MODERN BANKING

BY

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PREFACE TO THE THIRD EDITION

WHEN the first edition of this book was written in 1937 it was essentially a snapshot, through a theorist's eyes, of banking (mainly English banking) in the middle nineteen-thirties. The present edition is similarly a snapshot of banking at the beginning of the nineteen-fifties. The material has changed substantially in the meanwhile: radical changes were already in progress in the nineteen-thirties and my Second Edition, prepared in 1946, came too soon after the war to allow for the crystallization of the innovations. To allow adequately for these changes and to make room for other improvements almost complete rewriting of the book has been necessary, although much of the original structure remains.

The only substantial change in the scope of the book is that it is now just a book about banking, to the exclusion of any attempt to outline the theory of international prices. The old Chapter 7, which included some analysis of the determinants of the balance of payments, has gone and with it has gone Chapter 8 on international currency arrangements. In its place the new Chapter 6 takes the balance of payments for granted and seeks to trace the impact of external transactions on the banking system. But since the International Monetary Fund has some of the characteristics of a bank, and since the International Bank is called a bank, I have included an appendix on each of these twins, and these appendixes are lineal descendants of the last part of the old Chapter 8.

The revolution in the technique of central banking has involved a complete recasting of Chapter 5 (in many ways the heart of the book), though a few of the original paragraphs remain. Partly for the same reason Chapter 3, on the discount market, has demanded extensive rewriting. In this part I have been greatly helped by Mr. R. H. Jessel and Mr. W. T. C. King, whose intimate knowledge of the discount market has been freely available to me.

The original Chapter 6, on the *modus operandi* of Bank Rate, has been largely rewritten as the new Chapter 7, in the light of the controversies and experiences of the last thirteen years, and the new Chapter 8 is in a sense an addendum to it. In Chapter 9 there are substantial changes near the end. Chapter 10 is very much what it always was. The original Chapter 11, on the problems of 'Stock Market Control,' was written very much under the shadow of 1929. It has now given way to a rather wider discussion of 'Qualitative Credit Control', but part of the original chapter appears as Appendix III. Chapter 12 is not greatly changed, though both for this chapter and for Chapter 4 I have had the benefit of the specialist knowledge of my colleague, Mr. J. S. G. Wilson, in the field of banking in the Dominions.

Although so much of the book has been newly written it remains the same *kind* of book. The original was 'addressed primarily to the university student who wishes to include in his honours course a study of banking sufficient to enable him to understand how this important part of the economic system really works nowadays'. This is equally true of this Third Edition: what has changed most is that 'nowadays' means 1950 instead of 1937. I have tried to maintain much the same level of exposition as in the original book. Again it is, as before, a summary and restatement of ideas that are the subject of agreement among most economists. But perhaps my personal point of view has done more this time than before in shaping the arguments and in drawing the conclusions; most of all, this is true of the new Chapter 13, 'Some Reflections for the Monetary Theorist'.

However much the personal element has intruded, my debts to others are necessarily very great indeed. Particularly I owe much to the teachings and the published works of Professor D. H. Robertson and Lord Keynes, as must anyone who writes in this field. The background of monetary history is important though unobtrusive, and for this I owe much to Sir Theodore Gregory and Professor R. G. Hawtrey. My teachers at Cambridge and my present and former colleagues at Oxford and London have played a continuing part. I have had the benefit of advice on particular points from many people of great experience in the ways of the City of London; and the files of *The Economist* for a century and of the *Banker* for the last quarter of a century have played their part. Mr. R. Turvey and Mr. A. C. L. Day have undertaken the dreary work of checking typescript. The London School of Economics has provided efficient service for much of the typing of the present edition. Professor D. H. Robertson has been good enough to read the proofs and has suggested a number of small but valuable corrections.

One debt stands apart. My serious study of the problems discussed in this book began when I first joined the staff of the London School of Economics. My main duty, as circumstances then were, was to assist Barrett Whale, and to assist him was to have at hand a rich and generous source of ideas, inspiration, and encouragement. Through all its changes this book has remained firmly based on the foundations laid in those years. He died within a few days of my completing this Third Edition; I can now only wish that he would have been willing to acknowledge the book as still his own grandchild.

R. S. S.

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INTRODUCTORY

1. *The Supply of Money and the Price Level*

FOR many decades banks have been recognized as traders in money. Were this their sole function economists would undoubtedly be interested in them, just as economists are interested in the activities of the issuing houses or any other section of the capital market. The linking of borrower and lender, in that it influences the particular direction of the crystallization of capital, is a process of economic significance. But banks and banking have in fact bulked far larger in works on economics than have issuing houses or the solicitors who arrange mortgages on property. The reason for this treatment is that banks are not merely traders in money but also in an important sense *manufacturers* of money.

