SOME ASPECTS OF WAR FINANCE.

THE use of monetary terms in discussions of public finance, though convenient, tends to obscure the essential realities which they represent. It is usual to say that the Government requires so many millions of money for the prosecution of the war. What the Government really needs is not money, but goods and services.

These goods and services are provided mainly from the country itself, and to some extent from other countries.

The country possessed at the beginning of the war a vast store of accumulated material wealth in the shape of buildings, plant, railways, ships, stocks of consumable goods, foreign investments, etc. This may be termed the national capital. Some portion of this capital has been consumed or transferred to other countries in the course of the war, but the bulk of it is still intact, and of this a considerable quantity is being temporarily utilised for war purposes.

The greater part, however, of the goods furnished by the country for the war, and the whole of the services, have been called into being in the course of the war. That is to say, they have been contributed out of the growing resources of the country or out of what may be termed the national income.

The truth of this proposition is evident enough when the question is viewed in its proper light as one of the consumption of goods and services. But if it were considered as a matter of money, an opposite conclusion might be drawn, owing to the misleading fact that a large amount of fictitious money capital has been created for financing the war, by processes which are discussed later.

The goods and services provided from foreign sources have been partly exchanged against portions of the country's wealth, both capital and income, partly supplied on pure credit, in which latter form they constitute a real additional resource.

The most important of the financial tasks of the Government consists in the employment of suitable methods for obtaining possession of the goods and services required from the country.

There are two governing considerations which bear on the choice of methods for obtaining the goods and services in question.

The first is that a war such as the present demands the maximum of national effort. In other words, the requirements of the Government for goods and services suitable for the prosecution of the war are limited only by the quantity which it is strictly necessary to retain for the maintenance of an efficient level of subsistence for the population.

The second is that the goods and services absorbed for the purposes of the war cannot be replaced during the war, and that only a small proportion, in the shape of stocks of surplus goods and borrowed material, can be replaced after the war. The bulk of the wealth created by the national effort for war purposes is destroyed in the course of the war.

It would logically follow from these considerations that each individual should be called upon to contribute to the utmost extent of his ability in goods and services without expectation of return.

Such ideal conditions, however, could hardly be realised except in a socialist community, where the national capital and the organisation of distribution are in the hands of the State.

In dealing with a community where most of the national capital is in private hands, and where the economic fate of individuals depends on their success in realising gain and avoiding loss, the exaction of contributions for the war must be so contrived as to preserve the existing incentives to effort.

Thus if every person engaged in productive enterprise were required to surrender absolutely all that he gained beyond a certain fixed limit, he would be deterred from putting forth efforts which could be of no benefit to him, and might possibly leave him with a loss. He would, moreover, not be deterred from waste or extravagant expenditure which did not reduce his gains below the limit allowed to him.

Similarly, with respect to accumulations of material wealth in private hands, if the Government were to select from them and confiscate all the portion suitable for national purposes, this action would not only operate as a deterrent to further effort, but would penalise those whom accident had led to hold their wealth in this form, and cause them serious injury.

In dealing, then, first, with the incomes of individuals, that is to say, with the shares which they respectively acquire in the general total of goods and services produced in the course of the war, it becomes necessary, in the interest of production and economy, to allow them to retain a portion of every increment of income in excess of the minimum which may be considered as strictly necessary for subsistence in each case. In fiscal terms, taxation will bear some proportional ratio, whether fixed or graduated, to income.

In thus allowing individuals, however, a right to more than their due share of goods and services, it is highly expedient to prevent them, if possible, from exercising that right at a time when it is a matter of vital necessity for the nation to employ the whole of its available resources in the prosecution of the war.

This object might be attained if individuals were required to make over their rights to the Government for a term of years. This is the device of a forced Government loan applied to surplus of income.

The same device is applicable to surplus capital. Persons possessing capital in the shape of goods or foreign investments which may be diminished in the course of the war by sale or Government requisition would receive Government bonds in its place.

By these means the portion of the incomes of individuals which remains at their free disposal would be reduced to the minimum considered indispensable, and at the same time they would be compelled to divert to the service of the State, directly or indirectly, their surplus stocks of material wealth.

