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Interim Report of the Cunliffe Committee, 1918: Report on Currency and Foreign Exchanges After the War. As the First World War drew to an end, the British Government commissioned a report on the war's consequences for the currency and foreign exchange markets. The Committee, reflecting the consensus opinion of British financial and commercial sectors, unanimously recommended a return to the gold standard, the reduction of government debt and borrowing, and the accumulation of sufficient reserves to underpin the system. The excerpts below include the analysis of the pre-war situation and the disturbances caused by the war as well as the recommendations of the Committee.

Introduction

My Lords and Sir,

1. We have the honour to present herewith an interim report on certain of the matters referred to us in January last. In this report we attempt to indicate the broad lines on which we think the serious currency difficulties which will confront this country at the end of the war should be dealt with. The difficulties which will arise in connection with the foreign exchanges will be no less grave, but we do not think that any recommendations as to the emergency expedients which may have to be adopted in the period immediately following the conclusion of peace can usefully be made until the end of the war is clearly in sight and a more definite opinion can be formed as to the conditions which will then prevail. We have had the advantage of consultation with the Bank of England, and have taken oral evidence from various banking and financial experts, representatives of certain chambers of commerce and others who have particularly interested themselves in these matters. We have also had written evidence from certain other representatives of commerce and industry. Our conclusions upon the subjects dealt with in this report are unanimous, and we cannot too strongly emphasize our opinion that the application, at the earliest possible date, of the main principles on which they are based is of vital necessity to the financial stability and well-being of the country. Nothing can contribute more to a speedy recovery from the effects of the war, and to the rehabilitation of the foreign exchanges, than the re-establishment of the currency upon a sound basis. Indeed, a sound system of currency will, as is shown in paragraphs 4 and 5, in itself secure equilibrium in those exchanges, and render unnecessary the continued resort to the emergency expedients to which we have referred. We should add that in our inquiry we have had in view the conditions which are likely to prevail during the ten years immediately following the end of the war, and we think that the whole subject should be again reviewed not later than the end of that period.

Volume II

The Heyday of the Gold Standard, 1820-1930

The currency system before the war

2. Under the Bank Charter Act of 1844, apart from the fiduciary issue of the Bank of England and the notes of Scottish and Irish Banks of Issue (which were not actually legal tender), the currency in circulation and in Bank reserves consisted before the war entirely of gold and subsidiary coin or of notes representing gold. Gold was freely coined by the Mint without any charge. There were no restrictions upon the import of gold. Sovereigns were freely given by the Bank in exchange for notes at par value, and there were no obstacles to the export of gold. Apart from the presentation for minting of gold already in use in the arts (which under normal conditions did not take place) there was no means whereby the legal tender currency could be increased except the importation of gold from abroad to form the basis of an increase in the note issue of the Bank of England or to be presented to the Mint for coinage, and no means whereby it could be diminished (apart from the normal demand for the arts, amounting to about £2,000,000 a year, which was only partly taken out of the currency supply) except the export of bullion or sovereigns.

3. Since the passing of the Act of 1844 there has been a great development of the cheque system. The essence of that system is that purchasing power is largely in the form of bank deposits operated upon by cheque, legal tender money being required only for the purpose of the reserves held by the banks against those deposits and for actual public circulation in connection with the payment of wages and retail transactions. The provisions of the Act of 1844 as applied to that system have operated both to correct unfavourable exchanges and to check undue expansions of credit.

4. When the exchanges were favourable, gold flowed freely into this country and an increase of legal tender money accompanied the development of trade. When the balance of trade was unfavourable and the exchanges were adverse, it became profitable to export gold. The would-be exporter bought his gold from the Bank of England and paid for it by a cheque on his account. The Bank obtained the gold from the Issue Department in exchange for notes taken out of its banking reserve, with the result that its liabilities to depositors and its banking reserve were reduced by an equal amount, and the ratio of reserve to liabilities consequently fell. If the process was repeated sufficiently often to reduce the ratio in a degree considered dangerous, the Bank raised its rate of discount. The raising of the discount rate had the immediate effect of retaining money here which would otherwise have been remitted abroad and of attracting remittances from abroad to take advantage of the higher rate, thus checking the outflow of gold and even reversing the stream.

