A Century of Bank Rate

R. G. Hawtrey
A CENTURY OF BANK RATE
OTHER BOOKS BY R. G. HAWTREY

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CAPITAL AND EMPLOYMENT, SECOND EDITION
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THE POUND AT HOME AND ABROAD
A CENTURY OF BANK RATE

by

R. G. HAWTREY
PREFACE

HAVING undertaken to give a series of three Alfred Marshall Lectures at Cambridge in November, 1937, on A Century of Bank Rate, I was confronted with the fact that, though there is a profusion of statistical material available, this material had never been systematically analysed in the manner which appeared to me requisite for the elucidation of the subject. It seemed essential to do something towards filling the gap, and in pursuing that object I found that I had gone a long way beyond my primary purpose of supplying a statistical background for the lectures. In the lectures no more than a brief summary of the results that emerged from my statistical investigations was possible. In the present volume the statistical material, which is set out in detail in the Appendices, provides the basis for a historical survey of the period from 1858 to 1914, the Antonine age of Bank rate. For both the earlier and the later history of the subject the interpretation of the statistical evidence is assisted by the pronouncements of the Bank of England made in the course of official inquiries, the Parliamentary Committees of 1832, 1840–1, 1848 and 1857–8, and the Macmillan Committee of 1929–31. But for the all-important middle period very few such pronouncements are to be found.

I have to thank Sir Cecil Kisch for very valuable help in preparing a portion of the statistical material, and the Bank of England for kindly confirming some of the data employed. But the sole responsibility for the facts as well as for the opinions remains mine.

I have written this book in a private and personal capacity, and nothing in it is to be associated with my official position at the Treasury.

R. G. HAWTREY.

September, 1938.
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FOREWORD TO NEW EDITION

PROJECTS OF STABILISATION

In 1937, when I delivered the lectures which were afterwards expanded into this book, I had long been advocating a monetary policy of stabilisation of the purchasing power or wealth-value of the money unit. The resolutions adopted at the Genoa Conference of 1922, recommending international co-operation in the regulation of credit “with a view to preventing undue fluctuations in the purchasing power of gold”, held out great hopes, but bore no fruit. The restoration of the gold standard by Great Britain and other countries in 1925 seemed in the eyes of most people a sufficient stabilisation of their money units. Their hopes were falsified by the crises of 1931 and 1933, which started the great depression of the nineteen-thirties, and led to the renewed suspension of the gold standard in Great Britain and America.

The Monetary and Economic Conference, which was inaugurated by the League of Nations in 1933, produced a resolution recommending that central banks should introduce into their credit policy a bias tending to correct any excess or deficiency of business activity in the world. “The central banks”, it said, “will have done what is in their power to reduce fluctuations in business activity, and thereby also undue fluctuations in the purchasing power of gold.”

This phrasing evidently betrayed doubts as to the power of a central bank to exercise any considerable control over the flow of money. It was little use urging a stabilisation policy on the monetary authorities of the world so long as they were completely sceptical of their power to carry it out.

It was the prevalence of this scepticism that led me to choose A Century of Bank Rate as the subject of my lectures in 1937. My purpose was to show that the reliance on Bank
rate as the instrument of monetary policy had been evolved through a century of experience, and that despite changes this experience was applicable to the problems of monetary policy in 1937.

Changes 1832—1937

The changes had undoubtedly been great. In 1937 the gold standard was in abeyance, whereas the experience of the years 1833-1914 had been obtained under the gold standard, and Bank rate policy had been governed by gold movements. The detailed statistical material (in the Appendices) revealed what had not been fully appreciated before, the importance under nineteenth century conditions of fluctuations in the interior demand for gold (pp. 49-54). When the market rate of discount in London was very low, the country banks did not hasten to send superfluous gold coin received from their customers to London to be invested in bills. A rise in the rate would make it worthwhile to do so, and the gold which they sent to London found its way forthwith into the Bank of England’s reserve.

The power of attracting gold from the country banks, like the attraction of gold from abroad, though of immediate help in making good a shortage of reserves, was not a help but a hindrance in the more fundamental purpose of tight credit in restricting demand. A spell of high Bank rate would restore the reserve in a few weeks, only to be followed by a loss of gold as soon as the rate was lowered. Hence the violent zigzags which appear in Appendix I up to about 1880. Only after repeated alternations of high and low rates, would the expansive tendency of credit be effectually checked (pp. 64-5).

It was the growth of branch banking through amalgamations and mergers which eventually ended these fluctuations of interior demand (pp. 55-6). The disuse of gold coin and the abandonment for practical purposes of the fixed fiduciary issue system have made the reserve position independent of movements in the circulation of currency. But the attraction of money from abroad remains as a complication in estimating the effect of a high Bank rate.
The gradual disuse of bills of exchange in the financing of internal trade (pp. 56-61) tended to make traders more sensitive to the terms of borrowing.

Since 1914 far wider fluctuations of price levels and wage levels had become possible than before. The fluctuations of prices were not only in terms of inconvertible paper units, but in terms of gold and of money units fixed in gold. The world had a foretaste of what this change meant in the violent inflation and deflation of 1919-22 (pp. 130-4). The return to gold in 1925 brought hopes of relative stability, which were shattered by the crises of 1931 and 1933 (pp. 143-5), and the ensuing appreciation of gold, which reduced the world price level by more than half (p. 251).

