengthened a growing national demand for the industrialization of the country. An Industrial Commission was set up and it pointed to the completely unorganized state of the Indian capital market and argued that lack of financial facilities was holding back the development of Indian industries. This is the background against which to view the amalgamation of the three Presidency Banks, which became the Imperial Bank of India in 1921.

The new bank was recognized from the beginning as a semi-public institution with provision for a certain measure of control by the Government, for which it was to act as its main banker with free use of Treasury funds. It was also expected to act as a bankers' bank, holding their cash balances, rediscounting their bills, and assisting them in times of crisis. At the same time the Imperial Bank was permitted to retain the commercial banking business which it had inherited from the Presidency Banks and, indeed, it was required to go farther and open no less than 100 new branches within five years of its establishment in order to further 'the banking development of which this country stands so much in need'. But its activities were somewhat restricted and it was forbidden to deal in foreign exchange[1] and was not given the power to issue notes.

At one time it was thought that the Imperial Bank might itself assume the functions of a central bank, but that was not to be, and the period of unchallenged Imperial Bank leadership lasted no more than five years. By 1927 plans for a separate Reserve Bank were being laid and it was clear that, sooner or later, the Imperial Bank would lose its privileged position among the other commercial banks. Even in the period 1922–7 the Bank was not given a completely free hand, since the Government was at that time implementing a deflationary policy through its management of the currency and the exchange market. Indeed, the chief gain came through the establishment of the 'pioneer' branches, which together with

[1] This restriction was lifted by an Amending Act of 1934 when the Reserve Bank was set up as the Central Bank.

an increase in the branches of other banks introduced a much greater internal mobility of funds than had existed previously. The position was further improved by the cheap remittance facilities which the Imperial Bank began to provide. Another significant change was the disappearance of the Independent Treasury System. Previously, the Treasury had tended to demand funds just when they were most urgently needed for other purposes and had released them in the slack season. But, with the transfer of government balances to the Imperial Bank, the latter was able to offset, at least in part, the vagaries of Treasury demands and to avoid the worst effects of seasonality in the demand for credit.

Nevertheless, Imperial Bank action was limited in a number of ways. There could be no adequate solution of the problem of currency inelasticity, for example, while the issue of notes was still subject to the Paper Currency Amendment Act 1920. Not only were there restrictive requirements, but the provisions to meet seasonal demands were such as to be almost inoperative. For the purpose of accommodating seasonal requirements, for example, the Controller of Currency was authorized to issue notes up to Rs. 5 crores, against inland discounted bills maturing within ninety days, and this additional issue was to take the form of a loan to the Imperial Bank against the deposit of accepted bills of exchange at an interest rate of 8 per cent. per annum. But this meant in practice that no assistance would be given until the discount rate of the Imperial Bank exceeded 8 per cent. Subsequently, the rate was lowered to 6 per cent. and the maximum loanable amount raised to Rs. 12 crores. In addition, however, the arrangements failed to recognize that the 'hundi', which is an important credit instrument in India, is not the equivalent of a bill of exchange. It is true that both are written orders to pay, but while bills are usually drawn against goods in transit or in godown, 'hundis' tend to be used mainly for 'accommodation' purposes and there may be no evidence to show whether goods capable of providing the ultimate security currently exist or not. Indeed, the discounting of a 'hundi' by a joint stock bank for an indigenous banker indicated nothing as to the value of the harvest of the man requiring the advance in the first instance. It merely reflected the credit standing of the indigenous

banker who was willing to put his signature to it. Under these conditions, insistence that only inland trade bills, or 'hundis' drawn for trade purposes and maturing within ninety days of acceptance, could be used as a basis for an emergency issue of currency, raised major difficulties, because it meant that there was no adequate supply of eligible bills available.

Initially, the Imperial Bank operated fairly successfully as a bankers' bank, holding balances for the other banks and even making advances to them. However, the fact that it also operated as a commercial bank had the effect of restricting the use that might have been made of it by the other banks, which were somewhat averse to seeking assistance from a competitor. This suspicion was accentuated by the lack of any provision to restrict the profits of the Imperial Bank and it was felt that, when faced with a direct choice of protecting public or private interests, there was a temptation to sacrifice the former. Moreover, it was argued that the Imperial Bank was inclined to neglect the importance of developing ancillary credit institutions and that it had been positively obstructive in its attitude towards the extension of co-operative banking, to which it was reluctant to grant free remittance facilities, for the purpose (in its own phrase) of competing 'in ordinary banking business with commercial banks which have no such advantage'.[1] Finally, the Bank was under foreign (i.e. British) management and closely connected with other foreign interests in the country and, rightly or wrongly, it acquired a reputation for being anti-Indian, which was fatal to the acceptance of its leadership. In these circumstances, it was natural that there should be a desire for a separate central bank which could be regarded as a truly national institution.

II

The first attempt to establish a Reserve Bank proved abortive. An enabling bill, which was introduced in the Legislative Assembly in 1927, aroused such a storm of controversy[2] that

[1] *Central Banking Enquiry Committee Report*, vol. i, Part I, 1931, p. 145.

[2] The Government favoured a shareholders' bank on the model of the then privately owned Bank of England. The Legislative Assembly, on the other hand, preferred a bank under public control. See K. N. Raj, *The Monetary Policy of the Reserve Bank of India* (Bombay, 1948), pp. 64–65.

the proposal was shelved. Then, with the subsequent slump in agricultural prices, came further postponement, as it was considered undesirable to launch a new institution into such an inhospitable environment. Before a Reserve Bank could be set up the budget should be balanced, the Government's short-term debt reduced, and India's export surplus (which was required to meet annual obligations abroad) restored to more normal dimensions. To a large extent these conditions were satisfied by 1933 and the Government therefore introduced a new Reserve Bank Bill which received the assent of the Governor General by March 1934, and the institution itself began its operations in April 1935.

The new Reserve Bank of India was a 'shareholders' bank', with a share capital of Rs. 5 crores. Separate registers of shareholders were to be maintained at Bombay, Calcutta, Delhi, Madras, and Rangoon, though shares were to be transferable from one register to another.[1] Shareholders were required to be Indian subjects domiciled in India, British subjects (with certain qualifications), or a company or co-operative registered or having a branch in India. Nevertheless, there were several provisions calculated to qualify this emphasis on private ownership. These were intended to make the Bank more acceptable to those who favoured a State Bank. First, capital to the extent of Rs. 220,000 was reserved for allotment to the Government to be held on its behalf by Directors nominated by itself. The Government was also to transfer to the Bank rupee securities to a value of Rs. 5 crores and these were to be allocated by the Bank to its Reserve Fund. Second, half of the Central Board of Directors was to be nominated by the Government. The composition of the Board was as follows: eight Directors elected on behalf of the shareholders on the various registers; four Directors, in addition to one government official, nominated by the Government; and a Governor and two Deputy Governors to be appointed by the Government 'after consideration of the recommendations made by the Board'. Mixed local boards[2] were also set up consisting of five

[1] In point of fact the transfers which took place resulted in an increase in the number of shares held in the Bombay area, and (latterly) in some increase in Calcutta holdings, at the expense of other areas. In addition, there was a tendency for shares to be concentrated in fewer hands.

[2] For Bombay, Calcutta, Delhi, Madras, and (at that stage) Rangoon.

members elected by shareholders and not more than three nominated by the Central Board from shareholders registered in that area. Third, after making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds, &c., the Government was empowered to fix a rate of dividend in general not exceeding 5 per cent. but with the possibility of further participation. Any surplus accrued to the Government.

The structure of the Bank was modelled very largely on that of the Bank of England. It was divided into two departments—an Issue Department and a Banking Department—to be kept separate and wholly distinct. The assets of the Issue Department were to consist of gold coin, gold bullion, sterling securities, rupee coin, and rupee securities, not less in amount than the total of the liabilities of the Issue Department. Of the total amount of these assets not less than two-fifths were to consist of gold coin, gold bullion, or sterling securities, provided that the amount of gold coin and bullion should not at any time fall below Rs. 40 crores in value, the bulk of which had to be held in India. Government of India rupee securities might only be held to the extent of one-quarter of the total amount of assets, or Rs. 50 crores, whichever was the greater, though with government sanction the amount might be increased further to the extent of Rs. 10 crores. The sterling securities which might be held as assets included balances with the Bank of England, first class bills of exchange, and (except for its first two years of operation) United Kingdom government securities maturing within five years. Assets requirements might, of course, be temporarily suspended but only with government sanction and on payment of a stated tax penalty. Within British India the Bank was possessed of the sole right to issue notes and arrangements were made for it to take over the existing Treasury issues together with the appropriate assets.

In the Banking Department the Bank was authorized to undertake a wide range of banking business, including *inter alia* the acceptance of money on deposit but without payment of interest; the collection of moneys for government authorities, banks, and other persons; and the purchase, sale, and rediscount of bills and promissory notes drawn and payable in

India and (*a*) bearing two or more good signatures, one of which should be that of a scheduled bank, and arising out of bona fide commercial or trade transactions, in which case maturity was required to be within ninety days of purchase or rediscount; or (*b*) bearing two or more good signatures, one of which should be that of a scheduled bank or a provincial co-operative bank, and drawn or issued for the purpose of financing seasonal agricultural operations, or the marketing of crops, and maturing within nine months; or (*c*) bearing the signature of a scheduled bank and issued or drawn for the purpose of holding or trading in government securities and maturing within ninety days. It was also provided that the Reserve Bank might purchase from or sell to scheduled banks sterling in amounts not less than the equivalent of one lakh of rupees, and purchase, sell, or rediscount United Kingdom bills (including Treasury Bills) maturing within ninety days. In addition, the Reserve Bank was empowered to keep balances with banks in the United Kingdom. With regard to advances, these might be made to the central and such local governments as controlled their own revenues, subject to the condition of repayment within three months, or to Indian States, local authorities, scheduled banks, and provincial co-operative banks, repayable on demand (or by arrangement within ninety days) and against acceptable security. There was no limit to the purchase and subsequent sale of United Kingdom government securities provided these would mature within ten years of the date of purchase, but Indian securities of government origin were required to be fully guaranteed as to principal and interest and could only be held in the Banking Department up to prescribed limits. For example, the total value of such securities might not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund, and three-fifths of the deposit liabilities of the Banking Department, and there were also restrictions on the Bank's holdings of securities maturing after one year. Furthermore, the Bank was specifically empowered to act for governments in the purchase and sale of gold or silver, bills, securities or shares; the collection and remittance of proceeds of securities or shares; and the management of the public debt. The Bank could also deal in gold coin and bullion on its own account.

As a central bank the Reserve Bank was (*a*) the Government's banker and, indeed, had both a right and an obligation to transact government business;[1] (*b*) it had the sole right to issue bank notes and was required to manage the note issue; (*c*) it was set up 'to regulate . . . the keeping of [banking] reserves with a view to securing monetary stability . . . and generally to operate the currency and credit system of the country to its advantage';[2] and (*d*) it was under an obligation to buy and sell sterling within the limits of certain fixed rates for the purpose of maintaining the external value of the rupee in terms of sterling. Any change in buying and selling rates could be made by special legislative provision and with the Royal assent.

For the purpose of regulating the banking system the Reserve Bank was provided with the traditional weapons of central bank control as evolved in countries with mature economies, though it was unlikely that these would prove as suitable in a country whose economy was still relatively undeveloped, and where financial institutions were not fully integrated into a 'system'. Thus, the Bank was first to publish from time to time 'the standard rate' at which it was prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the Act. In addition, the Bank could use its 'power of direct discount' in cases of 'special

[1] 'As the banker to the Government, the Reserve Bank was required to transact all the general banking business of the Central Government without any remuneration except what accrued to the Bank through the interest-free balances held with it. For the management of the public debt it was entitled to a nominal payment, but not for the issue of new Government loans. Under this agreement between the Bank and the Government, the Bank also undertook the responsibility for supplying the sterling required by the Government to meet its obligations abroad. Thus the function of being the Government's banker gave the Bank the effective responsibility for the flotation of the Government loans, the sales and redemptions of Treasury bills, and the purchase of sterling from the market from time to time. But, perhaps more significant than these formal duties, was the role assigned to it of being the adviser to the Government on financial matters. Thus it could not only be an agent to do the work of the Government on its behalf, but it could mould the policy of the Government itself in the matter of its financial transactions and responsibilities connected therewith' (K. N. Raj, op. cit., p. 71). As adviser to the Government on financial matters, the Bank took an important step forward when in Aug. 1945 the Department of Research and Statistics was established. This provided an enlarged basis for informed advice. Since its inception this department has been doing increasingly valuable work, much of which is published.

[2] Reserve Bank of India Act, 1934, Preamble.

urgency', making it 'necessary or expedient that action should be taken . . . for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture'.[1] This was to enable the Bank to relax the conditions relating to the purchase, sale, or discount of bills and promissory notes, the purchase or sale of sterling, or the making of loans or advances, in so far as these required it to deal with specified bodies only (e.g. the scheduled banks), and to offer help direct to those in need of it. Second, the Bank was empowered to undertake open market operations whenever it deemed these to be necessary. Third, each 'scheduled bank' was required to maintain with the Reserve Bank deposits which should be not less than 5 per cent. of its demand liabilities and 2 per cent. of its time liabilities in India.[2] For a bank to be 'scheduled'—i.e. to be included in the Second Schedule of the Act—it was necessary that it should be a company or corporation engaged in the business of banking in British India with a paid-up capital and reserves of not less than Rs. 5 lakhs, and any bank whose capital and reserves fell below this limit, or which ceased to carry on the business of banking, could be excluded from the schedule. Alternatively, certain penalties might be imposed until the requirements had again been met. For purposes of information all scheduled banks were required to furnish weekly (in some cases monthly) returns to the Reserve Bank setting out their over-all position. The Bank might also require returns from provincial co-operative banks with which it had business dealings.

In the field of agricultural credit the Bank was to create a special department, the functions of which were (*a*) to maintain an expert staff to study all questions of agricultural credit and to be available for consultation by both governments and banking organizations, including provincial co-operative banks; and (*b*) to co-ordinate the operations of the Bank in connexion with agricultural credit and its relations with provincial co-operative banks and any other banks or organizations engaged in the provision of agricultural credit.

[1] Reserve Bank of India Act, 1934, s. 18.

[2] In this context, liabilities did not include paid-up capital or reserves or any credit balance in the profit and loss account of the bank.

III

As has already been indicated, the Reserve Bank began its operations on 1 April 1935. It then took over control of the note issue from the Government and also the management of the public debt and government accounts from the Imperial Bank of India. In those centres where the Reserve Bank was not represented, the Imperial Bank became its agent for the transaction of government business. It was not, however, until 4 July 1935 that the Reserve Bank announced its first official Bank Rate. This was set initially at 3½ per cent., but on 28 November easy market conditions and the 'weight of money awaiting investment' compelled a reduction to 3 per cent. where (until recently) it remained. The next step was to establish official contact with the scheduled banks. This was effected on 5 July, when the scheduled banks lodged their statutory deposits with the Bank in accordance with s. 42 of the Reserve Bank of India Act.[1]

The Bank was now fairly launched and its next task was to frame a policy. But what should be its objectives? There were thought to be two main possibilities. Either the Bank might use its powers to increase the volume of credit available for trade, industry, and agriculture and attempt to mitigate the evils of seasonal stringency and fluctuating interest rates, or it might attempt to control currency and credit 'along the lines approved by banking experience'. In point of fact, there was no necessary conflict. It depended on the circumstances. 'Accommodation' might be the appropriate policy at one time and 'control' (or restriction) at another. When, however, we come

[1] In the following year an attempt was made to place the general banking law in India on a sounder basis by introducing the Indian Companies (Amendment) Act, 1936. This Act embodied some of the more important recommendations of the Central Banking Enquiry Committee which reported in 1931. Previously, bank incorporation, organization, and management was governed by the Indian Companies Act, 1913, which (apart from certain sections) was common to banking as well as to non-banking companies. Under the new legislation, banking companies were prohibited from carrying on a non-banking business; no banking company might employ or be managed by a managing agent other than a banking company; a minimum paid-up capital of Rs. 50,000 was required for banks incorporated after the commencement of the Act; any charge on unpaid capital was prohibited; non-scheduled banks were required to maintain minimum reserve funds and cash reserves; interests in other companies were restricted; and a moratorium might be granted to a bank in temporary difficulties.

to consider the *emphasis* of policy in these earlier years, we find that 'accommodation' was the order of the day. At this time, it will be recalled, the economy was still climbing out of agricultural depression and the dangers of deflation were thought to be ever present. In these circumstances the Reserve Bank scarcely had a free choice in the matter.

What, next, were the characteristics of the 'system' which it was intended to regulate? First, there were in fact two fairly distinct systems of banking to be brought within its fold. On the one hand there were the commercial banks proper—the scheduled and non-scheduled commercial banks. On the other were the indigenous bankers and money-lenders—private firms and individuals, who for the most part carried on a mixed business of banking and trade. One should also perhaps exclude from the organized sector the village co-operative societies.[1] How were these institutions—and, in particular, the indigenous bankers and money-lenders—to be brought into direct contact with the Reserve Bank? Alternatively—and given the constitution of the Reserve Bank—was it possible to devise a more indirect mechanism, which would forge a link between what were in fact two more or less separate systems, for example, by developing a bill market? It was quite apparent that the second course would involve considerable difficulty. First, the development of a bill market would take time. Second, from an orthodox banking point of view, the 'hundi', which was by far the most important indigenous credit instrument in use, was not a very satisfactory form of security, since quite often it represented a transaction of an 'accommodation' character and was not backed by goods in saleable form.

[1] It has been suggested to the author that this exclusion is not entirely accurate, since the co-operative banks form part of the central money market and have more in common with the commercial banks than with the indigenous institutions. This may well have been true from the beginning of the provincial co-operative banks, even of the central co-operative banks. But, in the earlier years of the Reserve Bank, the degree to which the village co-operatives could be said to be part of the 'organized sector' was limited. The links between the several parts of the federal structure of co-operatives were by no means as strong as my critics have supposed. Indeed, the Reserve Bank's own activities in this field (discussed below) are sufficient to justify the author's statement in the text. If the village co-operative is part of the organized sector today, it is nevertheless well to remember that it may not always have been so.

In point of fact the new legislation did not envisage any radical transformation of the existing banking structure.

> All that it attempted was to draw the scattered and rather undisciplined elements of that structure into the orbit of a new Reserve System and to give it a loose unity and coherence by opening up channels for closer contact between them. . . . The Reserve Bank was . . . to be an institution superimposed on a heterogeneous mass of commercial banks, exchange banks, co-operative banks, indigenous bankers, and money-lenders, giving them assistance subject to the satisfaction of certain conditions, and unifying the floating resources of the whole system through the development of a bill market.[1]

But, as events worked out, the only regular customer of the Bank was the Government. There was at this stage no discounting of commercial bills[2] and, although there were certain small transactions in 1938, there was only one major pre-war discounting of Treasury Bills—in January 1939 when bills to a value of Rs. 7·8 crores were taken up by the Bank.

It has been argued that over this period the scheduled banks were self-sufficient and had no need to go to the Reserve Bank for assistance. But there was more to it than that. Throughout this period the cash position of the Imperial Bank was very strong and there is reason to believe that the Imperial Bank used its position to establish itself as an important lender in the money market. Indeed, as early as June 1935 the Imperial Bank began to extend its influence by offering day-to-day advances against government securities at a 'call loan' rate of 3½ per cent., which was reduced to 3 per cent. a month later. It offered to extend similar accommodation to commercial banks, or (if they preferred) to grant them longer-term advances against security at its slightly higher 'advance' rate.

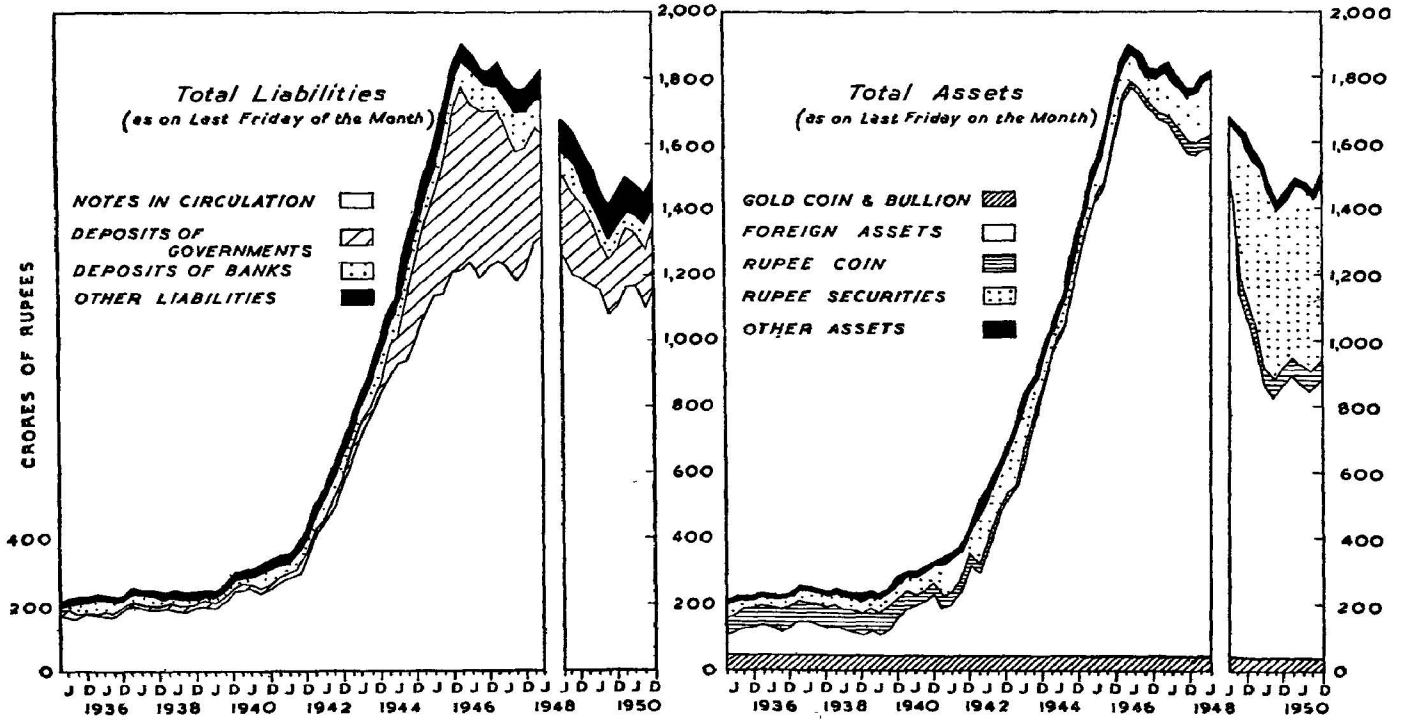
As a result of its offer of these new facilities, the Imperial Bank came to attract to itself the stock exchange brokers, who previously had only been able to secure such funds as the exchange and other commercial banks could spare from their own activities. In addition, the offer of loans to the banks either on a call rate basis or as an advance resulted in the establishment of a direct relationship between the two rates, the advance rate being consistently ½ per cent. higher. The Imperial

[1] K. N. Raj, op. cit., pp. 78–79.

[2] Indeed, these do not appear in the Bank's balance-sheet until June 1949.

RESERVE BANK OF INDIA

Liabilities and Assets, Issue and Banking Departments Combined


Total Liabilities
(as on Last Friday of the Month)
NOTES IN CIRCULATION
DEPOSITS OF GOVERNMENTS
DEPOSITS OF BANKS
OTHER LIABILITIES
Total Assets
(as on Last Friday on the Month)
GOLD COIN & BULLION
FOREIGN ASSETS
RUPEE COIN
RUPEE SECURITIES
OTHER ASSETS
CRORES OF RUPEES
0
200
400
600
800
1,000
1,200
1,400
1,600
1,800
2,000
J D J D J D

Bank thus came to occupy an important position in the money market. But financial activity in India tends to be concentrated in cities like Bombay and Calcutta and the funds within these markets have a high degree of mobility and are extremely sensitive to the prevailing rate of interest. Moreover, through brokers and speculators, these money markets are closely linked with the stock exchanges and with the bullion and commodity markets.

Under these conditions, if a bank could have a controlling influence in the supply of funds to the call loan markets of Bombay and Calcutta, or in the rates charged there, it could then be said to hold the key to the only section of the Indian money market structure which was susceptible to control and which supported a form of economic activity which in fact needed constant and effective supervision.[1]

On the other hand, the principle of non-competition with the scheduled banks effectively prevented the Reserve Bank itself from playing any direct part in the affairs of the call loan markets. Even if the Bank had availed itself of its emergency power to make direct loans and discounts, without operating through a scheduled bank or provincial co-operative bank, for all practical purposes its rate would have remained a penalty rate. So far as the scheduled banks were concerned, its rate was ineffective, because they found it cheaper to go to the Imperial Bank. It was only when that bank's resources became inadequate that the Reserve Bank was likely to be approached, and, indeed, that appears to be the explanation of the discounting operation of January 1939.[2]

Meanwhile, the Reserve Bank had attempted to bring the indigenous bankers into its system. In accordance with its statutory obligations, the Reserve Bank addressed a circular letter[3] to all scheduled banks and to representative indigenous

[1] K. N. Raj, op. cit., p. 87.

[2] Evidence that the Reserve Bank was anxious to increase the scope of its discounting operations and to develop a rediscount market was provided by the Bank's decision to standardize arrangements for the rediscount of Treasury Bills (both Central and Provincial) at rates only slightly higher than those prevailing at the nearest weekly tender. See Reserve Bank *Annual Report*, 5 Feb. 1940, p. 15.

[3] The original circular was addressed to all scheduled banks and to the Shroff Association. It recognized that the indigenous banker must continue to be an essential part of the banking structure of the country and that any scheme for the proper control and regulation of banking in India must contrive to bring him

bankers on 6 May 1937 with the object of securing their opinions as to the possibility of linking the indigenous bankers with the Reserve Bank. On the basis of the replies the Bank then proceeded to formulate a draft scheme in August 1937 to provide indigenous bankers with the facilities of direct discount and advances against government securities, as well as remittance concessions, though subject to their shedding their non-banking business, maintaining proper books of account, which would be open to the Bank for inspection, and the filing of periodic statements similar to those supplied by the scheduled banks. But the indigenous bankers were not prepared to accept these conditions, and preferred to continue the old arrangements whereby they received accommodation from

within its ambit. But it would be impossible for the Reserve Bank to deal with the indigenous bankers direct. Their number was too large and their business of such a highly personal and fluid character that any real attempt to gauge the amount of credit which could usefully be accorded to them would require personal contacts which would necessitate the creation of an impossibly large and costly organization. But the Reserve Bank was prepared to deal with the indigenous banker through some intermediate agency which would share the financial responsibility and undertake detailed examination and control. However, such an agency would have to be a self-contained legal entity with adequate resources. It would also have to maintain separate and properly audited accounts of its banking business and segregate this from any other business that it might be conducting. In any case, such other business would have to be confined to bona fide trading and speculation was ruled out. For purposes of control, balance-sheets and accounts would have to be supplied to the Reserve Bank and deposits maintained on the same basis as the scheduled banks. Alternatively, business might be transacted with indigenous bankers through scheduled banks. Two types of document might be dealt in: first, the bona fide trade bill, when the scheduled bank would be responsible for its representing a genuine trade transaction, so that it would be self-liquidating; second, a promissory note, originating with an indigenous banker, with possibly a second signature and discounted by a scheduled bank. In both cases, the documents should be drawn or made for the purpose of helping local trade or agriculture. Initially, such documents would not be definitely discounted by the Reserve Bank, which would merely make demand advances to a scheduled bank against such security and the scheduled bank would be responsible for the collection of the bill on maturity. The scheduled banks would be required to classify bills presented for discount in terms of commodities financed and would have to undertake to keep the Reserve Bank informed of their total advances in these categories, so as to avoid over-trading by particular individuals or in particular commodities. Such advances were not to be regarded as automatic and were to be cleared at the end of the season normal to the commodity financed. The scheduled banks were to be given limits of credit and it was made clear that they would have to operate primarily and ordinarily on their own resources. Any benefits accorded to the scheduled banks were to be passed on 'in a tangible manner' to the indigenous banker for whose benefit the scheme was being primarily devised.

the Imperial Bank and other scheduled banks. Nevertheless, the Reserve Bank left its offer open and remained ready to take up the matter with the Government with a view to the amendment of the Act if the indigenous bankers should decide to conform with its conditions or could suggest any other practicable alternative.

The Reserve Bank turned next to an examination of ways in which the financial machinery of the country could be improved so as to make credit more extensively available to the agriculturist at reasonable rates of interest 'by bringing within the banking structure the village money-lender who is the largest supplier of agricultural credit in India'. This second scheme was set out in a circular addressed to all scheduled banks and dated 3 January 1938. It seemed to the Bank that finance might be made available to cultivators to a much larger extent if the agency of the money-lender was utilized more fully and 'if his advances to the agriculturalist on the security of his produce were to be drawn up as bills in such a form that they could be discounted with the scheduled banks' and rediscounted by the Reserve Bank. In areas where the financial machinery was inadequate and the agriculturist had to pay an unduly high rate of interest, the Reserve Bank expressed itself prepared to rediscount such bills at special rates 'by the grant of rebates to scheduled banks in respect of agricultural paper'. It was to be a condition that the benefit of the rebates would be passed on to the agriculturist. 'This will be ensured if the scheduled banks would agree to charge a rate not exceeding say 2 per cent. over our discount rate and the moneylender would pass on credit with a further margin of say not more than 2 per cent. to the agriculturalist, in which case we would be prepared to grant a rebate say of 1 per cent.' Rebates would only apply to bills or promissory notes drawn or issued for the purpose of financing the marketing of crops maturing within nine months, and the scheduled bank discounting such paper would be responsible for satisfying itself that the money-lender was credit-worthy, that his business was conducted on sound lines, and that he kept simple books of account in proper form. Again, no approach was made to the Reserve Bank, though it was recognized that there were a number of technical difficulties in granting financial accom-

modation against agricultural paper. For example, it was objected that the smaller agriculturist did not normally borrow against the security of his produce, since his requirements were for crop production rather than marketing and he was accustomed to obtain the necessary finance by keeping a running account with a money-lender and was reluctant to commit himself to bills payable on a fixed date. Neither were the scheduled banks in a position to gauge the money-lender's credit nor to dictate the rate of interest which the latter should charge to the cultivator against produce bills. Furthermore, the keenness of the competition for first-class discounts meant very fine rates and there was little scope for the scheduled banks to rediscount with the Reserve Bank at a profit. Finally, debt relief measures had introduced an element of uncertainty into agricultural credit, which did not favour the successful introduction of innovations.

A further obstacle to the development of a bill market was the onerous stamp duty and, in January 1940, the Bank persuaded the Central Government to effect a reduction and thus remove a major impediment to the popularizing of usance bills.

The development of Reserve Bank leadership, it might be added, was seriously interfered with about this time by the advent of a banking crisis in South India. At the end of June 1938 the Travancore National and Quilon Bank closed its doors, and this created much nervousness among bank depositors as to the strength of other local banks. This bank was the product of an amalgamation and the Reserve Bank had granted a liberal credit to cover the actual period of the changeover. Thereafter, it was made quite clear that no further assistance would be granted unless full information was supplied as to the actual position of the amalgamated institution. The Reserve Bank was refused facilities for a full inspection of their books and, in the circumstances, did not feel that it was justified 'in giving what would have amounted to unconditional assistance'.[1] As soon as news of the crisis was received, credit limits were sanctioned to banks in South India, and these limits were later doubled. In its acute form, the crisis did not last long, but an underlying feeling of nervousness remained.

[1] See Reserve Bank, *Annual Report*, 1940, pp. 52–53.

Later in 1938 more South Indian banks asked for help, and increased limits were sanctioned in certain cases. Then, in order to avoid similar difficulties in the future, the Reserve Bank issued a circular letter (supplemented later by an explanatory memorandum) to all scheduled banks

> setting out the nature of the relations between the Reserve Bank and the scheduled banks and laying down a policy for the guidance of such banks as might want accommodation. . . . The crisis also revealed that one of the difficulties in the way of making advances to scheduled banks during such times was the absence of a sufficient quantity of rediscountable assets. . . . In order that the banks might build up a stronger portfolio, consisting of more eligible paper, an increase in the amount of bills traded in by them is an obviously necessary preliminary.[1]

There can be no doubting the motives which prompted the Reserve Bank to encourage the scheduled banks to place themselves in as sound a position as possible, but the effect was unfortunate. The scheduled banks appear to have interpreted the Reserve Bank's communication as a refusal to grant help, except under highly restricted conditions, and as evidence of a disinclination to act as a fully fledged lender of last resort by using its emergency powers. This reacted on their willingness to accept its leadership and hampered the Reserve Bank in its efforts to strengthen its influence over them.

At the same time, the Reserve Bank's attitude should not be regarded as wholly unreasonable. Banking practice in India still leaves much to be desired. For example, dividends have been known to be declared out of profits arising from security transactions (instead of these amounts being placed to reserves) and window-dressed balance-sheets were by no means uncommon. Indeed, in all the circumstances, it would seem that the Reserve Bank did as much as could reasonably be expected of it. After 1943, for example, there was quite a scramble to establish new banks, and considerable anxiety was felt as to the ability of many of these institutions to survive the difficulties of the transition from war to peace. By 1946, however, the public felt reassured and expected that the banks would now attempt to consolidate their position.

But the growing speculative activity on the stock exchanges, en-

[1] Reserve Bank. *Annual Report*, 6 Feb. 1939, p. 23.

couraged by a prematurely favourable budget, the announcement of the conversion of 3½ per cent. Paper, and the deteriorating political situation in the country . . . again gave rise to some anxiety about the banking situation. Signs of smaller banks in Bengal getting into difficulties were noticed early in November, 1946. The crisis was, however, held in check by a prompt statement issued by our Calcutta Office and also by the Government of Bengal contradicting exaggerated reports. The Reserve Bank offered to purchase Government securities from all banks to provide necessary assistance. This had a steadying effect and conditions soon returned to normal. Those that were thus affected were mainly the non-scheduled banks whose troubles were due largely to mismanagement, indiscriminate opening of too many small branches, reckless lending operations, speculative operations on the stock exchange and lack of properly trained personnel. Though the scheduled banks fared well on the whole during this difficult period, one bank in Bombay failed recently as a result of following unsound methods. The Reserve Bank is always prepared to aid banks in difficulties, not of their own making, by timely advice, if sought, and by financial help, when necessary, and in fact such assistance has been rendered from time to time. Difficulties have been encountered only by those banks which sought to make the best of both worlds—risky, high profit yielding assets and ready succour by the Reserve Bank.[1]

In January 1942 the Reserve Bank had tried a new approach to the problem of cheap agricultural credit. It propounded a scheme for extending financial accommodation to the co-operative central banks through the provincial co-operative banks, for the purpose of financing seasonal agricultural operations, or the marketing of crops, at special rates. Under this scheme it was proposed to grant a rebate up to 1 per cent. to provincial co-operative banks rediscounting agricultural bills with the Reserve Bank, provided the benefit of the rebate was passed on to agriculturists. Later, as a special case and on an experimental basis, this rebate was raised to 1½ per cent. This was in addition to existing arrangements under which accommodation was granted to provincial co-operative banks against government securities. At first very few applications were received, but gradually the system gained in popularity and the Bank was approached with increasing frequency. During the four years ended June 1947 the provincial co-operative banks drew only Rs. 3·25 lakhs from the Reserve Bank. In the year ending

[1] Ibid., 4 Aug. 1947, p. 45.

June 1948 the Bank sanctioned credit limits to the extent of Rs. 67·70 lakhs, and for the following year Rs. 180·25 lakhs, and applications for accommodation were much heavier than those actually granted.[1] Thus encouraged, the Bank has been considering 'how policy can be further liberalised without sacrifice of principle, and procedure further simplified'.[2]

It is necessary to turn now to a consideration of a traditional technique of credit control—open market operations—and to discuss the Indian experience. The Reserve Bank was specifically empowered to undertake operations of the usual type by buying and selling securities, or gold coin and bullion. The extent and effectiveness of open market operations will depend on three main conditions: first, the magnitude of the resources available for the purpose; second, the quality and volume of assets in which the central bank is permitted to deal and which it might hold; and, third, the type of market in which such operations have to be undertaken.

In the first place, the Reserve Bank's power of expanding the supply of money available to the community was restricted by the size of its own cash reserves. Of the total amount of its assets in the Issue Department not less than two-fifths had to consist of gold coin, gold bullion, or foreign securities, and the amount of gold coin and bullion could not at any time be less than Rs. 40 crores in value. This set the ultimate limit, though the operations themselves took place through the Banking De-

[1] Reserve Bank, *Annual Report*, Aug. 1948, p. 55, and Aug. 1949, p. 15.

[2] In Oct. 1950 the Bank set up a Department of Banking Development 'mainly with the object of giving concentrated attention to the extension of banking facilities to semi-urban areas and to the problems of rural finance. One of the principal duties of the new Department has been to implement the recommendations of the Purshotamdas Committee on rural banking. The Central Board approved the Committee's proposals for an extension of remittance facilities at reduced rates, for the provision of better facilities for exchange of notes and coin, for the removal of impediments in the way of the expansion of commercial banks in rural areas, for the improvement of the machinery of rural finance both as regards the mobilisation of rural savings and the extension of rural credit and for the development of warehousing'. (Reserve Bank, *Annual Report*, Aug. 1951, p. 7.) Some of the proposals of the Committee were also embodied in the 1951 amendments to the Reserve Bank of India Act. For example, the paper of co-operative banks now becomes eligible for rediscount under Section 17 (2) (*a*) of the Act, and the period of accommodation for seasonal agricultural operations and marketing of crops has been extended from a maximum of nine months to a maximum of fifteen months. See 'Rural Finance in India', *Reserve Bank of India Bulletin*, Sept. 1951, pp. 661–3.

partment. It has been argued that in times of crisis (as in 1938) the resources of the Reserve Bank were inadequate for this purpose. Nevertheless, an examination of annual balance-sheets would suggest that there was still scope for quite a significant monetary expansion if in the view of the Reserve Bank that had seemed desirable.

The second limitation can likewise be exaggerated. Formerly, the Reserve Bank was permitted to buy or sell without limit government securities of the United Kingdom maturing within 10 years. This was later extended under amending legislation to include similar securities of any foreign government. But with regard to Indian government securities there was a double limitation on volume: (*a*) the aggregate value of such securities might not exceed the aggregate amount of the Bank's capital and reserves, plus three-fifths of the Banking Department's deposit liabilities; and (*b*) there were restrictions on the amount of such securities which might be held in the Banking Department with a maturity of more than one year. These could not exceed capital and reserves, plus two-fifths of deposit liabilities, and further restrictions were applied to securities maturing after ten years. The significant restriction lay in the emphasis on short-dated holdings, since (on the basis of balance-sheet figures) there still appeared to be room for expansion in an over-all sense. In general terms, the Reserve Bank's power to influence the supply of money and credit was qualified, in the case of a desired expansion, by the degree to which the required assets were available for purchase in the market, since not all assets were equally eligible, and, in the case of a desired contraction, on the availability of assets for sale. Here the major limitation related to the quantity of assets held by the Reserve Bank, but there was also a secondary limitation because of the necessity to preserve the ratio requirements already indicated.

Third, there was the question of the responsiveness of the market in which it had to operate. Prior to the establishment of the Reserve Bank, the Imperial Bank provided the basis of such unity as existed. Both the exchange banks and the Indian commercial banks had dealings with it and certain of the indigenous bankers kept accounts there. Nevertheless, the Imperial Bank remained the rival of other institutions and the

structure of the money market was very loose indeed. In the circumstances, the chief role of the Imperial Bank in its relations with other financial houses was to assist the market in the busy season by discounting 'hundis'. Even with the establishment of the Reserve Bank the position did not change very much and the old relationship tended to remain. The banks remained relatively independent of the new central bank and preferred to lend amongst themselves. It was only when the larger banks found their resources depleted that there was any inducement to approach the Reserve Bank, and the latter's control over the market was therefore somewhat limited.

However, with the establishment of the Reserve Bank, there was the possibility of a creation of emergency credit in times of stress and the scheduled banks could approach it directly for accommodation. But accommodation tended to take the form of advances and in the early years there was little evidence of the use of open market operations for this purpose. Moreover, such influence as the Reserve Bank had was virtually limited to the central section of the money market and there was little chance of exerting any direct pressure in the bazaar markets. However, absence of direct influence must not be taken to mean that the Reserve Bank was completely powerless in the bazaars. It is well known that operators in the bazaar markets are often obliged to approach either the Imperial Bank or the other commercial banks for the discounting of their bills, or in order to obtain advances against approved security. Hence, in so far as they might be forced by conditions in their own markets to seek assistance from institutions in the Central Money Market, they exposed themselves indirectly to the regulating influence of the Reserve Bank. But, as elsewhere in recent years, government emphasis on a cheap money policy has considerably restricted the freedom of the central bank to operate at its own discretion.

The effectiveness of open market operations depends largely on the character of the securities in which the central bank is entitled to deal, as well as upon the nature and organization of the market in which these operations must be taken. As already indicated, the Reserve Bank was restricted mainly to dealings in short-term securities, and this constituted an initial limitation

on the possible scope of its activities by discriminating against dealings in longer-dated securities, so that the market in which operations were possible was relatively narrow. In addition, regular borrowing and lending relations between the several money markets were not as yet fully developed and the absence of clear-cut channels for the flow of credit from the Reserve Bank to its ultimate users in agricultural or even industrial production seriously limited the power of the Reserve Bank to exercise any real influence over the economy as a whole.

In the earlier years, it would seem that open market operations were only used to a limited extent as a means of credit control. Apart from other considerations, the market was much narrower than it is today, though the very narrowness of the market had its advantages. It was largely a question of adapting techniques to circumstances and of using them for those purposes for which they were most appropriate. In a narrow market, prices will be relatively sensitive to intervention on even a moderate scale and the central bank can therefore exercise a very potent influence on the prices of securities. It is true that there will be some resultant variation in the availability of credit, but this is incidental rather than purposive.

Until after the outbreak of the Second World War, there had been little evidence of buying or selling securities on any scale, and the purpose of such transactions appeared to be either the maintenance of gilt-edged prices or preparation of the market for the floatation of a new loan. Perhaps, and rather less obviously, there was some attempt to relieve seasonal stringency. But the evidence is conflicting and difficult to disentangle.[1] More recently there is direct evidence that in 1946–7 'the Reserve Bank supported the market on a substantial scale to help maintain security prices and stabilise the banking and financial structure generally at levels which there was a reasonable prospect of holding. This produced a steadying influence on the money market and the banking system. . . .'[2] Again in

[1] See K. N. Raj, op. cit., pp. 104–6.

[2] See Reserve Bank, *Annual Report*, 4 Aug. 1947, p. 18. Elsewhere in the same *Report* (p. 49), there is a further reference to the 'cushioning' of institutional selling 'by the continued and substantial support extended by the Reserve Bank. The open market operations carried out by the Reserve Bank in this

1950–1 open market purchases of government securities were made by the Reserve Bank 'to relieve the heavy pressure on banks for seasonal funds'.[1]

At times the Bank has also attempted to guide the choice of the market. For example, if the Bank wished the market to absorb a particular type of security, it attempted to persuade institutional investors, such as insurance companies and the larger banks, to take up securities held by the Reserve Bank, offering a good 'turn' on such transactions as an inducement and undertaking to keep prices and yields steady. Contact between the Reserve Bank and the rest of the market may be direct, as in the case of the Imperial Bank and the insurance companies, or through brokers, in which latter circumstances it is the practice of the Bank to advise its own broker discreetly of its wishes. Again, the Reserve Bank has both encouraged and assisted the commercial banks to secure a more balanced distribution of the maturities of their security holdings. Thus, in March 1948 the banks were advised by circular that there was too marked a preference for long-dated securities and that they should build up a stronger second line of defence in the form of holdings of short-term securities. In a follow-up circular in August 1948 the need for corrective action was further emphasized. 'Banks which already have followed a wrong policy during the past should gradually reduce their long-term securities so that they do not disturb the Government securities market and are able to spread their losses, if any, over a period of time. They will also have to restrict fresh advances until they have a better balance of their security portfolio.' It was appreciated, however, that if these banks attempted 'to dispose of their long-term securities in large blocks, not only may the banks suffer losses themselves, but they might also disturb the Government securities market. In that event, either the Reserve Bank of India or the Government of India may have to step in to support the Government securities market'.[2] The progressive improvement in the maturity distribution of scheduled bank holdings of government

behalf tended to meet the seasonal demand for funds and to provide the increased cash resources aimed at by the banks. . . .'

[1] Reserve Bank, *Annual Report*, Aug. 1951, p. 17.

[2] Reserve Bank of India, *Annual Report on the Trend and Progress of Banking in India* (period ended 31 Dec. 1949), p. 222.

securities in terms of this advice is indicated in the following table:[1]

Date	No. of banks	Treasury Bills	Securities maturing				Ratio of total securities to total resources
			Within 5 years	Between 5 and 10 years	Between 10 and 15 years	After 15 years	
		%	%	%	%	%	%
Dec. 1945	89	4·69	25·09	25·22	19·06	25·94	50·50
Dec. 1946	90	3·23	18·38	24·08	26·73	27·58	44·71
Dec. 1947	93	6·33	24·16	22·94	20·05	26·53	43·14
Dec. 1948	94	0·98	28·76	20·67	31·92	17·69	44·64
June 1949	91	0·97	26·91	22·60	31·56	17·91	36·75
Dec. 1949	92	1·72	28·37	26·85	25·83	17·23	39·46

At the same time the Reserve Bank has also been interested in keeping the long-term market 'healthy' and has been prepared to give that market support when necessary by buying long-dated securities at par.

Most of the open market activity initiated by the Reserve Bank is carried out in Bombay and Calcutta, with the emphasis on the former. Operations in Madras are on a much smaller scale.

Traditionally, 'open market operations' have been thought of as dealings in securities. In an Indian context, however, the term has sometimes been applied to the purchase or sale of sterling[2] or other foreign exchange. As a means of credit control, operations in this market have obvious limitations, since the amount of foreign exchange available at any particular time is largely determined by activity in the export trades. Even under former conditions, and except within narrow limits, the extent of purchases and sales, as well as their timing, was beyond the control of the Bank. Under existing circumstances, the sale of foreign exchange is dictated by exchange control policy, which is governed partly by India's own requirements and partly by the over-all position of the sterling area. The administration of this control is in the hands of a special department of the Reserve Bank, but the operation is delegated very largely to a number of the scheduled banks which are licensed to act as authorized dealers in foreign

[1] Extracted from ibid., Statement 26, p. 162.

[2] e.g. see Raj, op. cit., p. 101.

exchange (though some are authorized to deal only in sterling). Each such dealer operates on his own account and only refers borderline cases to the Reserve Bank. It might also be mentioned that it is the practice to allow these banks to hold reasonable working balances with their offices or correspondents abroad, not only in sterling but (where appropriate) in dollars and other foreign currencies as well. Then, if the working balances which any such bank holds of a particular currency are too large, the bank in question is required to sell the excess to the London control. Similarly, if working balances are run down below a comfortable level, the bank may replenish its supply of the currency concerned by application to the control.

Given these limitations, the exertion of anti-inflationary pressure has tended to take the form of more direct relations with the money-market. The occasion and the opportunity for this development came in 1943, when the impact of war-time inflation necessitated positive action. The period April to July 1943 represented a climax in the development of war-time inflation and was followed by the first attempts to implement a system of economic control. The first step was a warning from the Finance Member to speculators in general and to the cotton trade in particular, and this was followed in May by the prohibition of all forward and option dealings in bullion. A measure of compulsory saving, capital issues regulation, and control of the production and distribution of cloth were all intended to prevent the worst excesses of inflation. Next, the Government of Bombay specifically requested the authorities of the Bombay Stock Exchange to take effective measures to prevent speculation in stocks and shares. In line with this general policy were the powers assumed by the Central Government in July 1943 under the Defence Regulations, which permitted the prohibition of bank advances against specified commodities, including bullion. Repayment of outstanding advances within a specified period was also required. At the same time, the Reserve Bank sent a circular to all the scheduled banks advising them that

> it is not the intention of the Government of India to interfere with the finance of trade through loans and overdrafts granted by [Banks] to their regular customers for legitimate trade purposes. There is no objection to banks continuing to grant advances to mills or factories for the

purpose of buying and holding stocks of raw materials, to wholesale and retail trades for the purpose of buying goods for re-sale, or to recognised bullion merchants against the security of gold and silver held by them in the normal course of their business as bullion merchants. Banks are, however, warned that any indication that advances are being taken from them for speculative purposes may compel Government to issue orders . . . prohibiting such loans in the public interest regardless of the interference with normal business that might result.[1]

However, these controls appear to have been largely ineffective. For example, on the financial side, their operation depended almost entirely on the discretion of the banks themselves and, in its very nature, this tended to result in much looseness, especially at a stage when Reserve Bank leadership was only developing. A leading example related to large-scale speculative purchases of equities in July and August 1946. These were financed to an appreciable extent by bank credit and were undertaken solely with the object of reaping capital gains. This boom was essentially an unstable one and would sooner or later have led to a reaction. Foreseeing this danger, the Reserve Bank had warned the banks as early as May 1946,[2] but in certain quarters its warning was apparently not heeded, with the result that some banks (and particularly the smaller ones) not only involved themselves in difficulties but, in attempting to achieve liquidity, also caused a set-back in the market. This placed the Reserve Bank in a difficult position. It had been urged that

the Reserve Bank should have put pressure on the banks to desist from a policy that would steepen the recession and should have asked the banks not to lighten their commitments in equities. But, as the law does not permit the Bank to purchase or advance against equities, such a direction would not have been proper, apart from the consideration that even if legally possible such purchases would only have worsened the inflationary situation. When prudent finance requires commercial banks to desist from such advances, the central bank can hardly be expected to render such aid.[3]

In this particular instance the Reserve Bank appears to have acted as boldly as it reasonably could and, indeed, its action

[1] See Circular 3, para. 3, 20 July 1943, published in Reserve Bank of India, *Annual Report on the Trend and Progress of Banking in India* (period ended 31 Dec. 1949), p. 208.

[2] Circular 6, ibid., p. 211.

[3] Reserve Bank, *Annual Report*, 4 Aug. 1947, p. 49.

seems to have been not without effect, though, in part, the subsequent fall in equity prices was the result of 'excessive speculative fervour'. The Reserve Bank also sought further information and this too might be considered in the nature of a minor sanction, but this was scarcely its main purpose. The scheduled banks were asked to indicate the details of their outstanding advances against shares as on 30 November 1945 and 24 May 1946, advances below Rs. 25,000 to any one person or firm being excluded.

> The next circular on the same subject was issued towards the end of January, 1947, giving a brief analysis of the replies received. . . . After pointing out that between November 1945 and May 1946 the advances against shares showed a much faster rise than the total advances of all types, the circular drew the attention of the banks to the need for restricting advances against shares to a reasonable proportion of their resources . . . and the advisability of fixing absolute maxima for advances per share in the case of speculative counters. It is needless to say that it was not, and it is not, the intention that banks should deny credit on any terms or to any extent against shares.[1]

Again, after the devaluation of the Indian rupee in September 1949 a resurgence of speculative activity was feared. Banks were therefore advised to restrict their advances to genuine trade requirements and not to grant any accommodation for speculative purposes. They were also required to submit to the Reserve Bank a daily return of all credit limits sanctioned by them in excess of Rs. 1 lakh. When, after a scrutiny of these returns, the Reserve Bank was of the opinion that certain advances were of an undesirable character, the banks concerned were advised to effect a recall.[2]

However, not all of the responsibility for the anti-inflation programme could be shouldered by the Reserve Bank and the effectiveness of its influence obviously depended on the relations between its action and government policy. A new anti-inflation programme was announced on 9 October 1948. The measures proposed by the Government fell into two main categories: (*a*) those which were intended to curtail government expenditure as well as to reduce excess purchasing power in the hands of the community; and (*b*) those which were in-

[1] Reserve Bank, *Annual Report*, 9 Aug. 1948, p. 58.
[2] Ibid., Aug. 1950, p. 11.

tended to increase the volume of essential goods and services. In the first category the more important measures included the balancing of all government budgets (Central and Provincial), a revision of government capital expenditure, postponement of repayments of E.P.T. and other deposits, a revival of the 1943 scheme of interest-bearing deposits with the Treasury, the issue to the public of a new short-term obligation in the form of Treasury Deposit Receipts with maturities of 6, 9, and 12 months, bearing interest at 1 per cent., 1¼ per cent., and 1½ per cent. per annum respectively, the raising of the maximum permissible limit for investment in Post Office Savings Bank deposits and in National Savings Certificates, and the limitation of company dividends. In the second category were measures designed partly to stimulate production and partly to augment supplies by allowing a larger flow of imports. The concessions to industry included a liberalization of depreciation allowances, exemption from taxation of new industrial undertakings (subject to certain conditions), abolition of the capital gains tax, reduction of super tax, reduction of import duties on plant and machinery as well as on essential industrial raw materials, reduction or abolition of duties on certain exports, and transport priorities for essential key industries. In addition, direct assistance was provided to industries through the Industrial Finance Corporation which commenced operations on 1 July 1948.[1]

[1] The establishment of this Corporation was the result of the joint study and efforts of the Reserve Bank and the Government. It was to provide medium- and long-term credits to industrial concerns in those cases where normal banking accommodation would be inappropriate or a new capital issue impracticable. However, it was only permitted to assist public limited companies and co-operative societies engaged in the manufacture or processing of goods, mining, or the provision of power. Its authorized share capital was fixed at Rs. 10 crores, which was divided between the Central Government, the Reserve Bank, the scheduled banks, the insurance companies, the investment trusts, and the co-operative banks. The last group failed to take up their full quota. All shares were guaranteed by the Central Government. In addition to share capital, the Corporation was authorized to issue bonds to the extent of five times the amount of its paid-up capital and reserves. The Corporation might also accept long-term deposits from the public to the extent of Rs. 10 crores. It was empowered to offer assistance in a number of ways—by guaranteeing loans floated in the market, by subscribing to debentures, by granting loans or advances, or by underwriting industrial issues. Guarantees and accommodation were limited to twenty-five years, and securities taken up in fulfilment of underwriting commitments were to be disposed of within seven years. The Corporation was not permitted to subscribe

After devaluation in September 1949 even more concentrated efforts were required to control inflationary tendencies. Between January and June of that year, India's external accounts position had deteriorated markedly and steps had to be taken to correct the adverse balance. On the basis of decisions reached at the Commonwealth Finance Ministers' Conference in July 1949, India undertook to reduce dollar expenditure to 75 per cent. of the 1948 level. Internally, this called for an intensification of anti-inflationary policies. The two main objectives were now to bring about a reduction in the level of prices and an increase in the country's foreign exchange resources. In addition to the reduction of imports from hard currency areas—consistent with maintenance of the flow of essential goods—special emphasis was laid on a rapid expansion of exports. There was an attempt to lower the price level by a cut in the prices of controlled commodities, such as foodgrains, cloth, yarn, pig iron, and steel. Speculation was to be checked by a prohibition of trading in futures (e.g. in cotton seeds and sugar), and export duties were levied on certain articles (e.g. jute manufactures) exported mainly to hard currency areas. Measures to reduce government expenditure, to regulate credit facilities (in order to discourage the speculative holding of stocks), and to encourage national savings and investment were to be intensified.

Unfortunately, much of this programme failed to produce the required results and the plans to stem inflation were largely abortive. In part, this was due to the inability of governments to balance their budgets. In part, the plans were thwarted by administrative difficulties and the community's disinclination to co-operate. In these circumstances, the burden carried by the Reserve Bank has continued to be heavy.[1]

IV

Past experience had brought to light a number of weaknesses in the organization of Indian banking, but recently the authori-

directly to industrial shares and there were limits to the interest it might take up in any single concern. All applications are judged on the basis of the usual banking criteria. Its activities to date are still of an experimental character. Operations have been on a small scale but have been sufficient to show a modest profit.

[1] As a further disinflationary measure, the Reserve Bank raised Bank Rate from 3 to 3½ per cent. on 14 Nov. 1951.

ties have been more active in their attempts to strengthen the position. It is appropriate, therefore, that we conclude this chapter with a discussion of the content and purpose of the new arrangements. In this connexion, there are two main items to consider: (*a*) that which relates to the Reserve Bank itself; and (*b*) that which concerns the extent of its control over other banks and financial institutions.

With regard to the central bank itself, the Finance Minister announced in the Indian Union Parliament on 4 February 1948 that the Government had decided to nationalize the Reserve Bank as soon as possible after the termination of the Joint Monetary Arrangements between India and Pakistan. Inter-Dominion monetary arrangements were terminated on 30 June 1948, and the Reserve Bank (Transfer to Public Ownership) Bill was introduced in the Union Parliament on 9 August and became law on 3 September 1948. But the new measure did not pass without protest from the Reserve Bank Board. After careful consideration of the issues involved it was of 'the opinion that the decision to nationalise the Reserve Bank was premature at the present stage of the country's political and economic development and that such a step may be fraught with very great danger'. It therefore passed a resolution in those terms which was forwarded to the Government, but the latter maintained its attitude, holding that the balance of advantage lay in nationalizing the Reserve Bank and that there was no reason why it should modify the policy to which it was committed.[1]

The new Act provided, first, for the transfer of all shares to the Government, compensation to be paid to shareholders on the basis of Rs. 118–10 per share in the form of government promissory notes bearing interest at 3 per cent.[2] and repayable at par on such date as may be fixed by the Government. Subsequently, this date was set as 15 October 1975 or, by three months' prior notice, an earlier date on or after 15 October 1970 might be chosen. The vesting date was fixed as 1 January 1949. In cases where the amount of compensation was not an exact multiple of Rs. 100, the difference was paid in cash.

