INTEREST RATES IN AUSTRALIA, 1931–1956:
POST-MORTEM ON AN ERA OF CHEAP MONEY

THESIS FOR THE DEGREE OF MASTER OF COMMERCE

JAMES STUART HARDY HUNTER

INTEREST RATES IN AUSTRALIA, 1931-1956:
POST MORTEM ON AN ERA OF CHEAP MONEY

<table>
<thead>
<tr>
<th>Part</th>
<th>Subject</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Historical: Theory of Interest Policy Before 1933</td>
<td>2 - 29</td>
</tr>
<tr>
<td>II</td>
<td>Historical: The Introduction of Cheap Money in Australia</td>
<td>30 - 72</td>
</tr>
<tr>
<td>III</td>
<td>Statistical: Trend and Structure of Interest Rates, 1930-1957</td>
<td>73 - 104</td>
</tr>
<tr>
<td>IV</td>
<td>Analytical: Behaviour of Interest Rates from 1931 to 1950</td>
<td>105 - 169</td>
</tr>
<tr>
<td>V</td>
<td>Historical and Theoretical: Theory of Interest Policy, 1933-1951</td>
<td>170 - 239</td>
</tr>
<tr>
<td>VII</td>
<td>Conclusion: Lessons of Australian Experience</td>
<td>269 - 274</td>
</tr>
<tr>
<td></td>
<td>Bibliography</td>
<td>275 - 278</td>
</tr>
</tbody>
</table>
PART I

THEORY OF INTEREST POLICY BEFORE 1933

<table>
<thead>
<tr>
<th>Section</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>J.S. Mill</td>
<td>3 - 4</td>
</tr>
<tr>
<td>Alfred Marshall</td>
<td>4 - 6</td>
</tr>
<tr>
<td>The Direction of Neo-Classical Thought</td>
<td>6 - 9</td>
</tr>
<tr>
<td>Knut Wicksell</td>
<td>10 - 12</td>
</tr>
<tr>
<td>Gustav Cassel</td>
<td>13 - 14</td>
</tr>
<tr>
<td>Irving Fisher</td>
<td>14 - 16</td>
</tr>
<tr>
<td>R.G. Hawtrey</td>
<td>16 - 18</td>
</tr>
<tr>
<td>J.M. Keynes: &quot;Treatise on Money&quot;</td>
<td>18 - 19</td>
</tr>
<tr>
<td>Macmillan Committee on Finance and Industry</td>
<td>19 - 22</td>
</tr>
<tr>
<td>Outline of Development of Bank Rate and open market policies before 1933</td>
<td>22 - 28</td>
</tr>
<tr>
<td>Monetary Policy in Australia prior to 1933</td>
<td>28 - 29</td>
</tr>
</tbody>
</table>
J.S. Mill

Mill's writings occupied a pre-eminent position in the economic thought of the period 1840 to 1870. He did not deviate greatly from the basic tenets of the Ricardian system. However, he showed that the tendency for profits to fall in the long run as capital increased was subject to certain counteracting influences such as speculation, Wakefield's "fields of employment" and an improvement in the terms of trade. It should be mentioned that such qualifications were designed to strengthen orthodox theory and not to provide a substitute for it.

Mill said that the rate of interest depends, "essentially and permanently, on the comparative amount of real capital offered and demanded in the way of loan; but is subject to temporary causes of various sorts, from increase and diminution of the circulating medium."(1) Although Mill nowhere presents an integrated theory of the trade cycle, these so-called "temporary causes" illustrate the discontinuity of economic progress.

One of these disturbances is speculation which is characterized by credit expansion and low interest rates. When the speculative boom collapsed there was an increased desire for liquidity and the rate of interest rose.(2) But for most of the

---

(2) Cf. J.S. Mill: "The Influence of Consumption upon Production". Some Unsettled Questions of Political Economy. (London, 1948) . . . N.B. these essays were written in 1829 and 1830.
time interest rates tended to fall "from the gradual process of accumulation". Mill also observed how there was gradually a movement into equities during the boom because people were disposed to take greater risks and a movement back to cash as the panic set in and later into bonds when conditions became more normal.\(^{1}\)

The sudden opening of any new and generally attractive mode of permanent investment will likewise raise the rate of interest as does a war with its unusually large demands on the loan market.\(^{2}\) An increase in the volume of money lowers the rate of interest.\(^{3}\)

In his Essay\(^{4}\) Mill refuted the doctrine of "The Impossibility of General Overproduction" and postulated conditions in which prices might fall because of a deficiency of demand. His remedy was to increase the money supply and lower interest. However, this was a special case and was not very important in his work as a whole.

Alfred Marshall

According to Marshall, the rate of interest was determined by supply and demand just like any commodity. Interest was paid to induce people to forgo present for future gratifications.\(^{5}\) Thus we have an upward sloping supply curve and a downward sloping demand curve, because it was also assumed that a lower rate of interest increased the demand for capital.

\(^{1}\)Cf. Principles \(\text{Ibid.}, \text{pp.386-8 and pp.439-448.}\)

\(^{2}\)\(\text{Ibid.}, \text{p.389}\)

\(^{3}\)\(\text{Ibid.}, \text{p.391}\)

\(^{4}\)\(\text{op. cit.}, \text{pp.69-70}\)

\(^{5}\)Principles of Economics \((\text{Macmillan, 1947}), \text{pp.81 and 232.}\)
In the long run the supply and demand for capital were in equilibrium, although in the short run an increase in the demand for capital was met by a rise in the rate of interest rather than by an increase in supply. Correspondence, however, was eventually achieved because of the operation of the "Principle of Substitution". When the rate of interest rose, capital would be withdrawn partially from those uses where its marginal utility was lowest. Conversely when it fell, it would be found profitable to employ extra-marginal units of capital. Thus Marshall distinguished between the market rate and the normal rate of interest. These are only equal when sufficient time has elapsed for supply and demand to be fully adapted to each other.

The emphasis on the "passage of time" is not without significance. While there were certain "fundamental truths", it was the true work of economic analysis to demonstrate "how much more numerous are the exceptions to this general preference (i.e., for present as against deferred gratification) than would appear at first sight".\(^{(1)}\) It is in this context that Marshall carries us to the very brink of general equilibrium analysis. He criticised Böhm-Bawerk's exclusion of everything that is not strictly speaking an intermediate good from his definition of capital. The true doctrine he thought was that, because interest has to be paid for and can be gained by the use of capital, those long and roundabout methods are avoided unless they are more productive than others.\(^{(2)}\)

\(^{(1)}\) Ibid., p.582 \(^{(2)}\) Ibid., p.583n.
What are the exceptions? One is that saving is governed by a number of factors besides the rate of interest - by custom, habit of self-control and ... the power of family affection. But while many people seemed to take little notice of the rate of interest, "a strong balance of evidence seems to rest with the opinion that a rise in the rate of interest ... tends to increase the volume of saving". (1)

The Direction of Neo-Classical Thought

The view handed down by Hume and Smith was that the rate of interest tended to fall in the course of economic progress, as the volume of savings increased. As the State could do nothing to augment capital, it could not interfere with the "natural" rate of interest. The rate of interest was an effect, not a cause, of economic progress. (2) Ricardo concluded that the rate of interest was determined by the rate of profit to be obtained by the employment of capital. The rate of profit could not depend upon the rate of interest. (3)

Mill showed that the market rate might diverge from the equilibrium rate because of temporary disturbances but in the main body of his work there was nothing to suggest that the rate of interest was anything more than a passive variable. Sooner or

(1) Ibid., p. 533.
(2) This doctrine, however, had been opposed by a number of seventeenth-century writers. Witness, for example, the views of Josiah Child.
later it would find its "natural" level and it was generally unwise for the State to tamper with it. The direction of neoclassical thought, however, was towards establishing a causal connection between the level of interest and the volume of investment. This was accomplished by shifting attention somewhat to the demand for capital. When Marshall said that the demand for capital was guided by the principle of substitution he was merely recognizing that in the short run the rate of interest was one of the costs which the entrepreneur had to take account of in deciding how far, and in what directions, to push his investments. The margin of profitability of each entrepreneur was closely related to the rate of interest. If the rate fell without any change in other elements of costs, more machinery could profitably be employed. His analysis was applied to the whole economy: "The margin of profitability moves irregularly outwards in all directions whenever there is a fall in the rate of interest,"\(^{(1)}\) and further ... "the demand for the loan of capital is the aggregation of the demands of all individuals in all trades; and it obeys a law similar to that which holds for the sale of commodities". Marshall admitted that government borrowing was in a rather special category but said that even in that sphere the rate of interest "exercises a perceptible influence".\(^{(2)}\)

\(^{(1)}\) op. cit., pp.520-1  \(^{(2)}\) Ibid., p.521
However, even though Marshallian theory accorded more or less equal weight to both short and long term factors in its analytical framework, it was conceived essentially in real and not in monetary terms. Mill had come close to a monetary explanation of the trade cycle and in doing so was greatly influenced by writers such as Tooke, Ellis, Chalmers, Lauderdale and Wakefield as well as by the severity of the 1824-25 financial crisis. But these disturbances were exceptions to the general rule that money was a medium of exchange having no special significance in itself.

It was Wicksell who was responsible for showing that the level of interest rates had a direct connection with prices and the state of trade. It was one of Wicksell's aims to arrive at and justify a principle of monetary policy.\(^{(1)}\) A fall in the rate of interest had a tendency to raise prices and to further production; in the case of very long-term investments only a small fall in the rate of interest was required to produce a given increase in price while at the other extreme of raw materials, the fall would need to be a good deal larger to bring the same price response.\(^{(2)}\) Wicksell dispelled the neo-classical inference that an easy money policy could result only


\[^{(2)}\text{Knut Wicksell : Interest and Prices : A Study of the causes regulating the volume of money (Macmillan, 1936), pp.91-2. (N.B. - Wicksell wrote in 1898).}\]
in inflation; it was not the quantity of money but the relationship between the natural and market rates of interest that determined the level of prices. The quantity of money had no causal significance whatever.

Unfortunately relatively little attention was paid to Wicksell's works until comparatively recently. The conversion by which interest rates were discussed within the framework of changes in monetary rather than real phenomena was only partially realized by other early twentieth century writers. However, Fisher and Cassel had much in common with Wicksell and also exerted an influence on the trend of thought on monetary questions prior to the rise to prominence of the Keynes-Hawtrey-Robertson trio.

It is certainly quite wrong to think that the views of writers prior to 1930 were so alike that we can describe them as classical or by some other label indicating homogeneity. Pigou probably carried on the "classical" tradition in the sense that he brought Marshall up to date while still preserving his basic premises and conclusions. Pigou, however, was not a monetary theorist; he did not think that fluctuations in economic activity originated to any appreciable extent from monetary disturbances, and held that it followed from the postulates of "classical" economics that there could be no idle savings.
Knut Wicksell

Wicksell was the economist who threw out the strongest challenge to the adequacy of the self-adjusting normal equilibrium models. He considered that the main problem of monetary theory lay in the question of why prices rose or fell and was impressed with Tooke's observation that the rate of interest was generally low during times of falling prices and high during times of rising prices.

He asserted that changes in prices owed their origin to divergences between the "natural" and market rates of interest. The natural rate was said to be governed by the marginal productivity of capital which Wicksell, following Böhm-Bawerk, regarded as arising from the roundabout methods of production such as would exist if money were not used. This has been interpreted by contemporary writers as the rate which equates savings and investment. Thus Wicksell integrated the theory of money with the theory of interest and showed that money could not be "neutral" when a divergence occurred between the natural rate and the market rate because this gave rise to price movements which tended to be cumulative in character. Furthermore, as the natural rate was changing almost continuously, it would be a very exceptional set of circumstances that would render money innocuous.

Wicksell regarded this analysis as a mere amplification of the Quantity Theory and not an explanation of the trade-
cycle, which he attributed to real causes.\(^{(1)}\) He objected strongly to the idea that rising prices were due simply to an excess of money and falling prices to a scarcity. The volume of money was merely a consequence of changes in the demand for instruments of exchange brought about by price movements. The cause of price movements was to be found not in absolute changes in market rates of interest but in changes relative to changes in the natural rate.\(^{(2)}\)

There is some resemblance here to Keynesian analysis. Keynes also held (in his General Theory) that absolute changes in the rate of interest commanded less importance than their position relative to the marginal efficiency of capital schedule which is somewhat akin to the "natural" rate of interest as used by Wicksell. However, with Wicksell the emphasis was on price and not income effects and his system was an inherently unstable one. He argued that if a lower rate were imposed on a hitherto stable system and maintained at that lower level the increase in prices which resulted would give rise to further increases ad infinitum. Hence a cheap money policy was likely to cause an uncontrollable rise in prices.\(^{(3)}\) Keynes stressed the inherent


\(^{(2)}\) Interest and Prices, op. cit., pp.166-7.

\(^{(3)}\) Ibid., p.100.
instability of the Investment Demand Schedule itself but such instability did not give rise to a cumulative departure of the whole system from an equilibrium position. At least two further factors distinguish the Keynesian system; one is the difficulty of keeping interest rates low because of liquidity preference and the other is the belief that in the long run the marginal efficiency of capital schedule would fall to zero.

Another point of similarity, however, is that Wicksell did much to shift the traditional emphasis on bank rate. He said that the benefits of a cheap money policy were not fully felt until long term interest rates had moved in sympathy with short term rates.\(^{(1)}\) It was a change in bond rate - not the discount rate - that was the operative factor in price changes. The discount rate, however, was important in relation to international capital movements.\(^{(2)}\)

While no statistics of the natural rate were available, the banks were not powerless to influence the level of economic activity; the practical guide was the level of prices. If prices were tending to rise the rate of interest must be raised and if tending to fall, it must be lowered. The goal was the stability of the price level.\(^{(3)}\) The main cause of instability

\(^{(1)}\) Ibid., p. 192.
\(^{(2)}\) Wicksell became increasingly sceptical as to the efficacy of purely monetary measures to arrest pronounced price movements.
\(^{(3)}\) Ibid., p. 89
was found in the failure of the banks to promptly adjust their market rates of interest whenever there occurred a general change in the price level.

**Gustav Cassel**

Cassel was more confident than Wicksell in the ability of the banks to mitigate business cycles by appropriately manipulating interest rates. In fact he went as far as to say that if the banks always acted promptly to ensure equality between the true equilibrium rates and their money rates, the trade cycle would be a "thing of the past". Observed cycles were explained in terms of unavoidable changes in the production of real capital.(1) The expansion of real capital was hampered by a relatively high rate of interest.

As for interest theory, Cassel was essentially Marshallian and not Böhm-Bawerkian. The rate of interest simply accommodated itself to the demand and supply of capital. As for interest policy, the rate of interest was a most powerful instrument for stimulating investment. The true comparison, however, was between the Bank Rate (not bond rate), and the "equilibrium rate".(2)

---

The "true equilibrium rate" was apparently the rate which maintained a constant price level. A reduction in Bank Rate was assumed to lead to a fall in bank lending rates, thence to an increased demand for loans and rising prices. If the banks failed to prevent a departure of Bank Rate from the true equilibrium rate, wide price fluctuations and serious economic disturbance would ensue.

Cassel, like Marshall, thought that the rate of interest was only one of the factors which affected saving. However, while savings did not vary much with usual fluctuations in the rate of interest, the latter was "an essential factor keeping up the supply of net savings to its actual height."(1)

Irving Fisher

Fisher's Appreciation and Interest (1896) is comparable in many respects with Wicksell's Interest and Prices. Both grappled with what may be called the Ricardo-Tooke Conundrum of why the rate of interest had often been low during times of falling prices and high during times of rising prices.(2)

Fisher made no formal distinction between natural and market rates of interest but spoke instead of nominal and real rates. The real rate was the nominal rate corrected for changes in the value of money. He said that theorists in the past had mistaken nominal rates for real rates.(3) The inherent

(1) Ibid.
instability of the system was due to a failure of the market rate to adjust itself sufficiently to a change in prices.

Any price rise tended to be cumulative because the market rate of interest was not raised to an extent sufficient to neutralize the future fall in the value of money. When prices were rising profits would also rise and borrowers could afford to pay a higher "money" interest. The movement tended to be cumulative because it was some time before people realized that borrowers were, in fact, better off than before the price rise. The interest rate would not therefore be fully adjusted to the level of prices - i.e., to the fall in the value of money. This situation, however, would soon lead to an increased demand for loans and to an investment boom. The boom ends because "in self-protection" the banks must eventually raise the rate of interest. A financial crisis and a downturn in economic activity followed.

Both Fisher and Wicksell played up the importance of money and their conclusions did not vary greatly. Thus Fisher said: "the monetary causes are the most important when taken in conjunction with the maladjustment in the rate of interest." There were differences, however, in methods. Most important perhaps was Fisher's use of the crude Quantity Theory to explain changes in the value of money. Wicksell regarded this as an unsatisfactory tool of analysis and, as mentioned earlier, did
not even consider it as an operative factor in the situation. On the other hand it may be objected that he was able to maintain this position only because of his particular regard to the natural rate of interest, which was a non-monetary phenomenon, and its position relative to the long-term market rate in the determination of prices. It has been claimed that this smacks of circular reasoning, and that by definition he had tended to assume the problem away.

R.G. Hawtrey

The increasing importance of monetary phenomena was carried a stage further by Hawtrey who wrote at a time when interest in trade cycle problems was mounting and when central banking techniques were developing rapidly.

In one of his early publications\(^1\) Hawtrey said this: "whereas the influences arising out of the banking system are very important, those which arise from conditions of production and consumption have but little bearing upon the state of trade as a whole." In a later publication\(^2\) he said that the principal instrument for regulating credit was the rate of interest which was determined by the demand and supply of loans. Against the view that variations in interest rates were not of much significance when compared with prospects of profit, Hawtrey held that profits were high because prices were rising and it was under

\(^{1}\) Good and Bad Trade (London), 1913, p.130.
\(^{2}\) Currency and Credit (London), 1927.
these conditions that it becomes exceptionally profitable to buy and hold stocks. If the rate of interest was raised sufficiently high to offset the extra profit, there was every reason to expect an immediate reaction on the demand for new credits.

Hawtrey admitted that a change in the rate of interest may be of small moment to the manufacturer but thought it was a very important consideration for the wholesaler. In fact the trade cycle was set in motion because of the high degree of sensitivity of commercial borrowing to a change in credit terms. It was the market rate that actually checked or stimulated borrowing but it was Central Bank action in making Bank rate "effective" that secured the attainment of a particular market rate. (1) The rate of interest on short-term borrowings was the primary weapon of credit contraction but could be reinforced by other methods "open to bankers to discourage their customers from borrowing." (2)

In 1930 Hawtrey was confident that the timely action of central banks could serve to maintain a stable price level. He altered his position somewhat as a result of the Depression, for he admitted that the course of events had disclosed a weakness in the power of central banks. (3) He no longer insisted that a reduction in Bank rate was sufficient in itself to promote

recovery. The latent tendency to revival however, could be reinforced by the central bank purchasing securities in the open market. People do not have an unlimited desire to hold cash balances.

Hawtrey undoubtedly went further than any other economist in elevating the role of monetary policy.

**J.M. Keynes: A Treatise on Money**

In 1930 Keynes was confident that the rate of investment could be controlled through appropriate adjustments of market rates of interest and that the level of saving would also respond to a change in interest rates.

For the most part, the *Treatise* did not break new ground in the realm of economic theory, and certainly not in interest theory. In a sense we have something of a superstructure built on a variety of hitherto loosely knit ideas. Problems were posed in a different way - in a more challenging way: we feel that the author is searching for something big. According to Dillard(1) the *Treatise* marked the turning point from a monetary theory of prices to a monetary theory of output. The central proposition, however, was that the cause of much instability was to be found in a divergence between the natural and market rates of interest - and there was nothing novel in that idea. Greater attention would seem to have been focused on changes in the level of saving and investment; the

---

(1) *Post Keynesian Economics* - Edited by K.K. Kurihara (Rutgers, 1954), p.4
importance of the *Treatise* however, consists not so much in the particular theoretical structure employed as in the nature of the conclusions reached and the direction of thought in what subsequently proved to be a critical turning point in history.

Keynes maintained that there was a direct relationship between the long-term rate of interest and the level of investment. A dear money policy deterred new investment because it lowered the value of capital goods. However, it increased the rate of saving. When the price level of new investment goods fell, it not only upset the balance between investment and saving, but decreased the profits of those engaged in the production of consumption goods. By the same token a fall in the rate of interest increased investment relative to saving and raised the profits of those engaged in the production of consumption goods. Both effects led to an increase in the volume of employment which entrepreneurs were prepared to offer at existing wage rates.\(^{(1)}\)

**Macmillan Committee on Finance and Industry**

The increased attention given to monetary aspects of crises and cycles after World War I reached its high watermark with the Macmillan Committee’s Report of 1931.

The Committee thought that there were some limitations to the usefulness of a Bank rate policy but that in conjunction

with other monetary weapons, it offered the best means of evening out fluctuations in economic activity.

It was recognized, however, that the particular situation which confronted Britain in 1930 was of an exceptional nature and that it might not therefore respond to the treatment prescribed for a more "normal" situation. The pressing problem was to increase exports, an objective which might be jeopardized through too much credit expansion.

Of the Bank rate, the Committee said that "it exercises a pressure in the right direction" whatever the extent of the disequilibrium may be.(1) It was sometimes difficult to know whether a rise in Bank rate was intended to correct a temporary maladjustment or was the prelude to a more general and widespread contraction. However, the confusion which this creates in the minds of businessmen can be averted if the Bank of England states the position clearly on each occasion.(2)

Bank rate was a proper instrument not only for correcting a temporary disequilibrium in the international loan market, but also for regulating the pace of internal expansion. But it was inadequate by itself only within certain limits. It would not be sufficient, for example, when substantial changes in the level of industrial costs were called for.(3)

(1) Par 216, p.96  
(2) Par 218, p.97  
(3) Par 221, p.98
The Committee admitted that in conditions of extreme uncertainty and despression a change in the Bank rate might not be sufficient in itself "to attract borrowers for purposes of new enterprise". It was thought, however, that this aspect of things had been exaggerated and that in normal circumstances the banking system had "indisputable power" to influence investment by increasing the quantity of money and reducing the cost of bank credit. In the normal course, the new issue market was highly responsive to the easing of bank credit. This ensured more real investment, larger profits and a greater stimulant to enterprise generally.\(^1\)

The monetary authority was indeed very powerful and the greater danger was in the direction of letting loose too strong a force which could not be controlled later on.\(^2\) In fact there is quite a bit of evidence which suggests that the Committee was obsessed with the danger that the banks might expand credit too fast.\(^3\)

The Committee seems to have been impressed with the argument that dealers were highly responsive to changes in the short-term rate of interest. House-building and public utility undertakings were fairly sensitive to changes in the long-term rate of interest.

In Addendum I it was considered that a cheap money policy offered the best prospects for stability. The immediate

\(^{1}\)Pars. 232 and 233, p. 102.

\(^{2}\)Pars. 234-6, p. 103.

\(^{3}\)Cf. Addendum I.
problem was caused very largely by the reluctance of acceptable borrowers to come forward. The remedy as a first step was a fall in the long term rate of interest or some kind of State action.

Outline of Development of Bank Rate and Open-Market Policies before 1933

Before 1930 the functions of central banks were confined almost exclusively to acting as government banker, protecting the currency from gold and capital movements and acting as lender of last resort and clearing agent for the banks. After 1850 the note issue declined in significance and it is not surprising that we find the emphasis gradually shifting from control over currency to control over credit. It came to be generally conceded that the availability of credit could be influenced by changing the price of credit. Credit control however, was administered in a very indirect and impersonal way, firstly through Bank rate and later supplemented and reinforced by open market operations in Government securities.

By 1870 the Bank of England was a true bankers' bank and London had developed as an international money centre. The use of Bank rate as a means of influencing gold movements and hence internal conditions dated back to 1825, although it was not until the Bank Charter Act of 1844 that the amount of bank money was tied to gold (representing a decisive victory for the "Currency School") and the idea of a penal rate developed.
The second half of the 19th Century was the heyday of the Gold Standard system of monetary regulation. Indeed, up to the First World War the purpose of Bank rate was to regulate the amount of the gold reserve and in that capacity its role may have been somewhat restricted. But what it possibly lacked as an initiating force it seems to have made up in the ever-widening range of its effects. For example, the idea that the Bank rate was a powerful psychological weapon grew rapidly. Hawtrey(1) says that "when the use of Bank rate to restrict credit became an established practice, trades, being aware of the intentions of the Bank, were inclined to anticipate them". Thus if the initial increase in the Bank rate brought no response, it was reasoned that the rate would go higher until the required effect was produced.

The theory of the Gold Standard was that it became profitable to export gold when the balance of payments was unfavourable and the exchanges adverse. If the imbalance persisted long enough action would have to taken to protect the gold reserve. This usually took the form of a rise in the Bank rate which had the "immediate effect of retaining money here which would otherwise have been remitted abroad and of attracting remittances from abroad to take advantage of the higher rate, thus checking the outflow of gold and even reversing the stream."(2)

Conversely when the exchange became too favourable there would be a tendency for gold to flow into the country and the Discount Rate would be reduced.

Before World War I the Bank of England was not happy about imposing a credit policy on the banks but its Bank rate policy developed to a stage where it became a recognized technique for changing bank reserve positions and for influencing expectations. The theory developed that a change in Bank rate soon spread to other interest rates and thereby affected the amount currently borrowed to finance expenditures whether for real investment or to add to stock holdings. Thus the Cunliffe Committee(1) said that the raising of the Bank rate and the steps taken to make it effective in the market "necessarily led to a general rise of interest rates and a restriction of credit. New enterprises were therefore postponed and the demand for constructional materials and other capital goods was lessened." Consumption expenditure would also fall and with stocks being "unloaded" the result was a general decline in prices which, "by checking imports and stimulating exports, corrected the adverse trade balance which was the primary cause of the difficulty."

Up to the beginning of our period, Bank rate was assumed to be the most suitable instrument for correcting an internal disequilibrium. With the disintegration of the gold standard and

(1) Ibid.
the difficulties which followed World War I, a policy of open-market operations was increasingly resorted to as a means of stabilizing the pound sterling and making Bank rate more effective in the market. Central banking in England responded to the challenge of a new era, although policy continued to be influenced by the desire to return to gold at the old parity. It seems clear that the initiative for changes in bank rate before 1930 came largely from changes in external conditions.

In the United States, the recently established Federal Reserve System moved haltingly towards a policy of influencing interest rates and hence credit conditions by means of open-market operations in conjunction with changes, where necessary, in the official discount rates of the various Federal Reserve Banks. In the United States the emphasis virtually from the beginning was on open market operations rather than on Bank rate as a penal rate, which had its origin mainly in the nature of the debt structure and the disposition among member banks against borrowing directly from the Reserve banks.

There may be a tendency to think that the use of Bank rate to correct an internal disequilibria depended in some way on the existence of the Gold Standard. Looking back in 1951 over a 20-year period of cheap money in which the currency was not tied to gold we might be excused for thinking that one could not work without the other. However, I think that events since 1951
have shown that this is not so, although it is admitted at once that the effects of a change in Bank rate are now somewhat different from what they were in the twenties and different again from what they were prior to World War I.

Under the Gold Standard the gold reserve was used as an indicator of the monetary situation, it being argued that the gold reserve reflected the demand for currency and credit which in turn fluctuated with the level of economic activity. This being so it is understandable that some economists were pleading for a quicker response by the monetary authorities; although its efficacy was unquestioned, Bank rate rarely anticipated the economic climate. In this sense the Gold Standard made for a considerable inflexibility in policy and with the suspension of the Standard it was simply a matter of finding an indicator or indicators to replace the gold reserve-indicator which would enable monetary policy to counteract inflationary or deflationary tendencies.\(^1\) An important indicator in Australia is the level of London funds while in the United Kingdom it is the level of gold and dollar reserves.

There is an essential difference between the management of our present monetary system and that which operated under the Gold Standard. Under the Gold Standard it was often necessary to deflate heavily to maintain stable exchanges, which more often

than not involved a considerable degree of unemployment. Under the Bretton Woods system governments may be reluctant to alter exchange rates and are required to lodge a formal application with the I.M.F. where significant changes are at issue; but when an imbalance occurs the first line of defence is usually to cut back imports and possibly seek temporary assistance from the Fund. Fiscal and monetary policies may also be used but the point is that governments are not now prepared to deflate heavily to secure external balance. If the deficit appears to be due to more fundamental causes the appropriate course is to depreciate the currency. The question of a dispute between the Fund and a member country hardly arises and it is recognized that each government must decide for itself as to the best means of restoring balance without increasing unemployment.

We saw in earlier sections that economists differed in some important respects in their approach to monetary questions. These differences should not be overlooked; but there would seem to have been a pretty general measure of agreement that a change in interest rates, however initiated, was an appropriate means of securing a balance between savings and investment. Some writers emphasized changes in short rates, others long rates; the efficacy of a flexible interest policy, moreover, would depend partly on the resiliency of the cost structure and partly on the particular money market through which its effects were transmitted.
In England it was a powerful weapon for bringing the system back to an equilibrium position. This view could hardly have been more forcefully presented than in the Report of the Macmillan Committee.

Monetary Policy in Australia before 1933

In the 1920's Australia lacked a money market and the bond market was an extremely narrow one. The economy was largely dependent on international trade and particularly trade with the United Kingdom. Furthermore, a considerable part of the capital expansion was financed by overseas loans arranged in London. The Commonwealth Bank had been established in 1911 but by 1930 its central banking functions had not advanced a great distance. It played no part either in the control of credit or the maintenance of the gold standard. It is true that central banking was "in the air" and that one or two steps were taken in the direction of equipping the Bank with some of the armoury of a reserve bank; but for all intents and purposes credit policy - such as it was - was assumed by the trading banks, who did not take kindly to the idea of a Central Reserve Bank. (1)

From what has been said in the preceding paragraph, it is hardly surprising that the theory and practice of banking in Australia before 1930 developed in an ad hoc fashion and was strongly affected by the prevailing view in London. Sir Ernest Harvey's visit was a case in point. (2) Australia was a

dependent economy and it was clear that there could not have been a Bank rate or open-market policy in Australia of the kind used in more advanced economies. But the close link with the United Kingdom provided a good substitute in the absence of effective central bank control. Fluctuations in London Funds were manifested in changes in both the cash reserve and advance deposit ratios. A fall in London Funds was a signal for a general restriction of credit while a rise foreshadowed an expansion of credit. Credit contraction was expedited by a rise in both Bank Advance and Fixed Deposit rates while expansion was helped by a fall in these rates. In some vague sort of way these measures were thought to redress an imbalance between savings and investment. In a sense therefore there was a policy although it was fairly automatic and responded somewhat after the fashion of Bank rate under the gold standard. The absence of a developed money and capital market and a virile central bank, however, must have severely limited the usefulness of this "policy".
PART II

THE INTRODUCTION OF CHEAP MONEY IN AUSTRALIA

Section 1  Steps to Reduce Interest Rates in Australia  ...  ...  31 – 57

Section 2  Explicit Motives for Adoption of Cheap Money Policy  ...  ...  58 – 72
Section 1: Steps to Reduce Interest Rates in Australia, 1931-35

This Section is divided into the following sub-sections viz.:

(a) Provisions in the Premiers' Plan for reducing interest rates.

(b) Steps taken by the banks to reduce advance rates in accordance with their undertaking at the Premiers' Conference.

(c) Successive reductions in fixed deposit rates.

(d) Successive reductions in advance rates.

(e) Reductions in savings bank deposit rates.

(f) Movement of bond and share prices.

(g) Reductions in Treasury bill rates.

(h) Reductions in other interest rates.

(a) Provisions in the Premiers' Plan for reducing interest rates.

To help bridge the gap in government accounts and restore public confidence, the Premiers' Plan of May/June, 1931, provided for:

(i) reductions in government expenditure;

(ii) increased taxation;

(iii) a conversion loan to secure a reduction of 22\(\frac{1}{2}\) per cent in the internal interest burden;

(iv) reductions in bank interest rates.

The proposals, which embodied the major recommendations of the
Copland Committee, were submitted to Cabinet on 6th June and in general approved.

The conversion of the internal debt from $5\frac{1}{2}$ per cent and 6 per cent to 4 per cent was expected to result in a saving to the budget of about £3 million in 1931/32 and to assist general recovery through a fall in costs. It was to be accompanied by corresponding reductions in bank, mortgage and other interest rates.¹

The conversion loan proved a spectacular success. Of a total internal debt of £558 million, dissent to conversion was made in respect of only 3 per cent, which was in the end compulsorily converted with the assent of both political parties.² The operation was greatly facilitated by the fact that about 40 per cent of the total holdings were in the hands of banks and insurance companies. These institutions were approached during the conference and, after some debate, expressed their willingness to convert. Most of them believed that interest rates ought to come down.

The Premiers' Plan contemplated a reduction of bank and savings bank rates of interest on deposits and advances, but prescribed neither the amount of reduction nor the machinery by which it should be brought about. At the Premiers' Conference a voluntary promise was accepted from the commercial banks that

they would reduce their rates on the average of one per cent. At a Conference of bankers which was held one week after the Premiers' Conference the banks very reluctantly agreed to reduce rates on fixed deposits and advances by an average of one per cent. Reductions in the rates offered for new fixed deposits were to take place at once and those on advance rates were to be made with reasonable expedition, the method being left to the banks individually.\(^{(1)}\) Fixed deposit rates were reduced on 26th June and the reduction in advance rates is discussed in the next section. There was no difficulty about an immediate reduction in savings bank rates because business was conducted almost exclusively by government sponsored institutions. The Commonwealth Savings Bank reduced its maximum rate by one per cent in July while the State Savings Bank of Victoria reduced its rate by \(\frac{1}{2}\) per cent and Savings Bank of South Australia by \(\frac{1}{4}\) per cent.

It was also agreed at the Premiers' Conference that special relief should be afforded to private mortgagors. Accordingly all States passed legislation scaling down the level of fixed money payments by \(22\frac{1}{2}\) per cent.

The N.S.W. Act further provided for the reduction of dividends on preference shares by \(22\frac{1}{2}\) per cent. No other State did this but the general practice of reducing fixed obligations of all sorts resulted in a number of companies making appeals to their shareholders for a voluntary reduction, which was

\(^{(1)}\) Giblin op. cit., p. 118 and Report of the Royal Commission on Banking, p. 70.
frequently granted.\(^{(1)}\)

As far as bank interest rates were concerned, therefore, no attempt was made to force the banks through legislative action to make any prescribed reductions.

(b) Steps taken by the banks to reduce advance rates in accordance with their undertaking at the Premiers' Conference.

While the banks moved together in bringing down fixed deposit rates by one per cent in July, there was a notable absence of enthusiasm for an immediate reduction in advance rates. There was furthermore no single school of thought. Some banks moved forward in the belief that lower rates would help revive the demand for advances while others tended to hang back. The hesitancy generally in reducing overdraft rates in compliance with the Premiers' Plan can be attributed largely to the widely held belief in banking circles that the rate was determined for them by the level of fixed deposit rates and that, since the average fixed deposit was of twelve months duration, the maintenance of the profit margin necessitated a lag before overdraft rates could come down.\(^{(2)}\)

While the overall position is somewhat obscure, writers are generally agreed that the reduction of one per cent in the average rate on advances had been completed by all the banks by the 1st October, 1931.\(^{(3)}\)

---

\(^{(1)}\) McLaurin, op. cit., pp. 88-9  
\(^{(2)}\) Ibid., p. 229  
\(^{(3)}\) Cf. Giblin, op. cit., p. 120 and Report of the Royal Commission on Banking, op. cit., pp. 70-1.
As was said earlier, there was no compulsion in this matter; the main issue is whether the banks honoured the undertaking which they gave to the Premiers. However, in New South Wales an automatic reduction of $22\frac{1}{2}$ per cent was required and three of the other States provided that, if advance rates were not brought down by October 1st, they would be reduced by proclamation. But this did not prove necessary. The Wallace-Bruce Committee reported in April, 1932 that the banks had "reduced interest on overdrafts by an average of about 14 per cent" in accordance with their agreement under the Premiers' Plan.\(^{(1)}\)

Information on rates prevailing for cheque-paying banks as a whole on the eve of the Premiers' Plan is scant, but for the year 1929/30 the rate for all cheque-paying banks varied between 7 and 8 per cent, having been increased by $\frac{1}{2}$ per cent on the two preceding years.\(^{(2)}\) Prior to the Premiers' Plan the Commonwealth Bank's maximum rate for bank overdrafts was $6\frac{1}{2}$ per cent. This rate had been effective since July, 1925. In July, 1931 the bank reduced it by one per cent to $5\frac{1}{2}$ per cent and the Sydney banks would appear to have taken similar action at about the same time, their maximum rate having fallen from $8\frac{1}{2}$ per cent in July, 1930 to 7 per cent in July, 1931.\(^{(3)}\) The Melbourne banks were slower to make downward adjustments. In September, 1931 the National Bank, for example, reduced its minimum overdraft

\(^{(1)}\) Ibid., pp.89-90 \(^{(2)}\) Finance Bulletins McLaurin, op. cit., p.228.
rate from $6\frac{3}{4}$ per cent to $6\frac{1}{2}$ per cent and again to 6 per cent in December.\(^{(1)}\)

All banks seem to have become increasingly mindful of the need for special concessional rates to primary producers. According to a statement by Mr. Heffer,\(^{(2)}\) (Acting Chief Inspector of the Bank of N.S.W.), the bank's ruling rate for farmers' overdrafts was reduced by $1\frac{1}{2}$ per cent on 1st July, 1931.

Despite the antipathy of some banks to an immediate fall in overdraft rates and their insistence that such falls depended very largely on fixed deposit rates and other costs over which they had no real control - despite these delaying tactics - the banks announced publicly that an average reduction of one per cent had been made from 1st October, 1931, and the Banking Commission in 1937 was apparently satisfied. Giblin points out, however, that the reduction was not from the level of June, 1931, as the Premiers expected, but from the peak in 1930.\(^{(3)}\)

(c) Successive reductions in fixed deposit rates.