The Great Depression

The great depression of the nineteen-thirties has passed into history as a unique period of misery and distress. The helplessness of successive Governments in Germany, faced with six million unemployed, led directly to the accession of Hitler to power, and so to the second World War.

People concerned in public affairs are apt to treat monetary policy as a technical matter which the normal practical man need not trouble to understand. The great depression is often regarded as a visitation comparable to Attila "the Scourge of God", to the Tartar invasions, or to the Black Death, instead of being the inevitable consequence of more than doubling the wealth-value of the world's money unit.

Even those who recognise that the depression was a monetary phenomenon are not always alive to the train of causation which brought it about.

In my Good and Bad Trade (1913) I showed how the effect of the rate of interest on short-term borrowers is modified by the prospect of rising or falling prices, and how a low rate might fail to revive demand in a depression. I pointed out (p.186) that, "in order to counteract the effect of falling prices, bankers fix a rate of interest lower than the natural rate by the rate at which prices are believed to be falling", but "if the rate of depreciation of prices is actually greater
than the natural rate of interest, ... nothing that the bankers can do will make borrowing sufficiently attractive. Business will be revolving in a vicious circle: the dealers unwilling to buy in a falling market, the manufacturers unwilling to maintain their output in face of ever-diminishing orders."

The present volume (pp.250-3) gives a slightly different account of this "stagnation" of business. Since it is the expectation of falling prices that influences the borrowing traders, account must be taken of the circumstances which cause such an expectation. A fall of prices in the recent past is in itself just as likely to cause an expectation of a recovery as of a further fall. The sign that prices of goods are too high relatively to demand is the accumulation of unsold stocks. Traders who are encumbered with such an accumulation cannot be tempted to order more, however liberal the facilities for borrowing. In such circumstances the vicious circle is more correctly described in terms of redundant stocks than of falling prices. A fall in demand leads to an accumulation of stocks, the accumulation of stocks leads to a decline in orders, the decline in orders leads to a decline in output, thus to a decline in incomes, a decline in sales and a renewed accumulation of unsold goods (p.62).

**Bank Rate After Its First Century**

My century of bank rate may be said to have begun with the recommendation of the representatives of the Bank of England in 1832 for the repeal of the laws against usury (p.16), and to have ended with the reduction of Bank rate to 2 per cent on the 30th June 1932. For two-thirds of the thirty years that have passed since that reduction Bank rate may be said to have had no history. Apart from the ephemeral rise to 4 per cent on the outbreak of war in 1939, it remained at the traditional minimum of 2 per cent till it was raised to 2½ on the 8th November 1951. Up to the outbreak of war it was beyond dispute that industry needed an expansion of demand, and the question of raising Bank rate to bring about a contraction did not arise. When the
war came, reliance was placed on controls, and without free markets there was no scope for monetary management through the rate of interest. After the end of hostilities, controls were not immediately relaxed, but it was soon clear that they were failing to prevent inflation. The removal of price controls in America in 1946 let loose a flood of redundant money, and the rise of American prices led inevitably to corresponding rises in other countries which were maintaining fixed rates of exchange on the dollar. In Great Britain wartime controls had had the same result of accumulating a mass of redundant money. So long as price controls were effective, the outlet for spending was limited by the available supplies valued at controlled prices, and there was no more than a trickle of spending to drain away the redundant money. The rise of prices in 1946-8 started the idle money circulating and initiated an orgy of inflation.

When there were two thousand millions of superfluous money for spending, dear money could do little to check expansion. Bank rate remained quietly at 2 per cent, and overdraft rates low.* But the rise of prices was itself steadily eliminating the redundant money. The rise was accelerated when in 1949 the dollar value of the pound was reduced from $4.03 to $2.80. Thereafter the pound had not merely to keep pace with the declining wealth-value of the dollar, but had in addition to make up for the abrupt increase in the sterling equivalent of dollar prices by 44 per cent. In 1952 the gross national product reckoned at current prices was 59 per cent greater than in 1946, while bank deposits had increased only 19 per cent. The redundant money had practically been absorbed.

From that juncture there starts a new chapter in the history of Bank rate. The rise from 2 per cent to 2½ immediately on the change of Government was no more than a signal that the long sleep was over. But devaluation had failed to ensure a favourable balance of payments, and in March 1952 Bank rate was raised to 4 per cent. That was

*The traditional minimum of 5 per cent on overdrafts had long been in abeyance (see my The Pound at Home and Abroad, p.6).
not a high rate, but it is the extent of a rise rather than the level the rate rises to that influences borrowing (see pp.240-3), and a rise by more than one point on one day has always been unusual. A slackening of the inflationary tendency had already been felt before the end of 1951, and how much the Bank rate contributed to the process it would be difficult to estimate. Anyhow the balance of payments was satisfactorily restored, and the reserve of gold and dollars rose from £602 million in June 1952 to £1,078 million in June 1954.