[1] Reserve Bank, *Annual Report*, 9 Aug. 1948, p. 29.

[2] With the exception of shares held by directors of the Bank who received promissory notes to a value of Rs. 100 per share.

Second, the existing Board, consisting of a proportion of elected directors, was now replaced by one entirely nominated by the Central Government. A similar change was made in the constitution of the local boards. The Central Board will now consist of a Governor and two Deputy Governors, four 'Regional' Directors (one from each of the four local boards), six Directors without regional limitation, and one government official, i.e. fourteen in all. Third, the Central Government was empowered to 'give such directions to the Bank as it may, after consultation with the Governor . . . consider necessary in the public interest', but, subject to any such directions, the general superintendence of the affairs and business of the Bank were entrusted to the Central Board, or to the Governor acting on its behalf and within the scope of its regulations. Fourth, the Bank was now enabled to hold, in addition to sterling, certain other currency assets both in the Issue and Banking Departments. For the purposes of this provision, foreign securities which may be held as part of the assets are defined as securities payable in the currency of any foreign country which is a member of the International Monetary Fund and falling within the following categories: (*a*) balances at the credit of the issue department with the bank which is the principal currency authority of the foreign country concerned, or, if there is no such bank, with any bank incorporated in that foreign country; (*b*) bills of exchange bearing two or more good signatures and drawn or payable at any place in that foreign country and having a maturity not exceeding ninety days; and (*c*) government securities of that foreign country maturing within five years. The new legislation also terminated the then existing practice of the Reserve Bank in keeping balances with banks in the United Kingdom and extended the Bank's scope by permitting it to buy and sell foreign exchange.

Next, there was the question of extending the Reserve Bank's powers. To this end, a series of proposals, drafted in the form of a Bank Bill, had been submitted to the Central Government for its consideration as early as November 1939, and this was circulated for the purpose of obtaining the views of the public, but no very drastic changes were likely while Government and Reserve Bank alike were concerned with the

urgent problems of war.[1] In any case, the replies received from the banking community indicated that such a measure would undoubtedly be the subject of much controversy and that it was therefore desirable that only 'interim measures involving the minimum of legislation' be considered.[2] Even so, it was some time before any practical steps were taken. A fresh start was made when a Bill 'to consolidate and amend the law relating to banking companies' was introduced in the Legislative Assembly on 16 November 1944, and by 11 April 1945 this had been taken as far as a motion for reference to a Select Committee to meet in October, but the dissolution of the Assembly caused the Bill to lapse. The same procedure was followed with a second and revised Bill introduced on 15 March 1946. This likewise was withdrawn and a further Bill, incorporating the necessary amendments, was introduced on 22 March 1948.

Meanwhile, events were moving too fast to permit of this protracted hold-up in the legislative process and a number of emergency measures were employed. On 15 January 1946 the Government of India promulgated the Banking Companies (Inspection) Ordinance, under which the Central Government was empowered to direct the Reserve Bank to undertake an inspection of the books and accounts of any banking company and to report thereon to the Central Government. If, after consideration of any such report, the Government was of the opinion that a bank's affairs were 'being conducted to the detriment of the interests of its depositors', they might prohibit the bank from receiving fresh deposits, refuse its inclusion in the Second Schedule, or (if it had already been so included) direct its exclusion from the Schedule. In addition, there was provision for appropriate penalties. A number of inspections followed and action was taken in certain cases.

Another interim measure was the enactment of the Banking Companies (Restriction of Branches) Act, 1946. It had been observed that a number of banks were opening branches mostly in places where adequate banking facilities were already available and were thus forestalling the provisions of legislative proposals relating to the control of branch banking.

[1] There can be no doubt that the orderly development of the Bank as a central bank was rudely interrupted by the outbreak of war.

[2] See Reserve Bank, *Annual Report*, 11 Aug. 1941, pp. 26–27.

In several cases, it was found that the new branches worked to the detriment of the interests of the depositors by incurring heavy capitalised expenditure out of proportion to the resources of the banks, payment of high rates of interest on deposits, indulging in speculative activities to make up for the high cost, employment of untrained managers, etc., and that these developments were fraught with danger to the banking structure of the country.[1]

The new legislation which became operative on 22 November 1946 provided the powers necessary to restrict the opening and change of location of branches of banking companies. Licences had to be granted for these purposes and quite a number of applications were dismissed.

Both of these measures added considerably to the work of the Department of Banking Operations first opened within the Reserve Bank in Bombay on 1 August 1945, and, in view of its greatly increased responsibilities and the necessity to decentralize the work, arrangements were made to establish branches in the other main centres of the Bank's activities.[2]

A Reserve Bank of India (Temporary) Ordinance was promulgated on 20 September 1947 for the purpose of enabling the Bank to grant emergency advances to scheduled and non-scheduled banks against such form of security as it might consider sufficient, but, as the Reserve Bank had no occasion to grant such advances, the Ordinance was allowed to lapse on 20 March 1948. However, the continued delay in securing the passage of the new Banking Companies Bill resulted in the issue of the Banking Companies (Control) Ordinance on 18 September 1948, so that certain of the essential provisions contained in the Bill could be brought into operation with im-

[1] Reserve Bank, *Annual Report*, 4 Aug. 1947, p. 26.

[2] 'For administrative purposes, the Department is divided into three Divisions, namely, the Operations Division, the Inspections Division and the Liquidations Division, each under a Deputy Chief Officer dealing respectively with the scrutiny of returns received from banking companies and general administrative matters, the inspections, and the liquidations of banking companies. The Department has established a branch each at Calcutta, Madras, Delhi and Kanpur. The offices at Calcutta, Madras and Delhi are each under the charge of a Deputy Chief Officer, while the office at Kanpur is under the supervision of the Manager at that centre. The Central Office at Bombay generally deals with matters of policy relating to the administration of the Banking Companies Act, while the branch offices look after the actual administration of the Act with regard to banking companies within their respective areas.' Reserve Bank of India, *Annual Report on the Trend and Progress of Banking in India* (period to 31 Dec. 1949), p. 9.

mediate effect. This Ordinance empowered the Reserve Bank to render assistance to banks more freely, but at the same time vested in it greater powers of control than it had hitherto possessed. Thus, the Bank was again enabled to make loans and advances against such forms of security as the Bank might consider sufficient (as under the earlier Ordinance), but, in addition, it was given the important new power of determining 'the lending policy to be followed by banking companies generally, or by any banking company in particular, and also to decide the purposes for which advances may be made, the margins to be maintained, and the rates of interest to be charged'.[1] Other important provisions included authority for the Bank to call for half-yearly returns showing classification of advances and investments; to prohibit banks from making advances against the security of their own shares or from granting unsecured advances to any of their directors, or to firms and private companies in which a director was interested; to require banking companies to maintain in the Provinces of India at the end of each quarter assets to a value of not less than 75 per cent. of their demand and time liabilities therein; to require the previous consent of the Reserve Bank for an amalgamation; and for the appointment of the Bank as Official Liquidator in certain circumstances.

Finally, the Banking Companies Bill, 1948, as amended by the Select Committee, was passed by the Union Parliament on 17 February and came into force on 16 March 1949. The new Act repealed the Banking Companies (Inspection) Ordinance, 1946, the Banking Companies (Restriction of Branches) Act, 1946, the Banking Companies (Control) Ordinance, 1948 and Part X A of the Indian Companies Act, 1913. Besides incorporating the various interim legislative measures together with amendments adopted from time to time since the first proposals for the effective regulation of banking were mooted towards the close of 1939, the Act also embodied a number of other provisions, the more important of which were as follows: (*a*) the obligation on the part of all banks operating in India to take out a licence from the Reserve Bank; (*b*) the obligation on the part of the non-scheduled banks to maintain in cash the same percentage of their demand and time liabilities as was

[1] Reserve Bank, *Annual Report*, Aug. 1949, p. 11.

required to be maintained by the scheduled banks with the Reserve Bank;[1] (*c*) the obligation on the part of banking companies to maintain, two years after the commencement of the Act, 20 per cent. of their demand and time liabilities in cash, gold, or unencumbered approved securities; and (*d*) prohibition of interlocking directorates. But there were also provisions for exemption from certain of these requirements and a number of such exemptions were granted.

Under the new legislation, the field of banking has been defined as covering 'the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise'. The legislation applies to all banking companies[2] except co-operative banks.[3] The forms of business in which banking companies may engage have been laid down and trading in goods as such has been prohibited. Nor may bank directors be the means of linking their institutions with non-banking activities. A bank must clearly indicate the nature of its business by using as part of its name the words 'bank', 'banker', or 'banking'. Banks must be licensed by the Reserve Bank and specific requirements as to minimum paid-up capital and reserves have been stated. These requirements vary ac-

[1] It might now be argued that the distinction between scheduled and non-scheduled banks is no longer necessary. Yet there is still some prestige value to be attached to inclusion in the Second Schedule, since a bank with the necessary minimum capital requirements need not necessarily be admitted and must satisfy the Reserve Bank as to its position before being included. Moreover, a scheduled bank may still be 'de-scheduled' and the Reserve Bank can thus invoke these powers as a means of applying sanctions against any bank which departs from good behaviour.

[2] The indigenous bankers, in so far as they remain private firms, are still outside the direct control of the Reserve Bank. In any event, it is not desired to bring undue pressure to bear on them, because any such action might conceivably result in their withdrawal from banking business and this would involve the loss of a very useful institution. The position is extremely delicate and the Reserve Bank must be content to exert a tactful influence. Already certain indigenous bankers, who carried on a family business in company form, have altered their Articles of Association and declared themselves non-banking companies. Firms which were merchant bankers are in this way restricting their business to merchanting only.

[3] Co-operation is a State matter and the institutions concerned come under the direct control of the various Registrars of Co-operative Societies. Nevertheless, through its Agricultural Credit Department, the Reserve Bank can, and does, exert a wide influence and has done much to extend a knowledge of the functions of co-operative activity.

cording to the nature of a bank's commitments and the number and situation of its places of business.[1] It is further provided that, until the amount of reserves is equal to that of the paid-up capital, not less than 20 per cent. of net profits shall be transferred to reserves each year. In addition, all banking companies (and not merely the scheduled banks as previously) must now maintain by way of cash reserve either themselves or in an account with the Reserve Bank a sum equivalent to at least 2 per cent. of their time liabilities and 5 per cent. of their demand liabilities. Moreover, two years after the coming into force of the 1949 Act, every banking company must maintain in cash, gold, or unencumbered approved securities, an amount which is at least 20 per cent. of its total time and demand liabilities in India, and assets held in India must not be less than 75 per cent. of local deposit liabilities. Returns will be required by the Reserve Bank monthly as evidence of each bank's position, in addition to which the Bank

> may at any time, by notice in writing, require a banking company to furnish it . . . with statements and information relating to the business of such banking company, and . . . may call for information every half-year regarding the classification of advances and investments of banking companies in respect of industry, commerce and agriculture

and the Reserve Bank may, at its discretion, publish such information in consolidated form. Special provisions relate to the preparation and publication of accounts and balance-sheet in a prescribed form and its filing (with the auditor's report) with the Reserve Bank. On the direction of the Central Government, the Reserve Bank may inspect the books and accounts of any banking company, though it must supply to such company a copy of its report on such inspection. Specific provision is made for suspension of business and winding up of banking companies, with the Reserve Bank as official liquidator. Schemes of arrangement between a banking company and its creditors also require to be certified by the Reserve Bank 'as not being detrimental to the interests of the depositors of such company'. Existing restrictions on the opening or transfer of branches were continued.

No banking company shall open a new place of business or change,

[1] See Banking Companies Act, 1949, s. 11.

otherwise than within the same city, town or village, the location of an existing place of business without obtaining the prior permission in writing of the Reserve Bank; and before giving any such permission the Reserve Bank may require to be satisfied by an inspection . . . or otherwise as to the financial condition and history of the company, the general character of its management, the adequacy of its capital structure and earning prospects and that public interest will be served by the opening or, as the case may be, change of location, of the place of business,

though temporary arrangements might be made to afford banking facilities to the public 'on the occasion of an exhibition, conference or mela'.[1]

Under the provisions of the Act, power has been taken to impose restrictions on amalgamations. No agreement, arrangement, or scheme for the amalgamation of any banking company with another may be made without the previous sanction in writing of the Reserve Bank. But more interest has recently attached to positive action and, where banking companies are too small for efficient operation and the adequate spreading of risks, the Reserve Bank has used its influence to encourage such companies to amalgamate into larger units. Recently, it has facilitated the merger of four Bengali banks. These were the Bengal Central Bank, the Comilla Banking Corporation, the Comilla Union Bank, and the Hooghly Bank, which in December 1950 became by amalgamation the United Bank of India Ltd. This amalgamation was first mooted in June 1946, and specific proposals were formulated early in 1949. These banks had much in common in that they were all Bengali in origin and concerned with the finance of local trades and industries. Nevertheless, there were difficulties. Under former arrangements, amalgamations had to be approved by all shareholders and, initially, there were additional legal complications arising out of the transfer of assets.[2] There was also the problem of absorbing surplus staff. If overheads were to be reduced, some retrenchment was desirable. On the other hand, and quite apart from humanitarian considerations, there was the question of retaining goodwill. The United Bank therefore

[1] See Banking Companies Act, 1949, s. 23.

[2] The position was resolved by the passage of the Banking Companies (Amendment) Act, 1950, which *inter alia* set out a detailed procedure for the amalgamation of banking companies.

sought to absorb surplus staff by opening new branches. At all stages of the discussions the Reserve Bank stood ready to offer its advice and helped to smooth away some of the legal difficulties.[1]

A second banking reconstruction was brought about as a direct consequence of Reserve Bank inspection. It concerned the Bharat Bank Ltd. On the surface, all might have seemed well. Its liquid position was not unsatisfactory and its assets, though not immediately realizable, exceeded its outside liabilities. Upon investigation, however, it was found that its methods of working and, in particular, its attitude towards the granting of advances, left much to be desired. These defects were brought to the notice of the bank's directors and, after an unsuccessful attempt to reconstitute the directorate, a partial merger with the Punjab National Bank was decided upon. Under this scheme the Punjab National took over the liabilities of the Bharat Bank in respect of deposits in the Indian Union against the transfer of equivalent assets. This transfer was effected on 13 March 1951, when fifty-nine branches of the Bharat Bank commenced functioning as branches of the Punjab National, while its other Indian branches were merged with the local offices of the latter.[2]

It is understood that the Reserve Bank would also favour an amalgamation of certain banks in South India, which is another area where it is thought that the banking structure is weak. It is argued that there has been an excessive competition for deposits, which has forced up interest rates and encouraged the acceptance of the more risky types of business. In addition, certain banks have attempted to compete for new business by the indiscriminate opening of branches and in a number of cases the Reserve Bank has seen fit to refuse its permission. But again amalgamation would present many difficulties and much persistence and tact will be necessary if this scheme is to be brought to fruition.[3]

[1] In addition, it would seem that the act of amalgamation was hastened by the failure of the Nath Bank and the general loss of confidence in Bengal which resulted in a run on all these banks, the Reserve Bank being obliged to grant advances to two of these institutions to tide them over their difficulties. The amalgamation took place shortly afterwards. See Reserve Bank, *Annual Report*, Aug. 1951, p. 11.

[2] Ibid.

[3] Technically, 'the initiative in the matter must come from the banking com-

Power to control the business of banking is equally important. Under the new legislation, the Reserve Bank, where it is satisfied that 'it is necessary or expedient in the public interest to do so', may 'determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, and when the policy has been so determined, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy as so determined'. To this end, the Reserve Bank may 'give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances, and each banking company shall be bound to comply with any directions as so given'.[1] In addition, the Reserve Bank may 'caution or prohibit banking companies against entering into any particular transaction or class of transactions, and generally give advice to any banking company'.[2] Power to exempt from any provision of the Act may be given by the Central Government on the recommendation of the Reserve Bank. Appropriate penalties are provided for any contravention. But strong though the requirements of the new legislation are, they are not wholly one-sided and the Reserve Bank may 'give assistance to any banking company by means of the grant of a loan or advance' against any 'form of security . . . the Bank may consider sufficient'.[3] These powers of the Reserve Bank, specified by legislation, represent a great extension of the Bank's original powers both as regulator of the system and as lender of last resort. This is in line with central banking developments elsewhere.

The administration of the Banking Companies Act, 1949, as amended, is the responsibility of the Reserve Bank's Department of Banking Operations and a considerable expansion of

panies themselves' (*Annual Report on the Trend and Progress of Banking in India* (period to 31 Dec. 1949), p. 26, but the Reserve Bank can and does exert its influence in the required directions.

[1] Banking Companies Act, 1949, as amended, s. 21.

[2] Ibid., s. 36, (1) (*a*).

[3] See ibid., s. 36, (1) (*c*), and Reserve Bank of India Act, 1934, as amended, s. 18, (1)–3.

its staff has been necessary in order to ensure efficient performance of its various statutory duties and, in particular, the examination of licence applications, the scrutiny of the various returns required under the Act, and bank inspections. It was decided to inspect all banking companies in order to determine their eligibility for licences, though it was appreciated that this programme would take some time to complete.[1] In certain cases, applications for the opening of new branches have involved an inspection, when the financial condition and history of the banking company, the general character of its management, the adequacy of its capital structure, and the earning prospects of the proposed office might all require examination. However, in the longer run, the more important purpose of bank inspections will be effective central bank supervision. Accordingly, it has been proposed

to institute a systematic periodical inspection of all banking companies governed by the Act. The ultimate aim is to create an organisation for an annual inspection of each bank and steps are being taken to recruit the requisite staff. The training of this staff will, however, take some time. In the meanwhile as many banks as possible will be inspected, but the inspections will not be confined to banks whose working is regarded as unsatisfactory. The primary object of the inspections will be to help banks in the establishment of sound banking traditions by drawing attention to defects or unsatisfactory working methods at an early stage.[2]

Work already carried out by this department has been sufficient to demonstrate numerous instances of unhealthy development in the methods of operation of banks in India. Examples which have been brought to light include

the tendency to grant a disproportionately large portion of their advances against security of immovable property, making of advances on inade-

[1] The practice of inspection of banking companies on a restricted scale was started by the Reserve Bank in consultation with the Government of India in 1940, when, with the prior consent of banking companies concerned, the Reserve Bank undertook to inspect their books and accounts with a view to determining the real or exchangeable value of their paid-up capital and reserves for the purpose of considering their eligibility for inclusion in the Second Schedule to the Reserve Bank of India Act. The purpose of these inspections was limited, but they, nevertheless, afforded an opportunity to the Reserve Bank to obtain a better insight into the working and methods of operation of the banking companies. Reserve Bank of India, *Annual Report on the Trend and Progress of Banking in India* (period to 31 Dec. 1949), pp. 21–22.

[2] Reserve Bank, *Annual Report*, Aug. 1950, p. 10.

quate securities to concerns in which the banks' directors or their friends and relations are interested, indiscriminate policy of branch expansion, interlocking of funds between banks and concerns in which their directors are interested, and attempts made by the managements of some banks to secure control of certain industrial undertakings by misuse of the banks' funds. The Bank has also noticed, in the case of some banks, a tendency to manipulate figures appearing in their published statements of accounts with the object of concealing from the public the true financial condition. Several small banks have been found to have granted loans and advances far out of proportion to their total resources. Such defects are always brought to the notice of the managements of the banks concerned and they are directed to rectify them. It is also usual in such cases to prescribe special periodical returns from the offending banks with a view to watching the progress made by them in the desired direction.[1]

In extreme cases more drastic sanctions could be applied. Thus, a scheduled bank might be 'de-scheduled', or, if a bank's position had deteriorated badly, it might be prohibited from accepting further deposits and an even closer watch would be kept on its activities. The ultimate sanction would, of course, involve liquidation. It will be apparent that the burdens of the new department are heavy and its task has not been made easier by the opposition both of the larger banks, which regard supervision as unnecessary and only calculated to create additional work, and the smaller banks, which (apart from a disinclination to reveal certain of their practices) find the making of the new returns a costly undertaking. But, in the general case, there can be little doubt that under Indian conditions there is no practicable alternative and systematic inspection is long overdue.

At last there is the opportunity of solving two of the most intractable problems of Indian banking. First, it is necessary to develop a tradition of sound banking practice. Second, it may now be possible to curtail the almost habitual emphasis in India on the 'shortage of credit' and on the necessity for 'accommodation' and thereby to control the inflationary tendencies, which the central bank has hitherto been virtually powerless to counteract. Our previous analysis would seem to suggest that operation of traditional techniques through the money markets is not by itself a sufficient solution, under

[1] Reserve Bank, *Annual Report*, Aug. 1950, p. 12.

Indian conditions and that the direct controls which have latterly been resorted to are—in this environment—indispensable supplementary techniques. For this task, however, the central bank requires more than powers to control. It must have a strong banking system to work with and there are still too many small and uneconomic banking units which must be weeded out by amalgamation and absorption. This may sound a ruthless policy but it is the only way in a country in which small units have become a danger to themselves and to the community. Moreover, now that the Indians are responsible for their own affairs, it is easier for them to take radical action. So long as the Reserve Bank was thought to be under 'foreign' influence, its position was exceedingly difficult and it had to proceed tentatively and with great forebearance. Not that we can expect a rapid transformation in Indian bank organization. There is much to be done and progress will be slow. But the foundations are laid and the way ahead is clear.

Postscript:

In January 1952 the Reserve Bank decided to create a bill market. This had been in contemplation for some time and an experimental scheme was finally evolved in consultation with representative bankers in Bombay and Calcutta. The Reserve Bank already had power to make advances against certain eligible securities. This was the basis of the new scheme, under which advances will be granted to scheduled banks in the form of demand loans against demand promissory notes (themselves supported by usance promissory notes from bank customers). But it will first be necessary for the scheduled banks to convert at least a portion of the demand promissory notes taken from customers as security for loans into usance promissory notes maturing within ninety days. Advances may then be made by the Reserve Bank on this basis in respect of scheduled bank lending anywhere in India and applications will be received at its offices in Bombay, Calcutta, Delhi, Madras, and Kanpur. However, before extending credit, the Reserve Bank will consider not only the nature of the security offered but also the way in which the applicant bank conducts its business, and the central bank may refuse to accept particular offerings without assigning a reason. Advances were to be made at ½ per cent. below Bank rate in the first instance, though the relevant rate might later be varied at the Reserve Bank's discretion. Furthermore, the rate chosen was ½ per cent. below the Imperial Bank's call loan rate and thus offered the banks a clear inducement to use the new facilities. In addition, half the cost of the stamp duty incurred in converting demand into time bills was to be borne by the Reserve Bank. The minimum limit for such advances was fixed provisionally at Rs. 25 lakhs and individual bills accepted as security were to be not less than Rs. 1 lakh.

MONEY AND BANKING IN PAKISTAN

I. GENERAL BACKGROUND

THE Dominion of Pakistan consists of two widely separated territories nearly 1,000 miles apart. Western Pakistan of over 300,000 square miles has a population of 34 millions and East Bengal, 54,000 square miles, about 46 millions. Since there is no land corridor, communications are by sea and air. The problems which faced the new State were tremendous. An administration had to be created, millions of refugees resettled, and defence forces established. Separatism threatened the frontier. Commerce was disrupted by the flight of Hindu and Sikh clerks, traders, bankers, and money-lenders. The country had no currency of its own. Overshadowing all this, there was soon to be the dispute with India over Kashmir. The situation was further complicated by the fact that at all levels the new nation was short of experienced personnel. It was not surprising, therefore, that there should be doubts—especially during the weeks immediately following the transfer of power on 15 August 1947—of Pakistan's ability to overcome such a formidable array of initial obstacles. But energy and enterprise enabled the new nation not only to survive but also to make much progress.

The economy of the country is primarily agricultural. Cash crops include cotton from West Pakistan, exported through Karachi, and jute and tea from East Bengal, the principal port of which is Chittagong. Pakistan jute is normally consumed to a considerable extent by Indian mills in Calcutta, but latterly an increasing amount of jute has been exported overseas through Chittagong. The main food grains are wheat in the west and rice in the east. Other important products include oilseeds, tobacco, wool, dried fruits, hides, and skins. Industrially, Pakistan is weak, though ambitious plans are afoot. Power and coal supplies are deficient. It is hoped to relieve this by developing hydro-electric schemes and thermal (oil-burning, stations, but these schemes will take some years to

mature. Meanwhile, efforts are being made to expand existing light industries (such as cotton textiles) and to establish new ones, especially in the light engineering field. For the most part industry will be left to private enterprise with a certain amount of State assistance, but the public utilities will all come under State ownership. It is against this background that we must consider the financial aspects of the development of this new Dominion.

II. A NEW CENTRAL BANK

Financial autonomy did not follow immediately upon the establishment of the new Dominion. In the interim it was provided by the Pakistan (Monetary System and Reserve Bank) Order, 1947 that the Reserve Bank of India should continue to act as the currency and banking authority in Pakistan. Initially, these arrangements were to have continued until 30 September 1948, but it was subsequently felt that it was in the best interests of the new Dominion that this situation be ended as early as possible and, by agreement with the Government of India and the Reserve Bank, the date of the transfer of authority to the new State Bank of Pakistan was advanced by three months. Operations began as from 1 July 1948, and Pakistan had asserted her claim to financial autonomy. This was not an easy step to take as banking in an undivided India had been almost entirely in the hands of non-Muslims, most of whom, after partition, preferred to migrate to Indian territory, leaving behind them few trained men to take over their functions. Indeed, the disruption was so acute that many banks were forced to close their doors and considerable reorganization was necessary. The new central bank itself could only draw on those Muslim officers of the Reserve Bank of India who opted for service in Pakistan, and these were barely sufficient to provide the most essential services. An ambitious training programme was planned, though obviously this could do little to solve the immediate problem. In addition, the country was in the grip of an inflation inherited from the war years, and monetary stability was an urgent requirement. Thus the environment into which this infant central bank was born was scarcely the most favourable.

The constitution of the new State Bank was set out in the

State Bank of Pakistan Order of 13 May 1948, as amended. The capital of the new institution was set at PRs. 3 crores,[1] 51 per cent. of which was subscribed by the State. By this means it was proposed to associate the experience and drive of private enterprise with direct State participation in the formulation of policy. Both shareholdings and voting rights were limited (the maximum number of votes accorded to a single shareholder, with the exception of the Central Government, was ten), the object being to ensure the representation of the small man.[2] Under an amending Order provision was also made for a reserve fund of PRs. 3 crores to consist of a deposit of rupee securities by the Central Government. The control and management of the Bank was placed with a Board of Directors to consist of a Governor and Deputy Governor(s),[3] five nominated non-officials, one Government official, and three elected members, one each from Karachi, Lahore, and Dacca. Until the first elections were held in November 1949 and pending the allotment of shares, the Board functioned with nominated Directors only. Day-to-day administration is in the hands of an Executive Committee. Provision was also made for local boards at Karachi, Lahore, and Dacca to deal with problems of a purely local character. These consist of four members elected by shareholders in the areas concerned, together with not more than five members nominated by the Central Government. The annual general meeting must be held within three months of the date on which the accounts are closed for the year.

The business of the Bank is divided in orthodox fashion between an Issue Department and a Banking Department. The State Bank was given the sole right to issue notes and was required to keep not less than 30 per cent. of its total assets in the Issue Department in the form of gold coin and bullion, silver bullion, or approved foreign exchange, the remainder of the assets to consist of rupee coin, rupee securities, and certain types of bills and promissory notes eligible for purchase by the

[1] It will be convenient to use the abbreviations 'PR' to represent the Pakistan rupee and 'IR' the Indian rupee. 1 crore = 100 lakhs = 10,000,000.

[2] The numbers of private shareholders are fairly evenly distributed between the various areas centred on Karachi, Lahore, and Dacca, but the bulk of the shares are registered at the first two centres.

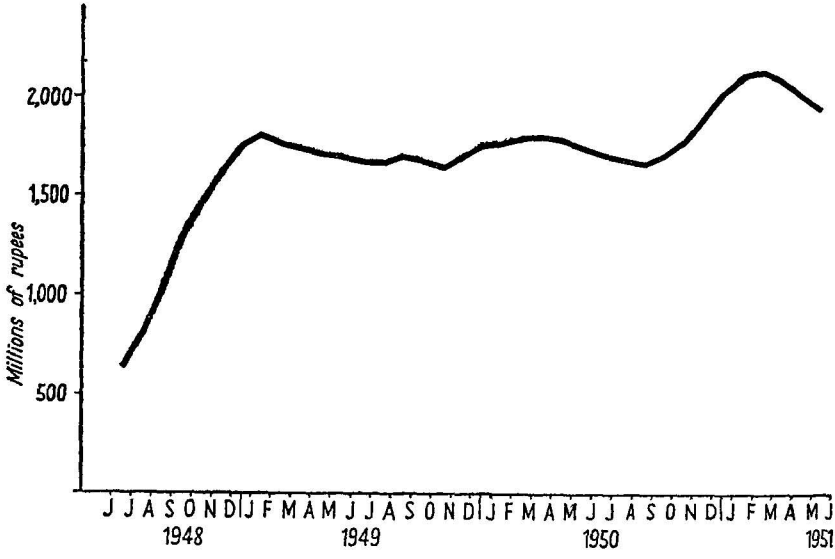
[3] No Deputy Governor has yet been appointed.

Bank. On 1 July 1948, when the State Bank of Pakistan took over from the Reserve Bank of India, large quantities of Reserve Bank notes were still in circulation under the interim arrangements. It was then agreed that the Reserve Bank would transfer the assets held against these notes as and when the notes were withdrawn from circulation, replaced by Pakistan currency, and returned to the Reserve Bank. The various types of relevant Reserve Bank assets were to be transferred from its Issue Department in the same proportions as were held by it on 30 June 1948, and assets falling to the share of the State Bank were in turn to form part of the assets of its Issue Department. In its Banking Department, the State Bank was responsible for keeping the deposits of the various government bodies—Central, Provincial, and Local—and of the banks, for both of which groups it was to provide the usual banking facilities. Again, it was necessary to provide a formula on the basis of which to divide the assets of the Banking Department of the Reserve Bank of India, and the State Bank's share was proportionate to the amount of deposits of the Government and banks in Pakistan. Payment was to be received in sterling assets in the form of United Kingdom Treasury Bills and securities, which were to amount to about Rs. 100 crores. It was under these formulas that Pakistan was to acquire her share of sterling balances, though their release for overseas expenditure was a matter for separate negotiation with the Government of the United Kingdom.[1]

Pakistan was from its inception a member of the sterling area and kept all its reserves of foreign exchange with the Bank of England and, in receiving and making payments, it accepted the terms of agreements made by the United Kingdom with other countries. Normally the State Bank of Pakistan would have no direct dealings with banks in other countries. Hence, the Payments Agreement made with India constituted an innovation in sterling area arrangements in that it provided for

[1] As a result of discussions held in London in July 1951 a new agreement was reached which constituted a material departure from the pattern of earlier arrangements in that it provided for the virtual freeing of Pakistan's balances of blocked sterling. Part of this release was intended to serve as a currency reserve. This was freed immediately, while releases for expenditure were to be spread over a period of about six years. Full consultation in these matters between the two governments was provided for.

direct dealings between the State Bank of Pakistan and the Reserve Bank of India, and purchases and sales of each other's currencies were made between the countries themselves instead of through London. Under this agreement, there was provision for a holding limit of Rs. 15 crores and, prior to the trade deadlock which resulted from the non-devaluation of the Pakistan



PAKISTAN
Notes in Circulation

rupee when other sterling area currencies were de-valued in September 1949, Pakistan ran a credit in trade with India.

The withdrawal of Indian notes circulating in Pakistan was undertaken by the State Bank during its first year. Some difficulty was experienced because of the shortage of available stocks of new notes, the inadequate staffing of the country's Treasuries, the wide area over which operations had to be conducted, poor communications, and the largely illiterate population. Moreover, the retirement of Indian notes was only the first step. The notes had then to be transferred to the offices of the State Bank at Karachi and Dacca, counted, examined, packed, and shipped to India. Despite these difficulties, Indian notes amounting to Rs. 123 crores had been withdrawn and shipped to India by the end of the year. After including Pakistan notes issued by the Reserve Bank of India before the

State Bank took over and making allowance for certain adjustments, the Pakistan Government was entitled to receive assets from the Reserve Bank to the extent of Rs. 176·75 crores. Against this, assets valued at Rs. 127·67 crores were in fact received by the State Bank, but after March 1949 further transfers by the Reserve Bank were held back under instructions from the Government of India. In the event, India's liability had turned out to be more than she had anticipated. One of the difficulties was the extent to which Indian notes had crossed the borders of India and Pakistan after the State Bank had accepted responsibility for the note issue.[1] The position was further clouded by differences arising out of the non-devaluation of the Pakistan rupee.

The principal function of the State Bank as a central bank was to regulate currency and credit 'in the best interests of the country so that monetary stability should be ensured and the most favourable conditions maintained for . . . promotion of economic activity on healthy lines'. In the first instance, the primary instruments for carrying out such a policy were to be open market operations and discount policy.

First, the State Bank was empowered to purchase and to sell government securities of any maturity; to deal in specified securities of local authorities; and to purchase, sell, and discount certain types of bills and promissory notes of a maturity of not more than ninety days, except that where such instru-

[1] The dispute related to whether in lieu of this portion of the notes retired from circulation in Pakistan she was entitled to a share of the assets of the Reserve Bank of India or whether their value was to be adjusted in terms of the Payments Agreement between the two countries. India held that Pakistan was not entitled to the transfer of a portion of the assets of the Reserve Bank in respect of such notes as had moved from India to Pakistan during the period 1 July 1948 to 30 June 1949. On her side, Pakistan argued that movements of notes normally took place in *both* directions and that these movements were anticipated when the agreement for the transfer of assets was reached. It was maintained that movements of notes from India to Pakistan must have been very largely offset by reverse movements from Pakistan to India as a result of the transactions of refugees and the transfer of Hindu profits and capital. In any event, Pakistan was convinced that India had seriously underestimated the value of Indian notes in circulation in Pakistan. In support of this contention, it was also argued that people in the areas of Pakistan were less bank-minded than those in other parts of the sub-continent and that, because areas which became part of Pakistan produced a larger proportion of cash crops, such as jute and cotton, the circulation of notes in Pakistan would necessarily be larger per head than in India itself, with its greater emphasis on subsistence farming.

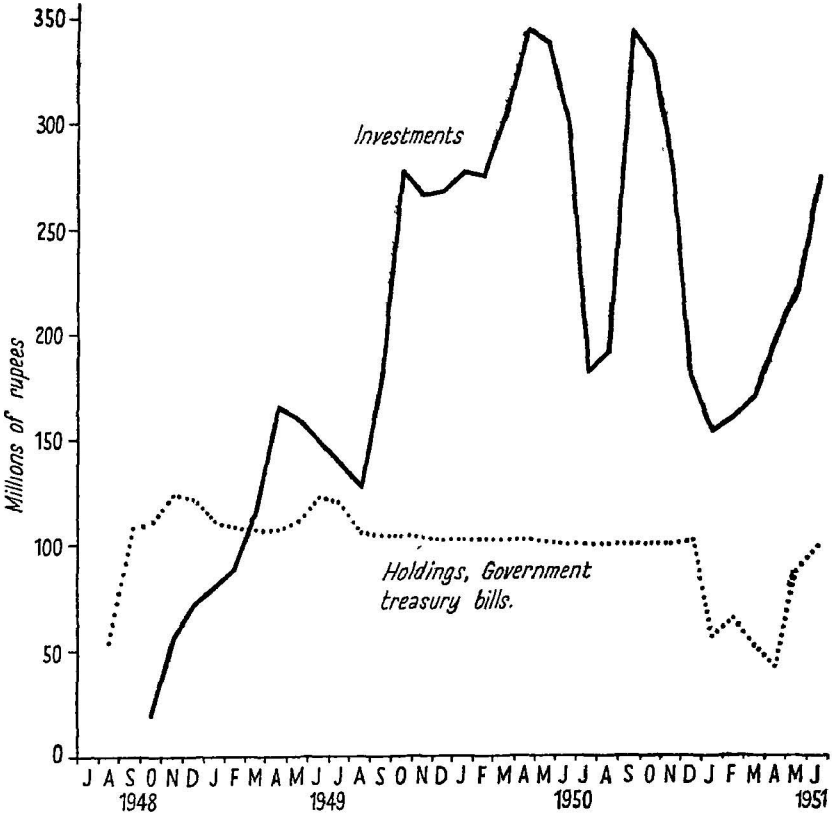
ments related to the financing of seasonal agricultural operations, or the marketing of crops, maturities of up to nine months might be accepted. Second, the State Bank might extend to local authorities, scheduled banks, or provincial co-operative banks, loans and advances against specified types of securities, either repayable on demand, or on the expiration of a fixed period not exceeding thirty days. Third, the Bank stood ready to discount or rediscount certain types of bills, or other commercial paper, and was to announce its rate from time to time. This was fixed at 3 per cent. per annum and its published rate has remained unchanged, but higher penalty rates have been imposed latterly for accommodation of more than one week.[1] Fourth, the Bank was to assure the continued functioning of banking services and the readiness of banks to meet their legal obligations and a special department of the Bank was set up to take all practicable measures to ensure the protection of Pakistani depositors. Finally, the Bank was to act as banker to both the Central and Provincial Governments in Pakistan and might make short-term advances from time to time to cover government expenditure in excess of revenue. It was also to manage the public debt and to arrange for the issue and service of loans.

Profits arising from this business were to be divided between the shareholders and the Government. After provision for all bad and doubtful debts, depreciation of assets, contributions to staff and superannuation funds, a cumulative dividend at a rate of 4 per cent. per annum was to be paid by the Bank on the shares issued by it. Any surplus was to be paid to the Government of Pakistan. In return, the Bank was exempted from income and super tax on any of its income, profit, or other gains.

As a basis for open market operations, an attempt was made to develop a securities market, but the stock exchange in

[1] Thus, from Nov. 1950 interest has been charged at 3 per cent. for the first week, 4 per cent. for the next three weeks, and 5 per cent. for any subsequent period. It was pointed out that it was not the function of the State Bank to meet the need for seasonal finance. Its function was to act as lender of last resort and to assist banks during periods of emergency. Banks were expected to keep their funds and investments in a state of 'proper balance' so that they could meet all seasonal requirements from their own resources. It was felt necessary to take steps which would definitely discourage the banks from seeking central bank assistance except in emergencies.

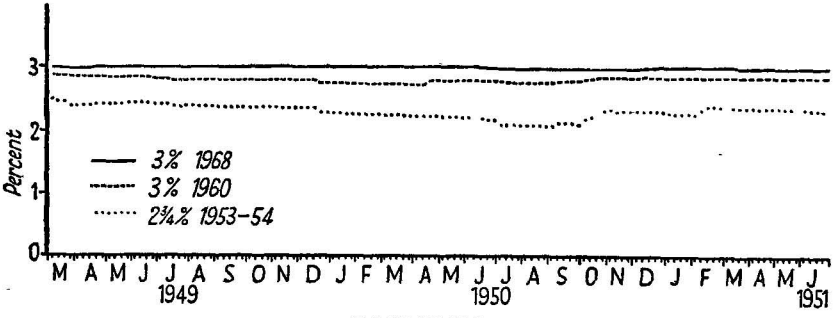
Karachi still remained very restricted and the supply of investment scrip was limited. The main demand came largely from banks and other institutional investors. At an early stage the State Bank indicated its intention to give reasonable support to the market and funds were also provided in this way during



STATE BANK OF PAKISTAN

periods of stringency. In all cases, dealings took place through brokers. The market is admittedly narrow, but central bank intervention is important, because, as in India, trade—and hence the demand for finance—is highly seasonal. During the busy season the banks can use all the money they can lay hands on. On the other hand, the slack season is associated with a marked increase in their liquid resources. In these circumstances the State Bank has been prepared on occasion to buy securities from the banks during the busy season for the

purpose of putting them in funds and to sell securities to them when their cash balances rise. The Bank informs its broker that it is prepared to buy (or sell) and leaves it to the rest of the market to make use of the facilities offered. So far, the transactions have only been on a small scale, but the procedure has now been definitely established. Apart from the effects on bank liquidity, this apparatus has provided a more or less consistent demand for such securities as are available, and prices have been very stable.

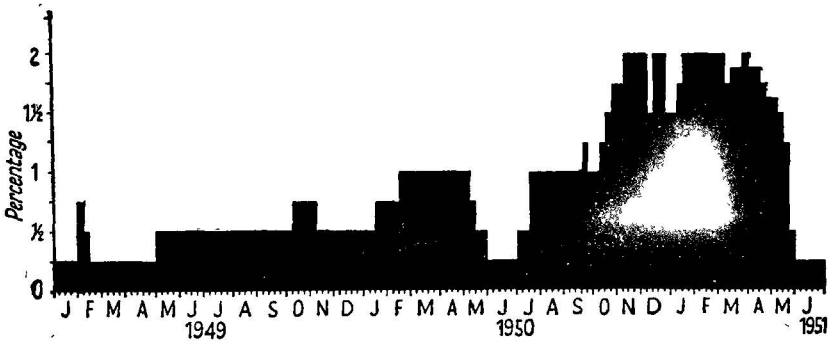


PAKISTAN
Yield on Government Securities

The pattern of interest rates also reflects the seasonal demand for finance. The State Bank's discount rate provides the basis of the market structure and, occasionally, the banks have sought accommodation of this character from the central bank, though when credit is tight it is their normal practice to sell securities. Rates for fixed deposits are quoted at ½ per cent. per annum for six months and 1¼ per cent. per annum for twelve months. In the recent past, the larger banks have done their advance business on the basis of a minimum rate of approximately 3 per cent. per annum, though tight money conditions may raise the effective minimum to 3½ per cent. Parties not considered to be first-class risks would pay an appropriately higher rate. The discount rate on hundis varies a good deal and depends on the standing of the customer.[1] The seasonal character of the business done is most obviously reflected in the rate on inter-bank call loans. In Karachi this is quite a well-developed market. The rates vary between ¼ per cent. and 2 per cent. per annum, but may go even higher in an ex-

[1] On bills for collection, the exchange banks charge ¼ per cent. commission.

ceptional season. The effective minimum, however, is ½ per cent. Very little business is done at ¼ per cent., since at this rate the banks do not consider it worth the trouble of lending and they would rather remain liquid. The annual cycle of rates on inter-bank call loans in Karachi is indicated in the graph below. Money may be lent for two or three days, but when the rate is high loans can run for two to three weeks.[1] In other centres, the market is less well organized, but a certain amount of call loan business is done between the banks.



KARACHI
Inter-bank Call Money Rates

However, in a system which is still relatively immature, the central bank has felt the need for a more direct control over the commercial banks than can be provided by resort to the traditional weapons. In addition, the Government felt acutely its lack of complete independence in the banking field as a result of the foreign ownership of most of the banks operating in the country. Of thirty-five leading banks doing business in Pakistan at the time of the partition, only two had their head offices there, and the policies and activities of the majority of the

[1] The money market in Karachi has been described as 'completely an inter-bank affair' and, when funds are scarce (as they were during the 1950–1 season), 'the money market, in fact, ceases to exist. Attempts made by some brokers to induce certain big corporations to utilise their surplus funds by lending them on the market did not arouse noticeable response. The exchange banks were of course able to import funds from London by selling sterling to the State Bank and covering themselves by buying forward. Forward contracts are at 6 months option and if the sterling is not taken up until the end of the period the rate works out at approximately ¼ per cent. per annum. London money market rates for this type of business were 1 to 1½ per cent. per annum. So the banks were borrowing at less than 2 per cent.' See State Bank of Pakistan, *Annual Report*, year ended 30 June 1951, p. 17.

banks were directed from outside the country. Nevertheless, policy could be influenced by controls and, as in India, the more important banks were listed as 'scheduled banks'. These were required to maintain with the State Bank a balance, which at the close of business on any day was to be not less than 5 per cent. of the demand liabilities and 2 per cent. of the time liabilities of each such bank in Pakistan. Furthermore, by an amendment to the original Order, the Bank might now increase these reserve requirements by notification in the event of its becoming necessary to limit credit facilities in order to safeguard the economy. The liabilities on the basis of which the amounts to be lodged were calculated did not include paid-up capital, reserves, or credit balances in profit and loss account, nor the amount of any loan made to such banks by the State Bank. The scheduled banks were also required to furnish a return to the central bank stating their position as at the close of business each Friday.

The original powers of the State Bank to control and regulate the banking system were considerably widened by the passage of the Banking Companies (Control) Act, 1948, as amended. The purpose of this legislation was to enable the central bank to control bank loans and advances and to lay down certain requirements as to the maintenance of both liquid assets and of the proportion of total assets held in Pakistan. Thus, initially, banking companies could be required to hold in Pakistan assets amounting to 75 per cent. of their demand and time liabilities to depositors in Pakistan.[1] Subsequently, this ratio was raised to 85 per cent.[2] because of evidence that certain banks were transferring assets to India and thereby prejudicing the rights of local depositors.[3] Moreover, the prescribed percentage must now be maintained throughout the year instead of at the close of each quarter as previously. Under the same Act, the State Bank was accorded

[1] Though in the first instance only 60 per cent. was requested.

[2] In point of fact 80 per cent. was required.

[3] Nevertheless, it may be argued that certain of such transfers are normal, since financial requirements are seasonal and, before partition, it was quite common for bank funds to be transferred to East Bengal to finance the movement of jute and for them to move back to Calcutta when the season was over. Presumably, in the view of the State Bank, the transfers of assets to which it objected were not of this character.

general powers to call for information from the other banks and to discourage, or even to prohibit, banks from undertaking particular types of transactions. On the other hand, and under an amendment to the original State Bank Order, the central bank, in the event of an emergency, might now assist both scheduled and non-scheduled banks directly by offering either loan or discount facilities. Further assistance to the banking fraternity was provided by remittance facilities within Pakistan and between the various offices of the Bank and the Treasury or their agents. These facilities were available at low rates for banks, co-operative institutions, and the public. As a result, money rates have tended to become substantially uniform over the whole of the country.

As part of the system of banking control, the State Bank was empowered by the Banking Companies (Inspection) Ordinance, 1946, provided it secured the previous sanction of the Central Government, to carry out bank inspections. Because of lack of staff, the State Bank has been unable to undertake the inspection of all banks and has been obliged in the main to limit its activities to cases where inspection appeared to be necessary in the interests of depositors.[1] In consequence, certain banks have been prohibited from receiving fresh deposits and, on occasion, liquidation has proved to be unavoidable.[2] Furthermore, in terms of the Banking Companies (Restriction of Branches) Act, 1946, as amended, banks must apply for a licence from the State Bank for the opening of new branches (even though these are only to meet seasonal or temporary demands), or for changing the location of existing offices. Similar arrangements applied in undivided India, but foreign banking companies were not included. After partition,

[1] The Bank has not considered it necessary to undertake inspections of the larger banks, whose methods and policies are known to be generally sound. At the same time, it would not be desirable to give the impression that inspections were only carried out when the Bank had reason to suspect the soundness of the institution in question and inspections have, on occasion, been ordered in the absence of such evidence.

[2] During 1950–1 'the State Bank decided to liquidate two banks in Western Pakistan for their continued failure to comply with the statutory requirements under the Banking Companies (Control) Act, 1948. It also decided to take into liquidation those Non-Scheduled Banks in East Pakistan which similarly failed to fulfil the statutory requirements of the said Act.' State Bank of Pakistan, *Annual Report*, year ended 30 June 1951, p. 30.

the law was amended to apply to all banking companies operating in Pakistan.

By the larger banks, the Banking Companies (Control) Act is generally regarded as a good piece of legislation which is wisely administered. So far as they are concerned, however, the regulations are not restrictive in any very material sense, because they are accustomed to be even more conservative in their policies than is required by the State Bank. Its restrictions are therefore aimed primarily at the smaller and less well-managed banks and it is to be regarded as essentially a precautionary measure. In framing its proposed regulations, the State Bank is accustomed to consult fully with the commercial bankers in order to ascertain their reactions and, if possible, to meet their objections, so that the State Bank has attempted to give leadership rather than to exercise control. Apart from consultation, the commercial banks are advised of central bank policy by means of periodic circulars, but there has been no hint of direction. Thus, at one time, the banks were requested not to make advances against Indian government securities and industrial shares, because of disturbances, which might have made realization difficult. Admittedly, the State Bank has an important reserve power, but so far there has been little need for restriction and the long-term need is for an expansion of banking facilities. It will, of course, be necessary to avoid an indiscriminate growth.

In order to study the problems connected with agricultural credit, a separate section has been set up in the Banking Control Department and an Agricultural Credit Officer appointed. For the most part, this section will be concerned with the working of co-operative banks in the various parts of the country. Its initial task is to make a general study of agricultural credit, but due attention will be given to local conditions which vary from province to province.

III. COMMERCIAL BANKING

The structure of commercial banking in Pakistan owes much to the inheritance of institutions developed in undivided India, but partition brought problems of its own and their solution has already produced certain changes which require our

attention. Indigenous banking in the Indo-Pakistan subcontinent has for long been the virtual monopoly of particular Hindu castes. Moreover, with the development of joint stock banking many of these moved into the field of commercial banking proper. On the other hand, for historical reasons and because of the entrenched position of the Hindu banking castes, few in the Muslim community entered the banking trade, which until recent years remained practically closed to them.

Partition was followed by widespread riots and bloodshed, as a result of which Hindu businessmen, industrialists, and bankers fled from Pakistan to India. Economic life in Pakistan was almost paralysed and banking organization suffered what then appeared to be irreparable damage. Before partition, banking was fairly well developed in the area now forming West Pakistan, but with the migration of the Hindus a large number of these banks were forced to close down. As against 364 offices of the scheduled banks operating before partition, only sixty-two remained open immediately afterwards, though since then there has been a considerable revival. As at 30 June 1951, there were thirty-two scheduled banks in Pakistan operating 201 offices. In some cases banks were closed down without discharging their liabilities to depositors or making any arrangements for payment. In addition, Muslim refugees who came to Pakistan in large numbers held their deposit accounts in India and they, too, were often unable to secure repayment. Indeed, the number of such complaints received by the Pakistan Government was so considerable that a separate section of the State Bank was set up with representatives at Karachi and Dacca to make investigations. However, reference to the banks concerned did not produce satisfactory results and the matter had to be taken up at Dominion level before agreement on some of the more important issues could be reached. On the other side of the border, similar hardships were being suffered by refugees from Pakistan.

Moratorium arrangements were invoked in both the new Dominions to meet this situation. India found that certain banks, with registered offices in East Punjab and Delhi, held most of their assets in the West Punjab, now part of Pakistan, whereas most of their deposit liabilities had been transferred to their branches in India. Because of difficulties in securing

access to records and assets in the West Punjab, some of these banks found it almost impossible to make any immediate arrangements for meeting the claims of their depositors, many of whom were refugees. To avoid unnecessary distress, the Government of India, in consultation with the Reserve Bank, promulgated the Banking Companies (East Punjab and Delhi) Ordinance, 1947, which empowered the Government to make an order staying for three months the commencement or continuance of all actions or proceedings against a bank seeking its protection. Temporary assistance was provided by the Government. Pakistan promulgated a similar ordinance—the Banking Companies (Pakistan) Ordinance, 1947—but without provision for government assistance. These ordinances lapsed on 27 March 1948 and 22 April 1948 respectively. But in Pakistan a Rehabilitation Finance Corporation was set up with a capital of PRs. 1 crore to assist refugees to re-establish themselves. They might borrow, for example, for the purpose of buying sewing machines, or yarn, and setting themselves up in cottage industries.

Joint Stock Banking

In Pakistan, commercial banking proper (apart from the new National Bank of Pakistan, which will be separately considered) may be most conveniently divided into three groups: the exchange banks, the Indian banks, and the Pakistani banks. All the leading exchange banks are represented, and Indian banks include the Imperial Bank of India (whose functions as government agent will gradually be taken over by the State Bank and the new National Bank), the Bank of India Ltd., the Central Bank of India Ltd., the United Commercial Bank Ltd., and the Allahabad Bank Ltd. (a subsidiary of the Chartered Bank of India, Australia, and China and virtually an exchange bank in centres such as Lahore, where the Chartered Bank has no branch). The Punjab National Bank Ltd. has now transferred both its head office and most of its activities to India. The leading Pakistani banks are the Habib Bank Ltd., the Muslim Commercial Bank Ltd., the Bank of Bhawalpur and the Australasia Bank Ltd. The National Bank of Pakistan, which is a State-sponsored institution, must also be included in this category. The oldest Pakistani bank is the Central

Exchange Bank, founded in 1926, but it is not sufficiently large to be included as a scheduled bank.[1]

Business is done on lines similar to those already discussed in our chapter on India, though necessarily the emphasis is even more on the finance of crop movement, especially cotton and jute. A useful business is also done in hides and skins. The exchange banks naturally do the bulk of the work in foreign exchange, but the other joint stock banks, as in India, are developing an interest in this field. For the rest, the banks accept current and fixed deposits and also do a savings bank business. They discount bills and make advances. Much of this lending is fully secured,[2] and only a small amount is lent on the personal reputation of the borrower. Advances are commonly made at rates ranging from 3 per cent. per annum to 5 per cent. Besides their discount business, the banks also accept bills for collection. There is still a small hundi market in Karachi though with the migration of the Multanis to India this business has virtually dried up. Shikarpur, which was formerly the most important market in undivided India, has fallen away to nothing. Such discounting of hundis as remains is done primarily by the Imperial Bank of India.

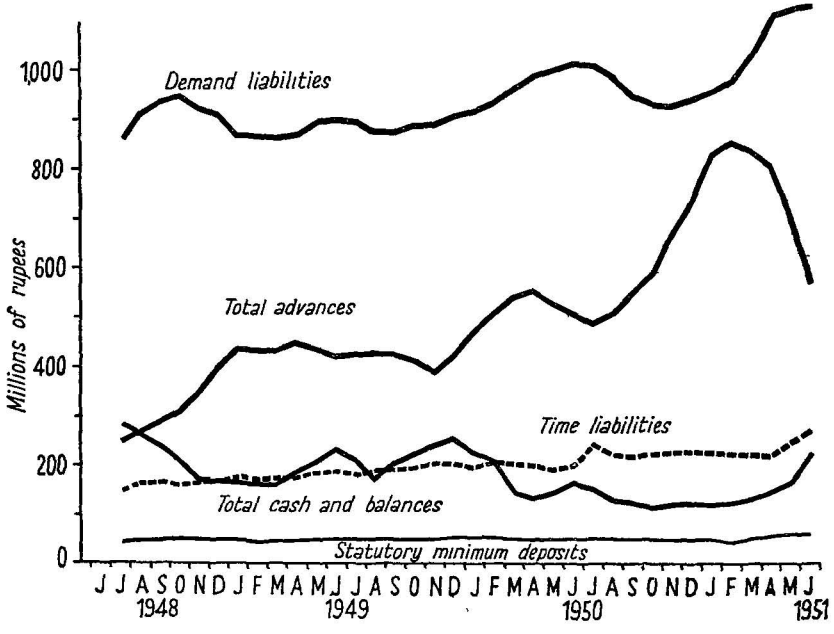
The origins of the Pakistani banks make an interesting story. The Habib Bank was founded in 1942 with a capital of Rs. 1 crore, but it grew out of a Muslim merchant banking firm of forty years standing. The shares are still held by the family. Its business is run on sound (indeed, one might say, conservative) lines and it appears to be in a very safe position. The Muslim Commercial Bank was established in 1948 by a group of wealthy Muslims interested in a Muslim banking venture. The directors and most of the staff are drawn from the Muslim community, but the management is European. Initially, it was primarily interested in foreign exchange busi-

[1] Its exchange business is done through the agency of larger banks. The bank does a current account business, accepts savings-bank deposits (with limited cheque facilities) at 1½ to 2 per cent. per annum, and fixed deposits at 2½ per cent. per annum for six months and 3 per cent. per annum for twelve months. Its range of advance rates at 5 to 9 per cent. per annum is correspondingly higher than those of the larger banks. Its activities and rate structure are fairly typical of the smaller banks as a whole.

[2] Loans by way of pledge seem to be more common than those given against hypothecation, which form of taking security is reserved for first-class risks only.

ness, but latterly it has been widening the range of its activities and establishing branches up-country.

Probably the most romantic story of all is that of the Australasia Bank.[1] The bank was established in 1942 in a motor garage in Lahore with a staff of three. Initially, it was little more than an agency for the collection of rents from the family



PAKISTAN
Scheduled Banks Consolidated

estate. Then, the tenants began to open accounts and the bank to make advances against gold, insurance policies, and merchandise. Management of family properties led to the business of managing other people's estates and the new bank soon ran into opposition from the established banks. This attitude was said to be due to a desire to discourage mushroom banking. Discrimination took the form of a collection charge applied to local cheques, on the grounds that the new bank was not in the

[1] This rather unusual name for a Pakistani bank was chosen by the founder because of family associations with Australia. It was also expected that it would encourage confidence in the new institution.