5. If the adverse condition of the exchanges was due not merely to seasonal fluctuations, but to circumstances tending to create a permanently adverse trade balance, it is obvious that the procedure above described would not have been sufficient. It would have resulted in the creation of a volume of short-dated indebtedness to foreign countries which would have been in the end disastrous to our credit and the position of London as the financial centre of the world. But the

raising of the Bank's discount rate and the steps taken to make it effective in the market necessarily led to a general rise of interest rates and a restriction of credit. New enterprises were therefore postponed and the demand for constructional materials and other capital goods was lessened. The consequent slackening of employment also diminished the demand for consumable goods, while holders of stocks of commodities carried largely with borrowed money, being confronted with an increase of interest charges, if not with actual difficulty in renewing loans, and with the prospect of falling prices, tended to press their goods on a weak market. The result was a decline in general prices in the home market which, by checking imports and stimulating exports, corrected the adverse trade balance which was the primary cause of the difficulty.

6. When, apart from a foreign drain of gold, credit at home threatened to become unduly expanded, the old currency system tended to restrain the expansion and to prevent the consequent rise in domestic prices which ultimately causes such a drain. The expansion of credit, by forcing up prices, involves an increased demand for legal tender currency both from the banks in order to maintain their normal proportion of cash to liabilities and from the general public for the payment of wages and for retail transactions. In this case also the demand for such currency fell upon the reserve of the Bank of England, and the Bank was thereupon obliged to raise its rate of discount in order to prevent the fall in the proportion of that reserve to its liabilities. The same chain of consequences as we have just described followed and speculative trade activity was similarly restrained. There was therefore an automatic machinery by which the volume of purchasing power in this country was continuously adjusted to world prices of commodities in general. Domestic prices were automatically regulated so as to prevent excessive imports; and the creation of banking credit was so controlled that banking could be safely permitted a freedom from state interference which would not have been possible under a less rigid currency system.

7. Under these arrangements this country was provided with a complete and effective gold standard. The essence of such a standard is that notes must always stand at absolute parity with gold coins of equivalent face value, and that both notes and gold coins stand at absolute parity with gold bullion. When these conditions are fulfilled, the foreign-exchange rates with all countries possessing an effective gold standard are maintained at or within the gold specie points.

<u>Changes which have affected the gold standard during the war</u>

8. It will be observed that the fall in a number of the foreign exchanges below the old export specie points which has taken place since the early part of 1915 is not by itself a proof that the gold standard has broken down or ceased to be effective. During the present war the depredations of enemy submarines, high freights, and the refusal of the government to extend state insurance to gold cargoes have greatly increased the cost of sending gold abroad. The actual export specie point has, therefore, moved a long way from its old position. In view of our enormous demands for imports, coupled with the check on our exports due to the war, it was natural that our exchanges with neutrals should move towards the

export specie point. Consequently, the fall in the export specie point would by itself account for a large fall in our exchange rates. Such a fall must have taken place in the circumstances, even though all the conditions of an effective gold standard had been fully maintained.

9. The course of the war has, however, brought influences into play in consequence of which the gold standard has ceased to be effective. In view of the crisis which arose upon the outbreak of war it was considered necessary, not merely to authorize the suspension of the Act of 1844, but also to empower the Treasury to issue currency notes for one pound and for ten shillings as legal tender throughout the United Kingdom. Under the powers given by the Currency and Bank Notes Act 1914, the Treasury undertook to issue such notes through the Bank of England to bankers, as and when required, up to a maximum limit not exceeding for any bank 20 per cent of its liabilities on current and deposit accounts. The amount of notes issued to each bank was to be treated as an advance bearing interest at the current Bank Rate.