Before the end of 1954 the position had begun to deteriorate; an adverse balance resulted in a loss of reserves. Bank rate was put up to 3¼ per cent (27 Jan. 1955) and 4½ (24 Feb.), and in July, when the effect appeared insufficient, a "credit squeeze" was imposed: the banks were to effect a "positive and significant reduction" in their advances. This was done. The total of the Clearing Banks' advances was brought down from £2,186 million in June 1955 to £1,851 million in December. Yet the reserves fell in the same half-year from £957 million to £757 million. At last Bank rate was put up to 5½ per cent (16 Feb. 1956). A slight improvement became visible but in the latter part of the year was interrupted by the Suez crisis. A loss of reserves amounting to £254 million was partly made good by a drawing of £201 million from the International Monetary Fund. The Suez crisis was a transitory disturbance, and in Feb. 1957 Bank rate was reduced to 5 per cent. The reserve was then £744 million, or, if the £201 million received from the I.M.F. be excluded, £543 million. An increase of £106 million brought it at the end of June 1957 to £850 (649) million. But thereupon another crisis boiled up, and something like a panic led to Bank rate being put up from 5 per cent to 7 in September.

All this time inflation was raging. At a time of rapid technological improvement and rising productivity the rise of prices gives an inadequate measure of an inflationary tendency. The rise of wages is a better indicator, and in the five years 1946-51 the wage level (men's hourly earnings) rose 36 per cent.
The situation was comparable to that of 1919-20 (pp.212-14). If the short-term rate of interest was to deter borrowers, it would have to be high enough to outweigh the speculative gains traders were expecting to make from rising prices, and so to stop their anticipatory purchases of goods. The successive rises of Bank rate to 4½ and 5½ per cent were not high enough.

The devaluation of 1949 resulted in the pound being undervalued. British costs expressed in dollars, and in those money units which had not been devalued, had become too low, and British exports were underpriced.* British manufacturers encountered a state of intensified demand which was reflected in the demand for labour. The rise in wages and prices since 1949 had been far from sufficient to restore equilibrium, and there was a clear prospect of a further rise.

At last the rise of Bank rate to 7 per cent (involving an overdraft rate of 8) broke the spell. For the moment the anticipatory purchases were checked. But the expectation of rising wages and prices continued. For, so long as the pound was undervalued, there was an excessive demand for British products in export and import markets.

The high Bank rate damped down demand at home, and mitigated the strain on the labour market. But it did not completely relieve the strain. Overtime was diminished, but unemployment, though slightly increased, remained abnormally low. For the productive resources released by the decline of demand at home became available to increase exports.

In 1920 the expectation of rising prices was based on the visible fact that the Government was paying its way by inflationary methods. A high bank rate was required so long as the expectation so founded continued. The Government had in December 1919 imposed a limitation on the issue of currency notes, and in April 1920 brought out a budget promising a substantial surplus. The 7 per cent Bank rate of April not only checked anticipatory purchases, but led people to believe that the deflationary measures

*See The Pound at Home and Abroad, pp.7-8 and 123-33.
of the Government would be effective. There was no longer any ground for expecting demand to expand or prices to rise.

In 1957 the position was different. The contractive effect of a high Bank rate is transitory. Once traders have adjusted their stocks to the state of credit, the contractive effect ceases. A trader who wants to reduce his stocks restricts the orders he gives for replenishment to something less than the amount he disposes of by sale. When he has achieved the desired reduction of stocks, his orders are once again equal to his sales. That stage may be long delayed by the vicious circle of deflation (pp.61-2) but so long as there was an insistent demand from abroad for the under-priced British exports, the vicious circle could not be joined. The contractive effect of the 7 per cent Bank rate was felt up to the summer of 1958. By that time the returns of overtime worked showed a reduction from 12.23 million hours in August 1957 to 9.26 million in August 1958. Bank rate had been reduced by steps to 4\frac{1}{2} per cent, and was further reduced to 4 on the 20th November 1958.

The year 1959 saw a marked revival of activity. A growing demand was evidenced first by a big increase in overtime, and then, in the first half of 1960, by a resumption of the rise of wages. Bank rate was put up to 5 per cent (21 January 1960) and 6 (23 June), but there was little if any effect on productive activity. The clear inference should have been that the state of demand and the prospect of rising prices had again induced anticipatory purchases. And there was in fact a sharp increase in imports. Yet Bank rate was reduced to 5\frac{1}{2} per cent (27 October 1960) and 5 (8 December). The reserve position looked highly favourable; after repayments amounting to £97 million to the International Monetary Fund, the reserves were increased in the second half of 1960 by £121 million. But the gain was delusive. It was due to a big influx of money from abroad, which raised the overseas sterling holdings outside the Sterling Area from £803 million in December 1959 to £940 million in June 1960, and £1,407 million in December 1960. If a high short-
term rate of interest is to attract foreign money, there must be confidence in the money unit. The favourable conditions of 1958 and 1959 had re-established confidence in sterling, and the attraction of a yield of 6 per cent on securities repayable in a few years exerted a powerful pull, even after Bank rate had been reduced. The huge inflow, depending on foreign confidence in sterling, concealed from the public a heavy adverse current balance.