'Bank Square'. The Australasia Bank was at that stage a non-scheduled bank, but it was claimed that at this time it was not accorded the facilities available even to that class of bank. The Reserve Bank of India, for example, as the then central bank responsible for this area, was loath to grant facilities for the exchange of notes or the grant of accommodation. After two years, the bank was moved to a new building. It did the same business as before though on an increased scale. A number of branches were opened. In due course the bank applied for inclusion in the schedule. It was thoroughly inspected and became a scheduled bank in the financial year 1946–7. Partition came as a severe blow. The Indian branches were looted and gutted by fire and, from branches in Pakistan, there was an exodus of Hindu staff, but the business of the bank was carried on—in many cases by raw recruits. Staff turnover was high, but recruitment and training continued. The bank was now entrusted with the collection of Treasury revenues and payments on behalf of the Government in certain centres. Subsequently, it was granted a licence to undertake foreign exchange business, and further branches were opened. The bank is still small, though included in the schedule, but it does a business comparable in quality and scope with larger and longer-established banks. If any proof were needed that the Muslim is capable of the initiative and persistence to embark upon the complex business of banking, this case study should provide useful evidence.

National Bank of Pakistan

The most obvious effect of partition in the field of banking was the loss of facilities[1] and the corresponding need to expand existing services or provide new ones. In part, this has been met by private enterprise and the development of Pakistani joint stock banks, as already described. To a certain extent the functions of the co-operative banks were modified and ex-

[1] 'There are certain parts of the country, in particular a large part of East Bengal, which are deplorably lacking in banking facilities. There are certain towns and areas where private and semi-public organizations do not know where they should lodge their funds for safe custody.' Speech delivered by Mr. Zahid Husain, Governor, State Bank of Pakistan, 29 Sept. 1949, on the occasion of the First Annual General Meeting of the Bank, as printed, p. 8.

tended to enable them to assist in filling the gap. But the major responsibility for providing expanded facilities has been placed on the shoulders of the new National Bank of Pakistan. This is a partly private, partly government, venture. It is sponsored by the Government, which must hold not less than 25 per cent. of the share capital, the remainder being held in private hands. Relations with the State Bank will be close, since under a State Bank of Pakistan (Amendment) Ordinance, 1950, the Government has appointed the Governor of the State Bank (Mr. Zahid Husain) as President of the National Bank of Pakistan. The new bank's authorized capital has been fixed in the first instance at PRs. 6 crores, though the share capital may be increased (or decreased) with the sanction of the Central Government. The head office of the bank is at Karachi and the constitution provides for a central board and three local boards at Karachi, Lahore, and Dacca. All types of banking business are undertaken, including exchange banking. But two of the new bank's functions are regarded as of particular significance. First, loans are made on the security of goods, by way of agricultural credits, and for the purpose of financing general trade. Primarily, it appears to be the intention to finance jute, cotton, and other agricultural commodities, in order to assist growers of cash crops. Second, the bank provides facilities for 'the paying, receiving, collecting, and remitting of money, bullion, and securities.' In this role, it will act as agent of the State Bank in places where the central bank is not represented and will thereby assume functions at present in the hands of the Imperial Bank of India, which originally acted in this way for the Reserve Bank of India and which, after partition and the setting up of a new central bank for Pakistan, has acted similarly for the State Bank. National Bank branches are to be established over a wide area and so supplement the relatively inadequate banking facilities at present available, particularly up-country, and thus stimulate the further expansion of business and commerce.[1] In pursuance of this policy, branches have been opened steadily and, by December 1950, National Bank offices numbered seventeen.

[1] Losses incurred by branches established at the request of the Government in under-banked areas were partially compensated by means of a subsidy from the Central Government.

Originally, it was intended to establish the bank by Act some time in 1950, but in September 1949 it was decided to set it up immediately in view of the threatened crisis in the jute market in East Pakistan, occasioned by the devaluation of sterling and the Indian rupee. Accordingly, the National Bank of Pakistan Ordinance was promulgated and, in November 1949, the bank opened at Karachi and Lahore in Western Pakistan, and at Dacca and a number of other places in East Bengal. At an early stage the National Bank became a scheduled bank. Under the transitional provisions of the bank's ordinance, however, it was only permitted in the first instance to undertake the business of financing jute, cotton, and other agricultural commodities, though this power could be extended with the prior approval of the Central Government. In order to obtain funds necessary for the finance of the jute trade, Central Government permission was obtained for the acceptance of fixed deposits in sums of not less than PRs. 1 lakh and the arrangement of inter-bank call loans from the scheduled banks in sums of not less than PRs. 25 lakhs. In the initial stages, the National Bank borrowed from the central bank, but latterly considerable funds were obtained by way of fixed deposits and inter-bank call loans.

For reasons already mentioned, the bank's initial activities were concerned with the finance of the jute trade.[1] In East Pakistan, where the jute is grown, large sums of money were advanced to jute merchants, who were appointed agents of the Jute Board,[2] in co-operation with which the bank assisted in the stabilization of jute prices. Subsequently the Co-operative Department of East Bengal undertook the co-operative market-

[1] In the following season the bank was also called upon to provide considerable support for the cotton trade.

[2] The Jute Board began operations in November 1949 with the object of overcoming difficulties occasioned by the change in the rupee rate of exchange between India and Pakistan. It appointed about 200 agents for the purpose of bringing the jute to market and of these about sixty were on the National Bank's short list as approved agents. Advances were made to them at 4 per cent. per annum, i.e. 1 per cent. above Bank Rate. As a temporary expedient and because of the trade dispute with India and a consequent carry-over of jute, an arrangement was entered into whereby the National Bank also made advances to Government agents at 3½ per cent. per annum. The latter were then able to take jute from middlemen with more than they could carry and there was no hold-up in payment to the grower. The Government guaranteed the bank against any losses which might result.

ing of jute in various districts of the province and sought financial assistance from the National Bank.[1]

Formerly, much of the finance for the movement and marketing of the Pakistan jute crop came from Calcutta, a considerable proportion of the trade being in the hands of Marwaris acting through agents. The strength of their position was undoubtedly due to the geography of East Bengal and the division of the province by the unbridgeable Brahmaputra, as a result of which most of the trade from the western half was diverted to Calcutta, the fibre being bought in the interior by Marwari agents. For similar reasons, this part of the country was poorly provided with banking facilities and indigenous institutions were given full scope. In the eastern part of the province the jute went mostly for export through Chittagong and the Marwaris played a secondary role.

The marketing process was somewhat complicated. Jute was ready for sale as soon as it had been dried after retting and stripping, but the timing of the sale depended largely on the conditions of its transport to its markets. The movement of the jute from grower to mill or presshouse took place in three distinct stages: (1) from the grower to the primary or rural markets, where it changed hands in unsorted condition, or, at most, only after rough grading; (2) the secondary or assembling markets, where it was sorted and baled by hand-operated presses into loosely graded 'kutcha' bales (gradings were in terms of top, middle, and bottom qualities), which balings formed the bulk of Indian mill purchases, or it might be packed into 5-maund[2] hydraulically screw-pressed 'pucca' bales for shipment overseas or to mills in India; and (3) from these up-country baling centres direct to mills in the Calcutta area, to balers for further re-sorting (either for export overseas, or for sale to Indian mills), or to speculative dealers in the terminal markets of Cossipore, Shambazar, and Hathkola in Calcutta.

It has been estimated that, in the primary stages, about 75 per cent. of the crop was sold direct by the growers to travelling dealers, known as 'farias', 'paikars', or 'beparis'—either at

[1] It has been argued, however, that very little assistance has as yet been given the agriculturists under these arrangements. See 'Jute Marketing and Co-operatives in Eastern Pakistan', *State Bank of Pakistan Bulletin*, Sept. 1951, pp. 18 ff.

[2] A maund represents a weight equivalent to 82 lb.

their homes or at the nearest villages. These dealers used either their own finance, or acted as the agents of merchants. The popularity of this system of marketing was due to the fact that the harvesting of early jute coincided with the coming of the monsoon. Such fair-weather tracks as there were disappeared. Even rivers frequently changed course. About 80 per cent. of the crop was brought to the markets by country boat during July to October, the remainder coming in later in the season by cart or headload. The 'bepari', who was the biggest of the direct contact men, provided his own transport to convey the jute to secondary markets for disposal to larger dealers or balers. On many occasions when on a buying expedition, the 'bepari' might be completely out of touch for a week at a time with price changes in the secondary markets, so that he shouldered a considerable risk. Many of the smaller dealers—the 'farias' and 'paikars'—belonged to the cultivator class and they could not afford to carry these risks. They therefore confined their activities to the nearest villages and primary markets only.

A substantial percentage of the crop was purchased by 'beparis', who were financed by merchants known in the trade as 'mahajans' located at the large village markets or baling centres. They acted as middlemen and, after a rough sorting, sold to other merchants or to balers. Another intermediate dealer was the 'arathdar', generally found in baling centres. He might either finance the 'bepari', or accept jute for resale on a commission basis. He provided both transport and storage facilities and was perhaps the most important of the early intermediaries. In addition, both the 'mahajans' and the 'arathdars' speculated in the market, and in all the larger baling centres a large number of brokers (or 'dalals') were to be found. It is almost unnecessary to comment upon the large number of charges, brokerages, and allowances both in cash and kind which crept in at all stages of this process of marketing (amounting to perhaps 3 per cent. of cash value), together with persistent malpractices, such as (on the side of the buyer) manipulating the scales and (on the side of the seller) watering the jute to increase weight. Such activities could almost be regarded as a normal adjunct of life.[1]

[1] See 'Jute Marketing', by A. S. Low in *Jute and Gunny Review*, vol. ii, No. 5 (July 1950), pp. 407–13.

It is difficult to establish the extent to which this system still prevails. The nature of the country and the absence of adequate alternatives would suggest that over large areas there has been little change. In the past, apart from accommodation granted to shippers, bank finance was usually made available to the baler, merchant, or the mills acting through agents, against a pledge of stocks, and the banks insisted on the usual margins. (To provide the necessary margin, non-bank finance was, of course, employed.) A proportion of the funds normally came from Calcutta, but with the development of exchange difficulties between India and Pakistan, and related central bank action, funds moved less freely. Foreign commercial banks operating in East Bengal still provide much of the necessary finance, but their activities are now supplemented to an important and increasing extent by loans from the National Bank of Pakistan. Bank finance is then, as it were, passed back to the smaller men who assemble the jute for the larger markets. In addition (and even before the Korean War boom) the fixing of minimum prices and the introduction of a scheme offering a guarantee of government purchase[1] if sales could not otherwise be effected made it possible for many agriculturists and dealers to provide their own finance. Nevertheless, the expansion of the co-operatives into the field of jute marketing suggests that there was still some dearth of finance in the primary stages of the marketing process. To the extent that the co-operatives operate in this field, there will, of course, again be a passing back of bank funds made available by the National Bank. Over the course of time, these newer arrangements are likely to modify the institutions traditionally employed to finance the movement of this crop.

Co-operative Banking

Pakistan inherited the system of co-operative banking followed in undivided India,[2] but, after partition, the demands made upon these banks were heavy. Apart from the disruption

[1] Government support ended in June 1950 though the Government stood ready to intervene again if the price of jute threatened to fall unduly.

[2] The organization includes credit societies, land mortgage banks, multi-purpose co-operatives, marketing societies, farming societies, stockbreeding societies, health societies, industrial co-operatives, consumers' stores, house-building societies, and (latterly) co-operative insurance.

of commercial banking services, there was the disappearance of the Hindu indigenous banker. To a certain extent, Muslims began to operate a money-lending business (though usury is frowned on by the religion of Islam). In addition, because of restrictions on the alienation of land, this business tended to be confined to agriculturists. There was, therefore, scope for an expansion of co-operative activity both in the ordinary commercial field and in the provision of agricultural credit. Further, the co-operatives came to act as treasuries for the new Pakistan Government in the North-west Frontier Province and the West Punjab and, on behalf of the Government, they made purchases from producers of large quantities of field crops valued at crores of rupees. They also assisted materially in the distribution of controlled articles such as sugar and cloth. Although not a new activity, a good deal of assistance has been given, since partition, to the cottage industries, especially in the West Punjab.

Normally, commercial banking would have been outside the powers of the co-operatives, but the serious dearth of facilities after the disturbances at the time of partition prompted the authorities to relax the relevant by-laws under the Co-operative Societies Acts to enable them to undertake a general banking business.[1] Whether this development will be permanent remains to be seen. The co-operative banks themselves appear to welcome the additional business, but many observers feel that it is an extension of activity beyond their experience and therefore to be discouraged. It is probable that there will be some withdrawal from this business as the National Bank grows and opens more branches, but the co-operatives may still be left with a limited field and, to the extent that it is not economic to open branches in small centres, they may con-

[1] The Sind Provincial Co-operative Bank in Karachi, however, was handling commercial business even before partition. As a basis of comparison with commercial banks proper, this bank allowed ½ per cent. on current accounts, 1 per cent. on savings bank accounts, 1½ per cent. on six months' fixed deposits, and 2½ per cent. on twelve months' fixed deposits. Its overdraft business (i.e. commercial banking business) was done at rates ranging from 4 to 6 per cent., whereas loans to societies (co-operative business proper) were made at 4 per cent., with a penalty of an extra 1 per cent. in cases of default (all rates quoted per annum). Loans were only made on the basis of stocks of commodities at a margin of 75 per cent. and never on standing crops. Parties paid their own storage charges for the use of municipal godowns.

tinue to offer general banking facilities for some time. It is unlikely that Muslim indigenous banking will ever develop sufficiently to fill the gap.

The scope for co-operative banking within its traditional fields is considerable in Pakistan. Apart from the West Punjab, the movement made a late start in areas which are now part of Pakistan. In Sind, co-operatives were only introduced in 1918, and in the North-west Frontier Province nothing was done until 1925, while in Baluchistan, the Tribal Areas, and Agencies no effort was made to establish a co-operative prior to independence. In Sind and the North-west Frontier Province, the 'central banks' have been merged into provincial banks and the latter deal with the primary societies direct. Both the Central and Provincial Governments have made grants-in-aid and loans for schemes of agricultural and industrial improvement through co-operatives. The co-operative movement is strongest in the West Punjab, less so in Sind, and weak in East Bengal.

It is perhaps useful to consider why co-operation should be strongest in the Punjab. The burden of agricultural debt in this area and the unpopularity of money-lenders gave the initial impetus. The money-lender has been forced out by three main sets of circumstances. First, high war-time prices gave the cultivators the opportunity to clear some of their debts, though it was the big landlords who seem to have been most successful in repaying their borrowings; second, there was the flight of Hindu money-lenders during the disturbances following partition; and, third, the operation of the Land Alienation Act. The money-lender was a Hindu 'bania' and the borrower a Muslim agriculturist. Under this Act the 'banias' were prohibited from acquiring the land of the agriculturist. The 'bania' retained all other rights for twenty years. Thereafter the land was clear of debt. There were, of course, penalties for the debtor who refused to pay. In these circumstances, the money-lender came to play a less important part in the finance of agriculture and the co-operatives, as the obvious alternative, grew in strength. But the position is not quite as simple as that. It would seem, for example, that the Punjabi is more co-operative-minded than other Pakistanis. The Punjab also has a strong middle class with developed habits of thrift. And, not

least, the Punjab has had a succession of very able Registrars of Co-operatives.

In Sind, apart from other considerations, it would seem that archaic land laws stand in the way of the further development of co-operation. Under a somewhat feudalistic system, the peasant is virtually a landless labourer. He has few rights and can be dispossessed. The result is that about 85 per cent. of the population in this province is outside the co-operative movement. Without security, the co-operatives cannot advance to the tiller of the soil, and there is a strong movement to bring in legislation for the protection of the tenant. This would give him security of tenure and the co-operatives a basis on which to lend. A further step to improve the situation in Sind is the consolidation of the co-operatives. Small co-operatives are being merged into bigger units. These 'Taluka' banks (a 'taluka' is almost the equivalent of a district) are multi-purpose and it is hoped that they will be the basis of a stronger organization.

Co-operation in East Bengal has not been very successful. As elsewhere in undivided India, the depression of the thirties proved to be a major setback. The price of jute, which was the principal cash crop in this area, fell heavily. The co-operatives attempted to hold their deposits by offering rates of 7 to 9 per cent. per annum, but withdrawals went on. Many of the smaller banks were forced into liquidation and, in other cases, reconstruction schemes had to be drawn up. But, in this area, the movement never really recovered from the depression. Partition created new difficulties. Previously, East Bengal had been served by an 'apex bank' in Calcutta, so that a new organization had to be set up and the East Pakistan Provincial Co-operative Bank was founded in April 1948. The new bank had no funds and no securities, and the Government had therefore to make arrangements for the advance of loans to primary societies, wherever necessary. Little development of commercial banking business by co-operatives has been permitted in East Bengal.[1] This policy is associated with the number of branches the National Bank opened in this area

[1] The 'apex bank' makes advances against gold and commodities, but the central co-operative banks have not yet been allowed to do so because they are not strong enough to shoulder the risks and would be liable to attract the less credit-worthy borrowers.

immediately after its foundation. Indeed, the co-operative movement in East Pakistan now appears to be re-directing its activities from credit to multi-purpose activities.

But, although progress has been uneven, the co-operative movement in Pakistan as a whole has made considerable advances since partition. The total number of co-operative societies is approximately 50,000, the number of members about 2·25 millions, and working capital exceeds PRs. 450 millions. On the basis of an average family of 5 persons, the movement embraces about 11 million people, or 13·5 per cent. of the total population of the country.[1] In order to co-ordinate the work of the co-operatives in the provinces, a Co-operation and Marketing Adviser has been appointed. He is also concerned with educating the people in the scope and methods of co-operation. There can be no doubt that the co-operative movement has the wholehearted support of the Government.

Industrial Finance

As has already been mentioned, Pakistan is primarily an agricultural country, but there is already a certain amount of industry and plans are well advanced to expand further this side of the economy. To a certain extent, the Central and Provincial Governments have been able to assist the cottage industries in various parts of the country. Loans have also been made to specific industries, such as sugar and cement. It is proposed to set up a government-sponsored Industrial Development Corporation, with a capital of PRs. 25–30 crores, to assist certain other industries including jute, paper, fertilizers, shipbuilding, and heavy chemicals, but this is a long-term plan. In the interim, an Industrial Finance Corporation has been established under the Pakistan Industrial Finance Corporation Act, 1949, to provide medium-term finance to industries which would otherwise experience difficulty in raising the necessary funds. Capital for industrial development in Pakistan is still 'shy' and some such encouragement had to be given in order to bring forth such capital as might be available.

This Corporation began with a nominated board in Septem-

[1] See H. S. K. Lodi, 'Co-operative Movement in Pakistan,' *Co-operation and Marketing Review*, vol. iv, No. 1, Jan. 1950.

ber 1949. The head office is in Karachi.[1] Its authorized capital was fixed at PRs. 3 crores, though this figure might be increased. The Government holding must be at least 61 per cent. the remainder being sought from institutional investors, including Provincial governments, banks, insurance companies, and investment trusts. The shares of the Corporation and a minimum annual dividend were guaranteed by the Central Government. The Corporation has established a reserve fund but, until this reaches the same figure as its paid-up capital (at present PRs. 2 crores), the rate of dividend has been restricted to $2\frac{3}{4}$ per cent. per annum. When the required reserve has been built up, the rate of dividend will still be subject to a ceiling of 5 per cent. per annum, any surplus being paid to the Central Government. The Corporation is subject to tax in the ordinary way.

The general superintendence and direction of the affairs and business of the Corporation is in the hands of a Board of Directors[2] which with the assistance of an Executive Committee[3] and a Managing Director has full powers in these matters. In discharging its functions, the Board is required to act 'on commercial considerations, but with due regard to the interests of industry, commerce and the public interest generally'. On policy matters the Board will be guided by such instructions as may be given to it by the Central Government. In the event of any dispute, the decision of the latter is final. Provision was made for the appointment of a Technical Advisory Committee to consist of experts to give technical advice on schemes submitted to the Corporation for financial assistance, or on any matter referred to the Committee by the Board.[4] In addition, the Board may appoint *ad hoc* committees to assist it in its work.

The borrowing powers of the Corporation are limited to five times the amount of its paid-up capital and reserve fund.

[1] On 21 Mar. 1951 an office was also opened at Chittagong in East Bengal.

[2] The Board consists of five Directors appointed by the Central Government and to serve during its pleasure, three elected by the other shareholders to serve for a period of two years, and a Managing Director appointed by the Central Government for a term of three years, though eligible for re-appointment.

[3] Consisting of the Managing Director, as Chairman, one Director elected by the nominated Directors, and one elected by the elected Directors.

[4] A committee of five has since been appointed with the Managing Director of the Corporation as Chairman.

Within these limits and with the prior approval of the Central Government, it may issue and sell bonds and debentures for the purpose of increasing its working capital at such rates as are approved by the Government which shall guarantee interest on and repayment of such liabilities. In addition, the Corporation may accept deposits on terms and conditions and to the extent approved by the Central Government.

Business which the Corporation may transact is restricted to the accommodation of public limited companies and includes the guaranteeing of loans floated by industrial concerns in the public market and repayable within a period not exceeding twenty years; the underwriting of issues by industrial concerns of stock, shares, bonds, or debentures; the taking up of any such securities within the terms of an underwriting agreement (but it must dispose of such securities within a period not exceeding seven years); the granting of loans or subscription to debentures of industrial concerns for periods not exceeding twenty years. In certain circumstances, repayment may be required within the agreed period. At present, the effective maximum appears to be twelve years and most loans have been granted to run nine to ten years, with repayment by instalments beginning in the second or third year. Interest is charged at a rate of $4\frac{1}{2}$ per cent. per annum, but there is no investigating charge or other expenses to be met by the applicant. All guarantees, loans, or debentures must be secured and in the case of any single concern shall not exceed in aggregate $7\frac{1}{2}$ per cent. of the paid-up share capital of the Corporation except with the consent of the Government, and in no case shall the amount of any loan exceed PRs. 30 lakhs. A commission will be charged in consideration of any guarantee or underwriting and the Corporation may impose such conditions as it may think necessary. The Corporation may not subscribe directly to the shares or stock of any company having limited liability. Funds may be invested in the securities of the Central Government or of any Provincial Government.

During its first two years of operation the Corporation only granted direct loans, but recently it has agreed to underwrite the issue of shares and debentures.[1] Generally speaking, it has

[1] See Pakistan Industrial Finance Corporation, *Second Annual Report*, 30 June 1951.

advanced against a mortgage of the fixed assets of the borrowing concerns and has, of course, required full insurance cover in all such cases. A wide range of industries has been assisted. Those which benefited most included textiles, sugar, printing, food processing, and electricity.

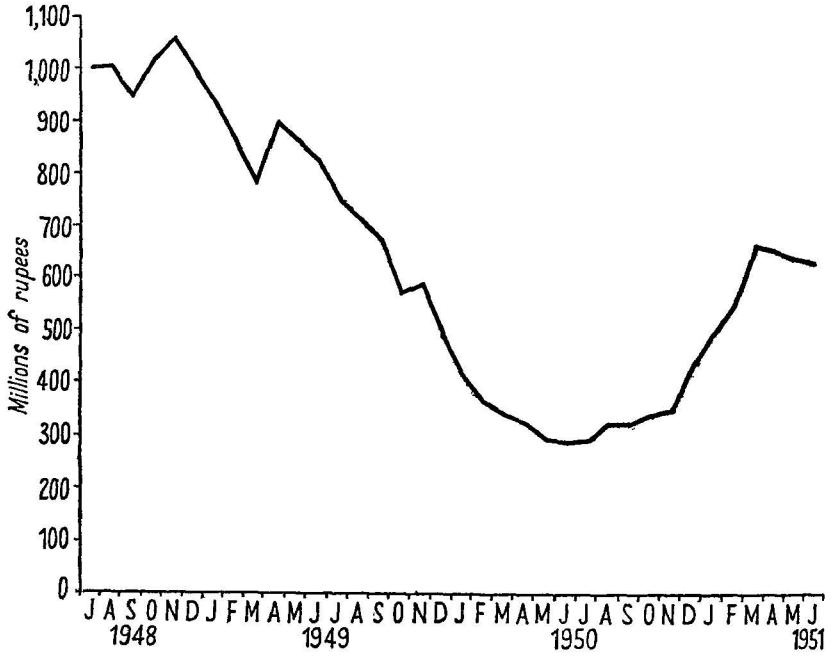
In general, there can be no doubt that the provision of adequate banking facilities is an essential prerequisite of a healthy economy, but under the inflationary conditions which operated prior to and after partition, the general restriction of credit in Pakistan, which was a by-product of reduced banking services, was not wholly disadvantageous. Furthermore, the dearth of technical and industrial skills combined with an uncertain future to restrict private industrial investment. Meanwhile, the Government was following a prudent budget policy and taxation was maintained at high levels. Unfortunately rather more had to be spent on defence than a poor country could strictly afford. Yet the inflation appears to have been brought under control and no longer dominated the situation. The stage was set for an expansion of banking facilities on sound lines.

IV. THE TWO RUPEES

As well as maintaining the internal value of the currency, the State Bank, in co-operation with the Government, was made responsible for protecting the exchange value of the Pakistan rupee. At present, transactions in overseas currencies are still subject to exchange control, the administration of which is under the supervision of the Bank within the terms of the Foreign Exchange Regulation Act, 1947. The regulations themselves are framed by the Government and the discretion of the Bank in these matters is severely restricted. The operation of the control is decentralized as much as possible and the Bank appoints authorized dealers (e.g. the scheduled banks), who are permitted to operate within the limits laid down for them and subject to the instructions which might be issued to them from time to time. Thus by no means all transactions pass through the hands of the control itself. In fact, about 90 per cent. of total transactions—perhaps more—are dealt with by the banks on their own responsibility. Furthermore, the authorized dealers are permitted to hold working balances for

the purpose of meeting their requirements and subject to regular accounts being submitted to the control.

Foreign exchange is regarded as a national asset to be used with care in the best interests of the country. Exchange control policy has been governed by two factors—the amount of sterling releases from blocked accounts and the over-all sterling area



PAKISTAN

Balances held outside Pakistan. (Includes cash, short term sterling securities and balances with Reserve Bank of India)

dollar position—and has accorded with sterling area policy as a whole. Under the International Monetary Fund and Bank Act, 1950, Pakistan has now joined both these international bodies and is therefore also bound by their articles of agreement. Sterling is bought and sold at rates based on the official parity of the Pakistan rupee. Transactions in Indian rupees were governed initially by the terms of the Payments Agreement with India under which the State Bank of Pakistan bought and sold freely Indian rupees at official rates and the Reserve Bank of India dealt in Pakistan rupees on a similar

basis. At that stage no exchange control operated between the two Dominions.

As an ancillary function the Pakistan exchange control was also made responsible for the supervision of all new foreign investments in Pakistan, and compliance by foreign investors with the Government's industrial policy was thereby ensured.

However, most of the interest in foreign exchange matters has so far centred on relations between Pakistan and India. It was clearly not anticipated when the original Payments Agreement was drawn up between the Dominions that any marked divergence between the two rupees was at all likely. In the course of time, no doubt, the complementarity of the Indo-Pakistan sub-continent may have been modified and political division may have been sufficient to cut across the traditional economic integration of this region. But, as a result of the impact of sterling devaluation in September 1949, the transition to a new economic alinement was rudely disturbed without anything approaching full adjustment having taken place. In the event, India elected to follow sterling, while Pakistan decided to maintain the value of her currency in relation to the dollar. This had far-reaching effects.

In view of the devaluation of sterling, it was argued that it was impossible for India to avoid similar action without detrimental effects on her own economy. India's trade is largely with sterling area countries, so that any appreciation of her rupee as against sterling would have made her exports even more costly in overseas markets. Not only would this have undermined her competitive position in what was then becoming a buyers' market, but it would also have had the secondary effect of reducing still further the volume of imports she could afford to buy with her export income. In addition, it was feared that any stand she might have been able to make against such action would have been subject to doubts as to her ability to avoid devaluation in the future, and this would have acted as a powerful psychological barrier to any transactions at the old rate of exchange and trade might have been brought to a standstill. Devaluation of the Indian rupee was quite frankly 'a defensive measure'.

However, some previous consultation with Pakistan was clearly necessary under the terms of the Payments Agreement

between the two countries. Article I of this Agreement stipulated specifically that 'the official rate of exchange as between the India rupee and the Pakistan rupee will continue to be at par, and will not be altered by either Government except after due notice and mutual consultation'.[1] It is probably true that, when that agreement was entered into, the possibility of sterling devaluation was not visualized and the haste with which India felt that she must reach a decision was no doubt—from her point of view—a good enough excuse for unilateral action. The position was further complicated by the fact that Pakistan was not then a member of the International Monetary Fund. But the facts of the matter are clear. Pakistan (and Ceylon) were merely 'informed' of India's intentions and there was no consultation. In the result, it was India which put herself in the wrong.

Meanwhile, Pakistan had decided not to devalue. In other words, given the decision of the United Kingdom and of India, she was prepared to allow her currency to appreciate against both the pound sterling and the Indian rupee to the extent of some 44 per cent. The Pakistan rupee-sterling rate now went to about 2*s.* 2*d.*, while the Indian rupee-sterling rate remained at 1*s.* 6*d.* Before reaching this decision, the Pakistan Government gave very anxious consideration to the question. The basis of the Pakistan decision was primarily her balance of payments position. Devaluation, as her Finance Minister pointed out, was a remedy for a deep-seated disequilibrium in a country's balance of payments, or was appropriate where a country had an export trade capable of expansion by this device. It was argued that Pakistan's balance of payments position was not such as to necessitate devaluation, nor did her exports—almost entirely raw materials—admit of any appreciable expansion. It was true that for a time she had had an unfavourable balance of payments, but this was regarded as principally due to the disruptive effects of partition and was of

[1] Furthermore under Article VI of the agreement 'in the event of either Government taking action which results in a depreciation of its currency in terms of the currency of the other Dominion', Indian rupees held by the State Bank or (as the case may be) Pakistani rupees held by the Reserve Bank, were to be revalued on the basis of the new parity and the account of whichever bank incurred a loss as a result of such action was to be written up by an appropriate amount.

a temporary character only. For the twelve months July 1948 to June 1949 there was an over-all favourable balance of Rs. 48·67 lakhs. Within this total, a favourable balance with India of Rs. 60·97 lakhs was offset by a deficit with the rest of the soft currency countries of Rs. 25·72 lakhs. But there was a favourable balance with the hard currency areas of Rs. 13·42 lakhs, including a slightly favourable balance with the United States.

If there had been a devaluation of the Pakistan rupee, it was felt that this would have been unlikely to result in any increase in the volume of exports, partly because these consisted almost entirely of raw materials, the demand for which was not likely to increase very much in response to a fall in price, and partly because the supplies for these goods in Pakistan were themselves relatively inelastic. A significant increase in production was not within the capacity of the country and, in particular, devaluation would not have achieved its main objective of increasing sales in dollar areas. It would therefore have led to a net diminution of dollar earnings. It was realized, of course, that the virtual appreciation of the Pakistan rupee in terms of sterling would tend to result in some falling off in exports, particularly to India, but it was 'confidently expected that after an initial period of adjustment' trade would resume its normal course. This appears to have been the major miscalculation. If trade with India was regarded as being at all important—and on a fair appraisal of the facts it must have been[1]—Pakistan could hardly expect that non-devaluation of her rupee would not have unfavourable repercussions. It is true, of course, that there were certain compensating advantages. On the import side, devaluation would have meant a rise in the rupee prices of dollar goods. Non-devaluation meant that imports of non-dollar goods would actually become cheaper in terms of rupees.

Reinforcing the balance of payments considerations were two others: first, the desire to prevent an increase in, or better still, to bring down, the high level of domestic prices; second, the need to secure capital imports at the lowest possible prices

[1] In the first place, a favourable balance with India was necessary to balance deficit trading elsewhere and, second, under the General Debt Settlement between the two countries, Pakistan had agreed (beginning in 1952) to make payments to India in respect of Pakistan's share of inherited common debts.

for purposes of development. Fear of any further upward pressure on the domestic price level was undoubtedly an important influence. In Eastern Pakistan, in particular, marked inflationary pressures had been in existence for some time and it was only recently that these had been checked. In these circumstances, the Government was not prepared to risk high prices for essentials in East Bengal. Quite apart from the welfare of the inhabitants, a further upward pressure on prices (as a result of the inflationary effects of devaluation) must have affected the costs of production and therefore the price of rice (which in this instance is grown and consumed in the same area). Rice is the staple food of East Bengal and on its price depends very largely the price of raw jute, which is also produced in this part of the country. Moreover, raw jute is not only Pakistan's major export, but it is also a significant dollar earner. Furthermore, it was hoped that the decision not to devalue the Pakistan rupee would tend to bring about a fall in prices (as a result of lower prices for imports), which in East Bengal would contribute to the relief of a sorely oppressed part of Pakistan's population.

In addition, the Government had in mind its plans for the future development of the country. Pakistan is predominantly an agricultural country and, in the view of the Government, is in need of industrialization. Devaluation would have placed the hard currency areas beyond its reach, and it was in these areas that Pakistan hoped to find 'a cheap and ready source for capital goods'. It was known that Pakistan had been somewhat disappointed at the lack of any large-scale inflow of British investment and had therefore come to look to the United States for satisfaction of at least some of her capital requirements. Maintenance of her exchange rate with the dollar meant that she could still secure the capital goods and the essential raw materials she required without additional cost from hard currency areas, while from those countries which had devalued, it should now be possible to obtain her requirements at much more favourable prices than before. If she herself had devalued, her development programme would have been jeopardized and she was not prepared to allow this to happen.

From India's point of view, however, Pakistan's decision could scarcely be regarded with equanimity. Pakistan had been

supplying the bulk of India's raw jute requirements, a significant proportion of her raw cotton imports as well as a certain amount of wheat, hides and skins, and other primary commodities. In return Pakistan took from India about two-thirds of her total requirements of coal, a quantity of cotton textiles, and other general manufactures. For India, therefore, Pakistan's decision not to devalue meant a steep rise in the prices of her imports of two essential raw materials—jute and cotton. As a result, India attempted to neutralize the effect of the new exchange rate on her domestic economy. India's problems were, first, the prospect of an increase of some 40 per cent. in her adverse balance of payments with Pakistan; and, second, the danger of further rises in the internal price level. Her policy was therefore ostensibly directed towards conserving within the Indian economy not only stocks of essential raw materials, but also supplies of goods normally exported to Pakistan. Initially, export duties were levied, but latterly a trade ban was attempted. This was reinforced by a control of currency transactions between the two countries. In short, there was a virtual declaration of economic war.

However, trade between two countries with a long land frontier is never easy to control and there appears to have been much evasion of these restrictions. This meant that a differential rate of exchange between the two Dominions could not be effectively maintained, except to the extent that such a rate was offset by changes in their respective price levels. Trade still went on, though the flow was now considerably interrupted.[1]

In general terms, the trade which continued took three forms: (1) there was peasant trading in small essentials; (2) there was the attempt by refugees to move their capital from one Dominion to the other or to send remittances to families in the other Dominion; and (3) there was a certain amount of smuggling of goods normally traded between the two countries on a commercial scale, such as jute from Pakistan and cotton textiles from India. There can be no doubt that in each of

[1] It was estimated that even on a liberal basis the amount of trade and other transactions between the two Dominions 'would, perhaps, hardly exceed twenty per cent. of the normal pre-devaluation level of total trade'. See K. N. R. Ramanujam, 'Indo-Pakistan Balance of Payments', *Reserve Bank of India Bulletin*, Feb. 1950, pp. 82–91.

these categories there was some movement of goods across both the Punjabi and Bengali borders. Without question, there was more of such trade in the early days of the dispute than latterly, when it became increasingly difficult to move goods as the policing of the borders became more efficient.

The small essentials in which peasants traded included such necessary, if humble, things as condiments, betel nuts, and mustard oil (for cooking purposes), and (from East Bengal to India) fish and eggs. For the most part, trade was in terms of barter deals, and the exchange rate derived from these transactions bore no necessary relation to the official Pakistan rate (which was not then recognized by India).

There was also a continuing and urgent demand for Indian rupees by refugees in Pakistan, who had left families in India. They were prepared to buy at almost any price and, in the absence of official sources of supply, the rate asked was frequently most unfavourable to them. Alternatively, Hindus from East Bengal with Pakistani rupees found that the rate moved against them in Calcutta, when they wished to convert into Indian currency. Indeed, to overcome the hardship imposed by transactions effected sometimes at less than parity, the Reserve Bank of India offered to buy Pakistani rupees at par. Again, capital transfers might take the form of the movement of goods. A Muslim moving from India to Pakistan would buy (say) textiles for sale on arrival and, if he wanted money urgently after crossing the border, he might have to sell at a discount. Once more, the derived rate would be unfavourable as compared with the official rate in Pakistan. The Pakistan Government's attitude to this trade was that there was no prohibition on her part as regards trade with India and any such imports helped to keep prices down. India, on the other hand, appeared to allow trade unofficially and despite her trade ban.

Throughout this period, official exchange business between the two Dominions was at a standstill, but the 'black market' was quite active. The rates quoted fluctuated between the most extraordinary limits. Between Karachi and Bombay, at one time, PRs. 100 would buy IRs. 110 to 120. Across the borders of the two Punjabs and the Bengals, the rate was most variable. In the Punjabs, a comparable rate seems to have been

PRs. 100 = IRs. 105 to 115, and between the Bengals it fell to as low as PRs. 100 = IRs. 95 to 98. Even where these rates were not derived from barter deals,[1] which was in any case a somewhat unreliable means of estimation, allowance had to be made for the fact that the relevant markets were narrow and highly localized and that the rates quoted in them must therefore have been artificial in the extreme. Pakistan always maintained that if her rate had been determined as a result of free trading, the official Pakistan rate of PRs. 144 = IRs. 100 (or something very like it) would without doubt have been established. Whether this situation would have been brought about must remain an open question. But to argue, as some Indians did, that the rates quoted at the border should be taken as the criterion ignored the narrowness and highly artificial character of these markets.

Much greater difficulty was experienced in attempting to smuggle bales of cotton and jute from Pakistan to India. Nevertheless, jute did trickle across the border to India from East Bengal. This was impossible to eliminate altogether. The network of waterways in the two Bengals lent itself to such activities, and, despite all precautions on the Pakistan side of the border to prevent sales of jute at less than the minimum price, bales of jute even arrived mysteriously at Dum Dum (Calcutta) Airport. With the introduction of a guaranteed market in East Pakistan, there was less inducement to smuggle jute to India, but a certain amount of jute might have been attracted by higher 'black market' prices in India, or smuggling may have been induced by the shortage of rice supplies just before the harvest. The latter type of transaction tended to die out once the new season's crop became available. Nevertheless, there were certain discrepancies in India's jute statistics, which suggest that smuggling was more significant than the Pakistanis would admit.

[1] The evidence suggests that only small quantities of notes were dealt in and, frequently, such traffic took the form of money-changing at railway stations, where the rates quoted depended on the day-to-day conditions of supply and demand. Jute was sometimes paid for by using bank deposits in Pakistan and smuggling it to India. This represented capital export. In other cases, hundis were drawn at par, which allowed some profit to the drawer. Also, when operations took place between two accounts—one in India and one in Pakistan—business was often done at par.

The jute trade represented a difficult case. The Indian mills argued that price was the determining factor. They were prepared to buy as much of Pakistan's jute as she cared to sell, provided the price was not too high. On the Indian side of the border, it was sometimes said that it was price and not the exchange rate they were worried about, though obviously neither could be considered in isolation. There can be no doubt that devaluation came at just the wrong time for the jute trade, since it was then the peak of the buying season. It has been argued that, if it had come either earlier or later, an agreement could have been reached much more easily.

The basis of the difficulties in the jute trade appeared to derive from the existence of a bilateral monopoly. Pakistan wanted to exact a monopoly price for her jute. She could sell her good quality jute overseas without difficulty, but, for the lower grades, the Indian mills were her only buyer and India felt that she could dictate the price at which she bought. This peculiar situation was quite apparently a consequence of a complementary economy in the Bengals, which had existed long before partition. Pakistan naturally wanted the highest price she could get for her raw material. She also objected to pressure being brought to bear against her exchange rate which, as a result of her non-devaluation, had now moved against India. The latter sold the final product and felt that any rise in prices would eliminate the competitive advantage she had secured in the dollar area by means of devaluation. In these circumstances Pakistan found it difficult to understand why India had imposed an export duty on hessian and felt that this, combined with India's attitude to the Pakistan rate of exchange, represented an attempt to benefit the Indian exchequer at the expense of the Pakistani grower. The Indian position was somewhat complicated. India did not accept the exchange rate declared by Pakistan and, without exchange facilities between the two Dominions, it became impossible for mills to buy Pakistani jute. This created the danger that competing demands for the limited supplies of Indian jute would cause a rise in price, which would have raised the cost to the industry just as surely as buying Pakistani jute. Immediate steps were therefore taken by the Indian Government, in co-operation with the Indian Jute Mills Association, to fix

maximum prices, in order to restrict the export of raw jute, and a rationing system was devised so that all mills would be assured of a share in available supplies. Corresponding maxima were fixed for jute manufactures, as it was anticipated that, without control, prices would soar to levels which would have offset the benefits of devaluation. But that would not have prevented profiteering in jute manufactures abroad, so the export duty on hessian (or burlap) was raised in three stages from IRs. 80 per long ton to IRs. 1,500 per long ton.[1] The export duty on jute packing was also raised from IRs. 50 to IRs. 150.[2] If prices in hard currency countries remained at pre-devaluation levels, the Indian Government would take the benefit of devaluation. But the Americans had already forced prices up against themselves, by holding off the market in the earlier part of the season (in anticipation of devaluation) and then indulging in panic buying when they realized that the supply of jute goods was likely to be short. One unfortunate result of the Indian Government's decision was to raise prices in the sterling area to a point where the use of substitutes was encouraged to the detriment of the industry.

The main results of this deadlock—only partially relieved by the exchange of raw jute for jute manufactures and other goods in terms of a trade agreement signed by the two countries on 21 April 1950[3]—was a slowing down in the movement of the crop in Pakistan and a chronic shortage of raw jute for manufacture in Calcutta, with the mills working short time and incurring losses. Pakistan had no difficulty in selling her

[1] Inevitably there was a certain amount of evasion of the export duty by means of under-invoicing.

[2] Subsequently (and rather surprisingly) this duty was raised further to IRs. 350 per long ton in Mar. 1951 after the signing of a trade agreement with Pakistan.

[3] Transactions took place in Indian rupees for which a separate account was maintained by the State Bank of Pakistan with the Reserve Bank of India. The value of goods and commodities purchased by Pakistan were to be, as near as possible, equal to the value of the jute purchased by India. In addition, there were a number of commodities (including the small essentials which are traded across the borders of the Punjabs and the Bengals) in which trade was to be permitted 'without import, export and exchange restrictions on either side in respect of transactions in these commodities, to the extent that traders in either country are able to finance exchange of goods without any assistance from either government in the shape of releases of foreign exchange'. Pakistan was also to supply a certain amount of wheat. In point of fact, it was extended for a period of four months to enable Pakistan to complete her deliveries of jute.

good quality jute, but her transport facilities in East Bengal were sorely tested (especially her railways) and the port of Chittagong was at one time virtually choked with shipping she could not handle. Over the longer period, this could be met, in part, by increasing the capacity of Chittagong and by developing a new port at Chalna. It was also Pakistan's intention to hasten the establishment of mills for the manufacture of jute in East Pakistan itself. But all this would take time and the question of costs could not be ignored. India, on the other hand, was attempting to increase her own acreage of jute and to become less dependent for the raw material on Pakistan. Again, this would take time and meant some sacrifice of acreage previously devoted to food growing, though the diversion in terms of acres was not likely to be large. Meanwhile, the high price of jute goods intensified the search for substitutes and this threatened the overseas markets of both Dominions.

Most of the emphasis has been on the jute trade because it was here that the complementarity was most obvious and that relations became most strained. But cotton also occasioned difficulties. Nevertheless, the Pakistan cotton crop was easier to move and to sell. India could import from elsewhere, though she had to spend dollars to do so. She could also find alternative markets for her piece-goods, and Pakistan could buy elsewhere. But hold-ups in production and the necessity to redirect trade imposed losses on both countries and, if it had not been for more fundamental differences involving political considerations and national pride, the deadlock must surely have been resolved much sooner.

Whatever may have been thought at the time of Pakistan's decision not to devalue her rupee in sympathy with sterling—and the arguments were by no means confined to one side—events subsequently moved in such a way as to justify the Pakistan decision. Any doubts that may have remained were set at rest by the extraordinary rise in world demand for cotton and jute occasioned by fear of war. Undoubtedly it was this change in the economic climate, together with the serious position of raw jute supplies, which lay behind India's decision to resume trade talks with Pakistan. The resultant agreement covered the period 26 February 1951 to 30 June 1952. The principal commodities included in the schedules were raw

jute, cotton, food grains, hides and skins from Pakistan, and coal, iron and steel, timber, cement, jute manufactures, paper, and textiles from India.[1]

Even more important was the fact that India accepted the par value of the Pakistan rupee as the basis of the agreement. Furthermore, Indian rupees earned by Pakistan from transactions under the agreement became convertible into free sterling without restriction and at any time at the option of the State Bank of Pakistan. The Reserve Bank of India was granted a similar option in respect of balances held in Pakistani rupees. At the same time the Reserve Bank of India announced the extension of exchange control to Pakistan, whose rupee became a foreign currency for the purpose of all financial transactions and subject to the restrictions imposed under the Foreign Exchange Regulations. Remittances from India to Pakistan could now be made only through authorized dealers in foreign exchange. Similar arrangements applied in Pakistan. Initially, however, only current payments were covered and capital transfers were excluded, pending the settlement of procedural details with the Reserve Bank of India. In any case, capital transfers were to be settled between the two banks in blocked sterling and adjusted through the appropriate accounts at the Bank of England. Official buying and selling rates for the Pakistan rupee were announced by India and, within the month, the International Monetary Fund which had deferred a decision at its Annual Meeting at Paris in September 1950 announced its acceptance of an initial par value for the Pakistan rupee at 3·30852 rupees to the United States dollar—the rate proposed by the Government of Pakistan. Thus ended one of the most damaging trade disputes of recent years.

[1] In Apr. 1951 the State Bank of Pakistan announced arrangements for forward exchange dealings in Indian rupees. Transactions were to be effected through authorized dealers (under the supervision of the State Bank) upon presentation of a firm contract for the supply of goods to or purchase of goods from India.

Appendix to Chapter 7
STATE BANK OF PAKISTAN

	Loans and Advances		
	To governments	*Other*	*Internal discounts*
1948		(*Thousands of rupees*)	
July	700	..	..
August	1,425	150	..
September	75	..	..
October	..	..	..
November	..	..	..
December	1,180	..	..
1949			
January	2,800	5,625	..
February	300	1,325	..
March	..	125	..
April	240	..	..
May	1,200	..	..
June	150	..	..
July	840	20	..
August	1,000	..	..
September	..	300	..
October	..	1,802	..
November	..	750	4,835*
December	..	9,127	8,867*
1950			
January	425	13,185	..
February	3,650	16,163	..
March	360	19,060	..
April	875	14,599	..
May	125	8,129	..
June	620	7,352	..
July	450	8,506	..
August	500	33,568	..
September	100	55,373	..
October	..	59,937	..
November	125	79,289	..
December	460	84,239	..
1951			
January	250	111,308	..
February	500	127,122	..
March	1,080	111,345	..
April	1,275	53,093	..
May	875	10,004	..
June	2,260	228	..

* It may be instructive to supply the detailed weekly figures for this period of two months:

1949		*1949*	
Nov. 11	4,150	Dec. 2	11,692
18	6,465	9	14,330
25	8,727	16	18,315

8

BANKING IN IRELAND

IT is difficult enough to describe any country's banking system in a brief chapter. The writer on Ireland is beset by a special difficulty. The name 'Ireland' and the adjective 'Irish' have become ambiguous. The solution adopted here is that the term 'Ireland' will be used only with application to the whole island; the twenty-six counties cut out from the United Kingdom in 1921 will be described always as 'the Republic', and the six remaining counties as 'Northern Ireland'. The corresponding adjectives will be 'Irish', 'Republican', and 'Northern'. Where it is necessary to draw distinctions not coincident with the political boundary, 'northern' and 'southern' (minuscule initial) will be used. Only by some such usage can clarity and consistency be attained.

I

Banking in Ireland has grown up as a branch, but a distinctive branch, of British banking. Its local history has been often of more than local interest. Up to 1845 it displays also many of the characteristics of an independent system which after 1845 wither away. Owners, managers, and clients have always been predominantly Irish.

Historically, the systematic development of banking in Ireland begins with the *épuration Maintenon* of 1685 and the Williamite settlement of 1691. Until then, the necessary conditions of security and enterprise were lacking. David Digges La Touche established his poplin factory and began his banking business in Dublin in 1693. Even at this early date an important contrast between north and south shows itself in that Louis Crommelin's linen venture in the north developed on industrial, not banking, rails. The north, indeed, remains attached always to the Scottish rather than the English culture-province in preference for hard money, sales-resistance to private banking, growth of joint stock banking, selection of bank directors, early use of the overdraft, &c.

The eighteenth century was the era of the private bank, and legislation was no more helpful in Ireland than in England towards the establishment of sound banking. An Act of 1709 provided that the 'notes' of a banker, goldsmith, merchant, or trader should be transferable by mere delivery and endorsement. Partnership laws prevented the solid capitalization of banking (1741); bankers were prohibited from engaging in trade but traders were not prohibited from engaging in banking (1756); bankruptcy laws were amended, not in a rational sense, but so as to impose excessive penalties on bankrupt bankers (1759). Traders of all sorts, as well as bankers proper, issued notes, struggled to extend their circulation, and with lamentable frequency failed to meet their obligations. The successive crises which undermined the credit of the Kingdom were inquired into by Parliamentary Committees, which dispatched their business with a speed and succinctness to be envied by their twentieth-century successors but signally failed to stop the rot. Two technical developments are worthy of note—the deposit–receipt already current in Scotland appears in a bank established in 1758, but this bank was badly managed and closed its doors in the same year; the failure of the public authorities to maintain an adequate supply of small change was met by the wide circulation of traders' tokens, corresponding to the 'bons' issued by French Chambers of Commerce in the nineteen-twenties.

The 'mushroom banking' and recurrent crises which characterized southern Ireland during the first half of the eighteenth century are not surprising. It is easy to condemn the early eighteenth-century bankers as chancers, which they often were, in Ireland as elsewhere. Yet their opportunity arose from the currency chaos which the public authorities failed to cleanse; they were experimenters in the economical art of substituting exchange of obligations for payment in currency; and their unreliability and instability pale into insignificance beside the magnificent frauds of later governments which profited by the banks' experience to supplant them at their own game. But 'from experience cometh wisdom', and after the crises of 1760 the spate of private banking dried up. Another crisis supervened in 1770, but on that occasion a committee of 'the Lord Lieutenant of Ireland, the nobility, gentry, merchants and

traders of Dublin' announced that they would accept as cash the notes of four well-established private banks (including La Touche's Bank) and incipient panic was stayed—an early example of a technique well-tried afterwards. In 1804 there were still fifty private banks in existence (only two in the northern half of the island), but the crisis of 1820 made a great killing among them. Once the joint stock banks appear in 1824, the surviving private banks were liquidated, or converted into or absorbed by joint stock banks, La Touche's being taken over by the Munster Bank in 1870. The sole surviving private bank in Ireland now is Messrs. Guinness and Mahon, founded in 1836.

The first proposal for a chartered Bank of Ireland, similar in outline to the Bank of England and Scotland, came in 1695, but was dropped by Parliament. Of two competing Petitions in 1719–21 with the same object, one succeeded in obtaining a Charter, but Parliament failed to pass the confirming legislation largely owing to the propaganda of Swift and Molyneux. A similar project originating in Belfast in 1780 also faded out, but in 1783 the Bank of Ireland was finally established by Charter with confirming legislation. It was welcomed by the private banks, and the La Touche firm played a large part in its formation and early administration, David La Touche being its first Governor. The Bank of Ireland was similar in intention and structure to the Bank of England, even to such details as the two-year rotation of the offices of Governor and Deputy-Governor. Its legal history largely parallels that of the Bank of England, and need not be recapitulated in detail here. The critical distinction is that in respect of note-issue the Bank Charter Act, 1844, put the Bank of England into a special position, while the Bankers (Ireland) Act, 1845, assimilated the Bank of Ireland to the joint stock banks, and all subsequent legislation (notably the Republican Acts of 1927 and 1942) has still further whittled away any pre-eminence enjoyed by it. Until 1845 or thereabouts the Bank of Ireland performed the functions of a central bank as they were then understood. The Bank's position was one not of power but of 'leadership', based on resources, prestige, and a sense of responsibility. The Bullion Committee had its predecessor in an Irish Committee of 1804. Since 1845 these functions have naturally withered

away, although as late as 1885 the Bank of Ireland took a positive lead in meeting the Munster Bank crisis, and it is still the most influential of the Irish banks.

Joint stock banking developed with greater native vigour in the north than in the south. The crisis of 1820 had emphasized the lacuna in the banking system which the Scots had been filling since 1716. The Northern Bank was established in 1824, the Hibernian Bank in 1824, the Provincial Bank (memorable for the activity of Thomas Joplin) in 1825, the Belfast Bank in 1827, the National Bank in 1834, the Royal Bank in 1835, and the Ulster Bank in 1836. Of these seven banks three (the Northern, Belfast, and Ulster) had their *siège social* in Belfast, and two (the Provincial and National) in London, and were therefore not precluded from note-issue by the Bank of Ireland's monopoly. The disputes between the Bank of Ireland, the private banks and the new joint stock banks had their effect, through John Horsley Palmer, on British banking theory and practice. Between 1834 and 1864 some eight other joint stock banks opened and closed their doors, mostly after a very short course. Only one was added definitely to the roll. The Munster Bank opened its doors in 1864, took over La Touche's Bank in 1870, closed down in 1885, and was replaced by the still-extant Munster and Leinster Bank. The Sinn Fein partisan Land Bank was subsidized and given some government accounts under the title of National Land Bank when the Republic was established in 1921, and later sold to the Bank of Ireland of which it is now a subsidiary named the National City Bank. Incorporation with limited liability was permitted from 1858, and the Bank of Ireland's position assimilated by statute in 1935. The Bank of Ireland's stock is fully paid, but the shares of the other banks are only partly paid-up. Those whose head offices are outside the Republic maintain local Boards of Directors and local registers of shareholders in Dublin.

II

Essentially, the situation crystallized by the Act of 1845 still endures, although what appears superficially to be its most important part has practically vanished—namely, the regulation of note-issues. In the middle of the nineteenth century

note-issue constituted a much larger proportion of banking business than it does now. Even in 1870 the obligations on notes of the Irish banks amounted to one-third of their obligations on private deposits—£7·4 millions against £24·4 millions.

In respect of note-issues the Bankers (Ireland) Act, 1845, illogically perpetuated the results of historical accidents by continuing average preceding circulations as 'fiduciary notes', all 'excess issues' to be covered pound for pound by gold or Bank of England notes. All bank-notes remained the specific obligation of the issuing bank, ranking top for payment in full on liquidation, and being subject to a Banker's Composition Duty of 7*s.* per £100 on all notes outstanding, whether fiduciary or excess. This Irish Act followed, therefore, the same general lines as the Bank Charter Act, 1844, but did not contain its provisions for the surrender of fiduciary issues. It has long been argued that this fiduciary issue is a 'privilege', on the doubtful ground that the 'issue of money' is a state prerogative which should not be conceded to a private institution, and on the more realistic ground that its existence gave the particular banks enjoying it an advantage over their competitors in extending their business. The fiduciary issues assigned were—Bank of Ireland £3,738,000; Provincial Bank £928,000; National Bank £852,000; Ulster Bank £311,000; Belfast Bank £282,000; Northern Bank £243,000: Total £6,354,000. Until the First World War 'excess issues' were never of great amount, being £1,078,000 in 1870 and £1,199,000 in 1910. The rest of the circulation was made up of gold and Bank of England notes (which were not legal tender in Ireland). By prohibiting fractional notes and notes under £1 the Act also eliminated a number of historical curiosities.