To put successive reductions of fixed deposit rates in a true perspective, we may list here the rates which obtained prior to and as an immediate outcome of the Premiers' Conference. These are as follows:

\[(1)\text{Royal Commission on Banking: Minutes of Evidence, p.138}.\]
\[(2)\text{Evidence given before the Royal Commission on the Wheat Industry on 5th July, 1934, and reprinted in Cross Currents of Australian Finance (Angus & Robertson, 1936), pp.280-1.}\]
\[(3)\text{Giblin, op. cit., p.121}.\]
Rates in Force

<table>
<thead>
<tr>
<th>Period</th>
<th>From January, 1930 to June, 1931</th>
<th>26th June, 1931</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 months</td>
<td>41/2 per cent</td>
<td>31/2 per cent</td>
</tr>
<tr>
<td>6 months</td>
<td>43/4 per cent</td>
<td>33/4 per cent</td>
</tr>
<tr>
<td>12 months</td>
<td>5 per cent</td>
<td>4 per cent</td>
</tr>
<tr>
<td>24 months</td>
<td>51/4 per cent</td>
<td>41/4 per cent</td>
</tr>
</tbody>
</table>

Further reductions in fixed deposit rates occurred at the following dates:

(i) November, 1931  
(ii) March, 1932  
(iii) May/June, 1932  
(iv) November, 1932  
(v) February, 1933  
(vi) April, 1934  
(vii) August, 1934  
(viii) October, 1934  
(ix) December, 1934

With the exception of the adjustment in December, 1934, the Commonwealth Bank and the trading banks moved together with comparatively little delay in most cases. Beginning early in 1933 the Commonwealth Bank initiated all changes in deposit rates, with the exception of the rise in March, 1936. The changes in fixed deposit rates for the relevant period are as follows:
<table>
<thead>
<tr>
<th>Period for which rates operated</th>
<th>3 Months</th>
<th>6 Months</th>
<th>12 Months</th>
<th>24 Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929/30</td>
<td>4½%</td>
<td>4½%</td>
<td>5%</td>
<td>5½%</td>
</tr>
<tr>
<td>26/6/31 to 25/11/31</td>
<td>3½%</td>
<td>3½%</td>
<td>4%</td>
<td>4½%</td>
</tr>
<tr>
<td>26/11/31 to 6/3/32</td>
<td>3%</td>
<td>3½%</td>
<td>3½%</td>
<td>4%</td>
</tr>
<tr>
<td>7/3/32 to May/June 1932</td>
<td>2½%</td>
<td>3%</td>
<td>3½%</td>
<td>4%</td>
</tr>
<tr>
<td>May/June 1932 to 31/10/32</td>
<td>2½%</td>
<td>3%</td>
<td>3½%</td>
<td>3½%</td>
</tr>
<tr>
<td>1/11/32 to 6/2/33</td>
<td>2½%</td>
<td>2½%</td>
<td>3%</td>
<td>3½%</td>
</tr>
<tr>
<td>7/2/33 to 11/4/34</td>
<td>2%</td>
<td>2½%</td>
<td>2½%</td>
<td>3%</td>
</tr>
<tr>
<td>12/4/34 to 8/8/34</td>
<td>2%</td>
<td>2½%</td>
<td>2½%</td>
<td>2½%</td>
</tr>
<tr>
<td>9/8/34 to 10/10/34</td>
<td>1½%</td>
<td>2½%</td>
<td>2½%</td>
<td>23/4%</td>
</tr>
<tr>
<td>11/10/34 to 16/12/34</td>
<td>1½%</td>
<td>2%</td>
<td>2¼%</td>
<td>2½%</td>
</tr>
<tr>
<td>17/12/34 to 23/3/36</td>
<td>1%</td>
<td>1½%</td>
<td>2½%</td>
<td>2½%</td>
</tr>
<tr>
<td>24/3/36 to 23/1/40</td>
<td>2%</td>
<td>2½%</td>
<td>2½%</td>
<td>3%</td>
</tr>
</tbody>
</table>

The reduction in fixed deposit rates as from 27th November appears to have been taken as a matter of course and the banks all moved at once. This step aroused little interest at the time, partly because it was not unexpected and partly because other more weighty matters – such as policy on exchange rates – engaged the attention of the Board and the banks.

The reductions in March, 1932 also appear to have excited little comment.

In May, 1932, however, the banks did not move together. Three banks – the Wales, Bank of Australasia and the Union Bank announced a reduction from 3½ per cent to 3½ per cent for twelve
months deposits and from 4 per cent to 3½ per cent for two year deposits. In June these new rates became general. "While the majority of banks had thought it better not to reduce, first one institution acted individually, being followed by two others, the position being thus gradually disintegrated. Three large banks then decided to take the same step, not so much from conviction as for the sake of general unanimity and with the object of bringing about unison amongst bankers once more".

The next reduction of fixed deposit rates occurred in November, 1932. From about this date more interest appears to have been aroused on the question of cheap money. The trend was observed as a world-wide phenomenon and one which was natural enough in circumstances of economic depression and which would therefore have occurred in the absence of government interference. It was argued that as long as fresh enterprise was insufficient to absorb fresh savings, the tendency toward cheap money would continue. The increasing tendency to place money on fixed deposit was also regarded as a reason for the lower rates.

The trend of bank deposits and the ratio between interest-bearing and non-interest bearing deposits is as follows:

(1) Australasian Insurance and Banking Record, May 1932.
(2) Ibid., June, 1932.
(3) Ibid., November, 1932.
While deposits bearing interest rose by £12.5 million (or by 7 per cent) between June, 1929 and June, 1932, current account deposits in the same period fell by £20.7 million (or by 19 per cent).

Further reductions in interest rates on Commonwealth Treasury Bills and new fixed deposits in the Commonwealth Bank and the trading banks were announced towards the end of January, 1933 and took effect from 6th February. This marks an important turning point because it was the first time that the Commonwealth Bank took a definite lead in the reductions. A.C. Davidson was prominent in urging further reductions in interest rates and the rates standby expressed a willingness to follow a lead from the Commonwealth Bank "in further action to reduce interest rates along sound lines". (1) Judging from comments by other leading bankers about the same time, it would seem that these sentiments came to/widely shared.

Apart from the lead which the Commonwealth Bank could give by varying its own fixed deposit rates, the fixed deposit

(1) Ibid., February, 1933.
rates of the trading banks were said to be influenced by the rate on savings bank deposits, the yield on government securities, and other similarly secured avenues of investment. Many leading bankers when questioned before the Royal Commission on Banking as to the principle followed in fixing deposit rates replied that they were largely dependent on market conditions and the policy of the Commonwealth Bank and Commonwealth Savings Bank in fixing their own deposit rates.

In February, Davidson was urging a further reduction in fixed deposit rates.

"A further reduction of...say, half of one per cent would ease the interest rates on advances both by trading banks and other financial houses. The wool report demonstrates that further reductions in these rates would be a welcome relief.... The recent steady fall in the yields of Australian consols shows plainly that interest rates are weakening under the slow influence of a declining demand for money. It would give a fresh impetus to business if this tendency were accelerated by the Commonwealth Bank buying enough Australian consols to bring their yields nearer to the new rate on two year fixed deposits. This would obviate big transfers from fixed deposits to Government securities, and consolidate the beneficial effect of the lower rate
in promoting other forms of investment. With fixed
deposit rates, rates on advance would fall. The
lower rates at which money could be borrowed would
bring new fields of expenditure within the scope of
practicable business, and the way could be open for
longer term borrowing by Governments to the degree held
practicable and safe. 

Bank fixed deposit rates did not fall again, however,
until April, 1934, although the new rates of 2\textsuperscript{1/4}\%, 2\textsuperscript{1/2}\% and 2\textsuperscript{3/4}\%,
for 6 months, 12 months and 24 months deposits respectively were
regarded as being exceptionally low. The rate of 2\% for 3 months
maturity remained unchanged. This reduction was decided upon
by the directors of the Commonwealth Bank on 11th April and took
effect from the following day. The Sydney and Melbourne banks
came into line but the Melbourne banks moved with much reluctance
as "apart from the influence of the Commonwealth Bank and the
Sydney banks, which forced their hands, they were against a
reduction of rates under present conditions."\(^{(2)}\)

In August the Commonwealth Bank announced a reduction
in the rate of interest allowed on fixed deposits for 3 months
from 2 per cent to 1\textsuperscript{1/2} per cent and the Associated Banks made a
similar announcement on the following day. The new rates took
effect from 9th August.

\(^{(1)}\) \textit{Ibid.} \hspace{1cm} \(^{(2)}\) \textit{Ibid.}, April, 1934.
On 10th October, 1934 it was announced by the Chairman of the Commonwealth Bank that the Board had decided to make a further reduction of $\frac{1}{2}\%$ in the rate of interest allowed on fresh fixed deposits for 6, 12 and 24 months. The new rates, taking effect on 11th October, were $1\frac{1}{2}\%$, $2\%$, $2\frac{1}{2}\%$ and $2\frac{3}{4}\%$. The two Sydney banks reduced their rates similarly as from 12th October. The Associated Banks in Victoria took the same step but with some feelings of reluctance as is indicated by the following statement:

"The Victorian banks, without in any way reflecting upon the decision of the Commonwealth Bank Board, would have preferred to keep the old rates stable for some time longer. They hold the view that frequent alterations are somewhat upsetting to the business community...until comparatively recently the trading banks always quoted higher rates for term deposits than the Commonwealth Bank, but today it will be seen that they are now all in line." (1)

The new rates were slightly lower than those reached in the cheap money era of the 1890's. In September, 1896, three leading banks reduced their rate for 12 months fixed deposits from 3 per cent to $2\frac{1}{2}$ per cent and for 6 months deposits from $1\frac{1}{2}\%$ to $1\%$ in Victoria, South Australia and Tasmania while the rest of the banks continued to allow 3 per cent for 12 months fixed deposits. Rates remained low for a number of years after 1896, as the effect of droughts held back enterprise.

(1) Ibid., October, 1934.
The final downward adjustment in fixed deposit rates was announced by the Commonwealth Bank in December. It was for \( \frac{1}{2} \) per cent on 3 months and 6 months maturities, and took effect from 17th December. The trading banks, however, decided not to follow on this occasion.

(d) **Successive reductions in advance rates**

Apart from the one per cent reduction which was generally made effective by 1st October, 1931, announcements of reductions in advance rates of private trading banks were made on four successive occasions - in August, 1932, March, 1933, May, 1933 and July, 1934. As noted earlier, however, these announcements are only part of the story as there appear to have been considerable variations from time to time in rates charged by each bank to different classes of borrowers according to ability to pay and the degree of essentiality of the industry concerned. The provision of finance was of course influenced by other considerations besides the interest charge.

Changes in the maximum overdraft rate of the Commonwealth Bank to this period were as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>New Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>July, 1932</td>
<td>5%</td>
</tr>
<tr>
<td>January, 1933</td>
<td>4(\frac{3}{4})%</td>
</tr>
<tr>
<td>April, 1934</td>
<td>4(\frac{1}{2})%</td>
</tr>
<tr>
<td>November, 1934</td>
<td>4(\frac{1}{4})%</td>
</tr>
</tbody>
</table>
When the trading banks increased their advance rates after March, 1936, the Commonwealth Bank did not raise its advance rates and the 4\(\frac{1}{2}\) per cent rate was in fact retained till August, 1932.

No reductions were announced by the private banks as a whole between October, 1931, until the end of August, 1932, although an all-round reduction had been mooted for some months and the Commonwealth Bank had acted in July. In this period there were of course, some downward moves by individual banks using their own discretion and with special reference to the requirements of the more necessitous cases. In July, 1932, the Sydney banks reduced their maximum rate from 7 per cent to 6 per cent\(^{(1)}\) while in September the National Bank reduced its minimum rate from 6 per cent to 5\(\frac{1}{2}\) per cent - about \(\frac{1}{2}\) per cent higher than that ruling for the Sydney banks. The announcement by the Melbourne banks at the end of August stated that the reductions would take effect not later than 1st October, 1932.\(^{(2)}\)

The general fall in advance rates is brought out by the fact that at 30th June, 1935, there were no loans above 6\(\frac{1}{2}\) per cent and that over 80 per cent of advances were carrying interest charges of less than 5 per cent, although the predominant rate was about 5 per cent.\(^{(3)}\) During 1934 and 1935 two of the banks quoted a maximum rate of 5 per cent on all advances.\(^{(4)}\)

\(^{(1)}\) McLaurin, op. cit., p.228.
\(^{(2)}\) Australasian Insurance and Banking Record, September 1932
\(^{(3)}\) Cf. Report of the Royal Commission on Banking, Table II, p.315.
\(^{(4)}\) Ibid., p.92.
primary producers are concerned, the Associated Banks have
decided upon a maximum charge of 5 per cent per annum. (1)
(This had been reduced to 5½ per cent in May, 1933). The new
rate operated from 1st July. There is also evidence that many
banks charged no more than 4½ per cent where ability to pay was
doubtful and in extreme cases interest charges were suspended. (2)

Mr. Davidson welcomed the reduction announced by the
Commonwealth Bank on 21st January, 1933, to a maximum of 4½ per
cent for bank overdrafts. He hoped it was the precursor of
further action by the Commonwealth Bank in "giving a lead to and
assisting the trading banks in reducing their rates of
interest." (3)

As from 1st July, 1934, the Bank of N.S.W. and C.B.C.
of Sydney announced that the maximum rate of interest on bank
overdraft would be 5 per cent compared with 6 per cent previously.
The minimum was also reduced from 5 per cent to 4½ per cent
whereas the Melbourne banks would appear to have retained the 5
per cent rate. The Commonwealth Bank's maximum rate was reduced
to 4½ per cent in April, 1934 and 4¼ per cent in November.

(e) Reductions in Savings Bank deposit rates

From July, 1931 to January, 1935 the Commonwealth
Savings Bank reduced its maximum deposit rate five times. Other

(1) Announcement by Chairman of Directors of Associated Banks
of Victoria on 19th June, 1934, and reprinted in Cross
(2) Cf. Mr. Heffer's statement on 5th July, 1934.
(3) Australasian Insurance and Banking Record, February, 1933.
savings banks made a similar number of adjustments. At 30th June, 1930, both the Commonwealth Savings Bank and the State Savings Bank of Victoria allowed a maximum of 4 per cent on current deposits. In December, 1934 both institutions announced that as from 1st January, 1935 the rate of interest allowed on deposits up to £500 was to be 2 per cent. Thus in a matter of about 5 years the rate had been cut by half. In the same period the Savings Bank of South Australia reduced its maximum rate from 4½ per cent to 2½ per cent while the Hobart Savings Bank and the Launceston Bank for Savings reduced theirs from 4½ per cent to 2½ per cent.

Two of the early reductions in the deposit rate of the Commonwealth Savings Bank were announced concurrently with a reduction in the maximum overdraft rate. This comparison, together with successive reductions made by the State Savings Bank of Victoria, are given in the following table:

<table>
<thead>
<tr>
<th>Date from which new rates operated</th>
<th>C.S.B. Deposit Rate</th>
<th>S.S.B. of Victoria Deposit Rate</th>
<th>Commonwealth Bank Overdraft Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>July, 1925</td>
<td>6½</td>
<td></td>
<td></td>
</tr>
<tr>
<td>October, 1928</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>July, 1931 (c)</td>
<td>3</td>
<td></td>
<td>5½</td>
</tr>
<tr>
<td>August, 1931 (c)</td>
<td></td>
<td>3½</td>
<td></td>
</tr>
<tr>
<td>December, 1931 (c)</td>
<td></td>
<td>3¼</td>
<td></td>
</tr>
<tr>
<td>April, 1932 (c)</td>
<td></td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Date</td>
<td>C.S.B.</td>
<td>S.S.B. Vic.</td>
<td>C'wealth Bank</td>
</tr>
<tr>
<td>--------------</td>
<td>--------</td>
<td>-------------</td>
<td>---------------</td>
</tr>
<tr>
<td>July, 1932</td>
<td>$2\frac{3}{4}$</td>
<td></td>
<td>5</td>
</tr>
<tr>
<td>December, 1932 (c)</td>
<td>$2\frac{1}{2}$</td>
<td>$2\frac{3}{4}$</td>
<td></td>
</tr>
<tr>
<td>January, 1933</td>
<td></td>
<td></td>
<td>$4\frac{3}{4}$</td>
</tr>
<tr>
<td>March, 1933 (c)</td>
<td></td>
<td>$2\frac{1}{2}$</td>
<td></td>
</tr>
<tr>
<td>April, 1934</td>
<td></td>
<td></td>
<td>$4\frac{1}{2}$</td>
</tr>
<tr>
<td>June, 1934 (c)</td>
<td>$2\frac{1}{4}$</td>
<td>$2\frac{1}{4}$</td>
<td></td>
</tr>
<tr>
<td>November, 1934</td>
<td></td>
<td></td>
<td>$4\frac{1}{2}$</td>
</tr>
<tr>
<td>January, 1935 (c)</td>
<td>$2$</td>
<td></td>
<td>2</td>
</tr>
</tbody>
</table>

(c) Adjustments effective from 1st of Month.

The Commonwealth Savings Bank was responsible for initiating reductions in savings bank deposit rates during this period. According to McLaurin\(^{(1)}\) the co-operation of the Commonwealth Savings Bank was of material assistance in bringing down fixed deposit rates although the Royal Commission on Banking\(^{(2)}\) concluded that there was very little evidence to suggest that in this period great use was made of savings bank activities for the purpose of regulating credit.

The trading banks, however, were apparently aware of the potential control over credit which the Commonwealth Bank possessed by virtue of its extensive interest in the savings bank field. This power is exemplified in the words of Mr. Davidson:

\(^{(1)}\) *op. cit.*, p.231 \(^{(2)}\) *op. cit.*, pp.71-2.
"It is possible that trading banks may fear the loss of deposits to the Savings Bank or through the investment in Government securities of money previously deposited. The Commonwealth Bank holds the key to all these doors. By purchasing Government securities itself the Central Reserve Bank can, by an almost negligible expansion of Central Bank credit, bring down the yield on such securities and make them less attractive as an alternative to the fixed deposit of money. By its control of the Commonwealth Savings Bank it (i.e., the Commonwealth Bank) may almost be said to dominate the Savings Bank situation. It can thus give a lead to the trading banks and the other Savings Banks in declaring a reduction of fixed deposit rates, a lead which, in their own interests, the trading banks are sure to follow." (1)

The trend for this period in the deposit rates of all Savings Banks is as follows: (2)

(1) Australasian Insurance and Banking Record, February, 1933.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1930</td>
<td>4</td>
<td>4</td>
<td>4½</td>
<td>4½</td>
<td>4½</td>
</tr>
<tr>
<td>1931</td>
<td>4</td>
<td>4</td>
<td>4½</td>
<td>4½</td>
<td>4½</td>
</tr>
<tr>
<td>1932</td>
<td>3</td>
<td>3</td>
<td>3½</td>
<td>3</td>
<td>3½</td>
</tr>
<tr>
<td>1933</td>
<td>2½</td>
<td>2½</td>
<td>3</td>
<td>2¾</td>
<td>2¾</td>
</tr>
<tr>
<td>1934</td>
<td>2½</td>
<td>2½</td>
<td>3½</td>
<td>2¾</td>
<td>2¾</td>
</tr>
<tr>
<td>1935</td>
<td>2</td>
<td>2</td>
<td>2¾</td>
<td>2¾</td>
<td>2¾</td>
</tr>
</tbody>
</table>

(f) **Movement of Bond and Share Prices**

In 1928/29 the yield on Australian Commonwealth Loans (all issues) was 5.35 per cent. In 1929/30 it increased to 5.71 per cent. In 1930/31 the bond market was disorganized but apart from the crisis period of March-June, 1931, the average was about 7 per cent. The Premiers' Plan provided for the conversion of the internal debt to securities bearing interest at the rate of 4 per cent per annum but this rate was not actually realized in the market until September, 1932, and no cash was raised from the loan market in this period. The yield on all issues in 1931/32 averaged 5 per cent.\(^{(1)}\)

In the next three financial years the yield on Commonwealth Securities continued to fall so that in 1934/35 the average for all issues was 3.32 per cent.\(^{(2)}\)

A year by year analysis of the behaviour of the bond yields during the cheap money era is undertaken in Part IV and

\(^{(1)}\) Cf. Monthly Review of Business Statistics, No. 4
\(^{(2)}\) Ibid.
the nature of the statistical information available is set out in Part III. The broad movement of Australian share prices during this period is also given in Part III.

(g) Reductions in Treasury bill rates

In the period under review Treasury bills were discounted at the following percentage rates:

<table>
<thead>
<tr>
<th>Date</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>October, 1930</td>
<td>6.0</td>
</tr>
<tr>
<td>July, 1931</td>
<td>4.0</td>
</tr>
<tr>
<td>November, 1932</td>
<td>3.50</td>
</tr>
<tr>
<td>January, 1933</td>
<td>3.25</td>
</tr>
<tr>
<td>February, 1933</td>
<td>2.75</td>
</tr>
<tr>
<td>June, 1933</td>
<td>2.50</td>
</tr>
<tr>
<td>April, 1934</td>
<td>2.00</td>
</tr>
<tr>
<td>October, 1934</td>
<td>1.75</td>
</tr>
</tbody>
</table>

The first issue of Treasury bills was made in 1927 but were initially issued strictly for lag of revenue purposes and paid off within the financial year. In 1929/30, however, they were issued as a means of providing funds to meet revenue deficits as well as loans for public works. In the three years to 30th June, 1933, Treasury bills to the extent of £48 million had been issued, £28 million being held by the trading banks at that date and £20 million by the Commonwealth Bank. There was no further rise in the volume of bills until World War II.

This substantial increase in Treasury bills was of course, directly related to the cessation of overseas borrowing
and the poor response to internal loan issues, although as the loan market improved efforts were made to curtail further issues and to fund old ones. Resort to Treasury bill finance helped the banks to tide over a difficult period by offsetting the effects on liquidity of the fall in London funds and advances. It also assisted Governments to some extent. In 1930/31 and 1931/32, for example, Treasury bills represented about 14 per cent and 25 per cent respectively of total funds employed by governments.

The Treasury bill discount rate is, of course, an administered rate. As shown in the table, it was reduced by 2 per cent soon after the Premiers' Plan and by a further one half per cent in November, 1932. A number of further downward adjustments were made in succeeding years and in January, 1935 the rate was fixed at 1.75 per cent. In June, 1931 the Commonwealth Bank gave an assurance that it would meet bills at maturity and this had the result of making the bills more and more attractive to banks as a suitable form of investment for their liquid funds. The demand for Treasury bills in that sense rose - and certainly after 1932, faster than supply. The rate paid on Treasury bills therefore fell faster than most other rates. While the Treasury bill rate fell from 3 1/2 per cent to 1 3/4 per cent between November, 1932 and January, 1935 the fall in advance rates for the trading banks was from about 5 1/2 per cent to 4 1/2 per cent. (1)

(1) Giblin, op. cit., p.156n.
The Treasury bill rate was in no way a parallel instrument for influencing other interest rates on the lines of the Bank Rate in the United Kingdom although it is conceivable that it could have performed such a function had there been an active open market in bills. Despite the Commonwealth Bank's power to alter the discount rate at will, this power is an arbitrary one and does not in itself either induce other interest rates to change or depend necessarily on such changes. Its main significance is found to lie in its relation to the profits of the trading banks.

The rate paid on Treasury bills was principally a means of assisting the banks. It helped them at a time when their liquid resources were increasing but when they were experiencing acute difficulty in expanding loans. There is one sense, however, in which it may have been relevant to the structure of interest rates and that concerns the willingness of the banks to reduce overdraft rates which were generally less sensitive to market conditions than fixed deposit rates. In the thirties fixed deposit rates appear to have been highly sensitive to market influences and variations in the ratio of interest - bearing to non-interest bearing deposits were symptomatic of important changes in the economy. There was also a tendency on the part of the banks to preserve a fairly constant margin between advance and deposit rates. On the face of it, therefore, it would appear that market pressure for lower rates,
given the maintenance of this customary margin, which was accompanied by a reduction in the Treasury bill discount rate, could adversely affect bank profits and make the banks less willing to effect a reduction in overdraft rates. It follows, that unless the authorities desired an alteration in this margin, which is exceedingly improbable in the circumstances, they would hesitate before altering the rate, unless of course more bills were available to be taken up by the banks. This is one sort of limitation which may have existed to prevent a too rapid fall in the rate.

In practice, therefore, the Treasury bill discount rate may have been less flexible than is commonly imagined; it may have been strongly influenced by market conditions and banking rigidities. On the other hand, it was very high before the depression and fell faster after 1931 than did other rates. This was no doubt due in some measure to the growing attractiveness of bills to the banks as a form of investment which overtaxed the available supply. Despite the comment in the above paragraph there is virtually no evidence of the Treasury bill discount rate having been a significant factor in the structure of interest rates in the 1930's. It was not an initiating force in the market.

(h) **Reductions in Other Interest Rates**

Other interest rates which may claim special attention in this section are :-
(a) rates of interest charged on mortgage loans by the Savings banks;
(b) rates on Commonwealth Savings Bank loans to Local Government authorities;
(c) maximum rates charged by the Commonwealth Bank for Rural Credit advances.

The course of (a) and (b) were greatly influenced by changes in the rate payable on savings bank deposits which as we have seen was in turn influenced by fixed deposit rates and the prevailing market price of government securities.

The rate payable on Rural Credit advances was probably more autonomous in character. It was reduced by one per cent in July, 1931 and further successive reductions took the rate to 3½ per cent in July, 1934 - a very significant fall in four years. The changes between 1925 and 1940 were as follows:

<table>
<thead>
<tr>
<th>Date from which new rate operated</th>
<th>Rural Credits Department - Commonwealth Bank (Maximum Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>October, 1925</td>
<td>6½%</td>
</tr>
<tr>
<td>March, 1927</td>
<td>6%</td>
</tr>
<tr>
<td>January, 1929</td>
<td>5½%</td>
</tr>
<tr>
<td>July, 1930</td>
<td>6%</td>
</tr>
<tr>
<td>July, 1931</td>
<td>5%</td>
</tr>
<tr>
<td>July, 1932</td>
<td>4½%</td>
</tr>
<tr>
<td>January, 1933</td>
<td>4½%</td>
</tr>
<tr>
<td>July, 1933</td>
<td>4%</td>
</tr>
</tbody>
</table>
Date | Maximum Rate
--- | ---
July, 1934 | $3\frac{3}{4}$
July, 1940 | $3\frac{1}{2}$

Source: Commonwealth Bank Annual Report, 1956/57

Rates of interest charged on mortgage loans by the various savings banks together with the rate on credit foncier housing loans of the State Savings Bank of Victoria, which, however, have become important only in recent years, are set out below. The Commonwealth Savings Bank did not seek mortgage loans during most of this period.

<table>
<thead>
<tr>
<th>Year ended 30th June</th>
<th>State Savings Bank of Vic.</th>
<th>Mortgage Loans (a)</th>
<th>State Savings Bank of Victoria Credit Foncier Loans (b)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Savings</td>
<td>Hobart Savings</td>
</tr>
<tr>
<td>1929</td>
<td>6 - $6\frac{1}{2}$</td>
<td>$6\frac{1}{2}$ - 7</td>
<td>6</td>
</tr>
<tr>
<td>1930</td>
<td>7</td>
<td>$6\frac{1}{2}$ - 7</td>
<td>6</td>
</tr>
<tr>
<td>1931</td>
<td>6</td>
<td>$6\frac{1}{2}$ - 7</td>
<td>6</td>
</tr>
<tr>
<td>1932</td>
<td>$5\frac{1}{2}$</td>
<td>5 - 7</td>
<td>5</td>
</tr>
<tr>
<td>1933</td>
<td>5</td>
<td>5 - $5\frac{1}{2}$</td>
<td>$4\frac{1}{2}$</td>
</tr>
<tr>
<td>1934</td>
<td>$4\frac{1}{4}$ - $4\frac{1}{2}$</td>
<td>$4\frac{1}{2}$ - $5\frac{1}{2}$</td>
<td>$4\frac{1}{4}$</td>
</tr>
<tr>
<td>1935</td>
<td>$4\frac{1}{4}$ - $4\frac{1}{2}$</td>
<td>$4\frac{1}{2}$ - 5.</td>
<td>$4\frac{1}{4}$</td>
</tr>
<tr>
<td>1936</td>
<td>$4\frac{1}{4}$</td>
<td>$4\frac{1}{2}$ - 5</td>
<td>$4\frac{1}{4}$</td>
</tr>
</tbody>
</table>

(a) Report of the Royal Commission on Banking, Table 25, p.335.

(b) Report of the State Savings Bank of Victoria for year ending 30/6/55. Outstanding loans during this period were only about £5 million for houses and...
£13 million for dwellings and shops. New Loans advanced fell very sharply after 1930 and in the case of loans for dwellings and shops did not show any appreciable recovery until 1936. Housing loans however rose sharply in 1933.

The rate of interest charged on loans to Local Government authorities by the Commonwealth Savings Bank was reduced by one per cent in 1932. Successive reductions are set out in the following table:

<table>
<thead>
<tr>
<th>Year to 31st December</th>
<th>C.S.B. Loans to Local Government Authorities (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930</td>
<td>5 7(^{\text{r}}) 6(^{\text{i}})</td>
</tr>
<tr>
<td>1931</td>
<td>6</td>
</tr>
<tr>
<td>1932</td>
<td>5</td>
</tr>
<tr>
<td>1933</td>
<td>4 4(^{\text{i}}) 4(^{\text{r}})</td>
</tr>
<tr>
<td>1934</td>
<td>3 3(^{\text{i}}) 4(^{\text{r}})</td>
</tr>
<tr>
<td>1935</td>
<td>3 2(^{\text{i}}) 4 4(^{\text{i}}) 3 3(^{\text{i}})</td>
</tr>
<tr>
<td>1936</td>
<td>4 4 3(^{\text{i}}) 3 3(^{\text{i}})</td>
</tr>
</tbody>
</table>

(a) Commonwealth Bank Annual Report, 1956/57. This is a varying rate which increases or decreases with the rate paid to depositors. Cf. Commonwealth Bank Statistical Bulletin, Banking Supplement, May, 1954.
Section 2: Explicit Motives for Adoption of Cheap Money Policy

This Section is divided into the following subsections, viz.,:

(a) Introduction
(b) The Early Keynesian Argument for Cheap Money
(c) The Principal Arguments used for Cheap Money
   (i) Distributional argument
   (ii) Budgetary argument
   (iii) Cost Reduction argument
(d) Reasons for Choosing the Direct Method of Reducing Interest Rates in 1931.

(a) **Introduction**

The era of cheap money began during the Great Depression. In Australia, as elsewhere, interest rates were brought down by measures which formed part of wider steps to deal with the economic catastrophe. Under the influence of later theory we might be inclined to suppose that the object of these measures was to stimulate recovery by reducing interest rates and thereby encouraging investment. In other words, we might be tempted to think that the early Keynesian argument weighed heavily in the minds of those advocating cheap money.

Actually there is very little evidence that this argument for cheap money played a significant part in Australia at the time. We find it in some of Copland's writings, and
also Davidson's. At the end of 1933 Copland declared that an era of very low interest rates was necessary to restore investment to a position where current savings could be absorbed. In 1931 Davidson traced out the early Keynesian argument and claimed that it supported the sequence of measures actually taken in Australia. In Davidson's view unemployment was due to low profit expectations which could only be reversed by a reduction in interest rates. However both writers introduced an important qualification: The condition for stimulating recovery along these lines was the avoidance of inflationary finance and a conscious effort to restore balanced budgets.

(b) The Early Keynesian Argument for Cheap Money

In the Treatise on Money published in 1930, Keynes maintained that a major cause of the slump had been the pursuit of policies (notably the return to gold at the old parity and the Reparation payments) which had raised the natural rate of interest to a level which could not be justified by the underlying economic situation. A substantial fall in the long-term rate of interest was a necessary condition for economic recovery.

According to Keynes, the rate of interest was an appropriate means of ensuring an approximate equality between the

---

(1) D.B. Copland: Australia in the World Crisis 1929/33 (C.U.P. 1934), pp.159-63.
value of savings and investment. When this was attained the rate of interest was said to be at its "natural" level (though not necessarily the right level), and prices would be fairly stable. Whenever a divergence occurred between saving and investment, there was also a divergence between the market and the natural rate of interest.

At that time Keynes was of the opinion that the monetary authorities could exercise effective control over the rate of investment through appropriate variations of market rates of interest. To meet a fall in prices, he strongly advocated a fall in the rate of interest as this would raise the value of capital goods and thereby increase investment and employment. The basic assumption was that the attractiveness of new investment depends upon prospective income relatively to the rate of interest. A cheap money policy would also reduce the rate of saving and increase the rate of profit for those engaged in the production of consumption goods.

This argument appears to have had few close adherents in the early 1930's, not because of any failure to understand the argument or to grasp the importance of a revival in investment as is suggested by McLaurin,(1) but because the short-run problem was regarded as being essentially a matter of restoring confidence through a progressive approach to balanced budgets. A fall in interest rates could help there. It is

(1) op. cit., p.96.
true that the Copland Committee, while stressing the importance of cushioning the fall in national income by spreading the loss equitably, declared that of "even greater importance" than the relief to budgets resulting from interest reductions "would be the indirect effects on industry brought about by a general reduction in interest rates." \(^{(1)}\) However, these "indirect effects" were not elaborated for the reason that the Committee's terms of reference related exclusively to the immediate problem of restoring confidence and spreading the income loss equitably. \(^{(2)}\)

Although after the Premiers' Plan we can find some scattered references to suggest that low interest rates were considered important because of the direct stimulus they would give to investment, the argument was never fully explained and was never the central theme. Indeed there is no evidence of a cheap money policy being thought of as a continuing objective before 1933.

Even the arguments of Copland and Davidson mentioned earlier rested on the assumption that a Plan would be evolved to create a favourable atmosphere for an expansion of investment. The reduction in interest rates provided for under the Premiers' Plan was therefore inspired by other factors. As a rule the

\(^{(1)}\) Battle of the Plans, op. cit., p. 96.
\(^{(2)}\) Cf. L.F. Giblin, The Growth of a Central Bank. Take for example the following passage on page 102: "... The report studiously abstained from any discussion of future policy for the restoration of production and employment. It was concerned with the immediate problem of restoring confidence..."
banks were opposed to low interest rates and the Commonwealth Bank Board avoided the issue as much as possible. The Keynesian view that central banks could exercise effective control over the level of investment by appropriate variations in rates of interest can be contrasted with the Commonwealth Bank Board's insistence that interest rates were set by factors outside its control. The Board did not seem very interested in the fall in interest rates and generally considered the matter from the point of view of the effect on government finance.\(^{(1)}\)

Towards the end of 1933 Copland declared that a lower rate of interest was the only effective means of channelling savings into investment that would involve new spending and employment.\(^{(2)}\) Indeed he went as far as to say that "any proposal that would not offer a fall in the long-term rate of interest had little merit as a contribution to recovery."\(^{(3)}\) The great danger of an expansionary monetary policy, however, was that it would raise interest rates and therefore impose an additional strain on the Budget. This would increase the deficit and require an increasing amount of new credit and currency to be created for balancing the budgets in successive years. In these circumstances it was argued that an inflationary policy would soon get out of hand and bring about a collapse of the currency.\(^{(4)}\) Until confidence was restored

\(^{(1)}\)Ibid., pp.116-7  \(^{(2)}\)D.B. Copland, op. cit., pp.159-163  
\(^{(3)}\)Ibid., p.63  \(^{(4)}\)Ibid., pp.62-3.
there was little hope of bringing interest rates down and therefore little prospect of economic recovery. (1)

Copland's view therefore was that the early Keynesian argument for cheap money, while perfectly valid in normal times, was of little more than academic interest in 1931. Davidson likewise thought that recovery rested on a fall in interest rates because of the fillip it would give to investment but considered that this would only be jeopardized by an inflationary monetary policy. Given greater stability in the public finances, low interest rates must stimulate recovery and arrest the drift in the price level. (2)

(c) The Principal Arguments Used for Cheap Money

We see from the preceding section that the course of policy in 1931-33 was overshadowed by the need to restore confidence, and, what was then believed essential to it, a return to balanced budgets. The argument for cheap money hinged very largely on this connection. Interest rates were not reduced in the Premiers' Plan because anyone thought of a direct connection with the level of investment; increased private investment was inconceivable without budget equilibrium and the return of confidence. There were three principal reasons why a fall in interest rates was considered desirable in 1931.

In the first place, a fall in interest rates was an appropriate method of adjusting sacrifices between income

groups and of enabling the Premiers' Plan to be acceptable to all parties. In short it was a means of spreading the income loss, not so much to redistribute income as to restore the pre-depression distribution. The argument was that holders of fixed money claims should make a contribution to the loss of real income. This is a social rather than an economic argument. It rests on a value judgment as to whether in the circumstances it was right and just for rentiers to share in the burden despite the nature of contracts that had been entered into. However, it was a question to which economists had to turn their attention in devising a plan of economic recovery. Wages had been cut, farmers' incomes reduced and company profits had fallen sharply; only those in receipt of fixed incomes had not suffered directly from the Depression and many large holders had gained from the rise in the value of money.

In the crisis conditions of 1931 prompt agreement on a plan of action was essential. A 22½ per cent reduction in income from government bonds was a means of securing such an agreement and the proposal therefore assumed a place of first importance at the time. It appealed in point of equity. Since World War II we have acquired a wide range of weapons for affecting the distribution of income, progressive income tax being by far the most important. There is still a school of thought which plugs for low interest rates on distributional
grounds but chiefly because of these new weapons and the persistence of inflation since the war, these views have not been able to regain their former appeal or importance in the general scheme of things.

The argument advanced in 1931 appeals as a sensible one given the circumstances/the absence of techniques which we now possess after nearly two decades of the Welfare State.

The argument which made the deepest impression in the early 1930's was that an immediate fall in interest rates was desirable on budgetary grounds. In view of the widespread belief at the time that the restoration of confidence hinged very largely on the attainment of budgetary equilibrium, this argument was naturally an important one. A fall in interest rates, so long as it was not accompanied by an expansion of central bank credit, would assist all governments to balance their budgets and therefore help restore confidence. It was essentially a short-run problem. Once governments had got their houses in order a further fall in interest rates might have other beneficial effects, including the ability to raise substantial sums from the loan market.

Given the balanced budget philosophy of the day, this argument for cheap money was sound. The conversion operation made a significant contribution to balancing budgets in 1931/32.
The saving was approximately £5.5 million and the actual deficit about £18 million.\(^{(1)}\)  The benefit of course, extended to future years also.

With governments now pledged to budget for deficits or surpluses according to the state of the economy, the argument as used in 1931 is no longer important. Fixed interest payments have grown at a considerably slower pace than have other items of government expenditure; in 1931 however, the interest cost was high in relation to the total budget expenditure of Commonwealth and States so that it was worth while cutting this item back along with the other more variable ones.

The third argument was that lower interest rates would speed recovery by encouraging the farmer to expand output more than he would otherwise have done. This was expected to afford some early relief to the balance of payments.

In other words it was assumed that interest was a significant element of cost to the primary producer and that the export industries were highly sensitive to changes in costs and prices.

We would not accept either of these assumptions today partly because the centre of gravity has shifted from price to income effects.

In 1931 it was widely believed that recovery must begin in the rural sector.\(^{(2)}\) The Premiers' Plan was framed on


the assumption that costs must come down. This particular argument, however, was expressed vaguely and no attention was given to elasticities to ascertain just how much difference a change in interest rates would be likely to make to the volume of export production. It was assumed without proper enquiry that the export producer was highly sensitive to a change in his price-cost ratio or profit margin. We now know that a fall in the margin is just as likely to induce an expansion of rural production as is a rise in the ratio. When a producer has no control over his price, and there is either a fall in this price or a rise in costs, his behaviour is prone to be directed towards maximizing income in the short run by increasing output.