This, however, is not all. It would still be necessary to prevent individuals from acquiring rights to goods and services by means of the machinery of banking and credit.

Attempts in this direction might be made in a variety of ways, such as by selling bonds of the Government loan, by borrowing on this or other property, or by drawing on bank deposits. This point is discussed in fuller detail later.

It would therefore be necessary to impose some degree of restriction and control on transfers of and loans on property and banking operations generally.

Assuming that, when worked out in detail, these and other incidental difficulties can be more or less successfully met, the combination of taxation with forced loan appears to be the system best adapted for securing for the Government the greatest possible share of the national resources in the case of a war of the present magnitude.

The Government has, however, followed the traditional course of procuring its resources by means of taxation coupled with voluntary loans. It has also, in the course of the war, borrowed a certain quantity of foreign securities from their holders, restricted the investment of capital abroad and in new issues at home, instituted control over the distribution of certain essential commodities, and taken various other measures intended to prevent improper dissipation of the national resources or to divert them into useful channels.

It has not, however, imposed any restrictions on the market in Government loans or other home securities or most kinds of property, nor on banking operations generally.

The result of this policy has been both to leave in the hands of the people rights to a larger share in the national income than that which is strictly indispensable, and to permit them to supplement that share by means of the machinery of banking and credit.

At the same time, the active propaganda instituted by the Government on behalf of voluntary loans has caused this machinery to be employed very extensively to furnish the Government with command over goods and services. The methods by which this result has been brought about require some detailed explanation.

The amounts standing to the credit of depositors in banks constitute rights of those depositors to general purchasing power, that is to say, claims to goods and services, which may be exercised at any moment by the holders.

The banks, however, relying on the improbability of these rights being exercised to any great extent at one time, conduct a profitable business by transferring them temporarily to others, by means of short loans against merchandise and other security, and by employing them in the purchase of negotiable securities, keeping a small reserve in legal-tender currency for the satisfaction of depositors who may demand it.

Depositors draw on their accounts, that is to say, they exercise their claims, to some extent continually from day to day. But the persons to whom they transfer these claims in the course of business usually re-transfer them to the same or some other bank. In banking parlance, cheques drawn on a bank are usually paid in by the holders to the credit of their accounts in the same and other banks, without the use of coin or other legal-tender currency.

The claims of depositors may thus be satisfied to practically any extent, and used as purchasing power for a multitude of transactions, provided that they do not take the form of demand for currency, without obliging the banks as a whole to reduce their loans or investments.

This vast fund of latent purchasing power, at the disposal of depositors, is susceptible of further expansion by the faculty of the banks to make fresh loans.

Just as the rights of depositors may be exercised to any extent without affecting the position of the banks as a whole, provided currency is not demanded, so, subject to the same condition, the banks may create fresh rights in favour of borrowers to an extent limited only by the amount of security which may be offered and their own discretion. The cheques drawn on a bank in virtue of its loans will be paid in by the holders to their accounts in the same and other banks, and the only change in the aggregate position of the banks will be an enlargement of their loans on one side balanced by an enlargement of their deposits on the other.

The possibility, however, that currency will be demanded is always present, and for this reason banks under normal conditions work with a constant eye to the necessity of keeping their small reserve of currency up to the ratio of their deposits which they consider compatible with safety. This consideration operates as a check on the undue expansion of loans, which must lead to a diminution of the ratio of reserve of currency to deposits either by a fall in the former or by a rise in the latter.

Now in normal times the only legal-tender currency is gold or bank notes convertible into gold. The amount of loans is therefore more or less strictly limited by the amount of gold available.

But immediately on the outbreak of war the Government provided an emergency legal-tender currency in the shape of currency notes, of which the issue was subject to no statutory restrictions, and which it placed at the disposal of banks, on certain conditions, to enable them to meet their liabilities in currency if called upon to do so.

Since that time, therefore, the influences which formerly acted in restriction of bank loans have not been operative with the same force, and banks have been in a position to expand their loans to a considerable extent without apprehension of being unable to meet their obligations in cash in the event of a run on their deposits.

Given these conditions, and in response to the urgent appeals of the Government for funds on attractive terms, the public and the banks have naturally taken advantage of the facilities open to them to subscribe largely to Government loans.