The separation of the Republic in 1921 created no problems of necessity, but several of expediency, relating to currency standard, legal tender, profits from the issue of legal tender, and control of banking operations. The Republican Government appointed a Commission of Inquiry, whose report in 1926 resulted in the Currency Act, 1927. In effect, this Act substituted Legal Tender Notes to be issued by a new Currency Commission (renamed Central Bank in 1942) for the pre-existing circulation of 'excess' bank-notes and notes of the Bank of England. It extended a fiduciary quota to all banks

continuing in practice in the Republic, and imposed a charge of 1½ per cent. (raised to 3 per cent. in 1932 and reduced to 2½ per cent. in 1937) on the total quota, including 'till money'. An aggregate of £6,000,000 was apportioned thus—Bank of Ireland £1,760,000; National Bank £1,365,000; Munster and Leinster Bank £852,000; Provincial Bank £649,000; Hibernian Bank 439,000; Ulster Bank £419,000; Royal Bank £273,000; Northern Bank £243,000. The banks which had previously enjoyed the right of note-issue were required to pull their total circulation down by stages to the new quotas, replacing their 'excess issues' by legal tender notes bought at par from the Central Bank. This arrangement transferred the profits of issue of legal tender in the Republic from the London to the Dublin Treasury. It also accepted to some extent the 'privilege' argument mentioned above, and altered the character of the surviving bank-notes. The old issues were called in and replaced by a new issue of Consolidated Bank Notes, identical in appearance for all banks save for a not too ostentatious printing of the name of the responsible bank.

This Act conferred some slight advantage on the banks not previously permitted to issue notes, and inflicted measurable loss on the former banks of issue, especially on the Bank of Ireland. It is notable also in European banking legislation for its acceptance of the impractical American notion that there ought to be some connexion between 'fiduciary note issues' and 'liquid sound advances'. This Republican legislation necessitated corresponding legislation for Northern Ireland, the Bankers (Ireland) Act, 1928. It fixed new fiduciary quotas for the banks doing business in Northern Ireland based on an estimate of their note-business in that state, but did not generalize the 'privilege' nor disturb the structure of the 1845 Act.

In 1934 the Republican Government appointed another Commission of Inquiry into Banking, Currency, and Credit, which reviewed exhaustingly the whole field covered by its generous terms of reference, and reported in 1938. Its fruit, the Central Bank of Ireland Act, 1942, extinguished the Consolidated Bank Notes, with further loss to the commercial banks and profit to the Central Bank, but called for no consequential legislation in Northern Ireland. As a result, the Re-

public's locally produced circulating medium has now become entirely government money (which has at any rate one merit in common with the gold standard, viz. simplicity). The circulation of these notes has increased from £7·1 millions (1930 average) to £11 millions (September 1939), and £50·3 millions (September 1950). Progress to this point has entailed two minor problems and one major one. First, the question of 'dead notes' was settled by the presumption that £687,000 of outstanding notes were 'dead', required no transfer of securities on their account from the banks to the Central Bank, but remained the banks' obligations if they should be presented. Secondly, the accrual to Republican authorities of the profits from legal tender issues involved the reduction to a minimum of the circulation within the Republic of other familiar notes, since fair division of the spoils requires consistent repatriation. In the Republic the banks have for many years, at the request of the Central Bank, collected and handed over in-coming notes. No doubt a similar clearing is regularly effected on the other side, but with this difference, that unfamiliarity with the new local and Republican instruments will necessarily render their circulation outside the Republic less free than that of United Kingdom instruments inside the Republic.

The major problem has been that of the monetary standard. The two Republican Commissions of Inquiry (1926 and 1938) recommended sterling parity, and successive governments have maintained the Currency Act, 1927, which ensures that parity by the device of the Central Bank selling Republican Legal Tender notes against United Kingdom government securities and being obliged to convert these notes in London at par into Bank of England notes (through its agent, the Bank of England). There have not been wanting, naturally, critics of this arrangement, with absurd notions of 'monetary independence' and escapist ideas about the power of monetary twiddling to control the real environment, but serious opinion, including all party politicians in power, has accepted the 'sterling link' because of the shattering consequences of breaking the extremely intimate personal, social, commercial, and financial relations between one corner of the British Isles and the rest. Governmental financial incontinence in the United Kingdom, however, has since the Second World War somewhat

altered the picture and created a new theoretical argument for a Republican pound appreciating, not depreciating, in relation to the Royal pound—but the practical arguments remain much as before.

III

Nine banks now operate with branches throughout Ireland with varying local, political, and confessional concentrations of clientele (save that the Royal Bank has exchanged its branches in Northern Ireland for those of the Belfast Bank in the Republic). Branch-banking, developed by the Bank of Scotland since 1774, was vigorously pushed by the Provincial Bank from its foundation in 1825 and adopted by the Bank of Ireland in the same year. Two interesting sidelines have been the Bank of Ireland's note-issuing agreement with the ill-fated Tipperary Bank in 1838, and the National Bank's scheme of 'local participation' which foundered in 1856. Branch-banking in Ireland presented in its early stages the universal teething-troubles of managerial responsibility and central control. Even today it is possible for directors and officials to hold very different views about the real responsibility of branch managers, turning on the limitation of the manager's independent discretion about accommodation to customers and the continued vitality of the directors' 'daily committee'.

The century-old decline of population in Ireland has given an especial significance there to another problem—has not perhaps the growth of bank branches, especially in periods of ebullience such as after the First World War, gone too far? In a competitive system the natural tendency of each separate bank is to extend its branches into every town where it anticipates sufficient business to cover the special costs of each branch, allowing for the notorious difficulty of estimating the costs and earnings of a particular branch. This economic tendency was often reinforced by considerations of prestige, when estimates of costs and earnings would be given less than their cool weight. Banking offices in Ireland increased from 180 in 1844 (one per 45,000 inhabitants) to 859 in 1913 (one per 5,000 inhabitants) and came to 1,018 in the Republic alone in 1934 (one per 3,000 inhabitants). This is a high density in relation to population, and a still higher density in relation to business.

It is quite on the cards that Ireland is 'over-banked', in the sense that the net earnings of all the competing banks could be increased by an agreed reduction of competing branches.

The banks have made a start independently in closing uneconomic branches. The Royal and Belfast Banks have swopped branches on opposing sides of the Border. Two lines of development are visible and probable—amalgamation of banks and exchange of branches. Both have so far been unimportant for want of a stiff incentive. That incentive has now been provided by the progressive increases in officials' salaries, culminating in the Arbitration Award of February 1951 for the Republic, following the strike which began on 23 December 1950. It is probable that in due course a similar scale will become effective in Northern Ireland. Comparisons are difficult, but it appears that the new Republican scale is distinctly higher than the scales ruling in England and Scotland. Whichever form the probable contraction of banking operations takes, the problem of redundancy will arise again, the problem which in the form of a block in promotion has already for nearly thirty years poisoned relations between the banks and their staffs. In Ireland no solution on the Scottish model is apparent for lack of alternative employment for senior bank officials.

Competition between the Irish banks is still active, although by agreement certain fields are excluded. On the staff side, the Irish Bankers' Joint Committee negotiates with the Irish Bank Officials' Association, both organizations covering the whole country. On the customers' side, the Irish Banks' Standing Committee has for many years fixed an 'Irish Banks' Rate', tied to the Bank of England's discount rate, and carrying with it ceilings for interest on deposits and floors for interest on accommodation (i.e. a structure of Irish banks' rates). The rules have never been so rigid as to exclude special arrangements for special accounts (e.g. payment of interest on the current credit balance), but by and large they have resulted in uniform treatment and in competition for accounts on bases other than interest rates. This is where the branch manager comes in again.

The Irish banks remained largely outside the amalgamation movement in Great Britain, and only two of them (the Belfast

and Ulster Banks, holding between them about one-fifth of the system's aggregate assets) form part of larger combinations. Indeed, the small scale of Irish banking is still a matter of some interest. The combined balance-sheets at 31 December 1950 totalled only some £458 millions. The largest was the Bank of Ireland (£100 millions); only three others (the National, Munster and Leinster, and Ulster Banks) exceeded £50 millions; and the Royal Bank's total was only £17 millions. The great majority of the shares are held in Ireland, and in small parcels, the average holding being only £255 (1936) and directorship qualifications are small. The averages of deposit and loan accounts are also small, and personal and intimate contact between 'the Manager' and his clients is still the rule. The branches run by these managers are also generally small in terms both of staff and, still more, of volume of business—of the 566 whole-time offices in the Republic, 302 have four hands or less, and only fifty have ten hands or more.

The necessary consequence of legislation since 1845, in Ireland as in England and Scotland, has been to press commercial banking more and more into the mould of deposit as distinct from note banking. Naturally, the history of deposit-banking and its instruments (the current account, the cheque, the overdraft, and the deposit-receipt) in Ireland goes back far behind 1845, but until then private, joint stock and chartered banks did build up their business largely on notes, and the inability to issue notes continued to be regarded as a hardship for nearly a century thereafter. The change can best be illustrated by the fact that in 1870 the Irish banks' liabilities included notes at £7·4 millions and current, deposit, and other accounts at £24·4 millions, whereas in 1910 the corresponding figures were £7·6 millions and £54·9 millions, in 1920 £25·8 millions and £182·9 millions, and in 1950 £10·6 millions and £405·2 millions respectively.

Deposit-banking in Ireland, however, has been and remains much more of a savings-bank type than in England or the U.S.A. The country banks in England and the Scottish banks share this feature to a less extent, and it is also less pronounced in the northern than in the other Irish banks. Direct information is lacking, as the Irish banks (in common with the other British banks and in contrast to American banks) do not

publicly analyse their deposits into 'time' and 'demand'. Reluctantly, the banks practising in the Republic furnished the Banking Commission of 1934–8 with a special account of their time-deposits and demand-deposits (using the American phrase for lack of a convenient British alternative) related to the Republic, and for 1936 the resultant was: time-deposits £90 millions; demand-deposits £22 millions (the accounts of government departments and local authorities being excluded). The banks insisted, and with a good deal of justice, that in actual practice the divide between the two classes is so hazy that the computation is of doubtful value, but it does emphasize the importance of savings-deposits in the banking system. It is, of course, unreal to take any year in the nineteen-thirties as normal or representative. The First World War had greatly increased the Irish banks' balance-sheet totals because, apart from the depreciation of money, the farmers' war profits went into deposit-receipts and reappeared on the other side as investments. The change was from £91 millions in 1913 to £247 millions in 1921. Of the 1914–18 profits, some were dissipated in the land-speculation of the nineteen-twenties (in which the banks cannot be held blameless), more in the succeeding agricultural depression, and more again in the economic war (time-deposits fell from £105 millions in 1932 to £90 millions in 1935). The same thing happened again in 1939–45 (though on a less extravagant scale). Balance-sheet totals rose from £208 millions in December 1939 to £366 millions in December 1945.

Out of the two wars, on top of the previous habits of the people, has grown a mass of 'sterling investments' which now gives a definite character to Irish banking in its technical sense, and also excites the itching fingers of amateur economists and professional politicians. 'Schemers' with ambitious ideas, petulant abuse of the banks, and nonsense about 'alien control' are now common form. A curious kind of inverted Keynesian doctrine receives a great deal of partisan publicity in the Republic, to the effect that the poverty of the Republic, as compared with Northern Ireland and Great Britain or France, is due to prolonged 'under-investment', and that the banks have been among the greatest villains of the piece because they insisted on investing the funds (or, in some versions, 'credit') of

the 'Irish people' in 'foreign debt' instead of in 'Irish production'. Always there follows a conventional list of what-have-you. The mythology of 'Thar's gold in them thar mountains' dies hard, and in Republican Ireland it now takes the rather pathetic form of a propaganda that 'investment' (hitherto blocked by the unexplained malice of bankers, capitalists, West Britons, and similar bogymen) is a sufficient substitute for, not a co-operator with, enterprise and work in releasing the supposed potential wealth hidden in the island's meagre natural resources. In fact, invested capital often goes down the drain, and the Irish banks, given their obligations to their depositors, have had little alternative to the holding of gilt-edged stocks—which have incidentally yielded a not inconsiderable income to all concerned. It remains arguable, however, that these banks have, in contrast to the private banks of the eighteenth century, been too conservative in their distribution of their assets, and in particular that they might have shown more initiative in encouraging domestic investment and in shifting part of their portfolios into dollar securities. Yet any argument must turn only on shades of prudence in circumstances beyond the banks' own control.

For some years now the London clearing banks have published particulars of the distribution of their advances between various categories of borrowers. The Irish banks had never done so, and when, reluctantly, they furnished the Banking Commission of 1934–8 with a breakdown they rightly emphasized the approximativeness of the categories. The distribution for 1936 in the Republic was: farmers 26·4 per cent.; co-operative societies 1·7 per cent.; manufacturing, building, railways, transport, &c., 8·9 per cent.; trusts, stockbrokers, agents, professions, private 20·3 per cent.; wholesale and retail merchants 23·0 per cent.; public bodies 6·5 per cent.; unclassified 13·2 per cent. No later information is available. While one can share sympathetically the banks' reluctance to waste time and effort on satisfying Pickwickian curiosity, one may also feel that the banks have failed in their public relations: under fire from the nationalist, socialist, and customer angles (which often coalesce, especially when a customer fails to get a loan or to meet his obligations), they have made no effort to counter the flood of often malicious, often foolish, but sometimes pointed *agitprop*.

One aspect of this 'distribution' question is of special interest. While no information is available about the ownership of the system's 'time-deposits' generally, the 1934–8 Commission was informed that in January 1937 in the Republic such deposits held by 'farmers' amounted to £35·6 millions, while advances to 'farmers' totalled £12·6 millions. These figures have a bearing on the vexed question of agricultural credit, which is naturally of great significance in Ireland. Two different and inconsistent criticisms are levelled at the banks—that they were too free with loans for the purchase of farms, especially in the boom of the nineteen-twenties (hence the problem of 'frozen loans'), and that they are too reluctant to lend for agricultural development purposes. The question is too involved for treatment here, beyond the remarks that on balance the farming community appears to have been even in 1937 in a strongly creditor position against the banks, that freedom of agricultural credit depends on the adequacy of the security offered, that the governmental financing of land-purchase has been reinforced by compulsive powers, and that other agencies (Co-operative Credit Societies and the Government Agricultural Credit Corporation) have been no more successful than the banks.

Banking conducted in the conservative manner of the Irish banks has not failed to earn profits, and no bank has had to close its doors since 1885. In 1910 they earned total published profits of £990,000, representing 1·2 per cent. of their total resources. In 1920 the corresponding figures were £1,700,000 and 0·7 per cent.; in 1938 they were £1,314,000 and 0·6 per cent.; in 1950 £1,430,000 and 0·3 per cent. Their dividend distribution policy has been conservative also. If bank shareholders had been permitted to share proportionately in the increase of money income which nearly all other classes of society have enjoyed since 1910, the profits declared should have reached about £5 millions.

In recent years the relations between the banks and their staffs have deteriorated, culminating in the bank strike of 1946 in Northern Ireland and the recently concluded strike in the Republic. In an industry which in the past enjoyed relations of a 'family' type, this development is alarming, but something of the same sort has recently been growing in other even more

ancient and honourable institutions, and what is happening in banking is, in part, just one aspect of a social revolution. The deterioration in staff relations has, however, also been due in part to circumstances peculiar to the banks. An agreement in 1919 provided for cost-of-living bonuses and payment of salaries free of income tax, two principles open to serious objections but valuable to the employees; and the abrogation of this agreement in 1941 has rankled. Subsequent arrangements have not given satisfaction, and the negotiation machinery has left much to be desired. The trouble culminated at Christmas 1950 in a strike which occasioned closure of the banks for six weeks.

IV

As already noted, the Bank of Ireland a century ago was exercising some at least of the functions of a central bank. Even before 1845, however, the Irish banks had begun keeping their reserves in London, and the National Bank was a member of the London Clearing House from its inception. The type of business of the Irish banks (largely dominated by savings-deposits and investments, and of a very conservative character) does not lend itself easily to refined methods of central-bank control, but, so far as that is possible, the Irish banking system's central bank has been and is the Bank of England. The cash basis of the Irish banking system is now its holding of sterling securities. The political changes of 1921 and the formal establishment of a Republican Central Bank by the Acts of 1927 and 1942 have not altered that fundamental relationship. This Bank started as the Currency Commission with the primary function of issuing Legal Tender notes to replace the 'excess issues' of the joint stock banks and of transferring the relevant profit from London to Dublin. The Banking Commission 1934–8, expressed no very decided opinion on the question whether a formally constituted central bank could really be effective on a 'fringe' economy such as that of the Republic; nevertheless, the Act of 1942 renamed the Currency Commission the Central Bank and gave it the usual paper powers. Its shareholders are the commercial banks, on the American model, but the majority of the directors, including the Governor, are appointed by the Government. As things stand,

though, this Central Bank is little more than an investment trust supplying the greatest portion of the Republic's circulating medium at par and managing a fund of sterling bonds which has rapidly increased from £7·6 millions in December 1933 to £46·4 millions in September 1950. After the United Kingdom Treasury (which was fair enough), the Bank of Ireland has been the chief contributor to the Central Bank's funds. The Bank of Ireland remains (either in itself or through its subsidiary the National City Bank) the government banker (except in so far as government loans have been issued through and underwritten by a consortium of all the banks). The three important points of impact of government financial policy (or incontinence) on the London Money Market—Ways and Means Advances from the Bank of England, Treasury Bills, and Treasury Deposit Receipts—do not exist in Dublin. The Department of Finance has secured the short-term accommodation it required, above what the Departmental Funds could provide, by stated amounts of twelve-month bills taken up sometimes under pressure, by all the banks in agreed quotas.

Naturally, the link with sterling and the absence of any effective central bank localized in the Irish Republic are sore points with many politicians. They are blamed for all our economic ills, and the most extravagant notions are publicized about the 'development' that is inhibited by them. It is hardly possible to take this *simpliste* propaganda seriously. The notion of 'controlling the credit policy' of the Republican commercial banks through the provision of cash by a Republican central bank has no basis in reality—partly because the banks in question have no 'credit policy', and can have no credit policy so long as the conditions under which they do business remain as they are; and partly because their portfolios of United Kingdom bonds give them virtually unlimited, independent access to cash. Even if the 'control' of a central bank in Dublin extended over the whole island, and if the Irish unit of account were completely fluid in its relation to the pound sterling, it is difficult to see how the behaviour of the Irish banks in their ordinary business could be influenced by 'central bank' decisions in Dublin, save on two highly improbable conditions: the confiscation of all the banks' 'sterling assets' and the

prohibition of their acquiring any more. In this context, the experience of the Bank of France is relevant. Perhaps in 1914 an Irish, or a Scottish, or a Welsh, or a Manx central bank was a real possibility, but it is so no longer—the profits of two wars have seen to that.

Central Bank of 'Ireland'

Banking Return—September Quarter 1950

(The figures below represent an average of figures for a selected date in each of three months of the quarter. They cover all of the associated banks under the Central Bank Act, 1942, and the National City Bank, Ltd.)

LIABILITIES	*In the Republic*	*Elsewhere*	*Total*	ASSETS	*In the Republic*	*Elsewhere*	*Total*
Capital paid up	4·5	3·7	8·3	Cash and balances with London agents and other banks	15·7	29·9	45·6
Reserve fund and undivided profits	6·8	4·5	11·4	Money at call and short notice	—	23·5	23·5
Notes in circulation	1·4	7·9	9·3	Bills (non-government)	4·1	0·4	4·5
Current, deposit, and other accounts	249·7	106·0	355·7	Loans and advances	97·5	37·8	135·3
Acceptances	3·5	1·0	4·5	Investments:			
Other liabilities	6·2	3·8	10·0	(*a*) Government	9·0	156·5	165·5
				(*b*) Other	7·5	3·4	10·9
				Premises	2·0	0·9	2·8
				Liabilities of customers for acceptances, &c.	3·5	1·0	4·5
				Other assets	2·3	4·2	6·5
TOTAL	272·1	127·0	399·2	TOTAL	141·6	257·6	399·2

(Figures reduced to £millions. Excess of 'assets elsewhere' over 'liabilities elsewhere' £130·6 millions, showing some decline from the post-war peak, but a decline incomparably smaller than the 'adverse balances on visible trade' registered by the Republic since 1945.)

From its inception the Central Bank began collecting and publishing in accessible form in a quarterly *Bulletin* the scanty financial data relating to the Republic, and added to it by requiring from the shareholding banks a quarterly statement in which their business was divided, under the usual balance-sheet headings, into that conducted in the Republic and that conducted 'elsewhere'. The division of the banks' business into 'Republican' and 'Other' obviously presents logical difficulties, and has given a deceptive precision to the notion of 'external assets', but it does provide a rough basis for the comparison of banking behaviour in the Republic and Northern Ireland. For information, the latest available return (September 1950) is appended. Two points might be added to it:

(*a*) The weekly average clearing of notes, bills, and cheques

in Dublin (the first thirty-six weeks of each year) was £6 millions in 1939, £8·1 millions in 1945, and £17·5 millions in 1950.

(*b*) At 31 December 1949 the balance due to depositors in the Republican Post Office Savings Bank was £50·5 millions, and on 31 March 1950 the amount of Republican Savings Certificates outstanding was £12·8 millions; to these must be added deposits in the Trustee Savings Banks, the Northern Ireland Savings Certificates, and the unknown but large deposits in the United Kingdom Post Office Savings Bank and holdings of U.K. Savings Certificates.

9

BANKING IN NEW ZEALAND

BECAUSE of its origins and associations New Zealand banking has been strongly influenced by English banking. But the process of adapting English models to New Zealand conditions was neither rapid nor smooth, and in the course of its evolution New Zealand banking has acquired some distinctive features. The system is, accordingly, best explained by giving an account of the successive problems bankers have had to face in developing it. As we shall see, the major problem during the first two decades was the provision of a currency, and, during the remainder of the nineteenth century, the provision of credit facilities. Since then bankers have been mainly concerned with problems arising from the external exchanges.

Early Currency Difficulties, 1840–70

The whalers and traders who drifted to New Zealand after 1790 relied mainly upon barter in their transactions with the natives, but promissory notes issued by Sydney merchants played some role as currency, and a heterogeneous coinage filtered in from New South Wales. When systematic colonization began in 1840 the New Zealand Company invited the Union Bank, which had recently been incorporated to undertake banking in the Australasian colonies, to open branches in its settlements. This invitation was promptly accepted; a branch was opened at Wellington in 1840 and another at Nelson in 1842. Almost at the same time a rival, and purely local concern, the New Zealand Banking Company, opened at Kororareka. It was not long, however, before both banks ran into serious difficulties. Maori risings paralysed business at Kororareka, and the New Zealand Banking Company had to be wound up. Maori resistance to European occupation also brought the southern settlements to great distress, and the New Zealand Company was forced to suspend operations and

payments. The Union Bank thereupon reduced its branches to mere exchange agencies.

To add to their other difficulties, the settlers now found themselves handicapped by a dearth both of currency and credit. Relief was given by the issue of what was, in effect, an inconvertible state currency. Fitzroy, like other early governors, was in constant financial trouble, and when he found himself facing dangerous Maori rebels and a bankrupt Treasury he decided to extend the issue of debentures as payment for Crown debts. In order to facilitate their acceptance he proclaimed them legal tender. They were soon selling at a discount of 15 per cent., but undoubtedly eased the shortage of currency. Merchants quickly followed Fitzroy's lead by issuing debentures and tokens of their own, down to denominations of 6*d.* and 3*d.* The Colonial Office, however, disallowed the ordinance making debentures legal tender, and ordered their withdrawal. This instruction was carried out by Grey, Fitzroy's successor, during 1845 as part of the reconstruction of the public finances.

At this time the victory of the Currency School during the debate on the renewal of the Bank of England's Charter had made a great impression upon Whitehall, as was shown by a Circular Letter of 1846, which set out the principles to be observed in colonial banking legislation. Only legally authorized corporations should be permitted to carry on banking, banks should not engage in any business other than discounting and gold buying, they should not lend on the pledge of land or merchandise, their liabilities should not exceed three times their paid-up capital, notes should be convertible and limited to the amount of the paid-up capital, and they should furnish regular returns. These principles were observed in the New Zealand Bank Charter Ordinance, but only one bank was ever set up under the terms of this Ordinance—the Colonial Bank of Issue.

The influence of the Currency School was shown much more strongly in a second letter, urging Grey to establish a state bank having a monopoly of issue, and quite aloof from discount. The Colonial Bank of Issue, accordingly, opened its doors in 1850, prepared only to exchange coin for notes or notes for coin. A gold reserve of 25 per cent. (soon raised to

33⅓ per cent.) was kept in the Colony, and the balance was invested in British Consols. The colonists had expressed their dislike of a State bank from the first, and dislike became resentment as they saw their funds being sent to England to earn 3 per cent. at a time when their own Government was forced to borrow at 8 or 10 per cent. It was clear, moreover, that no bank was likely to start operations in the Colony where deposits were hard to collect unless it had the right of issue. The Colonial Bank might have provided an unimpeachable currency, but it had certainly aggravated the shortage of credit. In 1856 the colonists took advantage of their new powers of self-government to wind it up, and restored the right of issue to the Union Bank.

No general act was passed to replace the Bank Charter Ordinance, but its principles found some expression in the various acts passed to license new banks. These acts all granted the right of issue provided that notes were convertible, that they did not exceed three times the gold coin and bullion held within the Colony, and that they did not exceed local holdings of gold and public securities. Provision was thus made for a gold circulation standard based on fixed minimum percentage reserves. Some attention was also paid to deposits; local liabilities were never to exceed three times the coin, bullion, and public securities held in New Zealand. These general provisions were not modified until the outbreak of the First World War.

The colony prospered during the fifties because of the Australian gold rushes, and the Union Bank not only restored the functions of its branches at Wellington and Nelson, but opened further branches at Auckland, Lyttelton, Christchurch, and Dunedin. When the right of issue was regained the Oriental Banking Corporation entered the Colony, and its competition forced the Union Bank into more liberal lending. For some reason, however, the Directors of the Oriental Bank became dissatisfied with their New Zealand business, and sold it to the Bank of New South Wales on the eve of the Otago gold discoveries. Appreciating the profits to be derived from gold buying, Larkworthy, the official responsible for negotiations with the Bank of New South Wales, decided to join Thomas Russell in founding a local bank. They made so

successful an appeal to local patriotism that the Bank of New Zealand was floated without difficulty, and was soon performing one-half of the Colony's banking. Three other attempts were made during the sixties to establish local banks, but the New Zealand Banking Corporation was ruined by the Overund-Gurney failure, and the Bank of Auckland by an absconding manager. The Bank of Otago did well enough in a small way until it sold out to the new National Bank in 1874. Meanwhile the Bank of Australasia had also established a profitable connexion in New Zealand.

Economic progress was rapid in the sixties as the gold rushes led to a trebling of population and to an increase of 750 per cent. in exports. Throughout this decade the Bank of New Zealand never paid a dividend of less than 15 per cent., and the other banks also did well. Gold buying provided an ideal business since it was both lucrative and safe. The aggregate banking return for December 1867 shows the kind of business that the banks were doing in this period.

Liabilities and Assets of the New Zealand Trading Banks, December 1867

Liabilities in N.Z.	£ 000's	*Assets in N.Z.*	£ 000's
Notes in circulation	645	Coin and bullion	1,193
Deposits	2,885	Securities	815
Other local liabilities	180	Discounts	2,242
Excess of local assets	2,254	Advances	1,526
		Other local assets	187
	5,964		5,964

Gold buying is reflected in the large gold reserve, which was double the note-issue and one-third of the total note and deposit liabilities. Deposits bore a high proportion to notes because of the early and widespread use of cheques; three-fifths of the deposits in this return were current accounts. Discounts were much the largest asset, and advances were not much larger than gold holdings. The large excess of local assets is explained by liabilities to local shareholders (which, in the case of the Bank of New Zealand, amounted to £650,000) and by the Australian banks using Australian funds to develop their New Zealand business.

Credit Policy, 1870–95

The gold output had passed its peak in 1867, and in the next few years bankers found themselves in a quandary. In order to maintain profits, now that gold buying was declining, loans would have to be expanded. This step, moreover, was made more urgent by the complaints about credit restriction which were beginning to interest Parliament. Yet what types of loans could be readily expanded? Discounts and seasonal advances were the backbone of English banking, but there was not much scope for them in a country which had few secondary industries and nothing resembling an active money-market. The great demand was for medium- and long-term advances, and this demand was growing very rapidly as Vogel's ambitious scheme of immigration and public works was opening up new areas for development. In Australia the banks had already begun to take advantage of a recent decision of the Privy Council that banks had a valid claim to any land that came into their hands as security for an advance. There was no longer any legal barrier to such advances; was it really unsafe to grant them in a rapidly developing country where property values had so steep a rising trend? True, they were contrary to English practice, but then conditions were different, and surely the gold output provided a substantial margin of safety against liquidity risks?

After a period of hesitation New Zealand bankers plunged into mortgage banking in 1873, when their loans jumped from £3,565,000 to £5,908,000. By 1879 loans had climbed to £19,475,000, and by 1886 to £20,259,000. This enormous expansion of credit was accompanied by a significant shift in the proportion of advances to discounts; in 1867 advances were less than 70 per cent. of discounts, but in 1886 discounts were less than 50 per cent. of advances. To some extent the change reflects the growing popularity of borrowing by overdraft, but it is mainly explained by generous loans on all types of rural and urban properties. When the crash came the Bank of New Zealand was not only the Colony's largest landowner, but was also trying to dispose of flour mills, fibre works, timber yards, ironmongeries, tramways, loan companies, a sugar mill, and an insurance company.

The economic force of these injections may be appreciated when it is pointed out that in 1879 exports were equal to only one-quarter of banking loans, and imports to only two-fifths. Notwithstanding the large loans which the State was raising in London for public works, credit expansion produced markedly unfavourable balances of payments. These were financed to some extent by local branches of the Australian banks drawing upon their parent institutions, but to a greater extent by the deposits which the Bank of New Zealand and the National Bank were raising in England. By offering 5 per cent., at a time when Consols were yielding less than 3½ per cent., they succeeded, between 1875 and 1879, in attracting about £2,500,000 in English deposits.

Credit was the dominant influence in New Zealand's short-term fluctuations between 1870 and 1884. A moderate upswing of 1870–4 was brought about by a credit expansion of £4,600,000 together with an expansion in public loan expenditures of £2,200,000. When the London financial crisis of 1874 caused a loss of English deposits credit expansion ceased, and the Colony experienced a recession until 1876. In that year money became cheap again in London, and English deposits increased. Between 1876 and 1879 advances and discounts expanded by fully 40 per cent., and there was a further boom. But this boom was uneven, and showed itself mainly in the land market, where the price of agricultural land trebled.

Export prices, however, had been falling, and by 1878 bankers were alarmed about the properties upon which they had made such heavy loans. When the failure of the City of Glasgow Bank provoked another financial crisis in London, credit was suddenly contracted in New Zealand by £2,000,000. This immoderate change led to a year of more or less general inability to meet engagements—a year when debtors were said to be vainly offering 20 per cent. on good security. The land boom suddenly collapsed, and the price of agricultural land was halved. Frightened by the consequences of their action, and encouraged both by a revival of public borrowing and by a rise in wool prices, bankers resumed credit expansion as abruptly as they had reversed it. Loans rose by £4,400,000 between 1880 and 1882, and the depression seemed to be over.

Another fall in wool prices, however, convinced bankers

that they had better give up any hope of a quick recovery in exports. Credit ceased to expand after 1882, and after 1885 was steadily and cautiously contracted. Export prices had continued to fall, and an outflow of private capital, together with a collapse of public borrowing, led to a severe depression which did not really lift until after 1895.

This long depression gave an agonizing experience of the dangers of mortgage banking. Loans became frozen, the properties which were supposed to secure them became unmarketable, and English deposits fluctuated in the most damaging way. Bankers had ample cause to appreciate the folly of borrowing short in order to lend long, and ample proof that there is no inevitable tendency for colonial property values to go on rising. The Australian banks were least affected by these troubles, not because of superior wisdom, but because they had withdrawn funds for investment in the booming Australian land market. The Bank of New Zealand and the National Bank, however, suffered heavy losses; in the end, the Bank of New Zealand was able to survive only through the help of the State and at the cost of its independence.

Both local banks took advantage of the abundance of English capital during the early eighties in order to promote loan companies which took over some of their frozen assets. But these measures proved insufficient. The National Bank had to write off large sums for bad debts in 1885, and again in 1891. The Bank of New Zealand shrank at first from taking similar steps, but in 1887 the directors were forced to admit heavy losses and to ask for a shareholders' committee to examine the Bank's affairs. Reserves were written off along with two-thirds of the paid-up capital, and a Consolidated Properties Department was set up to administer some £3,450,000 of bad debts. Two years later further losses were revealed, the capital was reduced by another £300,000, and a company was formed to take over the frozen assets. Then came the Baring crisis, which caused a heavy drain of English deposits, followed by the Australian banking crisis of 1893, which also damaged the Bank. Alarmed by their position, the directors asked the Government to make bank-notes legal tender. As this request was granted for a period of only six months, they then tried to buy out the National Bank, but

failed to raise the necessary capital. The final blow came when one of the Bank's largest clients suspended payments. The Cabinet agreed to the general manager's urgent request for help in keeping the Bank open, and in a single night the 'Bank of New Zealand Share Guarantee Act' was passed through all stages.

The news led to feverish financial conditions, and the Bank suffered heavy losses of deposits and coin. Other banks were also affected, but to a lesser extent, and all had made preparations for some such trouble. By 1895 confidence had been effectively restored and the crisis was over.

The Bank of New Zealand, however, had still many troubles to face. As a consequence of a request for state assistance in connexion with frozen assets, the structure of the Bank was entirely recast in 1895. Its remaining reserves were written off, £500,000 of the unpaid capital was called up, and the State subscribed £500,000 preference shares as well as guaranteeing an issue of £2,000,000 for ordinary capital. In return the State appointed the president (who had a power of veto) and one other director. The State also guaranteed shares in an Assets Realization Board which was to take over from the Estates Company, and the Bank was authorized to buy out any other banking business.

Auditors were accordingly sent to inspect the Colonial Bank of New Zealand, a popular concern which had been set up by South Island interests during the seventies in opposition to the Bank of New Zealand. For many years the Colonial Bank had seemed to lead a charmed life amidst the troubles which beset its rivals. There was, therefore, considerable astonishment and scandal when the auditors disclosed that it was in a desperate position. At the final settlement the Bank of New Zealand took over only the sounder accounts, and the Colonial Bank's shareholders were considered lucky to recover one-half of their capital.

The Sterling Exchange Standard, 1895–1935

Since 1895 the financial strength of the New Zealand banks has never been called into question. Bankers had thoroughly learned the lessons of the past, and all followed much safer lending policies. They were helped in switching over to more

liquid types of advances by the general and increasing prosperity of the period 1895–1920, and, in particular, by the great expansion of exports which refrigeration made possible. In 1895 the frozen meat trade was well past its teething troubles and the dairy industry had also begun to make good progress; over the next twenty years exports rose from £9,300,000 to £31,430,000, meat accounting for one-quarter of this increase and dairy products for another quarter. Over the same period the value of factory production rose from £9,549,000 to £43,034,000. These developments naturally gave bankers wider opportunities for short-term lending.

By this time, moreover, the pressure upon the banks for mortgage finance had greatly eased. Loan and mercantile companies were now providing most types of rural credit, the new State Advances Office was granting cheap mortgages for both rural and urban properties, and savings banks, building societies, and solicitors' trust funds were meeting an increased proportion of the demand for long-term credit. The reluctance of the banks to provide such credit was revealed by a Royal Commission on rural credit in 1925. As a result of its report the Government invited financial concerns to make provision for long-term finance to farmers. The Bank of New Zealand was the only bank which responded to this appeal. It set up a Long-term Mortgage Branch financed by a special share issue of £1,406,250, but the Branch never made much progress and, contrary to the original intention, such loans as it made were mainly for urban properties.

Besides changing over to a more conservative type of lending, the banks took steps to strengthen their co-operation with one another. The system of internal exchanges was reorganized in 1902 when a 'Pool' was set up in Wellington. Each bank kept gold deposits at the Pool, and used them to settle inter-bank debts, although drafts on Sydney and London also played a part. Shortly after the First World War broke out the system was modified by the use of 'settlement notes', printed by each bank in as large denominations as £1,000,000, and convertible into gold or overseas exchange. These notes were later replaced by a system of inter-bank deposits under which balances with debtor banks were treated as deposits, earned a low rate of interest, and could be converted by arrangement into over-

seas exchange. Bankers thus felt little need for the clearing facilities offered by the Reserve Bank when it was opened in 1934. Nor did they feel much need for a special co-ordinator of banking policy. They had set up their own organization, the Associated Banks, which fixed interest and exchange rates, and acted, when necessary, as negotiator with the State, or as spokesman to the public.

From the early days up to 1930 the banks had maintained approximate parity with sterling, variations in the rate seldom exceeding 3 per cent. Until 1914 this parity was the consequence of the legal requirement that notes should be convertible into sovereigns, but bankers did not preserve it by adjusting credit to changes in gold reserves. Their practice, rather, was to adjust gold reserves to notes and deposits so as to preserve a fairly stable relation between them. Changes in loans had no direct relation to changes in gold, and gold played a negligible part in adjusting external credits and debits. The essential reserves of the banking system, at any rate after the sixties, were holdings of sterling in London. These provided the buffer for external transactions, and these governed credit in New Zealand.

It is easy to understand the importance of sterling funds when it is appreciated that Britain was the major market both for exports and imports, and was much the most important source of public and private overseas loans. We have seen, however, that in the seventies and eighties credit had an extraordinary elasticity owing to the ready transfer of funds between the local and overseas offices of the Australian banks, and owing to the collection of English deposits. Loans consistently exceeded deposits between 1873 and 1894, and were seldom limited by current additions to sterling assets arising from the New Zealand business.

After 1895 English deposits shrank to small proportions, and the Australian banks had long since reduced their local loans below the level of their local deposits. We find, therefore, a more conventional sterling exchange standard. Notes and deposits tended to vary simultaneously with current additions to sterling balances, and loans and investments were adjusted to these balances with a lag of about a year. It should be mentioned that changes in bank loans were seldom pro-

duced by means of changes in interest rates; large changes in interest rates were very infrequent. To a considerable extent the demand for credit was adjusted to changes in sterling funds by the reactions of external receipts upon incomes, and hence upon imports. But when it was necessary for the banks to take action to assist this kind of adjustment they had, in the absence of a developed money market, to rely upon fairly direct methods of altering credit. When they wished to foster an expansion of credit bankers became more tolerant about raising overdraft limits and more ready to grant accommodation to new borrowers. When they wished to foster a contraction of credit they followed an opposite policy, and, since credit contraction was usually dictated by dwindling sterling funds, importers found their loans more severely restricted than those of other people.

The First World War naturally led to some important changes in banking. Bank-notes were immediately made legal tender, and the export of gold was forbidden without the consent of the Minister of Finance. Further legislation widened the range of securities which could be used as legal cover for notes, and gold disappeared from circulation. Like other countries New Zealand experienced a violent inflation between 1914 and 1920. The inflation owed something to credit expansion, since the banks subscribed heavily to war loans, but advances fell as a proportion of deposits from 89 to 64 per cent. The major cause of inflation was the cumulative favourable balance of payments which resulted from the difficulties in procuring imports. Sterling funds, however, were quickly reduced after peace returned, and there was actually something of an exchange crisis when accumulated war-time orders were suddenly delivered in 1921. By 1925 advances and discounts had returned to their pre-war proportion of deposits, gold was a smaller proportion of assets, and sterling balances were a compensatingly larger proportion. The main effect of the war, therefore, was to produce such alterations in the structure of assets and liabilities as were needed after the withdrawal of gold from circulation.

The depression of the thirties had more marked effects upon New Zealand banking. A sudden fall in overseas borrowing and a fall in export prices led, in 1930, to a devaluation of

the Australian pound from parity to £A125 = £100 stg. New Zealand's position was much easier, but sterling was being lost to Australia, and the Associated Banks decided to meet the position by a double adjustment. They raised the sterling rate to £NZ110 = £100 stg. and lowered the Australian rate to £NZ90 = £A100. These adjustments, however, did not completely eliminate arbitrage profits, so that sterling funds continued to drain to Australia.

Liabilities and Assets of the New Zealand Trading Banks, 1898–1928

Liabilities in N.Z.	*Dec. 1898 £000's*	*Dec. 1928 £000's*	*Assets in N.Z.*	*Dec. 1898 £000's*	*Dec. 1928 £000's*
Notes in circulation	1,074	6,521	Coin and bullion	2,752	7,262
Deposits	13,859	53,732	Securities	3,190	5,965
Other local liabilities	85	1,147	Discounts	1,732	1,290
Excess of local assets	2,350	2,653	Advances	9,155	46,811
			Other local assets	539	2,725
	17,368	64,053		17,368	64,053

During 1931 New Zealand's own position deteriorated; export receipts fell heavily and the Government found difficulty in raising new sterling loans. An agreement was made whereby the Government had first call on London funds, and exports were licensed, the condition for a licence being that the proceeds were paid into one of the banks. These arrangements were in force for only a short time, as the Government soon succeeded in floating a loan for £5,000,000, and this eased the position.

Meanwhile agitation was growing for a further rise in the exchange rate in order to help farmers who were badly hit by the heavy fall in export prices. The Associated Banks disapproved of this proposal, but in January 1933 the Government decided to raise the rate to £NZ125 = £100 stg. As a measure of appeasement it agreed to purchase all exchange which the banks found surplus to their requirements, payments being made in Treasury Bills earning slightly less than 5 per

cent. interest. The result was that New Zealand built up a sterling balance of £40,000,000 under conditions of severe depression. The rise in the rate, and the turn of world prices, increased export receipts and led to a substantial growth of deposits. But advances failed to increase, and imports did not rise sufficiently to prevent the emergence of large favourable balances of payments.

The Reserve Bank

The Associated Banks were also opposed to the establishment of a Reserve Bank, and here, too, they were overruled. They argued, with reason, that the formal decentralization of the banks had not prevented them from co-operating effectively, and that they had shown themselves well able to withstand severe economic changes. There was, however, a good deal of popular suspicion that the banking system had something to do with the severity of the depression, and the Government invited Sir Otto Niemeyer to report upon the reform of the New Zealand banking system. At this period officials of the Bank of England were perhaps inclined to regard banking reform in other countries as a matter of closer imitation of the English system. Sir Otto, at all events, recommended the setting up of a New Zealand model of the Bank of England, complete with the apparatus of discount rate and open market operations, notwithstanding the primitive and weak condition of the local money market.

An Act was passed in 1933 which gave substantial effect to his recommendations. The Reserve Bank was to be a privately owned institution, although the State was to subscribe the reserve fund of £1 million, and was, in the first instance, to appoint not only the Governor and Deputy-Governor but all seven directors. The issue of notes was to be the Bank's monopoly, and it was required to keep a minimum reserve of 25 per cent., in gold or sterling, against its demand liabilities. It was also to maintain convertibility with sterling at a rate which the Board was to determine. The trading banks were obliged to withdraw their issues, to hand over their gold stocks at the old mint parity, and to keep deposits at the Reserve Bank equal to 7 per cent. of their demand liabilities and to 3 per cent. of their time liabilities. The State transferred its

banking business from the Bank of New Zealand to the Reserve Bank, although the Bank of New Zealand was to act as the Reserve Bank's agent outside Wellington. In a single operation the Reserve Bank acquired sterling, and the trading banks their statutory deposits, when the State sold £25 millions of the sterling it had bought from the trading banks as surplus to their requirements after the exchange rate was raised.

Before the Reserve Bank had had much more than a year to set about its business the general election of 1935 brought a Labour Government to power. One of its first acts was to nationalize the Bank and to make some important changes in its functions and powers. It was now formally laid down that the Bank's general function was 'to give effect so far as may be to the monetary policy of the government'. The Governor was given authority, subject to the consent of the Minister of Finance, to raise the statutory deposits of the trading banks with the Reserve Bank. This change had the great merit of introducing a practical method of credit regulation, but it has never been used. The Bank was also empowered to grant accommodation to the Treasury up to the full estimated annual revenue (instead of up to one-half of the revenue) and to give overdrafts to the new state marketing organization for dairy produce. . nificantly enough, the Minister of Finance could also authorize the Bank to suspend the free sale of sterling.

The subsequent history of the Bank, and an explanation of its working, are best considered in relation to the following table of its liabilities and assets.

Liabilities of the Reserve Bank

(*£ millions*)

Year	*Bank-notes*	*State deposits*	*Trading bank deposits*	*Other deposits*	*Net reserve ratio per cent.*
1936	10·7	6·4	8·3	0·2	92·1
1939	16·1	2·8	10·7	0·3	27·0
1942	25·8	12·1	18·7	1·4	43·3
1945	41·1	12·2	44·0	1·0	63·3
1949	51·3	11·4	73·8	0·4	38·1
1950	55·1	15·6	74·2	1·1	—
1951	60·4	18·8	69·3	4·9	—

Assets of the Reserve Bank

(*£ millions*)

Year	*Sterling and gold*	*Advances to marketing organizations*	*Other advances to the State*	*Other advances*	*Investments*	*Discount rate per cent.*
1936	23·6	1·3	1·3	—	2·0	2·5
1939	8·1	6·1	13·6	—	3·7	3·7
1942	25·3	6·8	23·1	—	4·2	1·5
1945	62·9	2·1	24·2	—	11·8	1·5
1949	52·2	3·5	37·6	4·9	41·9	1·5
1950	55·8	5·1	52·2	5·4	31·3	1·5
1951	67·9	3·4	51·1	6·8	27·1	1·5

Little comment is needed in regard to the Bank's liabilities. It enjoys the usual central banking privilege of a monopoly of the note-issue. 'State deposits' include accounts of the marketing organizations as well as those of government departments, both inside and outside the Public Account; 'other deposits' include a number of internal accounts of the Reserve Bank itself, and also small sums held on account of other central banks. The Reserve Bank is legally free to accept deposits from anyone, but as it cannot pay interest on them it collects none from the public. It will be noted that the trading banks, as a whole, have kept much larger deposits with the Reserve Bank than is required by law; in 1936 these deposits exceeded the legal minimum by 240 per cent. and in 1951 by 370 per cent. There are, however, considerable variations in the ratios maintained by individual banks; some are close to the legal minima.

The net reserve ratio was the ratio of gold and sterling assets to the Bank's public liabilities, and up to 1950 this had to be maintained at a legal minimum of 25 per cent. unless the Minister of Finance authorized the suspension of this requirement. The Reserve Bank Amendment Act of 1950, however, abolished the statutory reserve, and simply laid upon the Board the duty of maintaining the reserve at a level which would, in its opinion, provide a reasonable margin for contingencies.

Gold holdings are all valued at cost, although £2·8 millions were originally taken over from the trading banks at the old parity of £4. 4*s*. 0*d*. an ounce, and other parts of this reserve

were bought when gold was below its present price. Here, then, we have an undervalued reserve, the extent of the undervaluation being perhaps £5 millions. Sterling exchange comprises deposits at the Bank of England and British Treasury Bills with an unexpired currency of three months; it could also include commercial bills of a similar currency payable in London and bearing two good names. Legal provision was also made for net gold exchange—deposits or bills payable in countries whose currencies were convertible into gold, but no entries have ever appeared under this head, as not even dollars are freely convertible into gold. The recent amending Act has further widened the definition of the reserve to include net balances with central banks in countries whose currencies are freely convertible into sterling; at present small sums are held on account with the central banks of the United States and Canada.

Advances to marketing organizations have a somewhat complex history. At first they were made to the Marketing Department which was set up in 1936; the Internal Division handled eggs, fruit, and honey, and the External Division all exports of dairy produce. At the outbreak of war bulk purchase agreements were made with the British Government for most exports, and the External Marketing Division took over meat and wool in addition to dairy exports. A Milk Marketing Division was added to the Department in 1944, but in 1946 a free market was restored for wool. A year later dairy exports were handed over to a Dairy Products Marketing Commission, and soon after meat exports to a Meat Producers' Board. These two organizations are largely in the hands of producers, and both are financed by the Reserve Bank. Advances are by overdraft and at a rate of 1 per cent. It should be noted that this financing of exports enables the Reserve Bank to acquire large sums of sterling directly.

'Other advances to the state' are mainly ordinary ways and means advances, advances to the State Housing Division, and for other types of public works. These are all made by discounting special Treasury Bills, also at a rate of 1 per cent. The Bank publishes an official discount rate which has remained unchanged at 1½ per cent. since July 1941. Legally it relates to approved bills of exchange, but so far has had little

significance. As has just been noted, the Bank advances to state departments and the marketing organizations at less than this official rate, and it was not until last year (1951) that any trading bank has had to rediscount with the Reserve Bank. The rate was fixed at 4 per cent. in 1935 and was reduced to 2 per cent. by the following year. During the exchange crisis of 1938 it was put back to 4 per cent. for nearly a year, but then fell to the present level of 1½ per cent. in 1941. These changes were not reflected in the trading banks' interest rates, and can be regarded only as indicating the Bank's views about credit conditions. Even as such an indicator the discount rate has since fallen into disuse, although there has been some recent discussion about following Australia's example of reviving interest-rate controls as a means of countering inflation.

'Other advances and discounts' included, until 1951, only drawings by the French and Czechoslovakian Governments of credits granted to them for wool purchases; France was granted £5 millions in 1947 and Czechoslovakia £1 million in 1948. At the end of December 1950 this item stood at £5·7 millions. But a month later it stood at £9·2 millions, indicating that at least one trading bank had been forced to rediscount in order to maintain its statutory reserve with the Bank. Nor is it difficult to conjecture how this came about; wool prices trebled when the new season's sales opened in December 1950, and this caused a heavy increase in advances; between September and December the aggregate advances of the trading banks jumped from £95 to £107 millions. This rediscounting operation is notable, because it marks the first occasion that the Reserve Bank has been called upon to provide such facilities. There is, however, no reason as yet to suppose that rediscounting will become a normal operation.

'Investments', until 1951, were all New Zealand government securities, none of which are valued at more than their nominal value. This is prudent practice, but leads to something of a concealed reserve. It may also involve something of a conconcealed sterling reserve, as some of those securities are bought and held in London (more especially when reconversion operations are in prospect). The Bank may deal in any securities issued, or guaranteed, by the Government of New Zealand or that of the United Kingdom. More recently the

Bank has set aside part of the increased balances from the wool boom of 1951–2 into British securities and has co-operated in the funding operation for British Treasury Bills. Its holdings of overseas securities are now £32 millions.

The table shows that during the first three years Labour was in power, there was a marked expansion of credit to the State, and an equally marked fall in sterling funds. The two changes, were, of course, connected; inflationary public finance led to higher money incomes and so to higher imports. At the same time there was some outflow of private capital to Australia, where investment was more attractive, and some repatriation of speculative balances held in New Zealand against an anticipated appreciation of the New Zealand pound. As a result of these developments the reserve ratio fell from 92 per cent. to very near the then statutory minimum of 25 per cent., and in December 1938 the Government took steps which virtually abolished the sterling exchange standard.

The Bank was released from its obligation to sell sterling on demand, and the Minister was empowered to authorize the variation, or suspension, of the minimum 25 per cent. reserve ratio. All exports were made subject to licence, the condition for a licence being that the proceeds were paid into a bank; the trading banks, in turn, were required to sell sterling on demand to the Reserve Bank. Imports were also licensed, and all overseas payments required a permit from the Bank. For a time 'invisible' exports were exempt from control, so that a black market for sterling developed with rates around £NZ140 = £100 stg. But in April 1940 exchanges of overseas currencies at other than the official rates were made illegal, and, a few months later, all holdings of overseas currencies, overseas deposits, and overseas securities had to be declared to the Reserve Bank. The Bank was given authority to compel the sale of such assets, but has never used this power. (In 1949 private overseas balances amounted to £2·5 millions, and private holdings of overseas securities to £37 millions.)

There was some disagreement between the Minister and the Governor about the Bank's power to control interest rates, but this was resolved by the Amending Act of 1939 which required the Board to give effect to any recommendation conveyed to the Governor in writing by the Minister of Finance.

Between 1940 and 1946 sterling funds increased very rapidly, not so much because of exchange control as because war-time difficulties in importing led to large favourable balances of trade. The Reserve Bank acquired a much larger share of these growing funds because it financed the sales of war-time exports of dairy produce, meat, and wool; in 1945 it held over 80 per cent. of the banking system's net overseas assets as compared with 66 per cent. in 1938.

War finance was associated with a further expansion of credit as investments and ordinary advances to the State rose from £17·3 millions in 1939 to £27·3 millions in 1942. Nevertheless the Government was aware of the danger of inflation and took comprehensive measures to restrain it after a Stabilization Conference had reported in 1942. These measures included the prohibition of further subscriptions by the trading banks to war loans, and, as will be shown later, control over their advances by the Reserve Bank. Efforts were also made to limit state borrowings from the Bank, with the result that its investments and ordinary advances to the State had reached only £41·1 millions by 1946 in spite of the repayment of £48·2 millions of overseas debt.

By far the greater part of war-time inflation in New Zealand arose from large favourable balances of trade. As the following table shows, the volume of money increased from £51·4 millions in January 1939 to £172·0 millions in January 1946; overseas transactions accounted for nearly 70 per cent. of this increase, and Reserve Bank credit for less than 25 per cent.

The position changed after the war. Between 1947 and 1950 overseas payments exceeded overseas receipts largely because of the greater availability of imports but also because some £24·7 millions of external public debt were repaid. In order to repatriate this external debt, and in order to finance a large public works programme, the Government borrowed £24·9 millions from the Reserve Bank. At the same time there was a marked expansion of trading bank advances, so that the volume of money rose by 28 per cent.

The post-war fall in the Reserve Bank's holdings of sterling exchange is not wholly explained by larger imports and the repayment of overseas debt. When the trading banks resumed the finance of wool exports in 1946 there was a shift in the

distribution of sterling funds. Much greater importance attaches to the restoration of parity with sterling in August 1948, which led to large nominal changes in the Bank's assets. Its sterling funds were written down by £17·4 millions, and those of the trading banks by £2·5 millions. To compensate for these changes, and also for losses on forward exchange commitments, the Government paid the Reserve Bank £600,000 in cash and sold it £20 millions of public securities. The effect of the exchange adjustment, therefore, was to increase trading bank deposits at the Reserve Bank, to reduce the nominal value of sterling funds, and to increase the Bank's investments. These changes are reflected in the tables given above for the Bank's liabilities and assets, but as they did not affect the volume of money they are not included among the causes of change in this aggregate.

Volume of Money, 1935–51

(All figures refer to the last balance day in Jan.)

(£NZ millions)

Volume of money	*1939*	*1946*	*1950*	*1951*
Coin (estimated) . . .	1·3	2·9	3·6	3·5
Notes held by public . . .	11·0	36·9	44·5	47·4
Demand deposits at Reserve Bank*	2·9	20·2	9·2	18·3
Demand deposits at trading banks	36·2	112·0	163·1	194·7
Total	51·4	172·0	220·3	263·9

Causes of change	*1935–9*	*1939–46*	*1946–50*	*1950–1*
Overseas transactions. .	−33·4	+82·8	−7·7	+27·5
Reserves Bank's loans and investments . . .	+19·2	+28·2	+39·2	−6·9
Trading banks' loans and investments . . .	+21·2	+15·3	+10·7	+33·9
Other items . . .	+3·3	−5·7	+6·1	−10·7
TOTAL CHANGE . .	+10·3	+120·6	+48·3	+43·8

* Excludes trading bank deposits.

During 1949 there was an acceleration of government borrowing from the Bank. For the year ended 31 March 1950 these increased by £26 millions, although the increase was largely nominal since state deposits at the Reserve Bank rose

by nearly £20 millions. The National Government which came to office in November 1950 roundly denounced its predecessor's practice and declared that it would refrain from any further borrowing from the Bank for ordinary purposes. Up to December 1951 it had reduced the Bank's ordinary advances to the State by £3 millions and the Bank's investments by nearly £28 millions. For the time being, at least, the Reserve Bank has ceased to be a direct contributor to inflationary pressures.

The Government has also made some changes in regard to exchange control. In March 1950 it lifted the prohibitions against transferring sterling area securities from New Zealand, and withdrew the requirement that sterling area balances and securities be notified to the Reserve Bank. These may now be dealt with freely, although export receipts must still be paid into a bank, and the taking or sending of money abroad is still subject to control.

In August 1950 a new Reserve Bank of New Zealand Amendment Act was passed. The general function of the Bank was extended by requiring the Board to take such steps as it deems necessary or desirable, within the limits of its powers, to promote and safeguard a stable internal price level and the highest degree of production, trade, and employment that can be achieved by monetary action. At the same time the Reserve Bank was required to give effect to any resolution of the House of Representatives in respect of any of its functions or business; this replaced the previous requirement that the Board should give effect to any instructions conveyed by the Minister of Finance. These are, of course, verbal rather than real changes.

The most significant changes brought about by the new Act are the abolition of the statutory minimum reserve of a 25 per cent. holding of gold and sterling against the Bank's demand liabilities, and the widened definition of this reserve. The Bank is now required 'to maintain reserves which, in the opinion of the Board of Directors, will provide a reasonable margin for contingencies'. Sterling reserves may now include 'balances standing to the credit of the Bank at the central bank of any country the currency of which is freely convertible into sterling'.

Some important changes have also been made in regard to

import control. From August 1950 to May 1951 about two-thirds of the items subject to import control were freed in so far as they came from soft currency sources. Hardly any goods which directly compete with New Zealand manufactures have yet been exempted, but the new Board of Trade has now started to consider removing import controls from some of these goods. It has also made licences more flexible; they can be used for any country except those which are scheduled as restricted, i.e. within the dollar or the rouble blocs. One result of these changes is that the Reserve Bank has had a lightening of the load of exchange regulation.