The prevailing view now is that the direct cost effects on industry of changes in interest rates are not very important. The Australian economy is heavily dependent on the level of world prices. A fall in export prices necessitates internal readjustments which now take the form of fiscal-monetary restraints (together with import controls) aimed at regularizing the flow of money demand and not cost adjustments which could only succeed if production were highly responsive to price changes. In the case of Australia's principal exports there is a marked lack of such responsiveness.
(d) Reasons for Choosing the Direct Method of Reducing Interest Rates in 1931

I have indicated how the Premiers' Plan started the ball rolling in the direction of cheap money and what the main motives of those advocating cheap money were. Brief reference may now be made to the question of why this method of bringing down interest rates was chosen in preference to others such as open-market operations and the creation of credit envisaged under Theodore's Plan.

The Commonwealth Bank made very little attempt to support the bond market during the depression. Giblin says that up to 1936 open-market operations of the central bank were relatively small and somewhat inconsistent, so that no definite policy is indicated by them.\(^{1}\) Open market operations were rejected because of the nature of the market for government securities and a feeling that the Bank's assets should be conserved to meet emergencies.\(^{2}\)

The "direct" method of reducing interest rates came about largely through a fear that other methods would produce inflation and therefore hinder a quick reduction in interest rates. In 1931 an issue of Treasury Bills to cover deficits was identified with inflation.\(^{3}\) In September, 1930, three leading economists recommended an expansionist monetary policy based upon the purchase of government securities by the central

---

\(^{1}\) Op. cit., p.183 \(^{2}\) McLaurin, op. cit., p.227
\(^{3}\) c.f. D.B. Copland, op. cit., pp.62-3
bank "with a view to maintaining the general level of prices. (1) However, in May, 1931, this course was rejected on the ground that the budgetary situation had become more serious.

The Copland Committee referred briefly to other methods of exacting a contribution from bondholders. One of these was to raise the price level by an expansion of central bank credit but this was rejected in the belief that it would destroy confidence in the currency (2) and that "with such a loss of confidence both interest rates and exchange rates would rise." (3) The increase in interest rates would be damaging to conversion operations and impose an additional strain on the budget. The other method cited was a further tax on income from property but the objection there was it would not reduce interest rates and would therefore not benefit the wage-earner paying off a house and other debtor classes.

Theodore considered that his plan for a fiduciary issue of Treasury notes would cause a fall in interest rates while the Copland Committee believed the result would be a rise in interest rates. We may briefly comment on this.

The Theodore Plan may well have increased interest rates, or at least made an early fall more difficult. This is

(1) Memorandum submitted to the Treasurer and signed by Giblin, Dyason and Copland, Ibid., pp.66-7
(2) W.R. McLaurin, op. cit., p.81.
(3) Battle of the Plans, op. cit., pp.92-3.
because of the highly unfavourable political and economic climate and the deeply rooted conviction that any policy which departed from the ideal of a balanced budget was inflationary, and as such prejudicial to what was then regarded as fundamental — a reduction of costs. The Plan may have had an adverse affect on public opinion because it was identified with inflation and more particularly because it was a planned expansion of credit.

A measure of credit expansion through the issue of Treasury bills did in fact taken place in 1930/31 and 1931/32 without a sharp rise in liquidity preference. In 1931/32 extra-budgetary finance to the extent of £9 million was found without giving rise to inflation on further loss of confidence. But this received comparatively little publicity and the Commonwealth Bank strenuously resisted the trend. (1)

Copland in reviewing depression policy in 1933 claimed that the desire of the inflationists to control and reduce interest rates was inconsistent with their proposals. This was because they underestimated the effect of their proposals on public confidence. (2) Monetary and banking policy was not enough: the structure of production must be considered along with the effect on public opinion of a vigorous monetary policy. The Australian experiment (i.e., the Premiers' Plan) succeeded because it gave attention to both these limiting influences. (3)

---

(1) C.f. Giblin op. cit. pp. 152-3
(2) C.f. Copland, op. cit., p.63
It is rather difficult to say how much credit creation would have resulted from Theodore's Plan. The fiduciary issue was to be limited to £18 million but it was also envisaged that the Commonwealth Bank would need to make heavy purchases of securities "in order to get the average yield back to 5 per cent."(1) Future government loans were to be issued at a rate not exceeding 5 per cent and interest on bank overdrafts was to be reduced correspondingly.

The course of events and prevailing views on public finance suggest that the market would have reacted strongly against such a plan. At the end of 1930 there was a serious loss of confidence and interest rates were rising. A year later the economy was still very vulnerable and an expansionary monetary policy would most likely have intensified the demand for liquidity. The Plan was heavily suspect and if it had failed to restore confidence it is unlikely that it would have reduced interest rates at all quickly.

Given the preoccupation in 1931 with balancing both government and oversea accounts, an expansionary monetary policy which threatened the stability of the price level was one likely to exert a downward pressure on the marginal efficiency of capital schedule. In the absence therefore of the prospect of a fall in the rate of interest, the level of investment would have fallen. The policy which the investor expected and which would, in his opinion, create a more favourable investment

(1) Battle of the Plans, op. cit., p. 2.
climate was one offering the prospect of an early fall in the internal cost level. As long as the right policy was regarded as being of this nature, anything which ran directly counter to it could scarcely have enjoyed a favourable reception, in the first instance at any rate. A policy of monetary expansion which left little prospect of achieving a balanced budget\(^{(1)}\) would almost certainly have been interpreted as an inflationary policy.

The fundamental proposition then is that the Theodore Plan was ill-timed. Thus Giblin said that while the Plan was reasonable and logical in principle it did not seem to take sufficient account of the practical and technical difficulties nor to have appraised at their full value the strength of the hostile economic forces......"he (Mr. Theodore) did not seem fully to appreciate the political and emotional reactions of his countrymen, and clung to the last to the belief that a panic flight of confidence could be corrected by processes of reason."\(^{(2)}\)

\(^{(1)}\) C.f. Giblin, op. cit., pp.159-60

\(^{(2)}\) Ibid., p.95
PART III

STATISTICAL STUDY

Section | Pages
-------|------
1. Nature and Source of Statistics Used | 74-77
2. The Trend of Interest Rates from 1930 to 1957 | 78-81
3. The Trend of Interest Rates in an International Setting | 82-86
4. The Structure of Interest Rates, 1930 to 1957 | 87-93

TABLES

1-4 Interest Rates - Australia, 1923/29 to 1956/57 | 94 A-D
5-8 Interest Rates and Share Prices - Australia and Overseas, 1923 to 1957 | 95 A-D

GRAPHES

A,B1,B2, Share Prices | 96-98
C Fixed Deposit Rates, 1920/21 to 1956/57 | 99
D,E1,E2, Yield on Short and Long-Term Government Securities Compared | 100-101E2
F1,F2,F3, Trend of Bond Yields and Share Prices Compared | 102F1-F3
G Comparison of Bond Market Yields and Rates on New Loans | 103
H,J,K, International Comparison of Interest Rates and Share Prices | 104H-K
Section 1:
Nature and Source of Statistics Used

The trend of interest rates in Australia from 1928-29 to 1956-57 is set out in Tables 1 to 4 and an international comparison of interest rates in Tables 5 and 8.

Fixed Deposit rates of the Australian Trading banks, Commonwealth Savings Bank Maximum Deposit rates, and Treasury bill discount rates averaged for each financial year are shown in Table 1. These statistics have been taken from Finance Bulletins of the Commonwealth Statistician. Yields on both short and long-dated Commonwealth Securities are also shown in Table 1. Figures for the period 1941-57 are from Finance Bulletins while yields on long-dated securities prior to 1941 are from early issues of the Monthly Review of Business Statistics. From 1933/34 to 1940/41 figures relate to securities with maturities of 10 years or more and taxed at 1930 Commonwealth rates and were originally published on a monthly basis in Commonwealth Bank half-yearly Reports. However, because of their close correspondence with the series of "All Issues" appearing in the Monthly Review, the latter series has been adopted for the period 1928/29 to 1933/34. No figure for the 1930/31 year was published.

No satisfactory statistics of yields on short-term securities are available prior to 1936 or for 1939/40 or 1940/41. The figures that are available for both short and
medium-dated securities are set out in Table 2. Average market yields at the end of June of each year from 1929 to 1936 as used by the Banking Commission are also shown in Table 2.

Bank overdraft rates for both the Commonwealth Bank and other banks and Savings Bank Deposit rates appear in Table 3. Overdraft rates are from Finance Bulletins, N.S.W. Statistical Registers and Commonwealth Bank Reports. This table also contains actual Fixed Deposit rates, Treasury bill discount rates and rates charged on advances by the Rural Credits Department of the Commonwealth Bank, thus differing from Table 1 where rates are averaged out for the year.

Deposit rates for the three principal savings banks are derived from the respective Annual Reports. The deposit rates of the Trustee Savings banks of Hobart and Launceston are not shown but have generally followed a pattern similar to the Savings Bank of South Australia. Nor is there any reference to the recently established private savings banks and the Savings Bank Division of the Rural and Industries Bank of Western Australia which have applied the same rates for ordinary accounts as the Commonwealth Savings Bank and the State Savings Bank of Victoria.

At 30th June, 1936, the interest rate on amounts up to £300 in the Trustee Savings banks of Hobart and Launceston was 2\(\frac{3}{4}\) per cent (deposits of amounts larger than £300 were not
then accepted) and the rate on amounts up to £500 at the Savings Bank of South Australia was likewise 2\(\frac{3}{4}\) per cent. The rate subsequently fell to 2\(\frac{1}{4}\) per cent in the war period. Since then the rate on deposits with the Trustee Savings banks has increased by stages to 3 per cent at 1st March, 1956, on amounts up to £450. From 1st March, 1957, this was raised to £500 and amounts in excess up to £1,500 were accepted for the first time, bearing interest at 1\(\frac{1}{2}\) per cent per annum. Thus the present position is that the rates for amounts up to £500 deposited with the Trustee Savings banks is marginally above that for other savings banks but less for amounts in excess of the £500 limit.

Table 4 shows rates of interest charged on mortgage loans and credit foncier lending. The source of this information varies somewhat as is indicated in footnotes to the table. Interest charges on mortgage loans and loans on own policies by Life Assurance companies are not readily available for the whole period. However, the maximum rate on own policy loans, together with other maximum rates permitted under National Security Regulations are shown in Part IV.

The only comprehensive indexes of share prices available to show a trend from 1930 to 1957 are those compiled by the New South Wales Government Statistician and published in the Monthly Review of Business Statistics. These relate to companies which conduct business wholly or largely in New South Wales. The base year originally used was 1928/29 but is
now the average of three years ended June, 1939. I have ad-
justed the earlier figures in the 34 active shares index in order
to conform with that base.

Other information on share prices includes the
Melbourne Stock Exchange indexes of 32 ordinary shares and 15
preference shares for the pre-war years and the Commonwealth
Bank's index of share prices for the more recent period. This
index has been compiled from Sydney Stock Exchange quotations
and relates to companies which, in the main, carry on business
in New South Wales.

However, the only share price indexes that have been
graphed are Mr. Lamberton's(1) main indexes (graph "A") and some
of those published by the N.S.W. Government Statistician
(graphs "B₁" and "B₂").

The movement of interest rates and share prices for
each calendar year between 1928 and 1957 in Australia, United
Kingdom, United States and Canada is compared in Tables 5 to 8
and on graphs "H", "J" and "K". The source of this information
is the U.N. Statistical Year books. The Banking Commission's
figures have been used as an indication of the behaviour of bond
yields in Australia between 1928 and 1932 as the U.N. figures
only extend back to 1932.

(1) See Economic Record, August, 1958, and D. McL.
Lamberton, Share Price Indices in Australia
(Sydney, 1958).
Section 2:

The Trend of Interest Rates from 1930 to 1957

Confining attention first to Australia we see from the accompanying tables and graphs that interest rates rose sharply on the eve of the Great Depression, fell to very low levels in the Depression years and indeed throughout the thirties, with but a temporary pause in 1935-36, were kept low during the war and later further reduced with a slow decline until 1950. Since 1950 interest rates have risen. Looking at the period as a whole we are impressed with three things:

(a) the exceedingly low level of bond yields and fixed deposit rates in the thirties compared with the twenties;

(b) the stability of interest rates during the war;

(c) the complete reversal of the cheap money trend since 1950, with administered rates lagging behind the bond rate.

Bond yields rose sharply in 1930 and in the first half of 1931 but fell soon after the Premiers' Plan came into operation.

After falling markedly between 1930-31 and 1934/35, bond yields edged up in 1935/36 and again in 1936/37 although there was no clearly defined trend in the pre-war years and the long-term rate at no time exceeded 4 per cent. Yields were tending to fall as the war broke out. Bond prices were pegged
during the war and continued to firm after the war. Selling pressure developed in 1951 and since that time, with brief respites in 1954 and 1957, the trend of bond yields has been upward. The average yield on long-dated securities was slightly lower and on short-dated securities appreciably lower in 1957/58 than in 1956/57.

Rates paid by the trading banks on fixed deposits were also regarded as affording a good indication of the cheap money trend before the war. The traditional method of restricting credit was for the banks to raise their deposit and advance rates, and this was done in January, 1930. At the end of June, 1931, however, in accordance with the undertaking given voluntarily at the Premiers' Conference, the banks reduced their fixed deposit rates on new deposits by one per cent for all maturities. Successive reductions took place until March, 1936, which was the occasion of the Commonwealth Bank's experiment with an issue of Treasury bills to the public.

Graph "C" shows the movement of fixed deposit rates over the whole period. Some interesting features of this movement are:

(a) the large number of adjustments in the thirties—eleven in a downward direction and one upwards;

(b) in the war rates on fixed deposits were reduced on five occasions and there was no increase until July, 1952. Subsequent increases were agreed upon in January, 1955, and March, 1956. In December, 1956
the 24 months rate was raised from 3 to $3\frac{1}{2}$ per cent;

(c) in 1933 and 1934 the Commonwealth Bank took an important lead in reductions of both fixed deposit and advance rates, although the reduction announced by the bank in December, 1934, was not followed by the trading banks, and

(d) in the mid-thirties rates reached levels lower than were recorded in the preceding great era of cheap money in the 1890's.

While bank advance rates generally moved in sympathy with fixed deposit rates, there were fewer adjustments and also much hesitancy, particularly in the early stages. No uniformity of treatment was observed by the banks. Rates quoted varied from bank to bank and were not as a rule published. Special concessional rates operated for necessitous cases and were sometimes suspended indefinitely. The Sydney banks tended to push ahead with successive reductions while the Melbourne banks wanted to hold the line. However, all banks placed considerable importance on a reduction in primary producers' costs. According to the Royal Commission on Banking, the average rate on bank advances fell from 7.12 per cent in June, 1931, to 4.92 per cent in June, 1935.

Treasury bill discount rates and interest on savings banks deposits were quick in responding to the cheap money conditions of the early 1930's. Between 1935 and 1952 the
Commonwealth Savings Bank deposit rate was effectively stabilized at 2 per cent but the rate on Treasury bills was reduced from 1.75 per cent to 1.50 per cent and immediately after the war to 1.00 per cent and in 1949 to 0.75 per cent. Savings Bank deposit rates were increased in 1952 when cheap money was officially abandoned. The rate on Treasury bills was also increased but, as was mentioned in Part II, the significance of this rate in Australia has been limited to its effect on Bank profits. The behaviour of the other "administered" rates would seem to call for little comment. They were pegged during most of the war period under National Security Regulations and were not permitted to rise in most cases until 1952.

Share prices fell steeply in 1929/30 and 1930/31 and did not recover much ground until 1933/34. However, compared with other countries, recovery set in at a comparatively early stage and continued uninterrupted until 1937. In that year the market enjoyed a boom but it did not last, the trend of prices being downward between 1937 and 1941. This picture is broadly true for both ordinary and preference shares, although preference shares fell much less in the depression and began their slow pre-war decline earlier than ordinary shares. Inflationary conditions would appear to have been responsible for the declining popularity of preference shares since 1948. This was accompanied by the wide-spread use of debenture finance and the advent of the "unsecured" note for medium and long-term borrowing.
Section 3:
The Trend of Interest Rates in an International Setting

The trend of interest rates and share prices from 1928 to 1957 in the United Kingdom, United States, Canada and Australia is shown in graphs "H", "J" and "K".

The phenomenon of falling interest rates for a large part of the thirties was not confined to Australia. It was to be observed in almost every advanced industrial community. In the United States, for example, the average rate on new issues of Treasury bills fell from 4.42 per cent in 1929 to 0.14 per cent in 1938 while bond yields in the same period fell from 3.60 per cent to 2.69 per cent. In the United Kingdom consols dropped from 4.60 per cent to 2.90 per cent and the Treasury bill rate from 5.30 per cent to 0.60 per cent.

Looking at the decade as a whole, there was a substantial fall in all countries; but it would be a mistake to think of it as a smooth uninterrupted movement. There is a notable lack of uniformity when we come to consider turning points. Whereas interest rates in 1930 and for part of 1931 rose sharply in Australia, they were generally falling in other countries. Bond yields in Australia did not commence to fall until September, 1931 despite a significant decline in 1930 in other countries, including Sweden and Switzerland. At the same time it is an interesting contrast that when bond yields did turn down in Australia they fell much more steeply
(that is, prior to 1935) than in other countries. The decline in bond yields did not gain momentum till 1932 in the case of the United Kingdom, and 1933 and even later in the case of the United States and Canada. Indeed in Canada the course of bond yields bears resemblance to the situation in Australia only for the years 1933 and 1934 and again in 1938 and 1939. In 1932 bond yields rose sharply in Canada but fell even more sharply in Australia. In 1933 bond yields in Canada started to fall again and this continued practically without a break until 1936. In Australia, however, the fall in bond yields had petered out by the end of 1934 and in the ensuing 18 months or so there was an increase of about one half of one per cent after which there was no clear trend until war-time conditions forced the rate down again.

The fall in the prices of industrial shares from 1929 to 1931 was much less pronounced in Australia, the United Kingdom and New Zealand than it was in the United States and Canada. However, this hardly comes as a surprise when we consider the great heights which the speculative boom had reached in the United States and Canada compared with much milder outbursts in other countries. Of more interest is the fact that industrial share prices in Australia recovered quite markedly between 1931 and 1932 and there was no further deterioration in the 1931/32 fiscal year. In this period share
prices were generally falling in other countries. In New Zealand, however, there was no substantial movement in either direction. This early recovery of share prices in Australia was accompanied by a considerable firming of bond prices.

The trend of bond prices in Australia lends substance to the claim that the Depression was felt earlier and that recovery came sooner than in other countries, but no clear-cut dividing line can be drawn between dear and cheap money. The turning point occurred at different times in different countries.

Likewise after the war, not all countries broke with cheap money at the same time. In the United States the Treasury bill rate was permitted to rise as early as 1947 and was later followed by rises in the Federal Reserve Discount rate and in bond yields. In both the United Kingdom and the United States active measures taken to arrest the rise in prices in 1950-51 included a rise in interest rates. "Consols" had risen in 1947 as the market defeated Dalton's bid for cheaper money but Bank Rate was not raised until November, 1951 and May, 1952.

In Australia, on the other hand, bond yields were reduced in 1947 and did not rise until early in 1951. Heavy market support continued after yields had risen, and the end of cheap money was not officially recognized until July, 1952, rather later than in most other countries.

In October, 1950, Western Germany raised its discount
rate from 4 to 6 per cent and in Canada the rate was raised from 1.50 to 2.00 per cent.

There has been no return to cheap money conditions since 1951. Interest rates have fallen, but never for very long and in Australia bond yields have done no more than "level out" at the higher levels. In most countries, however, interest rate policy has regained something of its pre-1931 flexibility, an objective which has been difficult to achieve in Australia where the capital market is still comparatively under-developed.

Since 1951, therefore, the trend of interest rates has been upward. Between 1951 and 1956 there were nine changes in the Federal Reserve Discount rate (seven of which were rises) seven changes in the U.K. Bank Rate (four rises) seven also in the Canadian rate (with six rises) and nine changes in Western Germany's rate (only three of which were rises).

Speaking generally interest rates have been much less flexible in Australia than in other countries since 1951. Reasons for this are considered later in Parts V and VI.

There was a strong upward thrust of share prices in all four countries and in New Zealand also between 1942 and 1946. In Australia this continued, and with but a slight pause in 1949, until 1951-52. In the United Kingdom share prices fell in 1948 and 1949 but have risen at a very rapid pace since 1952. This rise was however easily surpassed by the movement of share prices in the United States and Canada between 1953 and 1956.
We cannot fail to observe the very close correspondence between interest movements in the United States and Canada. In very general terms, the movement of interest rates in Australia since the war has corresponded rather more closely to movements in the United States than in the United Kingdom, but the fit is not very good and some striking divergences are:

(a) the behaviour of bond yields between 1945 and 1949, in 1954 and 1957;

(b) the behaviour of share prices since 1951.
Section 4:
The Structure of Interest Rates, 1930-1957

When economists talk about "the" rate of interest they are usually referring to the current market yield on long-dated government bonds. This is undoubtedly the most important interest rate in the Australian capital market, although it would be unreal to overlook other interest rates. The interest problem consists after all in relating a complex structure of indebtedness to changes in the terms on which borrowing and lending take place. Proceeding on the basis that share yields are a sort of interest rate,\(^{(1)}\) our structure of interest rates may therefore be presented broadly as follows:

(a) Central Bank Discount Rate  
(b) Treasury bill discount rate  
(c) Other money-market rates  
(d) Bank fixed deposit, overdraft and savings bank rates  
(e) Bond market rate (short term)  
(f) Bond market rate (long term)  
(g) Other (administered) rates including rates on mortgage loans by insurance companies and savings banks  
(h) Rates on debentures and other fixed interest securities issued by industrial enterprises  
(i) Preference share yields  
(j) Ordinary share yields

\(^{(1)}\) Joan Robinson: *The Rate of Interest and Other Essays* (Macmillan) (1952), p.7n.
Items (a), (b) and (c) have had very limited importance in Australia, although in recent years an "unofficial" market in "short" money has emerged, principally in association with the rapid growth of hire purchase. The Commonwealth Statistician has never published share yields, nor, to my knowledge, is this information readily available from any other source. It could, of course, be calculated from shares prices but this is a very laborious process. Market yields on company debentures have not been published systematically.

A.T.K. Grant\(^{1}\) has emphasised the fact that it is not possible to look at the demand and supply of one particular class of security in isolation from the demand and supply of other securities. The qualities which go to make up the various assets in the capital market hinge to a large extent around the uncertainty of future capital values and income yields and potentialities. Any satisfactory approach to the interest problem must start from the interdependence of various interest rates and from the significance of liquidity to individuals and businesses alike. Thus yields on company debentures, for example, are not determined independently of prevailing yields on Commonwealth securities. With due allowance for differing tax treatment and varying risk premiums we would, in the normal course, expect them to follow a similar pattern. We must, however, allow for the fact that the bond rate is now rarely permitted to find its own level, a fact

---

\(^{1}\) The Post-War Capital Market (Macmillan, 1936)
which, when superimposed on a situation of "excess" investment demand, can only result in a greater widening of the gap between debenture and bond yields.

Our statistical information does not permit us to trace this relationship. We can, however, compare yields on short-dated (2 year) securities with yields on long-dated (12 year) securities. Each series is shown in Graph "D", together with the average rate on 2-year Fixed Deposits for the relevant period, namely, 1934/35 to 1956/57. As pointed out earlier, yields on short-term securities are not available in a satisfactory form prior to 1936.

To assist in elucidating this relationship, attention is invited to Graph "E_1" , which sets out differences between:

(a) long-term market yields and short-term market yields,
(b) long-term market yields and the average yearly rates for 2-year Fixed Deposits, and
(c) medium-term and long-term security yields (available only for the period 1931/32 to 1944/45).

Graph "E_2" has little meaning in itself but is included for the sake of completeness. Differences between long-term market yields and Treasury bill discount rates (averaged out for each year) and between maximum trading bank advance rates (also averaged out for each year) and long-term market yields are shown in this graph.

The absolute difference between yields on short and
long-dated securities did not vary greatly during the war but, judging from the behaviour of other interest rates, it would appear to have been much higher than in the pre-war years, although we cannot say this with any real confidence. Since the war, however, statistics have improved and we are able to observe at least three important changes in this relationship. In 1945–46 and 1946–47 the gap widened considerably, which was certainly not caused by any general weakening in the prices of longer-dated securities. Loans were oversubscribed by large amounts up to 1950 yet the structure of interest rates was undergoing some important changes.

The gap narrowed in 1947/48 but widened again in 1948/49 and this trend continued and culminated in the sensational rise to a difference of close on 2 per cent in 1951/52. In both 1950/51 and 1951/52 there was less willingness to go "long" and the gap therefore widened. The position was of course affected by the abandonment of a number of controls which in earlier years had effectively reduced the competition for investible funds, as well as by the rise in liquidity preference. Since 1951/52 investors have apparently shown a greater willingness to go "long" than "short", because there has, until recently, been a continuing narrowing the gap differential, to the comparatively low level of 0.7 per cent in 1956/57. This was however accompanied by a continuance of the demand for private funds, a decline in the use of preference shares
and a generally unsatisfactory response to Commonwealth loan raisings with the need for some market support. The rise of short-term rates between 1952/53 and 1956/57 may have been influenced also by the increasing volume of debt with from 2 to 5 years to maturity. Thus at 30th June, 1957, approximately 47 per cent of the total debt outstanding matured in 5 years or less, compared with 20 per cent at 30th June, 1952. It is obvious that the structural problem is an exceedingly complex one with many interacting forces and that it offers scope for a good deal more research.

Another feature of graph "D" is the fairly close correspondence between the relationship we have just been discussing and the movement of the differences between long-term bond yields and 2-year fixed deposit rates. Furthermore, on the available evidence it would seem that the relationship between market yields on short and long-dated securities was a much more stable one in the thirties than either during or since the war. The difference was generally smaller and there were occasions when yields on short-dated securities exceeded the longer dated market yields.

The number of imponderables is multiplied many times when an analysis is attempted between the behaviour of bond yields vis a vis share price movements. No such analysis is attempted here and without statistics of share yields it is doubtful whether it would be a very rewarding study anyhow.
The trend of both dated security yields and share prices are shown in graphs $F_1$, $F_2$, and $F_3$.

The relationship between bond and share yields is normally an exceedingly loose one. In the short run share prices can be affected by any number of factors which have no bearing at all on the current bond rate. It is obvious that bond prices can rise only so far; the higher they go the greater the risk of capital loss and the greater the relative advantages, even after allowing for other risks, of investing in shares. Likewise, except in the most abnormal circumstances, share prices may be expected to fall very much further and faster than bond prices. On the other hand, the absolute level of the bond rate is, theoretically, regarded as establishing a limit to the movement of share prices. Share prices are related to profitability, which in the long run must always exceed the interest on the capital employed, if such capital is to be retained in the business. The large and well established concerns, may of course, be able to get by with a dividend yield of only 4 per cent or even less but the relevant yield in that case is not the dividend yield but the earnings yield and in fact the true yield is neither when intangible assets assume importance. The "true" yield must in all cases exceed the bond yield because of the much greater element of risk.

This is but an illustration of the fact that the general level of share prices has little meaning in itself and
certainly little meaning in relation to our study of interest rates and of cheap money. On the other hand movements in share prices may happen to reflect a change in the liquidity preference of the public or of switching between bonds and shares.

There is certainly little likelihood that "switching" was important in the depression years although it could have been so between 1934/35 and 1937/38. In 1951/52 and 1952/53 money was preferred to assets generally and between 1953/54 and 1956/57 it is again possible that some of the weakening in bond prices was caused by a healthier share market. This matter is discussed in Part VI. The changing importance of fixed deposit and other administered rates relative to the bond rate has attracted comment in other parts of the thesis.
<table>
<thead>
<tr>
<th>Year</th>
<th>C.S.E. Deposits</th>
<th>Treasury Bills Discount Rates</th>
<th>Commonwealth Government Securities (a) Taxed at Current Commonwealth Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 months</td>
<td>6 months</td>
<td>12 months</td>
<td>24 months</td>
</tr>
<tr>
<td>1928/29</td>
<td>4.00</td>
<td>4.70</td>
<td>5.00</td>
</tr>
<tr>
<td>1929/30</td>
<td>4.20</td>
<td>4.70</td>
<td>5.10</td>
</tr>
<tr>
<td>1930/31</td>
<td>4.50</td>
<td>5.00</td>
<td>5.30</td>
</tr>
<tr>
<td>1931/32</td>
<td>3.00</td>
<td>3.80</td>
<td>4.10</td>
</tr>
<tr>
<td>1932/33</td>
<td>2.20</td>
<td>3.00</td>
<td>3.20</td>
</tr>
<tr>
<td>1933/34</td>
<td>2.00</td>
<td>2.70</td>
<td>2.90</td>
</tr>
<tr>
<td>1934/35</td>
<td>1.30</td>
<td>2.30</td>
<td>2.60</td>
</tr>
<tr>
<td>1935/36</td>
<td>1.30</td>
<td>2.40</td>
<td>2.60</td>
</tr>
<tr>
<td>1936/37</td>
<td>2.00</td>
<td>2.50</td>
<td>3.00</td>
</tr>
<tr>
<td>1937/38</td>
<td>2.00</td>
<td>2.50</td>
<td>3.00</td>
</tr>
<tr>
<td>1938/39</td>
<td>2.00</td>
<td>2.50</td>
<td>3.00</td>
</tr>
<tr>
<td>1939/40</td>
<td>1.50</td>
<td>2.25</td>
<td>2.50</td>
</tr>
<tr>
<td>1940/41</td>
<td>1.43</td>
<td>1.98</td>
<td>2.23</td>
</tr>
<tr>
<td>1941/42</td>
<td>1.25</td>
<td>1.75</td>
<td>2.00</td>
</tr>
<tr>
<td>1942/43</td>
<td>1.13</td>
<td>1.64</td>
<td>2.00</td>
</tr>
<tr>
<td>1943/44</td>
<td>0.56</td>
<td>1.00</td>
<td>(b) 1.50</td>
</tr>
<tr>
<td>1944/45</td>
<td>0.50</td>
<td>0.75</td>
<td>1.10</td>
</tr>
<tr>
<td>1945/46</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1946/47</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1947/48</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1948/49</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1949/50</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1950/51</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1951/52</td>
<td>0.50</td>
<td>0.75</td>
<td>1.00</td>
</tr>
<tr>
<td>1952/53</td>
<td>0.96</td>
<td>1.46</td>
<td>(d) 1.73</td>
</tr>
<tr>
<td>1953/54</td>
<td>1.00</td>
<td>1.46</td>
<td>(d) 1.73</td>
</tr>
<tr>
<td>1954/55</td>
<td>1.13</td>
<td>1.88</td>
<td>2.33</td>
</tr>
<tr>
<td>1955/56</td>
<td>1.58</td>
<td>2.08</td>
<td>2.23</td>
</tr>
<tr>
<td>1956/57</td>
<td>2.25</td>
<td>2.75</td>
<td>3.20</td>
</tr>
</tbody>
</table>

(a) Rates for securities maturing in 2 and 12 years estimated from rates on securities maturing in 0-5 and 10 or more years respectively. Figures relate to last Wednesday in month.

(b) Rate was 1.5% on first £10,000 of Deposit and 1.00% on amounts in excess of £10,000.

(c) The order made by the Commonwealth Bank under the National Security (E.O.) Regulations fixing maximum rates of interest was revoked on 29th July, 1952.

(d) From 1/3/1952 rate was 1.75% on first £10,000 of Deposit and 1.50% on amounts in excess of £10,000.
TABLE II
YIELDS ON COMMONWEALTH SECURITIES: 1928/29 TO 1956/57

<table>
<thead>
<tr>
<th>Year</th>
<th>All Issues</th>
<th>Short Dated</th>
<th>5 and under</th>
<th>Long Dated</th>
<th>Average market yields</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A.C.L. (M.R.B.S.)</td>
<td>2 years (a)</td>
<td>10 years</td>
<td>12 years</td>
<td></td>
</tr>
<tr>
<td>1928/29</td>
<td>5.35</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1929/30</td>
<td>5.71</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1930/31</td>
<td>n.a.</td>
<td></td>
<td></td>
<td></td>
<td>13.00</td>
</tr>
<tr>
<td>1931/32</td>
<td>4.99</td>
<td></td>
<td>5.41</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1932/33</td>
<td>3.98</td>
<td></td>
<td>4.08</td>
<td></td>
<td>3.75</td>
</tr>
<tr>
<td>1933/34</td>
<td>3.53</td>
<td></td>
<td>3.48</td>
<td>3.54</td>
<td>3.25</td>
</tr>
<tr>
<td>1934/35</td>
<td>3.32</td>
<td></td>
<td>3.24</td>
<td>3.53(e)</td>
<td>3.51</td>
</tr>
<tr>
<td>1935/36</td>
<td>3.76</td>
<td></td>
<td>3.73</td>
<td>3.77(e)</td>
<td>3.88</td>
</tr>
<tr>
<td>1936/37</td>
<td>3.89</td>
<td>(b)</td>
<td>3.57</td>
<td>3.85</td>
<td>3.94(e)</td>
</tr>
<tr>
<td>1937/38</td>
<td>3.68</td>
<td>(b)</td>
<td>3.30</td>
<td>3.66</td>
<td>3.71(e)</td>
</tr>
<tr>
<td>1938/39</td>
<td>3.84</td>
<td>(b)</td>
<td>3.67</td>
<td>3.83</td>
<td>3.84(e)</td>
</tr>
<tr>
<td>1939/40</td>
<td>3.71</td>
<td></td>
<td>3.64</td>
<td>3.67(e)</td>
<td></td>
</tr>
<tr>
<td>1940/41</td>
<td></td>
<td></td>
<td>3.04</td>
<td>3.13(e)</td>
<td></td>
</tr>
<tr>
<td>1941/42</td>
<td>2.40</td>
<td></td>
<td>2.97</td>
<td>3.24</td>
<td></td>
</tr>
<tr>
<td>1942/43</td>
<td>2.48</td>
<td></td>
<td>2.77</td>
<td>3.24</td>
<td></td>
</tr>
<tr>
<td>1943/44</td>
<td>2.45</td>
<td></td>
<td>2.69</td>
<td>3.24</td>
<td></td>
</tr>
<tr>
<td>1944/45</td>
<td>2.47</td>
<td></td>
<td>2.46</td>
<td>3.25</td>
<td></td>
</tr>
<tr>
<td>1945/46</td>
<td>2.19</td>
<td></td>
<td>2.71</td>
<td>3.24</td>
<td></td>
</tr>
<tr>
<td>1946/47</td>
<td>1.93</td>
<td></td>
<td>3.21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1947/48</td>
<td>2.34</td>
<td></td>
<td>3.16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1948/49</td>
<td>2.07</td>
<td></td>
<td>3.12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1949/50</td>
<td>1.95</td>
<td></td>
<td>3.13</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1950/51</td>
<td>1.99</td>
<td></td>
<td>3.21</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1951/52</td>
<td>2.05</td>
<td></td>
<td>3.95</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1952/53</td>
<td>3.03</td>
<td></td>
<td>4.54</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1953/54</td>
<td>3.10</td>
<td></td>
<td>4.44</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1954/55</td>
<td>3.49</td>
<td></td>
<td>4.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1955/56</td>
<td>4.39</td>
<td></td>
<td>4.76</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1956/57</td>
<td>4.71</td>
<td></td>
<td>5.06</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(a) Taxed at Current Commonwealth rates and estimated from rates on securities maturing in 0-5 years.
(b) Under 5 years and taxed at 1930 Commonwealth rates.
(c) Finance Bulletins Nos. 33 and 39. Taxed at 1930 Commonwealth rates. Also N.S.W. Statistical Registers prior to 1934/35. Medium dated 7 years from 1942/46.
(d) Taxed at Current Commonwealth rates and estimated from rates on securities maturing in 10 or more years.
(e) Taxed at 1930 Commonwealth Rates.
(g) 10 years and over and taxed at 1930 Commonwealth rates.
### TABLE 3

**ACTUAL ADMINISTERED RATES OF INTEREST: 1928/29 TO 1956/57**

<table>
<thead>
<tr>
<th>Year</th>
<th>Treasury Bill Discount Rate</th>
<th>Commonwealth Bank Rural Credits Dept. Max. Rate</th>
<th>Fixed Deposits: Cheques Paying Banks</th>
<th>Overdraft Rates (Max. Rates)</th>
<th>Savings Bank Deposit Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>3 mths</td>
<td>6 mths</td>
<td>12 mths</td>
<td>24 mths</td>
</tr>
<tr>
<td>1928/29</td>
<td>4.5</td>
<td>5.5</td>
<td>4.0</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>1929/30</td>
<td>6.0</td>
<td>5.5</td>
<td>4.5</td>
<td>4.75</td>
<td>5.0</td>
</tr>
<tr>
<td>1930/31</td>
<td>5.5</td>
<td>4.0</td>
<td>3.5</td>
<td>3.75</td>
<td>4.0</td>
</tr>
<tr>
<td>1931/32</td>
<td>4.0</td>
<td>4.5</td>
<td>2.5</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>1932/33</td>
<td>2.5</td>
<td>4.0</td>
<td>2.0</td>
<td>2.5</td>
<td>2.75</td>
</tr>
<tr>
<td>1933/34</td>
<td>2.25</td>
<td>3.75</td>
<td>1.0</td>
<td>1.5</td>
<td>2.25</td>
</tr>
<tr>
<td>1934/35</td>
<td>1.75</td>
<td>2.0</td>
<td>2.5</td>
<td>2.75</td>
<td>3.0</td>
</tr>
<tr>
<td>1935/36</td>
<td>1.75</td>
<td>3.50</td>
<td>1.5</td>
<td>2.0</td>
<td>2.25</td>
</tr>
<tr>
<td>1936/37</td>
<td>1.5</td>
<td>1.25</td>
<td>1.5</td>
<td>1.75</td>
<td>2.0</td>
</tr>
<tr>
<td>1937/38</td>
<td>1.25</td>
<td>1.0</td>
<td>0.75</td>
<td>1.25</td>
<td>1.75</td>
</tr>
<tr>
<td>1938/39</td>
<td>1.0</td>
<td>0.5</td>
<td>0.75</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>1939/40</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1940/41</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1941/42</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1942/43</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1943/44</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1944/45</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1945/46</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1946/47</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1947/48</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1948/49</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1949/50</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1950/51</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1951/52</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1952/53</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1953/54</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1954/55</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1955/56</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1956/57</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Highest permitted by orders under National Security Regulations.
## TABLE 4

### RATES ON MORTGAGE LOANS AND CREDIT FONCIER LENDING

1928/29 TO 1956/57

<table>
<thead>
<tr>
<th>Year</th>
<th>State Savings Bank of Victoria - Credit Foncier Loans on Dwellings and Shops (a)</th>
<th>Private First Mortgages Registered in N.S.W. (b)</th>
<th>Rate on Mortgage Loans : Savings Bank of South Australia (c)</th>
<th>Rural Bank of N.S.W. Advances for homes (d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1928/29</td>
<td>6.5 - 7.0</td>
<td>6.5 - 7.0</td>
<td>6.5 - 7.0</td>
<td>6.25</td>
</tr>
<tr>
<td>1929/30</td>
<td>6.0</td>
<td>5.0 - 7.0</td>
<td>5.0 - 5.5</td>
<td>5.0</td>
</tr>
<tr>
<td>1930/31</td>
<td>5.0</td>
<td>5.0 - 5.5</td>
<td>5.0 - 5.5</td>
<td>4.75 - 5.0</td>
</tr>
<tr>
<td>1931/32</td>
<td>4.5</td>
<td>4.25 - 5.0</td>
<td>4.25 - 5.0</td>
<td>4.5</td>
</tr>
<tr>
<td>1932/33</td>
<td>5.3</td>
<td>5.0</td>
<td>4.25 - 5.0</td>
<td>4.75</td>
</tr>
<tr>
<td>1933/34</td>
<td>5.2</td>
<td>4.9</td>
<td>4.0 - 4.5</td>
<td>4.25</td>
</tr>
<tr>
<td>1934/35</td>
<td>5.3</td>
<td>4.7</td>
<td>3.75</td>
<td>4.25</td>
</tr>
<tr>
<td>1935/36</td>
<td>5.4</td>
<td>4.5</td>
<td>3.5 - 3.75</td>
<td>4.25</td>
</tr>
<tr>
<td>1936/37</td>
<td>5.5</td>
<td>4.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1937/38</td>
<td>4.25</td>
<td>4.13</td>
<td>3.5 - 4.25</td>
<td>5.0</td>
</tr>
<tr>
<td>1938/39</td>
<td>4.5</td>
<td>4.50</td>
<td>3.5 - 4.75</td>
<td>5.0</td>
</tr>
<tr>
<td>1939/40</td>
<td>4.9</td>
<td>4.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1940/41</td>
<td>4.4</td>
<td>4.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1941/42</td>
<td>4.9</td>
<td>4.4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


(c) Annual Reports of the Savings Bank of South Australia.