After the turn of the year, the reserves began to suffer losses, and in March 1961 the statistical return of the Balance of Payments disclosed an adverse current balance, in the second half of 1960, of £265 million (later corrected to £215 million). There resulted acute anxiety, which soon developed into panic. There was a flight from sterling, which would have reduced the reserves from £1,037 million at the beginning of June to £553 million at the end of July, if they had not been supplemented by £323 million from foreign central Banks under the Basle Agreement in March. Once again Bank rate was raised to 7 per cent (26 July 1961) and for the moment confidence was restored.

THE DEVALUATION PANICS

The crisis of 1961, like that of 1957, was one of confidence in sterling. There was a fear that the pound would be again devalued. A strangely misplaced fear!

People feared devaluation because successive British Governments showed by their pronouncements that they themselves feared devaluation. From time to time they had been warning the public that exporters could not stand any further increase in wages, and protesting that every effort must be made to maintain the dollar value of the pound at $2.80. A recognition that the pound was greatly under-valued at that rate would have made nonsense of the warning and the protest, but the authorities never thought it necessary to examine the situation from that point of view.

It is astonishing that so misguided a belief was generally accepted, even with the authority of the Government and their advisers behind it. The explanation, I think, has been
that whatever the cause of an adverse balance may be its immediate impact is felt in an excess demand for foreign exchange, and a tendency for the country’s money to be offered at a discount. People suppose that a depreciation of the money unit in terms of foreign units is the natural corrective of the adverse balance; and so it is when the adverse balance is due to an over-valuation of the money unit, as in 1931. But the root cause of an adverse balance of payments is excess spending, spending, that is, in excess of current receipts. Over-valuation causes an excess by reducing the current receipts from foreign demand. Declining orders cause unemployment in export industries. But excess spending arising in any other way has the same effect.

An under-valuation of the money unit might be expected to have a favourable effect on the balance of payments. And so long as industry is under-employed it does. But when full employment is reached, output encounters a limit, and exporters fail to meet the foreign demand. They do not seek export orders, or when they get them, they are late in delivery. Low-cost manufacturers do not put up their prices to what the demand can stand, and much of the favourable effect of the under-valuation is lost in the under-pricing of exports.

And under-valuation may actually have an unfavourable effect on the balance of payments through its reaction on the credit system. For it induces a state of markets in which traders expect costs and prices to rise, so that a higher short-term rate of interest is needed to have a given deterrent effect. When the banking authorities fail to appreciate this, they miscalculate the rate of interest appropriate to a given situation. In 1957 and 1961 a 7 per cent Bank rate was supposed to be desperately high, and only to be resorted to in a great crisis. The 6 per cent of 1960 or the 5½ of 1956 seemed severely high rates, and the 4 per cent of 1959 a moderate and prudent rate. In the circumstances of the times 4 per cent was “cheap money”, 6 per cent was very mildly deterrent, 7 per cent could just be regarded as high. The deterrent effect even of 7 per cent was largely psychological,
and it may be that without the expectations aroused by it a still higher rate would have been needed. The excess spending which causes the adverse balance takes shape in the anticipatory purchases which lax credit encourages.

The authorities believe that they have been keeping a tight hand on credit. When they find the country troubled by an apparently inexorable inflation and by repeated crises in the balance of payments, they are blind to the effect of what is really cheap borrowing and they look elsewhere for the explanation. When the Radcliffe Committee was asked on its appointment "to exclude exchange rates" from its inquiries, (Evidence, Question 982) Ministers must have felt very confident that $2·80 was just the right rate, and need not be inquired into.

RETROSPECT

When we look back on the monetary experience we have had since 1932, surely the moral to be drawn from it is above all the vital importance of maintaining stability of the value of the money unit. The depression of the nineteen-thirties was due to the doubling of the wealth-value of gold. And since 1934, when the present gold value of the American dollar was fixed, the value of gold as measured by the American wage level (hourly earnings in manufacturing) has fallen by three quarters.

The International Monetary Fund revived the gold standard, and based it on the American dollar. As the gold standard was practised in the nineteenth century, every country was free to depart from it or to alter the parity of its money unit. Now a change of parity requires the consent of the Fund. That consent was obtained and acted upon by Great Britain in 1949 with deplorable results. The pound already tied to the dwindling dollar, had to dwindle all the more.

Both the public and the politicians who take the responsibility of leading them are constantly exercised in their minds about rising prices, rising wages, crises in the balance of payments, and measures for the control of credit which
seem to restrict economic progress. They never seem to be aware that these are all aspects of one single question, the wealth-value of the pound, and that the wealth-value of the pound is dictated by the rate of exchange on the United States.

To unstable money are to be traced nearly all our economic troubles since 1918: the unemployment of the inter-war years; the over-employment and scarcity of labour since the second World War; the labour unrest incidental to perpetual wage demands; the hardships and dislocation caused by the declining value of small savings, annuities and endowments; the vexation of continual price rises even for those whose incomes on the whole keep pace with them; the unmanageability of the credit system and the resulting crises; the collapse of the prices of Government securities through distrust of the unit in which they are valued.

