JOURNAL OF THE STATISTICAL AND SOCIAL INQUIRY SOCIETY OF IRELAND.

THE FREE STATE CURRENCY PROBLEM.

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(Read before the Society on 17th December, 1931.)

I propose first to refer briefly to the historical background of the problem.

As regards the former history of the Irish currency perhaps the most remarkable feature is that at no time prior to 1914 was there a circulation of notes which were unlimited legal tender. At one time there was a dispute as to whether Bank of England notes were legal tender; the Bank of Ireland challenged their status by refusing to accept them even as a lodgment; but the matter was definitely settled in the Bank Act of 1845, which declared that Bank of England notes were not a legal tender in Ireland (except in payment of Government revenues).

In the 18th century there was a " free for all " currency system prior to the establishment of the Bank of Ireland. It was open to anybody to set up as a bank and issue notes without restriction, and even silver and copper coins. Occasionally, even manufacturers issued token money, made of silver, copper, tin, and sometimes cardboard, in payment of wages. This system was made necessary by a great scarcity of coin. It was estimated that in 1720 the nominal value of the coinage in the whole of Ireland did not exceed £400,000—this at a time when coin was a vastly more important medium for payments than it is to-day. Moreover, such coinage as then existed was a heterogeneous medley of pieces, including French, Spanish, Portuguese and other foreign issues, for the most part clipped, debased and depreciated. There was then no Mint in Ireland, and from the time of Henry VIII until 1780 the importation of gold and silver from the English Mint was prohibited.

Unfortunately the bankers of that period were not so prudent or experienced as they are to-day, while public confidence was more fickle, and paper was frequently issued in dangerous excess. There was a panic in 1720 and a fresh banking breakdown in 1732-34. In the inevitable Parliamentary post-mortem the trouble was ascribed to the habit acquired by the banks of issuing notes in excess of their capital—meaning, in excess of the amount of specie they possessed. Nowadays we are unperturbed in face of Irish banking liabilities running into nine figures, although we all know there is no gold in the country to meet them, but at that period the disclosure of a similar position was taken as reflecting doubtfully on the honesty of the bankers. Indeed, at the time I am speaking of, banking appears to have been regarded as not quite a respectable profession.

The remedy prescribed by the authorities was to increase the specie, and in 1737 a coinage was proclaimed for Ireland. Under this proclamation the parity of Exchange with England was fixed at £108 1-3rd Irish—£100 English (the English guinea being fixed at £1 2s. 9d. Irish, and the English shilling at 13d. Irish). Parities were also fixed for the various foreign coins in circulation at the time.

The introduction of a standard currency did not put an end to financial crises. There was another crisis in 1745, and a new series of banking troubles began in 1753. At that time the monetary system in Ireland might be described as a gold standard with a flavour of bimetallism. Ireland and England had quite separate currencies, and the Exchange between them was subject to fluctuation, being frequently adverse to this country. In 1753, for example, the Irish currency was at a discount of 3 per cent., and gold was exported to London to secure the profit on the Exchange. This efflux of gold aggravated the banking troubles until in 1760 there was a big crash, involving the failure of every bank that was issuing notes payable on demand. This meant that there was practically no paper money available, and in fact all monetary and business transactions were brought to a dead standstill. Thereupon fresh theories and new remedies had to be sought. (One theorist blamed the crisis on the profligate growth of the public debt, which had then risen to the extravagant total of £91,537 17s. 1½d.!). There was another crisis in 1770.

At length under Grattan's Parliament, in 1782, the Bank of Ireland was set up with a monopoly of the right of note issue amongst banks with more than six partners. This had the effect of providing a paper currency that was more reliable in the sense that holders might be more assured of being paid on demand. It did not, however, alter the fundamental position in any way.

After 1797, when the Bank Restriction Act was applied to Ireland, and the Bank of Ireland also was prohibited from paying gold, there was a long spell of inflation. Whereas just previously the Exchange was mostly in favour of Ireland, and there was no drain of gold, in the ensuing years the Irish currency was regularly at a discount, occasionally of over 8 per cent., although at that period the English currency also had gone off the Gold Standard. Hundreds of new bankers and near-bankers came into existence all over the country. The following description, quoted from a pamphleteer of 1840, refers to the mushroom bankers of about 1804:—

> "These adventurers resorted to expedients of all kinds for "the purpose of forcing a trade. They supplied small traders "with their notes, and used to pay a premium to get them "into circulation. The Bankers themselves were in the habit "of attending markets and fairs like so many hucksters, each "putting off his own commodity as best he might. . . . . . But "the mischief did not rest with the multitude of bankers. "Besides the 50 Private Banks there were as many as 295 "petty dealers and chapmen, grocers, spirit merchants, apothe-"caries and shopkeepers of all sorts, inundating the country "with a species of I.O.U., called silver money."