The Trading Banks

A recent amalgamation has reduced to five the number of trading banks in New Zealand. The Bank of New Zealand has long had the largest local business, and, like the National Bank, by far the greater part of its business is local. Both banks have London offices, and the Bank of New Zealand also maintains a small connexion in Australia, Samoa, and Fiji. In addition there are three Australian banks operating in the Dominion—the Bank of New South Wales, the Australia and New Zealand Bank, and the Commercial Bank of Australia. All of the banks operating in New Zealand have extensive branches and agencies, the total number of local offices being well in excess of 500. There is hardly a place of any size that has not more than one branch bank or agency; if the system is open to criticism on the score of branches it would be for wasteful duplication rather than for inadequate facilities. As in England, bank managers are relatively well paid and are expected to be socially acceptable to the clients with whom they have to deal. Fairly wide powers are usually given to branch managers to act independently of head office.

The history of the Bank of New Zealand has already been discussed up to the time when it became a semi-state concern. From 1898 to 1945 its Board consisted of four directors appointed by the State and of two directors elected by the shareholders. There was, however, little sign that the predominance of state directors made any real difference to the Bank's character. For all intents and purposes it seemed to regard itself, and to act, as a private institution. The Labour Party had

long had the nationalization of the banks in its programme, but, after it had come to power and nationalized the Reserve Bank, the leaders of the Party decided not to proceed further by nationalizing any of the trading banks. They felt that the changes they had made to the Reserve Bank, together with the subsequent exchange regulations, gave satisfactory control over the whole banking system. In 1945, however, they were forced to bow to a revolt of their own rank and file, and the Bank of New Zealand was nationalized by buying out the private shareholders. The Board now consists of appointments made by the Minister of Finance, and there are still subsidiary boards in London, Sydney, and Melbourne. The members are required 'to have regard to any representations that may be made to them by the Minister of Finance and shall give effect to any decision conveyed to the board in writing by the Minister'. Contrary to predictions made by the opponents of nationalization, the Bank has not lost ground since the State took it over; in 1945 it was responsble for 40 per cent. of total trading bank advances, but in 1949 for 48 per cent.

The activities of the trading banks are also most conveniently discussed with reference to their liabilities and assets.

Liabilities and Assets of the New Zealand Trading Banks, 1938 and 1949

(*Averages for calendar years*)

(*£ millions*)

Liabilities	*1938*	*1949*	*Assets*	*1938*	*1949*
Demand Liabilities in N.Z.	34·9	150·7	Coin, bullion, R.B. notes	4·8	12·3
Time liabilities in N.Z.	30·8	39·0	Balances at Reserve Bank	6·7	73·8
Other liabilities in N.Z.	18·4	9·8	Net overseas assets	7·0	14·5
			Securities	7·9	14·7
			Advances and discounts	55·9	82·0
			Land, buildings, &c.	1·8	2·2
TOTAL	84·1	199·5	TOTAL	84·1	199·5

The above statement, it must be emphasized, is not derived from published balance-sheets, but from the returns the banks

are required to furnish by the Reserve Bank Act. These returns are defective because they are not completely inclusive. 'Other liabilities' is here a balancing item, and comprises mainly the capital of shareholders. But it also reflects drafts in course of collection, and it is this which largely explains the fluctuation of the item between the two dates.

The Bank of New Zealand and the National Bank keep a much higher proportion of capital to balance-sheet liabilities than the English, or even the Australian, banks. In the case of the Bank of New Zealand, capital and reserve funds amount to 11 per cent. of balance-sheet liabilities, and in the case of the National Bank to 9 per cent. Before the war the proportion was greater because inflationary developments led to big gains in deposits while capital remained fairly stationary; in 1938 the Bank of New Zealand's capital was 20 per cent. of its liabilities. The reason for this unusually high capital is to be sought in the historical difficulties of collecting deposits in a new country and the restricted scope for short-term loans. But there is no doubt that an unnecessarily conservative policy was followed after 1895 as the recent changes show.

Demand liabilities in New Zealand are almost wholly current account deposits, which earn no interest, and are subject to a flat charge of 10*s*. a year. Time liabilities are mainly fixed deposits, earning rates of interest which range from ¾ per cent. in a three months' deposit to 2 per cent. on a three-year deposit. Fixed deposits have been comparatively stationary over the last decade owing to the low rates of interest paid on them, whereas current account deposits have quintupled. Before the war the ratio of free to fixed deposits was regarded as a sympathetic index of the trade cycle, the ratio rising in good times and falling in bad.

Coin, bullion, Reserve Bank notes, and balances with the Reserve Bank form the local cash holdings of the trading banks, and show much the most rapid increase of any asset. The ratio of cash to deposits was 17·5 per cent. in 1938, compared with one of about 9 per cent. for English banks. This higher proportion again reflects difficulties in short-term lending. But in 1949 the ratio had risen to 45·3 per cent. owing to war-time inflation and controls over trading bank advances and investments. Since then, as we shall see, it has fallen a

little. It has to be remembered, however, that these are aggregate figures which conceal considerable differences in respect of individual banks.

Net overseas assets are balances with banks in other countries and liquid types of investment held overseas, both in respect of New Zealand business and net of bills and drafts payable by New Zealand offices. They are, therefore, partly cash and partly money market assets, and should be considered together with cash held in New Zealand in judging the liquidity of the trading banks. The ratio of cash plus net overseas assets to deposits was 28·3 per cent. in 1938 and 53·2 per cent. in 1949. This is a more moderate change than that in the cash ratio alone, but it still shows a strikingly liquid position. It should be noted that the pre-war ratio of cash plus net overseas assets to deposits was close to the English ratio of cash and money-market assets to deposits. Since net overseas assets consist in large part of English Treasury Bills and the like, it is clear that the London Money Market serves the Dominion, as well as the British, banks as an avenue for short-term loans.

No very striking change has taken place in the proportion of securities to other assets. Securities reached a peak level of £37·7 millions in 1944, but after 1942 the Government banned trading bank subscriptions to new issues of public securities and followed a policy of paying off any securities held by the trading banks as they fell due.

Advances and discounts remained nearly stationary at under £50 millions between 1940 and 1944, because the trading banks lost the finance of meat and wool exports to the Reserve Bank, because the Government undertook a much larger share of the restricted import trade, and because many firms were engaged on war contracts for which they received advance payments provided by the Reserve Bank. At the same time the trading banks' advances were made subject to the control of the Reserve Bank as part of the stabilization programme. The types of advances thus controlled related to speculative purposes, purchases of real property, investments and advances for other capital purposes, repayment of mortgages, hire purchases and credit sales, and luxury purposes. Applications for such loans had to be referred to the Reserve Bank for a de-

cision. Although this system of control was informal in the sense that no regulations were issued concerning it, the trading banks co-operated very satisfactorily as the stationary level of advances shows.

After the war trading bank advances climbed from £52 millions to £82 millions in 1949, since the finance of wool exports was regained and imports increased. Relaxations were made in advance control during 1950. As from March the trading banks did not have to refer applications to the Reserve Bank if the amount did not exceed £2,000 nor the term two years. In May all advances up to £2,000 were freed from control, and, irrespective of the amount, advances for the purchase of livestock, farm equipment, and tools of trade. Simultaneously the limit for doubtful advances, requiring submission to the Reserve Bank, was raised to £4,000.

The effect of these measures was seen in the increase of trading bank advances from £79 millions in January 1950 to £113 millions in January 1951. But other factors intervened to push advances up to £138 millions in May 1951. Wool prices trebled when the new season's sales opened in December, and a waterfront dispute partially paralysed trade from February to July. Inflationary pressures were intensified, and the Reserve Bank was obliged to press the trading banks to exercise restraint in lending, although no formal regulations were issued for this purpose.

Some information is available about the distribution of trading bank loans. Discounts may be ignored, as they are a relatively negligible item, involving mainly local promissory notes, and the following table shows only the distribution of advances.

Before the war more than one-half of advances went to farmers, dairy companies, meat works, and other firms engaged in exporting or handling primary produce. There has been a notable relative decline in such advances, which may be accounted for by the prosperity of farmers and by the expansion of secondary industries brought about by wartime developments and protection through import control. The table suggests that advances to local manufacturers have risen from 8·7 to 17·0 per cent. Advances to merchants were abnormally low in 1940 owing to the controls over imports

which followed the exchange crisis of 1938, so that the proportionate expansion of these advances is somewhat exaggerated by the table. Altogether something like three-quarters of the trading banks' advances are granted to industry and trade.

Classification of Trading Bank Advances, March 1940 and March 1949

Category	*1940 per cent.*	*1949 per cent.*
Farmers	35·6	21·8
Industries allied to farming	15·3	19·4
Other industries	8·7	17·0
Merchants	12·5	17·7
Transport	1·4	2·1
Local bodies	1·4	1·0
Stock and station agents	1·4	0·7
Hotels, restaurants, &c.	2·3	3·0
Finance companies	2·9	2·0
Professional	2·7	2·3
Private individuals	10·1	9·4
Other	5·6	3·7
TOTAL ADVANCES (£ millions)	48·0	88·7

The banks publish a minimum overdraft rate, which has stood at 4 per cent. since 1941, but it applies only to large and highly credit-worthy transactions. Small borrowers seldom pay less than 5 per cent. Interest is reckoned twice yearly, and charged on the average daily balance for the period; the only additional charge is the flat rate of 10*s.* a year made for keeping any account. These terms are favourable in comparison with those granted by banks in other countries, and there have been few complaints in recent years about the cost or quality of banking services. One minor complaint might be made of the charge for collecting cheques or drafts on other centres, amounting to 6*d.* for sums up to £20 and increasing beyond that by 3*d.* per every additional £10.

At one time bankers attached importance to the ratio of advances to deposits because this provided some indication of changes in overseas assets. For if advances rose relatively to deposits, this might well mean that sterling funds were declining or that the banks were drawing upon Australian

sterling funds or upon deposits raised in England. Contrariwise, a fall in the ratio would indicate a growth of sterling funds. But, like the ratio of free to fixed deposits, this ratio of advances to deposits has lost much of its significance in recent years.

Monetary Controls and Monetary Policy

Up to 1935 monetary conditions in New Zealand were largely governed by the requirements of the sterling exchange standard. This control, as we have seen, was in many ways imperfect. The English and Australian connexions led to great elasticity of credit in the seventies, and imposed severe strains during the next two decades. The Australian connexion led to an undue shortage of sterling funds in the early stages of the last depression, and so forced a rise in the exchange rate. It was partly in order to correct such defects that the Reserve Bank was established, but as things turned out it was quickly obliged to issue so much credit to the State that an exchange crisis developed, and the sterling exchange standard was suspended. Since then credit regulation has been associated with direct controls, and sterling funds have been protected, not so much by any regulation of credit as by import and exchange restrictions.

The regulation of credit today has two aspects: limiting state loans from the Reserve Bank and ensuring that trading bank loans are kept within proper bounds.

In regard to the first aspect the Reserve Bank is powerless. The recent amending Act has made the Bank subject to Parliament rather than to the Minister, but this change is perhaps more nominal than real, and in any case the Bank is still required 'to give effect so far as may be to the monetary policy of the Government as communicated to it from time to time by the Minister of Finance'. For the time being the Government has imposed upon itself a self-denying ordinance in regard to Reserve Bank loans, but the continuance of this state of affairs depends upon the Government, not upon the Bank. It is not suggested that the position of the Bank is at all peculiar in this respect; most central banks are in a very similar position. Nor is it suggested that the Bank has no influence upon fiscal policy; the Governor is a leading official

adviser. But it has to be recognized that, in the last resort, credit regulation depends upon governments rather than central banks.

Control over trading bank loans is another matter. Here the Reserve Bank has real responsibilities and real powers. The establishment of the Reserve Bank snapped the direct link between trading bank loans and their overseas funds, at first because they could purchase exchange from the Reserve Bank, and later because the obligation to sell sterling on demand was abolished. The statutory deposits which the trading banks are obliged to maintain at the Reserve Bank took the place of their own holdings of overseas funds as the credit base for their loans. But the base has become so wide as to impose no restriction, because trading bank deposits with the Reserve Bank have long been much in excess of statutory minima.

In these circumstances the Reserve Bank came to rely upon direct regulation of trading bank loans through its advance control. This control, however, did not set overall limits to trading bank advances so much as limits to advances for particular purposes. During the war the real limits upon trading bank advances arose from the contraction in the demand for them as the Reserve Bank took over the finance of most exports, and also a large part of work on war contracts through advance payments.

After 1945 there was a great increase in the demand for trading bank loans, and, in 1950, considerable relaxations were made in the Reserve Bank's control over advances. For these, and other reasons, trading bank advances have risen very rapidly. At the moment the Bank relies mainly upon moral suasion to restrain the trading banks. There is, fortunately, an excellent spirit of co-operation between the Governor and the local general managers of the trading banks, and it is clear that moral suasion has had some success. Nevertheless, trading bank advances have risen sharply, and there are obvious limits to the effective co-operation of competing trading banks in holding down their own advances. It would appear to be safer, and fairer to the banks, to impose some more formal and impersonal control over their lending activities.

One such control has long been at the Bank's disposal. It has power to raise the statutory deposits which the trading

banks must maintain with it. Two difficulties perhaps stand in the way of exercising this power, but they are far from insuperable. One is that a very large increase is needed in order to be effective; in 1951 the excess of trading bank deposits over minimum requirements would have been wiped out if these requirements were raised, on the average, from 7 per cent. of demand, and 3 per cent. of time, liabilities to about four times these ratios. The other difficulty is that, since there are wide variations in the excess reserve deposits kept by individual banks, any uniform raising of reserve requirements would cause severe hardship for some of them. There seems, however, to be nothing in the Reserve Bank Acts which would prevent it from raising reserve requirements unevenly. Alternatively, banks could be compelled to fund their excess reserves.

These difficulties may help to explain why the Reserve Bank has never exercised this power. A more important reason is that, until quite recently, import, exchange, and other controls made the exercise of such power unessential. But now that these controls have been severely modified, and especially if further relaxations are in prospect, the Bank may be obliged to examine the powerful method of credit regulation it has long neglected.

The use of interest rates as a means of controlling credit has also been discussed. It is doubtful how far higher interest rates would be effective in New Zealand, which has no real capital market, and particularly doubtful under inflationary conditions when businessmen anticipate further increases of prices. This policy, moreover, would run into serious political opposition, because it would make for more expensive public borrowing, depreciation of public and other securities, and dearer housing. Adjusting the trading banks' reserve deposits would be more acceptable, as well as more effective.

These, however, are all questions of technique. The crucial questions relate to the kind of policy the Reserve Bank should follow in so far as it has independent powers. According to the new Act it is required to promote a stable price level along with the highest degree of production, trade, and employment. It is not formally required to restrain monetary demand to the level which is consistent with free importing,

but this may be regarded as an implicit requirement of recent government policy.

Little thought appears to have been given to the compatibility of these objectives, or to the priorities between them. In the immediate future, at least, price stability would seem to be a highly important objective, since New Zealand has over-full employment and there is widespread concern about the rising cost of living. On the internal side, the Bank's powers to promote price stability are the same as its power to restrain credit; it can urge the Government not to borrow from it, and it can curb the trading banks. But any serious attempt to exercise this latter power could easily lead to difficulties in regard to full employment. Wages are largely set by the awards and general wage orders of the Court of Arbitration. If these orders impose higher wages, restrictions on trading bank credit could lead to unemployment, as some employers would then be unable to find the money to pay the higher wages. Here is a real dilemma, politically dangerous, and not unrelated to the Bank's duty of giving effect to government policy.

It could be argued that this dilemma need not arise, provided prices were kept stable in other ways. The Court of Arbitration bases its general wage orders upon recent and prospective changes in the cost of living; the prime causes of such changes, in New Zealand, are export and import prices. These could, conceivably, be offset by the exercise of the Bank's power to fix exchange rates. Rising export and import prices, for example, were both offset for a time by the exchange appreciation of 1948. Repeated and unexpected changes of this kind are upsetting, but this danger could be reduced if the Bank announced a policy of altering the exchange rate at stated intervals so as to preserve overall stability in export and import prices in terms of the local currency. Export prices might not rise in the same proportion as import prices, but this difficulty could be met by fixing different rates for buying exchange from those for selling it. I believe that such a policy has much to commend it, but one would have to be very optimistic about the economic sophistication of the electorate to believe that it would find ready acceptance.

What of free importing? It is also easy to conceive that

import prices would so rise, and export prices so slacken, that import restrictions would have to be reimposed on goods already decontrolled—unless the Reserve Bank was able to to curb the demand for imports sufficiently by credit restriction. And this course could easily run into the difficulty that it would precipitate unemployment.

I have been able merely to touch upon these important issues. But sufficient has been said to show how complex and difficult are the Bank's problems in regard to monetary policy, and how limited are its powers to deal with them. It can hope only to advise the Government about the measures that seem most appropriate and feasible at any time, and to use its own limited powers in what seems to be the right direction.

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2. BOOKS

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POSTSCRIPT (May 1952)

There have been large changes in the last few months. For a variety of reasons private imports leapt from £43 millions in the last quarter of 1950 to £72 millions in the last quarter of 1951, and were £68 millions in the first quarter of 1952. Trading bank advances rose from £109 to £187 millions over the same period.

In December the Reserve Bank introduced new direct controls over advances and, in March, exchange controls. Importers now have a basic exchange ration equal to 80 per cent. of their imports for 1950, and must apply to the Reserve Bank for additional requirements. The sudden rise in imports has not only led to a big rise in advances but has also reduced the trading banks' excess deposits at the Reserve Bank. In March the Bank again made a loan to enable one bank to maintain its statutory deposit, and other banks were in similar difficulties.

Private imports will, in any event, soon fall back to a more normal level, but the removal of the new exchange controls, which the Bank hopes are only temporary, will also depend upon some revival of wool prices above their present level.

10

THE SOUTH AFRICAN COMMERCIAL BANKS[1]

I

SOUTH Africa shows a higher degree of concentration of commercial banking than any other major Commonwealth country. At the end of 1950 approximately 90 per cent. of total liabilities to the public in the Union of South Africa were held in the two big banks, both of which have their head offices in London and have widespread interests outside South Africa. Within the country they both have an extensive system of branches. This dominance of the Imperial banks appeared in the later years of the nineteenth century in Cape Colony and spread rapidly to the whole of the Union in the early twentieth century; earlier there had been experiences both of state banking and of local private banks.[2]

The first South African bank was basically a state mortgage bank, created in 1793 as a remedy for the extreme shortage of cash at the Cape. This Bank van Leening (Lombard or Loan Bank) received loans from the Dutch East India Company in paper rixdollars, and made loans to private individuals on the security of land, gold, and other property. Its loans soon came to be excessively illiquid and in 1808 it was reorganized. The Lombard Discount Bank was created as a subsidiary to accept deposits from the public at interest and to make discounts. For several years it did valuable work in providing credit, but its loans soon became illiquid and its resources proved to be inadequate in relation to the needs of the colony. The introduction of sterling in 1825 marked the beginning of the private banking movement and the decline of the Lombard Bank. In 1842 the bank discontinued business.

Between 1825 and 1827 and again after 1833 there was

[1] The author is indebted to all those bank officials and others who helped him in the preparation of these chapters by providing comment, criticism, and information. He is, of course, solely responsible for the opinions expressed and for any errors which may still remain.

[2] See E. H. D. Arndt's *Banking and Currency Development in South Africa*, (Cape Town, 1928) for a detailed history.

strong pressure for the creation of private banks, either on a purely local basis or with a London connexion. In 1837 persistence met its reward: the opposition of the Government was defeated and the first local bank came into existence under a Deed of Settlement permitting it to keep cash accounts, receive deposits, circulate notes, discount bills, buy bullion, and advance money on goods and property. For over two decades, however, British government opposition successfully frustrated plans for Chartered Imperial banks, while new private banks were opened in rapid succession, so that by 1861 there were twenty-seven.

At the height of their success, the local banks began to suffer the invasion of the Imperial banks, which in the next thirty years were to transform the Cape banking system. The lateness of the arrival of the Imperial banks on the scene resulted partly from Colonial Office opposition, which had been strongly exercised in the eighteen-thirties, and partly from doubt whether loans at over 6 per cent. were legal in the Cape—a doubt which was only removed in 1860. Between 1860 and 1890 four English banks were created to exploit South African opportunities, and the local banks collapsed or were absorbed in a series of crises. The London and South Africa Bank started operations in 1861 and was followed by the Standard Bank of British South Africa in 1862. The Standard Bank at once adopted a policy of absorbing local banks and developed an extensive branch system. The London and South Africa Bank made no offers of amalgamation but it, too, opened many branches. Thus the Imperial banks soon came to overshadow the local banks: even in 1863, before the process had gone far, the paid-up capital of the two Imperial banks practically equalled that of the twenty-five local banks remaining. This development prompted several proposals by local banks to amalgamate themselves and to open branches in order to provide stronger opposition to the encroachments of the Imperial banks.

The 1865 crisis ended a decade of high prosperity and brought rumblings of local opposition to the Imperial banks. The trade recovery after 1868 brought the Oriental Bank Corporation on to the scene in 1873. This was an extension of its operations from its main area of business in the East. The

seventies were a period of strain in which many of the local banks collapsed; the Imperial banks also suffered, and the London and South Africa Bank was absorbed by the Standard in 1877. Of the seventy-six banking offices open in 1880, forty-two were branches of the Standard Bank and nine were branches of the other Imperial bank, the Bank of Africa, which had taken over the African business of the Oriental Bank when it suffered severe losses in Asia. Only nine local banks survived.

The crises of 1881 and 1890 left only four private banks. The last of the Imperial banks, the African Banking Corporation, then appeared and bought up three of them. The surviving local bank was the Stellenbosch District Bank, founded in 1882 as successor to the Stellenbosch Bank which had failed five years earlier. So by 1890 the existing structure of commercial banking in South Africa had been virtually created in the Cape. Three Imperial banks transacted practically all of the colony's banking business. This triumph had come about mainly through the collapse of local banks in the recurrent crises of the preceding quarter century, and only to a less extent through amalgamation. The stresses to which all the banks in the Cape were subject in those years were severe. Inexperience and a tendency to grant loans which were insufficiently liquid added to the effects of sharp economic fluctuations. The toll was inevitable and not even the Imperial banks were immune. In the absence of legal restrictions prohibiting branch banking and overseas connexions it is hardly surprising that the change of structure was as rapid as it was, and as overwhelming in its effects. An extensive branch system could resist the pressures of local wars, of the collapse of particular industries, and of the defections of particular individuals more easily than local banks.[1] The broad basis of oversea connexions provided still more stability and was extremely helpful in view of the heavy reliance of the Cape on external trade. That the oversea connexion should be with London rather than elsewhere is least unlikely of all; trading, financial, and political connexions were all closest with London.

[1] Certain local banks (in particular the Cape of Good Hope Bank) developed a branch system, and these banks were among the last of the local banks to collapse.

Economic development in the other areas which were to make up the Union came later than in the Cape. Natal, a British colony, started with local banks in the fifties, but all of these save one had collapsed by the nineties in face of the competition of the Imperial banks. In the Orange Free State local banks and the Imperial banks started operations in the early sixties. Fear of foreign control and loss of profits abroad soon led to the prohibition of foreign banks, but by 1875 the Volksraad realized the disadvantages of this rule and allowed two Cape banks to operate. There was continual pressure for a State Bank,[1] and in 1876 £70,000 of the sum allocated by the British Government in settlement of the Diamonds Field claim was used to help establish a National Bank, of which the majority capital was held by the Government and which absorbed the remaining local bank.

In the Transvaal, banking came still later. Not until the early seventies were facilities available, although the Volksraad had already toyed with the schemes of several adventurers. Branches of two Cape banks were opened, of which only those of the Standard Bank remained after 1882. The Transvaal Government had to rely on the Standard Bank for banking services but disliked it and wished to avoid the British influence. Lengthy negotiations with British, Dutch, German, and French groups took place throughout the eighties and often interfered one with another. In 1888 Dutch private initiative created the Nederlandsche Bank en Crediet Vereeniging. Finally, in 1890, a concession was granted to a German-Dutch group (in which Schroeders of London were closely involved), and the National Bank of the South African Republic came into existence. During the rapid economic development of the nineties the remaining Imperial banks and a French corporation spread their activities into the Transvaal.

The first quarter of the new century was marked by extreme consolidation, although the immediate results of the collapse of the Boer Republics were only certain nominal changes. The former Transvaal National Bank (now the National Bank of South Africa) bought out the National Bank of the Orange

[1] Pressure for state banking has been a persistent feature throughout the monetary history of the whole of South Africa, especially amongst the Afrikaans-speaking population.

River Colony in 1910, merged with the Bank of Africa in 1912 (so establishing itself firmly in the Cape), and closed the remaining geographical gap by absorbing the Bank of Natal. In 1920 the Standard absorbed the African Banking Corporation, to become once again the bank doing most business. In 1925 the two remaining Dutch banks (the Netherlands Bank and the Transvaal Commercial Bank) amalgamated and finally in 1926 the National Bank amalgamated with the Anglo-Egyptian and the Colonial to create Barclays (D.C. and O).[1] The National Bank had over-expanded and suffered severe losses in the post-war recession. It had used up all its reserve fund, failed to pay dividends, and had to ask for external support. The new connexions and the shifting of the head office to London established Imperial banking as the dominant system throughout the Union.

In this way was established by 1927 the structure of commercial banking as it persists today. The only important subsequent development was the foundation of the Volkskas in 1935 as a People's Bank and its registration as a commercial bank in 1942. The extreme suitability of the branch system, with firm London links, for South African conditions is suggested both by the rapid victory in Cape Colony of the Imperial banks between 1860 and 1890, and also by the fact that subsequently the National Bank found it necessary to develop close connexions with London in spite of its long history as a local bank. The Standard Bank, which most resolutely and consistently developed itself along the lines which were to prove triumphant, was the bank with the most consistent success and the least financial anxiety. The reasons for the suitability of the Imperial many-branch structure in the Cape have been indicated above; the same advantages apply to the Union as a whole.

The Imperial connexion has frequently been the source of criticism of the Big Two banks. (The Netherlands Bank has suffered less because the Amsterdam connexion is less suspect than that with London; moreover, since January 1951, a new

[1] Barclays continue to operate in South Africa as the National Bank of South Africa Ltd. Recently Volkskas wanted to change its name to Suid-Afrikaanse Nasionale Handelsbank, but in Nov. 1951 Barclays were granted a perpetual interdict restraining Volkskas from using the proposed new name.

South African company with the same title as the Dutch company took over the South African and United Kingdom business of the Dutch bank, which still exists.) It has been suggested that there is insufficient awareness of local conditions, and that South African interests are likely to be sacrificed to those of foreign shareholders. Neither of these criticisms appears to be of appreciable significance; in particular, although most of the Directors live outside South Africa, decisions about South African operations are taken there by men on the spot with considerable local knowledge.[1] There was no apparent change in the operations of the Netherlands Bank when the link with Holland was temporarily broken by war in 1940.

It has also been argued that any requirements about the constitution and situation of the banks' assets and liabilities that may be imposed by the Union may be rendered ineffective if similar requirements are not imposed in other countries in which the banks operate. This criticism has been substantially reduced by the 'covered local position' requirements of the 1942 Banking Act. Each bank must have either in the form of assets other than claims actually situated in the Union, or in the form of claims payable in Union currency, sufficient assets to cover all liabilities payable in Union currency together with the paid-up capital and unimpaired reserve funds which it is obliged to keep in the Union by the same Act. Liabilities payable in Union currency constitute a first charge on these assets. Two exemptions to this principle were introduced by the 1947 Banking Amendment Act. South African trade in certain exports is highly seasonal; bills drawn on foreign buyers of such exports and discounted by South African banks are not local assets; insistence on a fully covered local position throughout the year would mean a position which was much more than covered over the year as a whole. Automatic relief was therefore granted to allow for these temporary positions. The other exception was that International Bank securities might count as local cover up to 5 per cent. of a bank's liabilities in the Union. The position is that the Imperial banks cannot use South African assets to finance losses

[1] See the evidence of Dr. de Kock before the Select Committee on the Banking Bill; S.C. 8/42 qq. 695, 698. Nevertheless, all new banks have now to be incorporated in South Africa.

abroad, unless the statutory requirements have been exceeded, or unless secret reserves have been built up in South Africa. So long as other countries do not have covered local position requirements, South Africa gains from the spreading of risks resulting from the widespread activities of the Imperial banks but does not suffer seriously if there are difficulties outside South Africa.

II

The South African banking system consists at the end of 1950 of forty-four institutions which are subject to the requirements of the 1942 Banking Act, and a number of institutions which are exempted from the operations of that Act (by section 2), because they are all subject to their own legislative enactments. The institutions which are subject to the Banking Act are 7 commercial banks, 12 people's banks, 1 loan bank, and 34 deposit receiving institutions, most of which are savings banks and trust companies. The institutions which are not subject to the Banking Act include the South African Reserve Bank, the National Finance Corporation of South Africa,[1] the Post Office Savings Bank, the Land and Agriculture Bank of South Africa (which has the right to accept deposits), the Public Debt Commissioners (which are authorized to accept deposits from approved bodies), several municipalities which accept money at call, and 33 Permanent Building Societies (which are essentially savings bank institutions). The definition of a commercial bank in the 1942 Act is 'a person who carries on a business of which a substantial part consists of the acceptance of deposits of money withdrawable by cheque'. At the end of 1950, using the total of assets held in the Union as a criterion of size, the Standard Bank was the largest, with 45·4 per cent. of total commercial bank assets in the Union. Barclays (D.C. & O.) was a close second, with 44·2 per cent., Volkskas held 5·6 per cent., and the Netherlands Bank 4·0 per cent., while the Stellenbosch District has only 0·3 per cent. The remaining two banks are recently opened subsidiaries, the Bank of Athens (S.A.) Ltd., and the Banque de l'Indochine (South Africa).[2]

[1] These two institutions are discussed in Chapter 11 below.

[2] Before the Banking Act, 1942, statistics of certain other institutions were included together with the institutions defined as commercial banks by the Act.

Inter-bank clearing of cheques is arranged through a Clearing House, of which there are five members, namely, the Reserve Bank and the four largest commercial banks. The Stellenbosch District Bank is not a member but receives facilities through the Standard Bank. The Clearing House is administered by representatives of its members under the presidency of a Reserve Bank official. Settlements take place through the Reserve Bank. They are daily in towns where there is a branch of the Reserve Bank and in other places weekly or whenever outstanding amounts come to exceed certain agreed figures.

The commercial banks operate in close co-operation on matters of common concern. There is a minimum tariff of charges[1] which provides broad agreement between the Standard Bank, Barclays (D.C. & O.), and the Netherlands Bank, while the Volkskas and Stellenbosch District Bank follow quite closely. The extreme concentration of the banking system makes such co-operation easy.

In addition to the seven commercial banks there is a number of other institutions which receive deposits. The 1942 Banking Act distinguishes three such types of institution: people's bank, the loan banks, and deposit receiving institutions. Institutions which want to carry on these kinds of business, as well as commercial banks, are required to register with a Registrar of Banks,[2] who has power to issue certificates of registration to institutions which satisfy the legal requirements and which do not carry on undesirable forms of business. The same kind of business is carried out by both the people's banks and the loan bank, but they differ in organization. The people's banks are co-operative in form while the loan bank is a limited liability company. They both accept deposits of money and make small loans. The size of their operations and their liquid asset requirements are laid down in the 1942 Act. Deposit receiving institutions are defined as persons who carry on the business of accepting deposits of money but who are

There is therefore some discontinuity in the aggregate statistics as from 1 July 1943, but it is not important because the sums involved are very small.

[1] This agreed tariff does not apply to all charges: for example, charges for foreign exchange transactions.

[2] The *Annual Reports* of the Registrar of Banks are an extremely valuable source of information on South African banking developments.

not a commercial, people's, or loan bank. Liquid asset requirements which are slightly more stringent than those for loan and people's banks are imposed.

As we have seen there are also several institutions whose operations are not covered by the Banking Act. The operations of the Post Office Savings Bank are on a much larger scale than those of the loan and people's banks; total deposits are some fifty times larger than those of these three institutions put together. The deposit liabilities to the public of the deposit receiving institutions registered under the Banking Act are equal to about a quarter of the deposit liabilities of the Post Office Savings Bank.

The Land and Agricultural Bank of South Africa, which was established in 1912, is subject to the consolidating Land Bank Act of 1944. It makes loans to farmers and agricultural co-operative societies either for certain specified purposes connected with farming, or for any farming use on security of a first mortgage, and is willing to make loans for long periods. Its capital is derived from parliamentary allocations, and further resources are obtained from commercial bank loans.

The Industrial Development Corporation was created by Act of Parliament in May 1940 to 'assist others in the financing of new industries and schemes for the expansion of existing industries'.[1] Its activities are confined to secondary industries. Applications are dealt with on their economic merits, and the Corporation will not provide an 'unduly' large proportion of the capital needs. Once the project is successful, it makes its holdings available for public investment, releasing its own resources for further use elsewhere. The Corporation does not seek control of undertakings it assists, but may be represented on the Board of Directors. The Corporation began operations in April 1941 with a capital of £5 millions, all of which is held by the Government.

Apart from these government sponsored institutions, there are several important sources of finance outside the banking system. In particular, mention must be made of the mining houses. Mining is of fundamental importance to the South African economy and its development has been dominated by

[1] *Industrial Development Corporation of South Africa*, 'Its Function, Scope and Methods of Operations', Johannesburg.

about six or seven major financial groups whose major interest lie in goldmining. They have developed important interests in other industries, and frequently give assistance in launching new enterprises. A new company is frequently nursed through its early years by a mining house, which will finance the enterprise out of current or accumulated profits. Only when it has reached the stage of being a going concern will shares be sold to the public, and even then the mining house is likely to maintain strong influence by retaining blocks of shares and continuing to appoint some of the Directors (although usually only a minority). Independent issues are floated as well, but an important part of the finance of new enterprises is carried out through the mining houses.

The Johannesburg Stock Exchange provides a broad market for mining and industrial securities. Central bank control of this market would not be easy, because its most important shares also have an active market overseas (in particular the London 'Kaffir' market), in addition to which there are the more general difficulties of central bank control in South Africa of which more will be said in the next chapter.

Unlike the share market, the market for government stock and for industrial bonds and debentures is a relatively narrow one. Most industrial capital is raised by means of shares, although there has recently been an increase in bond finance. The main market is in government and local authority securities. Most dealings take place between the commercial banks, the insurance companies, trust funds and certain business firms, and—frequently to the extent of over half the total demand—the Public Debt Commissioners.

Prior to the creation of the National Finance Corporation[1] practically no local market in bills existed. Recently an appreciably large amount of internal trade (other than in gold) has been financed by bills, and some of these bills are held by the commercial banks and a very few by the Reserve Bank.

III

We have seen that under the terms of the Banking Act the distinguishing function of commercial banking is regarded as

[1] The degree to which this institution contributed to the development of a bill market is discussed in the next chapter.

the acceptance of deposits withdrawable by cheque. There are three kinds of deposit; demand, time, and savings deposits, of which the first are the most important. Interest is paid on time and savings deposits. Rates payable on time deposits are not high. From 1942 to 1949 inclusive, nothing was paid on three-month deposits; six-month deposits have earned from ½ to 1 per cent. over recent years and deposits for twelve months 1½–2 per cent. up to a maximum of (latterly) £20,000 per person, and thereafter 1 per cent. Currently, savings deposits at Barclays and Standard earn 2 per cent., while the Post Office Savings Bank, Volkskas and the Netherlands Bank pay 2½ per cent. On demand deposits, no interest is payable. Charges are made for the remittance of cheques except within certain municipal areas. Charges are normally $\frac{1}{16}$ per cent. within 'special areas' such as the Rand and the area around Cape Town, and ⅛ per cent. on amounts less than £5,000 outside these areas. Some bankers charge double the normal scales in some cases, especially in country districts and on small cheques. Further charges are made for other services such as issuing travellers' cheques, handling bond coupons, safe deposits, and contract guarantees. It seems improbable that charges can cover the costs attributable to small accounts.

Advances are made by way of overdrafts; where government securities are deposited as collateral, up to 90 per cent. of their value will normally be advanced. As for mining and industrial securities, the banks grade these for their own purposes into three groups. Firstly there are tested dividend payers, on which 50 per cent. will usually be advanced; secondly, sound securities which are not necessarily reliable dividend payers, which are good for advances of up to 33 per cent.; and, finally, speculative securities which are only acceptable as make-weight to add to more reliable collateral. Although the margin requirements of the banks are high, with possibly unfortunate effects in times of slump, they are usually a salutary brake on speculation.

Minimum overdraft rates are agreed between the four larger banks which are members of the Clearing House. For 1950 the minimum charged was 5 per cent. per annum. This agreement (and similar agreements about minimum discount rates) is not as important as might appear, however, as the

majority of customers are not entitled to such rates, and on the other hand, advances against certain types of security are granted at lower rates. At least some of the banks grant advances against Union Government or approved municipal stocks at 4 per cent. by way of fixed loan and 4½ per cent. by overdraft, and advances to bodies such as municipalities are made at rates substantially below 5 per cent. It appears that with the Big Two, only about two-fifths of advances are granted at minimum rates.

The existence of this gentleman's agreement does not inhibit competition, either as to the rate charged or the amount of credit granted. Moreover there is plenty of room for competition in the provision of supplementary services such as trust and executor business, for which the larger banks have special departments. Competition for customers is increased by the fact that there are few towns with a branch of one of the Big Two which do not also have a branch of the other. In certain districts a branch of Volkskas is likely to be found as well. With one branch to every 3,000 Europeans in South Africa, it can be seen that banking services are liberally supplied.[1]

There certainly have been times when new branches were opened too freely. In the years 1921–6 over 270 branches of the Big Two were closed, often with heavy losses. Evidence before the Select Committee on the Banking Bill of 1942[2] suggested that one-third of the then existing branches were unprofitable, although on what basis this judgement was made it is difficult to see, since a large part of the benefit a bank derives from opening a new branch accrues as goodwill and extra business to its established branches. Even where a small town could clearly be satisfied with the branch of only one bank, rationalization would be difficult without very close co-operation between the Standard Bank and Barclays.[3]

[1] The Indian community makes extensive use of the banking system, but (apart from a certain amount of savings bank business) the banking habit is not developed among the natives.

[2] S.C. 8/42 q. 946.

[3] In 1950 the distribution of branches between the various banks was as follows: Barclays (D.C. & O.) 435; Standard 398; Volkskas 95; Netherlands Bank 40; Stellenbosch District Bank 2; Banque de l'Indochine 2; and the Bank of Athens 1.

Such co-operation would certainly bring to the fore the frequently expressed and usually exaggerated fears of the dangers involved in a high degree of banking concentration. The most serious danger is the possibility of the exclusion of new-comers. Frequently expressed are also the fears of inflationary expansion of credit which is easier when so many of the cheques drawn on one bank in a two-bank system return to the bank on which they were originally drawn. The third fear is that of excessive strength in relation to the State; a fear with little legal basis since 1933, when the Currency and Exchanges Act (s. 9) gave the Governor General power to 'make regulations in regard to any matter directly or indirectly relating to or affecting or having any bearing upon currency banking or exchanges',[1] and giving him the right to impose any penalties he wished. Not even a single monopolistic bank could withstand such legal power if a trial of strength should occur. Nevertheless, because of the undesirability on other grounds of a banking monopoly, the 1942 Banking Act included a clause forbidding the amalgamation of banking institutions without the consent of the Minister of Finance who must first satisfy himself that 'the transaction in question will not be detrimental to the public interest'.

IV

In accordance with the 1942 Act, detailed information relating to assets and liabilities has to be provided by banks to the Registrar of Banks in certain rigidly prescribed forms. For our purpose the most important is the *Quarterly Statement* of the commercial banks, of which a consolidated version is given below.[2] It provides for classification of liabilities and assets into those within the Union and those outside the Union. Our concern will be mainly with bank business within the Union.

Liabilities are classified into three groups; liabilities to the public, other liabilities, and contingent liabilities. Moreover,

[1] This power was used in Sept. 1949 temporarily to reduce the statutory minimum cash reserves of the banks held against demand liabilities from 10 per cent. to 7 per cent.

[2] For a detailed discussion see E. H. D. Arndt, 'The Union Banking Act, 1942', *South African Journal of Economics*, 1943, pp. 235–57.

liabilities in the Union are categorized in the returns into time liabilities and demand liabilities.[1]

Liabilities to the public consist of notes, deposits by the public, balances due to governments and banks and certain other small items. The Reserve Bank has a monopoly of note issue and so the commercial banks have no liabilities of notes in circulation within the Union. The biggest group of liabilities is that of deposits by the public, of which deposits payable on demand form the largest part. Time deposits[2] are much smaller. The proportion of time to demand deposits has fluctuated strongly in the last four decades; demand deposits have become relatively larger in the last twenty years.[3] In 1930–2 there were more time than demand deposits; the great change since then has been connected with recovery from depression, falling interest rates, and with the growth of building societies, the Post Office Savings Bank, and similar institutions which pay higher rates of interest than the commercial banks.

The commercial banks usually vary the interest rates they offer on time deposits with changes in the Bank Rate. This in turn reflects changes in South Africa's balance of payments and so in the cash reserves of the commercial banks. They are encouraged to vary deposit interest rates by the different statutory reserve ratios for demand liabilities and time liabilities (those payable after thirty days). It is in the interest of the banks that funds be transferred to time deposits since most of these count as time liabilities) when cash reserves are running low. In October 1931 there was a speculative outflow of capital, and rates were raised in November, and again in January, when the six-month deposit rate was $4\frac{3}{4}$ per cent. When the speculative stream was reversed in 1933, the rate was dropped to $\frac{1}{2}$ per cent., where it remained until October 1949; it was then raised to 1 per cent.

[1] There is a possible source of confusion here. Time *liabilities* are those payable after thirty days; they therefore include that part of time *deposits* payable after thirty days, while demand *liabilities* include time *deposits* payable within thirty days as well as demand and savings bank *deposits*.

[2] Which before 1943 were known as fixed deposits and are still so described in the Reserve Bank's *Quarterly Bulletin of Statistics*.

[3] The later war years were an exception; the ratio of time to demand deposits climbed to 16 per cent. in 1945, as a result of suppressed inflation and also the growth of Volkskas, which has a very high proportion of time deposits.

The different banks have markedly differing ratios of time to demand deposits. The Big Two who hold the accounts of the mining houses and other large concerns have a much smaller proportion of time deposits than Volkskas and the Stellenbosch; the Netherlands Bank is in an intermediate position.[1] The proportion of savings bank deposits also varies considerably from bank to bank. Volkskas has a bigger proportion of this business than any other bank. Savings bank deposits rank as demand liabilities and so there is not the same incentive to vary the rate of interest offered when the banks' reserve ratios change as there is to change the rate on time deposits.

Government deposits[2] have not been of much importance since 1927, when the Union Government accounts were transferred to the Reserve Bank from Standard and Barclays. 'Balances due to other Banks' is the next item, which is split between balances due to commercial banks registered with the Registrar of Banks and those due to foreign banks. A figure against the next item, 'Balance due to the South African Reserve Bank' would reveal borrowing from the Reserve Bank other than by rediscounting. The remaining items are quantitatively small. They are Bills Payable, Acceptances on Behalf of Customers, and Mortgages, &c., on Bank Property.

'Other liabilities' are liabilities other than claims payable by the bank. Most important here is paid-up capital and unimpaired reserve funds (the latter excludes secret reserves). The Banking Act requires that the commercial banks' capital resources in the Union must exceed an absolute minimum of £50,000 plus £5,000 for each branch in the Union in excess of five or 10 per cent. of its liabilities to the public in the Union, whichever of these sums is the greater. The absolute minimum requirement seems to be imposed for reasons of prestige and the confidence it creates. The 10 per cent. proportion can be modified by certain subtractions and the 1947 Act extended those which are permissible. For this purpose, the banks can now consider total liabilities to the public *minus*

[1] The percentage of demand to total deposits is much the same for the Netherlands Bank as for the Big Two, but the Netherlands Bank has few savings deposits, which tends to emphasize the time deposit percentage.

[2] 'Balances due to the Government' in the *Quarterly Statements*.

all balances held with the Reserve Bank and the value of all Reserve Bank notes held, together with the value of unencumbered government stocks and of Union Treasury Bills. The extension by the 1947 Act of permissible subtractions was introduced because the larger banks could only have complied with the stricter regulations of the 1942 Act by transferring large sums from their secret reserves. The published position of the smaller banks, as represented by the ratio of capital and reserves to liabilities, is relatively stronger than that of the Big Two, but the large banks probably have stronger hidden reserves. Exactly how large these reserves are it is impossible to say, but their existence is one of the reasons, and certainly a justification, for the marked decline in the ratio of capital resources to liabilities in the last forty years. The elimination of note liabilities, the rediscount facilities provided by the Reserve Bank, and an increase in the liquidity of commercial bank assets are also contributory factors.

Turning to the assets side of the commercial banks' balance-sheet, there are three main groups of asset, namely, cash, discounts, loans and advances, and investments. The most important item in the group 'cash reserves' is 'Balances with the Reserve Bank'. The 1920 Currency and Banking Act required that reserves of 13 per cent. should be held at the Reserve Bank against demand liabilities and 3 per cent. against time liabilities; the amending Act of 1923 reduced the former requirement to 10 per cent. and these requirements were embodied in the 1942 Banking Act. When the National Finance Corporation was coming into operation it was feared that transfer of funds to it would temporarily drain the balances of the Commercial Banks at the Reserve Bank, and the minimum demand liability ratio was reduced to 7 per cent. by executive order of the Government. The expected effect was soon offset by the operations of the Corporation and the effects of sterling devaluation, and in March 1950 the order was withdrawn and the 10 per cent. minimum restored.

Distinct from the Reserve Ratio which relates only to reserves at the Reserve Bank is the Cash Ratio which is given in the Commercial bank monthly returns and which also takes account of subsidiary coin, gold coin, and bullion, South African Reserve Bank notes, and, since 1949, balances with the

National Finance Corporation. The most remarkable movements in the cash reserve ratio were those between 1932 and 1933 and the sharp fluctuations in the forties; the significance of these fluctuations is discussed in the next chapter.

Since 1942 there has been a second legal requirement. The commercial banks must maintain liquid assets equal to not less than 30 per cent. of their liabilities to the public in the Union. This ratio has been maintained well in excess of the minimum and stood at 66·2 per cent. at the end of 1950. Liquid assets include Union Government stocks, stocks of certain public utilities and local authorities quoted on a Stock Exchange in the Union, stocks approved by the Registrar of Banks for the purpose, Union Treasury Bills, bills and other paper eligible for discount with the Reserve Bank, credit balances at the Reserve Bank and registered commercial banks and building societies, notes of the South African Reserve Bank, gold coin and bullion and subsidiary coin, and, since 1949, credit balances with the National Finance Corporation. 'Liquid assets' therefore include the more liquid parts of the other two main groups of commercial bank assets, as well as cash reserves. These other main groups are, firstly, discounts, loans, and advances and secondly, investments. Within the group of discounts, loans, and advances, the items 'Bills Discounted', 'Bills Purchased', and 'Bills Receivable' are small in relation to 'Loans and Advances'. Broadly, 'Bills Discounted' gives some idea of the use of bills in financing local trade, 'Bills Purchased' mainly relates to export bills, and 'Bills Receivable' mainly to import bills. In years of active import trade, the last item has reached considerable magnitudes, and it is the most important of the categories of bills business transacted by the commercial banks. Unlike the other two categories, however, 'Bills Purchased' gives little idea of the amount of these bills outstanding because of the practice of debiting these items weekly and at month ends to the accounts of overseas offices and correspondents.

The great majority of loans and advances are made to the public, and the item 'Advances to Governments' is very small. A substantial majority of loans and advances is classified as secured, and the security in the majority of cases is either in the form of stocks and debentures or mortgages over fixed

property. Fixed property mortgages have been very common. Although such loans are not necessarily used to purchase fixed property, there is a danger of illiquidity attached to them. Advances are made by overdrafts which are nominally repayable on demand, but have frequently been made for all purposes, long as well as short term. Plumptre states that 'the chief banks seem willing to devote amounts equal to their capital reserve funds and a proportion of their savings deposits to loans which might properly be considered long term'.[1] He adds, however, that the provision of an increasing amount of long-term accommodation is passing into other hands which can more safely undertake such commitments, and it appears that this tendency has continued in the last decade. The general view of bankers today is that although some customers rely too much on bank advances, the proportion of 'sticky' advances would, on examination, prove to be very small.

The proportion of discounts, loans, and advances to total liabilities to the public in the Union has tended to vary directly with the level of prosperity; the exception to this rule being in periods of war, especially 1939–45. From 69 per cent. at the end of 1918 the ratio rose to 80 per cent. at the end of 1920, and then fell to 62 per cent. in 1923 with the contraction of credit accompanying trade depression. At the end of 1929 the ratio reached 84 per cent. to be followed by a sharp contraction to 73 per cent. at the end of 1932. The sharp decline to 46 per cent. in the following twelve months is the counterpart of the substantial rise in bank cash in this period, as a result of repatriation of capital; subsequently there were fluctuations between 53 and 63 per cent. up to the beginning of the war. Commercial bank loans were an unimportant element in war finance, and as a result there was an absolute decline in discounts, loans, and advances to the middle of 1943, when the total of £36 millions was the lowest level reached since 1915. The total quantity of lending then expanded, but the percentage ratio continued to fall and was only 15 per cent. at the end of 1945. Reviving oversea trade and private activity led to a recovery in the following three years to 41

[1] Plumptre, *Central Banking in the British Dominions* (Toronto, 1939), pp. 45–46.

per cent. at the end of 1948. A subsequent sharp decline in Bills Receivable and a considerable decrease in Bills discounted and advances in the second half of 1949 led to a fall in the discounts, loans, and advances ratio to 38 per cent.; the year-end figure for 1950 was also about this level.

The *Quarterly Statements* give very considerable detail about banks' holdings of investments, but of the ten categories given only two are important, namely, local Union Government Stock and Union Treasury Bills. The investments ratio has shown a steady secular expansion since 1920, when it was 4 per cent. Early in the war it rose sharply from 17 per cent. at the end of 1939 to 33 per cent. at the end of 1941; then it declined to 26 per cent. at the end of 1945, around which figure it remained until the middle of 1948. Subsequently, a sharp expansion in Treasury Bill holdings from 1 to 1½ per cent. of total liabilities in 1946–7 to 11 per cent. at the end of 1949 led to an increase in the investments ratio to 37 per cent. at the end of 1949; at the end of 1950 the percentage was the same.

It can be seen, then, that the South African commercial banks hold similar types of assets to those held by commercial banks in other Commonwealth countries, with a higher percentage of the more liquid assets than in most cases. South Africa shows the tendency which has been the general experience this century for growing importance of government securities as assets, while since 1930 a secular decline in the quantitative importance of bank advances has been experienced.

II

THE SOUTH AFRICAN RESERVE BANK

THE South African Reserve Bank came into existence in 1920, towards the end of the period of monetary confusion associated with the war. During the First World War South Africa remained nominally on the gold standard, but its operation was ineffective as a result of an embargo on gold export. There were steady leakages past the embargo, and the continued convertibility of South African notes involved South African banks in considerable gold losses and large expenses in connexion with gold replacement. A Select Committee was appointed to consider the embargo and the desirability of modifying the statutory provisions in force in regard to currency and banking. The continuance of the embargo was recommended, together with the discontinuance of convertibility of paper into coin. (Instead, notes were to be convertible into fully backed gold certificates which were only to be temporarily inconvertible.) Finally, and of most permanent importance, the creation of a central bank was recommended. It was to assume the note-issuing powers of the commercial banks and to issue bank-notes against a 40 per cent. gold reserve. The main reason for the inclusion of this recommendation to form a central bank was the strong support of Sir Henry Strakosch, although there had been considerable discussion of the matter during 1919. The note-issuing powers of the commercial banks had been strongly criticized, while the decision was also influenced by dissatisfaction with the credit policy of the commercial banks and by the drain of gold from the country. The commercial banks received the scheme with some disfavour, although some individual bank officers showed an enlightened view, realizing the importance of preparation for difficulties which might still be distant.[1] The his-

[1] e.g. from the Standard Bank, Gibson, Qu. 1505A, Select Committee on the Gold Embargo; Robertson, *Journal of the Institute of Bankers in S.A.*, 1921, pp. 85–107. The views of certain members of the National Bank (e.g. Judson) were also favourable to the foundation of a central bank.

tory of the central banks created in the last forty years suggests that a new central bank may well take some time to find its feet and effectively develop its functions, and that the early years in which a central bank may have little direct influence on policy may be valuable in that the institution is becoming accepted and is learning where and where not its influence can be exerted.

The Currency and Banking Act of 1920 carried out the recommendations of the Select Committee. The original draft of the parts of the Act concerned with the Reserve Bank was based on the constitutions of the Bank of Java and the Bank of the Netherlands; revision led to closer approximation to the American Federal Reserve System. The Dutch models were more closely followed with regard to the types of business permitted to the bank; in particular the Bank was permitted to carry out commercial business directly with the public; while American influence was chiefly to be seen in the reserve requirements for the commercial banks.[1] The effective powers of the Reserve Bank in its early days were 'extremely limited',[2] especially with regard to internal business. The traditions of central banking in older countries with developed money markets severely limited the Bank's powers.

The original Act of 1920 required the commercial banks to subscribe to Reserve Bank stock and gave nominees of the commercial banks three of the eleven directorships. By an amending Act of 1923 these provisions were removed, it being realized that such requirements would make it difficult for the Reserve Bank to display authority over the commercial banks; moreover, it was found difficult to discuss matters such as discounts and advances when the Bank's customers were present, and there was fear of a feeling that the Bank was no more than an organ of the commercial banks. The present constitutional structure remains fundamentally as it was in 1923; a majority of the Directors is elected by the shareholders while a minority, including the Governor and the Deputy-Governor, is appointed by the Government. The 1944 Consolidating Act deprived stock in excess of £5,000 in the hands

[1] Kemmerer-Vissering Report, questions 4384–5.

[2] Cf. the evidence of the Governor, Kemmerer-Vissering Report, question 3217.

of one person of voting rights, and prevented further individual holdings of more than £5,000 from developing. The 1920 Act provided for a 6 per cent. cumulative dividend and for the remainder of profits to be allocated to the reserve fund until it amounted to 25 per cent. of the paid-up capital. When that point had been reached profits were allocated in determined proportions to the reserve fund, the Government, and the stockholders (who were not to receive a dividend of more than 10 per cent. until the reserve fund equalled the paid-up capital, after which all above a 10 per cent. dividend was to go to the Government). The 1944 Act provided that, when the reserve fund exceeds the paid-up capital, one-tenth of the surplus after a 10 per cent. dividend should augment the reserve fund and nine-tenths go to the Government.

The 1920 Act gave the Reserve Bank the sole right of note-issue; notes were convertible on demand into gold certificates (which were issued by the Treasury and were themselves *not* convertible into gold while gold stood at a premium). There was a statutory reserve requirement of 40 per cent. of the Reserve Bank's notes, deposits, and bills payable. One fifth of the reserve against deposits and bills payable could be in silver coin; all the rest was to be in gold. Since 1944 all the statutory reserve has had to be in gold. The 1933 Currency and Exchanges Act reduced the statutory percentage to 30.

By the 1948 amendment to the Reserve Bank Act the minimum legal reserve ratio was reduced to 25 per cent., and since 12 October 1948 the ratio has been calculated after deducting from the Bank's liabilities to the public an amount equal to its foreign assets. The immediate reason for this dispensation was the gold loan of £80 millions to the United Kingdom and the heavy loss of the Reserve Bank's holdings of gold and foreign exchange in 1948 as a result of heavy imports and the decline in capital flows to the Union. Under the original Act the reserve requirements could be suspended with Treasury approval if a graduated tax were paid on the short-fall in the reserve against the note-issue; this tax was removed in 1933. In December 1932 the Bank was relieved of the obligation to convert into gold, and its notes became full legal tender for all purposes. The 1944 Act reimposed the obligation to convert notes into gold but allowed for suspension of this requirement

by proclamation of the Governor General; this power of suspension was in fact immediately exercised.

The 1920 Act also imposed reserve requirements on the commercial banks: originally they had to hold 13 per cent. of their demand liabilities and 3 per cent. of their time liabilities as deposits at the Reserve Bank; the 1923 Act reduced the former percentage to 10 and in 1949, when the National Finance Corporation came into existence, the percentage was reduced to 7; the percentage required was once again raised to 10 in 1950.

The original powers of the Reserve Bank to make loans and advances were narrowly limited; under the 1920 Act advances could be made against the security of:

(*a*) stock, debentures, or bills with less than six months to run of the Union Government or local authorities in the Union;
(*b*) gold coin or bullion;
(*c*) such notes, drafts, bills, and bankers' acceptances as the Bank was allowed to purchase.

Under the original Act the Bank was forbidden to make unsecured loans or to advance money against fixed property or upon the security of any bank. In 1930 were added:

(*a*) certain non-speculative securities having a ready sale on the Stock Exchange;
(*b*) one name promissory notes of a South African bank with a maturity of not more than fifteen days;
(*c*) one name bills secured by title to staple commodities with extensive and active markets, to an amount not exceeding 75 per cent. of the current market price.

