

country has been borrowing steadily in Great Britain practically ever since these Islands were brought under the British flag, the dominating portion of our banking business has centred in London.

The system is quite a simple one. The banks maintain offices in London, and these offices receive the proceeds of the sale of our exports. The exporters receive credit for the amounts due to them, plus or minus exchange at the ruling rate, in the books of their respective bankers in New Zealand. These credits go to swell deposits. The importers, on the other hand, pay to their bankers by cheque in New Zealand the amount of their debt due abroad, plus or minus exchange on London at the ruling rate, and the British or other overseas merchant receives payment directly or indirectly out of the London funds of the banks. Such transactions result in a fall in deposits or an increase in advances in New Zealand, and a corresponding fall in the London balances of the banks.

Thus these London balances are being constantly fed by a stream of funds from the sale of exports and depleted by another stream of funds to pay for imports, the increases or decreases in the volume of either being reflected in the incidence of deposits and advances in New Zealand. The inward stream is also increased by the amount of loans raised abroad, and the outward stream by the payment of interest on such loans. In fact, all items that enter into the balance of international payments affect the position.

GOVERNING FACTORS.

As is demonstrated later in this statement, the volume of deposits is affected by advances and in other ways. The point to be noted in the meantime is that a credit or favourable balance in our overseas transactions widens the gap between the amount of deposits and advances. Deposits increase and advances are repaid by the credits to customers in New Zealand on account of the increase in the London funds of the banks arising out of New Zealand business. In so far as deposits are thereby increased, the community has more purchasing-power, while, on the other hand, the lowering of advances encourages the banks to grant further advances, thereby still further increasing purchasing-power. This additional purchasing-power unless utilized to pay off debts abroad will lead normally to an increase in imports which will tend to restore the balance in international payments.

Conversely, a debit or unfavourable balance in our overseas transactions (usually brought about by a fall in export prices or excess imports) leads to less deposits and a greater volume of advances—*i.e.*, the margin between them is narrowed. When this happens the banks are more conservative in granting advances to importers and generally take steps by pressure and perhaps by raising overdraft-rates to bring down advances, thus further decreasing the volume of credit in New Zealand. With less credit available, there is less scope for the purchase of imports and less spent on imports, which means less drain on the London balances of the banks.

In fact, the pressure on the London balances of the banks is what limits the amount of credit that can be created in New Zealand. As already pointed out, there is ample scope for expansion in so far as cash resources in New Zealand are concerned. If, however, the credit structure is enlarged, apart from any corresponding increase in local production, the additional resources will be used to buy additional imports, and thereby impose a drain on London funds. Failing internal action to lower the volume of credit, such a situation can be met only by raising the exchange-rate, which, in effect, means that more must be paid in New Zealand currency to obtain a given quantity of imports. Thus the additional credit created is neutralized by a depreciation in the purchasing-power of the monetary unit.

It may be pointed out that, while the banks can and do assist in maintaining equilibrium by variations of policy in respect of advances, there are other corrective forces always at work. For the most part purchasing-power reaches the hands of consumers in payment for services in production, using the word in its broadest sense. If, then, increases in the credit structure allow importers to bring in more goods from abroad than can be paid for with exports, having regard to other calls on the latter, the excess quantity of goods will generally be a drag on the market, unless prices are reduced to an unpayable level. Thus importers and merchants generally, although they act independently, are constantly endeavouring to equate supply to effective demand. Naturally they would not accept from the banking system credit for the purchase of more goods than they considered they could sell at a profit. Collectively they do make errors of judgment, for each one is endeavouring to get ahead of his competitors, but it is nevertheless true that to a large extent the initiative rests with the trading community.

The most enterprising banker cannot force advances upon people nor coerce them to make greater use of their deposits. Thus, if the psychological factor in the trading community is adverse, the banks would find it difficult to increase substantially the amount of credit used however much they desired to do so. Central banks can increase the credit available by buying up securities, but that does not put the extra credit to work. During the past year in most countries there has been an abundance of cheap credit available, but with the possible exception of Great Britain in recent months relatively little effective demand for it. In fact, increases in the credit structure involving currency depreciation are usually brought about by Governments borrowing from the banks and spending more than is collected by way of revenue.

Under the sterling exchange system in operation the London funds of the banks must obviously rise and fall by the balance of our international payments from year to year, and, as already explained, such rise and fall is reflected in the incidence of deposits and advances in New Zealand. Deposits, however, can be drawn in the form of notes, and are also affected by the purchase and sale of securities by the banks, so these factors must be taken into consideration in making comparisons to demonstrate the effect of external transactions.