10. It is not likely that the internal demand for legal tender currency which was anticipated at the beginning of August 1914 would by itself have necessitated extensive recourse to these provisions. But the credits created by the Bank of England in favour of its depositors under the arrangements by which the Bank undertook to discount approved bills of exchange and other measures taken about the same time for the protection of credit caused a large increase in the deposits of the Bank. Further, the need of the government for funds wherewith to finance the war in excess of the amounts raised by taxation and by loans from the public has made necessary the creation of credits in their favour with the Bank of England. Thus, the total amount of the Bank's deposits increased from, approximately, £56,000,000 in July 1914 to £273,000,000 on 28 July 1915 and, though a considerable reduction has since been effected, they now (15 August) stand as high as £171,870,000. The balances created by these operations passing by means of payments to contractors and others to the joint stock banks have formed the foundation of a great growth of their deposits which have also been swelled by the creation of credits in connection with the subscriptions to the various war loans. Under the operation of these causes the total deposits of the banks of the United Kingdom (other than the Bank of England) increased from £ 1,070,681,000 on 31 December 1913, to £1,742,902,000 on 31 December 1917.

11. The greatly increased volume of bank deposits, representing a corresponding increase of purchasing power and, therefore, leading in conjunction with other causes to a great rise of prices, has brought about a corresponding demand for legal tender currency which could not have been satisfied under the stringent provisions of the Act of 1844. Contractors are obliged to draw cheques against their accounts in order to discharge their wages bill - itself enhanced on account of the rise of prices. It is to provide this currency that the continually growing issues of currency notes have been made. The Banks instead of obtaining notes by way of advance under the arrangements described in paragraph 9 were able to pay for them outright by the transfer of the amount from their balances at the Bank of

England to the credit of the currency note account and the circulation of the notes continued to increase. The government subsequently, by substituting their own securities for the cash balance so transferred to their credit, borrow that balance. In effect, the banks are in a position at will to convert their balances at the Bank of England enhanced in the manner indicated above into legal tender currency without causing notes to be drawn, as they would have been under the prewar system, from the banking reserve of the Bank of England, and compelling the Bank to apply the normal safeguards against excessive expansion of credit. Fresh legal tender currency is thus continually being issued, not, as formerly, against gold, but against government securities. Plainly, given the necessity for the creation of bank credits in favour of the government for the purpose of financing war expenditure, these issues could not be avoided. If they had not been made, the banks would have been unable to obtain legal tender with which to meet cheques drawn for cash on their customers' accounts. The unlimited issue of currency notes in exchange for credits at the Bank of England is at once a have found necessary to adopt in order to meet their war expenditure.

12. The effect of these causes upon the amount of legal tender money (other than subsidiary coin) in bank reserves and in circulation in the United Kingdom are shown in the following paragraph.

13. The amounts on 30 June 1914, may be estimated as follows:

Fiduciary Issue of the Bank of England	£18,450,000
Bank of England notes issued against gold coin or bullion	£38,476,000
Estimated amount of gold coin held by banks (excluding gold coin held in the Issue Department of the Bank of England) and in public circulation	£123,000,000
Grand Total	**£179,926,000**

The corresponding figures of 10 July 1918, as nearly as they can be estimated, were:

Fiduciary Issue of the Bank of England	£18,450,000
Currency notes not cover by gold	£230,412,000
Total Fiduciary Issues	£248,862,000
Bank of England notes issued against coin and bullion	£65,368,000
Currency notes covered by gold	£28,500,000
Estimated amount of gold coin held by banks (excluding gold coin held by Issue Department	£40,000,000

of Bank of England), say	
Grand Total	**£382,730,000**

There is also a certain amount of gold coin still in the hands of the public which ought to be added to the last-mentioned figure, but the amount is unknown.