(d) N.S.W. Statistical Registers.
### TABLE 5

**GOVERNMENT BOND YIELDS - LONG-TERM**

<table>
<thead>
<tr>
<th>Year</th>
<th>Canada</th>
<th>United States</th>
<th>United Kingdom</th>
<th>Australia</th>
<th>New Zealand</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>15 year bonds</td>
<td>Partially Tax-Exempt</td>
<td>Taxable</td>
<td>2½% Consols</td>
<td>(a)</td>
</tr>
<tr>
<td>1928</td>
<td>3.98</td>
<td>3.33</td>
<td>4.47</td>
<td>4.60</td>
<td></td>
</tr>
<tr>
<td>1929</td>
<td>4.35</td>
<td>3.60</td>
<td>4.47</td>
<td>4.60</td>
<td></td>
</tr>
<tr>
<td>1930</td>
<td>4.16</td>
<td>3.29</td>
<td>4.37</td>
<td>4.48</td>
<td></td>
</tr>
<tr>
<td>1931</td>
<td>4.07</td>
<td>3.34</td>
<td>3.76</td>
<td>4.44</td>
<td></td>
</tr>
<tr>
<td>1932</td>
<td>4.52</td>
<td>3.68</td>
<td>3.38</td>
<td>3.75</td>
<td>3.94</td>
</tr>
<tr>
<td>1933</td>
<td>4.11</td>
<td>3.31</td>
<td>3.38</td>
<td>3.32</td>
<td>3.53</td>
</tr>
<tr>
<td>1934</td>
<td>5.59</td>
<td>3.12</td>
<td>3.08</td>
<td>3.26</td>
<td>3.53</td>
</tr>
<tr>
<td>1935</td>
<td>3.28</td>
<td>2.79</td>
<td>2.89</td>
<td>3.33</td>
<td>3.77</td>
</tr>
<tr>
<td>1936</td>
<td>2.97</td>
<td>2.69</td>
<td>2.94</td>
<td>3.77</td>
<td>3.33</td>
</tr>
<tr>
<td>1937</td>
<td>3.17</td>
<td>2.74</td>
<td>3.28</td>
<td>3.77</td>
<td>3.61</td>
</tr>
<tr>
<td>1938</td>
<td>3.09</td>
<td>2.61</td>
<td>3.38</td>
<td>3.76</td>
<td>3.81</td>
</tr>
<tr>
<td>1939</td>
<td>3.16</td>
<td>2.41</td>
<td>3.72</td>
<td>3.92</td>
<td>4.24</td>
</tr>
<tr>
<td>1940</td>
<td>3.28</td>
<td>2.26</td>
<td>3.40</td>
<td>3.61</td>
<td>3.81</td>
</tr>
<tr>
<td>1941</td>
<td>3.10</td>
<td>2.05</td>
<td>3.13</td>
<td>3.40</td>
<td>3.61</td>
</tr>
<tr>
<td>1942</td>
<td>3.08</td>
<td>2.09</td>
<td>2.46</td>
<td>3.03</td>
<td>3.24</td>
</tr>
<tr>
<td>1943</td>
<td>3.01</td>
<td>1.98</td>
<td>2.47</td>
<td>3.10</td>
<td>3.23</td>
</tr>
<tr>
<td>1944</td>
<td>2.99</td>
<td>1.92</td>
<td>2.48</td>
<td>3.14</td>
<td>3.24</td>
</tr>
<tr>
<td>1945</td>
<td>2.93</td>
<td>1.66</td>
<td>2.37</td>
<td>3.25</td>
<td>3.18</td>
</tr>
<tr>
<td>1946</td>
<td>2.61</td>
<td>2.19</td>
<td>2.60</td>
<td>3.24</td>
<td>3.01</td>
</tr>
<tr>
<td>1947</td>
<td>2.57</td>
<td>2.25</td>
<td>2.76</td>
<td>3.17</td>
<td>3.00</td>
</tr>
<tr>
<td>1948</td>
<td>2.94</td>
<td>2.44</td>
<td>3.21</td>
<td>3.14</td>
<td>3.03</td>
</tr>
<tr>
<td>1949</td>
<td>2.83</td>
<td>2.31</td>
<td>3.30</td>
<td>3.12</td>
<td>3.00</td>
</tr>
<tr>
<td>1950</td>
<td>2.78</td>
<td>2.32</td>
<td>3.54</td>
<td>3.14</td>
<td>3.03</td>
</tr>
<tr>
<td>1951</td>
<td>3.24</td>
<td>2.57</td>
<td>3.76</td>
<td>3.53</td>
<td>3.08</td>
</tr>
<tr>
<td>1952</td>
<td>3.59</td>
<td>2.68</td>
<td>4.23</td>
<td>4.34</td>
<td>3.85</td>
</tr>
<tr>
<td>1953</td>
<td>3.68</td>
<td>2.92</td>
<td>4.08</td>
<td>4.48</td>
<td>4.01</td>
</tr>
<tr>
<td>1954</td>
<td>3.14</td>
<td>2.52</td>
<td>3.75</td>
<td>4.46</td>
<td>3.98</td>
</tr>
<tr>
<td>1955</td>
<td>3.08</td>
<td>2.80</td>
<td>4.17</td>
<td>4.52</td>
<td>4.15</td>
</tr>
<tr>
<td>1956</td>
<td>3.63</td>
<td>3.06</td>
<td>4.74</td>
<td>5.03</td>
<td>4.65</td>
</tr>
<tr>
<td>1957</td>
<td>4.17</td>
<td>3.47</td>
<td>5.01</td>
<td>5.02</td>
<td>4.82</td>
</tr>
</tbody>
</table>

(a) Average yield of all Commonwealth bonds maturing in 70 years or more.

(b) Theoretical yield of 12 year Commonwealth bonds.

(c) 1937/43: 3½% bonds of 1953/57; 1944/54: 3½% bonds of 1960/63; beginning 1955, bonds with 10 years or over to maturity.

(d) 1928/35 Dominion L.T. bonds; beginning 1936, theoretical 15 years Dominion bonds.

(e) 1928/35: bonds due or callable after 12 years; beginning 1936 bond due or callable after 15 years.

* U.N. Statistical Yearbooks.
<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
<th>Canada</th>
<th>United Kingdom</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tap - 3 Months</td>
<td>Tender-3 months</td>
<td>Tender-3 months</td>
<td>Tender-3 months</td>
</tr>
<tr>
<td>1928</td>
<td>4.17</td>
<td></td>
<td>4.13</td>
<td>3.97</td>
</tr>
<tr>
<td>1929</td>
<td>4.75</td>
<td></td>
<td>5.25</td>
<td>4.42</td>
</tr>
<tr>
<td>1930</td>
<td>5.62</td>
<td></td>
<td>2.54</td>
<td>2.49</td>
</tr>
<tr>
<td>1931</td>
<td>5.00</td>
<td></td>
<td>3.49</td>
<td>1.60</td>
</tr>
<tr>
<td>1932</td>
<td>3.75</td>
<td></td>
<td>1.64</td>
<td>0.88</td>
</tr>
<tr>
<td>1933</td>
<td>2.65</td>
<td></td>
<td>0.59</td>
<td>0.52</td>
</tr>
<tr>
<td>1934</td>
<td>2.25</td>
<td>1.49</td>
<td>0.73</td>
<td>0.26</td>
</tr>
<tr>
<td>1935</td>
<td>1.75</td>
<td>0.84</td>
<td>0.52</td>
<td>0.14</td>
</tr>
<tr>
<td>1936</td>
<td>1.75</td>
<td>0.72</td>
<td>0.58</td>
<td>0.14</td>
</tr>
<tr>
<td>1937</td>
<td>1.75</td>
<td>0.59</td>
<td>0.56</td>
<td>0.45</td>
</tr>
<tr>
<td>1938</td>
<td>1.75</td>
<td>0.71</td>
<td>0.61</td>
<td>0.05</td>
</tr>
<tr>
<td>1939</td>
<td>1.75</td>
<td>0.70</td>
<td>1.32</td>
<td>0.02</td>
</tr>
<tr>
<td>1940</td>
<td>1.58</td>
<td>0.58</td>
<td>1.03</td>
<td>0.01</td>
</tr>
<tr>
<td>1941</td>
<td>1.50</td>
<td>1.01</td>
<td>0.10</td>
<td>0.33</td>
</tr>
<tr>
<td>1942</td>
<td>1.50</td>
<td>0.54</td>
<td>0.37</td>
<td>0.38</td>
</tr>
<tr>
<td>1943</td>
<td>1.46</td>
<td>1.01</td>
<td>0.38</td>
<td>0.38</td>
</tr>
<tr>
<td>1944</td>
<td>1.46</td>
<td>0.39</td>
<td>0.88</td>
<td>0.38</td>
</tr>
<tr>
<td>1945</td>
<td>1.04</td>
<td>0.36</td>
<td>0.51</td>
<td>0.60</td>
</tr>
<tr>
<td>1946</td>
<td>1.00</td>
<td>0.38</td>
<td>0.51</td>
<td>1.04</td>
</tr>
<tr>
<td>1947</td>
<td>1.00</td>
<td>0.41</td>
<td>0.51</td>
<td>1.10</td>
</tr>
<tr>
<td>1948</td>
<td>1.00</td>
<td>0.41</td>
<td>0.52</td>
<td>1.22</td>
</tr>
<tr>
<td>1949</td>
<td>0.83</td>
<td>0.48</td>
<td>0.51</td>
<td>1.55</td>
</tr>
<tr>
<td>1950</td>
<td>0.75</td>
<td>0.55</td>
<td>0.56</td>
<td>1.77</td>
</tr>
<tr>
<td>1951</td>
<td>0.75</td>
<td>0.80</td>
<td>2.20</td>
<td>1.93</td>
</tr>
<tr>
<td>1952</td>
<td>0.85</td>
<td>1.07</td>
<td>2.30</td>
<td>1.93</td>
</tr>
<tr>
<td>1953</td>
<td>1.00</td>
<td>1.69</td>
<td>3.73</td>
<td>1.75</td>
</tr>
<tr>
<td>1954</td>
<td>1.00</td>
<td>1.44</td>
<td>1.80</td>
<td>0.95</td>
</tr>
<tr>
<td>1955</td>
<td>1.00</td>
<td>1.62</td>
<td>3.73</td>
<td>2.66</td>
</tr>
<tr>
<td>1956</td>
<td>1.00</td>
<td>2.92</td>
<td>4.93</td>
<td>3.26</td>
</tr>
<tr>
<td>1957</td>
<td>1.00</td>
<td>3.76</td>
<td>4.80</td>
<td></td>
</tr>
</tbody>
</table>

* U.N. Statistical Yearbooks.
<table>
<thead>
<tr>
<th></th>
<th>Canada</th>
<th>United States</th>
<th>United Kingdom</th>
<th>Australia</th>
<th>New Zealand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>92</td>
<td>86</td>
<td>77</td>
<td>43</td>
<td>79</td>
</tr>
<tr>
<td>1932</td>
<td>22</td>
<td>22</td>
<td>46</td>
<td>28</td>
<td>55</td>
</tr>
<tr>
<td>1937</td>
<td>71</td>
<td>60</td>
<td>83</td>
<td>58</td>
<td>85</td>
</tr>
<tr>
<td>1938</td>
<td>59</td>
<td>46</td>
<td>69</td>
<td>57</td>
<td>82</td>
</tr>
<tr>
<td>1939</td>
<td>57</td>
<td>47</td>
<td>63</td>
<td>59</td>
<td>79</td>
</tr>
<tr>
<td>1941</td>
<td>40</td>
<td>39</td>
<td>57</td>
<td>60</td>
<td>84</td>
</tr>
<tr>
<td>1942</td>
<td>38</td>
<td>35</td>
<td>67</td>
<td>54</td>
<td>84</td>
</tr>
<tr>
<td>1943</td>
<td>49</td>
<td>46</td>
<td>81</td>
<td>65</td>
<td>95</td>
</tr>
<tr>
<td>1944</td>
<td>49</td>
<td>50</td>
<td>89</td>
<td>66</td>
<td>102</td>
</tr>
<tr>
<td>1945</td>
<td>58</td>
<td>59</td>
<td>96</td>
<td>68</td>
<td>106</td>
</tr>
<tr>
<td>1946</td>
<td>68</td>
<td>66</td>
<td>107</td>
<td>77</td>
<td>113</td>
</tr>
<tr>
<td>1947</td>
<td>62</td>
<td>60</td>
<td>109</td>
<td>90</td>
<td>119</td>
</tr>
<tr>
<td>1948</td>
<td>67</td>
<td>62</td>
<td>98</td>
<td>98</td>
<td>117</td>
</tr>
<tr>
<td>1949</td>
<td>64</td>
<td>60</td>
<td>87</td>
<td>94</td>
<td>113</td>
</tr>
<tr>
<td>1950</td>
<td>80</td>
<td>74</td>
<td>88</td>
<td>111</td>
<td>123</td>
</tr>
<tr>
<td>1951</td>
<td>107</td>
<td>91</td>
<td>102</td>
<td>134</td>
<td>129</td>
</tr>
<tr>
<td>1952</td>
<td>110</td>
<td>100</td>
<td>89</td>
<td>101</td>
<td>105</td>
</tr>
<tr>
<td>1953</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1954</td>
<td>114</td>
<td>122</td>
<td>131</td>
<td>106</td>
<td>111</td>
</tr>
<tr>
<td>1955</td>
<td>150</td>
<td>171</td>
<td>155</td>
<td>116</td>
<td>119</td>
</tr>
<tr>
<td>1956</td>
<td>177</td>
<td>200</td>
<td>139</td>
<td>113</td>
<td>121</td>
</tr>
<tr>
<td>1957</td>
<td>169</td>
<td>192</td>
<td>146</td>
<td>121</td>
<td>135</td>
</tr>
</tbody>
</table>

* U.N. Statistical Year Books.
  [Base: 1933 = 100]
<table>
<thead>
<tr>
<th></th>
<th>Canada</th>
<th>United States</th>
<th>United Kingdom</th>
<th>West Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>F.R. Board of New York</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average 1929</td>
<td>5.16</td>
<td>5.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1.00</td>
<td>2.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>From I 1948</td>
<td>1.50</td>
<td>1.25</td>
<td></td>
<td>5.0 (V 1949)</td>
</tr>
<tr>
<td>VII 1948</td>
<td>2.00</td>
<td>1.50</td>
<td></td>
<td>4.0 (VII 1949)</td>
</tr>
<tr>
<td>X 1950</td>
<td>1.75</td>
<td>2.50 (XI 1951)</td>
<td>6.0</td>
<td></td>
</tr>
<tr>
<td>VII 1950</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>X 1950</td>
<td>2.00</td>
<td>2.00</td>
<td></td>
<td>4.5 (VIII 1952)</td>
</tr>
<tr>
<td>V 1952</td>
<td>1.75</td>
<td>3.50 (IX 1953)</td>
<td>4.0 (I 1953)</td>
<td></td>
</tr>
<tr>
<td>I 1953</td>
<td>1.50</td>
<td>3.00 (V 1954)</td>
<td>3.5 (VI 1953)</td>
<td></td>
</tr>
<tr>
<td>IV 1954</td>
<td>2.00</td>
<td>3.50 (I 1955)</td>
<td>3.0 (V 1954)</td>
<td></td>
</tr>
<tr>
<td>II 1955</td>
<td>1.50</td>
<td>4.50 (II 1955)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IV 1955</td>
<td>1.75</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VIII 1955</td>
<td>2.00</td>
<td>2.00 (VII)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>X 1955</td>
<td>2.25</td>
<td>2.25 (IX)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>XI 1955</td>
<td>2.75</td>
<td>2.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>III 1956</td>
<td>3.00</td>
<td></td>
<td></td>
<td>3.5</td>
</tr>
<tr>
<td>IV 1956</td>
<td></td>
<td></td>
<td></td>
<td>4.5</td>
</tr>
<tr>
<td>VII 1956</td>
<td></td>
<td></td>
<td></td>
<td>5.5 (V)</td>
</tr>
<tr>
<td>VIII 1956</td>
<td>3.25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IX 1956</td>
<td></td>
<td></td>
<td></td>
<td>5.0</td>
</tr>
<tr>
<td>X 1956</td>
<td>3.50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I 1957</td>
<td></td>
<td></td>
<td></td>
<td>4.5</td>
</tr>
<tr>
<td>II 1957</td>
<td>(a)</td>
<td></td>
<td></td>
<td>5.00</td>
</tr>
</tbody>
</table>

(a) Beginning November, 1956, fluctuating rates are determined weekly at ¼ of 1 per cent above the last preceding average tender rate for 3 month Treasury bills. The effective rates have ranged between 3.77 in November, 1956 to 4.06 on 30/6/57.

* U.N. Statistical Yearbooks.
SHARE PRICES 9/29/28 TO 9/29/29 (M.R.R.S.)

Base: 1929-29 = 100.0.
SHARE PRICES, 1936-37 to 1956-57 (M.R.B.S.)

Base: Average of 3 years ended June, 1939 = 1000.

- - - - - - 23 Manufacturing Companies.
- - - - - - 10 Retail Companies.
- - - - - - 34 Active Shares.
D: COMPARISON OF SHORT AND LONG DATED SECURITY YIELDS AND 2 YEAR

FIXED DEPOSIT RATES: 1934/35 - 1952/53

Long-dated (12 years)

Short-dated (2 years)

2 Year Fixed Deposit Rate.
E1: STRUCTURE OF INTEREST RATES, 1931/32 to 1950/51.

- Differences between long-term bond yields and 1-year fixed deposit rates.
- Short-term bond yields.
- Medium-term bond yields.
STRUCTURE OF INTEREST RATES, 1931/32 to 1949/50

Difference between long-term bond yields + Treasury Bill Discount rates.

Difference between maximum call Bank Advance Rates and long-term bond yields.
Chart: Trend of Share Prices as compared with Bond Yields

Ordinary Shares (ex financial)
Lamberton

Preference Shares (Lamberton)

Yields on Long-dated Government Securities
F3: TREND OF SHARE PRICES AS COMPARED WITH BOND YIELDS
1928/29 to 1956/57
G: DIFFERENCE BETWEEN MARKET YIELDS + RATE ON NEW LOANS

Long-term Securities - 1932/33 to 1936/37

Excess of Market

Excess of Rate on New Loans.
TREASURY BILL RATES: 1925 - 1957

- Australia (Tap 3 months)
- United Kingdom (Tender 3 month)
- United States (---)

Year:
- 1925
- 1926
- 1927
- 1928
- 1929
- 1930
- 1931
- 1932
- 1933
- 1934
- 1935
- 1936
- 1937
- 1938
- 1939
- 1940
- 1941
- 1942
- 1943
- 1944
- 1945
- 1946
- 1947
- 1948
- 1949
- 1950
- 1951
- 1952
- 1953
- 1954
- 1955
- 1956
- 1957
PART IV.

ANALYTICAL : BEHAVIOUR OF INTEREST RATES FROM 1931 TO 1950

<table>
<thead>
<tr>
<th>Section</th>
<th>Dates</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td></td>
<td>...</td>
</tr>
<tr>
<td>I : 1931-39 - each financial year</td>
<td></td>
<td>...</td>
</tr>
<tr>
<td>II : 1939-1946 -</td>
<td></td>
<td>(a) 1939-1941</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) 1941-1946</td>
</tr>
<tr>
<td>III : 1946-1950 - each financial year</td>
<td></td>
<td>...</td>
</tr>
<tr>
<td>IV : Recapitulation , 1931-1950 : Assessment of Results on longer perspective</td>
<td></td>
<td>...</td>
</tr>
</tbody>
</table>
INTRODUCTION

The primary purpose of this part is to discover why interest rates moved the way they did in the cheap money era from 1931 to 1950, and more particularly to assess the relative importance of policy and the pressure of market forces as influencing interest rates from time to time. This calls for a fairly detailed study of economic trends and an assessment of their importance relative to various policy measures.

The interest rate we are primarily concerned with is the bond rate because this is the rate which is most sensitive to changes in economic conditions, to government policy measures and to the psychology of the public and business world. The bond rate has had special importance in Australia where there has been no open-market for Treasury bills and no Bank rate to signal the direction of official thinking. Much of the literature of the thirties would suggest that fixed deposit rates were the key to the interest structure. Most leading bankers giving evidence before the Banking Commission in 1935/36, however, considered that the best datum line was the current market yield on Commonwealth securities. Clearly both rates were important in this period and a change in one led to a change in the other and thence to other rates. With the decline in the importance of fixed deposits and the growing importance of the public sector of the economy during and since the war, fixed deposit rates have lost most of their earlier significance in the banking structure and more attention than
ever is now focused on the bond rate.

The following analysis proceeds in terms of the supply and demand for money which is the method employed by Keynes in his General Theory. As a preliminary to such analysis I therefore set out the essential features of this theoretical framework.

Interest is not a reward for waiting but rather for parting with liquidity. Interest is a purely monetary phenomenon, a payment for the use of money. The rate of interest equates the relative advantages of holding securities with the advantages of holding cash. On the one hand there is liquidity preference or the demand for money, and on the other the quantity of money. The demand for money must equal the supply. Liquidity preference is an ex-ante concept while the supply of money is, of course, "ex post". (1)

The demand for money has two principal facets. In the first place cash is needed to finance the current level of business activity (transactions demand) and as a precaution against future expenditure which at present is of an uncertain order. These Keynes classified under $M_1$, which is really the demand for money to hold with the intention to spend in the future. $M_1$ is income elastic but interest inelastic. In the second place there may be additional money desired to be held as a hedge against expected variations in the rate of interest.

---

This is termed the speculative demand for money or $M_2$. $M_2$ is interest elastic but normally income inelastic. It is mainly this factor which distinguishes the Keynesian analysis from other analyses.

With a given set of expectations, the lower the rate of interest, the greater the chances that it will rise in the future, until a level is reached (say $2\frac{1}{2}$ per cent for long dated bonds) when people would be willing to hold an unlimited quantity of cash. If expectations change people will be willing to hold more or less cash at a given rate of interest than previously. If such a variation in cash cannot be readily accommodated the rate of interest must change to secure again an equilibrium between the demand and supply of money. If there is, for example, a fear that interest rates will soon rise, some money will be demanded for the speculative motive. If $M_1$ is unchanged the existing interest level can only be retained by an increase in the supply of money. If the monetary authorities refuse to increase the money supply, the rate of interest will rise.

In practice a case as clear-cut as that is rarely encountered because $M_1$ is constantly changing. Every increase in income induces an upward shift in the $L$ function (the demand for money). With a fixed supply of money such an upward shift produces an increase in the rate of interest. In this case there is an increase in the velocity of money. However, it often happens that an increase in income is accompanied by a
reduction in the amount of money which it is desired to hold as an idle asset for speculative reasons, and a relatively small rise in the money supply may therefore be sufficient to prevent interest rates from rising.

In Australia during the cheap money period from 1931 to 1950 the bond market was influenced by a number of factors. The chief causes of variations in the supply of money were:

(a) the balance of payments
(b) Treasury bill finance
(c) bank advances
(d) central bank action, such as:
   (i) open market operations
   (ii) support to loan issues from central Bank and Savings Bank funds.

The demand for money has been related to the level of investment, income and employment and also to bank lending and debits to customers' accounts. It was also influenced by the Premiers' Plan, by the availability of real resources and by expectations of changes in economic conditions and in Government policy. Both demand and supply have of course, been affected during and since the war by direct controls, fiscal policies and quantitative and qualitative credit controls. Special Account policy was designed to immobilize liquid funds and thereby vary the level of bank lending and hence the supply of money in future periods.
It would be possible to analyse such factors in terms of Robertson's loanable funds analysis. This has the advantage of confining attention to flows over a period of time and of therefore avoiding the awkward problem of lags and mixing up "ex post" and "ex ante" concepts; it is also simpler and accords more with common usage. On the other hand it has the disadvantage of not highlighting sufficiently the matter of speculation and business psychology which is so important in short-run analysis. There is also the awkward problem of defining and identifying savings. The supply of loanable funds is said to be governed mainly by the level of current savings and the increase in bank advances, while the demand is made up broadly of investment expenditure, net hoardings and consumption expenditure in excess of current income.
Section 1: 1931-1939

(a) 1931-32

In 1931/32 the market rate for Commonwealth bonds fell from about 7 per cent to 4\frac{3}{4} per cent. In less than 4 months, that is from 30th September, 1931, to 7th January, 1932, the rate fell from 6.21 per cent to 4.85 per cent. However, for the remaining five months or so of the year there was comparatively little movement.

The main pressure for lower bond yields came from an increase in the money supply and the fall in private investment. There is also some evidence that the Premiers' Plan allayed panic and prevented a further rise in liquidity preference.

The average yield on all Commonwealth Securities fell by about 32 per cent during the year. Of this fall about 12 per cent would appear to have been caused by the increase in the money supply, 12 per cent by the depressed state of production and trade and the remaining 8 per cent by the favourable psychological impact of the Premiers' Plan.

The money supply increased by 5.3 per cent during the year, compared with a decrease of nearly 7 per cent in the preceding year and 5 per cent in 1929/30. The only other year in the thirties when this increase was surpassed was 1933/34.

Deposits of the private trading banks and all savings banks rose by £24 million in 1931/32. Liquid assets of the private trading banks rose by about £26 million mainly as a
result of the expansion of Treasury bills. In the same period bank advances fell by £12 million. Both movements were to some extent indicative of the depressed state of enterprise.

The evidence that the liquidity preferences of the public fell slightly during the year is rather scant but it is significant that the principal institutional investors - savings banks and Life Offices - helped materially to sustain the market demand for Commonwealth bonds. Holdings of Commonwealth securities, other than Treasury bills, by all savings banks rose by nearly £5 million, while holdings by Life Offices rose by approximately £9 million. This latter increase was particularly significant in view of the fact/their total assets during the year increased by only £7 million. In earlier years a major part of their increased funds had gone into mortgages, which however were severely curtailed in the depression years.

Australian trading banks have not invested large amounts in Commonwealth bonds; the ratio of fixed to current account deposits, however, was regarded as an important indicator of business conditions. While the absolute increase in fixed deposits was larger than in current deposits, which might indicate some unwillingness on the part of the public generally to buy bonds, the ratio between them was virtually constant at the high level appertaining in the two preceding years. There was however a slight fall in the ratio of fixed and savings bank deposits to current deposits. The share market was
heavily suspect and it is quite possible that the bond market received some benefit on that account.

The low level of private investment was accompanied by a fall in the current transaction demand for money, as well as in the decline in requests for bank accommodation. Bank clearings fell from a weekly average of £33.8 million in 1930/31 to £28.3 million in 1931/32. Expressed as a percentage of total deposits, bank clearings in this period fell from 7.5 to 6.0. Total deposits rose as a percentage of the national income and the income velocity of money (Y/M₁) fell from 7.0 per cent to 6.2 per cent.

It seems highly improbable that speculation was at all important at this stage. An era of cheap money was not envisaged. If, as was commonly asserted, there was a grave inflationary danger inherent in the increase in Treasury bills and that the economy would very soon be submerged again in a boom, we might have expected some reaction against the fall in interest rates. There is, however, no evidence of this having occurred. A large part of the increased funds of the institutional investors were used to purchase government bonds. It seems that "expert" market opinion, such as it was, was inclined to heavily discount the possibility of inflation while prices and employment remained so low. On balance it seems that expectations about the possible future level of interest
rates exerted a minor influence on the bond market by comparison with the increase in the money supply and the dearth of new investments, which were of approximately equal importance.

(b) 1932-33

Market yields fell from about 4.5% per cent to 3.5% per cent during the year. The Commonwealth loan issued in November failed by nearly £5 million but the May loan was over-subscribed by approximately £3.5 million.

The continued strength of the bond market is explained very largely by the failure of private investment to show any noticeable signs of recovery during the year. There is also some evidence that institutional investors were moving strongly into government securities in the process of readjusting portfolios to the changed economic scene. The volume of money however did not exert much influence on interest rates on this occasion.

In 1932-33 deposits of the private trading banks fell by £2 million, despite a slight improvement in the balance of payments position with overseas reserves rising by some £8 million and a welcome rise of £5 million in bank advances. Although difficult to identify, central bank operations were, on balance, deflationary. In the previous year their effect had been decidedly expansionary. According to Giblin(1) 1932/33

(1) op. cit., p.189
was the year in which the Commonwealth Bank made the greatest effort to reduce the liquidity of the banks, but the combined result was partially offset by the rise in London Funds which prevented any substantial fall in bank liquidity. At the end of the year the cash reserve ratio was 36.3%

Against this, however, was the increase of £24 million during the year in the holdings of government securities, other than Treasury bills, by all cheque paying banks and savings banks. Of this increase, £5 million had been contributed by the private trading banks and £2.3 million by savings banks. Life Officers increased their holdings, by £5 million, which once again is significant when viewed in the light of a total increase in all other assets of only £2.1 million. As with the experience of bank lending, this was to some extent conditioned by the failure of enterprise to push ahead with investment plans. But it may also provide some evidence that liquidity preferences were lower, reflecting a degree of speculation that interest rates would continue to fall.

The fall in interest rates cannot be explained by any one factor alone. The low marginal efficiency of capital however would explain most of the decline. The money supply did not increase but neither did liquidity preference. Thus Giblin, who regarded 1935 as the year in which investment displayed its first notable recovery, said: "Up to this point there must have been a growing accumulation of funds available for investment,
which went readily into loans as soon as confidence in bonds was restored. After 1934 these funds would have been diverted to private investment, including the building up of stocks." (1)

Although the level of investment remained in a very depressed state, factory employment rose by 9 per cent and the Gross National Product by 4 per cent during the year. The fall in the income velocity of money was arrested during the year and the ratio of fixed to current account deposits fell from 218 to 209. Bank clearings were somewhat higher than in the preceding year both in total and as a percentage of bank deposits. The transactions demand for money was however still very low, even if marginally above the previous year's level.

Thus the fall in interest rates in 1932-33 was very largely a response to market forces and not to decisions of policy. At this stage the Bank Board was very much concerned with the growth of liquidity but was beginning to look with increasing favour on the decline in market yields on government securities. The Board wanted low interest rates but not cheap money! This seemingly paradoxical attitude calls for some comment.

There is no doubt that the Board wanted low interest rates. It was mainly a question of how this was to be achieved. McLaurin (2) says that the Board did not attempt to force a rapid reduction in interest rates, although they undoubtedly favoured

---

(1) Ibid., p. 176
(2) op. cit., p. 231.
a gradual reduction. Interest rates were a means towards an end and the end was a reduction in government expenditure. The Board was very concerned that Governments might fail to carry out planned reductions in expenditure. The advocacy of a rapid reduction in interest rates, however, might have involved the Board in sanctioning more credit expansion, and this, of course, was not desired.

The opposition to credit expansion seemed to stem largely from a fear that a boom was "just around the corner." The existence of "excess" liquidity was apparently a threat to the stability of the system. Our paradox is resolved, however, when it is realised that the Board envisaged that the boom would be accompanied by a loss of confidence, followed by a rise in interest rates. It is exceedingly difficult to understand how the Board could have taken such a possibility seriously in the prevailing circumstances; nor does it follow that any loss of confidence would have caused a rise in interest rates. However such an idea was in keeping with "classical" thinking and was in fact argued — with considerable justification on that occasion — by some noted economists early in 1931 to oppose Theodore's Fiduciary Notes Plan.

The point then is that the Board was slow to see that an expansion of Treasury bills under prevailing circumstances would be more likely to reduce than to increase interest rates.

(1) Giblin, op. cit., p.117 (2) Vide Part II, ante
From early in 1933 the Board began to initiate changes in fixed deposit rates and by the end of the year there were definite signs that its attitude to the whole question of interest rates had changed. This aspect is considered at a later stage.

At first the Board was rather uncertain as to the importance which should be placed on the advent of low interest rates and what encouragement, if any, it should give to further the trend. In the early stages the Board's attitude was essentially the same as the trading banks, namely that interest rates were set by factors outside its control. Bond prices were, in other words, determined by the forces of supply and demand - the balance of payments, the propensity to spend and the level of private investment, for example - factors which were not within its province to influence directly. This attitude was the logical outcome of the Board's interpretation of its own functions as being concerned primarily with the stability of the currency and not with the state of production and trade. Given this pre-occupation with the price level, banking trends and the fear of inflation, the Board took the view that it did not much matter if rates rose or fell although as long as low rates were compatible with a stable price level there was something to be said in their favour. They could help to reduce costs and in particular ease the budgetary burden for governments. Moreover a stable bond market facilitated loan raisings, upon which so much depended.
This year saw a continuance of the cheap money trend. The market rate for Commonwealth bonds fell from 3½ per cent to 3¼ per cent during the year and two public loans were successfully floated raising a total amount of £22.6 million, including a subscription of £3 million from the Commonwealth Savings Bank. (1)

Although investment appears to have recovered some ground during the year, it was as yet too weak to have any marked impact on the bond market. A large part of the pressure for lower interest rates came from the increase in the quantity of money. Deposits with the private trading banks and all savings banks rose by 6.3 per cent - the highest for any year between 1931 and 1940. This was due mainly to the marked recovery in export prices. The terms of trade went to their highest level since 1928/29 and international reserves rose by £23 million. The cash reserve ratio reached a record level of 38 per cent. For the year as a whole, central bank operations were fairly neutral.

As in the preceding year, there was some evidence of a revival in the demand for money, although the demand for bank accommodation was still very sluggish. Bank Clearings, which had fallen by about one-third between 1928/29 and 1932/33, rose by 10 per cent in 1933/34, and the ratio of fixed to current

(1) Ibid., Table A, p. 175.
account deposits fell from 194 to 173. These developments were matched broadly by the rise in income. The Gross National Product rose by 9 per cent and the trade union percentage of unemployment fell to 23 per cent.

No difficulty was experienced in bringing the bond rate down to $3\frac{3}{4}$ per cent during the year. This was due, for the most part, to the expansion of the money supply and the continuing low level of investment demand; but it was probably aided also by a revision of expectations as a result of the decline in favour of the view that a boom was "just around the corner".

Economists had now ceased to emphasise the inflationary consequences of central bank credit and claimed instead that the expansion of Treasury bills had been a vital factor in promoting recovery. It had not only increased the money supply but relieved the pressure on the loan market and hence on the demand for funds. With the return of confidence credit expansion must reduce interest rates and actually relieve the strain on budgets.

(d) 1934–35

Towards the end of 1934 bond prices began to fall, although for the year as a whole the rise in bond yields was only $\frac{1}{2}$ per cent, from $3\frac{1}{4}$ per cent to $3\frac{1}{2}$ per cent. At the end of 1934 the market was still yielding $3\frac{1}{4}$ per cent and a public loan had been floated successfully in November at 3 per cent.
At the end of the financial year a £12.5 million loan was floated to give an effective yield of £3.8.5 per cent and was undersubscribed by approximately £1.7 million.

The hardening tendency of interest rates in the second half of the financial year had its origins in the fall in the supply of money and in the banks' cash reserves following upon an adverse swing in the balance of payments.

During the year export prices fell by nearly 17 per cent and the level of gold and foreign exchange holding by £29 million. Exports fell by £11 million while imports rose by £15 million and overseas reserves at the end of June, 1935, were less than at the end of June, 1933.

Although bank advances rose by £17 million in 1934/35 investment was still in a hesitant mood. Trading Bank deposits fell by £5 million and the movement from fixed to current account deposits continued. The income velocity of money, however, actually fell slightly during the year owing to the relatively small rise of 3 per cent in the Gross National Product. At the end of the year the Trade Union percentage of unemployment was about 20 per cent.

The movement of the various aggregates during the year were such that while the volume of money (defined to include savings bank deposits) showed no appreciable increase as it had done in the preceding year, the demand for money for the transactions motive would not have increased much either.
In the absence of special factors bearing on liquidity preference we would not therefore have expected any pronounced swing in bond prices in either direction.

The Commonwealth Bank brought a steadying influence to bear on the bond market in 1934/35. While the precise extent of assistance rendered is difficult to gauge, it would appear from Giblin that it was between £5 million and £10 million. In the previous year the Central Bank (including the C.S.B.) had been a net seller in the bond market. Bank liquidity fell to what was regarded as a danger point in June, 1935, but it would have fallen further in the absence of advances from the Commonwealth Bank and open market purchases.