The 1944 Act makes no restrictions about loans and advances except that advances and loans solely on the mortgage of fixed property are forbidden, and unsecured loans are forbidden except to the Union Government.

The original Act permitted the Bank only to discount and to invest in certain highly liquid assets. The supply of such assets available in South Africa was very limited.

The 1920 Act provided that the Bank should publish rates at which it would discount the various classes of bills, and

permitted it to buy, sell, and rediscount bills of exchange and promissory notes,

(*a*) with two or more good commercial signatures and not more than ninety days' maturity;
(*b*) with two or more good signatures and drawn for agricultural purposes and with maturity of not more than six months (these were not to exceed 20 per cent. of total discounts);
(*c*) with a bank's endorsement, issued and drawn for the purpose of carrying or trading in Union Government securities and with not more than ninety days' maturity.

In 1923 Union Treasury Bills and bills of local authorities in South Africa, having not more than six months to run, were added to the permitted list. In 1930 the maximum length of commercial bills was raised to 120 days, the 20 per cent. limit of agricultural bills was removed, as was the reference to bills drawn for trading in government securities. The 1944 Act no longer demands two or more good signatures.

The 1920 Act permitted the purchase without limit of Union and local government bonds and other paper with not more than six months to maturity, and allowed a sum not exceeding paid-up capital and reserve to be invested in securities with not more than two years to run of the Union or other governments. These restrictions were imposed through a desire to avoid a multiple increase of bank loans as a result of loans to the State which were not to be promptly repaid and to maintain maximum liquidity of the central bank. In 1930 the two-year limit to maturity was removed. The 1941 Finance Act allowed the Bank to invest in Union government securities an additional sum not exceeding one-third of its liabilities to the public. This relaxation was permitted in order to enable the Reserve Bank to purchase securities domiciled in London with a view to their repatriation and subsequent redemption by the South African Government. For a few months at the beginning of 1942 the holdings of government securities approached the maximum allowed by the 1941 Act. After the last large redemption operations in 1945 investments remained well below the permitted maximum until open market operations increased the Bank's investments.

The original Act permitted the bank to buy and sell precious metals and foreign exchange. In 1933 it was provided that profits or losses resulting from purchases or sales of exchange made in order to prevent the fluctuation of the exchange rate with London were to accrue to or be borne by the Government. Since the Finance Act of 1946 *all* profits and losses resulting from any gold or foreign exchange transactions have been for the Government's account.

II

The Reserve Bank publishes an Annual Balance-sheet relating to the position at 31 March each year. In addition, weekly and month-end statements are published. They both have the same form, but do not show all the items shown in the Annual Balance-sheet. A third source of statistics is the statement in the Bank's *Quarterly Bulletin* which provides a summary of the more important items.[1]

Attention has already been paid to the items 'Capital', 'Reserve', and 'Notes in Circulation' in the discussion of the development of the Bank's legal powers. 'Bankers' Reserve Accounts' are the minimum reserve balances which the commercial banks must maintain at the Reserve Bank, while 'Bankers' Current Accounts' represents their excess reserves. The item 'Foreign Currency Liabilities incurred as agents for the Union Government' arises out of loans made to the Union Government by groups of Swiss and American banks. The Bank acted as the Government's agent, and paid to the Govern-

[1] On the liabilities side, the main differences between the three sets of statements are in the items 'Reserve and Other Liabilities' of the Annual Balance-sheet. These items are not shown in the month-end statements in the *Quarterly Bulletin*, and there are considerable differences between the weekly and annual statements. The item 'Profit and Loss Account' is to be found in the Annual Statement but in neither of the others; 'Capital' does not appear in the *Quarterly Bulletin* statements. 'Notes of Other Banks in Circulation' (the still unredeemed parts of the issues of the commercial banks) appear as a separate item in the Annual Balance-sheet, as part of 'Other Liabilities' in the weekly statements, and as part of 'Notes in Circulation' in the *Quarterly Bulletin*. Similar complications are to be found on the assets side. 'Balances with Overseas Central Banks' appears with 'Other Assets' in the weekly statements, as does the item which appears in the *Annual Report* as 'Balances Employed under the Guarantee of the Bank of England', and in the monthly statements in the *Quarterly Bulletin* as 'Money at Call'. The different statements also give varying amounts of detail about the items 'Domestic Bill Discounts', 'Investments' ('Securities'), and 'Loans and Advances'.

Balance-sheet, 31 March 1951

	£SA	£SA
Capital		1,000,000
Reserve		2,419,578
Notes in Circulation		75,654,002
Deposits		
Bankers' Reserve A/Cs	36,572,289	
Bankers' Currents A/Cs	22,746,467	
Government and Provincial Current Accounts	53,552,781	
Other Accounts	3,439,308	
		116,310,845
Rebates on Bills not yet due		70,786
Foreign Currency Liabilities incurred as agents for the Union Government:		
U.S. Dollars	3,571,429	
Swiss Francs	2,993,033	
		6,564,462
Other Liabilities		3,376,613
Stockholders—Final Dividend		50,000
Government—Remainder of Surplus		758,822
		£SA 206,355,418

	£SA
Gold Coin and Bullion	72,704,051
Other coin	293,320
Balances with Overseas Banks	2,084,263
Balances employed under guarantee of the Bank of England	1,950,000
Foreign Bills	95,077,227
Domestic Bills Discounted	1,281,663
Loans and Advances	5,809,938
Government Securities	18,750,404
Other Securities	225,074
Furniture and Fittings	1
Fixed Property	1
Other Assets	8,179,476
	£SA 206,355,418

ment the equivalent in South African currency of the proceeds of the loans. In return for taking over liability to the Swiss and American banks the Reserve Bank received special stock certificates from the Government for the amounts concerned, with maturities and interest rates corresponding to those laid down in the agreements with the foreign banks concerned. The last two items on the Liabilities side represent Profit and Loss, and are allocated to the stockholders and the Government in accordance with rules laid down in the Acts.

On the Assets side, 'Balances Employed under Guarantee of the Bank of England' represent sums employed in the London market. This item, together with 'Balances with Overseas Banks' and 'Foreign Bills', represents the Reserve Bank's holdings of foreign exchange, of which a preponderent part was held in sterling. Of a total of over £99 millions, over £94 millions were held in sterling, over 4½ millions in U.S. dollars, and the rest in Canadian dollars and Swiss francs. The discounts of domestic bills represented temporary assistance to one of the commercial banks.

III

Having discussed the balance-sheet of the Reserve Bank and the development of its legal powers, we can now turn to investigate its effective powers and its operations. During the twenties, the Reserve Bank suffered from the frustration which has affected the early years of many central banks. To this were added the difficulties arising from the imitation of the American Federal Reserve System in a country where conditions were very different from America; where there were not thousands of banks but very few, and where there was no developed money market.

In its early years the new bank was severely restricted in the type of business it could do, especially as far as internal business was concerned, and its effective powers were limited. From the first it had a monopoly of note-issue; the volume of notes in circulation has shown a steady secular increase since 1921 which has only been interrupted three times. The first decline in volume, between 1924 and 1926, was associated with the return to the gold standard in May 1925 and mainly reflects the partial substitution of sovereigns for notes. A

second decline occurred between 1929 and 1932 and was associated with the depression. The most recent decline, which was even more slight than the other two, took place after the end of the war, between 1945 and 1947. The steady growth in the note circulation which has taken place throughout the rest of the life of the Reserve Bank has been much more marked than these minor declines. In particular, there was rapid expansion from 1932 to 1945. At the end of 1931 there were £8·9 millions of notes in circulation; at the end of 1938 £19·3 millions, and at the end of 1945 £68·0 millions. By the end of 1950 £76·4 millions had been attained. The expansion of the thirties was partly associated with the withdrawal of gold currency after the departure from the gold standard at the end of 1932 but was mainly connected with the increasing prosperity of the country. The war-time expansion was more than threefold and was mainly connected with the war-time inflation; general war conditions and the position of suppressed inflation probably added to private willingness to hold notes rather than less liquid assets.

The Reserve Bank has usually held legal reserves considerably in excess of the required statutory minima. In 1927 the Governor was able to say that it was customary to hold 50 per cent. legal reserves against notes and deposits. In September 1931, when Britain left the gold standard and sterling stood at a 25 per cent. discount in relation to the South African pound, there was a speculative flight of funds from South Africa, as it was believed that the South African pound would soon be devalued to parity with sterling. The Reserve Bank, unlike the large commercial banks, was willing to make sterling available to the public for all purposes, including this capital flight, and at the end of October the Bank's holdings of foreign exchange were only £400,000, while its gold reserve was only 43½ per cent. of its liabilities to the public, and so its reserve was dangerously near to the legal minimum. The Reserve Bank viewed the position with alarm and eventually persuaded Standard and Barclays to contribute sterling to an exchange pool. This meant that the commercial banks came to accept an uncovered position *outside* South Africa. Confidence (which probably had little foundation) in South Africa's ability to maintain the gold standard gradually developed, and towards

the end of 1932 the Reserve Bank was able to offer the Imperial banks considerable amounts of sterling to restore their London funds. The Reserve Bank sold practically all the sterling it had acquired up to the end of 1932 and made large profits on the transactions; it was able to recover with ease from the losses it had suffered in 1931 as the result of the depreciation of its holdings of sterling assets. By the end of 1932 the legal reserve ratio had recovered to 57 per cent. At the same time, in December 1932, a political crisis led to the abandonment of the gold standard; the Reserve Bank withdrew from the Exchange Market, and the South African pound returned to parity with sterling. This led to a large increase in the holdings of sterling by the Reserve Bank, while the reserve ratio fell to an average for 1933 of 39 per cent. In late 1934 and early 1935 the Bank's gold holdings were expanded at the expense of its foreign exchange holdings, the official reason given being the need for a strong position in conditions of uncertainty. From then until 1941 the reserve ratio continued at about 55–60 per cent. After mid-1941 large sales of gold were made to Britain, the proceeds being used for debt repatriation. Up to 1943 the Reserve Bank tended to accumulate gold as a result of the favourable balance of payments; in the last years of the war, sterling was accumulated instead of gold as agreements were made to sell to the Bank of England. By the end of 1945 the effect was that the reserve ratio was down to 41 per cent. In June 1946 the arrangement was ended by which the item 'Gold Coin and Bullion' (by now the whole of legal reserves) was valued at the old statutory price of £4. 4*s*. 11*d*. per fine ounce, while an item 'Gold Premium' in the Reserve Bank balance-sheet represented the difference between this value and the amount actually paid by the Reserve Bank. The Bank's gold holdings were revalued at the new statutory price of £8. 12*s*. 0*d*. per fine ounce, and the item gold coin and bullion came to reflect this new value. This was the greater part of the cause of the sharp rise in the reserve ratio to 91 per cent. at the end of 1946. The ratio declined through 1947 to 74 per cent., then in 1948 an extremely sharp decline took place. The gold loan to the United Kingdom reduced the Bank's gold holdings by £80 millions; within a week the reserve ratio fell from 74 per cent. to 43 per cent. The Loan Agreement provided that the Union

Government could demand repayment of the loan in sterling if the Reserve Bank's gold holdings fell below £100 millions. Immediately after the transfer, the gold reserve was in excess of this figure, but it continued to fall. As the ratio was approaching the 30 per cent. legal minimum, the authorities were becoming alarmed about the situation. In March restrictions were introduced which broadly limited the conversion of sterling into South African pounds to current transactions and to purchase of South African securities or genuine capital investment in South Africa. These exchange restrictions were designed to limit the flow of hot money from Britain to South Africa. This flow in fact stopped sharply with the accession of the Malan Government in May and precipitated the balance of payments crisis which had so far been masked by heavy capital imports.

Heavy imports of goods, especially from the dollar area, caused a continuation of the decline in gold holdings during 1948; the new Government sought to avoid import restrictions, and in October reduced the legal minimum reserve ratio so that the gold reserve could continue to be used to cover the dollar gap. Moreover, the basis of calculation of the legal ratio was relaxed, as we have seen. The Government was compelled in November, however, to introduce import restrictions, which prohibited the importation of certain goods, whatever the source, and which rationed foreign exchange for hard currency imports. Nearly all non-sterling area imports came into this category. The main intention of these restrictions was to reduce dollar expenditure; their effect was to cause a rapid shift to importing sterling area goods. Shortly before the November restrictions, gold losses had been taking place at a rate of nearly £9 millions a month, while sterling was being used up at a rate of £5½ millions. In the following three months gold losses fell to £3 millions a month, while sterling losses increased to a monthly rate of £10 millions. In March 1949 South Africa was compelled to draw sterling against the United Kingdom gold loan, and by September the whole of the £80 millions had been repaid in sterling.

Continuing difficulties made more drastic measures necessary. An announcement was made in March of the decision to sell semi-manufactured gold at a premium over the monetary

price; this caused a dispute with the International Monetary Fund.[1] In May announcements were made about drastic import controls which were to operate from 1 July 1949. At the outset, no permits were to be issued for consumers' goods, and essential raw material imports were to be cut by 50 per cent. if from sterling sources and by 67 per cent. if from other sources.

Throughout the first eight months of 1949 there was widespread and intent discussion in South Africa of the need for a change in the world price of gold. Although South African government policy was far from blameless, one of the strongest reasons for the balance of payments difficulties was the adverse shift in South Africa's balance of payments resulting from the rise in world commodity prices in terms of gold since 1939. The devaluation of the pound sterling in September 1949 gave South Africa opportunity to improve its position in this respect. The decision was immediately taken to devalue the South African pound by the same amount as sterling. The *home* price of gold rose, and so the terms of trade with countries which devalued tended to improve; but the hopes that the *dollar* price of gold would be raised were not to be fulfilled. The terms of trade between gold (and for that matter several other important South African exports, whose prices tended to remain steady in terms of dollars after devaluation) and dollar goods remained unchanged. Mr. Havenga, the Finance Minister, gave as his reasons for his decision to devalue the distortion of the economy resulting from the low price of gold, and the close financial, commercial, and Stock Exchange links between South Africa and the United Kingdom.

A great deal has been written in the last few years about these links with London and the nature of South Africa's relationships with the sterling area. Up to the end of 1947 South African gold was an important contribution to the gold and hard currency pool of the sterling area. In the period between the conclusion of the gold loan and devaluation, economic relationships between the two countries showed a marked deterioration, which reflected the changed relationships the gold loan

[1] Although the deteriorating exchange position was one reason for the decision to make gold sales at a premium, it was not the most important one. The principal reason was the need to help gold producers face steadily rising costs.

brought about between South Africa and the rest of the sterling area. The Financial Agreement involved a further withdrawal of South Africa from the sterling area, since she became still more divorced from the area's dollar pool. On the other hand, she continued to benefit from the freedom of transactions within the area. The theoretical importance of this depends on whether or not the hard currency pool is regarded as the fundamental feature of the post-1939 sterling area; the practical importance in giving South Africa the best of two worlds is unquestionable. The disadvantages to Britain of a heavy flow of capital to what had in effect become a hard currency country were serious and provided the background to the brusque refusal in early 1949 to allow South African municipalities to borrow in London.

Devaluation, by raising the prices in South African pounds of dollar products in relation to those of sterling products, helped to solve some of South Africa's problems. The foreign exchange reserves of the Reserve Bank started to improve even more rapidly after September than they had been deteriorating earlier in the year. The reasons were the tight and effective import controls which had come into force, the effects of devaluation, and the renewal of capital flows from Britain, partly as a result of a renewal of confidence in the South African Government's ability effectively to fight inflation and to control the balance of payments, and partly because of improved investment opportunities. In mid-October evidence of the ability to control inflation was given by the raising of the Reserve Bank discount rate from 3 to 3½ per cent., and a corresponding hardening of other short rates. The renewal of the capital inflow was also attributed to the release of funds which had been awaiting transfer until the position about devaluation had been decided; some of these funds were for investment in secondary industry, and others were to take advantage of the improved prospects of the gold industry. The result of these forces was that the Reserve Bank's gold and foreign exchange reserves rose from a low point of £52,200,000 on 16 September 1949 to £104,300,000 at the end of December. Part of this increase was caused by revaluation of gold holdings from the old statutory price of 172*s.* per fine ounce to the new level of 248*s.*, which took effect from 31 December 1949. The actual physical

quantity of gold held did not increase greatly; it was valued at £29·7 millions at the end of September and £45·4 millions at the end of December. Foreign exchange balances (predominately sterling) rose over the same period from £22·9 millions to £58·9 millions.

The Government did not give way to the temptation of this startling improvement in the situation to allow excessive relaxation of import controls; the lesson had been learnt that the country had to attempt to live within its means. From the point of view of South Africa, devaluation provided the opportunity for a remarkable recovery from the extremely unpleasant situation which had developed in mid-1949.

What of South Africa's relationships with the sterling area, which had deteriorated so seriously in the two years before devaluation? The immediate effect of devaluation was to cause a renewal of the capital outflow from England which has been seen to be the major disadvantage to Britain of the 1947–9 arrangements. The change in the relative prices of sterling and dollar goods provided, however, an incentive to South Africa to come to new arrangements about payments between Britain and the Union. The new agreement of January 1950 provided that South Africa should pay in gold for all 'essential' imports, whether they come from the dollar or sterling areas. The intention was that in the market for these goods 'universal' import licences should ensure free competition between dollar and sterling area suppliers. Other imports could be paid for in future only in sterling or other soft currencies. Mr. Havenga estimated that Britain would secure between a quarter and a half of the Union's gold output as a result of this agreement. In return, the danger that the London capital market might be restricted for the goldmining industry was removed. The traditions of South Africa raising capital freely in London and of South African gold being sold to Britain for sterling were both restored.

Gold and foreign exchange reserves continued to improve through 1950 (though at a decreasing rate), mainly as a result of continued capital inflow. At the end of April reserves exceeded £140 millions, at the end of June £153 millions; there was a slight decline in the third quarter, but in December £165 millions were held, of which nearly £70 millions were in

gold. This improvement allowed appreciable relaxations of import controls during 1950, and in February 1951 substantial relaxations were allowed.

IV

In the first years of its activities the Reserve Bank was not used by the Government as a depository for its funds. The Kemmerer-Vissering Report recommended that the Government 'should look forward to the time when it will use the Reserve Bank as the chief depository of Government funds', pointing out that the Government's loss of interest on its deposits at the commercial banks would be counter-balanced by the increased returns it would receive from its participation in the profits of the Reserve Bank. In the beginning of 1927 the chief government accounts were transferred from Barclays and Standard. The Government agreed to maintain a minimum credit balance of £750,000 in return for which the Bank handled the government accounts free of charge. This agreement was very valuable to the Bank, at the time, increasing both its resources and its prestige. The Bank acts as a general financial agent for the Government; for example, it took a central part in the debt redemption operations of the war years; moreover, it acts as an important financial adviser to the Government. Co-operation between the Treasury and the Bank is very close. It is generally believed that in 1932 the Bank gave advice that South Africa should not leave the gold standard; usually, of course, nothing is known publicly of the nature of the advice given to the Government.

V

A fundamental duty of a central bank is to help create and carry out the financial policy of the Government, and in particular to exercise control over the commercial banks in such a way that this duty can effectively be fulfilled. In its early years the Reserve Bank of South Africa was in an extremely weak position and was regarded with some hostility and disdain by the commercial banks. Gradually it has been able to build up a position of authority, and it is with this development that we must now be concerned.

The efficiency of the traditional methods of control, through

discount-rate policy and open market operations, depends very greatly on the nature of the money and capital markets. The absence of a bill market, the narrowness of the gilt-edged market, and the extensive oversea connexions of the Johannesburg Stock Exchange and of the mining and financial houses have all tended to make traditional methods of control difficult to operate. These difficulties were enhanced by the severe limitations, imposed by the original Act, on the Bank's powers to purchase and sell securities, to discount bills, and to make advances. These rigid limitations on the Bank's business until the 1930 amendments made it essential that every attempt should be made to create a bill market; the models of the Bank's constitution may have been Dutch and American, but the traditions behind its early operations were English. Discount rate could be effective only if a market existed in which the Bank could provide discounts. But all attempts to create a bill market were unsuccessful. Despite the offer of considerable pecuniary advantages in relation to overdrafts, no real market in commercial bills developed.

Within the last two years, another attempt has been made to promote an active short-term money market in South Africa. This development, the foundation of the National Finance Corporation, is an important one,[1] but it has not yet had any important influence on the techniques of central bank control, though it has certainly made control easier.

The fact of the absence of an active bill market does not mean that in the twenties the Reserve Bank never rediscounted bills for the commercial banks. In the National Bank's period of difficulty between 1922 and 1924 a considerable amount of aid was given chiefly by rediscounting commercial bills. Again, in the months immediately following Britain's departure from the gold standard, discounts of commercial and Treasury Bills increased sharply. Nor was this assistance exceptional except in scale; in the twenties small and occasional rediscounts for the commercial banks had become a common feature of the Reserve Bank's work, especially at month-ends when the cash shortage of the commercial banks tended to be particularly acute.

In 1922–3 the Reserve Bank succeeded in reducing the over-

[1] For some account of this Corporation see pp. 393–9 below.

draft and discount rates of the commercial banks. Nevertheless, the acceptance by the Bank of its duty as lender of last resort was not usually accompanied before 1929 by any close attention by the commercial banks to changes in the Reserve Bank's discount rate.

Since 1929, however, the commercial banks have come to change their overdraft and deposit rates when the Reserve Bank changed its discount rate. The absolute size of the margins between the rates has tended to be larger since the sharp decline in all three rates in 1931–2. In the absence of a bill market through which it would operate, how has the Reserve Bank been able to exercise this degree of authority? The Kemmerer-Vissering Report argued that a Reserve Bank in a country such as South Africa could not operate effectively if it acted almost exclusively as a bankers' bank. It was necessary that it should be able to operate more actively in the open market by lending to the banks and the public on bills and notes secured by warehouse receipts, by lending to banks against collateral of gilt-edged, by investing a limited amount in government and municipal securities with a maturity of over six months and by extending the maximum usance of commercial paper discounts to 120 days. In order to increase the power of the Bank to operate in the open market, the Commission recommended that branches should be opened in the main cities, so that direct discounting business could be done with the public. Five branches were opened by the end of 1926, but the Reserve Bank suffered a serious loss when it entered the commercial field, and direct discounts to the public never became important quantitatively. The commercial banks were annoyed at first by the threat of competition by the Reserve Bank, but when they came to realize how modest the competition would be, they ceased to complain. On the other hand, the degree of Reserve Bank control made possible by the change was very limited, because of the continuing lack of a bill market.

As we have seen, the greater part of the Kemmerer-Vissering recommendations were incorporated in the 1930 Act. To some extent open market operations were facilitated by the power to hold long-term securities. Nevertheless, this ability continues to be severely restricted by the absence of a broad

market in long-term securities. Moreover, the difficulty in control has increased since 1932 as a result of the very great excess cash reserves which the commercial banks accumulated. The Reserve Bank always suffered from the limitation that the banks' cash reserves were liable to vary, but at least before 1933 the free balances of the commercial banks were less than in subsequent years. The principal reasons for the changes in the commercial banks' deposits at the Reserve Bank and of their reserve ratio since 1932 have been changes in the balance of payments, which are reflected in the Reserve Bank's holdings of gold and foreign exchange.[1] If the Bank's gold and foreign exchange holding rises, because the Bank is buying more gold from the mines than it is selling gold and foreign exchange (net) to the commercial banks, bankers' deposits at the Reserve Bank rise correspondingly. If the commercial banks do not expand their loans (which they may well not do because the demand for reasonably liquid loans is rather inelastic) and if other things remain unchanged, the reserve ratio of the commercial banks will have risen.

In this way, the cash ratio of the commercial banks as a whole rose from 12·7 per cent. at the end of 1932 to 35·8 per cent. at the end of 1933; this sharp rise reflected the return of hot money after the South African pound left gold, and the import of large quantities of capital for mining development. The ratio declined in 1934 and 1936 as a result of debt redemptions and in 1937 as a result of heavy imports. At the end of 1937 the cash ratio was only 21·7 per cent. Subsequently there was a steady rise to the end of 1945, associated with the export surplus, heavy government expenditure, and the higher price of gold introduced at the beginning of the war. From February 1946 to June 1947 renewed imports of goods caused the cash ratio to decline from the 60 per cent. of the end of 1945 to 39 per cent. at the end of June 1947; speculative capital imports associated with the British convertibility crisis

[1] Since 1933 the commercial banks have tended to maintain a covered local position, and not to hold foreign exchange in excess of current needs; before 1931 the tendency was to hold less assets in the Union than there were liabilities. To the extent that the difference between local assets and liabilities might change, changes in the balance of payments would not be reflected in the Reserve Bank's holdings of gold and foreign exchange. Since 1942, as has been seen, a covered local position has been compulsory.

led to a reversal of the trend in the second half of 1947. This reversal was short-lived, however; the continuing import surplus and the reduction in the speculative flow led to a decline to 28·3 per cent. at the end of 1948. After devaluation the import surplus disappeared and then reappeared on a much smaller scale, while the capital inflow increased. Bank credit expanded after contracting in 1949. By the end of 1950 the ratio was 25·7 per cent.

It can be seen, then, that the large excess reserves which have been maintained by the commercial banks as a whole since 1933 mean that operations of the Reserve Bank which affect the quantity of bankers' deposits may have little direct effect on commercial bank lending. This does not mean that the minimum reserve requirements are useless. There is the important element of moral suasion, whose influence certainly exists although it is difficult to measure. The cash ratios of the smaller banks are generally much smaller than the ratios of the Big Two; the legal minima do in fact act as guides to the smaller banks. It is also possible for the legal minimum ratios to be altered, as was in fact done under the emergency powers of the 1933 Act in 1949. If such an alteration were in an upward direction, it might allow the Reserve Bank to regain a considerable measure of control over the expansion of bank credit.

VI

The base upon which the Reserve Bank has been able to build its greatest potentialities for controlling the commercial banks has been one which is peculiar to South Africa: the monopoly of the purchase of gold which the Reserve Bank acquired and the position the Bank consequently came to occupy in the foreign exchange market. The South African economy is extremely dependent on the goldmining industry and upon foreign trade, and it follows that an authority which can occupy a position of strong influence over the markets for gold and foreign exchange can, by that very fact, acquire a position of great power over the whole South African economy.

The South African Reserve Bank has always had the power to buy and sell gold; in this respect it is not unlike most other central banks. The actual exercise of this power has been

unusual, however. In 1925 the gold premium disappeared as sterling appreciated in terms of gold, and it became cheaper for the gold producers to sell gold to the Reserve Bank than to ship it to London. The Reserve Bank bought all the gold that was offered to it, and in the following year a voluntary agreement between the Reserve Bank and the Transvaal Chamber of Mines (which represented practically all the gold producers) was concluded, by which the Bank agreed to buy all the gold they produced. The intention of the Bank was to secure control over, although not a monopoly of, the exchange market. Before 1925 the Bank had not taken a large part in foreign exchange business, partly because of a tacit agreement which appears to have existed with the commercial banks not to compete actively until times were better, partly because of the risk of exchange losses in inconvertible currencies, but mainly because it was not the Bank's policy to do business with the public. After South Africa left the gold standard in December 1932 the formal agreement lapsed for a time (although in fact the Reserve Bank continued to buy all the gold). A new agreement was reached in May 1933; finally in 1939 Emergency Finance Regulations specified that all gold produced in South Africa should be sold to the Reserve Bank.

Under the arrangement developed after 1925 the Reserve Bank sold gold abroad, mainly in London, and acquired foreign exchange, mainly sterling. The Reserve Bank ceased to be primarily a purchaser of sterling and became a seller. South African pounds moved to a small discount with sterling, because the Reserve Bank had to cover the cost of sending the gold to London. The fundamental change in the position was that exchange policy ceased to be partly in the hands of the commercial banks and could no longer fall into the hands of the Chamber of Mines. If the mines had continued to sell gold in London, and if they had speculated on a rise in the price of gold (and depreciation of the South African pound) they might well have withheld sales of gold, created a balance of payments crisis, and probably have forced a depreciation. The strength of the Bank's hand with respect to exchange policy is to be seen in its difference of view from that of the commercial banks in the autumn of 1931; the Reserve Bank had obtained effective control over exchange rate policy. The power was

first seen in November 1925 when the Reserve Bank reduced its margin between buying and selling rates on London and was followed by the other banks.

After the departure from gold, the 1933 Currency and Exchanges Act authorized the Bank to operate an exchange stabilization fund, whose profits and losses accrued to the Government. The commercial banks needed much more foreign exchange (mainly sterling) than they could obtain from current commercial transactions; the only place where they could buy it was from the Reserve Bank, which acquired it through its monopoly of gold purchases. It was simple for the Reserve Bank to control the exchange rate with sterling (and so with other currencies) because the commercial banks could not charge less to their customers for sterling than the Reserve Bank charged them, and if the commercial banks charged too high a price to the public, then demand would leave the commercial banks and flow directly to the Reserve Banks. In fact it has never been necessary for the Reserve Bank to sell foreign exchange directly to the public on any appreciable scale. The Reserve Bank also has the weapon open to it of refusing to sell to a recalcitrant commercial bank, or of refusing to sell at the bankers' concession rate of $\frac{1}{8}$ per cent. below the published Reserve Bank selling rate. It has never exercised these powers, but they constitute a powerful and effective method of control which is probably not possessed by any other central bank.

VII

Qualitative control of credit has only been a recent development in South Africa, and has been associated with the balance of payments difficulties of the post-war years. At the annual meeting of the Reserve Bank in August 1947, the Governor expressed the opinion that a considerable amount of bank credit was involved in holding stocks of goods. Following this statement, a specific request was made to the commercial banks, at a special conference in October 1947, not to increase credit facilities for the purpose of financing imports of consumer goods. Late in 1948, as we have seen, import restrictions were imposed by the Government. In order to support these restrictions, and in order to counteract the inflationary pressure which would result as the supply of goods fell, the banks were

asked in December 1948 'as a matter of public policy' (to quote the Governor of the Reserve Bank) to 'contract credit facilities for non-productive purposes generally, and also to restrict advances in the case of the less essential and over-developed industries, with due regard to the obvious need for exercising discretion and avoiding unnecessary disturbances'.

VIII

Within the last two years, another attempt has been made to promote an active short-term money market within South Africa. Such promotion, with the intention of 'the utilisation of idle capital in the national economic interest',[1] was one of the three principal objects which it was hoped to gain by the creation in 1949 of the National Finance Corporation. The other two intentions were 'to facilitate the participation of foreign capital in the development of the resources of the Union', and 'to provide greater scope for co-operation and mutual consultation amongst the different classes of financial institution operating in the Union'. The Corporation was granted powers to accept deposits payable at call or after notice, and was to give preference to deposits by member institutions. Member institutions are building societies, commercial banks, insurance companies, the Reserve Bank, or other financial institutions which are holders of stock in the Corporation. The Corporation can also borrow by debentures, and can invest its funds in Union Treasury Bills and other Union government securities, in South African local authority and public utility securities, and in redeemable debentures of South African mining and industrial undertakings. Member institutions nominate directors, and the Governor General appoints directors representing member institutions 'with due regard to the value of the respective amounts of stock of the corporation held by the various institutions or classes of institutions and the desirability of ensuring that as far as possible all the various classes of institution will be represented'. The initial capital of £1,000,000 was over-subscribed and the Treasury made allocations which took account of the capital and

[1] Speech of the Minister of Finance introducing the second reading of the National Finance Corporation Bill. *House of Assembly Debates*, 23 May 1949. col. 6262.

net income of the various applicants. Mining houses were allocated £375,000, insurance companies £188,750, commercial banks £175,000, the Reserve Bank £100,000, building societies £100,000, and other financial institutions £61,250. Of the twelve Directors, one is a Treasury representative and the other eleven represent member institutions roughly in proportion to paid-up capital. Regard is paid to the desirability of having all classes of institution represented. Although the Reserve Bank has only one representative on the board, it has a predominant position in the operation of the Corporation; the Governor of the Reserve Bank, Dr. de Kock, was also appointed the first Chairman of the Corporation. In order to increase the liquidity of the Corporation's assets, the Reserve Bank is required[1] to discount Treasury Bills for the corporation at the rates at which they had been acquired by the Corporation or to purchase government, local authority, or public utility securities with not more than five years to run to maturity at current market prices, or make temporary advances to the Corporation against such securities at a rate not exceeding their current net yield to redemption.

It can be seen that the new Corporation has extensive powers, and that the purposes which these powers are intended to satisfy are even more extensive. The impression widely gained after the earlier statements by the Governor of the Reserve Bank was that the Corporation would borrow short and for the most part lend long. If a considerable part of the lending were to be for public utility and industrial development, the risks involved would obviously be great; the more so if an appreciable part of the short-term funds were to come from abroad and might rapidly be withdrawn. The original draft of the Bill did not provide any maximum limits to the duration to maturity of government securities that the Reserve Bank was required to purchase; the limitation to five years in the Act at least reduced the dangers of borrowing short and lending excessively long and throwing the burden on to the shoulders of the Reserve Bank. Moreover, the management of the Corporation is sufficient safeguard at present against excessive illiquidity. Nevertheless, the Act as it stands still leaves it open to the corporation to become excessively illiquid, with all the

[1] S. 4 of the National Finance Corporation Act, 1949.

dangers that involves. In as unstable an economy as that of South Africa, it is perhaps unwise to leave this uncovered by legal safeguards.

The powers of the corporation do, however, allow it to become something not unlike the London Discount Market, borrowing at call and short notice and holding bills and short-dated securities.[1] This was the type of operation emphasized by the Minister of Finance in introducing the Bill, and this has been in fact the position which has been more closely approximated to in the first year of operation of the Corporation. The great majority of the funds that have become available to the corporation have been invested in South African Treasury Bills. The reason for this decision was partly a transitory one, in that it was still uncertain how large a flow of funds would in fact be available to the Corporation over a period of time; but the reason was also partly a more permanent one, of caution and restraint. This more permanent reason has been behind the decision to acquire, initially, only government stocks, and primarily those with maturities of less than five years. Later in the first year of operations these self-enforced limitations were relaxed a little in favour of public utility securities with less than five years to maturity and government securities with less than seven years to run. At the end of the first year of operations, on 23 September 1950, the Corporation held total investments of £67,000,000 of which nearly £53,000,000 were Union Treasury Bills and practically all the rest were government securities of which far the greater part had less than five years to maturity. The Chairman's report on the first year's operations emphasized that, although 'further developments in the Corporation's investment policy can . . . be expected . . . the nature of the Corporation's deposits will always call for the greater part of its investments being of relatively short maturity'.

A major intention of the Corporation was to utilize idle capital in the national economic interest. At the time of the foundation of the Corporation, there was considerable scepticism about where exactly this idle capital lay. There are two facets to the idea that, before the Corporation existed, capital

[1] There is an important difference in that it does not always accept funds readily.

was not being used in the national economic interest. On the one hand, funds might be lying unused in South Africa; on the other, funds might be retained abroad by South African institutions because interest could be earned abroad. The facts that within a little over two months of starting operations, deposits had exceeded £43,000,000, and that by the end of the first financial year (June 1950) they were over £67,000,000 appear to support the view that there was in fact a large quantity of idle funds in existence. By the end of 1950 deposits nearly equalled £80,000,000. These deposits were all made by large institutions, since a minimum of £50,000 must be deposited or withdrawn at one time. All deposits in the first year of operations were at call, and initially $\frac{5}{8}$ per cent. was paid (compared with $\frac{3}{4}$ per cent. on six months' Treasury Bills). In October 1949, when this Treasury Bill rate was raised to 1 per cent. the call-money rate was raised to $\frac{7}{8}$ per cent., and the Corporation announced that it would accept deposits from non-member institutions, reserving the right to refuse deposits it could not employ profitably.

The nature of the deposits deserves further investigation. At the end of 1950 deposits at call totalled £78,900,000. Of this total, £15,750,000 was held by the commercial banks and the rest by other institutions. It is very doubtful, however, whether the remaining sum of well over £60 millions represents a fund of money which can permanently be expected to be available for investment by other institutions. The large size of the fund is undoubtedly connected with the rapid expansion of the gold-mining industry in the Orange Free State; much long-term capital has been raised for which employment has not immediately been available. It is rash to prophesy, but it seems likely that the Corporation will continue to be able to operate with a considerable quantity of deposits in the future; nevertheless it is quite possible that it cannot continue to rely on as large deposits as it has enjoyed so far.

The existence of the Corporation has made it easier for short-term funds to flow from one part of the South African economy to another. It appears likely that an active short-term money-market will be brought permanently into existence, and so will increase the efficiency of the allocation of resources by creating a tidy pattern of short-term interest

rates and by introducing greater flexibility into the financial structure. It has in turn been claimed by Dr. de Kock that the Corporation, by creating this flexibility, has helped the Reserve Bank in the performance of its functions. Although the creation of the Corporation has certainly increased the ability of the Reserve Bank to influence the financial community in general, and to increase the efficiency of the monetary system, it seems doubtful, in view of the way in which control over the commercial banks has been developed, whether much difference has been made to its powers of control over the commercial banks, which are in any case probably quite adequate.

Of the other two avowed intentions of the Corporation, little need be said. Closer co-operation between the different members of the financial community has no doubt been reached; the opinion of practising commercial bankers appears to be that as far as they are themselves concerned, there has not really been much difference made so far. As for the desire to attract foreign funds, nothing has yet been done. The improved balance of payments situation and the adequacy of the resources becoming available to the Corporation from within South Africa have together made it unnecessary to follow up this line. Perhaps it has also become more generally realized that South Africa has received plentiful capital from abroad, and that it is safer for the South African economy that such resources be received as long-term rather than as short-term loans. In the middle of 1949, when gold and foreign exchange reserves were very low, the Finance Minister expressed the hope that the Corporation would attract 'gilt-edged' foreign capital, which the Corporation could invest in mining and industry. If balance of payments difficulties recur it can be expected that this line of thought will be reopened. Moreover, the power to develop the Corporation in the direction of borrowing short and lending long still exists; whether that power will be used remains to be seen. At present, however, the Corporation is certainly doing valuable work in reducing the imperfections of the short-term market in South Africa.

More generally, we can conclude that South Africa has developed an effective and flexible system of central-bank control over the banking system of the country. In spite of initial uncertainties, a powerful system had come into existence by the

TABLE I. *South African Reserve Bank Liabilities and Assets*

(£SA thousands.) Figures for 31 December of each year

	LIABILITIES				ASSETS								
									Dom. bills discounted				
Year	*Notes in circulation*	*Bankers'*	*Deposits Govt.*	*Other*	*Gold coin and bullion*	*Gold premium*	*Foreign exchange*	*Subsidiary coin*	*Commercial*	*Treasury*	*Loans and advances*	*Investments*	*Total assets*
1921	—	6,520	—	—	4,746	—	—	—	—	—	2,200	600	7,666
1922	10,014	5,156	—	—	10,436	—	451	250	2,694	—	2,363	8	16,312
1923	11,359	4,868	—	2	10,652	—	3,248	100	2,856	35	513	17	17,508
1924	12,012	4,617	—	2	10,776	—	2,620	50	2,147	900	1,031	423	18,018
1925	9,367	5,891	—	196	8,015	—	6,847	50	124	1,340	—	530	17,056
1926	8,789	6,060	—	174	7,542	—	6,979	195	1,529	138	—	549	17,092
1927	9,565	4,838	2,759	162	8,226	—	8,386	194	954	116	189	574	19,742
1928	10,049	5,063	2,328	218	8,019	—	7,790	72	1,625	417	265	611	19,828
1929	9,875	4,898	1,174	560	7,506	—	6,867	79	1,370	1,826	324	596	19,507
1930	8,996	4,973	1,654	128	6,859	—	7,500	166	1,084	372	486	1,509	19,096
1931	8,949	4,267	1,277	529	8,104	—	41	405	2,885	803	2,226	1,133	18,461
1932	8,578	3,879	1,196	141	7,347	—	152	506	1,128	217	3,841	1,955	16,170
1933	12,076	26,598	1,073	3,096	17,144	4,015	18,926	346	7	—	2,200	1,726	45,413
1934	13,599	21,755	1,826	4,871	22,287	8,630	10,975	90	50	—	—	1,725	44,521
1935	14,855	27,890	2,057	4,441	25,723	11,042	12,012	75	332	—	—	1,726	52,696
1936	16,551	22,451	1,666	3,917	24,635	10,358	11,289	44	31	—	800	1,745	49,964
1937	18,228	16,933	1,478	5,063	22,937	9,276	7,338	128	281	—	3,537	1,725	46,448
1938	19,304	24,392	1,903	2,910	26,725	11,886	8,174	103	14	—	1,900	1,775	51,826
1939	20,940	23,721	4,623	4,637	29,749	14,824	8,869	109	6	30	182	2,551	57,466
1940	24,569	44,284	2,435	5,955	43,340	28,114	2,433	85	3	—	3,674	1,675	81,855
1941	30,236	49,533	15,616	7,359	44,465	29,217	2,020	251	—	—	—	28,134	101,117
1942	39,761	98,956	2,573	6,935	76,995	61,027	2,813	237	—	—	2,912	7,259	153,568
1943	51,175	124,923	5,379	6,329	85,625	69,466	14,950	254	—	—	1,470	18,949	193,137
1944	60,026	154,224	4,101	7,365	98,025	81,590	26,464	263	—	—	13,154	9,683	236,399
1945	68,031	184,565	11,773	6,255	110,909	94,900	60,982	263	—	—	3,610	2,689	275,293
1946	65,860	148,236	30,934	6,897	230,681	—	17,610	302	—	—	5,762	3,003	259,916
1947	65,789	168,715	9,687	10,950	187,117	—	60,691	382	—	—	8,189	2,997	262,171
1948	68,566	96,453	6,389	10,053	44,965	—	35,616	327	—	520	102,427*	3,083	190,249
1949	68,509	53,931	4,892	6,287	45,410	—	58,911	400	—	—	24,394	15,624	150,608
1950	76,431	66,884	32,663	9,329	69,745	—	96,258	264	—	2,056	6,212	20,468	199,576

* British gold loan. Source: *S.A.R.B. Quarterly Bulletin of Statistics.*

TABLE 2

Reserve Bank and Commercial Bank Reserve Ratios

Figures at 31 December each year

	Reserve bank	*Commercial banks (ratios to liabilities to public in the Union)*				
Year	*Ratio of legal reserves to liabilities to the public*	*Reserves at the Reserve Bank*	*Cash*	*Liquid assets*	*Discounts, loans, advances*	*Investments*
1918	—	—	9·8	—	69·3	3·4
1919	—	—	7·6	—	57·5	3·4
1920	—	—	11·8	—	79·6	4·1
1921	72·7	8·2	17·3	—	69·8	5·0
1922	70·4	7·6	14·6	—	66·8	4·3
1923	66·2	7·8	15·2	—	62·4	4·3
1924	65·0	8·0	15·2	—	62·6	5·9
1925	52·2	9·3	16·1	—	63·5	6·5
1926	50·4	10·2	17·0	—	69·5	5·1
1927	49·6	6·0	14·5	—	69·6	4·8
1928	47·4	7·9	14·0	—	72·0	8·2
1929	46·4	8·0	14·2	—	83·5	6·2
1930	44·4	7·8	12·6	—	69·3	9·0
1931	56·2	7·4	12·2	—	79·6	10·3
1932	57·2	7·0	12·7	—	73·0	14·8
1933	40·5	32·2	38·8	—	46·2	9·3
1934	53·4	25·2	29·1	—	54·5	10·0
1935	52·0	31·1	35·1	—	54·0	6·4
1936	52·5	23·4	27·0	—	55·4	14·2
1937	53·3	15·7	21·7	—	62·3	12·9
1938	55·4	24·2	28·5	—	53·0	15·9
1939	55·8	23·4	27·5	—	53·6	16·8
1940	56·9	35·5	39·9	—	33·9	25·2
1941	44·3	33·4	37·2	—	29·2	33·1
1942	52·2	49·7	52·5	—	19·4	26·8
1943	45·9	52·8	55·7	83·4	16·6	27·0
1944	43·5	56·8	59·7	84·2	15·8	23·9
1945	41·1	57·2	60·0	86·1	14·5	25·5
1946	91·4	43·3	46·2	75·4	26·6	27·3
1947	73·5	42·9	45·4	73·4	29·7	26·2
1948	31·0	25·5	28·3	62·6	41·2	30·9
1949	60·0	16·3	25·1	63·9	38·1	36·8
1950	75·3	17·9	25·7	66·2	37·0	37·4

Source: *S.A.R.B. Quarterly Bulletin of Statistics.*

forties, with the result that the innovations of the last few years have been less noticeable in their effects than would have been the case if the Reserve Bank had not already built a strong position for itself.

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Reports of the Annual General Meetings of the South African Reserve Bank. Contain useful analyses of the changes in the Reserve Bank balance-sheet and a survey of general monetary policy.

Annual Reports of the Registrar of Banks. Since 1947 a useful source of information on the commercial banks and other institutions registered with the Registrar. Plentiful statistics.

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12

BANKING ARRANGEMENTS IN CEYLON

Of all the Commonwealth Dominions Ceylon has the simplest and least-developed banking system. There are ten major banking institutions in the island. Nine of them are branches of foreign banks having their head offices abroad—in London or India. Amongst them are the branches of some of the large 'Imperial Banks' which have made Asia, Africa, and the East their special field.[1] The Bank of Ceylon, the only major indigenous bank in the country, established in 1939 under a special ordinance,[2] is a state-aided bank—a portion of its shares being held by the Government.

Most of the foreign banks came to the island in the second half of the nineteenth century when British capital began to pour into coffee, and later into tea and rubber, estates. With the investment of British capital in these industries and with the rapid growth in the country's foreign trade, branches of banks chartered abroad were established in order to meet the increasing demand for remittance facilities and for short-term credit to finance exports. To this day these banks remain primarily 'Exchange Banks' restricting themselves mainly to the finance of foreign trade and meeting part of the working-capital requirements of the British-owned estates and commercial firms. All of the commercial banks operating in Ceylon have their main offices in Colombo, the capital city of the island and its only important port of call for merchant shipping. Their names and the locations of their branch offices are as follows:

Mercantile Bank of India (1854).[3] Three branches, in Kandy, Galle, and Jaffna.

National Bank of India (1881). Three branches, in Kandy, Nuwara Eliya, and Galle.

[1] The origin and expansion of these banks are described in detail in A. S. J. Baster, *Imperial Banks*.

[2] Ordinance No. 53 of 1938.

[3] The figures in brackets denote the year when the branch was opened in Colombo.

Chartered Bank of India, Australia, and China (1892).
Hong Kong and Shanghai Banking Corporation (1892). One branch in Galle.
Eastern Bank (1920).
Grindlays Bank (1943). Took over the business of Messrs. Thomas Cook & Sons (Bankers) in that year.
Imperial Bank of India. (Bank of Madras, 1867, absorbed into the Imperial Bank in 1921.)
Indian Overseas Bank (1945).
Indian Bank (1932).
Bank of Ceylon (1939). Nine branches: one in Colombo and one each in Kandy, Galle, Jaffna, Kurunegala, Batticaloa, Trincomalie, Badulla, and Panadura.

Thus Ceylon has twenty-six banking offices to a population of nearly $7\frac{1}{2}$ millions. Even this figure gives too flattering a picture of the state of banking development in the island, for the offices outside Colombo do very little business. The commercial and economic life of the country is centred round Colombo.

All these banks engage in ordinary commercial banking business. They accept deposits, discount bills, deal in foreign exchange, and make loans against acceptable security. In keeping with the British tradition in banking practice, they restrict themselves mainly to short-term assets and self-liquidating loans. No definite information is available regarding their general lending policy. Broadly speaking, the main outlet for their funds is in the finance of foreign trade. They buy foreign trade bills, open letters of credit, and make other short-term loans to those engaged in foreign trade. These are usually against trust and warehouse receipts, personal security, or the hypothecation of movable property. The Ceylon Banking Commission which investigated banking and credit facilities in the island in 1934 remark on the almost total absence of bank credit outside the export and import business. 'The present banks', says the Report,[1] 'are mainly concerned with the finance of the foreign trade of the island.' The position has not substantially altered since then, though the establishment of the Bank of Ceylon and its rapid expansion into the more

[1] Ceylon Sessional Paper xxii of 1934.

important outstation towns has probably gone a slight way towards providing domestic credit facilities.

The operations of the banking system still remain a closed book to the general public. No elaborate classification of loans is available in Ceylon. The *Quarterly Statistical Bulletin* of Ceylon gives the following figures for 'Loans and Advances' outstanding on 31 December 1949:

(*Figures in thousands of rupees*)

		Per cent. of total
Agriculture . . .	7,717	7·6
Industry	32,867	32·5
Other	60,474	59·9
TOTAL	101,058	..

Advances to 'Industry' comprise 32 per cent. of the total. It is difficult to surmise what the banks classify as 'industry', for manufacturing industry is almost non-existent in the island and there are few industrial concerns developed enough to tempt the banks to lend to them. This item probably includes loans to transport and omnibus companies, cinema-circuits, building contractors, printing and publishing establishments, and similar 'secondary industry'. 'Other Loans' which account for nearly 60 per cent. of the total probably include advances to exporters and importers, wholesale and retail merchants, and consumption loans such as advances for the purchase of motor-cars. Advances to stockbrokers and 'personal and professional' loans would normally be included in this group. The smallness of advances to 'Agriculture' is dealt with elsewhere in this chapter.

A country's credit needs can only be understood against the background of its economic structure. Ceylon has no industries worth mentioning. It relies for the bulk of its national income on the export of tea, rubber, and coconut products. In both tea and rubber there is a large amount of foreign capital invested. In 1934 it was estimated that 80 per cent. of the acreage under tea and 45 per cent. of that under rubber were British owned. In both cases the estates were held by British and Ceylonese companies and by a large number of Ceylonese

proprietors and smallholders.[1] Coconut estates are largely in the hands of Ceylonese and so is the manufacture of coconut products such as copra, desiccated coconut, oil, and fibre. The bulk of the population, however, lives in the villages and does not find employment in the estates. These people eke out a livelihood by cultivating little plots of paddy-land either as peasant cultivators or as agricultural labourers employed by village land-owners. There is chronic under-employment in the villages as the available land does not provide work at a reasonable standard of living for everyone who is in search of it.

The British and Ceylonese Company estates do not experience much difficulty in obtaining working capital. When their own resources are inadequate they obtain credit from the banks on the security of produce awaiting sale, or against the pledge of 'movable properties', stocks and shares, and government securities. While individual proprietors of the large estates are today in the same position, the Ceylonese smallholder is gravely handicapped as the facilities of the banks are not as readily available to him. As a result they depend for credit on money-lenders and local dealers whose terms are by no means as favourable as those of the banks.

The peasants and village cultivators are completely outside the pale of the banking system. Cultivators require short-term credit as working capital for expenditure on seed and fertilizers for their subsistence during the interval between sowing and harvesting and for the finance of marketing operations. They also require long- and medium-term credit to purchase holdings, effect improvements, and to buy implements and draught cattle. As in India and Pakistan, organized credit has still left the rural economy untouched. Usury and exploitation in their most vicious forms are prevalent in the villages. The local capitalists, the professional money-lenders, and dealers or 'boutique-keepers', who often combine a lucrative credit business with their activities as dealers in produce, foodstuffs, and groceries, reap a rich harvest in the villages. Rates as high as 15 or 20 per cent. per annum are charged by the money-lenders, while loans in kind sometimes carry a return of over 100 per cent. The lenders, of course, are not entirely to blame,

[1] A smallholder has been defined as an owner of less than 20 acres.

for the high rates charged are partially compensation for the lack of adequate security for loans. One of the biggest problems confronting the country is the distribution of credit on easy terms in the villages.

The export trade in the main products of the island is in the hands of firms of high credit-standing who deal with importers of similar status. Bills arising out of such trade find a welcome place in the portfolios of the local banks.

A large portion of the import trade of the country is in the hands of Indian and Pakistani merchants. The better known amongst them have ready access to the banks. Ceylonese importers, except the larger and well-established firms, generally find it difficult to obtain accommodation, as the banks pay attention not only to the security offered but also the financial standing of the borrower. Before the Banking Commission of 1934 the complaint was made over and over again by Ceylonese businessmen that the foreign banks were unwilling to extend credit to them. The position has certainly improved since then, and the establishment of a large indigenous bank with government participation has compelled even other banks to consider more sympathetically the loan applications of Ceylonese. Until a few years ago bank credit usually found its way to domestic borrowers through an intermediary. The exchange banks and the Imperial Bank of India used to make loans to the 'Chettiar bankers'[1] (immigrant money-lenders from South India). These funds, augmented by their own resources, were lent out by the Chettiars at considerably higher rates of interest against security that the banks generally considered unsafe and inadequate. Long- and medium-term loans against the security of land and buildings were a common form of investment amongst the Chettiars. To most Ceylonese the Chettiar was the only source of accommodation. The scale of activity of the Chettiars has now considerably diminished. The depression of the thirties froze their assets and drove them out of business. When a bank lent directly to a Ceylonese customer it was invariably through the intervention of its 'Shroff'. He was a gentleman of some financial and social standing. It was his function to 'guarantee' the loans made to Ceylonese. In

[1] Chettiar bankers are an important source of finance to the indigenous businessman in Burma as well.

return he collected a sizeable commission both from the bank and its customers.[1] As a result the cost of credit was considerably increased. This practice was rightly condemned by the Ceylon Banking Commission, and is now happily on the decline. Today the Shroff usually performs the lowlier but more useful function of investigating the credit-worthiness of prospective borrowers.

With the exception of the Bank of Ceylon, no bank publishes a balance-sheet relating exclusively to its operations within the country. The *Quarterly Bulletin of Statistics* (March 1950) gives a consolidated statement for all banks, including the Bank of Ceylon, doing business in the island. The following table is abstracted from it:

Assets and Liabilities of the Banks in Ceylon, on 31 December 1949

(*Figures in thousands rupees*)

		Per cent. of total deposits
Liabilities		
Deposits: Demand, time, and savings	625,481	
Balances due to other banks in Ceylon and abroad	247,756	
Total deposit liabilities	873,237	
Other liabilities	30,632	
Assets		
Cash in hand	228,028	26·1
Balances due from other banks in Ceylon and abroad*	261,209	29·9
Bills discounted	53,230	6·1
Investments	205,744	23·6
Loans and advances	101,058	11·6
Other assets	25,905	2·7

* This item includes balances kept with the Imperial Bank of India by the other commercial banks for purposes of inter-bank clearing.

The total of deposits owned by the public, the banks, and the government, Rs. 873,237, works out roughly to Rs. 116 or £9 per head of population, and is an index of the poor state of banking development in the country.

As will be seen from the above table the banks carry a very

[1] The Banking Commission records that a minimum charge of 1–2 per cent. per annum was payable by the customer, while the banks usually paid one-tenth of the interest collected on the loans. The banks sometimes insisted on the Shroff's guarantee even on loans given to Chettiars.

high proportion of highly liquid assets. Cash, balances with other banks, and Bills of Exchange make up 62·1 per cent. of their total deposit liabilities. If to this figure is added their holdings of investments—mostly rupee and sterling securities and Ceylon Government Treasury Bills—the ratio becomes 85·7 per cent. This preponderance of liquid assets is, of course, partly to be explained by the fact that Ceylon is an overwhelmingly 'cash' economy, and the possibilities of a large scale withdrawal of cash are much greater than in more advanced countries. The amount of 'Cash in hand' has to bear some relation to the daily inflow and outflow of cash from the banks' vaults. A large daily withdrawal obviously requires a large stock of cash. However, in India where the banking habit is as undeveloped as in Ceylon the cash ratio of scheduled and non-scheduled banks taken together was as low as 11 per cent. in the year 1948–9, while advances and 'Bills discounted' fluctuated around 50 per cent. of total deposits. In Ceylon the paltry figures of 11 per cent. for advances and 6·1 per cent. for bills discounted indicates the very slight impact of the banking system on the economic life of the country. The banks' loans and advances are a measure of the extent to which they are supplying working capital to trade, industry, and agriculture. A fall in the ratio of loans and advances over the past several decades has, of course, been a characteristic of bank portfolios in more advanced countries of the world. But in a country where there are no alternative sources of finance the smallness of bank advances is a symptom of deficiencies both in its economic structure and its banking system. Fundamentally, it is due to the absence of investment outlets that would satisfy the requirements of the existing banking system. This in turn is due to the undeveloped and primitive state of the economy. There is here a vicious circle. Banks cannot make loans and advances unless there is a vigorous and developed economic structure. At the same time, the absence of an adaptable and flexible banking system, able and willing to meet the demands of an expanding economy, inhibits a country's economic growth.