The same writer says there was an enormous distribution of forged notes; every village had its expert "Detector of Forged Notes." Nevertheless, the country people preferred notes to gold.

The suggestion was made in 1804 that the Bank of Ireland should be amalgamated with the Bank of England, with the object of unifying the two currencies and thus obviating a fluctuating rate of Exchange on London. This, of course, was not adopted, but in 1825, after the gold standard had been restored in England at the old Mint parity, an Act was passed assimilating the Irish and English monetary units. In the following year the Irish coins were called in and the English coinage circulated in its place, at the parity of Exchange fixed in 1737. Thenceforward Ireland ceased to have separate currency; the same gold coin was the basis of the monetary system in the two countries. At about that time the practice as regards remittances to England was to issue drafts payable at 21 days, the banks capturing the interest. The Bank of Ireland, however, which was then forcing the pace against its new rivals, the joint-stock banks, reduced the usuance to sight. Thereafter the sight draft became the regular custom; the banks charged a small commission, but there was nothing in the nature of a Dublin-London rate of Exchange.

These joint-stock Banks, copied from the Scottish model, were first introduced into Ireland in 1825, under two Acts passed after the great panic of 1820, which practically made a clean sweep of the private banks. The Bank of Ireland had then been persuaded to restrict its monopoly to the area within 50 Irish miles from Dublin.

The early joint-stock banks in Ireland were as free as the private banks to issue notes to an unlimited amount even without any gold cover, but the Irish Bank Act of 1845 put a stop to that. It restricted the amount of uncovered notes that each bank might issue to the actual average it had in circulation at the time, while allowing an unlimited issue against specie. At the same time it prohibited the formation of any new bank of issue, joint-stock or private. The Bank Act also abolished the remainder of the Bank of Ireland's monopoly, thus admitting the other banks of issue into the Dublin area.

It may be worth mentioning here that although the banking legislation of that period may appear crude and primitive in the light of modern monetary science, yet there has grown up within its limits a banking system that has proved to be the most stable in the world. In these days particularly, when one reads of so many banking difficulties in countries abroad, it is comforting to reflect that there has been no failure of an Irish bank for nearly half a century, a record that can be claimed by no other country in the world.

The Irish banks adopted the practice of printing the names of all the branches on their notes, so that each note might be issued, and was payable, at any branch. The consequence was an exceptionally wide distribution of gold in Ireland. For example, in 1875 the National Bank had the largest gold holding of any bank outside the Bank of England. In 1914 all the gold was concentrated in the Bank of England and the new Currency Notes (or Currency Note Certificates) were made a legal backing in its place. The gold might have been brought back after 1925, but there appeared no advantage in doing so.

From 1923 to 1927 the position in the Free State was most unusual. The circulation consisted of Irish Banknotes, Currency Notes, Bank of England notes and British subsidiary coins, but there was no legal tender money, nor any legal unit of account. Theoretically it was possible for a rate of Exchange with London to develop during that period, but in fact, if not in law, the system was a Sterling Standard, not differing much in practice from the position in Scotland. There was no conscious Exchange management; the relation with sterling was automatically regulated by virtue of the bankers' very large portfolios of readily available assets in London. In recent years 45-50 per cent. of the assets of the Irish banks as a whole have been in the form of London funds and British Government Securities which, even for comparatively large sales, can be turned into cash overnight in London. These assets, of course, represent portion of the permanent savings of the country accumulated over a series of years, which for lack of domestic issues, have had to be invested abroad. No other country in the world, so far as I am aware, possesses so large a balance of liquid external resources in proportion to its banking turnover. This position dominates the problem of currency control in the Free State.