It is probably going too far to say that the Commonwealth Bank was pursuing in this year a conscious policy of cushioning the effect on the internal economy of an adverse movement in the terms of trade. But the year was a turning point in monetary policy because it was the first time that the Board pledged itself to a policy of low interest rates when the market was tending to push rates up again.\(^1\) By 1935 the Board was emphasising the importance of maintaining low interest rates, not because it would encourage private investment but because it would assist government financial operations.

After 1933 the Bank Board, while pressing vigorously for the funding of Treasury bills, allowed a measure of credit

\(^{(1)}\) c.f. Giblin, *op. cit.*, p.173, pp.155-7 and p.245
expansion so long as it involved little publicity and took the form of the acquisition of long-dated marketable securities. In 1935 the Commonwealth Bank abandoned its funding policy and emphasised the need to prevent any increase in the amount of outstanding bills. This new policy - one which to a large extent had been forced on the Board by the increasing difficulty of public loan raisings and strong opposition from the Loan Council - enabled the Board to advocate low interest rates with greater consistency and equanimity than had hitherto been possible.

Cheap money was, in a sense, at the crossroads in 1935. Balance of Payments difficulties were again emerging and it was argued in some quarters that to meet them it would be necessary to jettison the cheap money policy. Bond prices had begun to weaken at the end of 1934 and the real testing time for cheap money as a continuing objective had arrived. The Board, however, refused to allow market forces free play and showed a determination to keep interest rates low. It pledged itself to a policy of low interest rates and supported the market quite strongly.\(^1\) This policy was, if anything, strengthened in 1936 when the Board was opposed to a rise in interest rates as a means of offsetting boom conditions and in 1937 and 1938 when the Board vigorously applied open market techniques to ward off the recession. The Board's conception of its functions had obviously changed. Although it had displayed some weakness

\(^1\) Giblin, op. cit., p. 173 and p. 245.
in allowing the trading banks to raise fixed deposit rates in open defiance of its wishes, its refusal to persevere with the open market policy illustrates the importance which was being placed on preventing interest rates from rising.

In summary, the hardening tendency of interest rates in 1934/35 was promoted to a large extent by the unfavourable balance of payments position. On the other hand, the rise in income was relatively small and the Central Bank for the first time deliberately supported the market to counter the tendency of interest rates to rise.

(e) 1935-36

The market yield on Commonwealth securities went from 3.51 per cent at the end of June, 1935, to 3.88 per cent at the end of June, 1936, which was a larger increase than had occurred in 1934/35. Two public loans were raised but the response was far less encouraging than in either of the two preceding years. The total amount raised was £17 million, the redemption yield being 3.78 per cent for the November loan and 3.88 per cent for the June loan, the latter being under-subscribed by £1.8 million. Holdings of Commonwealth securities (other than Treasury bills) by all cheque-paying banks and savings banks, which had risen in earlier years, fell by £5 million in 1935/36. Trading bank holdings fell from £23 million to £15 million.

For the year as a whole central bank operations in Government securities were fairly neutral but in the final
In the quarter of 1935 the Commonwealth Savings Bank in an effort to steady the bond market purchased some securities from the public, about half of which (£1 million) represented a continuing addition to the credit base. However, this and other action proved insufficient to prevent a further deterioration in the loan market and a weakening of bond prices.

Nevertheless the events of the year show that the Board was more determined than ever to avoid surrendering cheap money. Its policy in the past had been dictated firstly by the concern for the high level of banking liquidity and the importance of meeting the inflationary danger by funding Treasury bills while the loan market was buoyant, and secondly by the realization that the most it could hope for when the market was not so buoyant was the prevention of an increase in the amount of bills outstanding from year to year. The third and final phase was the attempt to establish an open market in Treasury bills and this brought to a head a conflict between the Central Bank and the trading banks, which had been brewing for several years. In a sense this phase was won by the trading banks in that they were able to defeat the Board's immediate intention; but of even greater importance was the Board's unwillingness to persist with the experiment if it meant forcing up interest rates. It became increasingly evident to the Board that its powers for controlling interest rates and indeed for administering

(1) Ibid., pp.184-5.
the broader aspects of monetary policy were inadequate. At the time the Board wanted to avoid a rise in the rate of interest because of a possible adverse effect on government loan raisings. (1) It did not favour meeting the boom conditions of 1936 with a rise in interest rates for this reason. On 18th March the Chairman of the Board said: "The Commonwealth Bank does not desire interest rates to rise unless it is abundantly clear that such increase has become necessary through general economic and financial conditions." (2)

The rise in bond yields during the year can be attributed very largely to the growing demands of Australian industry for new capital and for the financing of stocks. During the year there was a notable expansion in private investment and trade was more active. The number of building permits issued for new dwellings averaged 1025 a month in 1935/36 compared with 763 a month in 1934/35, an increase of approximately 34 per cent. The Gross National Product rose by 12 per cent in 1935/36 and the Trade Union percentage of unemployment fell to 14 per cent.

These factors caused a sharp rise in the demand for money to satisfy the transactions motive. The demand for money rose faster than the supply and interest rates therefore rose. The ratio of fixed to current account deposits fell from 173 to

(1) Ibid., pp. 152-84.
(2) Report of the Royal Commission on Banking, p. 65.
167, a trend that had been well in evidence in earlier years. Bank clearings – a rough measure of the velocity of money – had risen faster than the volume of money during the year; but one of the best indicators of business activity is income velocity, or the ratio of income to current account deposits, and this had risen from 6.0 per cent to 6.6 per cent in 1935/36, after having fallen slightly in the previous year.

This was therefore a boom year in which the demand for funds outran the supply. Export prices rose by 27 per cent but imports and other invisible payments were also much higher, with the result that overseas reserves fell by £4 million. In 1934/35 and 1935/36 imports had increased by £27 million and bank advances by £26 million. In 1935/36 the trading banks unloaded £8 million of securities on the market which, as it does not appear to have been offset by central bank purchases, would help to explain the failure of bank deposits to rise during the year. While Giblin(1) considers that the activities of the trading banks were not important with respect to government loans, he admits that selling in 1935/36 contributed to the failure of loans and to some market weakness.

The growth in the demand for investible funds, the low level of bank liquidity, and the failure of deposits to rise may lead us to wonder why the rise in bond yields in 1935/36 was of such relatively modest dimension. The answer may be

(1) Ibid., p. 180
that the Commonwealth Bank reduced the extent of institutional
selling by its greater willingness to use Savings Bank funds
for purposes of controlling the volume of credit and by its
reiterated statements on the importance of retaining cheap money.

(f) 1936-37

The yield on long-dated securities fell from 3.94 per
cent in June, 1936 to 3.75 per cent in June, 1937. However, for
the year as a whole the average yield was 3.94 per cent compared
with 3.77 per cent in 1935-36. Monthly yields for the period
are shown in the following table: (1)

<table>
<thead>
<tr>
<th>Last Wednesday in Month</th>
<th>Average of Securities Maturing before 1944</th>
<th>Average of Securities Maturing 1944 and After</th>
</tr>
</thead>
<tbody>
<tr>
<td>1936 - June</td>
<td>3.78%</td>
<td>3.94%</td>
</tr>
<tr>
<td>- July</td>
<td>3.78%</td>
<td>3.94%</td>
</tr>
<tr>
<td>- December</td>
<td>3.80%</td>
<td>4.00%</td>
</tr>
<tr>
<td>1937 - April</td>
<td>3.59%</td>
<td>3.89%</td>
</tr>
<tr>
<td>- June</td>
<td>3.37%</td>
<td>3.75%</td>
</tr>
</tbody>
</table>

The loan market exhibited further weakness in
1936/37 but with some improvement towards the end of the year.
An amount of £15.4 million was obtained from two public loans
raised during the year with £2 million being lodged by under­
writers with respect to the November loan. The effective
yield for the November loan was £3.19.4 per cent and for the
April loan £3.19.1 per cent.

(1) c.f. Commonwealth Bank reports.
Export prices again rose - this time by 23 per cent - but on this occasion the rise in imports fell a good way short of the rise in exports. The level of overseas reserves increased by £35 million, trading bank deposits by £21 million and savings bank deposits by £5 million. As is set out in the above table, security yields were lower at June, 1937 than at June, 1936, although most of the improvement was concentrated in the second half of the financial year. In its half-yearly report of 30th June, 1937, the Commonwealth Bank, referring to the fall in bond yields, said: "The decline has been due to the high prices of Australian exports and to the flow of capital from abroad ... there does not appear to be any reason why these lower rates should not continue".

The supply of money increased faster than the demand, but demand was strong. The Gross National Product rose by nearly 9 per cent and the Trade Union Percentage of unemployment fell to 11 per cent which at the time was regarded as a reasonably healthy level. Retail and wholesale prices rose slightly. Retail sales in Sydney were 5 per cent above the level of the preceding year. Private investment expenditure, however, which had staged a notable recovery in 1935/36, slackened considerably in 1936/37 which may partly explain the failure of imports to rise as steeply as in the preceding year. In these circumstances it is not surprising that the bond market gained strength as the year progressed. Judging from
Commonwealth Bank Reports investment did not slacken until the second half of 1936/37.

The income velocity of money did not increase during the year, neither did trading bank advances. The favourable movement in the balance of payments, however, was not permitted to exert its full effect on bank deposits and cash reserves. The Commonwealth Savings Bank began selling securities early in 1937. By October net sales had reached £11 million.(1) It is not possible to gauge the precise extent of the contractionary influence in 1936/37 by such means but it was quite large on past standards. The resilience of the market to these operations is indicative of its underlying strength. Open market policy however was reversed at the end of 1937 as boom gave way to signs of impending recession.

(g) 1937-38

Yields on long-dated Government securities averaged 3.71 per cent in 1937/38 compared with 3.94 per cent in the previous year. Yields in 1937/38 were generally lower than in 1935-36. In the first half of the year the yield fell from 3.75 per cent to 3.70 per cent but rose again in the second half of the year. For the year as a whole bond prices moved within fairly narrow limits. Changes in monthly yields during the year are compared below with yields for the corresponding months of the preceding year:

(1) Ibid., p. 246
Average of Securities Maturing 1944 and After

<table>
<thead>
<tr>
<th></th>
<th>1936-37</th>
<th>1937-38</th>
</tr>
</thead>
<tbody>
<tr>
<td>July</td>
<td>3.94</td>
<td>3.80</td>
</tr>
<tr>
<td>December</td>
<td>4.00</td>
<td>3.70</td>
</tr>
<tr>
<td>January</td>
<td>4.00</td>
<td>3.59</td>
</tr>
<tr>
<td>March</td>
<td>4.00</td>
<td>3.68</td>
</tr>
<tr>
<td>June</td>
<td>3.75</td>
<td>3.77</td>
</tr>
</tbody>
</table>

Two loans were raised during 1937/38 - in November and May and with effective yields slightly above 3\(\frac{1}{2}\) per cent. Total proceeds amounted to £18.6 million which was a better result than in 1936/37. The May loan, however, required some assistance from the Savings Bank as market yields hardened with the advent of recession.

The most outstanding feature of the year was the rapid rise in imports which reflected a high level of internal demand. Imports rose in value by 23 per cent while exports fell by about 5 per cent. The inflow of capital, however, assisted the balance of payments position with the result that overseas reserves fell by only £8 million. Bank deposits, however, increased by £10 million during the year mainly as a result of the £24 million rise in bank advances.

This year is of great interest because it was the first time since 1928/29 that a boom had been sustained for long without the accompaniment of a rise in export prices.
The export price index fell by 12 per cent during the year. The rate of private investment, which had slackened in 1936/37, spurted forward again in 1937/38, although as mentioned earlier, recession fears were very strong by March, 1938. The investment boom was accompanied by a high level of bank advances and imports.

The money supply rose by 3.5 per cent which was high considering the fall in export prices and some official selling of securities in the early part of the year. Indeed it is rather misleading to consider the year as a whole in this way; bond yields fell in the first quarter of 1937 but rose in the first quarter of 1938. These diverse movements can be explained very largely by balance of payments fluctuations and prospects and by the open market operations of the Central Bank which had now become a regular feature of the Board's technique for affecting the credit base. According to Giblin(1) it was a "deliberate and determined policy".

In all the circumstances it is rather surprising I think that the bond market withstood the test of the change from boom to recession in the final quarter of 1937/38 so well. Despite the sharp fall in banking liquidity, there was no sharp rise in the liquidity preferences of the public or of business. In view of the difficulty of public loan raisings this may be attributed to the effect - partly psychological - of the reversal of open market policy and the wider recognition of the

(1) Ibid., pp.181-3, 247, 250
powers and responsibilities of the Central Bank, which the Banking Commission had no doubt helped to foster. Money was pumped into the market on a moderate scale in both 1938 and 1939 and it was not until August 1939 that yields on long-term securities reached 4 per cent.

(h) 1938–39

The average yield on long-dated government securities rose in 1938/39 but at the end of the year was still slightly below 4 per cent. A comparison of monthly yields for 1936–37, 1937–38 and 1938–39 is given in the following table:

<table>
<thead>
<tr>
<th>Last Wednesday in Month</th>
<th>Average of Securities Maturing 1944 and after</th>
<th>Average of Securities 10 years and over</th>
</tr>
</thead>
<tbody>
<tr>
<td>July</td>
<td>3.94</td>
<td>3.80</td>
</tr>
<tr>
<td>September</td>
<td>3.93</td>
<td>3.83</td>
</tr>
<tr>
<td>December</td>
<td>4.00</td>
<td>3.70</td>
</tr>
<tr>
<td>January</td>
<td>4.00</td>
<td>3.59</td>
</tr>
<tr>
<td>March</td>
<td>4.00</td>
<td>3.68</td>
</tr>
<tr>
<td>June</td>
<td>3.75</td>
<td>3.77</td>
</tr>
</tbody>
</table>

Loan market difficulties were intensified during the year because of the large conversion operation of December, 1938. The February loan failed badly with £3.6 million being lodged by underwriters out of total proceeds of £8.5 million. In the May/June loan only £4.75 million was obtained, of which
£900,000 was lodged by underwriters. Effective yields were £3.17.6 and £3.19.2 respectively.

Although the adverse balance of payments situation caused a drain on bank deposits in Australia, offsetting factors were an increase in bank advances, a rise in outstanding Treasury bills and central bank support of the bond market. Between June, 1938, and June, 1939, Trading Bank deposits rose by £2 million.

The demand for money was also lower because of the fall in the level of economic activity. The Gross National Product fell by 3.4 per cent, unemployment rose and the Export Price Index fell by about 20 per cent. Gold and foreign exchange holdings fell from £85 million in June, 1938, to £61 million in June, 1939. The pace of private investment expenditure slackened considerably and Governments faced revenue deficits for the first time in years. Wholesale trade fell by 1.7 per cent and bank clearings by 2 per cent. Bank liquidity went to a record low level, despite some central bank assistance.

Why then did bond prices weaken during the year? The answer must I think be found largely in the trend of world events and their effect on investor expectations. The re-appearance of budget deficits may also have unsettled the market. In 1938-39 the Commonwealth Bank's holding of bonds increased by £11 million as a deliberate inflationary measure.\(^{(1)}\)

\(^{(1)}\) Ibid., p.295
Section 2 : 1939-1946

(a) 1939-41

Before the promulgation of the National Security Regulations in November, 1941 and February-March, 1942, yields on Commonwealth Securities were falling. Between December, 1939 and June, 1941, the fall was of the order of \( \frac{3}{4} \) per cent. Yields on long-dated securities averaged 3.13 per cent in 1940/41 compared with 3.67 per cent in 1939/40 and 3.84 per cent in 1938/39. The fall in medium dated security yields during the same period was somewhat greater. After 1941 the long term market rate was stabilized at about 3.25 per cent and the short-term market rate at about 2.45 per cent. After the War these yields fell further. The market's stability between 1941 and 1946 was, of course, associated with war-time controls and is discussed in the succeeding section.

The following points seem to form a necessary background for a consideration of the cheaper money trend between 1939 and 1941:

(i) Government policy had been influenced - if slowly - by the experience of the thirties. As early as 1936 the Bank Board was opposing the raising of interest rates to moderate boom conditions and by 1939 subscribed to the view that interest rates should be kept as low as possible.

(ii) In 1938/39 the authorities were engaged in fighting a business recession and, as indicated earlier,
some difficulty was experienced in holding the bond rate below 4 per cent. The threat to the cheap money policy however was averted by decisive action in expanding the credit base.

(iii) The loan market was very weak in September, 1939.

(iv) The Central Bank, in view of the trend of business generally felt little compunction in permitting a measure of credit expansion till about the middle of 1940. The result was a fall in market rates of interest. From then onward, however, the economy climbed steadily out of recession and the level of unemployment fell rapidly. Greater care had therefore to be exercised in credit expansion. In the event it was buttressed by an elaborate network of economic controls, such as was not envisaged in 1940.

Interest rates fell in the first two years of the war. This was partly because market conditions were more favourable but a more important influence now was the Government's determination to bring interest rates down to their lowest practicable levels. Bank liquidity was increased by the rise in London balances and by official purchases of securities and commodity advances.

The authorities were determined to reduce interest
rates over the whole period of war. In his 1940/41 Budget Speech the Treasurer claimed that yields on government securities had fallen on the average by one per cent since the war and that rates on Treasury bills, bank deposits and overdrafts had also been reduced. Similar references in other Budget speeches and Financial Statements make it clear that the Government was doing everything possible to keep bond yields down.

Low interest rates were desired to minimize the cost of Government borrowing, but more generally to ensure that savings flowed readily into Government loans and were thereby diverted to the more essential requirements. Competition for savings was later reduced through both physical and financial controls. The latter consisted of control over interest rates, capital issues and bank advances. A subsidiary reason for keeping rates low during the war was to ensure that bond holders would not suffer a capital loss on their investments.

The terms of trade improved in this period. In 1938/39, which is commonly regarded as a recession year, international reserves fell by £25 million. This trend, however, was reversed in 1940, and in June, 1941, reserves stood at £95 million - an increase of nearly £35 million in two years. This factor accounted for about half the increase in the money supply and contributed to the situation in which finance was not a problem in the first two years of war. Giblin says that "it was found impossible to spend the money provided and care
had to be used to avoid the deflationary effect of the freezing of large Treasury balances."\(^{(1)}\)

It is not possible to gauge from official figures the extent of Commonwealth Bank and Commonwealth Savings Bank participation in market support during this period but the trading banks increased their holdings by about £40 million, of which £26 million was subscribed to new issues. According to Giblin the Commonwealth Bank also subscribed £10 million and the C.S.B. £7 million in this period. Thus of total loan raisings of £115 million during the period, £43 million was subscribed by the Central Bank and the trading banks. This is an indication of the magnitude of the support programme which contributed to the increase in bank deposits and liquidity, of which about £15 million was later frozen in special accounts.

The demand for money rose far less than the supply. This is evidenced in the figures of gross national expenditure, in the fall of £8 million in bank advances and the high level of banking liquidity. Gross private investment rose in 1939/40 but fell in 1940/41 as war expenditure increased. However, the important point is that the amount of finance available for capital expenditure was apparently more than adequate to meet these requirements. Gross national expenditure rose by 6.5 per cent in 1939/40 and 8.3 per cent in 1940/41. Considering the

\(^{(1)}\) op. cit., p.290
rise in the price level of about 10 per cent in the two years, these increases were not high even by comparison with pre-war standards.

The first reduction in fixed deposit rates occurred in January, 1940 and rates were reduced on three more occasions up to March, 1942. All moves were strongly resisted by the trading banks but the Board stood firm which as Giblin reminds us, was in striking contrast to the experience of 1936 when the trading banks increased rates in opposition to the Commonwealth Bank and the Bank felt compelled to follow. In advance rates there were three reductions up to March, 1942, equal in all to nearly \( \frac{1}{2} \) per cent (to maximum rate of 5%).\(^{(1)}\)

(b) 1941–1946

In the first two years of war the monetary authorities had supported the bond market not so much to prevent interest rates from rising as to ensure that they were kept as low as possible. The economy moreover was not yet at full stretch, there being therefore some scope for reflationary measures quite apart from the more general arguments for low interest rates. From the end of 1941, however, these conditions ceased to obtain and policy became more a matter of stabilizing the bond market to secure a particular low rate. This policy – often referred to as monetization of the debt – added greatly to the liquid assets in the hands of the public, but that did not seem to matter

\(^{(1)}\) Ibid., pp.282 and 287.
under a policy of controlled inflation. With most avenues of spending effectively shut off and no immediate risk attached to holding bonds, there was every incentive to hold long term securities.

A marked change came over the situation with the entry of Japan into the war and particularly with the fall of Singapore, in February, 1942. By the end of 1941 the transitional problems were largely overcome and unemployment reduced to negligible proportions. In the first phase of the war it had been possible to finance war expenditure from the proceeds of public loans and taxation, that is, without recourse to Treasury bill finance. In the second half of 1941 the matter was in some doubt and the Bank Board still endeavoured to have new bills redeemed as the proceeds of public loans came to hand. However, by the end of the year the requirements of war forced the abandonment of this policy.

In 1941–42 gross national expenditure rose by nearly 16 per cent or about twice the rate of increase of the preceding year. It rose by a further 14 per cent in 1942/43. As gross private investment fell during these years and consumption expenditure was pretty constant, the increase in war expenditure was even more marked. By the end of 1941 the Government was no longer embarrassed with Treasury surpluses. The immediate danger to Australia required very large increases in expenditure which were far in excess of what could be obtained
from loans or taxation. Though taxation was increased substan-
tially up to 1943-44 and large amounts obtained from loans, it was recognised that there were limits beyond which you could not push them and that better results could be secured from a policy of controlled inflation. That was the policy that was evolved, though with some initial hesitation, and by 1942 the Bank Board had accepted the inevitability of a rapid expansion of Treasury bills. With the danger so close to home, people accepted the tightening of economic controls without too much fuss.

This experience was not, of course, peculiar to Australia and policy was pretty much a rule of thumb affair in those days. There was very little time for theorising. Expenditure had to proceed irrespective of the source of finance. In taxation policy the emphasis was placed on the need to reduce excessive spending power rather than on the mere availability of finance. The same can be said for loan raisings after 1941.

In what did the policy of controlled inflation consist and what were its consequences for interest rates and economic conditions generally? Apart from controls over men and materials, over imports, capital issues, prices and consumer rationing, all of which greatly limited the range of investment opportunities, there were the all-important National Security (Economic Organisation) Regulations of November, 1941, and
February-March, 1942. These regulations were designed to prevent secondary inflation developing from the growth of central bank credit, to avoid excessive bank profits and to speed up the diversion of resources to the requirements of war. In some respects these regulations gave legal sanction to prior voluntary arrangements. Under the regulations the Commonwealth Bank was given power to require the trading banks to lodge surplus investible funds in special accounts and to direct the banks to follow a particular advance policy. The regulations also prohibited the trading banks from either subscribing to loans or purchasing bonds from the public without the consent of the Commonwealth Bank and established control over maximum rates of interest for most classes of lending or borrowing.

High rates on fixed deposits were regarded at the time as constituting a serious competitor to Government loans. It was also thought that fixed deposit rates were the key to the whole interest structure. The banks had reluctantly agreed to reduce fixed deposits rates in the early stages of the war.

The National Security Regulations gave the Commonwealth Bank power to fix maximum rates of interest for most types of lending or borrowing, other than by the Commonwealth Government. Details of orders issued under the Regulations are as follows:
## Maximum Rates of Interest fixed by Commonwealth Bank under National Security (Economic Organisation) Regulations.

### Date of Order

<table>
<thead>
<tr>
<th>Date</th>
<th>13/3/42</th>
<th>12/1/44</th>
<th>9/8/44</th>
<th>24/11/45</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trading Bank Overdraft Rate</strong></td>
<td>5</td>
<td>4⅔</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Loans by Pastoral Companies</strong></td>
<td>5⅓</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Loans to Local Authorities—</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Guaranteed</td>
<td>3⅕</td>
<td>3⅕</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>3⅔</td>
<td>3⅕</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Loans by Building and Co-operative Societies</strong></td>
<td>5⅔</td>
<td>5⅔</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td><strong>Loans by Building Societies guaranteed by State Government</strong></td>
<td>5⅔</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Loans by Life Assurance Companies on Life Policies</strong></td>
<td>5</td>
<td>4⅔</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fixed Deposits</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 months</td>
<td>1⅓</td>
<td>1</td>
<td>½</td>
<td>½</td>
</tr>
<tr>
<td>6 months</td>
<td>1⅓</td>
<td>1½</td>
<td>¾</td>
<td>¾</td>
</tr>
<tr>
<td>12 months</td>
<td>1½</td>
<td>1½</td>
<td>1¼</td>
<td>1</td>
</tr>
<tr>
<td>24 months</td>
<td>2</td>
<td>2</td>
<td>1⅔</td>
<td>1½(a)</td>
</tr>
<tr>
<td><strong>Victorian Savings Bank Deposit Stock</strong></td>
<td>1⅓</td>
<td>1½</td>
<td>1¼</td>
<td>1</td>
</tr>
</tbody>
</table>
Maximum Rates of Interest (Contd.)

<table>
<thead>
<tr>
<th></th>
<th>13/3/42</th>
<th>12/1/44</th>
<th>9/8/44</th>
<th>24/11/45</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings Bank Deposits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(C.S.B. and State Savings Bank of Victoria)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First £500</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>£501-£1000</td>
<td>1(\frac{1}{2})</td>
<td>1(\frac{1}{4})</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>(Other Savings Banks)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First £500</td>
<td>2(\frac{1}{4})</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>£501-£1,000</td>
<td>1(\frac{3}{4})</td>
<td>1(\frac{1}{2})</td>
<td>1(\frac{1}{4})</td>
<td></td>
</tr>
</tbody>
</table>
(a) Rate of 1% for amounts in excess of £10,000.

The control over bank and other interest rates, however, does not explain the stability of bond prices in this period. On the one hand private spending was severely restricted by means of both physical and financial controls and by high taxation and on the other the Government supported the bond market with a view to countering any sudden collapse of confidence.

According to Giblin the Sinking Fund was at all times a firm supporter of bonds, supplemented when necessary by the Commonwealth Bank. Discussions with the Stock Exchange resulted in a minimum price being put on bonds from June, 1940, which prevented any serious fall in price before the Bank could come to the rescue. The greatest net purchase from the public which the bank had to make in a year was about £11 million in 1941/42; in the three following years net purchases were of the order of £3 to £4 million.
During the period of war the money supply more than doubled, with an increase of approximately £750 million. The increase in Treasury bills and London funds account for about £500 million. As bank advances fell by about £90 million in this period it would appear that there was an addition of approximately £340 million to deposits as a result of support, either directly or indirectly to the bond market, or about £300 million between 1941/1946. A substantial part of this was represented by Commonwealth Savings Bank subscriptions to public loans. Broadly speaking the increase in the funded debt in this period was £1,100 million, of which about £300 million or just less than one third was concentrated in official hands. Thus official market support was at the rate of about £60 million a year, only slightly more than the 1946/47 rate. Trading bank deposits increased by £280 million between 1939 and 1945 but £220 million was immobilized in Special Accounts.

This result did not lead to runaway inflation. But in all countries suppressed or controlled inflation left its mark; it created a disposition against fighting inflation after the war and prompted the slogan that what was physically possible was also financially possible. Controls masked the real effect of the war-time credit expansion and led to the view that central bank credit was innocuous. The monetization policy undoubtedly helped foster such a belief because under
that policy the issue of long-term bonds seemed to lose all significance. If the risk of capital loss was removed what was the point of paying interest on the debt? Why not finance all expenditure through the creation of interest free central bank credit? It was argued that you do not counter inflation by raising the rate of interest but by progressive taxation and direct controls.\(^{(1)}\)

Section 3: 1946-1950

(a) 1946-47

(i) State of the Bond Market

In 1946/47 yields on long-dated securities fell from 3.25 per cent to 3.15 per cent. Yields in 1945/46 averaged 3.24 per cent and in 1946/47, 3.21 per cent. Yields on short-dated bonds fell from 2.47 per cent in 1944/45 to 2.19 per cent in 1945/46 and 1.93 per cent in 1946/47. The principal changes in yields on both short and long-dated securities are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Short-dated (per cent)</th>
<th>Long-dated (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>July, 1945</td>
<td>2.49</td>
<td>3.25</td>
</tr>
<tr>
<td>December, 1945</td>
<td>2.46</td>
<td></td>
</tr>
<tr>
<td>January, 1946</td>
<td>2.27</td>
<td></td>
</tr>
<tr>
<td>February, 1946</td>
<td>1.92</td>
<td></td>
</tr>
<tr>
<td>March, 1946</td>
<td>1.82</td>
<td></td>
</tr>
<tr>
<td>June, 1946</td>
<td>1.79</td>
<td>3.25</td>
</tr>
<tr>
<td>September, 1946</td>
<td>1.88</td>
<td></td>
</tr>
<tr>
<td>December, 1946</td>
<td>1.96</td>
<td>3.21</td>
</tr>
<tr>
<td>March, 1947</td>
<td>1.99</td>
<td>3.18</td>
</tr>
<tr>
<td>June, 1947</td>
<td>1.92</td>
<td>3.15</td>
</tr>
</tbody>
</table>

The year was marked by a rapid increase in the demand for money to satisfy the transactions motive and a relatively small increase (1.5 per cent) in the money supply. In the absence of official intervention in the market, these factors would have exerted pressure for a rise in bond yields. Strong market support however, was necessary to prepare the market for the advent of a 3 5/8 per cent coupon rate for long-term government securities. Commonwealth Bank and Commonwealth Savings Bank holdings of Commonwealth securities, other than
Treasury bills, increased by £53 million during the year.

(ii) **State of the Loan Market**

Both Commonwealth loans issued in 1946/47 were over-subscribed by many millions. The long-dated section of the October loan was issued at 3¼ per cent which was in line with the market. The amount sought on that occasion was £64 million. In April, 1947, the coupon rate was reduced from 3¼ per cent to 3⅔ per cent and the amount sought was £25 million. Once again the loan was over-subscribed. The interesting point, however, is that the announcement of the impending reduction was made in November, 1946, when the market was returning 3¼ per cent. By April the market rate had fallen to 3.16 per cent, which however, was still short of the rate at which the new loan was floated. This would suggest that despite the great increase in consumption and investment spending and the rather sluggish growth of the money supply during the year, there was still a considerable surplus of funds which went readily into government loans. This was in part a reflection of the patriotic response to the appeal for funds associated with development and partly a result of limited investment opportunities elsewhere.

The picture is reversed with respect to the shorter term securities. In the March, 1946, loan the coupon rate had been reduced from 2½ per cent to 2 per cent but the market had reached this rate somewhat earlier and in March the current yield was 1.82 per cent, and in June just short of 1.80 per cent.
In 1946/47 however, yields edged up very near to the coupon rate. In 1946/47 there was a narrowing of the gap between short and long term market yields. This was caused partly by the generally very optimistic outlook coupled with the knowledge that it was the Government's intention to keep interest rates low. Thus a fall in liquidity preference may have been responsible for some switching between short and longer dated securities. Furthermore, while current account deposits rose by £38 million during the year, savings and fixed deposits fell by £18 million.

With effect from 1st January, 1947, the maximum rates charged on fixed deposits and advances of trading banks, on pastoral company advances and on new loans made on policies by life assurance offices were reduced by $\frac{1}{4}$ per cent. These decreases were made under the Economic Organization Regulations.

(iii) Level of Spending

The continued operation of most of the wartime controls - particularly price and investment controls - prevented the rise in consumer spending from having much of an immediate influence on either commodity or security prices. But the growing desire to throw off wartime restrictions, coupled with the rise in wages and reduced taxation would appear to have caused a rise in the propensity to consume. The full employment policy was bearing fruit in securing a maximum use of resources and a resulting increase in output. As income rose, spending
rose also but apparently at a faster rate and there must have been some drawing off of cash balances built up in the earlier years when there had been less scope for spending.

Net expenditure of public authorities fell from £325 million in 1945/46 to £226 million in 1946/47 but spending for the community as a whole increased rapidly. Consumption expenditure was 18 per cent higher and gross national expenditure 7.6 per cent higher, than in 1945-46. Employment in factories rose by 8 per cent and private investment was starting to move forward strongly again. Evidence of the increased demand for money is provided by the rise of about 21 per cent in debits to customers' accounts. Expressed as a percentage of bank deposits, debits rose from 9.1 to 11.1.

(iv) Banking Trends

The redemption of Treasury bills and the fall of £17 million in international reserves were primarily responsible for the fall in bank liquidity. Bank deposits rose by only £22 million, the increase in bank advances of £65 million being offset in effect by the redemption of Treasury bills. The expansion of advances was financed in large part through a reduction of security holdings, which had been at an inordinately high level. Special accounts absorbed a further £9 million during the year.

(v) External Situation

Despite a fall in international reserves, the
external situation was very healthy and contributed to the general tone of business optimism. Some of the increased consumer spending went to finance imports about which there was growing concern, but the value of exports exceeded imports by no less than £100 million. Transactions mainly of a capital and non-recurring nature converted the current account surplus into a balance of payments deficit. These transactions included the £25 million grant to the United Kingdom and repayment of overseas loans amounting to £5.5 million.

(vi) Summary

The most important influences on the bond market during 1946/47 were the extent of official support, the relatively minor increase in the money supply, the rise of 40 per cent in export prices and the rise in consumer spending coupled with a growing opposition to the retention of wartime controls.

(b) 1947-1948

(i) State of the Bond Market

Yields on long dated securities in 1947/48 averaged 3.16 per cent, compared with 3.21 per cent in 1946/47. However, during 1947/48 there was virtually no change recorded in market yields for the longer dated securities although yields on shorter dated bonds fluctuated quite a deal, rising from 1.92 per cent to 2.49 per cent between June and January and falling to 2.34 per cent at the end of the year. There was therefore a further narrowing of the gap between short and long dated
securities during this year.

The main difference from the previous year was the rise of £75 million in international reserves. With the reduction of Treasury bills and the increase in bank advances again roughly offsetting one another, the rise in overseas funds was able to exert its full impact on the level of bank deposits. This was one of the reasons why official support of the bond market was on a much smaller scale in 1947/48 than in 1946/47. Holdings of Government securities, other than Treasury bills, by the Commonwealth Bank and C.S.B. increased by £29 million. The private trading banks were able to finance part of their bank lending from the sale of securities but not to the same extent as last year.

Although banks, other than the Central Bank and C.S.B. increased their holdings of securities, a disquieting feature was the relatively small net purchases of life assurance companies. In 1947/48 Life Offices increased their holdings by £3 million, compared with £18 million in 1946-47. While the supply of securities increased less than in the preceding year, it was significant that little more than half the increase in the available funds of the Life Offices in 1947/48 went into Government and Municipal securities, compared with more than 70 per cent in earlier years. This aspect of the post-war Australian bond market will be referred to again. In 1947/48 it did not appear to have any sway on the general market outlook.
and was not widely discussed until it had reached an acute stage in 1950.

Both loans were again heavily over-subscribed. The coupon rate was again $3\frac{1}{4}$ per cent for securities of 10-13 years maturity and no short dated securities were offered on either occasion.

(ii) Volume of Money

The volume of money rose by 5.7 per cent during the year which was certainly not a sensational rise but was considerably greater than in 1946/47. Current account deposits rose by £75 million, fixed deposits fell by £5 million and deposits in savings banks rose by £21 million. The banks were less liquid at the end of the year than at the beginning and the problem of financing advances, the demand for which was steadily rising, was soon to emerge. The fall in bank liquidity, however, had been much less than in 1946/47 and the volume of liquid funds was, of course, potentially very large. The amount called to special account, on the other hand, was £25 million as against £9 million the year before. Thus bank liquidity was increased by the favourable external developments and the support policy but reduced by budget and credit policies.

In the result it had been possible to reduce security holdings and meet special account requirements without causing a very appreciable drain on bank liquidity. Of major importance in this respect and to the maintenance of low interest rates was the favourable movement in the terms of trade.
(iii) **External Situation**

In 1947/48 the Export Price Index rose by 43 per cent with higher wool and wheat prices predominating. The total value of commodity exports was £407 million which was almost £100 million greater than in the preceding year. The value of imports, despite restrictions, amounted to £338 million which was £130 million greater than in 1946/47. Thus there was a favourable trade balance of nearly £70 million. After taking account of so-called invisible net payments and items of a capital nature, including a large capital inflow, the level of international reserves rose by £75 million, to a total of £274 million.

(iv) **Domestic Spending**

Despite the Government's fiscal and monetary policies and the continued operation, although in a modified form, of the wartime controls including capital issues control, the year saw a strong surge of spending, and an associated rise in the demand for money. Evidence of this is provided by the expansion of bank advances, the increase of 23 per cent in the Gross National Product and a further large rise in the velocity of money. Debits to customers' accounts were 18 per cent higher in 1947/48 than in 1946/47 and, expressed as a percentage of bank deposits, increased from 11.1 to 12.1. Income velocity also rose.

The level of private investment appeared to exceed all expectations. Business confidence was high with stocks rising in anticipation of demand and employment increasing further during the year. Public investment also increased but
there were large arrears to be made up and, despite the retention of price and other controls for most of the period, a competitive struggle for resources was emerging with a resultant increase in prices.

(v) Market Support and Controls

In conditions such as these and in a freely operating market mechanism there would be every reason to expect a fall in bond prices as had been the tendency in pre-war "boom" periods when the balance of payments was favourable. But the Government did support the bond market directly, as I have said, and indirectly through the administration of capital issues control which, while eased somewhat at the end of 1946, were not lifted until January, 1950. These controls were expressly designed to secure a plentiful supply of funds for essential purposes and to maintain low interest rates.\(^{(1)}\) The advent of selective credit controls in November, 1947, had a similar objective with respect to short-term lending. These controls were tightened in May, 1949.

(vi) The Fiscal Problem

Secondly the problem was no longer one of finance but of real resources. Thus while money was effectively channelled into government loans it could not all be spent and was therefore available to redeem Treasury bills. A redemption

\(^{(1)}\) c.f. Copland and Barback, op. cit., pp.315-7
of Treasury bills is a direct subtraction from bank deposits and liquidity; its effect on interest rates may however be fairly neutral in a fully employed economy when spending – particularly investment spending – is limited by a scarcity of resources. Thus it may be argued up to a point that if excess subscriptions had not been retained and used, in effect, to redeem Treasury bills, more funds would have been available from the public to buy bonds on the market and that this might have reduced the need for official support.