The dollar-value of the pound at $2.80 being accepted as the fixed basis of British monetary policy, the reserve of gold and dollars has naturally become the basis of day-to-day monetary policy. As the availability of the reserve is unaffected by changes in the note issue, management has become a matter exclusively of the balance of payments.

I have referred at the outset (p. xi) to the scepticism of the monetary authorities as to their power so to regulate credit as to maintain monetary stability. This scepticism has, I think, increased. At any rate they seem always to be unwilling to trust to Bank rate alone as a regulator. For example the resort to the "credit squeeze" in 1955, and to "special deposits" in 1961 to reduce the liquid resources of the banks. Yet the decisive effect of 7 per cent in 1957 and 1961 is hardly to be denied.

The book has been reprinted without alteration except corrections of misprints and one or two verbal errors.

July 1962

Ralph Hawtrey
CHAPTER I

THE ORIGINS OF THE TRADITION

Introduction

In the years preceding the outbreak of war in 1914 the reliance of the Bank of England on its discount rate or "Bank Rate" as the means of regulating its reserve had come to be universally accepted. The Bank was responsible for the currency of the country, and its responsibility was centred in the reserve of the Banking Department. Under the Bank Charter Act of 1844 the fiduciary issue of Bank of England notes was a fixed quantity, and the reserve represented the margin of surplus currency which the Bank was free to pay out without transgressing the limit so imposed upon it. If the reserve showed signs of falling to a dangerously low level, the Bank would raise the Bank rate till the reserve was restored. If the reserve rose unnecessarily high, the Bank rate was reduced.

This procedure had become a firmly established tradition—so firmly established that the reasoning on which it had been founded had been clean forgotten. When it was dug up in the course of the inquiries of the Cunliffe Committee in 1918 and the Macmillan Committee in 1930-1, it was regarded rather as an academic exercise than as a serious practical doctrine.

In recent years the traditional Bank rate policy has been frequently challenged. It has been challenged on the ground that it is injurious to trade and industry and sacrifices their interests to a pedantic monetary correctness. It has been challenged on the contradictory ground that its supposed efficacy is a fiction based on fallacious reasoning.

The object of the present work is to show how the Bank rate tradition grew up, what was in the minds of those who originated it, to what extent their intentions were realized
in the experience which followed, and what is its virtue in the circumstances of the present day and the future.

The opening chapter deals with the period in which the policy was enunciated and took form. The century covering the history of Bank rate begins with the amendment of the usury laws in 1833, but a preliminary account of the proposals and of the experience that gradually led up to that measure is necessary to make the story complete.

This first period covers the Parliamentary inquiries of 1832, 1840–1, 1848 and 1857–8. Here we have the authoritative representatives of the Bank of England first explaining why they desired power to raise their discount rate without the restraints imposed by the usury laws, and then at subsequent inquiries subjected to examination and criticism in regard to the manner in which this power, when it had been granted, was used.

It becomes clear that the policy was throughout regarded as a device for regulating the currency; it was a monetary application of a form of credit control. It is also revealed that the authorities of the Bank of England embarked on the policy with their eyes open to its dangers and drawbacks. They were aware of the injurious consequences of deflation, but they believed them to be unavoidable if the paramount object of a currency unit fixed beyond all doubt in terms of gold was to be gained.

In Chapters II and III we pass to the history of Bank rate in the period from 1858 to 1914. We no longer have the assistance of Parliamentary Committees as a guide to the interpretation of policy. That of 1875 on Banks of Issue hardly touched the subject. The Royal Commission on the Depression of Trade in 1885–6 and that on Gold and Silver in 1886–8 elicited no significant pronouncements from the Bank of England, though the evidence received by the latter is noteworthy for the formulation of the theory of credit regulation by Marshall.

Consequently in these chapters we have to go straight to the facts, and to interpret them in the light of the pronouncements of policy recorded up to 1858. Chapter III
sets out the statistical material in chronological sequence. Chapter II serves as an introduction to Chapter III, indicating the principles illustrated by the statistical data, so as to supply a theoretical basis for the interpretations suggested in the latter chapter. These chapters are mainly concerned with the movements of gold, exports and imports and interior demand, which are set out in detail in Appendices I and II.

Chapter IV carries on the story from 1914 to 1932.

Chapter V passes to the statistical investigation of another aspect of the subject, the relation of the long-term rate of interest to Bank rate. Appendix I records the price of Consols (or, from 1879 to 1888, the price of 2½ per cent. annuities) on the day preceding every change in Bank rate from 1844 to 1932. Chapter V analyses the data thus presented, and Chapter VI supplies a theoretical discussion of this part of the subject and generally of the relations between the long-term and short-term rates of interest. Chapter VII is concerned with the relations of the rate of interest to movements of the price level and to monetary conditions, with special reference to events since the War.

Chapter VIII is devoted to a number of pronouncements throwing light on the Bank rate tradition from Bagehot in 1873 to the Macmillan Committee in 1931.

Finally, Chapter IX contains a general survey of the subject with reference to the future as well as to the past.