The employment of deposits for this purpose has been supplemented by loans on security of various kinds, including the bonds of the Government loans themselves, of which each issue provides the holders with the means of borrowing to subscribe to others. Further, the banks themselves have been large subscribers, the mechanism of banking, as already described, rendering it possible for them thus to supplement their customers' loans to an almost indefinite extent by direct loans of their own.

The cumulative effect of all these operations has been to create and place in the hands of the Government an enormous fund of purchasing power, without effective compulsion on the public to limit the exercise of their own purchasing power to more than a relatively moderate extent, though considerable restriction of expenditure has doubtless been effected by voluntary effort.

Armed with this purchasing power, the Government has entered into competition with the public for the acquisition of the goods and services necessary for the war, with the inevitable result of a general and formidable rise in prices and wages.

This has in its turn reacted on the amount of purchasing power required by the Government, so that it has been necessary to raise larger and larger sums as the war has proceeded, and the system has become more and more costly.

These effects are essentially similar to those which would have been produced if, to the extent of the additional purchasing power employed, the Government had manufactured inconvertible currency notes and issued them in payment of its purchases, instead of raising the amount by loan.

This is only another form of the artificial creation of purchasing power, or what is known under the compendious term of inflation.

The Government would in this case have incurred, in place of the obligations maturing at fixed dates which it has incurred in respect of loans, an indeterminate obligation in respect of the currency notes, without having to support a charge for interest for the benefit of banks and others.

The currency notes would have been to a large extent deposited in banks, while a residue would have remained in circulation, just as, under the system adopted, the sums paid out by the Government are paid in again to a large extent to the banks, while a considerable amount of currency notes is in the hands of the public.

For it must here be noted that although the Government has not actually issued currency notes in payment of its purchases, it has had to issue them in considerable quantity as a necessary adjunct to the artificial creation of purchasing power by the method of loans.

The great rise in prices and wages has called for a large increase of currency in circulation, especially among the poorer classes who do not keep banking accounts. Employers of labour and others present cheques to the banks to be cashed in legal-tender currency, and as the demand increases and the banks' supplies get exhausted, they apply to the Government, which meets the demand by issuing more and more currency notes. The stock of gold available would be quite insufficient for the purpose, and currency notes have in fact entirely replaced gold coin in circulation.

The currency notes are nominally convertible into gold, but in practice advantage has not been taken of this provision, and the notes may for practical purposes be considered as fulfilling the function of inconvertible notes.

These conditions imply a departure from the gold standard of prices, and the substitution for it of an arbitrary standard which fluctuates according to the extent to which inflated purchasing power is effectively being employed.

Departure from the gold standard, or, in other terms, depreciation of the currency, is, in fact, a characteristic sign of excessive inflation. A further characteristic sign is the fall in the exchanges with countries which retain the gold standard.

This is a necessary condition of commercial intercourse between two countries, in one of which the prices of commodities are expressed in terms of gold and in the other in terms of a depreciated currency.

In the course of the present war, the monetary conditions in all countries have been so profoundly disturbed, and both commercial intercourse and rates of exchange subjected to so much restriction and regulation in the interests of national policy, that it is difficult, in the absence of detailed information, to present at this stage an accurate account of the interactions of money, exchange, and prices which have taken place.

This much, however, is clear, that the exchange with Great Britain in various countries has fallen appreciably, and that this fact has hampered the Government in the difficult task of obtaining commodities from those countries on credit.

It is a matter of vital necessity to a belligerent government to obtain supplies from other countries on credit to the utmost extent possible, and these countries are naturally the more reluctant to comply, that is, to invest in loans to that government, when its exchange is depreciated and subject to further unknown fluctuations.

Some weight must, however, be given to the consideration that foreign investors who have confidence in the future of the borrowing country find in a low exchange an additional inducement to give credit, as they will reap a profit in the event of a subsequent recovery.

A stipulation is often made that the supplies furnished on credit shall be eventually paid for in the currency of the lending country, thus throwing on the borrowing country the burden of any further fall in the exchange.