This comes, of course, to the very heart of the fiscal problem. Will savings be increased (or reduced) more than consumption? A funding policy will clearly not always have the same effect. It seems probable, however, that in the period 1946/50 budget policy reduced consumption expenditure more than savings; the redemption of Treasury bills greatly exceeded excess subscriptions and amounts likely to have entered the capital market. Of greater importance was that it reduced the possibility of secondary inflation. Thus it is not clear what effect fiscal policy was having on interest rates, but by comparison with changes in the balance of payments and the level of private investment it would appear to have been small. There is no evidence that it cut across the cheap money objective as might be a tempting conclusion if we were to look only at primary effects. In so far as fiscal policy limits the scope for spending and inflation in future periods it may well operate strongly in the direction of lower interest rates.
(vii) The Capital Inflow

The capital inflow was also assuming large proportions and it was not all 'hot' money. To the extent that it added to the supply of funds for long-term financing it would have correspondingly reduced the need to seek funds from the Australian public. Imports of capital equipment from non-dollar areas were increasing each year. Thus while investment expenditure was very high, the effective demand on the capital market was limited by control over capital issues and the availability of physical resources and did not cause undue strain, as it may have done if external developments had been less favourable.

(viii) Summary

Retail prices rose by about 9 per cent in 1947/48. Full employment was a major achievement but there was growing evidence that the production of basic commodities was beginning to lose out in the scramble for resources. The immigration programme was stepped up and this added to productive capacity but imposed additional strain in the short run. Economic stability was further threatened by a system of "partial" price controls.

(c) 1948-49

(i) State of the Bond Market

Bond yields were reduced even further in 1948/49 that is from about 3.16 per cent to 3.12 per cent in the case of long-
dated securities and from 2.33 per cent to 1.99 per cent for short dated securities. Two loans were issued during the year, one in September and one in March. The March loan was over-subscribed by nearly £20 million.

The events of the year permitted a significant relaxation of the official support policy. By the end of the year current market yields on long-term securities were in line with the 3\% per cent coupon rate. The significant thing is that this was achieved without an increase in official holdings and with the retention of excess loan subscriptions. Commonwealth Bank and Commonwealth Savings Bank holdings fell by £7 million during the year.

(ii) **Volume of Money**

This easier situation in the bond market was the outcome of a number of influences. The most important however, was the continuing high level of export prices and the rise of £178 million in the level of international reserves. This was the main reason for the increase of £110 million in bank deposits as the increase in bank advances was more than offset by the redemption of Treasury Bills. The volume of money rose by 9.5 per cent, a much larger increase than in either of the two preceding years. Despite a tightening of Special Account policy there was a substantial increase in the volume of funds seeking investment in 1948/49.
(iii) Domestic Spending

Another factor of importance was that although the demand for money was at a high level its continued advance was impeded somewhat by growing shortages of labour and materials. Thus the Gross National Product rose by 13.4 per cent, which was a much slower rate of increase than in 1947/48. Investment expenditure, though well maintained, was not able to improve on the previous year's growth. At the same time net expenditure by public authorities was now back to the 1945/46 level and large investment programmes in conjunction with the extensive immigration intake were undertaken. The level of employment rose, but less than in 1947/48.

Debits to customers' accounts were 21 per cent higher than in 1947/48 and, expressed as a proportion of bank deposits, increased from 12.1 to 13.4 per cent. This is evidence of a continuing high demand for money to satisfy the transactions motive. At the same time saving bank deposits increased by £33 million, or at about the same rate as in 1947/48 and fixed deposits rose by £15 million, reversing the trend of earlier years. This movement, coupled with the smaller rise in business stocks and the effect of the U.S. recession on business expectations together with the widening of the gap between short and long-dated government bond yields may suggest that there was also a rise in speculative cash holdings in 1948/49.
(iv) **Pressure on Resources**

Income tax concessions to individuals cost £22 million in 1948/49 and average weekly wage earnings were 14 per cent higher than in 1947/48. Personal consumption expenditure however, did not increase faster than in 1947/48. There was a large cash surplus. The related problems of inflation and unbalanced development seemed nevertheless to have been accentuated in 1948/49. The relaxation of controls had something to do with this but in any case it would have been exceedingly difficult to have forecasted the upturn in wool prices and the large capital inflow. The Government rightly concluded that these favourable factors must be assumed to be temporary and that overseas reserves were not therefore excessive. However, the immediate effect of the large rise in overseas funds was to increase the pressure on resources.

(v) **Life Office Security Holdings**

The behaviour of Life Assurance companies and certain other investor groups was beginning to cause concern. Life offices were mainly concerned with expanding their mortgage loans at this stage and not, of course, with liquidity as such. Although Life offices increased their holdings of Commonwealth securities by £21 million in 1948/49, less than 30 per cent of investible funds were devoted to government and municipal securities, compared with over 50 per cent in 1947/48. Up to this point, however, it is probable that Life offices were merely
returning to a more normal portfolio after the "excessive" war-time rise in security holdings.

(vi) **Banking Policy**

In 1948/49 amounts totalling £90 million were called to Special Accounts and with advances increasing by about £70 million the banks were less liquid at the end of the year than at the beginning. To help some banks who had run down security holdings more than others and to introduce an added degree of flexibility into the operation of credit policy, a system of special loans was introduced. It was considered important to meet the more essential requirements of industry for finance but not to do so by resorting to large scale releases from Special Accounts which might induce a too rapid rate of lending. These loans were subject to an interest charge of $3\frac{1}{2}$ per cent to dissuade undue reliance on them. These facilities were however, availed of to an increasing extent and the Bank's task was made difficult by the disappearance of controls and the growth of domestic inflation.\(^{(1)}\)

(vii) **Summary**

The Government had secured cheap money in earlier years when it was obliged to give the market some firm support. In 1948/49 low interest rates were maintained without the need for further support and the monetary authorities were in fact net sellers of securities. This result had been made possible by

the favourable overseas developments, some slackening in the rate of growth of domestic expenditure and the continuance of controls over capital issues. These factors more than offset some rise in liquidity preference and switching by capital cautious investors during the year. The economy, however, was at full stretch and seemed very vulnerable to a fall in export prices or a reversal of the capital inflow.

(d) 1949/1950

(i) State of the Bond Market

This was another buoyant year for the loan market. The amount received from public loans was £106 million which included £40 million of over-subscriptions. Market yields on long-dated securities averaged 3.13 per cent or the same as in 1948/49. In June, 1950, the market yield was 3.15 per cent compared with 3.11 per cent in June, 1949. Much the same stability was evident in short dated yields which did not rise above 2 per cent. From March, 1949, the minimum subscription to the short-dated loans was £1,000 and continued until June, 1955.

Bond market support was on a very modest scale in 1949/50. Once again the most important influences were the rise in wool prices and the capital inflow and the consequential rise in London reserves and bank deposits. The volume of money rose by 16 per cent, a substantially higher rate of increase than in either of the two previous years.

In 1949/50 Life offices became net sellers of
Commonwealth securities while expanding mortgage loans by £28 million and other loans and investments by £13 million. This has already been adverted to. Several other holders were also steadily selling securities, some as early as 1948.\(^1\) Banks, other than the Central Bank and Commonwealth Savings Bank, increased their security holdings (other than Treasury bills) by £32 million, reflecting a stronger liquid position. The large increase in "other" holdings is evidence of the strength of the bond market, particularly as Savings Bank deposits rose by £48 million, or at about the same rate as the previous year.

(ii) External Situation

In 1949/50 the value of exports rose by £74 million to a total of £617 million for the year. The value of imports, however, reflecting the high level of internal demand, rose faster to a total of £537 million. The capital inflow was even greater than in 1948/49 and was instrumental in causing international reserves to rise by £200 million. A large part of the capital inflow, however, was of a temporary nature and there was now growing concern as to the possible effects of a fall in export prices and a reversal of the capital inflow. Such an eventuality with investment so high would certainly have meant an accelerated market support policy or the abandonment of cheap money.

(iii) **Other Influences**

Despite the continual expansion of bank lending and the lodgment of amounts totalling £72 million to Special Accounts during the year, bank liquidity rose sharply. The main influence was, as I have said, the very favourable overseas payments position but there was also one further factor. Unlike previous years, the over-subscribed portion of public loan raisings was not used to redeem Treasury bills but to increase works expenditure beyond the amount approved by the Loan Council at the beginning of the year. Thus the Loan Council borrowing programme originally approved was £79 million but the actual States' works expenditure was £118 million and the redemption of Treasury bills only £15 million, compared with £85 million in 1948/49.

To all outward appearances the bond market exhibited considerable strength; but closer inspection showed up a number of inherent weaknesses. The level of investment was undoubtedly excessive in relation to available resources. Public works expenditure increased by £57 million during the year and many plans for private constructional purposes remained unfulfilled. In these circumstances the cheap money policy could only last as long as external conditions remained favourable or controls were tightened.
Section 4: Recapitulation, 1931-50: Assessment of Results on Longer Perspective

Between 1931 and 1935 interest rates fell principally under the pressure of market forces. Although the Premiers' Plan§ and the expansion of Treasury bills assisted the fall in interest rates, there was no deliberately planned policy of cheap money. It was mainly the dearth of new investment that kept interest rates falling. In 1933/34 however, the favourable balance of payments was also important.

Keynes' fear that speculation would increase and induce more money to be held for use in future rather than current periods as interest rates fell does not show out in Australian experience. The fall in bond yields came to a halt in 1934/35 not because of a rise in liquidity preference but because investment was now rising and because the adverse balance of payments was not offset by official action. The main institutional investors - savings banks and life offices - added substantially to the holdings of Government securities in this period.

Up to 1935 open-market purchases or investment of Commonwealth Savings Bank funds had not been used with the deliberate intention of influencing bond prices and hence interest rates. The year was nevertheless a turning point in monetary policy as the Bank Board stated openly for the first time that it wanted low interest rates to continue and that it
was prepared to intervene to secure it. This new policy was put into effect with varying degrees of success between 1935 and 1940. Official market support through the use of savings bank funds was rather sporadic but was generally intensified whenever the cheap money policy was threatened by adverse conditions abroad as in 1934-35 and 1937-38, for example. At other times the Bank seemed to sell more securities than it bought.

It is possible to exaggerate the importance of policy measures prior to the War. There were large fluctuations in bond yields each year from 1931 to 1939 and the foregoing analysis suggests that these can be explained largely by changes in income and the money supply as a result of market influences. If it is correct to speak of a cheap money policy before the war it was a policy of preventing interest rates from rising and not of forcing rates lower. In any case it is difficult to say when the cheap money policy - if there was such a policy - began. One possibility is the beginning of 1933 as it/from that time that the Commonwealth Bank initiated reductions in fixed deposit rates. We might prefer 1935/36 as the starting point as it was then that the Board began to evolve a technique for influencing credit conditions through the investment of savings bank funds. However, for the period as a whole neither had much bearing on the course of market rates. More generally the Commonwealth Bank became more favourably disposed towards low interest rates as soon as it had time to assess the results of the Premiers' Plan. This may have been of some small assistance to the bond
market indirectly, that is through expectations about the future course of interest rates. This factor, coupled with the growing realization that a boom was not imminent even if export prices should rise, may have been in the minds of institutional investors when making purchases. Speculation of this kind tended to help and not hinder the cheap money objective.

Interest rates were pegged for most of the war period. A cheaper money policy was put into effect early in 1947. This policy at first necessitated large-scale market buying from official sources, despite the retention of many war-time controls, favourable export results and an inevitable lag in production.

The Government was now pledged to cheap money so that the actual course of interest rates was more directly related to policy measures than to the behaviour of market forces. However, without the succession of favourable seasons and high export prices, the extent of market support would have been much greater. Methods of war-time finance had a revolutionary effect on notions regarding the legitimacy of central bank credit. In 1945 the danger of excess spending after the war was readily admitted but it was thought that the cheap money policy, even if it involved a concomitant credit expansion, should be continued and that excess spending be checked by other measures, notably high taxation, banking and other controls. It is interesting that this policy achieved a great deal of success in that cash surpluses were generally more than sufficient to offset the inflationary effects of the cheap money policy.
By mid-1948 a considerable change had come over the economy. A great expansion programme was under way and both private investment and consumption were increasing rapidly, despite limited resources. Such pressure would have had repercussions on the bond market in the normal course, particularly as war-time controls had either been abandoned or handed over to the States. The fact was, however, that market support had practically ceased. Had it been necessary the Government would most assuredly have stepped in and supported the bond market, but it was not necessary in the period we are reviewing. The great increase in the demand for money and some switching by capital-cautious investors was more than offset by the growth in the money supply consequent upon the upturn in export prices and the phenomenal inflow of capital. Interestingly enough, this was also a period when the rise in share prices was checked to some extent.

The period 1946/50 - in contrast to the pre-war years - was noted for a succession of favourable balance of payments. This was undoubtedly the dominating influence on the bond market. The main influence in the thirties was the decline in the marginal efficiency of capital and its painfully slow recovery. In the post-war years 1946/50 the marginal efficiency of capital remained high and the gradual disintegration of controls left the bond market vulnerable to a sudden reversal of the favourable
external influences.

My procedure in the foregoing Survey has been to set off changes in the demand for money against changes in the supply. Income, rather than the price level, has been taken as the initiating variable. A rise in investment, for instance, raises money income, which raises the "demand for money" and so the rate of interest. On the other hand an increase in the supply of money, "cet. par", lowers the rate of interest. In Part VI a similar analysis is carried out for the period 1950/56.
### PART V

**THEORY OF INTEREST POLICY: 1933-51**

<table>
<thead>
<tr>
<th>Sections</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>171-175</td>
</tr>
<tr>
<td>2</td>
<td>175-177</td>
</tr>
<tr>
<td>3</td>
<td>178-179</td>
</tr>
<tr>
<td>4</td>
<td>180</td>
</tr>
<tr>
<td>5</td>
<td>181</td>
</tr>
<tr>
<td>6</td>
<td>182-183</td>
</tr>
<tr>
<td>7</td>
<td>184-186</td>
</tr>
<tr>
<td>8</td>
<td>187-191</td>
</tr>
<tr>
<td>9</td>
<td>192-199</td>
</tr>
<tr>
<td>10</td>
<td>200-210</td>
</tr>
<tr>
<td>11</td>
<td>211-220</td>
</tr>
<tr>
<td>12</td>
<td>221-228</td>
</tr>
<tr>
<td>13</td>
<td>229-239</td>
</tr>
</tbody>
</table>
THEORY OF INTEREST POLICY: 1933 TO 1951

Part I concluded on a note of optimism regarding the ability of the recognised monetary controls to correct most of the economic disturbances likely to be encountered. Interest in monetary control as an anticyclical weapon was at its height around 1930 and it was assumed that businessmen paid close attention to the level of interest rates when planning investments. In the Report of the Macmillan Committee - which has special interest because it was released on the eve of the Great Depression - the general thesis that changes in interest rates exerted a powerful influence on the level of economic activity in normal conditions remained unchallenged.

The impact of Depression and a slow painful recovery in most countries despite a significant fall in interest rates gave rise to renewed thinking as to the efficacy of cheap money policies. Scepticism increased in 1938 when the results of empirical enquiries among businessmen were published in the Oxford Economic Papers. This drew comment from many eminent economists. It is the purpose of this chapter to trace the main strands of thought up to and including the abandonment of cheap money in 1951/52.

Section 1: The "General Theory"

In an earlier chapter we saw that monetary phenomena occupied a place of central importance in the Treatise and that the counter-cyclical role assigned to central banks was made
clear and definite. We saw also that Keynes was a member of the Macmillan Committee which decided that flexible monetary policies offered the most promising means of evening out fluctuations in economic activity.

No systematic treatment of the effects of interest rates on savings and investment is to be found in the General Theory. It was intended to deal primarily with questions of theory and only incidentally with the application of this theory to practice. Just the same it would have been remarkable if the experience of the years 1930-35 had not influenced Keynes towards some scepticism on the prevailing view that changes in interest rates exerted an appreciable effect on the volume of investment. Initially Keynes favoured cheap money because he believed a flexible monetary policy was the best means of counteracting boom and slump. Later he became sceptical about this and seemingly favoured a policy of keeping interest rates low at all times, abandoning any idea of a flexible interest policy. In the General Theory monetary policy tended to become a one-way affair to be employed aggressively only when lagging investment called for lower rates.(1) Seymour Harris maintains that after 1929 Keynes always supported low rates and never high rates(2) although he was much more dubious as to the

effectiveness of a low interest rate policy in 1936 than he had been in 1929.\(^{(1)}\)

Keynes' scepticism did not have its origins in a belief that investment decisions had suddenly become insensitive to changes in interest rates. The main trouble was that it may be difficult to bring rates down to the desired level if the liquidity preferences of the public were increasing faster than the quantity of money. The danger of raising interest rates in the boom lay in the difficulty of bringing them down fast enough in the succeeding depression. Keynes thought that speculative pressures had operated to defeat the will of the monetary authorities in their efforts to reduce interest rates in the Great Depression.

The theory of speculation revolves around the concept of a "normal" or "safe" rate of interest. Once investors feel that the rate is edging down below what they regard as safe in the light of past experience and expectations of future monetary policy, there will be a tendency to prefer cash to bonds and interest rates will rise. The same effect is produced where interest rates have risen but are expected to rise further. If representative opinion regards the prevailing rate as unsafe it will not last. However, if the monetary authorities are able to break through conventional beliefs as to what is a safe rate this tendency may be successfully counteracted and the rate

prevented from rising.\textsuperscript{(1)}

With a given state of expectation each decline in the rate of interest renders the next one more difficult. In short, Keynes thought that while the marginal efficiency of capital would fall to zero and might even be negative, institutional and psychological factors were present which set a limit much above zero to the practicable decline in the rate of interest.\textsuperscript{(2)} Keynes regarded 2 to $2\frac{1}{2}$ per cent as probably the lowest practicable long-term rate under a private enterprise type system. "Unless reasons are believed to exist why future experience will be very different from past experience, a long-term rate of say 2 per cent leaves more to fear than to hope, and offers, at the same time, a running yield which is only sufficient to offset a very small measure of fear."\textsuperscript{(3)}

Keynes distinguished between the demand for cash to hold for the transactions, business and the precautionary motives and the demand for cash to hold for the speculative motive. The former varies very largely with the level of income while the latter is said to depend on expectations concerning the future course of interest rates. Thus the level of interest at a point of time is strongly influenced by psychological phenomena — by what majority and representative opinion thinks it should be

\textsuperscript{(2)} Ibid., p. 218  
in the light of current and prospective developments and of past experience.

Keynes also believed that future fluctuations in the marginal efficiency of capital were likely to be too great to be offset by any practicable changes in the rate of interest.\(^{(1)}\)

The instability of the marginal efficiency of capital schedule seemed to assign a subsidiary role to monetary policy in countercyclical armoury. It was very doubtful if a reduction in the rate of interest could itself remedy a situation in which demand and business confidence were depressed — "it is not so easy to revive the marginal efficiency of capital, determined, as it is, by the uncontrollable and disobedient psychology of the business world."\(^{(2)}\)

The boom ends because doubts suddenly arise concerning the reliability of the prospective yield. Keynes believed that a high rate of interest was much more effective in a boom than was a low rate in a slump.

Keynes claimed that by showing that savings were determined by the scale of investment (not the level of interest) via the level of income and that investment was promoted by a low interest rate, the main justification for a high rate of interest had been removed.\(^{(3)}\)

To sum up we may say that Keynes did not think that a monetary policy directed towards influencing the rate of

\[^{(1)}\text{Ibid.}, \text{ p.}164\]
\[^{(2)}\text{Ibid.}, \text{ p.}317\]
\[^{(3)}\text{Ibid.}, \text{ p.}375\]
interest could hope to have any real measure of success in off­
setting fluctuations in the marginal efficiency of capital. For
one thing he expected these fluctuations to be very great and
for another he was not confident in the ability of the monetary
authorities to keep interest rates sufficiently low. He
generally opposed raising the rate of interest as an anti­cyclical
measure for fear that this might reverse the boom engines too
early. In 1938 he feared another slump and advocated low rates.
The important thing is that his argument was not that businessmen
were insensitive to changing interest rates when planning new
investments but that the range of practical manipulation was too
small for a flexible interest policy to be relied on as the prime
regulator of economic activity. His doubts about the ability to
reduce interest rates and keep them low for any time during
depression were not borne out by the experiences of most countries
in the thirties. The extent to which his theory of speculation
operated in Australia after World War II will be discussed in a
final section.

Section 2: R.G. Hawtrey

Hawtrey was an outstanding critic of the Keynesian
theoretical foundation and differed from Keynes in his inter­
pretation of monetary control. While Hawtrey admitted the
existence of a "credit deadlock" in 1931, he thought that it had
been given an exaggerated importance and that the downswing
would never have occurred had the monetary authorities switched
to easier credit sooner and not persisted in dear money when the depression hit. Hawtrey recognised that there were limitations to cheap money\(^{(1)}\) but considered that for most situations monetary policy was the best means of influencing the general level of activity.

In his early writings Hawtrey maintained that the response of commercial borrowing to easy credit was simultaneous. A high rate caused the wholesaler to restrict orders, while a low rate induced him to step up orders to the manufacturer. Thus a low rate raised the demand for consumption goods and, through the "Principle of Acceleration" raised, more than proportionately, the demand for durable capital. It is a change in the short-term rate of interest (Bank rate), therefore, that starts the whole system moving.

Keynes also thought the rate of interest had important economic effects but he was more interested in the bond rate than the Bank rate. In this, as in other related matters, he had much in common with Knut Wicksell. To Keynes it was the demand for durable goods which was of overriding importance, changes in stocks being mainly incidental to the general changes in business activity.\(^{(2)}\) Keynes did not say much about the "credit deadlock" and Hawtrey claims that he could not have done so in

\(^{(1)}\) The Depression caused Hawtrey to modify his views in one or two respects, as was pointed out in Part I.

view of his rejection of the operation of Bank rate via working
capital as the prime mover. He emphasised instead the obstacles
interposed by liquidity preference to a fall in the long-term
rate. In Hawtrey's view, Keynes' advocacy of loan expenditure
as an anti-slump weapon arose only when there had been a failure
on the part of the monetary authorities to take the necessary
steps to keep down the long-term rate of interest.

Hawtrey admitted that a low rate of interest would
eventually stimulate investment of a long-term character but,
as with a policy of public works expenditure, the process was too
slow and undependable. "When the banks relax credit, they
offer an inducement to speculators, investors and others to hold
more securities with borrowed money. That makes the investment
market more favourable and so tends to stimulate new issues.
But the stimulus to economic activity is not felt till the
capital outlay arising out of the new issues actually begins,
and that is likely to be after a long preparatory period."(1)

---

(1) R.G. Hawtrey: Trade Depression and the Way Out (London,
1933), p.132.
Section 3: The Oxford Enquiry

It was implicitly assumed by the neo-classicists that both savings and investment decisions were highly responsive to changes in interest rates. It was through such changes that an appropriate balance was secured between savings and investment. A flexible monetary policy formed the basis of contra-cyclical policy.

The first of these assumptions was laid bare by Keynes and the second came under heavy fire as a result of the empirical investigations conducted by the Oxford Economists' Research Group in 1938.

The main findings of the Group were:

(a) except for the building and construction trades, businessmen in framing policy took little notice of the prevailing rate of interest;

(b) the rate of interest might affect the policy of the speculative merchant;

(c) a change in Bank rate may have important psychological effects;

(d) a change in the long-term rate may affect the installation of labour-saving machinery;

(e) a rise in bond prices increases business liquidity and is thereby conducive to expansion.

The results of the Survey seemed to suggest that the direct cost effects on investment assigned to changes in the
rate of interest had been greatly overrated in the past. However, the indirect effects of changes in the long-term interest rate were thought to have more importance than had hitherto been assumed. Falling interest rates imply rising prices for securities which may enhance business liquidity and in turn make entrepreneurs more willing to undertake new investments.

With this important reservation the results of the Enquiry can be said to have reinforced the growing scepticism of the late 1930's concerning the ability of a cheap money policy to stimulate recovery; as a consequence the view gained ground that while interest rates had little effect on decisions to invest, low rates were to be preferred on budgetary and distributional grounds. The Enquiry also served a useful purpose by stimulating further thought and enquiry.
Section 4 : H.D. Henderson

In October, 1938, Professor Henderson in the first number of the Oxford Economic Papers commented on the Enquiry and pointed out that the rate of interest had more chance to be important for certain classes of long-term investment. Professor Robertson emphasised this too. Low interest rates held much appeal but there were few who could explain just how low rates stimulate recovery. There were difficulties in supposing that a very important influence of a direct character operated, either with respect to working or fixed capital. Besides durable goods, an important effect may be felt via the stock exchange. The Enquiry shows that the role of the ordinary businessman in transmitting effects is a passive one.
Section 5: F.A. von Hayek

Hayek also commented on the Oxford Enquiry and agreed that in the past the rate of interest had not, fact, exerted a significant influence on investment decisions; however, he thought this should not be interpreted as meaning that it cannot or ought not be made to do so.\(^{(1)}\) The fault rests with the monetary authorities who, more often than not, fail to adjust interest rates with changes in economic activity. As profits rise, the rate of interest should be promptly raised, and vice versa.

This is, of course, reminiscent of Wicksell, although an important difference was that Hayek did not hold that economic stability was necessarily secured through a constant price level. He considered that monetary phenomena were of vital importance in the dynamic process; put very briefly his argument was that a cheap money policy led to a lengthening of the structure of production without a corresponding increase in the desire to save. An increase in the quantity of money disrupted normal price relations. There is over-investment in the sense that investment in capital equipment is of such a degree of "round aboutness" that it forges far ahead of the output of finished goods. The important point here, however, is that the boom can be contained if the authorities promptly adjust the market rate to the natural rate, that is the rate which equilibrates savings and investment. Likewise a depression can be arrested by a suitable downward adjustment of the market rate of interest.

\(^{(1)}\) Profits, Interest and Investment (London, 1939), pp.66-8
Robertson generally shared the scepticism of this period concerning the efficacy of low interest rates to stimulate recovery but also wished to preserve a measure of flexibility in the monetary sphere. He did not believe that cyclical fluctuations were explicable purely in terms of monetary phenomena any more than they could be adequately explained by Pigou's business psychology principle. At the same time he paid more than ordinary attention to the monetary aspects of cycles.

Unlike Hawtrey, Keynes or the Austrians, Robertson never regarded cheap money as a panacea for Depression. He emphasised rather the structural problem endemic in a system which expands unevenly. He agreed with Harrod that the "Principle of Acceleration" occupied pride of place in trade cycle analysis. Although swayed by the empirical enquiries and the failure of cheap money to promote an early recovery, Robertson did not favour relinquishing control over the monetary weapon altogether. He wanted to retain some range of flexibility and was not happy with the impression being left by contemporary thought that interest was completely neutral as far as investment was concerned. He pointed to the danger of interest policy not being considered on its merits from a cyclical point of view but instead being dominated by the desire of governments for cheap money on narrow budgetary grounds.(1) As to the responsiveness of capital outlay to

(1) Lloyds Bank Review of September, 1937, and reprinted in Essays in Monetary Theory (Staples, 1940), p.131.
a change in interest rates, he said: "Some of the quantitatively more important forms of capital outlay in the modern world - the basic instruments of power, transport and business accommodation - are not very closely geared to the demand for particular types of consumption goods ... and it is precisely these forms of capital outlay which, because of their durability, are reasonably sensitive to the rate of interest."(2)
Some economists questioned whether the results of the Enquiry really meant that the rate of interest exerted no appreciable effect on the situation. Professor Machlup\(^{(1)}\) argued that in explaining actions of businessmen, steps of reasoning must be included which are not consciously performed by the individual and which probably cannot be performed with scientific exactness. Entrepreneurs are faced with an "extreme difficulty of calculating" so that their decisions tend to be based largely on factors not measured. Similar doubts troubled D.H. Robertson at the time. He said he wondered if they really meant that changes in the rate of interest had no effect on investment decisions or "if they merely meant that, sizing up the whole situation, they often decide in a different direction from that in which the rate of interest, if it were the only factor, would point."\(^{(2)}\)

Many businessmen had pointed out in answer to the questionnaires that they thought a rise in bond prices often had an expansionary effect because it increased the liquidity of business concerns and financial institutions and that this was a factor of some importance in deciding whether or not to invest. This was not a new argument - Keynes had stated it narrowly in his *Treatise*\(^{(3)}\) but it has become increasingly popular with

\(^{(1)}\)American Economic Review, September, 1946

\(^{(2)}\)"What has happened to the Rate of Interest?" Three Banks Review, March, 1949, p.20.

\(^{(3)}\)op. cit., Vol. II, pp.203-4
economists since the war. Thus F.A. Lutz(1) who sought a theoretical basis for the broadly negative conclusions of the Survey, pointed out that changes in the rate of interest may affect the readiness of financial institutions to grant credit or float bonds or stocks. It was possible for the rate of interest to influence the volume of investment even without changing the profit calculations of entrepreneurs.

Whether or not the rate of interest affected profit calculations, economists were now claiming that what mattered was not the rate of interest as such but the availability of money. If a change in the rate of interest affected liquidity - of financial institutions, businesses or private individuals - it could be expected to have an influence on the aggregate volume of spending in the community. This line of thought was well developed in Wallich's article at the end of 1946.(2) Changes in the market rates of interest produce changes in the capitalised value of income-yielding assets. The longer the term of an obligation, the greater its response to changing rates. Such capital gains, realized or unrealized, have important repercussions upon income because they are apt to affect the expenditures of the gainers or losers.

---


(2) op. cit.
We have finally a number of economists cautioning that the enquiries were directed disproportionately at the more risky enterprises where the rate of interest would normally have least effect.\(^{(1)}\)

Section 8: Australian Pre-War Views

In Part II we discussed the motives for the adoption of the cheap money policy in 1931. We found that the early Keynesian argument for cheap money was not important in Australia at that time. The general view among economists was that interest rates could not be reduced until there was a reasonable prospect of balancing budgets.

In the Treatise Keynes portrayed the rate of interest as the means whereby savings and investment were brought to equality with one another, which is precisely the basis Copland and Davidson used for their advocacy of a fall in interest rates in Australia. In 1931 Copland thought that investment would forge ahead once interest rates were reduced; but it was argued that interest rates could not be reduced until confidence was restored.

At this time it would appear that Keynes was confident that central bank action could reduce the bond rate to a level which would induce a significant increase in investment expenditures. At the same time it seems that he perceived a great deal of merit in the argument of Australian economists and it is well known that he praised the Premiers' Plan on more than one occasion, presumably on the grounds that the direct method used to reduce interest rates was the best that could have been done in the circumstances. At any rate it was not long before he abandoned the old theory and in 1933 was able to declare in his essay in the "Festschrift" for Arthur Spiethoff that the "fatal flaw" of orthodox theory
was its failure to provide a realistic theory of interest.

The Copland view seems to have been a plausible one to take at the time because credit expansion was identified with inflation, public confidence was at a low ebb and the political situation was highly explosive. What was much less plausible was the Commonwealth Bank's fear of inflation once the crisis period had passed.

Early views regarding the efficacy of low interest rates in stimulating investment were soon modified in the light of changing conditions and a changing conception of central banking and financial policies generally. By the end of 1933 most of the banks were beginning to lose some of their earlier ardour for cheap money. Even Mr. Davidson was beginning to question the effects of low interest rates. In 1935(1) he said that it was not necessarily easier to expand than to contract credit and that despite lower interest rates, advances would not increase if the community was not in a borrowing mood. He illustrated his arguments by reference to Hawtrey's "Credit Deadlock".

After 1932 the private banks resisted every move for lower interest rates but by 1935 the Commonwealth Bank Board was firmly convinced as to the importance of keeping interest rates low, although its argument was based more on the desirability of

---

(1) Royal Commission on the Monetary and Banking System of Australia : Minutes of Evidence, p. 467.
facilitating Treasury financing through an orderly bond market than on a belief that any appreciable stimulus to investment of a direct character was likely to result.\(^{(1)}\)

The Royal Commission on Banking heard evidence between January and September, 1936, and issued a Report in 1937. The Commission thought that low interest rates had assisted recovery and that after June, 1931, the Commonwealth Bank appeared to realize the desirability of using its powers to lower interest rates. In the Commission's view it was the responsibility of the Commonwealth Bank to determine generally in what direction and to what extent interest rates should move. Little exception was taken to the Bank's action between June, 1931, and March, 1936, with respect to interest rates but it was considered that the Bank should have used its powers to prevent the rise of fixed deposit rates in March, 1936.\(^{(2)}\)

There would seem to have been a disposition among economists for low interest rates in the late thirties. L.F. Giblin doubted the wisdom of using interest rates to control booms and depressions, and on budgetary and distributional grounds it seemed desirable to keep rates as low as possible. L.G. Melville, who was the Bank's economic advisor at the time, held a similar view and said\(^{(3)}\) that the difficulty about exercising control over credit merely through varying rates of interest was

\(^{(1)}\) See Part IV pp. 116-8 for a more detailed account of the Board's attitude to low interest rates.

\(^{(2)}\) Report of the Royal Commission on Banking, p.216

\(^{(3)}\) Minutes of Evidence, p.1123
the uncertainty and slowness of its action ... once the fever of boom conditions has gripped the community it takes more than a change of one or two per cent in the cost of fixed loans to deter speculators and entrepreneurs. Furthermore, changes in rates of interest are likely to be less effective in Australia than elsewhere and it was therefore necessary for the Commonwealth Bank to be given some control over the actual size of the credit base. (1)

It was generally agreed that a rise in interest rates should be avoided whenever possible mainly because it increased the cost of government finance and was therefore likely to conflict with other aspects of public policy. (2) It was further agreed that interest rates had not been kept artificially low in the thirties but had fallen because of market conditions. Not all economists favoured the continuance of low interest rates, however. T. Hytten for example, contended that a fetish for low interest rates might well intensify a future depression and emphasised the importance of allowing interest rates to take their natural course.

In the search for ways and means of cushioning the economy against the impact of changes in the balance of payments and other influences which bore directly on bank liquidity and lending, economists were coming to see the importance of

(1) Ibid., p. 1124
(2) Vide Economic Record, April, 1939.
instituting some form of quantitative banking control and accordingly to place rather less emphasis on variations in the price of credit. The failure to establish an open market in Treasury bills and the growing realization that it could be misleading to use overseas experience as a guide to policy in Australia where conditions were rather different also had some influence in that direction.
Section 9 : The Direction of Thought Since World War II : Early Post-War Views in United Kingdom and United States of America

Before considering the views of Australian economists and the rationale of government policies in Australia, we may briefly trace some developments in the theory of monetary policy in the United Kingdom and the United States, prior to the final abandonment of cheap money.

In the preceding section we noted how one of the foremost British economists - D.H. Robertson - was beginning to think that the pendulum may have swung too far against monetary policy. As a general rule, however, economists before the war had become exceedingly sceptical regarding the ability of the traditional monetary techniques to resume their former role as principal economic regulator. The experience with war finance and economic controls seemed, if anything, to increase this scepticism.

The U.K. White Paper on Full Employment issued in 1944 decided to maintain "cheap money" throughout the period of post-war reconstruction. Immediately after the war Hugh Dalton* attempted to force interest rates down to record levels, a policy which met with some initial success but which was finally abandoned in the face of market pressure for higher rates. He was successful in bringing the consol rate down from 3 per cent (the rate at which the war had been financed) in July, 1945, to $2\frac{1}{2}$ per cent in December, 1946, but failed to convince the market of the survival value of $2\frac{1}{2}$ per cent.

* Chancellor of the Exchequer from July 1945 to November, 1947.
Dalton's "cheaper" money policy was motivated principally by National Debt and distributional considerations, but there were some further reasons. He wished to minimize the cost of the building programme and to prepare the way for the Nationalisation Bills. In the new edition of his Public Finance Dalton has denied that his policy was inflationary in 1945/47 and both Harrod and Henderson supported that view.\(^1\) Low interest rates did not stimulate investment in this period because investment was held in check "by the need to obtain permission from the Central Government, or from the Capital Issues Committee or from the local authorities".\(^2\) Between January, 1946 and January, 1947, however, deposits of the Clearing Banks rose by £900 million, the inflationary effects of which it would seem were only partially offset by direct controls over bank lending. The failure to prevent the rate from rising above 2½ per cent and the growth in the volume of liquid assets held by the banks did not immediately give rise to much concern regarding the compatibility of the Government's avowed aim to preserve financial and economic stability in an expanding economy and the equally firm intention to retain the cheap money policy.

But the issue was no longer an open and shut affair. By 1948 increasing doubts were coming to be entertained about


\(^{2}\)Ibid., p.235
the advisability of assuming that interest rates had no positive function to perform. Where there had been fairly general agreement before the war that it was best to retain low rates on budgetary and distributional grounds, there was now a wide diversity of opinion developing between writers. Thus in 1948 two outstanding books were published - one by Harrod\(^1\) in which it was assumed that interest rate variations do not play an important part in contra-cyclical armoury and another by Meade\(^2\) in which a revival of control by the rate of interest was advocated. Meade argued that a higher rate would influence both sides of the demand-supply equation.

In March, 1949, D.H. Robertson\(^3\) questioned the wisdom of "putting the rate of interest in chains", and pleaded for "some sustained re-thinking in academic circles." He also advanced a new argument: under earlier monetary arrangements demands for exhorbitant wage rates might meet with insufficient money to foot the bill, but if the authorities were determined to keep the rate lower there was no such check. The current policy was therefore favourable to cost inflation, and in what has now become a famous phrase he said: "the monetary authorities have in effect abdicated from exercising that sovereignty over the standard of value which we thought we had

\(^1\) Roy Harrod: Towards a Dynamic Economics (Macmillan, 1948)
committed to their charge". At the same time Robertson did not propose that the interest rate should be allowed to go "free" thus rendering recourse to physical controls over capital outlay unnecessary.

In 1947 Harrod\(^1\) explained why he did not favour a revival of the price mechanism in the capital market. The capital market was not like other markets; the free play of market forces could not secure a rate of interest low enough to boost the economy when it needed it or high enough to restrain inflation when a different policy was demanded. For this reason he claimed that Keynes would have favoured more direct means of checking capital outlay in the early post-war years.

Apart from this, Harrod said it was "imperatively necessary" to have a low rate owing to the large size of the national debt. Another argument advanced was that if we accept Keynes' diagnosis that in the long run our economy needs a low rate of interest, there may be a danger in allowing it to rise now. For once it had risen it would not be easy to reduce it again. Furthermore, it was quite likely that a high rate of interest in present circumstances would exert but a small curbing influence on the volume of capital outlay.\(^2\)

Meade on the other hand argued that if interest rates had risen "the values of fixed income property would have fallen

\(^2\)Ibid., p.125
and the upward movement in the value of Ordinary Shares would have been mitigated, and the incentive to spend on the part of property owners would have been curbed." (1) Meade rejected the idea that the rate of interest was a negligible factor in determining whether or not money would be spent on new projects for capital development, and described a direct licensing system as "clumsy and inefficient". He advocated a considerable rise in the short-term rate of interest and a moderate rise in long-term rates somewhat above the probable average of future long-term rates. To have the desired effect, the rise in the long-term rate must be confidently expected to be fairly temporary - an expectation that would be much encouraged by a clear explanation on the part of the monetary authorities that rates of interest would be reduced again as soon as the period of strain on capital resources had passed.

