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Volume 10

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Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published in 1926 by Methuen & Co. Ltd.

This edition first published in 2017
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN: 978-0-415-79325-4 (Set)
ISBN: 978-1-315-21117-6 (Set) (ebk)
ISBN: 978-0-415-79345-2 (Volume 10) (hbk)
ISBN: 978-0-415-79349-0 (Volume 10) (pbk)
ISBN: 978-1-315-21101-5 (Volume 10) (ebk)

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FOREIGN EXCHANGE AND FOREIGN DEBTS

BY

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METHUEN & CO. LTD.

36 ESSEX STREET W.C.

LONDON

First Published in 1926

PRINTED IN GREAT BRITAIN

PREFACE

MY previous textbook, "Modern Foreign Exchange," was written in 1922 from the standpoint that, as I then put it, the changes in the world of Foreign Exchange brought about by the war were "destined, in the main, to be permanent."

The correctness of this view has been amply shown by the events of the four years which have elapsed since the above was written, and the viewpoint defined in the earlier textbook is now generally held by the more far-seeing part of the business community.

During 1924 to 1925 a new set of correlated events in the world of international finance (issue of the Reichsmark, Dawes Plan, stabilization, the Return to Gold, Debt Settlements) have altered substantially the Exchange conditions of 1922. The events in question do not constitute a "return to normal" in the sense of a return to pre-war conditions—that "normal" has gone for an indefinite period. They do constitute, however, a new "normal," which is likely to last for the next few years. This new normal I have called "The New Equilibrium"; for on the one hand it is an equilibrium, which fact distinguishes it from the chaotic fluctuations of the years immediately following the war, while on the other hand it is as different from the equilibrium of pre-war days as the political state of Europe in 1926 differs from that of 1914. It is accordingly from the standpoint of this New Equilibrium that the foreign exchanges of to-day should be studied.

When, therefore, a fourth edition of "Modern Foreign Exchange" was called for in 1926, it seemed best to rewrite the whole book from the standpoint of the new conditions. The result was a new book, as was natural enough in view of the crowded happenings of the last few years in the world of Foreign Exchange. Only a part of the purely technical section of the original book, that on Bills of Exchange, preserves its original form, and even here additions have been made. The last four and a half chapters are almost entirely new.

The study of Exchange movements to-day must ultimately base itself on the new body of Exchange reasoning worked out by Professor Keynes, Professor Cassel, and others. This new body of Exchange reasoning, which explains the phenomena of Foreign Exchange as they exist to-day, has, however, still not found its way to any appreciable extent into the textbooks, which were in the main written with reference to pre-war conditions and which continue to treat modern developments, in so far as they are treated in detail at all, as temporary aberrations from pre-war conditions, which are still called "normal." The present textbook tries to explain the essentials of Exchange movements to-day as they are understood by modern economists, in a form which will be comprehensible to the intelligent person of average education who is not a professional economist. I have had in mind throughout the students and the business men of whom my original Manchester audiences were composed, to whom much of the new reasoning, which has been written by economists for economists, is complicated in form to a most discouraging degree. Accordingly, such subjects as inflation, purchasing power parity, the course of the mark, the stabilization of the Exchanges, the return to the gold standard, and international debts are discussed more fully than has hitherto been the case in textbooks, but in a less technical manner than is necessarily adopted in an economic treatise. I hope to find the justification for the book, not in original theories, but in setting out in a form which can be understood by any person of average education the agreed conclusions of economists regarding the post-war Exchanges.

Any adequate textbook on Foreign Exchange which aims at being more than a guide to the Exchange market must aim at explaining phenomena as well as describing them. The problem is to balance description and explanation, technique and theory. It must combine some of the functions of a manual on foreign banking with those of a textbook on this section of economics. Throughout I have endeavoured to bear in mind that my readers, like my audiences, will want to know not only How ? but also Why ?

So far as the technique of foreign banking is concerned I have, in dealing with foreign bills, drawn on my own experience of both the banking and mercantile aspects, obtained in the capacity of financial manager of a mercantile company trading in various overseas markets, which I was enabled to amplify by the facilities kindly afforded me by one of the joint-stock banks for observing the daily work of Exchange trading in its foreign branch. The section on the legal aspect of Bills of Exchange is not only essential to the understanding of why bills have come to serve as currency, but will also be helpful, it is hoped, in connexion with the whole detailed description of the practice of dealing with documentary drafts, to both the student of the law and practice of banking and the young man who is entering on a business career.

