which is almost entirely cut off from foreign trade—merely enrich one set of Germans at the expense of another. The wealth of both nations, so far as it is devoted to war purposes, is being destroyed; but a great quantity of our wealth is also being used to pay for the enormous and increasing excess of our imports over exports. On the other hand, Germany's capacity to support herself without extraneous assistance has been developed and, so far as we can judge, almost perfected under the spur of necessity applied

THE SLUMP IN CENTRAL EUROPE.

Ferdie: "The All-Highest seems a bit below par."
Sultan: "Why did we ever leave our comfortable fence?"

—L. Raven-Hill, in Punch, London.

by the blockade of the British Navy. She is destroying her wealth on war material as fast as she can, but she is certainly not also exporting it freely. We, for our part, are burning the candle at both ends. We are destroying our wealth as fast as we create it, and we are also getting rid of our reserves in the shape of our investments abroad.

There is no gainsaying the fact that the war has created circumstances which render increased prices inevitable: the withdrawal of huge numbers of men from productive labour, feverish demand for war stores, difficulties of transport by sea and land, and numerous other circumstances, have an irresistible impulse in that direction. The knowledge that these powerful forces are actively at work is apt to lead us to ascribe to them the whole responsibility for the changes that have taken place in our monetary conditions. Even in the most peaceful times, however, greatly increased prices may result from large additions to the currency or, which comes to the same thing, from a relaxation of the restrictions on credit. Our commercial history furnishes many instances of sudden expansion of credit causing rapid increase of prices; but the capacity of credit to expand is never illimitable, and its limitation necessarily fixes a point beyond which prices cannot rise as the direct result of credit expansion. On the other hand, if we postulate a sufficiently vast addition to the currency, the extent to which prices may rise becomes practically illimitable. Apparently, therefore, a set of circumstances may exist, without the intervention of war, which are capable of forcing up prices to as high, or even a higher, level than they have now actually reached. No doubt the rise in prices from which we are suffering is due mainly to causes inseparable from war on a colossal scale—it may even be due entirely to such causes—but the possibility is by no means precluded that a part, even a large part, of it may be due to circumstances which it is within our power to alter, and which, moreover, have nothing whatever to do with commercial combines or the extortions of traders who endeavour to make the trials of their country a means of enriching themselves.

In an article published in a former number of this Review I endeavoured to trace the connection between prices and the amount of gold coin in circulation. From a comparison of mining returns with index prices it appeared that large additions to the output of gold were nearly always followed by higher commodity prices; that when they were not so followed the circumstance was due to the operation of important currency changes—such as the adoption of a gold standard by a first-class commercial nation—which necessitated the immediate use of very large quantities of the more precious metal. It further appeared that when the amount of gold suddenly required for new currency was very large, commodity prices tended to fall. These phenomena inevitably pointed to the conclusion that prices are largely influenced by the amount of gold in circulation. All the evidence went to show that if that amount increased at a faster rate than commerce, prices rose, and if, either as a result of diminished output from the mines or of extended use (e.g., in substitution for silver), it did not increase so rapidly as commerce, then the converse held and prices fell.

Banks are chiefly responsible for the erection of that "vast fabric of credit on a slender foundation of cash" of which so much has been written. In order to illustrate how they create credit, let us suppose that in table 1 X represents a bank and A, B, C, D, and E some of its customers, and that the transactions indicated in the chart shown below take place. The transactions are typical of those ordinarily conducted by bankers:—

off. The position was a decidedly awkward one; but the Government came to the rescue, and by issuing Treasury notes increased the size, and, consequently, the credit-carrying capacity of the currency disc. When, however, the nation had recovered from the first shock, the keystone of the policy of bankers became again the lending out of as large a portion of their funds as is consistent with the holding of sufficient cash to enable all sudden demands to be met. As an inevitable consequence of a reversion to that policy credit expanded, and the basis on which it expanded was not the former gold currency alone, but that currency extended and increased by such Treasury notes as had been issued without a gold reserve. Gradually the enlarged currency disc settled into a level, or very nearly level, position. Its credit-carrying capacity per unit of area became almost the same as it had been before the war, but as its area is greater the total credit that can be built up on it is larger. This means a very real addition to effective demand, and, consequently, an irresistible impulse towards higher price.

Treasury notes for which there is no gold backing

Table 1.

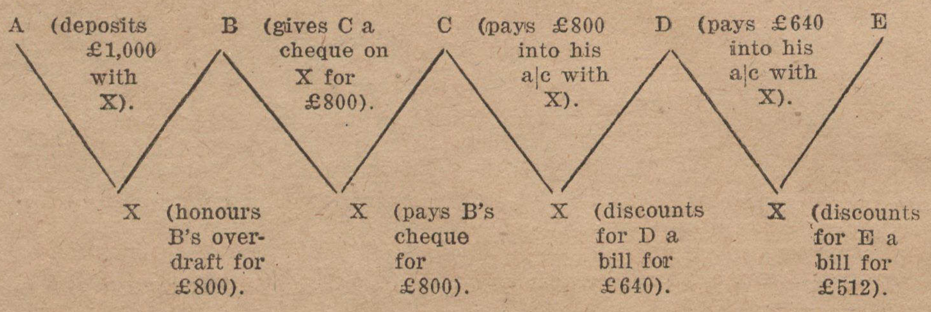


Table 2.