14. As Bank of England notes and currency notes are both payable at the Bank of England in gold coin on demand this large issue of new notes, associated, as it is, with abnormally high prices and unfavourable exchanges, must have led under normal conditions to a rapid depletion, threatening ultimately the complete exhaustion, of the Bank's gold holdings. Consequently, unless the Bank had been prepared to see all its gold drained away, the discount rate must have been raised to a much higher level, the creation of banking credit (including that required by the government) would have been checked, prices would have fallen and a large portion of the surplus notes must have come back for cancellation. In this way an effective gold standard would have been maintained in spite of the heavy issue of notes. But during the war conditions have not been normal. The public are content to employ currency notes for internal purposes, and, notwithstanding adverse exchanges, war conditions interpose effective practical obstacles against the export of gold. Moreover, the legal prohibition of the melting of gold coin, and the fact that the importation of gold bullion is reserved to the Bank of England, and that dealings in it are limited have severed the link which formerly existed between the values of coin and of uncoined gold. It is not possible to judge to what extent legal tender currency may in fact be depreciated in terms of bullion. But it is practically certain that there has been some depreciation, and to this extent therefore the gold standard has ceased to be effective.

Restoration of conditions necessary to the maintenance of the gold standard recommended

15. We shall not attempt now to lay down the precise measures that should be adopted to deal with the situation immediately after the war. These will depend upon a variety of conditions which cannot be foreseen, in particular the general movements of world prices and the currency policy adopted by other countries. But it will be clear that the conditions necessary to the maintenance of an effective gold standard in this country no longer exist, and it is imperative that they should be restored without delay. After the war our gold holdings will no longer be protected by the submarine danger, and it will not be possible indefinitely to continue to support the exchanges with foreign countries by borrowing abroad. Unless the machinery which long experience has shown to be the only effective remedy for an adverse balance of trade and an undue growth of credit is once more brought into play, there will be very grave danger of a credit expansion in this country and a foreign drain of gold which might jeopardize the convertibility of our note issue and the international trade position of the country. The uncertainty of the monetary situation will handicap our industry, our position as an international financial centre will suffer and our general commercial status

in the eyes of the world will be lowered. We are glad to find that there was no difference of opinion among the witnesses who appeared before us as to the vital importance of these matters.

Cessation of government borrowings

16. If a sound monetary position is to be re-established and the gold standard to be effectively maintained, it is in our judgement essential that government borrowings should cease at the earliest possible moment after the war. A large part of the credit expansion arises, as we have shown, from the fact that the expenditure of the government during the war has exceeded the amounts which they have been able to raise by taxation or by loans from the actual savings of the people. They have been obliged therefore to obtain money through the creation of credits by the Bank of England and by the joint stock banks, with the result that the growth of purchasing power has exceeded that of purchasable goods and services. As we have already shown, the continuous issue of uncovered currency notes is inevitable in such circumstances. This credit expansion (which is necessarily accompanied by an evergrowing foreign indebtedness) cannot continue after the war without seriously threatening our gold reserves and, indeed, our national solvency.

17. A primary condition of the restoration of a sound credit position is the repayment of a large portion of the enormous amount of government securities now held by the banks. It is essential that as soon as possible the state should not only live within its income but should begin to reduce its indebtedness. We accordingly recommend that at the earliest possible moment an adequate sinking fund should be provided out of revenue, so that there may be a regular annual reduction of capital liabilities, more especially those which constitute the floating debt. We should remark that it is of the utmost importance that such repayment of debt should not be offset by fresh borrowings for capital expenditure. We are aware that immediately after the war there will be strong pressure for capital expenditure by the state in many forms for reconstruction purposes. But it is essential to the restoration of an effective gold standard that the money for such expenditure should not be provided by the creation of new credit, and that, in so far as such expenditure is undertaken at all, it should be undertaken with great caution. The necessity of providing for our indispensable supplies of food and raw materials from abroad and for arrears of repairs to manufacturing plant and the transport system at home will limit the savings available for new capital expenditure for a considerable period. This caution is particularly applicable to far-reaching programmes of housing and other development schemes.