The method of presentation remains that developed by the experience of lectures delivered at the Bankers' Institute and at the Municipal School of Commerce of Manchester to audiences consisting of students preparing for the examinations of the Institute of Bankers and of business men. My obligations to existing works are numerous, and have, wherever possible, been acknowledged by footnotes. In particular, it is evident that in dealing with the effect of interest rates on the Exchanges and with Purchasing Power Parity, no textbook can escape heavy obligations to respectively the well-known works of Mr. Withers and

Professor Keynes. The short bibliography appended will, it is believed, be of assistance to students desirous of making a detailed study of particular aspects of the subject.

Finally, I am sure that the reader can best understand the Foreign Exchanges by studying their recent movements. Exchange rates do not operate in a vacuum, but in the actual world of international finance. Hence especial attention has been paid to inflation in Germany and France, deflation in Germany and Britain, price levels, foreign loans, the return to gold, and, above all, to foreign debts. It is the last-named factor which will decide the fate of the New Equilibrium and therewith the stability of existing Rates of Exchange. On no economic subject of to-day is the gulf between informed and uninformed deeper. I have attempted here to bridge that gulf by giving, for the first time so far as I am aware, a popular statement from the point of view of the Foreign Exchanges of the position created by the international debt settlements of 1925–1926. Just as the Exchange events of the half-decade following the war were determined by inflation, so those of the next few years will be determined by the debt settlements.

HUBERT C. WALTER

August 1926

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FOREIGN EXCHANGE AND FOREIGN DEBTS

PART I—OUTLINES

CHAPTER I

INTRODUCTORY—CURRENCY AND GOLD

IN the spring of 1914 the present writer, who was then travelling in Germany, found the cost of living there about the same as in England. In 1922 the same journey was substantially cheaper. In 1923 it was ridiculously, fantastically cheap. In 1924 Germany was the dearest country in Europe. In 1925 the comparison was about the same as it would have been in 1913.

These wide variations of prices were due entirely to the events happening at the time in the world of foreign exchange, which caused the prices at which German marks could be bought by English pounds to vary in an astonishing manner. Similar phenomena were being reproduced all over Europe.

They, and the popular interest which they aroused, were entirely a product of the war. Before 1914 the Foreign Exchanges were of interest only to a very small number of highly-specialized dealers in the principal financial centres of the world. The great English joint-stock banks themselves put their Exchange business through these dealers. The business community cared nothing for Exchange rates. There was no reason why it should do so, for the chief Foreign Exchange rates were invariably steady; they never fluctuated by more than margins which were so very small as to be of interest only to the dealers who, in a manner that no one outside their offices understood, bar two or three students, made a living out of them.

Since the war movements in these formerly so stable rates have been violent and unexpected. So vital has been the effect of these movements on the life of the peoples concerned that Foreign Exchange rates have acquired great "news value" in Fleet Street, and have in consequence found their way on to the front pages of the newspapers. The Bankers' Institute, appreciating the altered conditions with a quickness not general in the post-war world, altered the syllabus of its examinations in 1919; previously there had only been incidental questions on Foreign Exchange in the papers on the Practice and Law of Banking. In 1920 a conference of financial experts representing most of the principal nations in Europe was held at Brussels: the report issued by these experts on existing international commercial and financial conditions centred round the unsettlement of the Exchanges. So much for the changed attitude of the financial community. In the business world the use of the phrase "collapsed exchanges" as indicative of one of the causes of the present trade depression, and of "stabilizing the exchanges" as one of the remedies for that depression, have become commonplaces: before the war both phrases were unknown to the generality of business men.

It is evident that something of a radical nature happened as a result of the war which altogether altered the working of the Foreign Exchanges; and that that alteration is having very far-reaching effects on everyday business life. Perhaps the best example of what the alteration in the exchange position means in practice is this: before the war one pound, when changed into U.S. dollars, would buy $4{\cdot}86\frac{2}{3}$ dollars' worth of wheat. During a great part of 1920 the pound would only buy $3{\cdot}90$ dollars' worth —about 20 per cent. less. That is equivalent to the imposition of a tax of 20 per cent. on wheat imported from the U.S.

The secret of the importance and of the complications of Foreign Exchange to-day is that all the economic forces operating in a country work themselves out in its rate of exchange. The Exchanges register the economic health of a country; to-day they register the extent to which the economic equilibrium of the world, of Europe especially, has been upset by the war.