I do not propose to describe in detail the system introduced by the Currency Act of 1927, with which you are all familiar, except to stress a few points. The first is that the task of the Banking Commission of 1926 was one of readjustment and not of reconstruction. They were not faced with a problem of repairing a currency system that had broken down, as with similar Commissions in Continental and South American countries. They found a system in operation that was working efficiently. There was nothing wrong with it except that it was illogical, that it had a doubtful legal basis, and that the Government was being deprived of a legitimate source of revenue. Evidently the Commission decided that beyond putting these matters right they would "leave well alone" and not attempt any theoretical fireworks. The second point is that the Currency Commission set up in 1927 has not the function or responsibility of "managing" the currency; in this regard it is a purely passive agent. The third point I would stress is that so long as the *legal* position set out in the Currency Act is adhered to, the Free State £ can be neither at a discount nor at a premium on the Exchange with sterling. The system is that of a Pegged Sterling Exchange Standard.

Now, without considering daring experiments such as the silver or bimetallic standards, there was a variety of other practical currency arrangements which the Banking Commission might have recommended, and it is possible here to refer in a general way only to a very few.

The Commision were not without precedents for the Sterling Exchange Standard. There would have been more numerous precedents for some form of Gold Exchange Standard. In conjunction with this, the Commission might have recommended the setting up of a Central Bank, somewhat on the lines of the South African Reserve Bank. Thus, the commercial banks would be encouraged, or obliged, to keep balances with the Central Bank, and the cheque clearing for the whole of the Free State would be settled by drafts on this Central Institution instead of drafts on London. In addition to providing the domestic note issue, the Central Bank would be free to extend credit by making advances and discounting bills. Its dealings in this regard would be mainly with banks (although this would involve a departure from the joint-stock banking tradition in these countries).

One form of the Gold Exchange Standard would be that the

Central Bank should be obliged to issue legal tender notes against a tender of gold in London at the fixed Mint price, or of its equivalent in sterling, and to redeem (in London) in gold or its equivalent. The right of purchasing legal tender notes, and of presenting notes for redemption would, of course, not be confined to the banks but would be open to all comers. Under this system the Free State £ would no longer be pegged to sterling. There would be room for possible fluctuation even when sterling was on the Gold Standard, but the fluctuations would not depend on supply and demand, that is to say, on whether the London Clearing was going against or in favour of the Irish banks as a whole, but would depend entirely on the price of gold in the London market. The possible margin of variation would be approximately 3/3 per £100 (i.e. before the recent crisis), which would be quite sufficient to create an arbitrage interest.

A wider form of the Gold Exchange Standard would be that the Central Bank should be obliged to issue notes against a tender of gold or its equivalent in any of several specified international monetary centres. This would be an extension of the same principle. The arbitrage interest would now be greater, however, and the Dublin-London Exchange would be subject to fluctuations as wide as the London-New York Exchange. The extreme range of oscillation would be approximately 18/6 per £100 (i.e. with sterling on the Gold Standard).

It would not be necessary for the central institution to hold actual gold under either of these systems. A gold holding would only be necessary if the full Gold Bullion Standard were adopted. Under this system the Central Bank would be obliged to buy and sell gold coin and bullion at fixed prices in Dublin. This also would mean a fluctuating Dublin-London rate of Exchange, the extremes of fluctuation in normal times being determined by the cost of transporting gold between Dublin and London.

Any of the systems here described—which I do not want to be taken as advocating—would have been as practicable as the present Sterling Exchange Standard and could have been maintained with equal facility, at any rate prior to September last. The Banking Commission were deliberating at a time when the memory of the currency *malaise* on the Continent was still fresh in the public mind, and they were probably unduly impressed with the possibility of a currency breakdown in the Free State if the wrong system were chosen. Monetary stability, however, depends less on the choice of the standard than on the maintenance of a sound National Budget position and a strong commercial banking system. Without these, no currency system can work efficiently; with them, any of several systems will be right.

The problem may now be clarified as follows: There are three separate issues involved. The first is as to the form in which the assets backing the note issue are held. The second is as between a Central Bank and a purely note-issuing body such as the Currency Commission. The third is the question of the currency Standard to be chosen. It is essential to note that for the most part these issues are quite distinct. For example, portion of the assets backing the note issue, could be held in gold or invested in liquid United States or Continental securities whatever the currency Standard adopted, and whether or no there was a Central Bank.

Again, any form of Gold Exchange Standard could be maintained equally well without a Central Bank, while, on the other hand, the present system could be operated by a Central Bank as well as by a Currency Commission.

