

58. It is generally considered that in conditions of free competition exchange rates will be determined solely by the supply and demand for exchange funds held in overseas centres. In centres where competition is keen, and there are many operators, the exchange rate may fluctuate from hour to hour and from dealer to dealer. Under normal conditions the fluctuations are kept narrow by the willingness and ability of certain large dealers to add considerable sums to the exchange funds available when the demand is greater than the supply, and to hold large sums off the market when the supply is greater than the demand. Such stabilization of the exchange market is a part of normal exchange business in every country in the world. For New Zealand this stabilization was provided because the banks could hold varying amounts of overseas funds knowing that they had a stable value in New Zealand in New Zealand currency. They provided this through the sterling exchange standard. In a normal year exports are very heavy in the first half of the year, when they may exceed imports by many millions. In addition, Government loans have usually been raised in London about May. In these circumstances the supply of funds in London may exceed the demand over the first half of the year by between £10 m. and £20 m. An impossible position would arise if the exchange fluctuated in response to these changes. In the latter part of the year imports normally exceed exports, and the demand for funds overseas may be greater than the supply. If the exchange rate responded sensitively to changes in London funds, therefore, we might expect the rate to be abnormally low during the first half of the year and abnormally high during the second half. In practice the banks allow funds to accumulate in London during that part of the year when the balance of payments is favourable and allow these funds to become reduced in the latter part of the year without changing the exchange rate.

**Determinants of
Exchange Rate.**

59. This involves a considerable measure of control; but that control is customary and necessary, and would require to be maintained under any system of exchange operations. But New Zealand's exchange funds are affected by causes other than normal seasonal variations in the balance of payments. It is recognized that prices of New Zealand exports are subject to much wider price fluctuations than prices of New Zealand imports. When export prices rise, the country's national income is increased, more is spent, and imports tend to increase some time after an expansion of exports. When export prices fall, the country's national income is decreased and the community cannot then buy as many imports; but the import figures do not respond to the change in the community's purchasing-power until some time after, often about a year after the fall in export prices.

**Periodic Changes
in Funds.**

60. There are thus periods during which payments made to New Zealand substantially exceed payments made by New Zealand. These are usually periods of prosperity. There are also periods during which the payments made by New Zealand substantially exceed the payments made to New Zealand, and these are usually times of financial restriction and depression.

61. It has been shown that it is possible to estimate from the banks' assets and liabilities published in New Zealand the variations in the amount of their funds held on New Zealand's account overseas. Let us consider the figures for the March quarter during recent years. In 1925, a season of high export prices, funds held overseas were substantial. Export prices then fell and the balance of payments became unfavourable. By March, 1927, these funds had been reduced by nearly £11 m. Then export prices turned upwards, export values increased, and imports fell. By 1929 an additional £14 m. had accrued in funds held overseas. At this point prices fell heavily and the balance of payments became again unfavourable. By the December quarter of 1930 funds overseas had been reduced by £12.5 m. By the December quarter of 1931 imports had been reduced very heavily, the balance of payments had become favourable, and the funds had increased by £1 m. The funds held overseas in the December quarter last were about £2.5 m. greater than in the March quarter of 1927, and £11.5 m. less than in the March quarter of 1929. In these circumstances it might be expected that the exchange rate would not be depreciated more than in 1927, when it moved only $\frac{1}{2}$ per cent. from par. On this occasion, however, the fall in export prices has been heavier and more substantial.

62. But conditions other than the existing supply of funds influence the rate. The prospective supply and demand have also to be taken into account. It is probable that the New Zealand rate was raised to 10 per cent. largely because the banks anticipated heavy depletion of their overseas funds if the rate had remained lower. Two influences might have caused such depletion. First, at lower rates imports would undoubtedly have been heavier and the drain on their funds greater; secondly, no country can consider its exchange market in complete isolation from other markets which may influence it.

**Other Influences
on Rate.**

63. In addition, the liquidity, and not merely the supply, of such funds must be considered. Events in the money world in times of depression may freeze bank assets which previously were regarded as perfectly liquid, and it is possible that funds held overseas and normally available for New Zealand exchange purposes may be invested in securities at the moment less liquid than they were expected to be. In this complex of influences, therefore, it is difficult to determine from a mere estimate of funds what should be the exchange rate.