In the United States the cheap money policy was continued after the war and was not finally abandoned until March, 1951. A rise in short-term rates and some flexibility was permitted after mid-1947 but the real showdown between the Treasury and Federal Reserve did not occur until after the outbreak of hostilities in Korea in June, 1950. From the time of the "accord" until 1953 the Federal Reserve used its greater independence to permit some tightening of credit and some rise in interest rates.

(1) op. cit., p. 27
It was becoming clear as time went on that Treasury insistence on low interest rates was greatly impeding efforts to halt the inflationary spiral and more economists were stressing the need for some modification of existing policy. The large holdings of government securities by the banks and the absence of any counterpart to the Australian Special Account or the English Treasury Deposit Receipt procedure for controlling the growth of excess liquid reserves put an edge on the problem.

In 1947 Governor Eccles proposed that all Federal Debt should be made non-marketable. This was a very drastic measure and was supported by those who wanted a positive monetary policy. Governor Sproule submitted another proposal which was more acceptable to the Treasury. It was that the Central Bank should manipulate the market sufficiently to create some uncertainty and thereby slow down new capital issues and discourage switching. This policy was followed by the Federal Reserve but was not successful. In December the market stampeded and the Federal Reserve was obliged to buy bonds on a large scale to preserve par.\(^{(1)}\) On that occasion the market had shown that it was not yet accustomed to uncertainty. The failure demonstrates the dangers inherent in a policy which seems to be experimental in character. In March, 1951 the breaking of par was not accompanied by a wholesale collapse of the market. This was partly because the market was getting more accustomed to

fluctuating bond prices and partly because the authorities made their intentions crystal clear.

The Treasury's reasons for wanting to retain cheap money were various but perhaps the two principal ones were: (a) the desire to promote full employment and full production and a fear that a more restrictive monetary policy might jeopardize the attainment of that objective. (1) Allied with this was the belief that inflation could best be controlled by fiscal policy and (b) the dual objective of facilitating Treasury financing and holding down interest charges on the National Debt. It was argued that to abandon 2\(\frac{1}{2}\) per cent would disorganize the security market, make reconversion operations difficult, increase the debt burden and possibly impair the credit of the United States Government.

In the United States the Federal Reserve System had been moving towards a relaxation of the cheap money policy ever since 1946. Short term rates rose substantially between 1946 and 1948 and even the rise in long term rates was accomplished much less abruptly than in Australia for example, where the revival of monetary policy through changes in interest rates was pretty much a dead issue before 1951. In 1951, U.S. Government security yields averaged 2.57 per cent as compared with 2.32 per cent in 1950. In 1952 they rose further to 2.68%.

Thus between 1950 and 1952 yields on long-dated securities rose by about 15 per cent. The increase for the comparable period in Australia was nearly 40 per cent.

The greater independence of the Federal Reserve System which had been actively canvassing the prospects of a more flexible policy for a number of years, would partly explain the difference. In Australia and the United Kingdom it was virtually impossible for the respective central banks - particularly under Labour Administrations - openly to criticize Treasury policy even had they wanted to, although in Australia there is no evidence to suggest that there was any difference of opinion between the Commonwealth Bank and Treasury on that score before 1951. The reasons for the much greater faith in a continuing cheap money policy by the monetary authorities in Australia and the sudden abandonment of cheap money are discussed in subsequent sections.
Section 10: Theory of Interest Policy in Australia, 1945/51.

In Australia the cheap money policy was not seriously questioned until 1951. Towards the end of the war there was very little discussion about the pros and cons of retaining cheap money. There was very little discussion because there was general agreement that interest rates should be kept low and economists seemed to assume that low rates could be retained without difficulty especially if controls were continued over capital issues and consumer spending. It was thought by some that there would be some unemployment after the war and with it some pressure for higher interest rates. It was appropriate policy in view of this expectation to reduce interest rates now. This would help alleviate the housing problem and assist basic development. Some economists feared a post-war inflation more than a post-war slump but it was argued that a policy of low interest rates was still appropriate as inflation could be checked by more direct quantitative controls, capital issues and higher taxation.

The Government's policy of maintaining low interest rates was set down in May, 1945, in the White Paper on Full Employment. Policy was to continue to be directed towards low interest rates which it was hoped, in conjunction with the banking powers, would help stabilise the level of investment after the war. Low interest rates and the dependence more on taxation than on public loan raisings as a source of finance,
would also minimize the burden of debt on which interest is paid.

Throughout the period of Labour Administration and for at least a year after Labour's defeat, it continued to be accepted government policy to keep interest rates low and stable. There appear to have been four principal arguments used in support of this policy, viz.:

(a) low interest rates allow public works to be carried out with great value to the community. This argument has had strong public appeal;

(b) low rates help encourage private investment and may act as a buffer against possible adverse conditions in the future;

(c) in the past high interest rates have burdened the farmer and home-builder in particular. Low rates are desirable because they prevent certain groups from being exploited;


(2) Cf. H.C. Coombs: Development of Monetary Policy in Australia (the E.S. & A. Bank Research Lecture, 1954), delivered at the University of Queensland on 15th September, 1954. Coombs says that Australians are expansion-minded and look to the rapid development of their country. "They realize that expansion will be expedited if enterprise is not burdened with heavy capital charges."

(3) A Recession by at least 1949 was regarded as more than likely.

(d) low rates are desirable on budgetary grounds.

Commonwealth

The Bank favoured the continuance of the cheap money policy after the war and made the additional point that a rise in interest rates would rebound to the disadvantage of patriotic citizens who had subscribed to war loans.\(^1\) It would also aggravate the difficulties of the housing problem and increase the problem of the public debt. The Bank's view was that the cheap money policy could be of considerable value in securing a high level of employment after the war. In successive reports up to and including June, 1950, the Bank did not offer any comment on the appropriateness of the cheap money policy in the light of changing conditions and we must therefore conclude that it was thought that conditions did not warrant any review of the cheap money policy. Furthermore, it is doubtful whether even the events of 1950/51 shattered this view. Reference was made in that report to the increases in interest rates in the United Kingdom and U.S.A. as part of measures designed to check inflation associated with increased defence expenditures; the Bank was obviously alarmed at the inflationary trend but it was apparently unconvinced that the measures adopted overseas could work in Australia. Although reference is made to the weakening of the bond prices there is no suggestion that it might have been appropriate to reverse the cheap money policy.

Apart from a fairly steady stream of criticism

\(^1\) Commonwealth Bank Annual Report for year ended 30th June, 1945.
emanating from banks and financial journalists, particularly when the bond rate was lowered to $3\frac{1}{2}$ per cent in November, 1946, the ideas propounded in the White Paper seem to have commanded fairly general assent. No leading economist came out with a forthright denunciation of the Government's policy. The issue had in fact ceased to be an important one in 1949. As recently as May, 1950 Copland was able to write an essay on the "Development of Economic Thought in Australia, 1924/50" without any explicit mention of interest rates; yet less than a year later he was advocating a rise in interest rates as part of an eight point plan to halt inflation. That gives some idea of the dramatic change that overtook the economy - an aspect which is developed later in relation to the relevance to the Australian situation of comments by overseas economists. Even then, however, economists in Australia were slow to admit that the new weapons of economic policy were inadequate to deal with the magnitude of economic fluctuations encountered since 1950. On this point Copland said: "The present state of the economy does not inspire confidence in the efficacy of the new weapons we have chosen to take the place of the rate of interest. There is still some good wine in old bottles."(1)

The idea that deficiencies in the new weapons gave rise to a resurrection of the old has also been emphasised by a number of English and American economists. In Australia, however, an aggressive monetary policy through variations in

interest rates and open-market operations has been ruled out on at least three counts. One view, which would seem in this period to have been held fairly generally by Australian economists and which can be applied to the more direct forms of credit restraints such as special accounts, is that a credit policy sufficiently restrictive to curb the inflation would deliver too great a shock to business confidence. "If we tried to check a boom by raising the rate of interest, the increase would need to be so sharp that it would cause great dislocation and injustice."(1) This view was shared also by T.W. Swan and P.H. Karmel. Another is that these techniques cannot be expected to work very well in Australia which has no highly developed money market and where a high proportion of capital expenditure is less likely to be influenced by changes in the cost of borrowing.(2) The third reason is that the economy is subjected to wide balance of payments fluctuations on which it is heavily dependent for its prosperity and which, it is argued, can best be met by the more direct forms of control over bank liquidity.

As for the stock argument that changes in the rate of interest have no appreciable influence on investment decisions, we find little evidence of this having been important in Australia. Indeed, as was mentioned above, one of the basic reasons for this policy in the first place was that it favoured

(1) C.f. L.G. Melville : Economic Record, June 1946, p.16.
economic expansion and a high level of investment. At the time this was thought to be particularly important because of the strong body of opinion which asserted that the world would be in the throes of a major depression within a few years after the war. It is apparent that some senior government advisors held this view and it is therefore possible that the cheap money policy was retained mainly on such grounds. The sort of argument used in this context was that it was risky to allow interest rates to rise — or to raise them deliberately — to meet a merely ephemeral upturn in activity because it would in all probability be difficult to get them down again when the recession came. Furthermore, in the long run investment opportunities may diminish.

Thus the stagnation thesis, coupled with the theory of speculation and special features of the Australian economic and political framework seemed to present a strong case for keeping interest rates as low as possible. In fact by the end of the war belief in low interest rates had almost become a dogma(1) and the position did not change appreciably in the ensuing five years. Variable interest rates became a highly unfashionable subject for economists in Australia.(2) The "New Economics" with attention focused on the possibilities of fiscal policy obviously exerted an influence as did the period of war with the vast increase in debt on which interest had to be paid.

(1) H.C. Coombs op. cit., p.6
Contrary to what one would have thought, Coombs says that the prejudice in favour of low interest rates was intensified by the events of the thirties. "Many were convinced that the high rates of the late twenties were a factor in precipitating the depression and that the low rates of the late thirties were a significant element in stimulating recovery."(1)

We can, I think, sum it up by saying that Australians were essentially forward-looking in 1945. Any possible obstacle in the path of a speedy development must be removed, especially as economic conditions were vulnerable to sudden changes in trends overseas. One of these obstacles was a high rate of interest which was also oppressive to the groups which were likely to contribute most to this era of progress. (e.g., Home-builders, farmers and small businessmen). Both these points of view have been brought out very forcibly by H.W. Arndt(2). He says there are two quite general but weighty reasons for keeping interest rates as low as possible at all times. One is that, in the long run low interest rates favour investment which is a particularly important argument for Australia bent on developing its economic resources. The other is that interest payments represent transfers of income by and large, from active and enterprising to inactive members of the community, and by and large from the less to the more well-to-do.

Melville's views are of particular interest because he was amongst those who discounted the likelihood of any general

---

(1) Ibid., p.5  
(2) Copland and Barback, op. cit., p.307
unemployment in the early post-war years, but thought it was best to keep rates "as low and as stable as possible through all phases of business fluctuations."(1) He argued that a change in interest rates affected both saving and investment. As interest rates fall investment expands without limit and savings fall because income is redistributed to those who do most of the spending in the community; but interest rates have significant effects for savings and investments only if they are allowed to operate over a considerable period of time. There is therefore, no denial of the Keynesian proposition that interest rates cannot be relied upon to adjust themselves to economic circumstances in a way which equates investment and savings at the full employment level. A moderate increase in the rate of interest will not have much immediate effect in checking the boom while a large increase may have too much effect. However, Melville insisted that the matter could not be regarded as finally settled and that the retention of cheap money after the war would be inflationary because it would reduce the level of savings.

In September, 1950, Donald Cochrane(2) drew attention to some of the problems which had been accentuated by the rigid adherence to a policy of cheap money. While desirable from the point of view of taxation and fiscal policy, the cheap money policy was encouraging people to invest savings in the more risky fields and this was aggravating the problem of unbalanced economic

(1) _op. cit._, p. 16
(2) _Australian Quarterly_, September, 1950.
growth. Cochrane's assessment of the economic situation was that inflation was likely to persist and that as we could not afford to reduce taxation, every possible encouragement should be given to individual savings. Without investment controls, a cheap money policy may well prove to be an unwise policy. Cochrane concluded that it might be necessary to relax the cheap money policy temporarily and allow interest rates to rise.

The trading banks had consistently argued that the cheap money policy discouraged individual savings and must soon break under the strain of heavy investment demands. In 1947 the National Bank(1) pointed out that with the gradual relaxation of wartime controls and the easing of capital issues controls a policy which attempted "to maintain interest rates at abnormally low levels" may meet with serious difficulties. This was mainly because the attractions of investment in industry and commerce were likely to increase relative to Commonwealth loans. The cheap money policy may also have deleterious effects on individual thrift especially in association with high levels of taxation. The view was also advanced that in the long run the maintenance of cheap money would require "rigorous official control over all forms of investment".(2) The cheap money policy was, of course, prone to have an inflationary influence.(3)

While the banks have no doubt a vested interest in high

(2) See Address delivered by the Chairman at the Ordinary General Meeting of the Commercial Bank of Australia held in August, 1946. Reprinted in Copland and Barback, op. cit., p.302.
(3) Bank of N.S.W. Review, August 1951 and Ibid., p.304.
interest rates, they were not alone in claiming that the con-
tinuance of low interest was damaging the incentive to save and
that it was therefore inflationary, particularly in an expanding
economy. The real point of course, is that the banks do not
like having their activities controlled by the central bank or
anyone else in the interests of economic stability; but the
idea that the level of interest makes no difference to the
proportion of income saved was now being questioned. By 1940
the traditional belief in a direct connection between the level
of interest and personal savings was almost entirely
discredited; (1) but the experience with a fully-employed economic
system since the war leaves considerable doubt in my mind whether
governments can be entrusted to do the "necessary" saving.
Conditions have been quite different in the forties but in 1951
there was still a strong body of thought which considered that a
change in interest rates would have no appreciable effect on
savings. (2)

In 1952 H.W. Arndt considered that in the short run
the effect of higher rates on the level capital expenditure was
negligible compared with what could be done through credit
rationing and capital issues control, (3) but that in the long run
low rates favoured investment and high rates created a serious
problem because of the additional tax burden.

(1) Cf. T.W. Swan, Economic Record, June, 1940.
(2) See for example, H.W. Arndt op. cit., p. 306.
(3) Ibid., p. 305.
Arndt now agrees broadly with the neo-Keynesian view that cheap money is a desirable goal as long as it does not run counter to the overall economic objectives. Thus he supported a rise in interest rates in 1951-52 and 1955-56 when it became clear that the retention of low rates would have involved continuing market support at a level inconsistent with other policies designed to maintain reasonable stability in the economy. (1)

Section 11: Abandonment of Cheap Money: Symposia in United Kingdom and U.S.A.


In the United States, the Chicago School is well-known for its outspoken criticism of cheap money policies. It follows the Knight tradition of "laissez faire". Both Milton Friedman and H.C. Simons argue in an "a priori" fashion. Economic controls and in certain circumstances fiscal policies, threaten the basis of a free society. Monetary policy should be relied on solely to maintain full employment and a stable price level. They are prepared to let the rate go free and find its own level and argue therefore for it to be used as part of the price mechanism. It is claimed that variations in the rate of interest are more impersonal in character and do not discriminate against particular industries or borrowers.

The possibility that investment decisions may not be particularly sensitive to changes in the rate of interest is admitted but a rise in the rate of interest will make saving more attractive and reduce the liquidity of business. It is true that certain imperfections exist in the capital market as there will, for example, be a bias in favour of persons or units with large liquid resources, good connections, etc. However,
these imperfections are not regarded as being particularly significant when viewed against the alternative methods of controlling inflation, which would lead in their view to even wider deviations from the optimum distribution of resources.

This school of thought believes that open market operations should be employed to whatever extent is necessary to control inflation without regard for the resultant level of interest rates. The rate of interest must be judged on its consequences. Lerner is another economist who sees no virtue in a cheap money policy as such and has expended a considerable amount of energy in showing that a government, in order to control inflation, will simply borrow heavily from the public thereby raising the rate of interest. It needs to borrow only to the extent necessary to secure a rate of interest which is considered appropriate to the circumstances. Having done this and achieved a high level of income and a stable price level there is no National Debt problem. All actions, including the raising of the rate of interest, must be judged on their consequences and the higher interest payments are not a burden when income is rising. Conversely in time of deflation debt is redeemed so as to secure a lower rate of interest. It is apparent therefore that Lerner also argues in an "a priori" fashion although his argument is somewhat different from that of the Chicago School in that he favours using changes in taxation to vary consumption spending as a marginal weapon should the
rate of interest chosen fail to produce the "right" amount of spending. Friedman, on the other hand, regards a good combination as roughly a balanced budget together with whatever associated monetary policy would prevent inflation.

Both the "Classical" arguments of Friedman and the "Functional Finance" principles of Lerner tend to brush aside political, institutional and psychological factors although there might be something to be said for the argument that these would be less acute once the public was made to expect periodic fluctuations in bond prices. There might then be more "informed" speculation and hence less likelihood of a complete market breakdown. The experience of cheap money since the war lends some weight to this argument.

The "Economist"(1) has also argued the classical line. It favours using the rate of interest as part of the price mechanism, and at the time said that a variable rate of interest "provides an objective calculus of the relative worth of short-term end long-term projects. The very objective of any disinflation policy is to make marginal buyers less able to exert their demand." Professor Meade was another who argued strongly for using the price mechanism and once mentioned a rate of 15 per cent.

At the other end of the scale are economists who oppose any use of flexible monetary policy involving changes in

(1) Vide May 5th, 12th and 19th issues of 1951.
the rate of interest. They also argue in an "a priori" fashion and are generally found to favour the extensive use of direct controls. This viewpoint has a strong and fiery apostle in Thomas Balogh.

Balogh's main criticism is that monetary policy does not work by selecting investment optimally but by creating uncertainty and holding up the flow of finance in a way which invites cumulative movements. His argument then is not that monetary policy does not work, but that it works too well - that it tends always to overshoot the mark. Embodied in this is the notion - popular even now among Australian economists - that a small dose of monetary medicine makes little difference while a large dose kills the patient.

Harry Johnson is also an ardent supporter of fiscal policies and direct controls. His approach is somewhat more empirical than Balogh's but his conclusions are much the same. Johnson says that a rise in the rate of interest should be avoided if possible, because it only adds to costs and creates difficulties in the capital market. If a tighter monetary policy is thought desirable, however, it should be implemented by means of direct control over excess banking liquidity. Johnson was an active critic of the New Monetary Policy introduced in the United Kingdom in 1951, to which a brief reference may now be made.

Soon after the election Butler began to use monetary policy with two main ends in view - to apply extra disinflation
and to protect the balance of payments. Apart from the possible psychological effects of implied threats of sterner measures to come, the policy proceeded in two stages; one was the funding operation which meant a once-for-all reduction in the liquidity of the banking system, and the other was the raising of Bank Rate to 4 per cent in March, 1952,* together with a tightening of capital issues and selective credit controls.

Johnson was in favour of capital issues and selective credit controls but strongly opposed the funding operation and the subsequent raising of Bank Rate. His contention was that the reduction in liquidity could have been secured without the necessity of paying higher interest charges if the Treasury Deposit Receipt had been revived. There is nothing sacred about the 30 per cent liquidity ratio. This challenge did not pass unanswered. Dennis Robertson and Paish, for example, pointed out that the Government had rejected this alternative because it would not have had the desired effect on public opinion, particularly abroad. An important part of the policy was to restore foreign confidence in sterling.

In an earlier article Johnson argued that in future there would be a bias towards low interest rates and that the use of Bank Rate and open market operations had gone for good. Significant trends during and since the war had been the increase in the amount of public debt held by the banks, the increasing

* It had been raised from 2 to 2\(\frac{1}{2}\) per cent in November, 1951.
role of government in economic life and the widely accepted view that the interest elasticity of investment is low.

Both Balogh and Johnson regard monetary policy as workable but inappropriate because it is inequitable and inefficient. It works through business expectations. J.R. Hicks who certainly does not represent an extreme view on this subject, agrees that monetary policy works in this manner rather than through any so-called "cost" effect but does not regard it as a bad thing. Indeed, he says, that it is precisely because other regulators have been proved deficient in the post-war years that it was necessary to resurrect the "old" monetary policy. Once it was admitted that there was some rate of interest that would bring investment plans to a standstill, there is no need for Bank Rate ever to reach such levels (say 20%). All the Bank has to do is to show its willingness and ability to go "just as far as is necessary".

In an earlier article Hicks had stressed the asymmetrical nature of monetary control - an aspect to which Keynes had devoted some thought. Thus Keynes' 2 per cent minimum means not only that there is a limit to the possibility of stimulating industry by lowering Bank Rate, but also that because a reduction cannot get the same assistance from anticipations about the future as a rise can, it is doubtful whether a reduction can ever have a stimulating effect in the same sort of way as a rise has a depressing effect.\(^\text{(1)}\)

\(^\text{(1)}\) Cf. Manchester School, op. cit., p.153 and Joan Robinson The Rate of Interest and Other Essays (Macmillan, 1952), p.77.
Johnson's nearest counterpart in the United States is Seymour Harris who was a staunch supporter of the cheap money policy. He believes that in the fight against inflation most emphasis should be placed on fiscal policy and controls in that order. The high degree of liquidity in the American economy in 1951 was a serious threat to stability but could only be solved by increasing taxes and levying compulsory loans. These, together with income control, where necessary, adequate price and supply controls may keep the supply of money in check and induce additional demands for money for holding.

Harris says that the conflict between the Federal Reserve Board and the Treasury was over a rise in interest rates of from 1/4 per cent to 1/2 per cent and that a rise of such small magnitude could not depress investment much while there is the risk of it demoralizing the security market. Failure to use monetary policy to fight inflation is not primarily the result of Treasury pressure. Much more important is the fact that there is no disposition to fight inflation among the powerful interests that control the country.

Hansen at the time favoured the retention of cheap money but for rather different reasons than Harris. He thought that for most situations market imperfections would be too great for monetary policy to correct. In America in 1949/50 the great immediate need was to re-employ resources quickly for re-armament, a task which was quite beyond monetary policy.
Hansen is not a supporter of cheap money in all situations but thinks that conditions in the post war have not lent themselves to remedies involving increased interest rates. However, a point of major importance is that Hansen would be prepared to jettison the cheap money policy if it meant expanding the liquid assets in the hands of the public in a manner prejudicial to an effective fiscal policy. This viewpoint has the support of many Australian economists.

Thus Hansen's attitude to cheap money could logically vary from time to time, depending on his interpretation of the market situation. The same could be said of Lester V. Chandler, Richard Musgrave and possibly Dennis Robertson. Chandler interpreted the 1950 situation somewhat differently from Hansen and thought that there was room, within the confines of a comprehensive programme, for a rise in interest rates, if this is necessary to limit the availability of credit for spending purposes. He is rather critical of those like Harris who have proceeded as if the direct "cost" effects of an increase of \( \frac{1}{2} \) per cent in interest rates was the only matter at issue. They have failed to conceive of monetary policy in sufficiently broad terms.

Chandler favoured the use of monetary policy in conjunction with, and not as a substitute for, fiscal policy. His conclusion was that the rate of interest should be allowed to rise slightly and selective credit controls used as an adjunct to that policy. It is not just a matter of comparing the extra
costs involved in a rate change; monetary policy also embraces central bank propaganda to influence expectations of the market.

Musgrave also favours the use of selective credit controls. He says that if the rate of interest fails to narrow the deflationary or inflationary gap, the desirable level of rates would seem to hinge largely on distributional and debt management considerations. However, in view of the psychological aspect and the effect on the institutional investor, it may be desirable to retain some freedom in using interest rate adjustments as an element of cycle policy. The psychological aspects were in fact mentioned in the Oxford Enquiry and Musgrave considers that they are still important. He says that short-run effect of changes in the level of interest and especially anticipation of rate changes, may be more significant than the longer run effects of actual changes. Central bank action directed at a rate increase tends to be interpreted as a general signal of changing economic outlook, an indication that "the boom has run its course". (1) Quite apart from cost effects, this psychological factor alone may result in restrictive business action. In the upward phase of the cycle the cheap money policy may have to be relaxed to help close the inflationary gap, and prevent a diversion of funds to debentures and equities. Monetary policy works by creating uncertainty which first slows down the

financial boom and later the real investment boom.

Dennis Robertson was a participant in this debate and became very irritated with those who advocated direct controls. He rejected the idea that a higher Bank Rate worked by causing a collapse of confidence and believed that dear money had assisted the balance of payments. It had been an important step in the restoration of confidence in sterling.
Section 12: Reasons for the Abandonment of Cheap Money in Australia, 1951/52.

An account of the main economic trends in 1951/52 is given in Part VI as part of a detailed analysis to ascertain the extent to which interest rates reflected market conditions and the extent to which they were influenced by policy decisions. However, for the purpose of this study it is also desirable to set down the main events leading up to the abandonment of cheap money in July, 1952.

The first hint of trouble came in December, 1950, when a $3\frac{1}{2}$ per cent conversion offer to holders of £129 million of 4\% stock was accepted only to the extent of £100 million. Official support of the bond market was required on an increasing scale early in 1951 to prevent yields from rising, particularly after the collapse of the wool boom. In April, 1951, the £40 million Twelfth Security Loan was issued at an effective yield of $3\frac{1}{2}$ per cent, the authorities thus acquiescing in the rise in rates. This loan was over-subscribed but at that time insurance companies began selling heavily and bond prices started to tumble about June, 1951. While cheap money crumbled under pressure, share prices rose and the new issue market enjoyed a major boom. This was assisted by the removal in January, 1950, of capital issues control which was not

---

reinstated until February, 1951. After prolonged discussion which seems to have unsettled the market, the bond rate was raised to 3\% per cent in August, 1951. From that time loans began to be heavily under-subscribed but the end of the cheap money era was not officially recognised until June, 1952, with the prevailing market rate for long-term securities at about 4\%\% per cent. The coupon rate was raised to 4\%\% per cent in the November loan.

One could list a great many reasons why cheap money was pursued with such vigour after the war. For one thing it was easy to implement the policy in the early years and for another, the trend of thought in Australia moved strongly against allowing interest to rise after the war. After the war low interest rates were inconsistent with the view that investment is interest elastic but it was noted earlier that most economists immediately after the war did consider flagging investment a definite possibility. Nevertheless very little attention was paid to the results of the Oxford Enquiry. The main arguments - with hardly a dissenting voice - were that low interest rates were essential in view of the enormous increase in public debt, that they would assist economic expansion and were to be preferred on egalitarian grounds.

Likewise with the abandonment of cheap money, there is very little evidence that the authorities were motivated by the desire to implement a more flexible monetary policy. The main
fact, recognised but slowly by the authorities in 1951/52 and again in 1955/56, was that cheap money had to be abandoned and the open-market policy reversed if fiscal and other measures were to be given any real chance of success. The importance of reversing the open-market policy if it clearly endangers the preservation of economic stability has been stressed by Hansen in the international debate and in Australia by a number of economists including Coombs, Arndt, Rowan and Holder.

It is generally agreed that the efforts to prevent interest rates from rising in 1950/51 and 1951/52 contributed to the growth of inflationary pressure. In this period the Central Bank increased its holding of securities, other than Treasury bills, by about £170 million.

The main causes of increased market support and the abandonment of cheap money in Australia were as follows:

(a) collapse of the wool boom and the resultant liquidity crisis;

(b) expectation of a rise in the rate of interest, prompted partly by the belief that the authorities would soon have to take action involving a rise in interest rates to check inflation and partly by the rise in interest rates overseas;

(c) effect of inflation on the real rate of interest and diversion of funds to shares and debentures in an effort to cut capital losses;
(d) conviction that development must continue in spite of inflationary pressure.

It is plausible to argue that the continuance of inflationary pressure would have required the abandonment of cheap money sooner or later; but it seems very clear that the Australian monetary authorities were loth to let it go\(^{(1)}\) and may have been able to hold the line longer had it not been for the rather exceptional nature of the circumstances from 1950 to 1952. Inflationary pressures were intensified in 1949/50 and 1950/51. To some extent it was an imported cost inflation with heavy capital inflows, although 1950/51 differed in many respects from 1949/50 and earlier post-war years. As the Commonwealth Bank put it, 1951/52 was a year of dramatic change. The basic dilemma for the monetary authorities was how to cushion the impact of the liquidity crisis and at the same time restrain the growth of inflationary pressures. In the "nice" judgment required for such a solution the slavish concern for low interest rates had to go.

Thus Rowan says that "it is clear that the liquidity crisis not only eliminated cheap money but also brought about a collapse of the equity market. The steadiness of the administrative group of rates reflects the fact that the authorities parted with cheap money unwillingly\(^{(2)}\)". The sharp decline in wool prices in 1951 and the huge flow of imports, led to a rapid depletion of London funds with a consequent loss of bank

\(^{(1)}\) Cf. Part VI, et. seq. \(^{(2)}\) *op. cit.*, p. 209
liquidity and a general tightness of money. The reversal of the capital inflow also contributed to the final abandonment of cheap money.

The liquidity crisis may explain why cheap money was abandoned when it was, but it is very doubtful if the pre-1951 pattern of interest rates could have been continued for much longer even in the absence of such a crisis. It is easily overlooked that the level of investment demand was expanding rapidly in this period (1948/51) and that inflation was particularly acute in Australia. The effectiveness of monetary policy was reduced by the failure to put a break on public investment programmes or alternatively to revive the use of some direct controls and increase taxation. As there appeared to be no limit at all to the requirements of government works programmes and certainly no way of avoiding defence commitments, it is likely that a very restrictive credit policy would sooner or later have been required to meet the situation and that this would have sounded the death-knell of cheap money. Indeed the chief cause of pressure on the bond market in 1955/56 was the restrictive credit policy which induced holders to sell bonds as a means of obtaining cash. Tight budgetary policies provided little assistance to the retention of low interest rates in Australia because on both occasions they came too late, and then to cut back imports and enable the investment programme to be carried through with a minimum of recourse to central bank credit.
The persistently high level of internal demand was therefore a factor of some importance in the surrender of cheap money; but it would, of course, be entirely unreal to imagine that it was unrelated to balance of payments trends and prospects. It was precisely because the tempo of the Australian economy had become so geared to trends in international commodity prices and the flow of capital that cheap money ended when it did. The same can be said of the further rise in interest rates in 1955/56.

More generally, the diversion of funds from bonds to shares and debentures in 1950/51 and from most classes of financial assets to cash in 1951/52 was undoubtedly a major contributory cause of the breakdown of the cheap money policy in Australia. In 1949/50 the boom in equities would appear to have been caused more by a general feeling of confidence arising from persistently favourable balance of payments than by "switching" from bonds. While "switching", particularly by life assurance companies, was carried out on a large scale in 1950/51 it was, for the most part, offset by demands from other sections of the public. (1)

The tendency for funds to flow into debentures and notes rather than bonds has become even more marked in recent years and the Government's failure either to implement an effective fiscal policy or revive the use of direct controls was

(1) For a discussion of the importance of the wool boom in sustaining the demand for Commonwealth securities see H.W. Arndt: "The Post-War Australian Bond Market, Economic Record, November, 1954, also Part VI, et. seq.
an important cause of the further fall in bond prices in 1955/56 and the eventual acceptance of a coupon rate of 5 per cent for long-term government securities.

The argument that rates rose because people expected them to rise has, I think, been greatly overrated. Nevertheless there is something in the belief that the Government's handling of the situation - its refusal to admit bond market support and lack of a clear policy - added to speculative pressures and market support. A more drastic increase in bond rate and a clear announcement of intentions may have cleared the air and reduced the extent of market support. A more decisive policy would have been preferable. The most important influence here, however, was undoubtedly the rise in interest rates overseas.

J.O.N. Perkins has argued that Australia should be willing to pay a fairly high rate of interest in order to develop her resources. The basis of the argument is that capital flows fairly freely in response to interest rate differentials, high interest rates help stimulate saving and that the Australian market is strongly influenced by the prevailing rate in London in its views of what the rate of interest should be in Australia.\(^{(1)}\) The first two points are very debatable but the last was important in so far as it reinforced the growing belief that the pace of development could not be sustained indefinitely without a rise in interest rates and that more drastic measures

would have to be taken in Australia to restore internal balance.

The imperfections of the Australian capital market limit the scope both for changes in interest rates overseas to have a direct influence on rates in Australia and for the implementation of a positive monetary policy.
Section 13: The Case for a More Flexible Monetary Policy

In Australia the abandonment of cheap money was not therefore a deliberate act of policy but was forced on the authorities by events. In the United Kingdom and the United States, monetary policy, through changes in interest rates, performed a more positive function among the array of stabilization measures. This course is more feasible in countries which possess a well developed money market. Thus Dr. Coombs has recently stated that:

"Delay in changing the direction of central bank market policy whenever such a change would involve the acceptance of lower prices for government securities is inevitable so long as the central bank continues to be so large a factor in the market...In more developed economies there are markets which provide channels for large transactions in which prices and yields are determined essentially by market conditions...It is desirable that there should be a number of firms participating in the market as dealers - themselves holders of Government securities and financially strong enough to quote prices for a range of government securities. In such a market the central bank could operate in a way which ensured that its participation was marginal only and which would avoid it necessarily becoming involved for purposes conflicting with its basic policies."

On the other hand, the absence of a Bank rate to act as a warning signal may mean that the psychological factor as stressed by Musgrave and others in the international debate has less chance to be important in Australia. In like fashion it can be argued that with a simpler capital market than in either the United Kingdom or U.S.A. and with adequate controls over the banks there was less need to adopt a positive monetary policy. The relatively greater importance of the Government sector also makes for a narrowing of the range of investments which in practice a change in interest rates would be likely to influence. It can be argued also that the rise in the Bank Rate in the United Kingdom was directed mainly at restoring a measure of confidence in sterling.

While Lerner presents some interesting theoretical possibilities in his Principles of Functional Finance it seems to me to be extremely unlikely that Governments will ever behave in the manner indicated. Economists like Lerner want the price mechanism to work more effectively but usually evolve a system requiring more and more difficult decisions to be made. What for example is the "appropriate" rate of interest? How is it determined? What happens when the Government finds, as it did in Australia, that it cannot borrow any more from the public? Lerner's scheme would be wholly unworkable in Australia where the supply of loanable funds fluctuates widely from year to year in association with changes in the balance of payments.
The fact that Australia's prosperity still seems largely to hinge on the terms of trade is one reason for accepting the views of overseas economists with some caution. It is argued that these oscillations in our overseas reserves and hence in bank deposits and liquidity are best controlled by more direct means—such as Special Accounts which can be more easily reversed when conditions change and which do not necessarily cause repercussions through the entire system. While the volume of credit is controlled mainly with a view to offsetting the effects on liquidity of the balance of payments and government financial operations it may seem difficult to envisage a flexible interest rate policy being revived in Australia, especially as these changes would require large fluctuations in security prices unpalatable to any government. Until recently Harry Johnson's arguments have carried the day in Australia. These are that it is desirable to avoid the extra costs involved in higher interest rates by acting on bank liquidity more directly and that a rise in interest rates creates difficulties in the capital market. Australian economists have also been inclined to argue, as we noted in Section 10, that the effects of changes in interest rates are unpredictable and that a flexible interest rate policy is clumsy, inefficient and often inequitable; it is likely to reverse expectations and is therefore an unreliable weapon of contra-cyclical policy.\(^{(1)}\)

\(^{(1)}\)R.R. Hirst, *op. cit.*, p. 3.
More recent experience however has set economists wondering whether there might not be more to be said for a flexible monetary policy than they had been prepared to admit hitherto. Is there a case for using monetary policy in a more positive fashion in Australia? Should the open market policy have been reversed in 1950/51 and again in 1955? It is rather interesting that both Coombs and Rowan think that it should.

Dr. Coombs says that we entered the post-war period with a very restricted conception of the role of monetary policy and relying heavily on the direct controls characteristic of the war. In surveying the development of monetary policy since 1945, Dr. Coombs admitted that our capacity to restrain mounting inflation was weakened by the desire to maintain interest rates at the low wartime level. Two of his conclusions have particular relevance to this discussion. They are (a) that no monetary policy can be effective unless there is reasonable discipline in public investment programmes, and (b) that if it is necessary to counter a growing money supply, open market sales must not be subordinated to low interest rates, however desirable these may be.\(^{(1)}\)

Reviewing the more recent period Dr. Coombs has stated that from time to time we will be faced with active or potential inflation which can only be controlled by measures involving higher interest rates. Unwillingness to face this action would

\(^{(1)}\) *op. cit.*, p. 13.
make periodical bursts of inflation almost inevitable and increase the need to resort to more unpopular measures such as increased taxes.

The central bank will moreover continue to be handicapped in its open market policies until institutional developments in the Government security market reduce dependance on the central bank and until we become educated to accept changes in interest rates more readily. The objective must be to take action before cumulative tendencies have been established.\(^1\)

David Rowan\(^2\) contends that both quantitative and qualitative controls worked well since the war and particularly in the changing conditions from 1950 to 1952. However, if any criticism is to be levelled at the Bank it is that it could have reduced switching from bonds to equities if it had been prepared to openly abandon cheap money. The abandonment of cheap money in 1950 would probably have been unacceptable to the Treasurer anyway but if it had been possible it would not only have greatly reduced switching but diminished both the general optimism of business and the availability of funds through the capital market. It was unwise for the Bank to leave the initiative with the market and allow interest rates to climb steadily upwards in the face of official resistance. Rowan says that for monetary policy to be effective it must aim at influencing conditions in the new issue market and the decisions of financial institutions.

\(^{1}\)op. cit., p.12 \(^{2}\)op. cit., p.210-3.
other than banks. More generally, Rowan concludes that the traditional central banking techniques are ill-adapted to the needs of a dependent economy experiencing major fluctuations in external reserves. He supports the use of import and capital issues controls together with quantitative bank control as the first line of defence.

What is the case for a flexible monetary policy? The main channels through which monetary policy operates have been re-stated only recently by J.E. Meade\(^{(1)}\) and are as follows:

(a) the effect on investment directly;
(b) the effect on stocks. This will not be great if considerable price movements are expected;
(c) effect on new capital issues;
(d) reduction in trading bank lending;
(e) the effect on capital values of all forms of securities.

Thus a rise in the rate of interest reduces liquidity and therefore slows down both business expansion (in so far as reserves are invested in securities) and consumption expenditure;

(f) it affects the terms at which hire purchase schemes can be financed which (in the event of a higher rate) may dampen down the demand for durable goods.

The argument that lower interest rates, by reducing

costs, encourage an expansion of investment, is not as widely held as formerly. The assumption that investment decisions are highly sensitive to changes in interest rates has been the subject of considerable criticism particularly since the Oxford group of economists published the results of their survey in 1938. It is true that since 1951 the techniques of monetary policy have regained a measure of their former appeal but the main argument used now is not that a change in interest rates directly renders new investment either in fixed equipment or stocks more or less profitable than before but that a change in interest rates may have important effects on the availability of finance, on the stock exchange and on the direction of funds between various classes of investment.