Probably the most favourable attitude that the borrowing country could wish to find in a lending country is willingness to supply everything needed on credit, coupled with sufficient confidence for measures to be taken to prevent a fall in the exchange, even though this should involve inflation in the lending country.

These ideal conditions have been approached in at least one country—Egypt—which has exported a large surplus of commodities to the United Kingdom and its allies in the course of the war and invested the proceeds in British loans. At the same time the gold currency has been replaced by a paper currency, issued under arrangements which maintain the rate of exchange on London at or close to the normal gold par. The effect is that prices of imported and exported articles in Egypt have risen with those in the United Kingdom, and that a local inflation has taken place corresponding more or less with that in the latter country. The Government and the bankers in Egypt have, in fact, linked their fortunes with the pound sterling.

Without exhibiting, in general, quite this degree of accommodation, other countries have lent their resources extensively to the United Kingdom in the course of the war. A heavy liability has thereby been incurred to creditors abroad, partly through direct government agency, but also to a considerable extent through that of bankers and merchants in the ordinary course of trade, this latter being largely represented by Treasury bills and other short-term maturities. As a partial set-off against the liability to other countries, the United Kingdom has in its turn considerable claims on some of its allies for resources furnished to them.

Such being the broad features of the financial situation brought about by the war, it may be worth while to set out briefly a few of the considerations which bear upon the important problem of dealing with that situation after the war.

At the close of the war the Government will be under an enormous debt, due for repayment at various dates extending from the immediate future to thirty years ahead. A portion of this debt will be owed to foreign creditors.

As far as the latter are concerned, the debt can be repaid only in material wealth. The supplies furnished for the war will, however, as already remarked, have been consumed in the war, and the available exportable wealth of the country will have been reduced to the lowest limits. The only source, therefore, from which the debt can be repaid will be the national income or growing resources of the future.

As the national income will be inadequate to bear the charge of repayment of the large amount of debt due in the near future, the loans will have to be renewed in large measure at maturity, or replaced by fresh loans, on the best terms obtainable.

This problem is beset by peculiar difficulties, arising out of the fact, already noted, that these short-term maturities largely represent deferred claims for payment for goods supplied from foreign countries during the war through the ordinary channels of trade, and may therefore be expected to materialise in the shape of a demand for goods at the first favourable opportunity. It will be for the benefit of the country to satisfy foreign demands to the greatest extent possible during the period of inflation, rather than leave claims which have been created through the purchase of goods at inflated prices to be settled by the resale of goods at low prices.

Pending the satisfaction of these claims, it is not to be expected that their holders will accept renewal on any longer terms than those which they enjoy at present. In some countries they represent issues of paper currency in the hands of the people which may be exercised as purchasing power at any moment, thus rendering it incumbent on the issuing authorities to provide cover which is capable of being realised at short notice. But the maintenance of attractive rates of interest may have some effect in retarding the realisation of a portion of the claims.

The character of that portion of the debt which is owed to creditors at home is similar to that which is owed abroad, in so far as it represents a loss of goods and services consumed in the war. This loss, however, would have been entirely written off the national balance-sheet if it had been possible to obtain the goods and services by requisition or taxation. By the system of loan the goods and services have, in effect, been taken in exchange for a promise that their equivalent shall eventually be restored, with interest, out of the future resources of the community.

The stock and bonds of war loans represent, therefore, nothing more than claims to future income, and constitute in no way any portion of the wealth of the country. To the large extent to which the holders will themselves be called upon to contribute through taxation to the interest and redemption of the loans, the respective claims of the holders and the community will cancel each other; the balance of the holders' claims being provided out of income derived from other sources.

The problem of inflation requires, however, urgent attention, for its continuance threatens the country with financial discredit and possible disaster.

The pernicious influence of an arbitrary and unstable standard of exchange affects every department of economic activity. It hampers production by creating unrest among workers and discouragement among employers. It imposes an important additional element of risk on all enterprise, not only in the United Kingdom, but in other countries to whose trade and finance London acts as the pivotal centre. The position of London as the world's clearing-house can hardly survive a protracted period of depreciated currency and exchanges. The continuance of borrowing under a *régime* of inflation becomes fatally easy, tending ultimately to the breakdown of confidence in the pound sterling and in British financial obligations. The longer the period of inflation is extended, the more harmful will be its reactions, and the more painful and dangerous will be the process of readjustment to normal conditions.