The first issue is not really a currency problem. It is partly a banking administration problem and partly an Investment Trust problem. To say that the Currency Commission would now be able to realise a handsome capital profit if they had held portion of their assets in gold or French francs or United States dollars is merely to indulge in the pastime known as "jobbing backwards." It is not an argument against the Sterling Exchange Standard, which does not preclude the possibility of holding such investments. But whatever the Standard, or whatever the investment policy adopted, a very substantial commitment to sterling on the part of the Currency Commission and the Banks is unavoidable, seeing that the vast bulk of our external trade is with Great Britain and Northern Ireland. In this connection it may be useful to point out that there is a tendency to overestimate the effect of the fall in sterling on the value of British Government Securities. Even if the £ is eventually devaluated and re-stabilised on the basis of, say, a parity of \$3.90, this will not necessarily mean that the London market valuation of British Government Stocks will be permanently reduced by 20 per cent. Such writing-down will only be necessary for the holders in countries which remain on the Gold Standard at the pre-September parities. (As an example: the French Five Per Cent. Rentes issued in 1915-16,—i.e., before the French currency began to depreciate—are quoted around 28½ in London, but stand to-day at 100 in Paris.) It is sometimes suggested that portion of the backing for the note issue should be held in gold in Dublin, with the object of having a national gold chest for use in emergency. This idea is a survival of the obsolete Mercantilist economics and has little to recommend it. Keeping a gold hoard of, say, £3,000,000 would reduce the national income by about £150,000 a year at present rates, while the same object would be secured without this loss by a suitable investment policy.

On the question of a Central Bank, the essential distinction is that a Central Bank is a credit institution whereas a Currency Commission is not. A Central Bank can exercise the function of "managing" the currency whereas a purely note-issuing body is a passive agent. (It is conceivable, of course, that a body such as the Currency Commission might play an active part, by going out into the open market and buying or selling Government securities on its own initiative, but this would be very unusual.) If the circumstances are such as to call for control of the Exchange situation then a Central Bank will be necessary. Now in the peculiar conditions obtaining in the Free State no central Exchange management is called for under either a Sterling Exchange Standard or any form of Gold Exchange Standard, and, hence a Central Bank is not essential. Since the adoption of the new system the Free State £ has never deviated from the parity with sterling; obviously no Central Bank could improve on that. For the Free State the management of the Exchange position is automatic; it derives from the huge *masse de manœuvre* of liquid sterling assets held by the Irish banks, and also from the absence of any strong seasonal influences.

Further, it is doubtful if a Central Bank in Dublin could ever do much more than play at control. The classic principles of central banking control apply only where there is a highly developed Money market. If the Bank of England, for instance, wished to protect the Exchange position, the regular procedure would be to raise the official rate above the international level and veto local capital flotations by overseas borrowers. If the market did not immediately respond, the Bank could make the higher rate effective by selling securities. In normal times the effect of these tactics would be to check the outflow of funds and attract international floating balances. Or again, if the New York Federal Reserve Bank desired to ease the local credit position, it could take the initiative in reducing money rates and could very quickly extend the basis of bank credit by purchasing Bills and securities in the open market. Clearly, any such expedients would be useless in the Free State. There is no open Bill market in Dublin; the Dublin Stock market is not big enough or liquid enough to afford leverage for a Central Bank. The only way in which a Free State Central Bank could establish control, short of equipping it with the most drastic powers, would be by opening up branches and annexing a large proportion of the ordinary banking turnover. In that event the scope of its control would be limited to a power to raise deposit rates or to force down lending rates. By that means it could possibly on occasion force the whole scale of money rates here above or below the London level, as the case might be. But this would not be a big step towards effective control of the currency. It is very doubtful if a dear money policy here could attract a substantial volume of funds from abroad. On the other hand, it would be powerless to check an outflow due, for example, to a speculative boom in London or to a flight from the Saorstát currency. As regards the opposite policy, it is interesting to note that in 1836, when the Bank of Ireland, with the object of embarrassing its competitors, refused to follow an upward movement in the Bank of England rate, a considerable volume of English Bills was sent here for discount. Similarly, at the present time there is the possibility that a too cheap money policy might cause large depositors to withdraw funds for investment in Treasury Bills or for deposit with English banks.

It may be taken as a general rule that the half-dozen odd big international Money markets set the lower limit in money rates for the rest of the world. These centres can attract floating credits from abroad; other countries cannot. Consequently if the other countries attempt to keep a too low level of money rates, they run the risk of a drain of credits to the big financial centres. In the case of the Free State the pivotal rates are the British Treasury Bill rate and the English Banks' and Discount Houses' deposit rates. Obviously, it would be a most anomalous position if the ordinary overdraft rate here were less than the London Bill rate.

