Nassau William Senior's famous lectures on money and international trade have been newly issued by the London School of Economics and Political Science in their series of reprints. On re-reading these classic treatises one is led to the conclusion that the practical application of economic reasoning seems to meet with very great difficulties. We are living in a world where trade barriers become more and more insurmountable. In defending the system of protection and prohibition, every day the same arguments are heard again which Senior and his fellow economists have refuted and which Ricardo had already refuted years before. Why could this acute criticism of the Mercantile Theory of Wealth not succeed in convincing public opinion? Is there a weak point in the demonstration of the futility of the protection doctrine?

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1Nassau W. Senior:
2. Three Lectures on the "Value of Money."

Numbers 3, 4, and 5 in the Series of Reprints of Scarce Tracts in Economic and Political Science (London: London School of Economics and Political Science, 1931).

2[The Mercantilists believed that gold and other precious metals embodied true wealth, thus they advocated maximizing a country's exports while minimizing its imports—Ed.]
The foremost argument in the protectionist’s reasoning today is again, as in the days of the Mercantile Theory, the monetary standpoint. Restriction of imports is said to be indispensable for the maintenance of a country’s monetary equilibrium. It is true, one no longer speaks of the danger of losing the circulating stock of coined precious metals to foreign countries. But the only reason for this is the fact that practically no country maintains today an effective circulation of gold coins as most of them did till the outbreak of the War. The modern protectionist insists rather upon the necessity to secure the exchange ratio between the national and the foreign currency. What he does not wish to admit is that the exchange ratio does not ultimately depend on the balance of payments and that there is no danger of its being impaired so long as there is no over-issue of notes at home.

The question to be answered today is exactly the same as is expounded in Senior’s lectures on the “Transmission of the Precious Metals from Country to Country.” The difference lies only in the formulation, not in the substance. The problem is whether there is an automatic readjustment of the balance of payments or whether government is bound to interfere lest disastrous consequences follow. The chain of reasoning by which Senior proves that governmental interference is superfluous for this purpose considers a state of things where imports and exports of commodities dominate international business relations. For the present situation it seems necessary to keep in view the importance of credits, and accordingly to lay stress not only on the prices of commodities but also on the rates of interest. This, of course, does not in any way alter the essence of the problem, but it does seriously affect the political and ethical aspect of the question.

Considerations of this nature play in the eyes of public opinion a bigger role than is generally supposed. In discussing the problem of trade restrictions primarily with reference to the prices of goods, one imagines a selfish producer who demands higher prices from the poor consumer. In this case sympathy is on the side of the consumer. But in regard to rates of interest sympathy is given to the lender. Whereas in the question of commodity prices public opinion splits into two parties so that against the friends of higher prices stand always friends of lower prices, in the problem of interest there is but one opinion, i.e., in favor of low interest. As the matter of controversy seems to lie in the dilemma whether to maintain at home a lower rate of discount at the cost of import restrictions or to let the price of money rise under free trade, the scale goes down in favor of import restrictions. There is in every country a considerable opposition against import duties which one tries to justify by the necessity of
raising the home price level in favor of home production. The opposition is very weak when import duties are apologized for by the expediency of maintaining a low rate of interest.

There is no doubt that in countries where capital is very abundant the rate of interest would be much lower were there not opportunities of exporting capital to countries with a higher rate of interest. Had the United Kingdom or had France in the fifty or sixty years preceding the War not invested a large amount of money abroad, the money rate at London and Paris would have been much lower than it actually was. If at this time someone in England had demanded a restriction of foreign investments from the labor point of view, as the Liberal Industrial Report did after the War, it would have been intelligible at least from the point of view of a short-sighted class policy. But the strange thing was that at this time, not the capital-exporting countries, but the capital-importing countries complained more about the consequences of the international capital movements, assuming that it must lead to higher interest, whereas its effect for them was the contrary. Strange to say, in the 'seventies of the nineteenth century in Austria the theory was evolved that the Austrian paper currency isolated the country from the solidarity of international money markets and so enabled the bank of issue to expand credit and maintain a comparatively low rate of interest without any disadvantages. This false theory was duly refuted by Wilhelm Luccam, the then manager of the Austrian Central Bank. But nevertheless it survived in Austria and had from year to year more success in the whole of Europe, especially in Germany, and even in America.

When people today generally assert that things have so radically changed since the time in which the classical theory of money and foreign exchanges was expounded, that one cannot apply their results to modern conditions, they unfortunately do not give any proof. It is totally wrong to pretend that raising the rate of discount would not have any effect today on the flow of gold and on the exchange rate, or an insufficient effect. There is no proof that discount policy of the old type is inapplicable to the present situation. The fact is that the ruling parties prefer the consequences of a depreciation of the national currency to the consequences resulting from non-interference in the market's money rate.

Let us consider separately the different recent cases of departure from the old gold parity. There was the case of England in 1931. Britain had to choose between a policy of defending the gold standard by raising the rate of discount, as has been done over and over again, and a policy of depreciation. She decided for the second because it
made it possible to maintain unchanged the British level of prices and wages in the midst of a world a falling gold prices. Opinions differ on the soundness of this policy, and there is no doubt that it was very unsound from the point of view of Senior’s ideas. But there was nothing in the situation which could not be explained from the point of view of Senior’s theoretical teaching. It is true that his decision would have been very different from that of Great Britain’s rulers in 1931. He would have believed that nominal wages had to fall pari passu with prices, and that there was nothing alarming in a situation where the prices of raw materials which England buys fall more rapidly than the prices of the manufactures which England exports. But Senior in discussing these problems with Mr. Norman and Mr. Keynes would at the end of the conversation have said: “I see, gentlemen, that you follow other aims.” But he would have had no reason to say: “You have to cope with a situation which my theory does not cover.”