The existence of an effective gold standard in ordinary times constitutes a fairly adequate check on inflation, and, notwithstanding all its shortcomings, no better stabilising system has yet been devised. Reversion to free gold payments will not, however, be practicable until inflation has been already reduced. A premature attempt to restore them would bring about a demand for the conversion of purchasing power into gold far greater than could be satisfied out of the available supply of the metal. The demand would manifest itself with special force from the countries which have, as already noted, short-dated claims on London representing issues of paper currency. The holders of this currency would take advantage of any opportunity offered to exchange their paper for gold, the existing premium on gold acting as an additional stimulant in this direction.

Nor would it appear possible to reduce inflation by placing restrictions on the issue of currency notes. These notes, as already explained, have been issued as the necessary concomitant of inflation, and are not the original cause of it. As inflation diminishes, reduction of the note circulation must ensue. An isolated measure of restriction in present circumstances would probably defeat its own object by provoking a run on bank deposits, for which the recognised palliative would have to be applied in the shape of liberal fresh issues of paper currency.

It is important to remember, in considering this question, that it is not the total volume of purchasing power which contributes to inflation and reacts upon prices, but the extent to which it is being effectively exercised. That portion of it which is hoarded, unused, or potential is without effect upon prices. In terms of the quantity theory of money its "velocity" may be reckoned as zero.

This consideration affords some guidance as to the direction in which inflation may best be dealt with. It indicates restriction of the effective use of purchasing power as the real object to be aimed at, an object which is not necessarily attained by a reduction in the total volume of purchasing power, and which, on the other hand, is susceptible of realisation without such reduction.

The root cause of the present state of inflation is the continuous exercise of artificially-created purchasing power by the Government. To check its further progress the most effective step will have been taken when public expenditure is again confined within the limit recoverable by taxation.

This, however, essential though it is, is hardly likely to prove sufficient. The methods of war finance in force will leave a legacy of swollen bank deposits and war securities. It is to be feared that a stimulus to further inflation after the war will be provided by the facility, on the one hand, with which, in the absence of an effective check on banking operations, credits may be raised on securities, and, on the other hand, by the exercise of the purchasing power thus created, in addition to bank deposits, for the purpose of reconstituting that part of the national capital which has been destroyed in the war. The replacement of lost shipping, the arrears of maintenance of railways and buildings, the reconversion of plant from the uses of war to those of peace, the reconstitution of stocks, will take front rank among necessities. New enterprise will also put in its claims for capital. If to all these internal demands be superadded the claims from abroad in satisfaction of indebtedness, it is easily conceivable that the total effective demand will be overwhelmingly great in relation to the growing resources of the country.

Such is the disquieting prospect in view if the situation is left to the unfettered play of private interests. The danger is, however, susceptible of attack by Government or concerted action on the side both of supply and of demand.

On the supply side the scramble for essential goods might be met by a rational control of distribution, both internal and external. This involves serious practical difficulties, but it appears worthy of careful consideration, not only on the grounds at present under discussion, but in the special interests of industry.

On the side of demand the line of attack which offers the most promising results is that which would aim at preventing the conversion of potential into effective purchasing power. The effect of a capital levy in diminishing the volume of potential purchasing power has already been noticed, but this would have only a partial and indirect influence on the effective use of purchasing power. A surer means to the end in view, and one presenting fewer practical difficulties, would be a concerted measure of restriction of loans by banks.

It may be found advisable, at the same time, to maintain, adapted to suit conditions of peace, some of the other restrictions on the employment of capital which have been already introduced during the war.

It cannot be too clearly understood that the great demand which will be made on the country's resources after the war must be met, not by creation of fictitious capital, but by the maintenance of national production and national frugality to the highest possible degree. The efforts put forth during the war to increase output, to restrict consumption, to enlarge the sources of labour, will continue to be needed to repair the damage of war and to enable the country to meet its obligations. A wise administration, both economic and financial, will see to it that the national energy is directed into the proper channels with the minimum of friction and waste.

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Cairo, *October*, 1918.