**HENRY THORNTON**

The practice of using the Bank of England's discount rate as an instrument of monetary regulation may be said to start from the Bank Charter Act of 1833. The exemption of the discount on bills up to three months from the operation of the usury laws by Section 7 of that Act permitted the Bank for the first time to raise its discount rate above 5 per cent.

The idea was thirty years older. It was originated, I believe, by Henry Thornton, who, when giving evidence
before the House of Lords Committee on the Bank Restriction in 1797, remarked on "the unnaturally low rate of interest resulting from the usury laws, which confine the rate of discounting at the Bank to 5 per cent." "There might be," he said, "a much greater disposition to borrow of the Bank at 5 per cent. than it might become the Bank to comply with." He recurred to the subject in his *Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, which appeared in 1802. "The Bank," he wrote, "is prohibited by the state of the law from demanding, even in time of war, an interest of more than 5 per cent., which is the same rate at which it discounts in a period of profound peace." The demand for loans from the Bank depends, he said, "on a comparison of the rate of interest taken at the Bank with the current rate of mercantile profit." "At some seasons an interest of 6 per cent. per annum, at others of 5 or even of 4 per cent., may afford that degree of advantage to borrowers which shall be about sufficient to limit, in the due measure, the demand upon the Bank for discounts."

Only by limiting discounts was it possible to limit the Bank's note issue, and so to prevent inflation.

**The Credit System of the Early Nineteenth Century**

To make clear the commercial and financial organisation which elicited Thornton's comments, it will be necessary first to enter into a brief description of the credit system of the early nineteenth century, and especially to show the part played in it by bills of exchange.

A bill of exchange is an instrument for assigning the rights in a debt from one creditor to another. It is an order to the debtor to pay to the new creditor. It is written or "drawn" by the old creditor, and, to become binding, must be acknowledged or in technical language "accepted" by the debtor.

Under medieval conditions, as soon as the trade between any two distant places (even within the boundaries of one country) developed beyond casual and occasional adventures, and assumed some degree of regularity, the merchants
in one such place would have agents to transact their business in the other. The agent would sell his principal’s goods and hold the money received at the latter’s disposal. The merchant would direct his agent whether to use the money to buy more goods or to apply it to any other purpose. The earliest commercial bills of exchange were drawn by merchants on their agents, and were simply directions for the disposal of money in the agents’ hands. But by the eighteenth century the agent was beginning to drop out. The merchant sending goods to a distant place would draw a bill on the purchaser himself, instead of on an agent. That necessitated a prior agreement by the latter both to purchase the goods and to accept the bill, but, as communications improved, such agreements became more practicable. Nevertheless the functions of the agent could not be wholly dispensed with. The bill, when accepted by the purchaser on whom it was drawn, became the vital evidence of his debt to the seller, and someone had to take charge of it on behalf of the latter. It was to render these services in respect of the bills drawn for the internal trade of the country that the English banking system of the eighteenth century had grown up. The country banks of that time were primarily an organisation for dealing with bills, not only for discounting them, but for presenting them for acceptance, holding them in safe keeping, and collecting payment on maturity. Their note issues and deposits were originally incidental to these functions; traders made their bills payable to the banks, and were willing to leave the proceeds of discount or collection on deposit, or to draw them out in the convenient form of bank notes.

The merchant in any part of England would usually pay for his purchases by accepting bills drawn upon him by the sellers, and would receive payment by drawing bills on his customers. Payment might also be made by means of bills already in the possession of the purchaser and endorsed by him to the seller, or it might of course be made in cash. When a bill was drawn, the foundation of the bargain was that the purchaser should make payment at an agreed
future date. The bill was merely an instrument for assigning the debt so created to another creditor.

If a merchant's purchases and sales were paid for exclusively by the drawing of three months bills, his payments and receipts would be a perfect trace of his purchases and sales three months in arrear. He would at any time be paying for what he bought three months before, and receiving payment for what he sold three months before. There would be an excess of payments over receipts equal to the value of the goods bought and not yet sold up to three months before. This excess (along with the expenses incurred in his business) might be met out of his own capital. But it would be a widely fluctuating amount, and if his capital was sufficient to cover the maximum excess of payments over receipts, then at times when the excess was below the maximum he would hold a balance of idle cash. Idle cash is a loss. And this loss could be avoided if the merchant so limited the capital employed in his business that it was just enough when the excess of his payments over his receipts was at a minimum, and relied on getting some of his bills discounted whenever the excess rose above the minimum. In effect he might be increasing his business and supplementing his capital to the requisite extent by the discounting of bills; or, if his business did not expand to this extent, he might build up a private fortune in securities or property outside the business. The private fortune being withdrawn, the capital remaining in the business would be no more than the essential minimum; so equally in this case the usual practice would be to provide for the fluctuating excess of payments over receipts beyond the minimum by getting bills discounted before maturity.

A wholesale dealer selling to retail dealers would probably draw bills on them, but many of the bills would be small and local, and he would not rely on getting them discounted. He would assume the burden of financing the retailers from his own capital. The retailers would need the credit accorded to them by the bills in some instances to enable them to give credit to customers and in others to
allow for the time taken to sell off each consignment of goods bought.