Except for long-period investments, the interest elasticity of investment is now taken to be fairly low and consequently a fractional change in the rate of interest will not make much difference to investment plans. Even in the case of long-period investments the rate of interest is not very important as public works and housing activity, for example, are now determined largely by social and political considerations.

A rise in the rate of interest may however be a means of limiting the availability of credit for spending purposes and of making it more difficult to raise new capital. There are reasons for thinking that this may not be very important in Australia. If bank credit policy is not sufficiently restrictive
institutional lenders may be able to cover their capital losses and there may, of course, be an expectation of a further rise in the rate of interest. More important, however, the demand for funds may be so great that lenders continue to lend despite losses. The effect of this is to force up rates on debentures and notes and other funds competing for fixed term investments. This is undoubtedly a very important consideration in Australia where the failure to control the diversion of funds in the capital market would be likely to require large changes in interest rates/ unacceptable on budgetary and egalitarian grounds. It is arguable of course, that this diversion of funds may have been prevented or at least greatly diminished if the Government had acted more quickly and increased bond rate earlier.

A period of rising interest rates has also focused attention on the effect on capital values and hence consumption expenditure. Whether or not a fall in the rate of interest by increasing capital values and hence liquidity will cause an increase in consumer spending, depend largely on prevailing expectations concerning the future course of interest rates as well as on the nature of the circumstances before the change. If the rate is expected to fall even further the rise in consumption expenditure may be delayed to some extent by the possibility of greater capital gain later.

Likewise a rise in the rate of interest might be expected to have some dampening effect on consumption
expenditure, particularly if it is associated with a fall in share prices. But while this may be important at a particular time, it is clearly shrouded with uncertainty and would not be a reliable channel through which to allow monetary policy to work.

The trouble in Australia was that consumption expenditure was not much affected while a further rise in the rate of interest was in the offing. Furthermore a decline in liquidity does not necessarily put a stop to borrowing or the willingness to lend as people are often inclined to assume greater risks (work on smaller safety margins) if inflation is expected to continue. In so far as companies have large funds tied up in government securities however, the capacity for immediate expansion could well be affected by a rise in the rate of interest; however indications are that since the war companies have preferred not to tie up funds in this way, the main reason being that the pace of expansion has quickened and most firms are involved in an almost continuous need for expansion and replacement. Companies now also operate on smaller liquidity margins.

Obviously much will depend on prevailing credit policy but even more on the central bank's ability to convince representative opinion that no further rise in the rate need be expected. Success in co-ordinating these two aims could render a flexible monetary policy useful in putting a brake on consumption expenditure and holding up the availability of funds
for investment. Failure to co-ordinate them would mean large fluctuations in security prices which are undesirable on other grounds. There are reasons to believe that with the development of new institutions and the Central Bank's great awareness of the advantages of a flexible interest rate policy, these aims will be better co-ordinated in the future.

Meade's final argument is that a rise in the rate of interest may slow down the rate of growth of hire purchase and therefore dampen down the demand for durable goods. This seems to have limited application in Australia where a rise in the overdraft rate and/or a restriction of credit may do no more than force borrowers to go elsewhere for funds. The higher rates which they may be required to pay on deposits, notes and debentures are of small moment by comparison with the opportunities of profit opened up by hire purchase business. Hire purchase is itself to some extent demand creating. The only sure way of cutting back the demand for durables is through taxation and more direct measures, but if the higher rate is not regarded as temporary, consumption expenditure and hence the demand for hire purchase facilities may fall because of the decline in capital values referred to above.

Conditions of full employment and the accompanying problem of inflation in an expanding economy have brought into operation a wide array of monetary techniques for controlling the level of aggregate demand. Since 1950 or thereabouts more
attention has been given to the effects of changes in interest rates especially on the level of saving, as this has been at the heart of our problem. However changes in interest rates are not considered an appropriate means of offsetting the fundamental changes in liquidity which arise from changes in the balance of payments and the outcome of government financial operations. High interest rates were forced on the authorities by events. Cheap money was abandoned because it was found inconsistent with the policy of credit restraint and not because very much credence was given to the more positive case for a flexible interest policy. There is still an old-fashioned hankering for the national debt argument. The general view is that low rates have but a minor effect on investment. Certainly an overriding problem is the financing of capital works expenditure. A stable bond market is desirable in that it will enable major works expenditures to be financed with the minimum of inflation or disturbance to loan raisings. The tragedy of the Australian experiment is that efforts to retain stable bond prices have in fact added to inflation.
PART VI

ANALYTICAL: THE ABANDONMENT OF CHEAP MONEY,
1950-1956

Section 1: 1950-56 - each financial year .. 241-263
Section 2: Recapitulation: assessment of results on longer perspective .. 264-268
Section 1: 1950-1956

(a) 1950-51

(i) State of Loan Market

The amount raised from the loan market in 1950/51 was approximately £127 million or about £22 million more than 1949/50 which had been a highly successful year. In 1950/51 all three loans were heavily oversubscribed, yet the market developed unmistakable signs of weakness in the latter half of the year. A good summary of the position is found in the annual Report of the Commonwealth Bank:

"...public loan raisings have become increasingly difficult in the face of the strong demand for private industry for funds. Following a period of falling prices of Government securities...the long term securities of the twelfth security loan were issued at a discount of 1 per cent (May, 1951), though the nominal interest rate was unchanged at 3½ per cent. This was the first time since 1946 that long term Government securities had been issued with a yield of more than 3½ per cent..."

(ii) Bond Prices

Short-dated bond prices fluctuated very little during the year but a weakness in long-dated bonds became apparent after January, 1951. The current market yield in March averaged 3.27 per cent, compared with 3.17 per cent in December and 3.14
per cent in June, 1950. In the final quarter of the year official support was at a higher rate and yields in April and May were sustained at the March level. The real collapse came in June when, despite the more vigorous support policy, the average yield rose to 3.51 per cent. Bond prices continued to fall in the following year with the coupon rate being raised to 3 3/4 per cent in August.

The average market yield on long-term securities was only marginally higher in 1950/51 than in 1949/50 - 3.21 per cent compared with 3.13 per cent. The fall in wool prices in March had an important bearing on the subsequent rise in bond yields. In the first nine months of the year the rise in export incomes had been great enough to mask the operation of factors which were contributing to market weakness. There was a further fall in the bond holdings of Life Offices and other institutional investors and a growing preference for shares and other securities which offered a hedge against inflation. Share prices rose throughout the year until May.

In 1950/51 Commonwealth Bank and C.S.B. holdings of Commonwealth securities rose by £66 million but the holdings of investors other than financial institutions and governments also rose - by £44 million. Professor Arndt(1) considers that this movement can be explained largely by the wool boom which seems a plausible explanation especially in the light of more

---

recent experience between 1955 and 1957. Arndt's survey reveals that almost the entire increase in bond holdings of private companies between 1949 and 1951 was accounted for by those classified as "agriculture and pastoral". The inflow of capital was also an important source of funds and played some part in supporting the bond market during these years. As a corollary, the subsequent fall in wool prices and reversal of the capital flow "deprived the bond market of the major sources of support which it had enjoyed in the two preceding years".\(^{(1)}\)

(iii) Volume of Money

The volume of money rose by 19 per cent in 1950/51 for which the rise of £193 million in international reserves and £104 million in bank advances were largely responsible. Recourse to Treasury bills was avoided only by the pre-payment of tax on wool incomes which increased revenue by about £110 million in 1950/51. These factors, together with the support policy explain why, despite the continued and accelerated deterioration in the value of money in 1950/51 and the associated strong rise in the transactions demand for money, bond yields for the year as a whole rose but little.

(iv) External Situation

The supply of loanable funds bears a close relation to export prices and the movement of international reserves. In 1950/51 wool prices averaged 144d. per lb. greasy compared with 63d. per lb. in 1949/50. The export price index rose by 73

\(^{(1)}\)Ibid., p.268
per cent and there was a favourable trade balance of approximately £237 million. In 1949/50 the favourable balance had only amounted to £77 million but the capital inflow had been more than twice as great. This explains why the rise in overseas reserves was of approximately the same order in each of these years.

(v) Bank Advances

Despite a tightening of central bank policy and the reinstatement of capital issues control in February, 1951, the banks expanded their advances by over £100 million during the year. The rise of nearly 40 per cent in bank debits is an indication of the magnitude of the current demand for money. Debits rose from 14.6 to 17 per cent of bank deposits. The rise in time deposits was but a fraction of the total increase in deposits.

(vi) Domestic Spending

Investment and consumption spending attained high levels in 1950/51. Hostilities broke out in Korea in June, 1950, and rearmament dominated the world scene during the year. Defence expenditures were stepped up in Australia and net expenditure by public authorities was nearly 40 per cent greater than in 1949/50. Part of this increase was, of course, absorbed in rising prices but it also reflected a high migration intake (although lower than 1949/50) and real expansion. Gross private investment in fixed capital equipment was 34 per cent
higher than in 1949/50 while consumption spending received an added boost from the December Basic Wage Decision and the operation of the automatic cost of living adjustment system.

(vii) Summary

The rise in bond yields occurred in the second half of the year during which time there was a sensational rise in wool prices followed by an equally sensational fall. This development, coupled with the greater availability of imported goods and growing doubts as to the economy's capacity to absorb this increase, gave rise to increasing uncertainty about the future. The Government supported the bond market strongly to maintain cheap money but towards the end of the year there were signs that a market breakdown could not be long delayed. Once the wool boom had collapsed and the capital inflow diminished without any prospect of early relief to rising prices and costs, bond prices could not be prevented from falling without further endangering economic stability.
(b) 1951-1952

(i) **Loan Raisings**

The amount subscribed to public loans in 1951-52 was £64 million or about half as much as in 1950/51. The failure of the loan market followed upon a balance of payments deficit of great magnitude but the situation was also aggravated by the government's refusal to accept the inevitability of the dearer money conditions.

(ii) **Volume of Money**

In 1951/52 the money supply fell by 2 per cent which was the direct outcome of the fall of £480 million in international reserves. The fall in the money supply would have been much greater however, had it not been for the expansion of £45 million in Treasury bills and £185 million in bank advances. Open-market operations also added to the money supply.

(iii) **Banking Policy**

As a counter to the fall in overseas funds, the Central Bank reversed its banking policy and supported the liquid reserves of the trading banks. Special Account releases amounted to approximately £310 million and this enabled the banks to expand their lending, particularly for the purpose of financing rapidly accumulating stocks of imported goods. This action was instrumental in keeping the recession within bounds. The degree of unemployment which subsequently emerged in 1952/53 was comparatively mild and expansion was resumed without undue delay.
(iv) Abandonment of Cheap Money

Between August and November the Government made a desperate bid to hold the line, after having reluctantly raised the coupon rate from $3\frac{1}{2}$ per cent to $3\frac{3}{4}$ per cent in the August loan. This policy involved net purchases of securities from official sources on an increasing scale and by the end of November it was clear that the scale of selling was too great for a successful holding operation. Yields rose steeply after December, although it was not until near the end of the financial year that the authorities were prepared to concede defeat. Both the November and March loans for the longer maturities were issued at $3\frac{3}{4}$ per cent despite the fact that great difficulty was being experienced in keeping market yields down to that level. The March loan in particular proved a sorry failure which is not surprising when market yields had exceeded 3.8 per cent for three months prior to issue. Yields rose rapidly after March but the end of the cheap money era was not officially recognised until July, 1952, when the order made by the Bank under the National Security Regulations fixing maximum rates of interest for certain transactions was revoked. Bank deposit and overdraft rates were then permitted to rise. In the 1952/53 Budget Speech delivered on August 6th the Treasurer said that governments were naturally reluctant to pay increased rates of interest but should nevertheless recognise the "realities of the market situation."
For the year as a whole net purchases of Commonwealth securities by the Commonwealth Bank and C.S.B. amounted to £106 million. In June, 1952, the average yield was 4.62 per cent compared with 3.75 per cent in December and 3.51 per cent in June, 1951.

The fundamental causes of market weakness were as follows:

(a) the fall in the supply of loanable funds consequent upon the balance of payments deficit;

(b) the progressive deterioration in the value of money with no end to the inflationary spiral in sight. This was not a new factor but in earlier years it had been masked by high and rising export prices;

(c) the Government's failure to see the writing on the wall and move quickly towards a solution. Policy was indecisive and added to the general state of uncertainty and the associated rise in liquidity preference;

(d) the continuing high rate of economic growth.

There seems quite a strong case for arguing that an early reversal of open-market operations and the fixing of a coupon rate more appropriate to the circumstances may not only have secured a better response to public loans but also resulted in approximately the same increase in market yields without adding further to inflation. If the November and March loans
had been floated at 4 instead of 3½ per cent, the selling wave in the last quarter of the year may have been avoided. If we postulate a situation in which there was no market support we might have secured results which compare with the actual situation as far as the various factors causing the rise are concerned as follows:

<table>
<thead>
<tr>
<th>Factors Causing Change in Yield</th>
<th>With Market Support</th>
<th>Without Market Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Fall in Money Supply</td>
<td>+ 0.70%</td>
<td>+ 1.10%</td>
</tr>
<tr>
<td>(b) Rise in Demand for Money $(M_1)$</td>
<td>+ 0.30%</td>
<td>+ 0.30%</td>
</tr>
<tr>
<td>(c) Rise in Liquidity Preference $(M_2)$</td>
<td>+ 0.34%</td>
<td>+ 0.14%</td>
</tr>
<tr>
<td></td>
<td>+ 1.34%</td>
<td>+ 1.54%</td>
</tr>
</tbody>
</table>

If this guess is anywhere near the mark it suggests that without the support policy, or less support combined with greater realism in fixing the terms and conditions of loans in 1951/52, the rise in market yields may not have been appreciably greater than actually occurred with a full-blooded support policy. If that is the case there would have been a strong probability of a more healthy response to public loans not only in 1951/52, but in the ensuing year and of course the inflationary effects of the cheap money policy would have been all but eliminated. Up to a point therefore, the support policy was a self-defeating policy in the rather exceptional conditions of 1951/52.

Thanks mainly to swift action by the Commonwealth
Bank, the collapse of the export boom did not develop with a serious recession, but it left its mark on the investing public and was followed by a sharp rise in liquidity preference. Uncertainty both as to the future course of business and of bond prices together with the hardship already inflicted on recipients of fixed incomes was so great that cash seemed preferable to almost all forms of assets. In 1950/51 the share market had enjoyed a major boom and there was almost certainly some switching between government securities and shares and debentures. In 1951/52 however, people not only deserted bonds on an increasing scale but got out of shares also. Share prices fell rapidly as a consequence.

In 1951/52 Life Offices reduced their holdings of Commonwealth securities by a further £11 million while holders other than governments and financial institutions unloaded bonds to the extent of £35 million. This is the crucial difference between the situation in 1951/52 and 1950/51 when this group acquired additional holdings of £44 million. In 1950/51, particularly in the second half of the year, there was some evidence that increasing uncertainty about the future course of bond prices and the growing attractiveness of other forms of investment had manifested itself in some market weakness. The capital inflow had been greatly reduced also but the implications for the bond market were not immediately apparent in view of the phenomenal rise in wool incomes which, apart from its direct effect on the supply of loanable funds, had
traditionally been regarded as a pointer to business optimism. This supporting peg virtually guaranteed the strength of the bond market. When it was removed the bottom dropped out of the market.

The other major factor was that the underlying growth of the economy was not greatly impaired by the changing fortunes in export markets. The effect of re-armament was only now fully reflected in expenditures. Private investment was much higher in money terms and well maintained in real terms. The impression sometimes created is that consumption spending eased off and in real terms this is probably true. However, average weekly wage earnings rose by 23 per cent and the "horror" budget appeared to have a remarkably moderate impact on the level of spending. What it really did was to ensure that the Loan Council borrowing programme of £225 million would be carried through with a minimum of recourse to central bank credit.

(c) 1952-1953

(i) Loan Raisings

The most noteworthy thing about the year was that while the bond market regained something of its former stability without the need for market support, the amount received from public loans was slightly less than in 1951/52. On the face of it this may seem surprising in a year which recorded a sizeable surplus on overseas current account.

In the November loan the coupon rate was raised from $3\frac{3}{4}$ to $4\frac{1}{2}$ per cent. The Government not only demanded less from
the market, there being only two loans during the year, but, what is probably more significant, reduced the currencies of the long-term securities from 13 to 9 years and issued a loan in March with a currency of 2\(\frac{1}{2}\) years and carrying interest at 3 per cent with a discount of 10/-. In the previous year short-term loans were issued for 3 years and with interest at 2 per cent. This was indisputable evidence that the Government had at last acquiesced in dear money although there was no particular merit in trying to conceal this fact. After the November loan the market regained some semblance of stability. Yields fell between October and January and again between March and June. After June the downward movement persisted.

(ii) Level of Spending

To what influences was the bond market principally subject in 1952/53? Business was in rather a hesitant mood, and for the first time in many years an earnest endeavour was made to prevent Government expenditure from rising. These endeavours were not entirely successful of course, but total expenditure was restrained. The velocity of money, as evidenced by bank debits, declined while the fall in business stocks enabled advances to be repaid. Consumption spending increased by only 6 per cent.

(iii) Volume of Money

The money supply rose by 9 per cent during the year. International reserves rose by £186 million and despite restraint in total spending, the Government gave away about £50 million in
tax concessions and was forced to borrow a further £72 million from the Commonwealth Bank to cover the cash deficit for the year.

(iv) Other Influences

On the other hand, the tendency during the year for the raising of large sums through debentures and similarly secured obligations did something to unsettle the bond market. The share market was depressed and in 1952/53 more money was raised from debentures than from shares. Rates on debentures were edging up to 5 per cent which seemed an attractive yield at the time.

Furthermore, with the emergence of some unemployment and a fairly stable price level, some decline in liquidity preference could reasonably have been expected. Life Offices increased their holdings of Commonwealth securities by £6 million but otherwise the benefit from the revision of expectations would seem to have been secured by private industry seeking funds through the issue of debentures and the like, with very little renewed interest being shown towards Commonwealth securities. It is quite likely that savings bank deposits were drawn upon to finance a large part of fixed interest borrowing. It must also be remembered that hire purchase was now growing rapidly and that years of inflation had not put a premium on saving.

Another unfavourable factor as far as the bond market was concerned was the outflow of private capital. While the terms of trade were more favourable, export prices rose by
only 2 per cent, and the improvement in the balance of payments situation was largely attributable to the increased volume of exports and decreased volume of imports.

(v) Summary

The year had therefore been a dull one for the bond market. For this the policy pursued in the preceding 18 months must take some blame. The favourable balance of payments and large cash deficit in 1952/53 had been offset by the uncertain tone of business, the emergence of stronger competition for Government loans and the apparent outflow of private capital. As a result bond yields were not very different at the end than at the beginning of the year. However, the average yield in 1952/53 was appreciably higher than in 1951/52.

(d) 1953-1954

(i) State of the Bond Market

The bond market developed a firm tone in 1953/54. At the commencement of the year the market yield on long-term government securities was 4.48 per cent and at the end of the year 4.40 per cent. The extent of stability is evidenced by the fact that the average yield for the year was 4.44 per cent, compared with 4.54 per cent in 1952/53. A rise, however, occurred in yields on short-term securities, particularly in the June quarter. The 3 per cent 1957 loan was issued at a discount of £1.10.

From two loans issued during the year the amount
raised was £118 million, or more than twice as much as in 1952/53. The currencies for long-dated securities were also lengthened. This greatly improved response to public loans materially assisted the government's cash position. With continuing restraint on expenditure and revenue higher than anticipated, it permitted a reduction of £35 million in the short-term debt during the year.

The Central Bank did not need to support the bond market this year and its security holdings, other than Treasury bills fell by £30 million. There was a rise of £66 million in holdings of businesses and other non-institutional investors whereas in the preceding year these holdings had fallen by £25 million.

(ii) Reasons for Improvement in the Bond Market

How can we account for the market's underlying strength and the reduction in market support? The money supply rose by 6.5 per cent, but this was less than last year's increase. International reserves had risen by only £9 million as against £189 million in 1952/53. On the other hand bank lending enjoyed a rapid expansion.

The transactions demand for money was somewhat higher than in the previous year with a notable recovery in private investment. Bank debits rose by 15 per cent and proportionately more than the money supply.

These factors, had they been the only ones operating, would surely have combined to induce a rise and not a fall in
bond yields in 1953/54. An explanation for the market's strength must therefore be sought elsewhere.

While the evidence is scant it seems plausible to argue in the circumstances that there was a fall in the demand for money to hold for speculative purposes during the year. The economic outlook improved, unemployment was falling and the rise in costs and prices had virtually been halted. The narrowing of the gap between yields on short and long-dated securities had gathered pace during the year and may suggest that the fear of capital loss through further rises in the rate of interest was now being heavily discounted. On the one hand, the growing evidence of price stability reduced liquidity preference while on the other the large taxation reductions would appear to have stimulated saving as much as consumption despite a fall of 8 per cent in farm incomes.

Share prices were generally little higher in 1953/54 than in 1952/53 but the amount raised from the public through the issue of shares, debentures and unsecured notes was greater. There was certainly no lull in the growth of hire purchase.

This is a rather difficult year to analyse but everything suggests that the strength of the market was based mainly on the mitigation of fears regarding the future course of interest rates. The 4½ per cent coupon rate appealed to the market as reasonable in the circumstances. Important factors in this respect may have been the easier money trend abroad, the expansion of bank advances, the stability of internal prices,
the rather dull share market and the return of business confidence. Budget handouts may also have been important psychologically.

(e) 1954-1955

This was also a year of fairly stable bond prices though there is little doubt that had the market been left to itself prices would have fallen substantially.

(i) State of Loan Market

The loan market was subjected to strain from a number of directions. The rise in the money supply was appreciably less than in either of the two preceding years mainly because of the large fall in international reserves. Export prices fell by 9 per cent (wool prices by 14 per cent) and there was a steep rise in imports. The terms of trade fell from 127 to 113. The net inflow of private capital, however, was about £70 million more than in 1953/54, a substantial part of which it would seem was for investment of a long-term character.

In the second place there was a rise in business confidence with boom conditions towards the end of the year and interest rates rising in the United States and a number of other countries. While the rise in the money supply was comparatively modest, the velocity of money circulation rose at a faster pace, following a pattern similar to 1953/54. Bank debits rose by 10 per cent, and climbed to 19.3 per cent of bank deposits, the highest ratio on record in the post-war years.

The growth in the use of debentures and unsecured
notes to tap private savings did not falter and considerably more was raised from these sources and from new share issues in 1954/55 than in any other year with the exception of 1950/51. During the year interest rates on debentures edged up from 5½ to 6 per cent, and even higher for some hire purchase concerns under the strong pressure of demand for funds. It was the coincidence of these developments with the fall in wool prices and in the supply of loanable funds that was largely responsible for the spate of central bank buying to prevent bond prices from rising much above the coupon rate of 4½ per cent.

(ii) Support of the Bond Market

During the year Commonwealth Bank and C.S.B. holdings of securities, other than Treasury bills, rose by £46 million while investors, other than financial institutions and government, increased holdings by only £22 million, compared with £66 million in the preceding year.

The Commonwealth Bank commented upon the increased need for market support in its Annual Report for the year:

"During 1954/55 the demand for funds in the capital market by private industry and commerce, especially by hire purchase concerns paying high rates of interest, tended to impose pressure on the bond market and increased the difficulty of raising Government and semi-government loans. These factors led to an increase in the Bank's holdings
of Government securities".  

More recently the Governor of the Commonwealth Bank, Dr. H.C. Coombs, has said that:

"while the character of the dilemma was recognised from an early stage, the claims of low interest rates and stability of prices of government securities were difficult to resist... it was not until early in 1956 that Central Bank support for the market was reduced to normal amounts."(2)

While some difficulty was experienced in holding the bond rate to 4.50 per cent for most of the year public loan raisings amounted to £122 million, which was slightly better than the 1953/54 result. The August loan was well received but obviously £50 million was too much to ask for in November and there was a shortfall of approximately £13 million. Only £40 million was sought in the March loan and this met with success.

Yields on short-term securities rose sharply in the second half of the year which no doubt in part reflected the rise to prominence of finance companies offering handsome returns on deposits for periods up to 3 years. At the end of the year the market yield on long-term government securities was 4.53 per cent compared with 4.40 per cent at the beginning. The average yield for the year was 4.50 per cent compared with 4.44 per cent

---

(2) "Conditions of Monetary Policy in Australia" R.C. Mills Memorial Lecture 1958 (Delivered at the University of Sydney, on 29th April).
in 1953/54 and 4.54 per cent in 1952/53.

(f) 1955-1956

(i) Bond Yields

The average yield on long-term securities in 1955/56 was 4.76 per cent, compared with 4.50 per cent in 1954/55. When market support was reduced in February, 1956, yields rose sharply. The yield in June, 1955, was 4.53 per cent and in March, 1956, 5.12 per cent. There was a further rise in the final quarter with yields averaging 5.34 per cent in June, 1956. Yields on short-dated securities rose even more steeply, the average for the year being 4.39 per cent, compared with 3.49 per cent in 1954/55.

(ii) Support of the Bond Market

For the year as a whole the Central Bank increased its holdings of Commonwealth securities, other than Treasury bills, by £36 million. For about 8 months of the year the Bank continued to give the market strong support, despite the fact that this policy was clearly in conflict with the expressed aims of monetary regulation at the time. This was referred to in the Bank's Annual Report for the year where it was pointed out that:

"...in inflationary conditions the measures necessary to counter a market tendency for interest rates to rise can produce effects seriously inconsistent with the general economic policy being pursued." (1)

The Prime Minister came straight to the point in March when in the course of a special statement on economic measures he said:

"Under the circumstances of the market, the Central Bank, has until quite recently, felt called upon to support bond prices by abnormal (and, in total, huge) purchases, this again involving the creation and outlay of many millions of new money. This is inflationary." \(^{(1)}\)

There can be no doubt therefore why market support was reduced to more normal proportions in March and bond yields permitted to rise in excess of 5 per cent. \(^{(2)}\) It is, however, not so easily understood why this action was not taken sooner as it must have been clear that the forces making for higher yields were very strong and were not of an ephemeral character.

The reduction in market support was followed by rises in bank interest rates as it was becoming clear that funds would continue to be diverted from the banking system while there was such a disparity between official and market rates. In the May loan the coupon rate for long-term securities was raised from 4\(\frac{1}{2}\) per cent to 5 per cent and the loan met with a fairly good response despite the higher rates ruling in the market.

(iii) Reasons for Market Weakness

The chief explanation for the rise in the bond yields was the complete reversal of the expansionary credit policy of

\(^{(1)}\)Statement of Economic Measures, March 1956 (Government Printer), p.10.
\(^{(2)}\)See also comments by Coombs, op. cit.
earlier years. There was also a further fall in international reserves and deterioration in the terms of trade. On the other hand the government staved off a certain cash deficit by its March taxation measures and finished the year with an approximate balance between cash receipts and payments. Thus the money supply rose by only one per cent during the year while the velocity of money circulation continued to expand.

The other major factor was that government loans again experienced difficulty in competing with private industry for funds. While the three public loans brought in £93 million, or £30 million less than last year, the amount obtained from debentures and notes was substantially higher than the year before.

The rapid growth in hire purchase in 1953/54 and 1954/55 and the relatively high rates currently offered on short and medium term deposits was causing the government no small concern. The Prime Minister referred to this problem in his September Statement on the Economy and announced that representatives of the Hire Purchase companies had agreed to exercise restraint in hire purchase business in the ensuing nine months. The increase in outstanding balances during the year was of the order of £30 million, compared with £50 million in each of the two preceding years.

(iv) Summary

Private investment was significantly higher in 1955/56. This factor coupled with disequilibrium in the balance
of payments and the growing disparity between official and market yields referred to above go a long way towards explaining the market's underlying weakness. An offsetting factor was the strong inflow of capital. The growth of inflationary pressures during 1955 and the early part of 1956 almost certainly reinforced expectations that higher interest rates could not be long delayed and precipitated the diversion of funds referred to above and which had been apparent also in mid-1951.
Section 2: Recapitulation 1950-1956: Assessment of Results on Longer Perspective

Cheap money was not surrendered lightly in Australia. When market forces subjected the bond market to pressure in 1951 and again in 1955, the Commonwealth Bank supported the market strongly in an effort to prevent yields from rising. On both occasions this policy added to inflationary pressure and failed to achieve the desired objective. Market support was of the order of £180 million between 1950 and 1952 and £80 million between 1954 and 1956.

For the period as a whole market yields on long-term government securities rose from 3.15 to 5.34 per cent. The bond coupon rate was raised on three occasions - from 3½ to 3¾ per cent in August, 1951, from 3¾ to 4½ per cent in November, 1952, and from 4½ to 5 per cent in May, 1956. Bank and other interest charges however, were not permitted to rise until July, 1952, and again in 1956 and there have been no reductions since.

Australian experience suggests that a rise in liquidity preference, either as an inflation hedge or because of speculation concerning the future course of interest rates, can be a stumbling block to a policy of low interest rates. On the other hand our analysis shows that liquidity preference was not a particularly important factor in the Australian situation during these years; it operated strongly in two years only - in 1951/52 when it rose and helped defeat the support policy and again in 1953/54 when it fell and assisted the loan market. Looking at the period as a whole the most important factors
which induced the rise in interest rates were as follows:

(a) the deterioration in the terms of trade;
(b) the strong undertone of growth in the economy;
(c) the diversion of funds to debentures and other like securities.

It must be emphasised however, that the initial weakness in the bond market had its origins in the progressive deterioration in the value of the currency and the particularly steep rise in prices in 1950/51. Ironically enough this trend was closely allied with the boom in wool incomes which itself was instrumental in securing a steady demand for securities. As soon as wool prices found more normal levels, however, the market was fully exposed to the fears of further rises in the price level. There is little doubt that this set of circumstances touched off a strong rise in liquidity preference which, despite intensified market support, resulted in substantially higher interest rates.

It is also true that this rise in liquidity preference and the consequential rise in interest rates was accentuated by the absence of a determined government policy directed at quickly establishing a rate regarded as reasonable in the new circumstances. Nevertheless it seems that some delay is inevitable as long as the Central Bank is such a large factor in the market. (1)

(1) See pages 229 Part V.
By the end of 1952 it was clear that the growing competition for funds from the private sector through the issue of debentures and notes and the acceptance of deposits was emerging as the greatest single threat to Commonwealth loan raisings and indeed to the stability of the market generally. This was not a new development but it did not reach major proportions much before that time.

Such a development was of course related to the strong undertone of growth in the private sector of the economy which, unfortunately for the bond market, happened to coincide with pressures for very large public investment programmes and higher defence expenditures.

The period after 1950 can be contrasted in a number of respects with the earlier post-war years which were marked by a succession of favourable trade balances and a phenomenal inflow of capital. Between 1946 and 1950 cash surpluses were generally more than adequate to nullify the inflationary effects of cheap money. In 1951/52 and 1952/53 large cash deficits were incurred while the cash surpluses in subsequent years fell significantly short of the amounts by which the money supply was increased as a result of Central Bank support of the bond market. Another difference was that capital issues control, which had been a useful bulwark to the cheap money policy in the earlier post-war years, was suspended in January, 1950, reimposed in February, 1951, but finally abandoned in December, 1953. More important, however, from the standpoint of the bond
market was the fact that the main growth of hire purchase and
the development of an unofficial short-term money market seems
to have occurred since 1949.

Bond yields rose each year with the exception of
1953/54 when the bond rate of 4\frac{1}{2} per cent appealed to the market
as reasonable. In other respects also this year will rank as
one of the most stable on record. However, for the period as
a whole our analysis shows that interest rates in Australia were
not easily reduced once they had been permitted to rise. The
rigidity of the monetary system stems from the absence of a Bank
rate to signal changes in monetary conditions and lack of a
developed money market to transmit changes in the monetary
situation readily to all parts of the system. Of greater
importance however, was the presence throughout these years of
a widespread conviction that development must proceed in spite
of inflationary pressure, and this imposed a continuing pressure
on interest rates. As we saw in Part III, most countries were
subjected to similar influences in this period with rises in
Bank rates far outnumbering falls.

In Section I, I have traced the transition from cheap
to dear money conditions. It is clear now that if effective
measures were to be launched against inflation — and an effective
fiscal policy and direct controls could not be applied for
political reasons — interest rates had to be permitted to rise
in accordance with the realities of the market. The
Australian Government and the Central Bank were slow to
understand this, slower generally than monetary authorities in other countries. Just recently, however, there have been indications that the Australian financial system is being rapidly transformed with definite signs of the development of an active market in short-term money. If this trend persists - and there is every indication that it will - a more flexible monetary policy with less likelihood of the repetition of past mistakes may confidently be expected in future.
PART VII

CONCLUSION: LESSONS OF AUSTRALIAN EXPERIENCE
In the thirties monetary policy was to a large extent subordinated to the needs of government finance and the monetary authorities were feeling their way towards a technique of central banking that did not have to depend upon variable interest rates. During and after the war the Labour Administration pursued the cheap money policy with considerable vigour and very few economists questioned the wisdom of this policy until 1951.

Cheap money was abandoned in Australia, not because of a greater awareness of the advantages of a flexible monetary policy in a rapidly expanding economy, but because the degree of market support necessary to retain it would have seriously aggravated inflationary pressure. As it was, the rise in interest rates in 1951/52 and again in 1955/56 was associated with heavy market support, which ran counter to government policy generally.

Our study leads further to the conclusion that the rise in bond yields was the outcome of three principal influences - namely the rapid rate of economic growth, the fall in farm income, and the failure to prevent funds being diverted from bonds to debentures, unsecured notes and the like.

The fundamental cause of bond market weakness is not found to rest in the commonly accepted Keynesian explanation - that bond yields rose mainly because people expected them to rise, that is to say, that rates rose because people added to their speculative holdings of cash. Thus a popular argument
is that a succession of favourable balance of payments had instilled in businessmen a note of extreme confidence in the future. When this was upset in 1951 expectations were reversed because representative opinion expected rates to rise and rates had begun to rise overseas.

It is not suggested that this had no influence whatever on the situation in Australia, but it is contended that it cannot provide the major explanation. Bond prices fell mainly because of the sheer pressure of the demand for funds (for real investment) in relation to the supply and not primarily because of expectations about future interest rates. The preference for liquidity was related more to the needs of business expansion than either as a hedge against inflation or on account of fears for the future. Without an expansion of bank lending in 1951/52 the rise in bond yields would have been much greater.

The restrictive credit policy was an important cause of the further rise in interest rates in 1955/56, as was also the growing competition for investible funds; but on both occasions it was the fall in the supply of loanable funds consequent upon the deficit in the balance of payments that was at the root of the trouble.

At the same time it should not be overlooked that the attainment of external balance was greatly impeded by the failure to contain domestic inflation and that expectations about the future level of prices were important in diverting funds from bonds and the banking system. There was an important link
between the general level of prices, and particularly expectations of price changes, and the state of the bond market. This effect appears to have been particularly important in 1953/54 when fears of further price rises were allayed and the long-term bond rate of interest was stabilized in the market at 4 1/2 per cent without the need for official support.

One of the big questions is whether a deliberate rise in interest rates, say in the latter part of 1950 would have moderated the subsequent diversion of funds and reduced the extent of market support. If this policy had been able to dispel fears of further rises in the price level, it may have met with success but it is very doubtful if it would have done so in view of the wool boom and the high level of domestic spending. People did not necessarily sell bonds because of expectations of higher interest rates to come - this is one of the common fallacies - but because better existing opportunities for investment were presenting themselves and because cash was needed to repay debts to provide a hedge against inflation.

Thus while saving as a whole may not be very responsive to a higher bond rate, the latter is an important consideration in times of full employment and inflation regarding the choice of investments to secure the highest possible yields consistent with maximum security. Expectations about the price level therefore exerted a very powerful influence on the bond market in Australia and those expectations were
undoubtedly reinforced by the rise in interest rates in other countries.

We may, I think, conclude that there is no impelling evidence that Keynes' theory of speculation was confirmed by post-war events in Australia. Speculation was not so important as is popularly asserted. One of the most important lessons of Australian experience is that the vicissitudes of external trade not only make policy making an exceedingly difficult business but also render a flexible interest rate policy suspect both on economic and political grounds. As was pointed out earlier, there are already indications that imperfections in the Australian capital market are being overcome but even so there are grave obstacles to the use of flexible interest rates as a means of securing economic stability. Apart from the vicissitudes of external trade just adverted to, there is likely to be a continuing bias in the direction of economic expansion. A reasonably stable bond market is required to facilitate conversion operations connected with such expansion.

Nevertheless there is no particular merit in trying to hide from the public view the existence of pressures that will from time to time require a rise in interest rates. As a corollary it is desirable to grasp every opportunity to reduce interest rates so that ample scope exists for increases when conditions change. The second lesson then is that if we wish to be reasonably free of direct controls, we must come
to accept the inevitability of changes in interest rates. While large fluctuations in security prices are to be avoided, some fluctuations are inherent in the private enterprise system.

While there are many aspects of the problems I have traversed which call for further research, one of the most pressing needs is a study into the causes of diverging trends between short and long-dated security yields. I was only able to touch on this problem in this thesis, but I do believe that further research on these lines would be rewarding.
BIBLIOGRAPHY

A. BOOKS AND REPORTS


Commonwealth Bank of Australia Annual Reports.


Cunliffe Committee on Currency and Foreign Exchange (Interim Report, 1918).


Roy Harrod : Towards a Dynamic Economics (Macmillan, 1948).


R.G. Hawtrey : Good and Bad Trade (London, 1913).


Macmillan Committee on Finance and Industry, 1931.


Royal Commission : Minutes of Evidence (Government Printer, Canberra, 1937).

Readings in Monetary Theory (Blakiston, 1951).


Joan Robinson : The Rate of Interest and Other Essays (Macmillan, 1952).

D.H. Robertson : Essays in Monetary Theory (Staples, 1940).

Shann and Copland : Battle of the Plans (Angus and Robertson, 1931).


B. ARTICLES AND OFFICIAL PUBLICATIONS


Australian White Paper on Full Employment, 1945 (Government Printer, Canberra).

Budget Speeches: (Government Printer, Canberra.)


---: "Conditions of Monetary Policy in Australia", R.C. Mills Memorial Lecture, 1958 (University of Sydney).

J.R. Hicks: "Mr. Hawtrey on Bank Rate and the Long-Term Rate of Interest", Manchester School, Vol.X, 1939.


D.H. Robertson : "What has happened to the Rate of Interest?" Three Banks Review, March, 1949.


Statement of Economic Measures, March, 1956 (Government Printer, Canberra).


C. PERIODICALS AND OFFICIAL STATISTICS

Australasian Insurance and Banking Record

Economist

Federal Revenue Bulletin

Finance Bulletin

Monthly Review of Business Statistics

Commonwealth Bank Statistical Bulletin

N.S.W. Statistical Register