The shortage of real capital must be made good by genuine savings. It cannot be met by the creation of fresh purchasing power in the form of bank advances to the government or to manufacturers under government guarantee or otherwise, and any resort to such expedients can only aggravate the evil and retard, possibly for generations, the recovery of the country from the losses sustained during the war.

Volume II

The Heyday of the Gold Standard, 1820-1930

Use of Bank of England discount rate

18. Under an effective gold standard all export demands for gold must be freely met. A further essential condition of the restoration and maintenance of such a standard is therefore that some machinery shall exist to check foreign drains when they threaten to deplete the gold reserves. The recognized machinery for this purpose is the Bank of England discount rate. Whenever before the war the Bank's reserves were being depleted, the rate of discount was raised. This, as we have already explained, by reacting upon the rates for money generally, acted as a check which operated in two ways. On the one hand, raised money rates tended directly to attract gold to this country or to keep here gold that might have left. On the other hand, by lessening the demands for loans for business purposes, they tended to check expenditure and so to lower prices in this country, with the result that imports were discouraged and exports encouraged, and the exchanges thereby turned in our favour. Unless this twofold check is kept in working order the whole currency system will be imperilled. To maintain the connection between a gold drain and a rise in the rate of discount is essential to the safety of the reserves. When the exchanges are adverse and gold is being drawn away, it is essential that the rate of discount in this country should be raised relatively to the rates ruling in other countries. Whether this will actually be necessary immediately after the war depends on whether prices in this country are then substantially higher than gold prices throughout the world. It seems probable that at present they are on the whole higher, but, if credit expansion elsewhere continues to be rapid, it is possible that this may eventually not be so.

[...]

Legal limitation of note issue necessary

20. The foregoing argument has a close connection with the general question of the legal control of the note issue. It has been urged in some quarters that in order to make possible the provision of a liberal supply of money at low rates during the period of reconstruction further new currency notes should be created, with the object of enabling banks to make large loans to industry without the risk of finding themselves short of cash to meet the requirements of the public for legal tender money. It is plain that a policy of this kind is incompatible with the maintenance of an effective gold standard. If it is adopted there will be no check upon the outflow of gold. Adverse exchanges will not be corrected either directly or indirectly through a modification in the general level of commodity prices in this country. On the contrary, as the issue of extra notes stimulates the conditions which tend to produce an advance of prices, they will become steadily more and more adverse. Hence the processes making for the withdrawal of our gold will continue and no counteracting force will be set in motion. In the result the gold standard will be threatened with destruction through the loss of all our gold.

21. The device of making money cheap by the continued issue of new notes is thus altogether incompatible with the maintenance of a gold standard. Such a policy can only lead in the end to an inconvertible paper currency and a collapse

of the foreign exchanges, with consequences to the whole commercial fabric of the country which we will not attempt to describe. This result may be postponed for a time by restrictions on the export of gold and by borrowing abroad. But the continuance of such a policy after the war can only render the remedial measures which would ultimately be inevitably more painful and protracted. No doubt it would be possible for the Bank of England, with the help of the joint stock banks, without any legal restriction on the note issue, to keep the rate of discount sufficiently high to check loans, keep down prices, and stop the demand for further notes. But it is very undesirable to place the whole responsibility upon the discretion of the banks, subject as they will be to very great pressure in a matter of this kind. If they know that they can get notes freely, the temptation to adopt a lax loan policy will be very great. In order, therefore, to ensure that this is not done, and the gold standard thereby endangered, it is, in our judgement, imperative that the issue of fiduciary notes shall be, as soon as practicable, once more limited by law, and that the present arrangements under which deposits at the Bank of England may be exchanged for legal tender currency without affecting the reserve of the Banking Department shall be terminated at the earliest possible moment. Additional demands for legal tender currency otherwise than in exchange for gold should be met from the reserves of the Bank of England and not by the Treasury, so that the necessary checks upon an undue issue may be brought regularly into play. Subject to the transitional arrangements as regards currency notes which we later propose, and to any special arrangements in regard to Scotland and Ireland which we may have to propose when we come to deal with the questions affecting those parts of the United Kingdom, we recommend that the note issue (except as regards existing private issues) should be entirely in the hands of the Bank of England; the notes should be payable in gold in London only, and should be legal tender throughout the United Kingdom.