Banks in Ceylon are generally prepared to lend against marketable security such as government bonds, shares of well-established joint stock companies, stocks of goods awaiting

sale, life assurance policies, movable properties (machinery, furniture, and fittings of firms), and trust and warehouse receipts. It is the scarcity of this kind of security that explains the smallness of the total of bank lending in Ceylon. This is the country's major credit problem. In a backward economy the problem of security must always be a stumbling block. For adequate marketable security will be available only if there is a prior accumulation of wealth. Since the stock of accumulated capital is small, the kind of security demanded by the banks is necessarily scarce. The major asset in Ceylon is land, but the banks in Ceylon seldom or never make advances on real estate as primary security, for it is not 'movable property'. Even if they did so, there are seldom deeds or documents establishing clear ownership, or the land is held jointly by several persons in undivided shares, or in small fragments of no economic value. This state of affairs is due to the laws of inheritance prevalent in Ceylon whereby on a person's death one-half of his estate devolves on his wife and the other half is divided equally amongst his children, or more often owned jointly by them. It is not surprising, therefore, that banks have steered clear of real estate loans. Until steps are taken to establish unambiguous titles to land and the system of land-holding is altered, no lending institution can encumber itself with such loans. The existing banks working according to orthodox banking practice cannot, in the circumstances, be expected to extend their activities, however great their lending capacity may be. They will prefer to restrict themselves to the finance of foreign trade where risks are much less and profits are assured.

This is one reason why bank credit is unknown in the rural economy, where the type of marketable security demanded by the banks is non-existent. The whole problem of rural agricultural credit bristles with difficulties. It is tied up with the larger problems of poverty and ignorance. Concerted measures of economic development and land reform are necessary before the rural economy can get the full benefit of modern credit institutions. Even co-operative credit societies, which in some countries have freed the villages from the shackles of the extortionate money-lender, have in Ceylon to battle against heavy odds. The pre-requisites of co-operation are the ability to buy shares in a society and the competence to manage it. Poverty

rules out one, and illiteracy the other. It has been rightly said of Ceylon that those who need co-operation are unable to manage it and those who can manage it do not need it. Pending the development of co-operative societies, the banks should be encouraged to make advances against land where titles are clear and also to lend against the security of agricultural products. The greater effectiveness of the banking system in India is partly due to the fact that the indigenous banks in their loan operations have more successfully adapted themselves to their environment.

In this connexion the suggestion that the State should formulate schemes of guaranteeing or insuring the riskier loans of the commercial banks, contained in the recent *Report on a Central Bank of Ceylon*, is a very promising one. This Report[1] was prepared, at the request of the Government of Ceylon, by Mr. John Exter, an economist attached to the Board of Governors of the Federal Reserve System, and on the basis of the Report Ceylon has recently established a Central Bank.[2] Although the country's major credit problems are the development of the banking habit and the diffusion of agricultural credit, these questions have received scant attention from Mr. Exter. In fact no detailed inquiry into credit problems has been made by him in the Report. The Central Bank has been superimposed on the existing banking structure and little or no attempt has been made to remedy its deficiencies. No special incentive is offered for the banking habit to develop, or for new banks to spring up. The hope is merely expressed that the establishment of a strong central institution will strengthen the confidence of depositors in the banking system.

The new Central Bank of Ceylon is a government institution under the control of a Monetary Board of three members. The Governor and one other member is appointed by the Governor-General of Ceylon on the recommendation of the Prime Minister. The third member of the Board is the person holding office as Permanent Secretary to the Minister of Finance and is the link between the Government and the Board. In the

[1] *Report on the Establishment of a Central Bank for Ceylon*, Ceylon Sessional Paper xiv of 1949.

[2] The Central Bank of Ceylon commenced operations on 28 Aug. 1950, with Mr. Exter as its first Governor.

circumstances there is the danger that too much power and responsibility will be shouldered on the full-time member. In view of the far-reaching implications of central bank action it would have been perhaps wiser to have had a larger and more representative Monetary Board or, at least, an Advisory Council which would have kept the Board in touch with developments and credit needs in various sectors of the economy. No other central banking statute with the single exception of the Australian Banking Act of 1945[1] vests so much responsibility in the hands of so few men.

The Monetary Law Act of 1950, which established the Central Bank of Ceylon, vested in the Bank the power of note-issue and the control of banking and credit, with the intention of altering the entire system of creation of cash. Hitherto Ceylon had had an exchange standard fundamentally similar to those of the British Colonies.[2] Ceylon rupees were issued by the Board of Commissioners of Currency against the deposit of Indian rupees to its credit in the Reserve Bank in India; and the Board was obliged by law to pay out Indian exchange against the tender of Ceylon rupees.[3]

This arrangement ensured the international stability of the Ceylon rupee as long as the Indian rupee was stable. Until recently, of course, India was on a sterling exchange standard, so that the value of the Ceylon rupee was indirectly linked to that of sterling. In essence the system is similar to the gold standard, for the internal circulation tended to vary with the ups and downs of a country's balance of payments. A surplus created a demand for Ceylon rupees which was met by the

[1] In Australia full responsibility rests with the Governor, but he has an Advisory Council to assist him. The Philippine Central Bank Act of 1948, of which Mr. Exter was joint author, created a Monetary Board of seven members. But for this difference Ceylon's Monetary Law Act seems almost a carbon copy of the Philippines legislation. Cf. *Federal Reserve Bulletin*, Aug. 1948. The Philippines Central Bank Act.

[2] See Chapter 11.

[3] In 1944 the Currency Ordinance of 1941 was amended, enabling issue and redemption of Ceylon rupees against sterling. The system was the result of a process of evolution. Originally, Indian rupees used to be imported and exported according to the state of the balance of payments. Later, both the Currency Commissioner and the banks found it more convenient to obtain Ceylon rupees against Indian Exchange and to redeem Ceylon rupees by issuing drafts on its balances in India. The Currency Ordinance of 1941 merely legalized existing practice.

conversion of foreign currencies into rupees. In the absence of compensatory action by the banking system this tended to increase the domestic circulation. A deficit, similarly, tended to contract the internal circulation through the purchase of foreign exchange against Ceylon rupees.

The main criticism of this system is that, like the gold standard, it left the country no scope for monetary management, the only elasticity being in the hands of commercial banks, uncontrolled by a domestic monetary authority. Since all the assets against the Currency Board's note-liabilities had to be held in foreign exchange and British or Indian government securities, there was no room for offsetting changes in the circulation by official open market operations. As a result domestic prices and incomes could not be deliberately protected from fluctuations in the balance of payments. Arguments on these lines—not always based on a correct understanding of the limited part played by the Currency Board and of the complications due to the operations of overseas banks—have been used in criticism of the rupee-exchange standard as it operated in Ceylon. In practice, however, an export economy such as Ceylon cannot even with independent monetary institutions effectively pursue an independent monetary policy. Ceylon's level of prosperity is determined by the foreign demand for its staple exports—tea, rubber, and coconut products.[1] Its level of incomes is determined by the prices that these exports fetch in foreign markets. A slump in their prices leads to a disastrous contraction of prices and incomes, and when export prices rise there is an automatic expansion of income, in the level of monetary expenditure, and therefore in the domestic price level. A policy of 'compensatory spending' or open market operations cannot stabilize incomes or prices in a country so utterly dependent on foreign trade as Ceylon is.[2] However, the power to hold a portion of its assets in

[1] In 1948 out of a gross national income of Rs. 2,272 millions, Rs. 917 millions was earned directly from the export industry. A host of other occupations are in one sense or another ancillary to the export industries and are severely affected by conditions in the former. Cf. B. B. Das Gupta, *A Short Economic Survey of Ceylon*, p. 10.

[2] Domestic prices may, of course, be stabilized at the cost of having a widely fluctuating exchange rate. Needless to say, such a policy is least appropriate in the case of an export economy.

domestic securities gives the Central Bank greater freedom of action and should prove of some use when the country has a more diversified economic structure. Under the Act the Bank is merely required to keep an International Reserve adequate to meet any foreseeable deficit in the international accounts.[1] The Bank is obliged to buy and sell all convertible currencies, and the par value of the rupee is fixed at 2·88 grams of fine gold.

In the sphere of credit control the Bank is equipped with practically all the weapons of modern central banking. It has been recognized that the traditional instruments of control—discount-rate policy and open market operations—are likely to be particularly ineffective in a backward economic and financial structure. It is partly in recognition of this that the Bank is not to have a single published discount rate but is empowered to fix its rates 'in accordance with the character and term of each such operation'.[2] It may rediscount for the commercial banks' 'commercial credits' with maturities of not more than 180 days from the date of their acquisition by the Central Bank, and production credits[3] with not more than 270 days to run, and also make advances against similar assets or government and other specified securities.[4]

A central bank can influence the monetary situation through its interest-rate policy only if it is a normal and important source of funds for the banking system. It has been the experience of all the Dominions except perhaps South Africa that the use of central bank credit has been very limited.[5] Several facts serve to explain this phenomenon. In the first place, most Dominion commercial banks work to fairly large reserve ratios which are subject to variations within limits. Their reserves are usually much above the required minimum. The reserve ratio in the Dominions does not have the same significance that it has in the United Kingdom. Secondly, they

[1] Monetary Law Act, Section 65 (i).

[2] Ibid., Section 86.

[3] i.e. 'bills, promissory notes and other credit instruments resulting from transactions related to the production, manufacture or processing of agricultural, mineral or industrial products'. Cf. ibid., Section 82 (i).

[4] Ibid., Section 82.

[5] Cf. Plumptre, *Central Banking in the British Dominions*, chapter xi; Raj, *Monetary Policy of the Reserve Bank of India*, chapter vi.

hold a high proportion of liquid assets, including funds deposited in the London Money Market. Thirdly, in case of need they can always borrow in London rather than from the central bank. To a large extent, therefore, commercial banks in the Dominions are self-sufficient. For instance, the Advances and Discounts of the Reserve Bank of India during the period 1935–9 was practically nil.[1] The position in Ceylon is in most respects similar to that in the other Dominions. The banks have considerable excess reserves and a very high proportion of liquid assets. The Monetary Law Act requires the banks to maintain reserves with the Central Bank equal to between 10 per cent. and 40 per cent. of their demand deposits, and a ratio of 5 per cent. to 20 per cent. in the case of time and savings deposits. The Central Bank may vary the 'required reserves' within these limits. As will be seen from the table on page 406, the banks maintained a cash reserve of 26·1 per cent. and a foreign and domestic balance equal to nearly 30 per cent. of their total deposit liabilities. Thus the present requirements[2] are well below the cash holdings of the banks. Even if the required reserves were to put up their maximum, the banks should still not experience acute difficulty, though the elimination of a margin of 'slack' would probably inhibit their lending operations somewhat.

The figures in the table on p. 414 are end-year (and when available quarterly) cash ratios of the commercial banks. In column 2 are given the corresponding ratios of cash and local and United Kingdom balances to the total of all deposits.[3]

The table shows that the banks have not worked to any specific cash ratio. Until September 1945 they had a low ratio of 'cash in hand' while the ratio of liquid funds hovered round 50 per cent. Between December 1945 and March 1949 the ratio 'cash in hand' reached a high of 36·4 per cent. in December 1949 and a low of 17·4 per cent. in June 1949. Column 2 is much steadier. Its average value is 55·2 and the mean deviation is only 6·8. These facts indicate that the banks

[1] Cf. Raj, op. cit.

[2] The reserve requirements were initially fixed at their minimum: 10 per cent. and 5 per cent. In Jan. 1950 reserve requirements on demand deposits were raised to 14 per cent. with a view to checking the expansion of credit caused by a boom in export prices.

[3] *Source*: Department of Statistics, Ceylon.

were guided more by their general liquidity position than by their cash ratio, which they have allowed to fluctuate considerably. Balances held in the banks in the United Kingdom are, of course, as good as cash. Under the Currency Ordinance of 1941 banks could obtain Ceylon rupees by transferring these balances to the Reserve Bank of India. Today, Ceylon rupees can be obtained against them from the Central Bank, which is obliged by statute to buy and sell all foreign currencies. There is, of course, now the risk of exchange fluctuation, since the Central Bank, unlike the Board of Commissioners of Currency, has effective power to alter the par value of the rupee. The table also shows quite clearly the comfortably liquid position of the local banks. To the extent that they are prepared to see their reserves of 'cash and liquid funds' vary, they can remain impervious to the interest-rate policy of the Central Bank, and independent of it except during the most abnormal times.

Year	*Ratio of cash in hand* (*1*)	*Ratio of cash and domestic and U.K. balances (liquid funds)* (*2*)
31 December 1943	4·74	51·5
31 March 1944	4·55	50·0
30 June 1944	4·21	51·5
30 September 1944	4·55	52·3
31 December 1944	4·95	45·2
31 March 1945	4·39	42·5
30 June 1945	10·09	52·1
30 September 1945	13·72	55·7
31 December 1945	21·64	65·9
31 December 1946	20·74	55·5
31 December 1947	31·88	59·0
31 March 1948	29·36	62·5
30 June 1948	30·67	62·5
30 September 1948	28·18	58·1
31 December 1948	30·35	64·2
31 March 1949	26·41	54·2
30 June 1949	17·40	40·4
30 September 1949	33·96	65·0
31 December 1949	36·46	71·5
31 March 1950	20·15	43·5

This poses the problem which has faced other Dominion central banks from time to time—the ability of the commercial

banks to defy a restrictive policy of the Central Bank by obtaining funds from abroad. Section 94 of Ceylon's Monetary Law Act has clearly been framed to meet such an eventuality. It empowers the Central Bank during periods of inflation to fix special high cash ratios (not exceeding 100 per cent.) on deposits exceeding a predetermined limit. It may, however, sometimes be necessary for the Central Bank to resort to exchange control in order to check an import of foreign funds, especially as the outward flow of funds from the leading money markets to the less developed countries tends to increase during boom periods.[1] To deal with the converse problem of an undue accumulation of foreign assets, Section 76 empowers the Central Bank to prescribe the manner of determination of the maximum amount of the working balances which commercial banks may hold in foreign currencies.[2] Similarly, Section 77 enables the Monetary Board to direct the commercial banks to 'maintain a balanced position between their assets and liabilities in Ceylon rupees or in any other currency or currencies in which they operate'.

Even in the more developed countries interest-rate policy does not occupy the same crucial position that it did, say, twenty-five years ago. Theorists and practical men alike have less confidence than they used to have in the ability of interest-rate changes to influence either the volume of bank lending or the total of private investment.[3] In Ceylon not only is the expansion of bank credit governed by the state of economic activity, but the scope for controlled expansion is also restricted by the lack of security acceptable to the banks.

As in the case of most 'new' central banks open market operations are unlikely to be a major weapon of control. The market for securities in Colombo is extremely narrow and the volume of trading is negligible. The sale or purchase of securities on any considerable scale will cause wide variations in their prices. The values of the assets of the banks themselves will be affected as they are the largest holders of Ceylon

[1] Cf. Triffin, 'National Central Banking and the International Economy', *Review of Economic Studies*, vol. xiv (2), No. 36, 1946–7.

[2] Owing to the lack of investments the bulk of the banking funds used to be invested abroad. In recent years the issue of government loans has considerably reduced the proportion of overseas assets of the banking system.

[3] Cf. *Studies in the Price Mechanism* (Oxford, 1950).

government securities. Nevertheless, in case it had to sell securities, the Central Bank's stock of them would be almost inexhaustible. It will never run out of ammunition, for the law authorizes the Bank to issue its own securities.[1] Where, as in Ceylon, the scope for lending is severely restricted by institutional factors and economic backwardness the purchase of securities by the Central Bank can result only in the creation of a condition of 'hyper-liquidity' in the banking system. At best, the credit created on the basis of the additional reserves will go to swell the banks' holdings of government securities. The same applies to a reduction in reserve requirements with a view to stimulating a credit expansion. In a boom, of course, the Central Bank can prevent an increase in the money supply by making credit sufficiently scarce. But it is doubtful whether such a policy is desirable, for it is only during boom periods that the internal economy, normally sluggish and inactive, experiences a slight increase in the tempo of economic activity. At such times the selective control of credit is likely to be more desirable.[2]

In view of the limited effectiveness of the traditional instruments of central banking, other methods of quantitative and qualitative control are of the utmost importance. The law endows the Central Bank of Ceylon with a considerable armoury of such 'weapons' for 'direct action' and selective control. Indeed, its powers in these respects are on a par with those of the most autocratic amongst Commonwealth central banks. It has wide and extensive control over the portfolios of the commercial banks. For instance, the Central Bank may fix the maximum permissible maturities for loans and investments and the nature and amount of the security required for various types of credit operations (Section 98). It may prohibit commercial banks from increasing the amount of their loans and investments[3] or fix limits to their rate of increase (Section 99). These powers are similar to the powers given to

[1] Monetary Law Act, Section 90. The Swedish Central Bank has similar powers.

[2] For instance, by controlling the purposes for which banks make advances, the Central Bank can prevent the use of bank credit for speculation in the produce and stock markets which is common during inflationary periods. The limitations of this type and qualitative control are, of course, well known.

[3] 'Portfolio ceilings.' Cf. Monetary Law Act, Section 100.

the Commonwealth Bank of Australia by the Banking Act of 1945, whereby it 'may determine the policy in relation to advances to be followed by the banks . . . and may give directions as to the classes of purposes for which advances may or may not be made'.[1] More recently the Indian Banking Companies Act of 1949 gave similar powers to the Reserve Bank of India.[2] The Ceylon legislation also lays down that the

> Central Bank may prescribe the conditions subject to which the credit facilities of the Central Bank will be available to banking institutions, including conditions relating to the rates of interest charged by such institutions, to the purposes for which their loans in general are destined and to any other matter affecting or connected with the credit policy of such institutions.[3]

Furthermore, the Central Bank is empowered to prescribe the maximum ratios which various classes of assets may bear to the capital of a bank.[4] The power to fix margin requirements on letters of credit opened by banks[5] enables the Bank to exercise a broad control over the imports into the country. It is really not a monetary control in the ordinary sense, but it is a very useful instrument of economic policy. The law also provides for a Department of Bank Supervision which is enjoined to examine the commercial banks periodically and to report on their condition to the Monetary Board.

There can be no doubt that the Central Bank of Ceylon is extraordinarily well equipped to prevent unsound banking practices and consequent losses to depositors. The Monetary Law Act renders the banking system almost invulnerable in a liquidity panic by enabling emergency central bank loans to banks on almost any type of asset.[6] However, the phrase 'unsound banking practices' appears somewhat ironic in the context of conditions in Ceylon. Since the crash of the giant Oriental Banking Corporation in 1884,[7] there have been only two major bank failures.[8] In both cases they were branches of Indian banks and their collapse was not connected with the

[1] Cf. de Kock, *Central Banking*, 1946 ed., pp. 143 et seq.
[2] Banking Companies Act, 1949, Section 21.
[3] Monetary Law Act, Section 87.
[4] Ibid., Section 101.
[5] Ibid., Section 102.
[6] Ibid., Section 85.
[7] Cf. Baster, op. cit., p. 258.
[8] The Travancore National and Quilon Bank failed in 1938, and the Exchange Bank of India and South Africa in 1949.

activities of the branches in Ceylon. If the banks had a policy at all it was one of over-cautiousness. Yet like those of most central banks, the powers of the Central Bank of Ceylon in restraining a credit expansion look far more formidable than its powers of stimulating an increase of borrowing. Only when the country has a widespread and well-developed banking system is it likely that the extensive powers of the Central Bank will be fully tested. Ceylon is, in a sense, better placed than India. At the moment, its Central Bank has to exercise control over only a handful of strong and well-established banks, and not over hundreds of small unit banks which cannot be induced into any kind of relationship with it. Nor is it faced with the problem of controlling a vast and extensive indigenous credit market. The future of central banking in Ceylon will obviously depend upon the lines of development of commercial banking. It will depend upon whether Ceylon is going to have a large number of unit banks or whether banking will develop along the English model. It will be realized that development and extension of the banking system are essential if the Central Bank is at all to make its influence felt on the economic life of the country. For the moment, it may well have to be satisfied with what it can do by 'moral suasion' and by developing a spirit of friendly co-operation between itself and the few banking institutions.

The Central Bank is enjoined to carry out the National Monetary policy 'by regulating the supply, availability cost and character of credit', so as to secure, as far as possible, the following objects:[1]

(*a*) The stabilization of domestic monetary values.
(*b*) The preservation of the par value of the Ceylon rupee.
(*c*) The promotion and maintenance of a high level of production, employment, and real income in Ceylon, and
(*d*) The encouragement and promotion of the full development of productive resources of Ceylon.

It was pointed out in an earlier part of this essay that as long as Ceylon remains the export economy that she is today, the level of domestic prices will to a large extent be determined by forces beyond the control of the Central Bank. The Central

[1] Monetary Law Act, Section 5.

Bank has hardly any voice in the determination of 'domestic monetary values' or in the international value of the rupee, in the background of the stagnant and lop-sided economic structure in which she is called upon to operate. No central bank can force banks to lend when the demand for credit has fallen off, as it is bound to do when there is a slump in export prices. Only a broad-based and diversified economic system will enable the Central Bank to utilize its vast potentialities and enable its measures of price- and income-stabilization to operate in a more congenial environment.

Phrases such as 'a high level of production and employment' have no meaning as guides to central banking policy in an undeveloped economy. Ceylon suffers from chronic underemployment and a heavy pressure of population on the land. These problems have first to be tackled on a broader front before the economy can be at all responsive to purely monetary measures. In this context, the policy of the banking system and the kind of security against which it lends is relevant. The limited use of bank credit is at bottom due to the backwardness of the economy. Although economic development falls outside the scope of the Central Bank, it may foster it indirectly by encouraging a more enterprising policy on the part of the banks. It has been seen that banks in Ceylon hold an unconscionably high proportion of highly liquid assets and government securities. Wherever titles to land and agricultural property are unambiguous banks should be called upon to lend against such security.

There has been an age-long tradition against banks making long-term loans to finance the fixed capital requirements of trade, agriculture, and industry. It is argued that assets held against short-term liabilities should be easily realizable. While earlier notions of the special liquidity of short-term assets have now been proved to be largely illusory,[1] there may still be much to be said in favour of the traditional prejudice against long-term loans in countries which have already achieved some measure of economic development or have special institutions for long-term finance.[2] In Ceylon there is

[1] Cf. Sayers, *Modern Banking*, 2nd ed., pp. 213 et seq.

[2] In Ceylon there are two such institutions—the State Mortgage Bank and the Agricultural and Industrial Credit Corporation. They have so far not made

a strong case for a limited volume of 'mixed banking'. The commercial banks in the course of their ordinary operations acquire an intimate knowledge of businessmen and business conditions. They are better equipped than anyone else to tell a good business proposition from a bad one. The paucity of adequate short-term investment outlets is added reason why banks should venture out into the field of long-term finance. There are no hard and fast rules of sound banking. They vary with time and place. In a country where capital development is the most crying need the banks would not be risking too much if they converted a part of their swollen liquid assets into long-term loans. To begin with, banks may be compelled to invest their savings and time deposits on long term. There is provision in the Monetary Law Act for central bank participation in government-sponsored agencies for guaranteeing or insuring the loans of commercial banks.[1] The institution of such a scheme should go a long way towards protecting the banks and their depositors.

However it may come, economic development is a prior condition of effective central banking. No central bank can fulfil itself if it is to confine itself to regulating a credit system that barely touches the fringe of the country's economy. The Monetary Law Act concentrates on regulating the existing credit system rather than on developing and extending it. Steps towards the extension of banking facilities must go hand in hand with vigorous measures of economic development. A central bank is a necessary condition but not a sufficient condition of economic development.

much headway. Here again the absence of clear titles to land is hampering the extension of mortgage loans. The Monetary Law Act enables the Central Bank to lend to these institutions and is apparently satisfied that the country's requirements of long-term finance will be met by these sources (Section 84).

[1] Section 107.

13

THE COLONIAL EMPIRE

THIS chapter is intended to cover all those territories for which the Secretary of State for the Colonies is responsible, together with the self-governing colony of Southern Rhodesia (which for banking and currency purposes is indistinguishable from the colonies proper). These territories, a list of which is given in Table 1, cover an area of over two million square miles and have a population of some seventy-one millions. Widely dispersed geographically, they exhibit extreme diversity in every important characteristic. Their degree of political responsibility ranges from absolute tutelage, through a complex gradation of representation, to complete autonomy; their economic development differs from the pastoral nomadic Somaliland to the highly organized rubber-exporting Malaya; their codes of law and social ethics include those of African tribal reserves and the sophisticated conventions of holiday resorts in the Bahamas; their financial requirements vary from the near-zero of subsistence peasant cultivation in parts of Nyasaland to the complex network of international banking which surrounds the entrepôt of Hong Kong. In such diversity generalization necessarily does rough justice, but it will be the main purpose of what follows to describe and analyse the general pattern of the present banking structure and its methods of operation.

Consideration will be restricted to banking proper, that is to say the business of receiving on current account money which is repayable on demand and the making of advances. Thus the numerous forms of quasi-bank (savings banks, co-operative credit societies, thrift societies, land banks, &c.), which play an important part in colonial economies, but which would require a chapter to themselves, will not be discussed. It will be necessary, however, in order to show the position of the colonial banking system in relation to international finance, to give some preliminary consideration to the currency system and the operations of the various currency authorities. The

TABLE I. *Territories Covered by Chapter 13*

	Population (Thousands)
East African Group	
Somaliland Protectorate	500
Kenya	5,373
Tanganyika	7,403
Uganda	5,050
Zanzibar and Pemba	264
Central African Group	
Northern Rhodesia	1,645
Nyasaland	2,417
Southern Rhodesia	2,095
West African Group	
Gambia	276
Gold Coast (including Togoland)	4,200
Nigeria (including Cameroons)	25,000
Sierra Leone	1,870
Eastern Group	
Federation of Malay	5,159
Singapore	1,002
Brunei	41
North Borneo (including Labuan)	345
Sarawak	550
Hong Kong	2,317
Mediterranean Group	
Cyprus	480
Gibraltar	25
Malta and Gozo	313
*West Indies Group**	
Bahamas	78
Barbados	207
Bermuda	37
British Guiana	414
British Honduras	65
Jamaica (including Cayman, and Turks and Caicos Islands)	1,402
Leeward Islands	110
Trinidad and Tobago	619
Windward Islands	278
Western Pacific Group	
Fiji	285
British Solomon Islands	90
Gilbert and Ellice Islands	37
New Hebrides	47
Tonga	47
Atlantic and Indian Ocean Group	
Falkland Islands	2
St. Helena and Ascension	5
Aden (Colony and Protectorate)	731
Mauritius and Dependencies	471
Seychelles	35
TOTAL	71,285

* Used for convenience throughout the chapter to cover all the colonies shown under this heading.

Sources: The Colonial Territories, H.M.S.O. May 1950, Cmd. 7985, and *Economic and Statistical Bulletin of Southern Rhodesia*, Oct. 1950.

chapter will therefore be arranged in four sections under the following headings:

1. The Currency System.
2. Banking Structure and Policy.
3. Banking Services.
4. Theoretical Analysis.

1. *The Currency System*

At first sight the currencies of the colonies present a somewhat bewildering picture; primitive money continues to function in the most remote regions and in many territories the currency consists of a mixture of extra-territorial notes and coin of various nationalities, together with commercial banknotes and local government notes and coin. But if we ignore, for a moment, the individual idiosyncrasies, it is possible to discern an underlying pattern, and it will be convenient first of all to delineate this pattern by describing what may be called the 'standard system'. Under the standard system a colony (or group of colonies) has its own local currency which is issued by a currency authority charged with the administration of the currency arrangements, in accordance with the regulations laid down in the basic currency law. The operations of the currency authority are automatic and passive, and consist in being ready to buy and sell the local currency at a fixed rate (plus a small commission) against sterling in London. Sterling accumulated as a result of the issue of local currency is invested in London and thus constitutes a 'security fund', which serves as backing for the outstanding local currency, and out of which payments are made in sterling against local currency surrendered in the colony. Under this system the local currency operates exactly as if it were, in fact, United Kingdom notes and coin, and it will be convenient to speak of this process of issuing local currency against deposits of sterling as 'importing currency', and of the reverse process as 'exporting currency'; these operations being precisely equivalent to a physical migration of sterling.

This standard system is in operation in every one of the colonies with the exception of the following: the British Solomon Islands, the New Hebrides, the Gilbert and Ellice Islands, Aden, St. Helena, and the Protected Kingdom of

Tonga. In the Solomon Islands, United Kingdom, New Zealand, and Fiji coin are legal tender, but in fact the circulating medium consists of Australian notes and coin, the alternative forms of currency not being used because of their higher value in terms of Australian currency. In the New Hebrides (an Anglo-French Condominium), both United Kingdom and French currencies are legal tender—a fact that is not without complications when the Sterling-Franc rate is fluctuating! In fact, however, the chief circulating medium is again Australian currency. St. Helena, Aden, and the Gilbert and Ellice Islands have no local currency and use United Kingdom, Indian, and Australian notes and coin respectively. The Protectorate of Tonga in the western Pacific is an interesting and unique case of a colony with a foreign exchange-standard based on a currency other than sterling. The protectorate has a mixed currency consisting of local notes and imported New Zealand, Australian, Fiji, and United Kingdom currency, but the Treasury Notes Act of 1935 introduced a system precisely similar to the standard system except that it is nominally based on the Australian pound. There being no banks in the island, the currency authority is responsible for providing all foreign exchange, being obliged to convert local currency into *any* foreign currency, and vice versa, 'at the rate in the case of Australian Currency of one pound Tongan for one pound Australian and at such rate as he' (the currency authority) 'may deem fit in the case of any other currency'.[1]

It will thus be seen that these exceptions consist of one case of an Australian exchange standard[2] and five cases in which the dependency may be regarded as an extension of the territory of its 'parent' currency area in exactly the same way that the Isle of Wight is an extension of the currency area of the rest of England and Wales. In the whole of the remainder of the Colonial Empire (comprising 97 per cent. of the total population) the standard system is in operation, though in several colonies (particularly in the West Indies) the situation is superficially complicated by the circulation of small quantities of extra-territorial currency.

[1] Act No. 6 of 1947 (to amend the Treasury Notes Act, 1935) by the Queen and Legislative Assembly of Tonga, 17 Sept. 1947.

[2] Invested reserves are actually held in sterling, so that this may be regarded as an indirect sterling exchange system.

The standard system is not, in all cases, operated so that each colony has its own individual currency and currency authority; increasingly the tendency is for a number of territories, associated geographically and economically, to group together to form a currency union with a common currency and a joint currency authority. The four such currency unions which are at present in operation are as follows:

West African Currency Union (West African pound)	Gambia Gold Coast	Nigeria Sierra Leone.
East African Currency Union (East African shilling)	Kenya Tanganyika Aden.	Uganda Zanzibar
Southern Rhodesian Currency Union (S. Rhodesian pound)	S. Rhodesia N. Rhodesia Nyasaland.	
Malayan Currency Union (Malayan dollar)	Federation of Malaya Singapore Brunei British North Borneo Sarawak	

The basic currency law and the method of operation of the West African and the East African Currency Boards are the same except for one or two minor details. The boards operate in London in accordance with regulations laid down by the Secretary of State who also appoints their members. Their functions are to ensure that adequate stocks of local currency are available as required, and to employ the currency fund in London in the most profitable way, within the terms of the regulations, and consistently with that degree of liquidity considered desirable. The regulation regarding the type of security in which the West African Board may invest is as follows: 'The Board may invest its funds in sterling securities of the Government of any part of His Majesty's Dominions, or in such other manner as the Secretary of State may approve.'[1]

[1] West African Currency Board Regulations, 2 Sept. 1949. Appendix V to Report dated 30 June 1949.

In fact, however, the Secretary of State only approves of United Kingdom and Dominion government securities, or United Kingdom municipal loans, and never approves of investment in local securities; it is thus not possible for currency to be issued on a fiduciary basis.

The Boards publish annually a Report showing:

A. A detailed statement of issues and redemptions of currency during the year.
B. A detailed statement of currency in circulation.
C. Receipts and disbursements of the Board.
D. Profit and loss account.
E. Balance-sheet.
F. Detailed statement of investments.

In addition to the above, the West African Currency Board Report gives a most useful statement of the amount of outstanding currency notes in each month, thus giving an indication of seasonal fluctuations. Since the reports of all these authorities refer to the respective currency unions as a whole it is not possible to tell therefrom the currency outstanding in separate colonies; the Southern Rhodesian Board's Report and some of the Annual Reports of the individual colonies give an estimate of these individual figures based on the issues and redemptions made in the colony, corrected by information obtained from the banks regarding transfers between colonies, but these estimates must necessarily be subject to a wide margin of error.

The actual physical distribution of the currency is carried out by the Board's Currency Officers in the principal centres in the colonies concerned, and is normally done through the banks, since the Boards only operate in quantities above a minimum laid down in their regulations, which in the case of West Africa is £10,000. The commission which the Boards charge on transfers can be varied at their discretion but must not exceed stated maxima. The rates current in 1950 and the maxima laid down in the Regulations are as follows:

	1950 rate per cent.	*Maximum* per cent.
West Africa . . .	½	¾
East Africa . . .	¼	½

The profits accruing from earnings on investments plus commissions, after deducting expenses, are first used to accumulate a reserve fund against capital depreciation, which fund is normally of the order of magnitude of 7 per cent. to 10 per cent. of the invested funds; any surplus over and above this is distributed between the colonial governments. Up to 30 June 1950, £7,900,000 had been so distributed by the West African Board since its establishment in 1912.

The Southern Rhodesian currency union, which covers Southern Rhodesia, Northern Rhodesia, and Nyasaland, conforms to this pattern except in two particulars.

1. The currency authority is a Board of Commissioners which operates from Salisbury, Southern Rhodesia, and which employs the Standard Bank of South Africa Ltd. as its London agent.

2. By an Act passed in 1947 the Board may, if required by any of the three Governments, invest up to 10 per cent., 7 per cent., and 3 per cent. in the local stock of the Governments of Southern Rhodesia, Northern Rhodesia, and Nyasaland respectively. So far (1951) no use has been made of this provision.

The Malayan currency union also conforms to the pattern of the West and East African Boards, except that here again the authority is vested in Commissioners operating locally, in this case using the Crown Agents for the Colonies as their London agents.

A further consolidation is at present in the course of implementation in the eastern group of the West Indies, that is to say British Guiana, Trinidad, Barbados, and the Leeward and Windward Islands. This currency union will be administered on the standard system by Commissioners operating from Trinidad and conducting their London business through the Crown Agents for the Colonies. All other colonies operate the standard system individually (the currency authority being local Commissioners operating in the territory concerned), with some differences of detail in the regulations, and in the method of operation, but none of substance.

A variation in the pattern, of which mention must now be made, is the existence in the West Indies and in Hong Kong of commercial bank-notes. Provision is now being made for the withdrawal of the commercial note-issue in the eastern

group of the West Indies (British Guiana, Trinidad, Barbados, and the Windward and Leeward Islands) in accordance with a decision taken by the Barbados Conference of May 1946. In deciding upon this step, which is to be carried out in consultation with the three banks concerned, the Conference 'recognised the invaluable services the banks had rendered to the community, and the fact that they were entitled to due consideration on this account. Nevertheless, it was considered that the power to issue Currency Notes was a sovereign prerogative of the Government concerned.'[1] In Hong Kong the provisions which were made in 1939 for the withdrawal of commercial notes are in suspension, but the principle of the standard system is preserved, since the banks can only issue additional notes against their holdings of Certificates of Indebtedness which they obtain from the Government against surrender of sterling. Thus, instead of local government notes circulating (as is the case in the standard system), the commercial bank-notes circulate, but are backed note for note by Certificates of Indebtedness, which are themselves backed by a currency fund in the usual way. In addition to these commercial issues there is a small denomination government issue organized on the standard system.

Other things being equal it would be expected that currency would play a much larger part in the exchange transactions of an undeveloped economy than in those economies where the use of bank money is fully developed; in spite of this, however, such statistical evidence as is available indicates a low ratio of currency to colonial income, and there are two main reasons for this:

1. The standard of living being low, very little wealth is accumulated by the native population, and such wealth as is accumulated is held in the form of livestock, or land, or personal possessions such as ornaments, &c.; and not in the form of currency. Thus there is very little demand for currency as a capital asset.

2. A large proportion of transactions in native agricultural economies is carried out by means of credit, which has the effect of either, (*a*) reducing the period during which currency

[1] Report of Barbados Currency Conference, *Leeward Islands Gazette*, 11 July 1946.

needs to be held for transactions purposes, or (*b*) eliminating the need for currency for transactions purposes altogether. Thus where the local storekeeper supplies goods to the cultivators during the growing season on credit, there is no need for the latter to carry a stock of currency all the year round; when he receives payment for his crop (in currency), part of this goes straight to the storekeeper to cancel the outstanding debt, and returns quickly to the banks for redemption. Where the same middleman both retails consumption goods and purchases the local produce, the debt can be cancelled without the use of any currency at all. Both of these factors reduce the demand for currency for transactions purposes.

In the future, as a result of the high marginal rate of saving usually associated with a rapidly increasing real income, it must be expected that the ratio of currency to income will increase considerably unless this factor is offset by greater use of bank money. For the present, however, currency simply is not held in any quantity by the native populations; when it is received it is spent quickly. This being so, it would be reasonable to expect that those colonies which produce seasonal crops would exhibit large seasonal variations in their currency circulation, and this is found to be so. It is necessary, however, to be quite clear what is meant by 'circulation' in this connexion, and it is convenient to distinguish two concepts:

1. Total circulation. This is the total currency outstanding as shown in the Board's Reports.
2. Active circulation. Total circulation less currency held by banks.

The seasonal demand for currency for crop payments, which results in seasonal increases in the active circulation, may be met either from stocks of currency held by banks, or by import of currency; similarly, the rapid expenditure of crop money may result either in increases of stocks of currency by banks or in export of currency. Thus the seasonal variation in the active circulation may or may not result in seasonal variations in the official figures of total circulation according to whether it is affected by compensating movements in currency stocks or by currency migration. West African experience provides good examples of both alternatives. During the inter-war

TABLE 2

West African Currency Issues and Redemptions

(£1,000)

Year	*Issues* (1)	*Redemptions* (2)	*Net change* (3)	*Cumulative total* (4)
1912–14	1,174	130	+1,044	1,044
1914–15	113	530	−417	627
1915–16	1,224	100	+1,124	1,751
1916–17	952	Nil	+952	2,702
1917–18	1,389	Nil	+1,389	4,092
1918–19	3,949	Nil	+3,949	8,041
1919–20	9,100	3,651	+5,449	13,490
1920–21	1,964	6,887	−4,923	8,566
1921–22	369	2,003	−1,634	6,933
1922–23	1,214	715	+499	7,431
1923–24	1,137	1,220	−83	7,349
1924–25	3,536	1,718	+1,818	9,166
1925–26	2,705	3,031	−326	8,840
1926–27	5,361	3,543	+1,818	10,658
1927–28	4,601	4,150	+451	11,110
1928–29	3,004	4,696	−1,692	9,417
1929–30	3,062	4,262	−1,200	8,217
1930–31	24	3,210	−3,186	5,031
1931–32	1,580	2,074	−494	4,537
1932–33	1,491	1,078	+413	4,950
1933–34	Nil	1,512	−1,512	3,438
1934–35	2,203	394	+1,809	5,247
1935–36	2,502	Nil	+2,502	7,749
1936–37	7,957	729	+7,228	14,977
1937–38	Nil	3,240	−3,240	11,737
1938–39	10	4,720	−4,710	7,027
1939–40	1,339	440	+899	7,926
1940–41	970	200	+770	8,696
1941–42	4,192	Nil	+4,192	12,888
1942–43	6,190	Nil	+6,190	19,079
1943–44	2,471	Nil	+2,471	21,550
1944–45	3,312	Nil	+3,312	24,862
1945–46	4,132	Nil	+4,132	28,994
1946–47	7,945	Nil	+7,945	36,939
1947–48	5,985	Nil	+5,985	42,924
1948–49	20,131	Nil	+20,131	63,055
1949–50	Nil	1,650	−1,650	61,405

The cumulative total shown in col. 4 differs from the corresponding annual statement of 'W.A. Currency in circulation' given in the Board's Reports for two reasons: United Kingdom currency in circulation in West Africa prior to 1912 and since surrendered against payment in London is recorded as a redemption but does not alter the figure for West African Currency in circulation: while an exchange of such United Kingdom currency for West African currency locally enters the circulation figure as an increase but is not recorded as an 'Issue against payment in London'.

period the seasonal requirements were met almost entirely by currency migration; as a result the monthly figures of currency in circulation given in the Board's Reports clearly reflected the seasonal variation, and the movement of currency between London and West Africa was heavy, as can be seen from the figures set out in Table 3. During the period 1939–49, however, the pattern changed, and it will be seen that there were no redemptions of currency at all, although the seasonal variation in the active circulation undoubtedly persisted. The explanation is that when the currency returned via the merchants to the banks it was retained by them in West Africa instead of being brought back to London for temporary employment. The logic of this procedure from the merchants' point of view is illustrated by the following extract from the United Africa Company's *Statistical and Economic Review*:

The seasonal nature of the currency expansion was at one time reflected in the transfer of funds by the United Africa Company from the Gold Coast to London and vice versa. Now the interest that can be earned on money in London does not cover the cost of a bank transfer to London and back again to the Gold Coast, and the Company has lately followed the practice of holding money in the Gold Coast in the form of cash in hand or in the bank until the next cocoa season. The following figures reveal the seasonal nature of the currency requirements:

The United Africa Company Cash balance in the Gold Coast
Average for three years 1945–7

End of:	£000's
January	433
February	631
March	881
April	1,156
May	1,396
June	1,512
July	1,784
August	2,011
September	2,231
October	1,809
November	1,146
December	785[1]

[1] The United Africa Company, *Statistical and Economic Review*, No. 2, Sept. 1949, p. 18.

Similar arguments would explain the retention of this currency by the banks.

The factors which determine whether or not money shall be transferred by banks and merchants are fourfold—the cost of the double transfer, the yield expected on the temporary employment in London, the risk of capital depreciation during the period, and the availability of alternative funds in London. Clearly if the transfer rate is $\frac{1}{2}$ per cent. on the purchase of sterling and $\frac{1}{2}$ per cent. on re-purchase of local currency,[1] the money will not be transferred unless it is expected to earn more than 1 per cent. during the period. If the money will be required again in six months' time this means that it must earn at an annual rate of more than 2 per cent. after deducting any capital depreciation during the period. Moreover, money will not be transferred (even though its yield covers costs) if the banks or merchants have surplus funds in London.

Convenient terminology has been introduced by Mr. J. Mars in his discussion of Nigerian money and banking[2] to distinguish that part of the currency stock which is issued and withdrawn seasonally or cyclically from that part which remains permanently outstanding. Mr. Mars uses the term 'seasonally migratory currency' for the seasonally fluctuating component, 'cyclically migratory currency' for the cyclically fluctuating component, and 'localized currency' for the trend component. Some idea of the liquidity problem involved in the pre-war currency migrations—both seasonal and cyclical—can be seen from Table 2. The magnitude of the redemptions in the inter-war years was of the order of 30 per cent. of the outstanding currency, and in certain years the currency presented for redemption exceeded the issues by large amounts. In these circumstances it is clearly of the utmost importance that the currency authority is always in a position to supply large amounts of the local currency as required, and that large demands for redemption can be met without capital loss. At two points in the history of the African Boards these requirements have presented special difficulty; in 1949 the unprece-

[1] This is the current West African Currency Board rate and is also the rate currently charged by the *banks* for transfers from and to the four principal centres, a premium being added for 'up-country' transfers.

[2] J. Mars, *Economics of a Tropical Dependency*, ed. Margery Perham, London, 1947, vol. 2, p. 189.

dented expansion of local currency in West Africa placed a heavy strain on the Board's supply organization, currency notes being sent out by every available means, including specially chartered aircraft;[1] in 1931 the East African Board faced a crisis, largely as a result of the deficit with which the Board started operations, and the possibility that resources might prove insufficient to meet demands for redemptions was brought to the attention of the Secretary of State, as a result of which a guarantee fund of £1,500,000 was subscribed by the three Governments[2] and the rate for transfers to London was raised to 1½ per cent.

The ability to supply local currency is largely a question of anticipation and organization, while the ability to supply sterling is one of liquidity. When the demands on the sterling resources of the Boards are of a temporary character it is possible for funds to be obtained by means of bank loans, and this has been done on several occasions.[3] Normally, however, the Boards rely on the liquidity of their own assets and it will therefore be useful to look at a typical balance-sheet. That of the West African Board as given in the Report for 1949–50 showed the following position as at 30 June 1950.

LIABILITIES

	£	s.	d.	£	s.	d.
W.A. currency in circulation 30.6.50	66,276,841	3	6			
Less market value of W.A. silver coin	635,506	1	1			
				65,641,335	2	5
Surplus				6,093,171	2	1
				£71,734,506	4	6

ASSETS

Investments at mean market prices 30.6.50 . . .	65,057,626	0	0
W.A. and U.K. silver coin held at Currency Centres and in transit	5,414	19	0
Suspense Account	10,733	10	0
On Deposit	6,000,000	0	0
Cash in hand at bankers	660,731	15	6
	£71,734,506	4	6

[1] *West African Currency Board Report*, 30 June 1949.

[2] Kenya Ordinance, No. xvi of 1933; Uganda Ordinance, No. 4 of 1933; Tanganyika Ordinance, No. 4 of 1933.

[3] For examples see *West African Currency Board Reports*, 1928–9; 1929–30; 1930–1; 1937–8; and *East African Currency Board Reports*, 1929–30; 1930–1; 1931–2.

The detail of the investments given in the same report is indicative of the Board's strong *liquidity preference*, the distribution of investments according to redemption dates being as follows:

Life of security to redemption date	*Nominal value*	*Per cent. of total*
1–5 years	£28,388,500	44
6–10 years	19,175,000	29
11–15 years	9,425,000	15
over 16 years	7,569,900	12
	£64,558,400	100

With so large a proportion of its assets in *shorts*, the Board is clearly in a very strong position to meet possible demands for redemption. The reports of other authorities show similar positions.

It will be seen that the standard system, which has been described, is a perfect example of the sterling exchange-standard, and that the international purchasing power of the local currency is automatically pegged to that of sterling, with which it is always freely exchangeable. Only by a deliberate alteration of the parity (by act of State) could the international purchasing power of the local currency and sterling diverge by more than the small margin of the commission charged by the currency authority. The power to make such an alteration resides ultimately in the Secretary of State (except in the case of the self-governing colony of Southern Rhodesia), but in all cases it is subject to the limitations imposed by membership of the International Monetary Fund, at which body the United Kingdom Government stands proxy for the colonial governments. Up to date there has been only one case of a colonial currency being revalued against sterling; in 1933 the Fijian pound was adjusted from parity to £111 Fiji = £100 Sterling, half-way towards the Australian rate.[1] The interesting case of British Honduras, whose currency diverged temporarily from parity as a result of an alteration in the value of *sterling*, actually emphasizes the closeness of the relation between colonial currency and sterling. Up to December 1949 the

[1] Fiji Currency Notes Act, 1933.

B.H. dollar was nominally on a United States dollar exchange-standard, being interchangeable with the United States dollar at parity.[1] Thus it was the only colonial currency which was

TABLE 3

Local Currencies

	Local currency unit	*Number of local units per pound sterling*
East African Group	East African shilling	20
Central African Group	S. Rhodesian pound	1
West African Group	West African pound	1
Eastern Group		
Malayan Currency Union	Malayan dollar	8·57142857
Hong Kong	Hong Kong dollar	16
Mediterranean Group		
Cyprus	Cyprus pound	1
Gibraltar	Gibraltar pound	1
Malta	Maltese pound	1
West Indies Group		
Bahamas	Bahamas pound	1
Bermuda	Bermudan pound	1
Jamaica	Jamaican pound	1
British Honduras	British Honduras dollar	4
Barbados, British Guiana, Leeward Islands, Trinidad, Windward Islands	British West Indian* dollar	4·80
Western Pacific Group		
Fiji	Fijian pound	1·11
Tonga	Tongan pound	1·2525
Atlantic and Indian Ocean Group		
Falkland Islands	Falkland Isles pound	1
Mauritius	Mauritius rupee	13·3
Seychelles	Seychelles rupee	13·3

* In course of consolidation

not *automatically* devalued with sterling in September 1949; being tied to the United States dollar it appreciated *vis-à-vis* sterling. However, in December 1949, by a specific act of State[2] (which was opposed in the local legislature and only

[1] Invested funds were, however, kept in sterling, and from 1940 onwards (for Exchange Control reasons) this was also true of liquid funds.

[2] Ordinance No. 30 of 1949, 31 Dec. 1949.

implemented by Order of the Governor) the old parity was re-established,[1] and at the same time British Honduras was formally transferred to the standard system based on sterling. The fact that it is *possible* for such alterations in par values to take place obliges us to treat each colonial currency as a separate currency even though, as a result of the system which has been described, it functions exactly as if it were sterling; a list of these separate currencies, together with their par values, is therefore given in Table 3.

11. *Banking Structure and Policy*

The vast majority of banking business in the colonies is carried on by what may be called 'supra-territorial' banks; that is to say banks which operate in a number of different political areas. In contra-distinction to this, the term 'local banks' is used to cover those banks whose operations are restricted to the political area in which they are incorporated. Foreign banks, which play only a small part in colonial banking, may be conveniently considered in a separate category. Table 4, which sets out the distribution of branches of all types of banks throughout the colonies, illustrates the way in which the supra-territorial banks form a connecting link between the individual colonies. Moreover, it will be seen that, for the most part, the colonies are served by banks having the majority of their business *outside* the colonies—in most cases in one of the British dominions. The most important of these banks, from the colonial point of view, is Barclays Bank (Dominion, Colonial, and Overseas); this bank had its origin in the Colonial Bank which was established in 1836, by Royal Charter, for the purpose of carrying on banking business in the West Indies. It was re-incorporated with wider powers under the Colonial Bank Act of 1925, and in the same year the name was changed to the present style on acquiring the undertakings of the Anglo-Egyptian Bank Ltd. and the National Bank of South Africa Ltd. The outstanding feature of the bank is the wide coverage of its 620 branches, sub-branches, and agencies, which is unique in the world. The bank, whose Head Office is in London, is organized largely on a regional basis, the local areas of control within the colonies being East

[1] Actually $4 = £1 instead of $4·02 = £1 prior to sterling devaluation.

TABLE 4

Distribution of Branches of Banks throughout the Colonies

	Major non-colonial banking territory	E.A.				Cent. A.			W.A.				Eastern				Med.			West Indies										Pacific		Atlantic		Totals
		Kenya	Tanganyika	Uganda	Zanzibar	N. Rhodesia	S. Rhodesia	Nyasaland	Gambia	Gold Coast	Nigeria	Sierra Leone	Fed. of Malay	Singapore	Brit. Borneo	Hong Kong	Cyprus	Gibraltar	Malta	Bahamas	Barbados	Bermuda	Brit. Guiana	Brit. Honduras	Jamaica	Leewards	Trinidad	Windwards	Fiji	New Hebrides	Aden	Mauritius	
Supra Territorial Banks:																																	
Barclays Bank (D.C. and O.)	S. Africa	7	9	3		10	10	2		7	8	1					4	1	5	2	1		2	1	10	2	3	4				1	93
Standard Bank of South Africa Ltd.	S. Africa	8	9	3	1	10	16	4																									51
Chartered Bank of India, Aust., and China	India												11	3	5	1																	20
Eastern Bank Ltd.	India												2	1																			3
Indian Bank Ltd.	India												2	1																			3
Indian Overseas Bank Ltd.	India												3	1																			4
Mercantile Bank of India Ltd.	India												7	1		1																1	10
National Bank of India Ltd.	India	8	3	4	1																										1		17
Bank of Nova Scotia	Canada																								14								14
Canadian Bank of Commerce	Canada																				1				1		1						3
Royal Bank of Canada	Canada																			2	1		2	1	2	2	2	2					14
Bank of New South Wales	Australia																												2				2
Bank of New Zealand	N.Z.																												1				1
Bank of British West Africa Ltd.	—								1	10	17	2																					30
Hong Kong and Shanghai Banking Corp.	China												9	1	5	2																	17
Overseas Chinese Banking Corp. Ltd.	Far East												15	2	1	1																	19
Local Banks	—										4		1	3		4	9	1	7	1		5					1				1	37
Foreign Banks	Various		1										9	11	3	27	21	2											1			75
TOTALS		23	22	10	2	20	26	6	1	17	29	3	59	24	14	36	34	4	12	5	3	5	4	2	27	4	7	6	3	1	1	3	413

Colonies having no banks have been omitted from the table.
Agencies have been excluded, and sub-branches counted as branches.

Africa, West Africa, Rhodesia, and the West Indies, in each of which policy is directed by a Local Board or Local Director. The Bank of British West Africa Ltd. is also unique in its way, since it operates exclusively in colonial territory.[1] The bank was established in 1894 to acquire the Lagos business of the African Banking Corporation Ltd. and Messrs. Elder Dempster and Co., and in 1912 it took over the Bank of Nigeria Ltd. Over half of the Bank's subscribed capital is held, in roughly equal amounts, by Lloyds Bank Ltd., the Westminster Bank Ltd., the National Provincial Bank Ltd., and the Standard Bank of South Africa Ltd. To obviate a great deal of wearisome text, details of all the supra-territorial banks have been set out in Table 5.

It is now necessary to examine more closely the practical implications of this supra-territorial banking network, and the first point which must be made is that funds are used indiscriminately and are not segregated to a particular colony or currency union. In principle the branch managers in the various colonial branch offices are in exactly the same position as the branch managers of the deposit banks in the United Kingdom; they employ such funds as can be used locally in a manner consistent with the bank's lending policy, and any surplus becomes available for use elsewhere. Thus a bank serving more than one colony could offset a borrowing area against a lending area in exactly the same way that different districts are offset in England and Wales by the integration of the banking system. In actual fact, however, except for seasonal requirements, nearly all the colonies are 'surplus' areas; that is to say, given the bank's lending policy, the investment opportunities for banking funds are not equal to the supply of such funds, and the surplus which arises has perforce to be employed outside the colonies.[2]

In the absence of money markets in the colonies, the only assets which the colonial banker can hold locally are cash and advances. Having pushed his advances as far as his lending policy will permit, he will wish to hold as little of the non-

[1] Except for one branch in Tangier.

[2] Evidence of this is provided by such banking statistics as are published and is clearly shown by the final figures in each column in Table 6, to which further reference is made later.

TABLE 5

Supra-territorial Banks

Bank	*Incorporation*		*Capital paid up*	*Total assets*
	Date	*Place*		
Barclays Bank (D.C. & O.)	1836	London	£7,121,500	£408,082,158 31.3.50
Standard Bank of South Africa Ltd.	1862	London	£5,000,000	£269,712,508 31.3.50
Chartered Bank of India, Australia, and China	1853	London	£3,000,000	£151,520,444 31.12.49
Bank of British West Africa Ltd.	1894	London	£1,200,000	£52,182,778 31.3.50
Eastern Bank Ltd.	1909	London	£1,000,000	£24,108,046 31.12.49
Indian Bank Ltd.	1907	Madras	Rs. 52,96,276	Rs. 24,55,73,460 31.12.48
Indian Overseas Bank Ltd.	1936	Madras	Rs. 37,14,700	Rs. 10,14,20,836 31.12.49
Mercantile Bank of India Ltd.	1892	London	£1,050,000	£54,093,343 31.12.49
National Bank of India Ltd.	1863	Calcutta*	£2,281,250	£92,972,507 31.12.49
Bank of Nova Scotia	1832	Halifax	$C12,000,000	$C806,308,701 31.10.49
Canadian Bank of Commerce	1867	Toronto	$C30,000,000	$C1,646,320,246 31.10.49
Royal Bank of Canada	1869	Montreal	$C35,000,000	$C2,370,989,284 31.5.50
Bank of New South Wales	1817	Sydney	£8,780,000	£331,679,489 30.9.49
Bank of New Zealand	1861	Wellington	£6,328,125	£102,585,434 31.3.50
Hong Kong and Shanghai Banking Corporation	1864	Hong Kong	£1,250,000	£169,476,890 31.12.49
Overseas Chinese Banking Corporation Ltd.	1932	Singapore	$M10,000,000	$M163,824,665 31.12.49

* Registered in London, 1866.

earning asset—cash—as is considered safe, and he will therefore obtain his desired distribution of assets by buying securities, and lending 'call money', in the money market in which he normally operates—*providing he is willing to accept the exchange risk.* Since each colonial currency is a separate currency, the supra-territorial banks necessarily carry an exchange risk on the excess of their colonial deposit liabilities over their colonial assets—which excess will be called their 'uncovered liability'. The only way in which this risk could be eliminated altogether would be by segregating each colony so that no uncovered liability existed; but if this were in fact done the banks could no longer operate, in the absence of suitable local employment of their funds and the source of liquidity provided by a capital market. The very existence of the high grade banking which the supra-territorial banks provide is thus seen to depend upon their being able to employ their surplus funds in a monetary centre whose currency is related to the colonial currencies in such a way that the exchange risk on their uncovered liability is small. By virtue of the currency system described in Section I, London is such a centre, the risk of an alteration in parity between a colonial currency and sterling being considered negligible.

The position of the non-sterling banks which have branches in the colonies, that is to say Canadian banks which do business in the West Indies, calls for special comment. If these Canadian banks were to keep their reserve against their uncovered colonial liabilities in their own reserve centre, they would run an exchange risk on the much less unlikely contingency of an alteration of the parity between the colonial currency and the Canadian dollar. For this reason it is certain that the Canadian banks hedge against such uncovered liability by holding sterling in London.