Yet in another respect a radical change in the financial situation has been accomplished. In the modern banking system the short-term debts play a dominating role. The banks of the lending countries have lent enormous sums to the banks of the borrowing countries. Literally they had the right to withdraw this money at short notice. But in fact such withdrawals could not be effected at once, as the borrowing banks had lent this money to business which could not pay it back at all or at least only after some delay. The international credit relations were based on a fallacious assumption of liquidity. The moment the lenders tried to exert their right of withdrawal there were only two alternatives: open declaration of bankruptcy by the debtor banks or intervention of the government which suspended payments to foreign countries. The introduction of foreign exchange control in some continental countries in the summer of 1931 was a makeshift for a formal moratorium.

Banking today is not sounder when considered from the point of view of the home situation. Deposits subject to cheques and saving deposits are two entirely different things. The saver wishes to entrust his money for a longer period; he wishes to get interest. The bank which receives his money has to lend it to business. A withdrawal of the money entrusted to it by the saver can only take place in the same measure as the bank is able to get back the money it has lent. As the total amount of the saving deposits is working in the country’s business, a total withdrawal is not possible. The individual saver can get back his money from the bank, but not all savers at the same time. That does not mean that banking is unsound. It does not become unsound until the banks explicitly or tacitly promise what they
cannot perform: to pay back the savings at call or at short notice.

The deposits subject to cheques have a different purpose. They are the business man's cash like coins and bank notes. The depositor intends to dispose of them day by day. He does not demand interest, or at least he would entrust the money to the bank even without interest. The bank, to be sure, could not earn anything if it were to hold the whole amount of these deposits available. It has to lend the money at short notice to business. If all depositors simultaneously were to ask their deposits back, it could not meet the demand. This fact that a bank which issues notes or receives deposits subject to cheque cannot hold the total amount corresponding to the notes in circulation and to the deposits in its vaults, and therefore can never redeem at once the total amount of its liabilities of this kind, is the knotty problem of banking policy. It is the consideration of this difficulty which has to govern the credit policy of the banks which issue notes or receive deposits subject to cheque. It is this consideration that led to the legislation which limits the issue of bank notes and imposes on the central banks the retention of a reserve fund of a certain magnitude.

But the case of the saving deposits is different. Since the saver does not need the deposited sum at call or short notice it is not necessary that the saving banks and the other banks which take over such deposits should promise repayment at call or at short notice. Nevertheless, this is what they did. And so they became exposed to the dangers of a panic. They would not have run this danger, if they had accepted the saving deposits only on condition that withdrawal must be notified some months ahead.

Public opinion assumes that the real danger to maintenance of monetary stability lies in the flight of capital. This assumption is not correct. Capital invested in real estate or in industrial plants or in shares of companies holding property of this nature cannot fly. You can sell such property and leave the country with the proceeds. But—unless there is no expansion of credit—the buyer simply replaces you. If he is a foreigner, then the capital flight of the native is compensated by the immigration of capital from abroad. If the buyer is another native, then he can provide the means—when additional credit is not granted by credit expansion—merely by selling his property, and so the case with him is the same. One person or another can withdraw his capital from a country, but this can never be a mass movement. There is only one apparent exception, i.e., the saving deposit which can be withdrawn from the bank at once or at short notice. When the saving deposits are subject to instant withdrawal
and the bank of issue renders the immediate withdrawal possible by advancing credits for these savings to be withdrawn, then credit expansion and inflation cause the exchange ratio to rise. It is obvious that not the flight of capital but the credit expansion in favor of the saving banks is the root of the evil.

The pith of the problem lies in the deposit policy. Banks which promise no more than they can fulfill without extraordinary assistance from the central bank, never jeopardize the stability of the country's currency. And even the other banks who have been imprudent enough to assume liabilities which they cannot meet are only a danger when the central bank tries to assist them. If the Central Bank were to leave them to their fate, their peculiar embarrassment would not have any effect on foreign exchanges. That the additional issue of great amounts of bank notes for the sake of the repayment of the total amount or of a great portion of the country's saving deposits makes the foreign exchange go up is easy to understand. It is not simply the wish of the capitalists to fly with their capital, but the expansion of the circulation, that imperils monetary stability.

Had the central banks not believed that it was their duty to cover up the consequences of the deposit banks' wrong policy they would have not only maintained without artificial and, at the same time, ineffective measures of the stability of the exchange ratio, but would have forced the deposit banks to make agreements with their clients concerning the payments due. By such agreements they would have adjusted the payments due to the payments receivable. The Standstill Agreements would have been made definitively and for all debts, foreign, and domestic.

To sum up, we are not entitled to say that Senior in his writings on money and monetary subjects had to deal with problems other than those which we have today. The task of monetary and banking theory is in principle not different today from Senior's time. Different, of course, are the conditions of our banking organization, the institutions, and the considerations which politicians keep in mind. Different are the data, but not the mechanism of exchange and social cooperation. All the questions of principles which Senior had to face are identical with those which our theory has to answer. We may differ from Senior in regard to the treatment of the fundamental items of value and exchange, but we have still the same problems to solve. And notwithstanding all changes in economic thought and reasoning, in social conditions and political aspects, in banking organization and in business life generally, no one can read these old pamphlets without profit.