[...]

Summary of conclusions

47. Our main conclusions may be briefly summarized as follows:

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

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

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

The prerequisites for the restoration of an effective gold standard are:

(a) The cessation of government borrowing as soon as possible after the war. We recommend that at the earliest possible moment an adequate sinking fund should be provided out of revenue, so that there may be a regular annual reduction of capital liabilities, more especially those which constitute the floating debt.

(b) The recognized machinery, namely the raising and making effective of the Bank of England discount rate, which before the war operated to check a foreign drain of gold and the speculative expansion of credit in this country, must be kept in working order. This necessity cannot, and should not, be evaded by any attempt to continue differential rates for home and foreign money after the war.

(c) The issue of fiduciary notes should, as soon as practicable, once more be limited by law, and the present arrangements under which deposits at the Bank of England may be exchanged for legal tender currency without affecting the reserve of the Banking Department should be terminated at the earliest possible moment. Subject to transitional arrangements as regards currency notes and to any special arrangements in regard to Scotland and Ireland which we may have to propose when we come to deal with the questions affecting those parts of the United Kingdom, we recommend that the note issue (except as regards existing private issues) should be entirely in the hands of the Bank of England. The notes should be payable in London only and should be legal tender throughout the United Kingdom.

As regards the control of the note issue, we make the following observations:

1. While the obligation to pay both Bank of England notes and currency notes in gold on demand should be maintained, it is not necessary or desirable that there should be any early resumption of the internal circulation of gold coin.

2. While the import of gold should be free from all restrictions, it is convenient that the Bank of England should have cognizance of all gold exports and we recommend that the export of gold coin or bullion should be subject to the condition that such coin and bullion has been obtained from the Bank for the purpose. The Bank should be under obligation to supply gold for export in exchange for its notes.

3. In view of the withdrawal of gold from circulation we recommend that the gold reserves of the country should be held by one central institution and that all banks should transfer any gold now held by them to the Bank of England.

Having carefully considered the various proposals which have been placed before us as regards the basis of the fiduciary note issue […], we recommend that the principle of the Bank Charter Act 1844, should be maintained, namely that there should be a fixed fiduciary issue beyond which notes should only be issued in exchange for gold.

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

We have come to the conclusion that it is not practicable to fix any precise figure for the fiduciary note issue immediately after the war.

We think it desirable, therefore, to fix the amount which should be aimed at as the central gold reserve, leaving the fiduciary issue to be settled ultimately at such amount as can be kept in circulation without causing the central gold reserve to fall below the amount so fixed. We recommend that the normal minimum of the central gold reserve to be aimed at should be, in the first instance, £150 million. Until this amount has been reached and maintained concurrently with a satisfactory foreign exchange position for at least a year, the policy of cautiously reducing the uncovered note issue should be followed. When reductions have been effected, the actual maximum fiduciary circulation in any year should become the legal maximum for the following year, subject only to the emergency arrangements previously recommended. When the exchanges are working normally on the basis of a minimum reserve of £ 150 million, the position should again be reviewed in the light of the dimensions of the fiduciary issue as it then exists. We do not recommend the transfer of the existing currency note issue to the Bank of England until the future dimensions of the fiduciary issue have been ascertained. During the transitional period the issue should remain a government issue, but new notes should be issued, not against government securities, but against Bank of England notes, and, furthermore, when opportunity arises for providing cover for existing uncovered notes, Bank of England notes should be used for this purpose also. Demands for new currency would then fall in the normal way on the Banking Department of the Bank of England. When the fiduciary portion of the issue has been reduced to an amount which experience shows to be consistent with the maintenance of a central gold reserve of £150 million, the outstanding currency notes should be retired and replaced by Bank of England notes of low denomination.

***Source*:** *Parliamentary Papers, 1918*, Command Series 9182.