Thus it will be seen that all the supra-territorial banks hold funds in London, and by virtue of these funds the colonial banking system is based on the London Money Market in exactly the same way as is the banking system of England and Wales. Very little information is available as to the amount of the sterling funds of the colonial banks, but on 31 December 1948 the total sterling assets of the colonies totalled some £610 millions of which the principal holders were Malaya (£105

millions, West Africa (£145 millions), and East Africa (£105 millions).[1] These assets include the currency funds of the various currency authorities, which at that date totalled some £210 millions, thus leaving some £400 millions representing funds held by the Crown Agents, loans to the United Kingdom Government, and the London funds of the colonial banks. It is important to realize that these latter funds constitute the major part of the foreign exchange reserves of the system, the remainder being the currency fund. Thus the foreign exchange reserves are divided into two sectors—one sector being under the control of the currency authority and maintained at 110 per cent. of outstanding currency, the other sector being under the control of the commercial banks and varying in its proportion to bank money according to the banks' ideas of liquidity and opportunities for local employment of bank funds. The division of the reserves on this basis is similar in principle to that enshrined in the 1844 Bank Act in the United Kingdom.

Any discussion of the assets structure of the supra-territorial banks is severely limited by the paucity of banking statistics. The normal source of information in a self-contained system would be the published balance-sheets, but by reason of the complicated overlapping of the supra-territorial banks it is simply not possible to deduce even the total deposits in any colony from their aggregate figures. Furthermore, until quite recently, no official figures were published to cover this gap, so that it was not possible to determine one of the most basic economic quantities—the total money stock. This matter was the subject of a recommendation in a report by the colonial Economic Advisory Committee in 1945 as follows:[2]

> Estimates of currency in circulation are generally available. As for banking statistics the Colonial Office now receives figures for all the Colonies, via the Bank of England under an arrangement operating from 30th September 1943. These figures are very comprehensive and we suggest that all banks should be asked after the war to consider extending the series as far backwards as is practicable. The figures relating

[1] Mr. Rees-Williams in answer to a question in the House of Commons. *Hansard*, col. 1257, 25 May 1949.

[2] Colonial Economic Advisory Committee, *Report on Colonial Economic Statistics*. C.M. 13 Aug. 1945, Part I, para 21.

to Palestine are published monthly in some detail; the others are confidential. We recommend that after the war all such figures should be published periodically.

TABLE 6

Banking Statistics

	Kenya		*Tanganyika*		*Uganda*		*Jamaica*	
	1938	*1949*	*1938*	*1949*	*1938*	*1949*	*1944*	*1949*
Liabilities (£'000)								
Deposits:								
Demand	3,183	25,532	1,151	11,487	735	7,710	5,854	7,661
Time	1,747	2,299	542	1,095	701	544	788	756
Saving	312	1,062	106	525	72	270	4,790	4,969
Balances due to other banks:								
Locally	942	5,792	1,064	423	679	2,063	435	412
Abroad							—	—
Assets (£'000)								
Cash in hand	1,278	1,832	459	952	775	2,493	816	936
Advances:								
Industry	2,921	1,699	1,527	444	541	1,405	992	1,824
Agriculture		2,230		1,261		996	853	2,492
Other		6,460		1,576		1,040	1,503	5,281
Investments:								
Local	—	2,006	—	—	—	270	724	1,743
Other							776	384
Balances due from other banks:								
Locally	2,804	19,529	893	9,127	886	4,226	435	412
Abroad							5,097*	1,013*
Cash as per cent. of total deposits	24·4	6·3	25·5	7·3	51·4	29·2	7 1	6·9
Local assets as per cent. of total deposits	80·1	49·2	110·4	32·2	87·2	72·7	42·7	91·7

* Net.

Sources: The figures given are averages of the quarterly figures given in *East African Economic and Statistical Bulletin*, No. 7, and in the case of Jamaica, *Quarterly Digest of Statistics*, No. 7.

Since the war some colonies have given the figure for total deposits in their *Blue Books* and *Annual Reports*, though for a large number of colonies even this is still not done. The most comprehensive banking statistics available are those contained in the excellent publications the *East African Economic and Statistical Bulletin* (covering Kenya, Tanganyika, and Uganda) and the *Quarterly Digest of Statistics* for Jamaica.[1] Table 6 reproduces, in respect of the earliest and latest years available, the information given therein, together with two significant ratios deduced therefrom.

[1] Somewhat less detailed statistics are published quarterly in respect of Southern Rhodesia and regular statistics in respect of a number of other colonies will have been commenced by the time this book is published.

The first points which require explanation are the items 'Balances due to/from other banks'. In the absence of a Bankers' Clearing House, clearing between banks is normally carried on by means of accounts which each bank keeps with the others operating in the area; balances being settled periodically either in cash locally or in sterling in London. These accounts give rise to fairly large items outstanding between the banks within the colony, the algebraic sum of which is, of course, zero. In addition to these offsetting items there are balances due to and from the outside world, the net result of which represents a claim or a debt (usually a claim) on the part of the colony, which is the counterpart of the uncovered liability of the extra-territorial banks. This net item is given directly only in the Jamaican statistics but can be calculated from the East African figures by taking the difference between 'Balances due to' and 'Balances due from' other banks. An alternative approach to this relationship is obtained by expressing assets held within the colony as percentage of deposits within the colony, thus giving a standardized measure of the extent to which local funds are locally employed; this will be called the *local assets ratio.*[1] The distinctive feature of the colonial banking structure is that it permits this local asset ratio to differ greatly from 100 per cent., and to vary from colony to colony at any one time, and from time to time for any one colony, as can be seen in the final row of the table.[2]

It is important that the local asset ratio should not be misinterpreted; even where the ratio is 100 per cent. it may be that *self-contained* local banking would be quite impossible owing to the paramount banking requirement of suitable liquidity-grading of assets. This graded liquidity is achieved in the case of the supra-territorial banks on their assets *as a whole* and they can ignore such considerations in any particular territory. Thus a colony might show a local asset ratio of 100 per cent. but the local assets might be such as no bank,

[1] Local Assets Ratio $= 100 \left\{\frac{\text{Local Assets}}{\text{Local Deposits}}\right\}$ per cent.

$= 100 \left\{1 - \frac{\text{Uncovered Liability}}{\text{Local Deposits}}\right\}$ per cent.

[2] This is further illustrated in an illuminating special article 'The Banking System of Southern Rhodesia, 1936–1950', published in *Economic and Statistical Bulletin*, 7 Oct. 1950, subsequent to the drafting of this chapter.

restricted to operations to that colony, could possibly contemplate. Jamaica in 1949, for example, shows a ratio of advances to deposits of 69 per cent., which might be out of the question for a local bank.

The significance of the supra-territorial structure of colonial banking can also be seen in the local cash ratios shown in the table. Here again the range of variation is enormous and such that no self-contained banking system could support. While it should be stressed that these examples are not typical—the cash ratio in the West African colonies, for instance, is known to be much higher—the importance of a central reserve of cash, which as a result of the standard system can be transferred between centres as required, is immediately clear. The cash ratio of the two West African Banks over a period of twenty years has varied as follows:

Banks in British West Africa

Percentage Ratio of Cash to Deposit Liabilities

	B.B.W.A.	*Barclays (D.C. & O.)*
1930	24·1	20·0
1931	25·7	20·0
1932	18·2	22·5
1933	17·1	23·1
1934	10·9	23·6
1935	11·5	29·3
1936	22·4	29·1
1937	26·7	25·6
1938	59·3	28·7
1939	31·2	34·5
1940	28·8	33·5
1941	17·9	34·3
1942	23·1	32·4
1943	28·4	33·9
1944	20·5	33·7
1945	16·3	32·8
1946	10·5	37·0
1947	16·2	31·1
1948	14·9	32·0
1949	20·5	22·3
Average for period	22·2	28·9
Mean annual deviation	6·98	4·6

It is interesting to note the greater range of variation in the case of B.B.W.A. (which operates only in West Africa) as indicated in the annual deviation; moreover, if for both banks the data are divided into two periods—1930–8 and 1939–49—the mean annual deviation of Barclays (D.C. & O.) is 3·1 and 2·4, while that of B.B.W.A. is 8·8 and 5·2 for the respective periods. The smaller range of fluctuation in the case of Barclays (D.C. & O.) is due to offsetting cash requirements and to a more stable cash position in the Union of South Africa, which is heavily weighted in the aggregate figures. Such fluctuations as are shown in the B.B.W.A. figures would clearly not occur if there were a local money market for short loans in West Africa; the very high ratios (e.g. 1938) can only be explained by the accumulation of cash in West Africa which, having regard to the considerations of cost, yield, and risk (discussed in Section I) it was not considered worth transferring to London for temporary employment.

So far only the supra-territorial banks have been discussed, and it is now necessary to consider local banks. The total volume of business done by the local banks is not large, and only in two cases do they provide a high proportion of the banking services in a particular colony; in Bermuda the two local banks—the Bank of Bermuda and the Bank of N.T. Butterfield and Son—handle all the banking business in the island, while in Mauritius over half of the total deposits are with the Mauritius Commercial Bank. Particulars of the local banks known to be operating in the colonies are set out in Table 7. Unfortunately no balance-sheets are published in respect of the private companies, but the most striking feature of those of the public companies is their high cash ratio. Where it is possible to calculate the local assets ratio from the details given in the balance-sheets it is clear that the local banks, too, find it necessary to hold a fair proportion of external assets; thus in 1948 the balance-sheet of the Bank of Bermuda Ltd. showed a local assets ratio of 63 per cent.

As far as foreign banks are concerned, only in the two entrepôts (Hong Kong and Singapore) and in Cyprus is the business done at all significant. In Hong Kong and Singapore the twenty-three branches of foreign banks are almost exclusively concerned with the finance of foreign trade and consist of single

TABLE 7. *Local Banks*

Bank	*Date established*	*Type of company*	*Offices*	*Capital paid up*	*Total assets*	*Date*
Bermuda						
Bank of Bermuda Ltd.	1889	Public	3	£125,000	£5,652,863	30.6.50
Bank of N. T. Butterfield and Son Ltd.	1904	Public	2	£59,370	£4,175,120	30.6.50
Cyprus						
Bank of Cyprus Ltd. .	1943	Public	7	£466,324	£5,367,824	31.12.49
N. J. Dimitriou Ltd. .	1943	Private	1			
Banque Populaire de Limassol Ltd. .	1924	Public	1	£100,000	£987,643	31.12.49
Gibraltar						
A. L. Galliano . .	1855	Private	1			
Hong Kong						
Bank of Canton Ltd. .	1912	Public	8	$7,646,150	$82,908,465	31.12.48
Bank of East Asia Ltd.	1919	Public	5	$10,000,000	$79,215,487	31.12.49
Wing On Bank Ltd. .	1931	Public	4	$2,295,288	$18,797,837	31.12.47
Malta						
National Bank of Malta	1946	Private	2	£1,000,000		
Commercial Exchange Bank . . .	1880	Private	1			
Sciclunas Bank . .	1830	Private	1			
Tagliaferro and Sons .	1812	Private	1			
Vadala Co. Ltd. .	1874	Private	1			
Mauritius						
Mauritius Commercial Bank . . .	1838	Public	1	Rs. 3,000,000	Rs. 64,449,379	10.4.50
Nigeria						
African Continental Bank . . .	1948	Private	1	£5,000		
Agbon Magbe Bank .	1945	Private	1			
National Bank of Nigeria . . .	1933	Public	6	£35,000	£307,785	30.6.48
Nigerian Farmers Commercial Bank .	1947	Private	10	£1,220,000		
Malay and Singapore						
Ban Hin Lee Bank .	1935	Private	2			
Lee Wah Bank Ltd .	1920	Public	1	$1,604,950	$12,343,503	30.6.49
United Chinese Bank Ltd. . . .	1935	Public	1	$1,000,000	$11,039,497	31.12.49
Trinidad						
Gordon Grant & Co. Ltd. . . .	1872	Public	1	$2,400,000	$5,723,449	31.12.49

Remittance shops and native style 'banks' are excluded.

Sources: Bankers Almanac and Year Book, 1950–1, and the *Paton Report* (Nigeria).

offices of the principal American, French, Dutch, and Belgian trading banks. Only in Cyprus is local deposit business carried on by foreign banks on any scale, this being chiefly by Greek and Turkish banks as a result of the close historical and economic links with those countries.

To conclude this section a brief statement must be made

about the state of banking law. All of the West Indian colonies require that foreign banks shall be licensed, and the following colonies require that *all* banks shall be licensed: British Honduras, St. Helena,[1] St. Lucia, Trinidad and Tobago. Normally these licences are annual and require the payment of a fee. In Bermuda no person or firm may carry on banking business unless authorized by Act, while in the Gold Coast the Companies Act of 1906 expressly prohibits the incorporation of any company for banking business.

As a result of Exchange Control it is necessary for a bank, in order to operate fully in the colonies, to obtain recognition as an 'authorized dealer' in foreign exchange; this gives Government a *de facto* opportunity to exercise discretion regarding proposals to open new banks.

Only in three colonies—Bahamas, Kenya, and Hong Kong—is there any detailed legislation regulating banking, and the Banking Ordinances of these three colonies differ in scope considerably.

Bahamas. The Banks Act, 23 August 1909, applies to every bank carrying on business in the colony and calls for an annual statement in such form as the Governor-in-Council may from time to time direct. The Governor may call for further information, but private accounts may not be divulged.

Kenya. The Banks Ordinance, 29 April 1910, applies to any persons or body, whether incorporated or not, engaged in the business of banking in the colony and calls for filing of documents regarding capital composition, &c. The Governor may appoint inspectors on application by shareholders, or depositors owning more than half the total deposits. The Ordinance calls for a fairly detailed statement of assets and liabilities, prohibits the issue of notes, and stipulates that auditors shall be subject to the approval of the Governor as to competency.

Hong Kong. The Banking Ordinance, 29 January 1943, is the most recent and most comprehensive of colonial banking laws. It defines banking business and lays down that this shall only be transacted by a company which must first be licensed, and that only a licensed company may use the title 'bank'.[2]

[1] There are no banks in St. Helena to date.

[2] Special provision was made to cover the non-company banks actually in operation at that time.

The Governor-in-Council may (after consultation with his Advisory Committee) call for books, accounts, and documents, and may order the bank to refrain from banking business and/or cancel its licence. Licensed banks are required to pay an annual fee of $5,000 and provision is made for the publication of balance-sheets. The issue of notes is prohibited except by the chartered note-issuing banks.

Apart from the specific provisions set out above, banks which are companies within the meaning of the local Companies Ordinance (or Act) are subject to the provisions of that Ordinance. Normally this requires no more than the publication of a half-yearly statement of assets and liabilities. Regarding the statement required by the Companies Ordinance in Nigeria, Mr. Paton makes the following comment in his Report: 'The statement is archaic in form and the required data would be of little value in any attempt to assess the financial condition of the bank.'[1] Since this is the only legal requirement regarding banking in Nigeria it is hardly surprising that the term bank has been used in this colony to cover organizations of the most doubtful character carrying on business without regard to the interests of depositors, and in some cases perpetrating outright fraud. Mr. Paton gives the unsavoury details of three banks which have recently gone into liquidation in Nigeria with losses to depositors, in one of which the 3,570 depositors lost every penny of their £13,225 deposits.[2] The damage done to the development of sound local banking by such occurrences is deplored by all, and Mr. Paton makes far-reaching recommendations aimed at preventing their repetition. He proposes the enactment of a Banking Ordinance which would apply to any person or body carrying on business as a bank or using the title 'bank'. The provisions of the draft Ordinance call for a minimum subscribed Capital of £25,000 (50 per cent. paid up), and require a company to obtain a licence before commencing business. It further provides for the nomination of an officer of the Government to exercise general supervision and control of banks, with powers to call for books, accounts, and documents, whose duty it would be to examine the statements which the banks would be called upon to render to the Financial Secretary. These statements

[1] *The Paton Report*, para. 6. [2] Ibid., para. 4.

would show (quarterly) the assets and liabilities of the bank, distinguishing between internal and external items, and (half yearly) a detailed analysis of loans and advances within the colony. It is further recommended in the Report that these figures should be consolidated and published.

The failure (in 1949) of the Exchange Bank of India and Africa Ltd. (incorporated in Bombay in 1942), which had been operating in East Africa with an almost incredible disregard for the interests of its depositors, stimulated public opinion with regard to banking law, and it is expected that a Bill will be presented to the Legislatures in East Africa in the near future designed to prevent any similar occurrence. This failure, and those of local banks in Nigeria, serve to emphasize the considerable contribution which has been made to the stability of the Colonial economies by the integrity and restraint of the British banks, which has resulted in a record unbroken by any failure or suspension.

III. *Banking Services*

The general picture which emerges from a study of banking services in the colonies is that of a concentration of banks in the commercial centres where they perform the normal banking functions for the commercial community and for that small section of the total population (for the most part non-indigenous) which has acquired the banking habit. Their contact with the indigenous populations is almost entirely restricted to savings bank business which is only undertaken by some of the banks. With this picture in mind we should not expect the number of banks serving a particular colony to bear much relation to the total population, and Table 8, which gives the ratio of banks to population in the form of thousands of persons per bank, shows huge variations. The colonies have been arranged in descending order; at one end of the scale is Gibraltar with 6,000 persons per bank (a banking density almost as high as that of England and Wales), while at the other end of the scale is Nigeria with 962,000 per bank. Although this is a very crude measure of banking services—the volume of business done by a branch being far from uniform—yet the table does show a distribution which is consistent with other evidence of the degree to which banks are used by the whole population.

TABLE 8. *Banking Density*

	Number of persons per branch office (thousands)
Gibraltar	6
Bermuda	7
Cyprus	14
Bahamas	16
Malta	26
Leewards	27
Singapore	42
Windwards	46
Jamaica	52
Borneo	67
Barbados	69
S. Rhodesia	80
N. Rhodesia	82
Hong Kong	86
Malay	88
Trinidad	88
Fiji	95
British Guiana	103
Mauritius	157
Gold Coast	210
Kenya	234
Tanganyika	336
Nyasaland	403
Uganda	505
Nigeria	962

Colonies having less than three branches have been excluded

The services rendered by the banks to depositors differ in no respect from those associated with the banking system of the United Kingdom, but there is one special feature in connexion with charges which is worthy of note. The par clearance of cheques between different centres in the same monetary area which is an accepted practice in United Kingdom banking is by no means general in the colonies. In Africa a clearance charge of the order of $\frac{1}{4}$ per cent. is made generally, and in East Africa the charge varies with the rail distance between centres. The argument used to support these charges is associated with the huge distances between centres and the cost of moving actual cash. The fact that there are large one-way seasonal movements of cash for the purpose of purchasing the cash crops involves the banks in heavy costs in respect of the handling, transport, escort, and insurance, and since it is not possible to discriminate between transfers which involve cash

movements and those which do not, a general clearance charge is made. Some approximation to such discrimination is, however, attempted in the special charge made on transfers from Kenya and Tanganyika to Uganda during the cotton purchasing season.

The provision of bank credit may be conveniently considered under five heads: (1) Distribution; (2) Production; (3) Collection; (4) External Trade; (5) Agricultural and Industrial Development.

1. *Distribution*

The structure of distribution differs considerably from territory to territory, as do the credit terms of the importers and local manufacturers (where these are established). The main function of the banks in the provision of credit to the distributor is that of providing short-term funds to cover time lags between purchase and sale where this cannot be done from working capital. Methods vary but consist mainly of: (*a*) advances, either unsecured or against security unconnected with the specific transaction which is being financed; (*b*) advances against bills drawn by the seller on his buyer; (*c*) discounting of such bills. Since these bills are 'clean' (that is to say, no documents of title are attached), the banks rely upon their knowledge of the individual signatures in deciding upon the security of the loan. Since such advances are made to a large number of small traders, the banks need to keep in very close touch with the market. The main consideration which influences the banks' overall lending policy (as distinct from their attitude to individual borrowers) is their estimation of the stock position; although they normally take comfortable margins, the final guarantee of the eventual repayment of the loans is the absorption of goods into consumption at remunerative prices. An over-stocked position in which credit is frozen in the form of unsold goods is the bankers' nightmare, and for this reason he is always on the look out for a fall in consumer demand—both in particular lines and in general.

2. *Production*

The provision of credit for manufacturers in those places where local industry has been established follows the same

lines as that of British banks in more developed economies. With regard to agricultural production the position is more difficult. Where the unit of production is a large farm, or estate, or plantation, seasonal advances during the growing season are common, as are loans of somewhat longer duration for agricultural improvements. The figures in Table 6 indicate the relative importance of agricultural and industrial advances in those colonies for which a classification of advances is available. But much colonial agricultural production is carried on by peasant cultivators on small holdings to which the cultivator has no specific title, or where a title does exist it is one which is unacceptable as security since the land cannot be alienated. This fact, combined with the absence of any other form of suitable security (e.g. property deeds or insurance policies), renders advances to the peasant cultivator an unacceptable banking risk. Special institutions have been set up in many of the colonies (land banks and credit and savings banks) designed to provide short- and medium-term credit for agriculture, but these appear to work, for the most part, on traditional commercial lines and the same difficulty regarding security is encountered. On the other hand, producers' co-operative societies are playing an increasingly important part in providing short-term finance—in some cases with the assistance of bank loans; at the present stage the banks normally require a government guarantee for such loans and are accordingly paid a lower rate of interest than the commercial rate. In some cases (e.g. Northern Rhodesia), the co-operatives get the advantage of this lower rate, but in others (e.g. Uganda) the full commercial rate is charged to the co-operatives—the Government receiving the difference in consideration of its guarantee. The latter would seem to be the sounder method—the receipts by Government being treated as a reserve against the contingent liability under the guarantees. As the co-operative societies become more firmly established it should be possible for them to dispense with the Government guarantee and to obtain advances on the basis of their own credit standing at the commercial rate.

3. *Collection*

This term is used to cover the very important function of

moving the agricultural products from the growing areas to the export points. Where this function is performed by large-scale organizations (as, for example, by the United Africa Company in West Africa), the finance is obtained from the merchants' own resources. Where smaller-scale merchants handle the internal movement of the produce (as with tobacco in Rhodesia) they are usually financed by bank advances. Where the collection is done by statutory boards the finance may be provided either from the boards' accumulated funds (which are in many cases large), or directly from Government, or from the banks.

4. *External Trade*

In most of the colonies the ratio both of exports and imports to national income is high—in some cases phenomenally so. Since so large a proportion of total transactions is associated with international trade, it is clear that this must necessarily be one of the main constituents of the total demand for finance, and it is thus not surprising that the major part of the banks' lending is in connexion with imports and exports. As with the internal movement, a considerable part of the finance for external movement is provided in some colonies by the large-scale merchants; for example, the United Africa Company, which was responsible for the sale of merchandise in West Africa to the value of nearly £50 millions in 1948–9,[1] also financed its imports. The method by which imports are financed, where this is done directly by the banks, is either by means of documentary credits, the colonial banks opening credits on behalf of colonial importers, or by the consignment method, by which goods are actually consigned to the bank's warehouse from which they are collected by the importer against payment, or simply by advances to the importer. As regards exports, the banks perform the normal role in this connexion by negotiating the bills drawn under documentary credits opened abroad in favour of colonial exporters and frequently negotiate bills in respect of which no credit has been opened.

[1] United Africa Company, *Statistical and Economic Review*, No. 2, Mar. 1950, p. 38.

5. *Industrial and Agricultural Development*

The banks have followed the normal banking canons of avoiding loans of a permanent nature for the purpose of long-term development, but special organizations have been formed by two of the banks for the purpose of making funds available for these purposes. Barclays Overseas Development Corporation Ltd. (a subsidiary of Barclays Bank (D.C. & O.)) describes itself as 'a subsidiary company formed primarily for the purpose of assisting in the economic development of certain colonies and territories overseas in which the Bank is established'. The function of the Corporation is to provide finance of a long-term character, such as is not normally obtainable from a commercial bank, for well-grounded schemes of agricultural and industrial development. The Company, which was incorporated in London in 1946, has an authorized capital of £5 millions. The Standard Bank of South Africa has a similar subsidiary in the Standard Bank Finance and Development Corporation, which was formed primarily in connexion with development in East Africa, and which has an authorized capital of £500,000. The branches of the banks act as agents for their respective subsidiaries throughout the areas in which they function.

The provision made by such institutions as these is necessarily on the lines of European tradition, and the difficulty regarding adequate security prevents them from contributing to one of the major colonial problems—that of capital investment in peasant agriculture. It is clear that this problem is one which can only be solved by special provision and special institutions which need to be integrated into a comprehensive system of agricultural education, supervision, and research, involving considerable capital investment.

In addition to their services to the private sector of the economy the banks play their part in the provision of banking services to the colonial governments and to such public corporations as the Colonial Development Corporation, the Overseas Food Corporation, the Produce Control Boards, &c. Under the Colonial Development and Welfare Acts (1940 and 1945), £120 millions will be provided over the ten years 1945–55, and these funds, which will be raised by the United

Kingdom Government, will be credited to the account of the appropriate local government as they are allocated—the banking system thus acting as the normal means of transferring such funds.

In concluding this section on banking services it would seem appropriate to say a word on the dominance of extra-territorial enterprise in a colonial economy—of which the colonial banking system is a special case. It is certain that such progress as has been made in the development of the colonial economies could not have taken place without the financial facilities which the extra-territorial banks have provided, just as, in the early development of the dominions, the Imperial banks were invaluable in connecting their primitive economies to the mature monetary facilities of the London Money Market. The fact that the colonies depend almost entirely on externally owned financial institutions is the logical conclusion of international specialization in a situation in which the necessary skill, experience, and capital have not been available locally. It is possible that with their economic and political development the colonial peoples may wish to encourage local banking even though its efforts to carry on traditional types of business may, in the early stages, be less efficient than those of the extra-territorial banks. It seems unlikely that any advantage is to be gained by local banks attempting to compete in the sector which is already served by the established banks, but there would appear to be a strong case for developing indigenous institutions to cover that sector (the growing requirements of the native populations—particularly the peasant cultivators) which is at present almost untouched by the existing banking system. An integration of agricultural development funds, producers' co-operative societies, thrift and loan societies, and savings banks might be so developed as to provide a comprehensive range of financial services at a different level from those of the commercial banks, working on principles more appropriate to the special requirements of undeveloped economies.

IV. *Theoretical Analysis*

The theoretical discussion which follows will deal with three aspects of the colonial monetary system: the position of

the colonies within the Sterling Area, the determinants of the total supply of money, and the effect of introducing a fiduciary issue.

(i) *The Position of the Colonies within the Sterling Area*

It was shown in Section I that the rate of exchange between the colonial currencies and sterling is firmly fixed by the nature of the sterling exchange standard system in operation; it was further shown in Section II that the credit base, upon which the banking system operates, consists of sterling funds held in the London money market; to these two characteristics must be added a third—the fact that all of the colonies are *inside* the boundary of the Sterling Area Exchange Control.[1] The colonies thus satisfy the three conditions of membership of the Sterling Area—a stable exchange rate against sterling, the holding of sterling balances, and a common exchange control area. But the colonies are a special group within the wider Sterling Area of which they form part. Not only is their rate of exchange normally fixed to sterling, but it cannot be altered at their own discretion; not only is their currency normally backed by sterling, but it must be so backed by their basic currency law; not only do the banks normally hold sterling balances, but this is the only way in which they could operate profitably; not only does the sterling exchange control 'ring fence' embrace both the colonies and the United Kingdom, but the administration thereof is under the ultimate supervision of the United Kingdom Treasury; furthermore, the United Kingdom Government represents the colonies at the International Monetary Fund, where it has a common quota with the colonies. For all these reasons the colonies can be described as belonging to an 'inner circle' of the Sterling Area whose relations with London are more intimate and more rigid than those of the 'outer circle'. The principal advantage which the colonies derive from membership of the Sterling Area is that they thereby become part of a large area in which multilateral trade is freely transacted in sterling, and this area is one in which a very high proportion of their trade naturally takes place.[2]

[1] This is only true with qualifications as far as Hong Kong is concerned.

[2] This subject is dealt with fully by Mr. Paul Bareau in Chapter 14.

(ii) *The Determinants of the Quantity of Money*

It will be convenient to examine the determinants of the total money stock by setting out first of all the ways in which an increment of local money can come about. Local money can increase as a result of any of the following:

1. An excess of exports over imports.
2. An increase in bank advances by extra-territorial banks.
3. An increase in bank advances by local banks.
4. Transfers into local money of liquid capital of extra-territorial firms.
5. Transfers into local money of loans raised externally.
6. Transfers into local money of grants received externally.

Seasonally migratory money is provided, in the first instance, by items 2, 3, and 4; as these items are liquidated by the external sale of the produce, but prior to expenditure on imports, the money continues to exist as a result of item 1; as the income generated by sale of exports is spent upon imported merchandise, the money stock and the active balance are reduced *pari passu*; finally, the money stock will be reduced to the hard core of localized money, the level of which will differ from the preceding low point by the active balance of the period. The only case which represents local creation of money is item 3; as in any other system, bank money can be expanded by the activities of the local banks subject to the normal limitation imposed by considerations of legal tender reserve. Items 2 and 4 resolve themselves into cases of importation of money by external borrowing, due to the fact that the balance of payments boundary runs right through the centre of the banking and merchanting structure. The items can thus be regrouped as follows:

A. Import of money in exchange for excess of exports over imports. (1)
B. Import of money by external borrowing. (2, 4, and 5)
C. Import of money by unilateral receipt. (6)
D. Creation of money by local banks. (3)

If the money stock consisted *solely of currency*, then items 2 and 3 above would not occur and the monetary system would operate exactly like a country whose circulating medium

consisted entirely of full-bodied gold coin; the money stock of such a country would be strictly determined by the balance of payments, since an excess of payments would cause an outflow, and an excess of receipts would cause an inflow: many colonies where banking is not well developed do, in fact, operate somewhat like this.[1] If the money stock consisted *solely of bank money*, the foreign exchange reserve (upon which the money stock is based) would contract with an excess of payments, and expand with an excess of receipts; in the theoretical models of the exchange standard system it is always assumed that such contraction or expansion of reserves will induce a secondary contraction or expansion of money stock as a result of attempts by the banks to restore some ideal ratio which is critical. If we now combine these two pictures into a model of the exchange standard system using *both currency and bank money*, we see that the two effects described above are alternatives: to the extent that local money is dishoarded in the form of currency in order to maintain imports in excess of exports, sterling is made available to finance the deficit without a fall in bank reserves; to the extent that it is bank money which is dishoarded, reserves are drawn down and a secondary contraction will ensue.

In the colonial economy, however, the peculiar supra-territorial structure described in Section II necessitates considerable modification to this model. Firstly, since the banks normally serve a particular colony as one small part of their business, and since they do not hold sterling reserves specifically against their operations in that one colony, their credit policy will have no direct relation to the amount of reserve which they 'lose' or 'gain' on account of a particular colony,

[1] Mr. J. Mars, in his study of Nigerian money and banking, states this as a general conclusion necessarily following from the operation of the currency system, thus: 'This automaticity in the issue and redemption of currency means, however, nothing more nor less than that the increments and decrements of the localised currency are strictly determined by the balance of payments' (*Mining Commerce and Finance in Nigeria*, edited by Margery Perham, London, 1947, p. 185). This is an error in analysis, since it must be clear that the quantity of currency can change simply as a result of a change in the wishes of the public regarding the *form* in which they hold money—quite independently of the balance of payments. It is the total stock of money which is determined by the balance of payments (in the absence of local banks), and only if currency were the only form of money would Mr. Mars's proposition be true.

but will be determined by their liquidity position in general. Secondly, the limiting factor to local advances is *not* the availability of sterling reserves in relation to some ideal ratio, but the existence of acceptable investment opportunities, so that there is normally a considerable amount of slack in the system and the cash ratio is not critical. Formalizing this:

$$D = d_1+d_2+d_3+ \ldots d_n = r\,(C) = C+S+A,$$

where D = total deposits of any supra-territorial bank.
d_1, d_2, &c. = deposits in particular colonies.
r = ratio of sterling cash to total deposits.
C = sterling cash
S = sterling securities.
A = advances.

In such a situation an excess of payments by a particular colony may have any of the following effects, either singly or in combination:

1. Dishoarding of currency; r and C remain unchanged.
2. Contraction of d_1 offset by expansion of d_2; r and C remain unchanged.
3. r permitted to alter as C falls.
4. Fall of C offset by sale of securities; r re-established by a fall in S.
5. r re-established by a secondary contraction of D.
6. r re-established by a secondary contraction of d_1.

It would appear that in any case where $\frac{d_1}{D}$ is small the likelihood of the result being limited to alternative 6 is small, yet this is the result usually assumed in discussion of the foreign exchange standard model to which the colonial system is supposed to correspond.

(iii) *The Introduction of a Fiduciary Issue*

It has been shown that in all cases colonial currency is fully backed by sterling, but it has been suggested in recent discussion that departure from this practice might be justified in respect of that part of the outstanding currency which would under no circumstances be redeemed. This could be done by simply permitting the currency authority to hold locally issued securities as backing for currency up to a certain limit which

could be reviewed from time to time. At its inception this would amount to the cancellation of an external liability—the sterling obligation in respect of the permanently localized currency—and would thus set free an equivalent amount of the sterling reserve; thereafter the raising of the fiduciary issue would permit a costless increase in the permanently localized currency. A fiduciary issue of this kind would neither affect the operation of the sterling exchange standard system (since the 100 per cent. backing for migratory currency would be unaltered), nor give any grounds for loss of confidence in the currency. The argument against it is that once the 100 per cent. principle has been dispensed with the currency fund may come to be regarded as a treasure chest into which Government can dip from time to time, expediency rather than security being the criterion.

A very much more drastic change is envisaged by those who advocate a fiduciary issue as a necessary condition of local monetary management. This would involve a complete severance between the volume of local money and the volume of sterling balances and would require the setting up of a central bank to administer the foreign exchange reserves and to control the credit base; since this chapter is concerned with the system as it is, it would be inappropriate to enter into a discussion of the advisability or practicability of such a transition.

Postscript.—Since this chapter was drafted the West Indian Currency Union discussed on p. 427 has commenced operations.

14

THE STERLING AREA

THIS series of essays on Banking in the British Commonwealth would not be complete without some comment on the monetary setting in which these institutions have to operate. It is a setting in the formation of which the development of the banking systems described in the foregoing chapters have played no small part. That part, however, is only one of the many strands that have made up the pattern of the British Commonwealth currency system.

Among the other strands, that which must take precedence, both in point of time and of importance, is the natural tendency of the British trader to take his own currency with him, to buy and sell in terms of pounds sterling, and thus to implant sterling as the basic currency of the territories into which he pushed his merchant ventures.

Another formative influence was the conscious policy of successive British governments to establish some uniformity in their remittances to colonial territories.[1] The evolution of the sterling system has often been described as a purely functional process of adaptation, deriving from the commercial and industrial dominance of Great Britain in the nineteenth century. This is a correct description, but it must not be allowed to obscure the element of conscious volition that also entered into the growth of the sterling area. R. Chalmers, in his standard work on the *History of Currency in the British Colonies*, recalls the Treasury minute of 1825 suggesting that opportunity should be taken 'for introducing a fixed and uniform medium of exchange for all transactions connected with the public service, in place of the various, fluctuating and anomalous currencies . . . which have been productive of much private and public inconvenience'. This medium of exchange, according to the Lords Commissioners of the Treasury, should be 'the silver and copper currencies now in circulation in this country, provided the same be made convertible, at the will

[1] Cf. Chapter 13 above.

of the holder, into the standard gold currency of the United Kingdom, by means of bills of exchange, to be given at a rate to be fixed for each station by the officer in charge of the military chest, or some other public authority'.

The Order in Council promulgated as a result of this proposal envisaged a Colonial currency system closely akin to that which was later to be embodied in the machinery of Currency Commissioners described in Chapter 13 above. The essence of this machinery is the setting up in each colony of a currency authority which acts purely as a money changer, issuing local currency against receipt of sterling in London and, conversely, repurchasing local currency against payment of sterling in London. In this way the local currency is linked automatically to sterling.

The Treasury minute of 1825 envisaging 'a fixed and uniform medium of exchange' throughout the Empire was never realized. This vision assumed a degree of political hegemony and rigidity of structure of the Empire which was never to prevail—fortunately, perhaps, because it was the very reverse qualities of heterodoxy and elasticity which appear to have ensured the continuity of the Empire through its evolution into the Commonwealth. The middle decades of the nineteenth century were to provide much evidence of this disparity of economic and political evolution. Canada was to feel the strong pull of the United States dollar. In Australia, New Zealand, and South Africa the currency of Britain was to be in day-to-day use to make way ultimately for Australian, New Zealand, and South African pounds which were scarcely distinguishable from the £ sterling. In the West Indies the monetary situation was inevitably affected by the fate of the Spanish dollar which was current in Latin America long after the breakdown of the Spanish Empire. In India and South-east Asia the sway of silver was to be dominant in the case of the former until the closing decade of the nineteenth century, and the latter until well into the twentieth century. But though there was no question of 'introducing a fixed and uniform medium of exchange for all transactions connected with a public service' these territories (other than Canada and Newfoundland, where the pull of the dollar became the dominant influence) formed part of a sterling group of countries whose

banking monetary reserves were in large part kept in London, whose currencies were anchored to sterling.

Until the early nineteen-thirties, the existence of this group was scarcely perceptible. Its evolution had not been consciously designed, its individuality was inevitably lost in the much wider grouping of currencies based on gold, and, therefore, readily interchangeable into one another at relatively fixed prices. Up to 1914, when this international gold standard was in effect dominated by London, it might be claimed in retrospect that the sterling group was merely the inner core of a world-wide system which was in fact based on sterling. The gradual crystallization of that inner group into a bloc or area was due to a combination of political, commercial, and financial influences which brought the countries concerned within the monetary orbit of Great Britain and sterling. As British traders pursued their merchanting operations overseas it was in sterling that they bought and sold. Britain was the principal market for the goods produced in the new territories brought within the Empire. What Britain did not buy for its own consumption, it bought for sale to third parties through one or other of the great international markets that were to be found in London or Liverpool. These overseas territories therefore scarcely ever became conscious of foreign exchange operations other than those in sterling. It can truly be said that the vast bulk of their external trade was transacted in sterling. There was no question of any decision on their part to remit foreign currency proceeds on their exports to London. The process was established automatically by the fact that almost the whole of their export trade was invoiced in sterling.

There were, however, many other subsidiary influences all pulling in the same direction. The territories in question were hungry for capital and they found that capital almost exclusively in the British market. The loans were raised in sterling and sterling working balances had to be maintained in order to meet their service. As new territories were brought within the Empire their need for banking services was for the most part catered for by banks launched with British capital, often retaining their head offices in London. The banking reserves of these countries tended therefore to be kept in London. This was not only because the capital and often the

legal domiciles were provided by London, but because it was in this market only that adequate facilities were available for employment of liquid assets repayable at call or short notice.

It is in the light of all these considerations that an explanation will be found of the gradual emergence over the second half of the nineteenth and the first two decades of the twentieth centuries of a group of countries which came to use sterling both as the basis of their trade and the anchor for their currencies. It was never a perceptible grouping because it was merged in the wider system of the international gold standard, the workings of which were so largely dominated from London.

Although the sterling system was in many of its essentials operating over the first half of the nineteenth century, it only became clearly recognizable and assumed definite cohesion as from September 1931 when sterling left the gold standard. That event faced the countries, which until then more or less unconsciously adhered to the sterling system, with a definite choice: whether to follow sterling in its depreciation against gold or whether to continue unchanged the previous parities between their currencies and gold. As these decisions were made, some of them immediately, others with obvious reluctance and hesitation and after a considerable lapse of time, the shape of the sterling area began to emerge clearly.

Among the countries which chose sterling Australia and New Zealand had already been forced to depreciate before 1931 and had thus depreciated their currencies in terms of sterling. They chose to hold on to sterling at the then current parities when sterling itself began to depreciate in terms of gold. Other countries, including Egypt, India, Irak, and Portugal, kept rigidly in step with sterling when sterling and gold parted company in September 1931. Others required a little time for reflection before following sterling—among these were South Africa and the Baltic countries. But when they decided to follow sterling they depreciated at one stroke to the level of the £ and restored their former parities. There were a number of other countries, including Norway, Denmark, Sweden, and Greece, which resolved their doubts for a time by maintaining a kind of half-way house between

the gold bloc and the sterling system, but later relinked their currencies with sterling though at varying parities.

The sterling area as it evolved in the 1930's was thus a decidedly heterogeneous group of countries. It included the Colonies and Dependencies almost as a matter of course, since their monetary affairs were and still are, in a very large measure, handled in London. Also included were the Dominions, other than Canada and Newfoundland. Egypt and the Scandinavian countries, together with Portugal and Iran, were what might be termed full-time members though outside the Commonwealth. There were other countries, like Argentina and Japan, which were within the outer fringe of the sterling area. They found it convenient to maintain the parities of their currencies fixed in terms of sterling, since a great deal of their external trade was conducted in terms of this currency. At the same time they maintained little more than working balances as sterling reserves in London.

There was within this group no formality, no recognition of set rules and regulations, no commitment to take advice from London and certainly no pretensions on the part of London to rule the affairs of the other members except in so far as the various Colonial territories and dependencies had their monetary policies formulated for them in the appropriate government departments. The countries in question could leave or enter the system without consultation with London. They could even change their parities, as happened in the case of New Zealand in 1933, and again in 1948, when the parities were altered without consultation with the Mother Country.

This lack of consistency in sterling area relationships applied also to the manner in which they held their external reserves. Some of them, including the Colonial territories, maintained the bulk of their banking and currency reserves invested in sterling. Others, like Australia and New Zealand, had independent though relatively small gold reserves and held the larger part of their external reserves invested in sterling securities. Yet others, like the Scandinavian countries, Argentina, and Japan, clung to the system rather for the convenience of sterling as a monetary standard than for the facilities offered by London for holding reserves. In their

cases the bulk of their monetary reserve was kept in gold and the assets they maintained in London were little more than working balances.

The one feature that was common to all their relations with the system was their preference for sterling as a monetary standard as against the only available alternatives, namely, gold or dollars. In part this preference could be explained in terms of political ties. This was true of the sterling countries of the Commonwealth whose political and economic links with Britain and sterling were part of the texture of their history. In the case of the non-Commonwealth members of the sterling area, the pull of sterling was due much more to practical considerations. It could be explained in terms of the comparative economic stability that was to be found during the 1930's in Britain and the area over which sterling reigned. The depreciation of sterling in terms of gold had intensified the forces of deflation in the countries of the gold bloc. While sterling prices kept moderately steady after the departure of sterling from gold, prices expressed in terms of gold currencies fell heavily.

Britain also maintained both its national income and its imports from the rest of the world far more successfully than did the United States. The sterling area thus provided a sphere of comparative economic stability within which the volume of international trade did not suffer the drastic restriction which befell it within the gold bloc. The attraction of this comparative stability pulled in such late-comers as Argentina, Uruguay, Yugoslavia, and ultimately France when that country left the gold bloc.

The nucleus of Commonwealth countries in the sterling system had been strengthened as a result of the Ottawa Agreements and the Tariff Preferences established at the Ottawa Conference in 1932. The countries represented at this conference adopted a monetary resolution which defined the general objective of monetary policy within the sterling area as being first some recovery and then general stability of commodity prices. The resolution added that if other countries adhered to a similar policy, a wider sterling area could be formed within which the twin advantages of exchange stability and/or comparative stability of prices might be

enjoyed. This was the open invitation which a number of countries outside the Commonwealth were glad to accept in the nineteen-thirties.

The links forming the sterling area were also strengthened over this period by the establishment of a chain of central banks in the Dominions, most of them launched with the active encouragement and co-operation of the Bank of England. With these new central banks in South Africa, Australia, New Zealand, and India (and later also in Pakistan and Ceylon), the Bank of England maintained from the start the closest and most amicable relations. In some cases they were actually set on their course with the help of personnel from the Bank of England. The personal relations so formed and maintained must unquestionably be counted as part of the intangible mechanism which maintains the cohesion of the sterling area.

The next milestone in the history of the sterling area was the outbreak of war in 1939 and the institution of exchange control. In the immediate pre-war period the sterling area had lost all its neutral non-Commonwealth adherents. Sterling itself had been under considerable pressure and between July and September had depreciated in terms of dollars from $4.68 to $4.05. The non-Commonwealth countries in the face of advancing war could not be expected to maintain their allegiance to sterling and thus not only submit themselves to sharing the strains to which sterling would be subjected, but prejudice the position of neutrality which most of them hoped to preserve in the coming conflict. By the outbreak of war in September 1939 the non-British currencies had made their discreet departures and had floated off sterling.

At that point sterling exchange control came into being and since the decision was taken, and wisely taken, to make the control operate around the sterling area as a whole a statutory definition of that area had to be attempted. This was first made in Statutory Rules and Orders issued under the Defence (Finance) Regulations in July 1940. This defined the sterling area as including the United Kingdom and the Isle of Man, all the Dominions, Colonies, Dependencies, and Mandated territories (except Canada, Newfoundland, and Hong Kong) together with Egypt, the Anglo-Egyptian Sudan, and Iraq. This list was to be considerably amended in the years that

were to follow, but to this day the sterling area, known since the Exchange Control Act of 1947 as 'the scheduled territories', remains a precisely defined entity which it had never been before 1939.

Although the net of exchange control was thrown round the sterling area as a whole, that control has not been operated by a central controlling authority. Each member of the sterling area has been left to operate its own exchange control and its own import licensing policy. In the case of the Colonial territories that policy was prompted if not dictated by London, but for the rest the homogeneity in exchange control and import policies that has been maintained within the sterling area since 1939 has been the product of voluntary co-operation, of readiness to appreciate the obvious advantages of operating these controls on broadly similar lines. The general objective in view during and since the war has been the greatest economy of hard currencies and gold. During the war these were needed to finance essential purchases of munitions and materials. After the war the need for such policies were enjoined by continuing dollar scarcity of which periodic and spectacular reminders were provided in the sterling convertibility crisis of 1947 and the devaluations of 1949.

From the early and scarcely conscious beginnings of the sterling area it had been the habit of the members to use London as their banker, to conduct their external trade in terms of sterling, and to regard their London funds as their basic external reserves. But what had until the outbreak of the war been a matter of habit and convenience and could be reconciled with the maintenance of independent gold reserves, acquired greater formality thereafter. Most members of the sterling area, realizing the advantage of pooling their gold and dollar reserves as a means of economizing these resources, were content not merely to continue their traditional practice of leaving their external reserves in London, but also to abandon their previous habit of maintaining separate gold reserves.

Adherence to this traditional practice became the means through which enormous debts were built up within the sterling area membership during the war. As Britain incurred heavy military expenditure overseas, in the Middle East, in

India, and South-east Asia, and as materials continued to be imported from these territories without any proportionate balancing export goods (the export industries in Britain were otherwise occupied), the countries in question were paid sterling in London and began that process of accumulation of sterling balances which were to raise their level from a figure of £216 millions at the end of 1938 to £2,453 millions by the end of 1945. By the middle of 1949 these balances of sterling area countries had fallen to £2,225 millions, but from this point there began a new rise which had carried their total to £3,100 millions by the middle of 1951. The normal mechanism and traditions of the sterling system had lent themselves to a piece of war financing for which they were never meant. They had allowed debts to be accumulated with the tacit approval of creditors, an approval which would certainly never have been so readily given could the magnitude of these operations have been anticipated. The ease with which the machinery functioned may also have been responsible for the readiness on the part of the United Kingdom to accept as liabilities transactions that should perhaps never have taken that form, but should have been regarded as part of the mutual aid given and taken between allies in the pursuit of a common objective.

These developments were of profound significance both for the economic position of Great Britain and for the future functioning of the sterling system. Until 1939 Britain, the banker for the system, had also been the ultimate creditor, and this fact put into the hands of the British authorities weapons of control and the unquestioned leadership attuned to the position of the banker. By the end of the war this position had been reversed and on balance Britain had become a substantial net debtor to the rest of the sterling area. This was not to cause a disruption of the sterling system since in certain respects the power of the debtor is not much less effective than that of a creditor. With so many members of the sterling area holding abnormally large reserves in sterling, an added encouragement was given them to do nothing that might seriously endanger the stability of sterling. At the same time an entirely new relationship was created between Britain and the other members of the sterling area. In particular the problem of access to the central gold and dollar reserves and of

competitive bidding for British exports in the repayment of claims on London called into being entirely novel problems of sterling area discipline and self-restraint.

In March 1947 the control of sterling exchange in the United Kingdom ceased to be operated by statutory rules and orders and became part of the normal peace-time legislative structure through the enactment of the Exchange Control Act. What had been known as the 'sterling area' in the Statutory Rules and Orders became the 'scheduled territories' under the new Act. The first list of these territories under the Act was as follows:

1. The United Kingdom.
2. Any Dominion within the meaning of the Statute of Westminister, 1931, except Canada and Newfoundland.
3. Any part of His Majesty's dominions not being a Dominion within the meaning of the Statute of Westminster, 1931, or a part of such a Dominion.
4. Any territory in respect of which a mandate on behalf of the League of Nations has been accepted by His Majesty and is being exercised by His Majesty's Government in the United Kingdom or the Government of any Dominion.
5. Any British Protectorate or British protected State.
6. Egypt.
7. The Anglo-Egyptian Sudan.
8. Iraq.
9. Transjordan.
10. Iceland.
11. The Faroe Islands.

The schedule is amended from time to time as countries come in and go out of the area. Since it was drawn up Egypt and the Sudan have been removed from the list while Burma has been added to the schedule.

This group of countries falls into two broad categories. The first which might be regarded as the inner core of the sterling area includes all the countries which, together with the United Kingdom, have a common quota in the International Monetary Fund. They are the countries for which the British representative speaks in the new world monetary

organization now functioning in Washington. These countries, other than the United Kingdom, have no domestic central banks. Their currencies are managed by currency boards and currency commissioners which for the most part operate in London; invest their assets in sterling securities, and have no effective power of determining monetary and credit policy in the territories which they serve.

Beyond this inner core there are the other members of the schedules territories with their own independent central banks, with their separate representation on the International Monetary Fund (apart from Ireland and New Zealand which are not members of the I.M.F.) and possessing complete autonomy in monetary affairs. They are Australia, Ceylon, India, Pakistan, South Africa, Ireland, and New Zealand. The Union of South Africa, as the world's greatest gold producer and the holder of a substantial independent gold reserve, stands in a somewhat unusual relationship to the sterling area. During the war South Africa did not pool its gold in the central reserve, if this meant increasing its sterling balances. It sold as much gold to the United Kingdom as was required to balance its international payments and accumulated its surpluses in gold and not in sterling. More recently South Africa has begun to acquire substantial sterling balances, but its import policy for a large range of articles is based on a system of open general licences for which the whole world is allowed to complete on equal terms and where the successful exporters are paid in gold. These arrangements mean that for Britain, South Africa is virtually a hard currency country, even though it has remained an accepted member of the scheduled territories, within which current and capital payments remain free as far as the United Kingdom is concerned.

The emergence of the new Asian dominions as virtually independent countries and members of the sterling area, together with the changed relationship between Britain, the banker, and the rest of the sterling area, have brought into the open the question of the mechanism by which the hegemony of the sterling area in terms of monetary policy, import licensing, exchange controls, &c., is maintained. That problem was given still greater urgency by the devaluations of 1949 when some members of the sterling area appeared to follow

Britain with reluctance, one at least, Pakistan, did not follow at all and most of them felt some resentment at not having been sufficiently consulted about a matter which concerned them so intimately.

The issue concerns nothing less than the government of the sterling area. Since the sterling area developed gradually, functionally, in response to the convenience and needs of traders in Britain and countries trading mostly with Britain, no government of the sterling area was ever recognized or formalized. It was only after 1931 that such a machinery of government could have been conceived and the need for it was barely recognized at that time. The countries in question, other than the United Kingdom, were tacitly prepared to leave to London matters that concerned them closely, including the day-to-day adjustment of rates of exchange and the consequent determination of the sterling price of gold. These were decisions that had to be taken on the spot by the comparative handful of experts handling the affairs of the Exchange Equalization Account. There could be no question of making these decisions by committee. They were in fact left to the discretion of London. This problem became more difficult during and after the war when sterling-area policy came to involve such matters as homogeneity of exchange-control technique and voluntary acceptance of measures to economize hard currencies. The restriction of dollar imports, the self-restraint that had to be exercised in dipping into the central and common pool of gold and dollar reserve, the equal self-restraint required of some members of the sterling area in bidding for sterling goods, using for that purpose their abnormally swollen sterling balances; these and related matters put the voluntary discipline and the wholly unformulated mechanism of government of the sterling area to altogether unprecedented tests.

As is the way with British institutions, however, the changing needs of the situation began little by little to create the necessary responses. The financial crisis which preceded the suspension of the short-lived convertibility of sterling in September 1947 had been the occasion for a widely attended meeting of finance ministers of the Commonwealth at which most of the broad issues of sterling policy were considered.

This was the first of a series of such meetings which are now becoming regular annual occurrences and which fortunately no longer require an emergency to call them into being. These high level meetings of ministers of the Commonwealth are not, however, the forum in which detailed problems of policy and technique can be worked out. They would, moreover, be rendered largely ineffective if considerable preparatory work in collecting information and sifting data had not been done prior to their convening.

To meet the need for day-to-day contact and exchange of information a Sterling Area Statistical Committee was set up in London in 1947 on the initiative of the British Treasury. This was intended to serve as a meeting at which Britain, the self-governing Dominions, and representatives of the Colonies might exchange information about balances of payments, gold and dollar reserves, and other matters of common interest. This statistical committee has no pretence to any policy-making function. The problem of sterling-area policy is one which edges into the sphere of another organization also situated in London, the Commonwealth Liaison Committee. This was formed soon after the setting up of the Sterling Area Statistical Committee. It is a clearing house for ideas and suggestions and not an executive instrument of policy. Its members are, however, in constant touch with their own governments. They consider and discuss all the wider issues of sterling-area policy and there can be no doubt that their deliberations in London have considerable influence on policy decisions when they are taken.

Beyond the occasional meetings of finance ministers and the virtually continuous sessions of the two committees in London, the work of sterling-area policy co-ordination is also furthered by co-operation between the Bank of England and the banking and monetary authorities in the Dominions and Colonies. In the days of Montagu Norman's governorship the practice had already begun of appointing Commonwealth representatives among the Bank's advisers, the highest executive rank after the executive directors. The reverse movement has already been noted, namely, the provision by the Bank of England of key personnel in the new central banks established in the Commonwealth.

Unformulated and uncoordinated though it may have been, the work of building up some machinery of co-ordination and direction of policy for the whole sterling area has therefore been progressing. Whether the machinery as it exists at present provides a sufficient response to the recent emergence of the new Asian dominions, whose inherent loyalty to the sterling area is perhaps not quite on a par with that of the older dominions, still remains to be discovered. It is certainly open to doubt whether a decision such as the devaluation of sterling in September 1949 would again be taken with so little notice to and consultation with other and highly interested parties.

No review of the sterling area would be complete if it confined itself to the 'scheduled territories', whether they lie in the innermost ring of countries with a common International Monetary Fund quota, or in the virtually independent and financially autonomous sterling dominions. Beyond this there is a large and diversified group of countries which make considerable use of sterling in their current trade. They do not rank in the sterling area because under the terms of the Exchange Control Act they are not 'scheduled territories' but they form part of the wider sterling system. Many of these countries are in the so-called 'transferable account' group. They include the Anglo-Egyptian Sudan, Chile, Czechoslovakia, the Dutch monetary area, Egypt, Finland, Italy, Norway, Poland, Spain, Sweden, and the U.S.S.R. These countries are allowed to use their transferable sterling balances in payment of current trading operations between them without prior permission from the Bank of England. Payments for current trading operations can also be made between the sterling area and the transferable account group of countries without prior permission. Beyond these transferable account countries there are others with much bilateral trade and payments arrangements operate, but which nevertheless use sterling in making payments to third countries, although in each case prior permission for such use of sterling has to be obtained. This use of sterling is known as 'administrative transferability' as contrasted with the automatic transferability that obtains in the case of transferable account countries. The Bank of England annually publishes figures indicating the extent to which sterling is transferred in trade

which does not touch the scheduled territories. In 1950 such transfers amounted to £298 millions of which £143 millions represented automatic transfers and £155 millions administrative transfer facilities. The British Treasury has estimated that in 1948, when international merchandise trade amounted to £13,800 millions, about £5,000 millions, or 36 per cent. was transacted in sterling. According to the same authority the proportion would grow to about 50 per cent. if invisible transactions were added to merchandise trade.

The banking systems which are described in the earlier chapters (other than those of Canada and Newfoundland, which live and breathe in the dollar world) thus have their being in a far-flung monetary area within which, even through the harshest days of exchange control, there was complete freedom of current payments and, with one or two minor exceptions, freedom of capital movements. There can be no doubt that this monetary system has played its part in contributing to the stability of this banking organization just as, conversely, it was the extension of banking enterprise overseas which provided one of the main links that pulled the sterling area together.

INDEX

The following abbreviations are used to indicate the section of the book covered by the reference given:

A = Australia
C = Canada
Ce = Ceylon
Col = Colonial Empire
I = India
Ir = Ireland
NZ = New Zealand
P = Pakistan
SA = South Africa
StA = Sterling Area

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