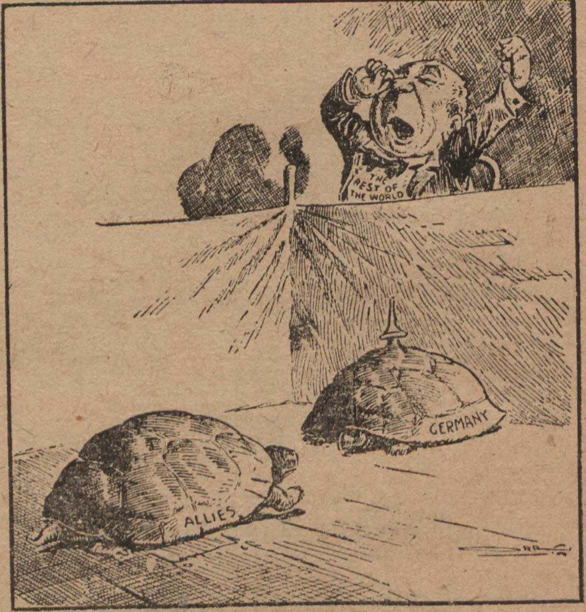
In the balance-sheet of the bank these several items appear under the following headings in table 2, profit made by the bank being omitted:—

Liabilities.		Assets.	
Current account balances	£1,440	Cash in hand and at Bank of England	£ 488
Deposits	1,000	Bills discounted	1,152
		Loans and Advances	800
Total	£2,440	Total	£2,440

On the basis of a deposit of £1,000 the bank would, accordingly, have given credit to its customers to the amount of £1,952, and would also have retained cash (£488) to the extent of 20 per cent. of its liabilities (£2,440). Interest would, of course, be chargeable on £1,952, but none would be earned by the £488 lying idle in the coffers of the bank. Now it is perfectly obvious that banks are not run in the interests of philanthropy. The object of their existence is to earn for their shareholders all the profits they can. In the illustration given, the bank would only have to pay interest, at a relatively low rate, on £1,000, and would receive interest, at a relatively high rate, on £1,952. A considerable profit would be earned; but, obviously, the gain would be still greater if the number of transactions were so increased that in the end no cash at all instead of £488 remained on hand. The extra profit would, however, be made at the expense of depriving the bank of a reserve with which to meet calls made upon it by its creditors. The constant aim of bankers is, therefore, to lend out as large a portion of their funds as is consistent with the maintenance of sufficient cash to enable all sudden demands to be met. Consequently, they pay particular attention to the percentage of their cash reserves to their liabilities. There is a low level below which they will not, for the sake of security, allow it to fall, and a high level beyond which they cannot allow it to rise and at the same time hope to earn dividends for their shareholders. Trade is in a constant state of fluctuation. Its variations require that there should be a considerable element of elasticity in the currency, and this elasticity is supplied by the capacity of credit to expand until the cash reserves of bankers show signs of falling below the safety limit or to contract until those reserves begin to exceed the profit limit.

An American writer aptly illustrated the capacity to build up credit by the analogy of sand piled up on a round disc. The disc represents the metallic, or the metallic and note currency, and credit the amount of sand that can be piled on it. As the area of the disc increases, so also does the amount of sand which it will bear. In exactly the same way, the amount of credit which can be superimposed on the currency bears a definite relationship to the quantity of gold and inconvertible paper money in use. If a disc on which sand has been piled be disturbed, some of the sand will fall off, and if it be tilted to an angle its carrying capacity is clearly reduced. The shock to the financial world in August, 1914, tilted the British currency disc to a very awkward angle, and a great deal of the credit which it was carrying was shaken

have, through their own direct action on the currency and still more through their effect on credit, a very powerful influence in depressing the purchasing power of money. No doubt there are many other factors which tend to increase prices; some of them are capable of Government control, others are not. But, in view of the distress which is being caused by the excessive cost of living, it is certain that the Government should seriously consider whether there is still justification for retaining in the currency any Treasury notes which increase the area of the currency disc. I do not, of course, suggest that the Government should withdraw Treasury notes from circulation altogether. In so far as they are covered



"HO, HUM!"

—Orr, in Nashville, Tennessean.

by a gold reserve they merely take the place of gold in circulation without any deleterious effect whatever on the currency, and they possess all the advantages which the Government claimed for them. But every Treasury note for which an equivalent amount of gold is not held in reserve is not only an instrument for increasing prices, but is also the creator of a powerful force working in the same direction as itself.