Manufacturers, like merchants, would be financed by bills. A manufacturer who drew bills for the goods he sold, and accepted bills drawn on him for the materials he bought, would have to pay wages and other expenses of production in cash. But that did not necessarily mean that he would depend to a greater extent than the merchant on getting bills discounted, for he might meet this cash outlay from his own capital. Like the merchant he would cover the variable margin in excess of his minimum working capital by getting bills discounted. For the manufacturer the variable margin would include the goods he has produced but not yet delivered and those he has delivered but has not been paid for.

**Bills on London**

Bills might be drawn on traders in any part of the country, but from the early days of the credit system there was a marked tendency for bills drawn on London to predominate. The more substantial merchants, those whose transactions were not merely local in character, would nearly always have either a head office or an important agency in London, and to all such the centralisation of receipts and payments was a great convenience. Even traders who had no London establishment tended in course of time to arrange with their bankers to have the bills drawn on them made payable in London.¹

In consequence of the monopoly of joint-stock banking enjoyed by the Bank of England till 1826, the banking system was in the hands of numerous banks most of which were small and none could have a capital exceeding the fortunes of six partners. Few banks had any branches, and none had an extensive branch system. One of the principal functions of the banks in any locality was to act

¹ That arrangement, relating merely to the place at which the trader undertakes to make payment, must be distinguished from the case where the banker himself accepts the bill on behalf of the trader.
as correspondents of banks in other places for the purpose of presenting bills drawn on that locality for acceptance and payment. A bank would need to have correspondents in all the places with which its customers ordinarily did business, and above all it would need a London correspondent. Every country bank would hold a reserve of London funds composed partly of a balance with its correspondent bank and partly of accepted bills payable in London.

The accepted bills might be left in London with the correspondent bank to be presented for payment on maturity, or sold in the discount market should funds be needed earlier, or they might be returned to the country bank to be available in local dealings. The country bank would employ these London funds to meet the needs of customers arising from liabilities for the purchase of goods or investments or for maturing bills in London. The reserve would be fed by the London receipts of country customers, by maturities of bills, and by the sale of bills in the London discount market. One country bank would acquire London funds from another in exchange for local bills or in settlement of balances. Any country bank would possess a considerable amount of local assets, not only local bills, but also advances to customers. Even in those days advances were a substantial item.

London was also the principal centre for foreign trade. The system of merchants' agencies persisted longer in international trade than in domestic trade. In the early nineteenth century the great merchants had not yet been transformed into merchant bankers, but most of the foreign exchange business was already concentrated in their hands. Any merchant who had an agency in a foreign centre was in a position to arrange for the acceptance and payment of other merchants' bills on that centre, or to buy such bills outright.

In proportion as the export and import trade of the country came into the hands of British merchants, the financing of the trade was centralised in London. Not
only did the merchants accept bills payable in London when they bought imports, but British manufacturers for export sold their goods to the British merchants and drew bills on them likewise payable in London. The smaller merchants would draw bills on the country to which the exports were sent for sale and would sell the bills to the greater merchants. The greater merchants might get the bills discounted in the country of destination, but alternatively they might hold the bills to maturity and depend on their own capital to cover the cost of the goods in the interval. There were also foreign merchants dealing in British imports and exports and financing them in the corresponding manner, but by the end of the eighteenth century the predominance of the British merchant and therefore of the bill on London was becoming established.

Thus it was usual for any trader, whether merchant, wholesale dealer or manufacturer, at all times to be both debtor and creditor on bills, debtor on those he had accepted, and creditor on those in his own hands. And he would probably from time to time sell a portion of the bills coming into his hands to meet current liabilities.

The London Discount Market

A country bank discounted bills for its customers, but the extent of its lending was limited by the amount of its note issue and deposits and the need of a cash reserve. By lending it created deposits which its customers could draw upon, and, if it lent too much, their payments to customers of other banks would exhaust its cash reserves. Even if the payments were made in the Bank's own notes, these would be presented for payment as soon as they had been deposited in another bank.

If some banks received more bills from their customers than they could safely discount, others received less. The bills drawn on local traders, which a country bank received in the course of its business, would not be readily marketable, and would probably be held till maturity. But bills on London were a suitable asset for any bank, whether in
London or in the country. Any bank with an excess of bills on its hands became a seller of bills on London, and it was to provide facilities for the sale of such bills that the London discount market came into existence. Bills were offered for sale direct by the traders themselves as well as by banks. The buyers of bills were those banks which did not receive enough bills from their customers to employ their funds.

The banks in the manufacturing districts were sellers of bills. The greater part of the output of such a district was for sale elsewhere, either in another part of the country or abroad, and bills would be drawn on the purchasers. An agricultural district would be more nearly self-contained and would draw relatively few bills; its banks would be regular buyers of bills in the London market. The banks in the City of London received the bills drawn in the course of foreign trade, while those in the West End received no bills from their customers, and were buyers of bills in the market.

That there were considerable areas of England in which the country banks seem to have been almost indifferent to conditions in the London discount market and went on year after year paying interest on deposits, charging interest on advances, and even discounting trade bills at unchanging conventional rates, is to be explained I think by the fact that in such districts the local demand for bills happened to be approximately equalled by local deposits.