Foreign Exchange has one quality about it which makes it both more interesting and more difficult than other sections of economics, in that it deals with economic conditions as they exist from day to day. This makes the subject more difficult, because it means the constant revising of explanations and theories. It also makes it more interesting, because we are enabled to apply our principles to the Exchanges as they exist, and check our theories accordingly.

To clarify our ideas at the outset, we may describe Foreign Exchange as the business of exchanging currencies, or as the study of the ways in which currencies are exchanged; the Foreign Exchanges are the markets in which this business is done; and Rates of Exchange are the prices of the various national currencies in terms of other national currencies.

The word "currency" is used in the same sense as the word "money" is often used. It is necessary to be clear about the meaning of these two terms. "Money" may mean a number of things, "currency" only one, There are certainly four things which the word "money" may mean:

(1) The standard or measure of value.
(2) Medium of exchange.
(3) Purchasing power.
(4) A loan of money.

The last mentioned meaning is the one in which the word is customarily used in the money articles in the newspapers. "Money was cheap to-day" or "Money was dear" obviously does not mean that twenty-one shillings could be obtained for one pound or vice versa. It simply means that if anyone wanted to borrow money, he could do so at a low or high rate of interest. There, clearly, money means "the loan of cash or credit." In the third sense of "purchasing power," an overdraft is money. In neither of these two senses is money equivalent to currency. The first two meanings quoted are in modern practice merged in each other. There is a clear enough theoretical distinction between the standard which measures value and the instrument or medium by which value is transferred from one person to another; but in the Western European industrial system the monetary system embodies both ideas. In the highly developed commercial system of ancient Babylon, the theoretical distinction was also effective in practice. In a sale of land, the price was agreed in terms of shekel-weights of silver, which were thus the standard of value, but it was paid in corn, slaves, animals, etc., which, valued on the same silver basis, served as the actual media of exchange.[1] In the Western European system to-day coins and notes serve both as standards of value and media of exchange.

Of these four meanings of the word "money," "currency" is equivalent to the second only, viz. a medium of exchange. Currency means this and only this. It has thus a much more circumscribed meaning than "money," which may have any of the other three meanings indicated. It has, however, a wider meaning than the term "Legal tender," which is that portion of the medium of exchange which a debtor can legally compel his creditor to accept in satisfaction of his debt. Thus an overdraft is money in the sense of purchasing power, but it is not currency.

[1] King: "History of Babylon," pp. 195, 196.

A cheque is currency, but not legal tender. A Treasury note is all three.

The currency of England consists of the following:

(1) Coins.
(2) Treasury notes.
(3) Bank-notes.
(4) Cheques, which are orders to bankers to pay.
(5) Bills of exchange, which are orders to pay.
(6) Interest coupons.

Of the six, the last three are what bankers call "Instruments of Credit," i.e. instruments by which credits, that is to say, book-debts, are recorded and transferred from one person to another. Such is our currency to-day. Before the war there were no Treasury notes.

The business of exchanging currencies became a necessary part of international trade as soon as international trade developed beyond the stage of barter. When we buy materials abroad, our currency has to be exchanged for the currency of the country in which the seller wishes to be paid, which is generally that of the country in which he is resident. Foreign Exchange is concerned with the quantity of our own currency which we give up in exchange for that of the seller. Assume that "A," a merchant, is trying to sell some mineral that is mined in the United States to a Dutchman. "A" knows he can get £33 per ton c.i.f. Amsterdam for the material. The price we will say is \$105 per ton at the American mine. Let us call rail freight \$5 per ton and ocean freight \$30 per ton. That gives a total cost to "A" of \$140. Pre-war, when the average rate of exchange with the United States was \$4·86 to the pound, \$140 would represent to "A" in sterling £(140 ÷ 4·86) = £28 16s., i.e. that is the sum which "A" would have had to expend in order to buy \$140 to remit to the exporter.