This is not to say that a Central Bank in Dublin might not be able to introduce a keener system of rate fixing. At present the Irish Bank rates are fixed in accordance with the Bank of England's official discount rate, which is frequently too high in relation to open market quotations. Again, it might be possible to justify the setting up of a Central Bank on grounds other than those of currency and Exchange control. My own view is that a Central

Bank could do useful work in helping to create a fluid Money and Capital market in Dublin, assuming that the Statutes were framed with that object in view and not merely copied from the new Continental models.

There remains the question of the Standard. Now, the ideal to be aimed at is unquestionably stability. But stability of the currency may mean either a stable internal purchasing-power or a stable external value, that is to say, stability of the price-level or stability of the Foreign Exchanges. The international Gold Standard is an attempt to combine both. The Gold Standard has shown itself capable of stabilising the Foreign Exchanges to a degree possible under no other international currency system yet devised, but it has failed to stabilise the world price-level. Stabilising the price-level has now come to mean, not smoothing out the seasonal and cyclical fluctuations, against which the technique of monetary science seems powerless, but eradicating the secular trend. During the past decade the secular trend has shown a strong downward bias, carrying the world price-level to a point at which the real burden of national and international debts became intolerable, and this is undoubtedly one of the fundamental reasons why the Gold Standard has broken down.

The whole question might have been thrown open in the Free State by adopting a system under which the currency would not be legally tied to anything, but that the monetary authority would adopt a policy of *de facto* stabilisation. The policy selected might be to stabilise the internal price-level. This would be to try and regulate the credit situation in accordance with a system of Index-Numbers of basic commodity prices, such as Sweden is now reported to be contemplating. Any such attempt could only land us in Utopia. The pre-1925 experience shows clearly that no country can cut itself adrift from the world price trend, except by violent inflation. In this matter all the nations are inter-dependent, and monetary science can offer isolation to none. There is no technique of currency manipulation, apart from deliberate inflation, by which the price-level in the Free State could be freed from the domination of the cross-Channel commodity markets. In this matter, as in that of money rates, Great Britain and the Free State might be compared with the earth-moon system. It is not that the moon revolves round the earth, but that they both revolve round their common centre of gravity. The Free State does exert a certain measure of influence on conditions in Great Britain, but certainly the common centre of gravity lies beyond the Irish Sea.

Failing, then, internal stabilisation, the monetary authority would have to fall back on a policy of external, or Foreign Exchange, stabilisation. To this end a choice would have to be made between operating the present Sterling Exchange Standard and operating some form of Gold Exchange Standard. Now, stability of the Foreign Exchanges means for the Free State nine-tenths stability with sterling. The present system does secure a non-fluctuating sterling rate; any of the other systems I have described would mean a fluctuating sterling rate—within very modest limits, it is true, but undeniably a non-fluctuating rate is more stable than a fluctuating rate.

Hitherto the distinction between the two currencies has been so unobtrusive as hardly to be noticed in drawing up Balance Sheets and making contracts. And yet the Saorstát £ is *de jure* as distinct and separate from the British £ as the Egyptian piastre or the Portuguese escudo, which are also pegged to sterling. If our currency had been linked with gold instead of sterling that distinction would have been apparent from the commencement. We should then have been faced with a grave decision in September last, when London suspended gold payments. It can hardly be doubted that our decision in that event would have been to join the group of countries that abandoned gold. It is not only that by remaining on gold—assuming that this were even possible—we should have created a 20-30 per cent. bounty on imports and a corresponding handicap on exports; this could has been surmounted by the bureaucratic expedient of levying a duty on all imports and handing over the proceeds as a bounty on exports, as has been done in South Africa. But much more serious would be the wholesale financial reconstruction involved in continuing to reckon our liabilities in gold at a time when so much of our assets had been turned on to a paper basis. As an example: for all the Irish Banks it would mean writing down the London assets, in the measure of the sterling discount with gold or, in the alternative, writing up the Free State liabilities. At present rates this would require for the Banks as a group writing-off possibly the whole of the paid-up capital and published reserves. Numerous other companies and individuals would, of course, be placed in the same predicament—and all this not because of any intrinsic loss in sterling, whose internal purchasing-power is still greater than at any time since 1914, but merely because of a self-imposed change in the conversion rate between the two units of account. The Free State has neither a vested interest in gold as a commodity, nor any Trusteeship for the Gold Standard, and it would have been neither wise nor valorous to try and cling to a system that has brought disaster to the debtor and producer interest all over the world.