At first the bill market was composed of mere brokers, who found buyers of bills to suit the sellers, and were paid by commission. About 1827 the practice began of lending money at call or short notice to bill brokers on the security of bills, and it soon grew. It was impossible for a bank to select bills with maturities to suit its future uncertain needs for cash, and it was inconvenient either to be perpetually buying and selling bills or to hold a large enough cash reserve to cover all contingencies. A loan at call to the bill-broker, earning a rate of interest a fraction less

than the market rate of discount on bills, was a simple solution of the problem. And it suited the bill-brokers too, for the needs of the banks for cash were mostly for payments to one another, so that loans called up would be balanced by new money lent.

But that was not always so. There might be an excess of bills created in the country as a whole. If for any reason there was increased activity of business, more bills would be drawn for the sale of more goods. Manufacturers, receiving increased orders, had to discount bills to provide cash to pay wages and other expenses of production. Additional currency would thus be created to pay additional incomes, and the additional incomes would generate increased demand. A vicious circle of expansion would be joined. Eventually the additional purchasing power would attract additional imports from abroad. There would be a twofold drain of gold, an internal drain to meet increased demands for currency and an external drain to pay for the excess imports.

**THE BANK OF ENGLAND AND THE GOLD RESERVE**

The demand for gold was concentrated upon the reserve of the Bank of England. The country banks drew what they needed from the London banks, and the London banks proceeded to sell bills in the discount market. But if there was a general shortage of cash, so that the sellers of bills in the market predominated over the buyers, there was no way of providing for the unsold residue of bills unless the Bank of England would take them. The practice had grown up of the Bank of England acting as the lender of last resort; it was expected to discount all eligible bills offered, whether by merchants or by bankers, and any bill on London maturing within ninety-five days and bearing two good English names (one being the acceptor) was eligible.

It was found, however, occasionally, under conditions of extreme pressure on the reserve, that the Bank could not afford to assume this responsibility. Thornton referred

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1 See my *Art of Central Banking*, pp. 116–26
to "a determination, adopted some time since by the bank directors, to limit the total weekly amount of loans furnished by them to the merchants. The adoption of a regulation for this purpose seems to have been rendered necessary by that impossibility of otherwise limiting at all times the Bank of England paper. The regulation in question I consider as intended to confine within a specific, though in some degree fluctuating, sum the loans of the bank, for the sake of restricting the paper."

When the Bank of England placed a limit on its discounts and absolutely refused bills, the whole credit system was endangered. Merchants who had relied on the bills they held as the means of raising cash would find themselves compelled to default on their own acceptances unless they could realise some other marketable assets. The prices of goods and of securities would be depressed by forced sales, and doubts of the solvency of the merchants whose names appeared on bills would lead to discredit of the bills.

No doubt Thornton, when he wrote, had in mind the attempt made by the Bank of England in December, 1795, to ration discounts. The attempt to limit its note issues by this method failed, for it did not avert the suspension of gold payments fourteen months later. Under the Bank Restriction that began in 1797 the Bank was no longer restrained by any consideration of its gold reserve; it became free to discount eligible bills without limit. And as notes down to one pound had been put into circulation concurrently with the suspension of gold payments, gold was no longer needed for internal circulation at all.

THE BULLION COMMITTEE

It was this state of things that led to the appointment of the Committee on the High Price of Bullion in 1810, in the proceedings of which Henry Thornton took a prominent part. In its Report the Committee found fault with the reliance of the Bank of England on the soundness of the bills it discounted as the sole safeguard against inflation,
without regard to their quantity, and recurred to the question of the usury laws (p. 51). "The law, which in this country limits the rate of interest and of course the rate at which the Bank can legally discount, exposes the Bank to still more extensive demands for commercial discounts. While the rate of commercial profit is very considerably higher than 5 per cent., as it has lately been in many branches of our foreign trade, there is in fact no limit to the demands which merchants of perfectly good capital and of the most prudent spirit of enterprise may be tempted to make upon the Bank for accommodation and facilities by discount."

The implication here is the same as in Henry Thornton’s work; the increase in the bills held by the Bank of England tends to bring about a corresponding increase in its note issue, and the latter increase can best be prevented by a rate of interest which is a deterrent on the former increase. To be a deterrent, the rate must offset the prospect of profit from the transactions intended by the borrowers, and, if the anticipated profit rises, the rate of discount ought to be free to rise without regard to any statutory limit.

**Bank Rate in 1822 and 1825**

As it turned out, the first occasion on which a change in the discount rate became a practical issue involved not a rise but a fall. In the early part of the eighteenth century the Bank of England’s discount rate had for twenty years been no more than 4 per cent. From 1742 to 1773 the rate of 4 per cent. had continued for foreign bills (except for an interval at 5 per cent. from 12th December, 1745, to 1st May, 1746) though inland bills had been charged 5 per cent. Thereafter the rate had been 5 per cent. for both classes of bills, and still was when the pound was restored to gold parity in 1819, and when convertibility into gold coin was resumed in 1821.

But whereas 5 per cent. had been an unduly low rate during the Napoleonic Wars, now under conditions of