Assuming " A's " gross profit to be 10 per cent., he would require to sell at the price of £31 13s. 7d. In pre-war days Dutch florins could usually be bought at the rate of 12·1 florins to the pound sterling, so that the price of £31 13s. 7d., or, bringing the shillings and pence to decimals of a pound, £31·6794, would represent to prospective Dutch buyers $31·6794 \times 12·1 = 383·32$ florins. But if the American exchange is what it was frequently during 1919–20—$3·50 to the pound—then the amount in sterling "A" has to expend in order to purchase $140 is £$(140 \div 3·50) = $ £40. Assuming the same gross profit as before (10 per cent.), " A " will now require to sell at the price of £44. Had the florin been at its usual pre-war rate of 12·1 florins to the pound sterling, this price would have represented to prospective Dutch buyers $(44 \times 12·1)$, or 532·4 florins. But at its 1920 figure of, say, 11·4 florins to the pound, £44 represents only $(44 \times 11·4)$, or 501·4 florins. Even supposing, therefore, that the mineral has remained at exactly the same price as in 1914, the price which " A " can quote to Dutch buyers has been raised from 383·32 to 501·4 florins, solely by the operation of exchange rates. Whether this increase will preclude " A " from continuing to do the business depends, *inter alia*, on whether the florin has become less valuable in terms of the dollar than it was in 1914 to the extent represented by the ratio 501·4 : 383·32. If the florin compared with the dollar has not lost in value to that extent, it will now be more advantageous to the Dutch purchaser to buy direct from New York. It is evident that fluctuations in exchange rates may, quite apart from factors of price, transport, etc., divert the currents of trade or dam them up altogether.

In the example given it will have been noticed that, at different stages of the transaction, " A " had to remit dollars to New York and the Dutch buyer had to remit sterling to London. How can remittances in foreign currency be made? In pre-war days there would have been five ways:

(1) By sending gold.

(2) By paying out of a foreign currency account.

(3) By sending interest coupons, payable in the foreign currency in question.

(4) By buying from a British bank and sending to the foreign creditor a draft in foreign currency. This draft is drawn by the British bank on a foreign bank situated in the centre in which the creditor resides—Paris, New York, Frankfort, as the case may be—and is for so many francs, dollars, or marks. A variation of this method occurs where the British bank, in return for the payment by the British debtor to it of a sum in sterling or for the authority to debit his account, instructs a bank abroad to pay to the foreign creditor a quantity of foreign currency; such instruction may be by letter (mail transfer), by telegram (telegraphic transfer), or by cable (cable transfer).

(5) By sending the foreign creditor a sterling draft, i.e. a draft entitling him to so many pounds, which he can exchange with his bank for an amount of his own currency.

No. 1 is now often impracticable, because prohibited by law; and pre-war, when it was generally permitted, it was not for obvious reasons resorted to in the ordinary way between merchants. Such sending of gold abroad as occurred was a specialized business in the hands of bullion dealers.

As to the other four of the five methods mentioned above whereby remittances abroad may be made, it will be evident that Nos. 2 and 3 are only possible in the special cases where the foreign currency account already exists or the interest coupons happen to be available.

In method No. 4, the most common method of making remittances abroad, the British bank in question has a balance in foreign currency at the foreign bank in question. In handing out a draft on that balance, or instructing the foreign bank to pay part of it away, in exchange for sterling or for the authorization to debit the customer's account, it is exchanging a foreign currency for sterling. The transaction at once raises two questions: How does the bank acquire the currency balance abroad; and at what price will it sell its draft thereon?

In method No. 5 also, where our foreign correspondent exchanges with his bank the sterling draft we sent him for a certain quantity of his own currency, two corresponding questions arise: What use will the buying bank make of the sterling draft, and at what price will it buy?

The first of each of the two questions put requires for its answer a description of the machinery of the Foreign Exchanges, a description, that is, of the means whereby foreign balances are created and remittances made out of them by the banks. The second question necessitates examining the factors which cause rates to move up and down.

CHAPTER II

MINT PARS

As to the manner in which foreign currency balances come into existence and the manner in which they are dealt with by the banks: this will be dealt with in detail in Chapters IV and V. Here we will anticipate by saying that trading and financial transactions bring into existence such foreign balances and put them at the disposal of the banks, who in turn exchange these balances among themselves in accordance with the instructions of their customers. What we are concerned with in this and the following chapters is the rates at which the banks carry out these exchanges: at what price, that is to say, will the banks sell their foreign balances? Or to put it in another way, at what price will the banks carry out for a customer an exchange of one currency into another?

This question, which the bank's customer would put in the form, "At what price can drafts in such-and-such a currency be bought or sold?" could before the war have been very quickly answered. In those days there were fluctuations in rates, but these were very small and were definitely limited in extent. There was then never any uncertainty as to what the rates of exchange between the principal European countries and the United States would be, apart from quite minor fluctuations. The rates only moved slightly on one side or the other of a fixed point. The reason for this steadiness was that there existed an international currency, and the exchange value of the currencies of the various countries in terms of this common international currency determined their exchange value in terms of each other. This international currency was gold.[1] The use of gold as an international currency

[1] This point seems to have first been clearly made by Mr. T. Gregory. See "The Foreign Exchanges, Before, During and After the War."