Perhaps we ought to be quite clear what we mean by 'money' and why we interest ourselves so much in the behaviour of money. Money is something that is widely accepted for the settlement of debts.[1] It is not of any direct use for the actual 'consumption' that is the ultimate end of all economic activity, nor is it of direct use in the process of producing consumption goods from other goods and services. But we can use money to buy goods and services, whether for immediate consumption or for use in the production of ultimately consumable goods. In a 'money economy' of the kind with which we are familiar the all-important process of producing goods for ultimate consumption is carried out at the direction of people who *buy* (*with money*) the original factors of

[1] The word 'debt' covers all monetary transactions. If a child enters a shop to buy a pennyworth of sweets, it asks for the sweets, thereby incurring a debt of one penny, which is settled immediately by passing the coin across the counter.

production, put them together, and *sell* (*for money*) the goods produced. They are induced to undertake this process by the prospect of a *money profit*. The direction of the original factors of production into the fundamental processes of producing what we want to live on depends upon various *flows of money*. An alteration in the flow of money implies an alteration in the flow of final goods and services. This is true whether the alteration takes the form of contraction or of expansion or of mere diversion of the flow of money. An expansion of the supply of money never takes the form of everyone finding their money balances increased in identical proportions.[1] The increase in the supply of money is at the outset concentrated in a few particular channels, and the persons to whom it goes are thereby enabled to increase the share of the factors of production or of the produced goods at their disposal. Any person or institution with the power of regulating the supply of money has therefore great significance in the economic world.

The peculiar importance of banks, distinguishing them from other financial institutions (insurance companies, building societies, money-lenders, &c.) which also lend and borrow money, is derived from the fact that claims against them, called *Bank Deposits*, are themselves *money*. People commonly do, by passing cheques to each other, transfer the title to bank deposits—ownership of the bank deposit passes from the drawer to the drawee of the cheque. The deposits, when so transferred, are widely accepted in settlement of debts, and it is for this reason that, in accordance with the definition of money (given in the previous paragraph) we can label bank deposits 'money'. Since we regard this as the most important distinguishing characteristic of a bank, we can define a bank

[1] The opposite process—an 'overnight' reduction of all money balances—played an important part in the monetary reforms in certain European countries at the end of the Second War, and its results provided illuminating evidence of the limitations of the Quantity Theory.

as an institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other.[1] The bank deposits in existence are thus an ingredient—in Anglo-Saxon countries the most important ingredient—in the total supply of money. The banks by their behaviour govern the supply of bank deposits (as will become apparent in later chapters) and thus have an important influence on the supply of money.

As a preliminary justification of the study of banking we can refer to the most elementary theory of the effects of changes in the supply of money—the theory known as the *Quantity Theory of Money*. It is stated in various forms, more or less rigorous. Sometimes it is said that changes in the supply of money tend to produce changes in the same direction in the general level of prices. The strictest version says that the value of money varies inversely, and the general level of prices directly, in proportion to changes in the supply of money. The first and vaguer form has the advantage of being more obviously consistent with observed facts. The second and more rigorous form has the advantage of being the clear conclusion of a tidy and logical argument built on strictly limited assumptions.[2]

The Quantity Theory is based on the fact that money is wanted not for its own sake but for the convenience of having ready command over objects of more direct service

[1] These definitions are chosen because they appear to me to describe in simple terms the common practices of people in a modern community, but I must emphasize that the main conclusions of monetary analysis do not depend upon the precise definitions chosen. Readers already attuned to modern economic analysis may prefer to think of the infinite variety of assets as ranged in order of liquidity, with Bank Deposits at (or near) one extremity of the range. The economic significance of a change in the supply of money is based on the disturbance of the liquidity-distribution of the public's assets, and such a disturbance occurs when Bank Deposits are changed, whether these Bank Deposits are or are not labelled 'money'.

[2] The following paragraphs are not intended as an exhaustive analysis of the Quantity Theory. The reader should refer, for further discussion, to the standard works of Marshall (esp. *Official Papers*), Fisher (esp. *Purchasing Power of Money*), Keynes, and Robertson.

to us. The more money a person holds the greater is the convenience he enjoys (assuming, of course, that his money is in convenient forms—not a thousand pounds' worth of threepenny-bits!). But the holding of money implies the missing of an opportunity of increasing one's satisfactions of other kinds. For a person can use money either for expenditure on immediate consumption, from which immediate satisfaction is derived, or for acquiring an 'investment' (e.g. the ownership of capital goods) which will yield him further money income in the future—thus enabling him to increase his income of satisfactions at some future date. In deciding to secure the convenience of holding a money balance, a person is deciding to deny himself the alternative satisfactions he might have enjoyed. Individuals and corporations do, in fact, get into the habit of holding a certain average money balance, the size of which depends on the money volume of their transactions, their habits of payment, and similar factors. Given other things unchanged, an increase in a money balance above the habitual level (having regard to seasonal and similar considerations) will lead the holder of it to consider spending more on consumption or investing more.[1] Now if there is an increase in the *aggregate* supply of money, holders of excess balances must predominate over holders of uncomfortably low balances. Accordingly there will be a *general* disposition to spend more on consumption or on investments. Spending more on consumption means that there is an increase in the money demand for consumption goods. On ordinary supply-and-demand lines we expect some rise in the prices of consumption goods and a connected tendency, perhaps, of supplies to increase. An increased money demand for investments has not such

[1] From a realistic point of view it is worth envisaging the possibility of things working the other way round: an individual sees an opportunity for profitable spending and is thereby stimulated to get into debt to a bank—the bank offering its own indebtedness (deposits) in exchange. The remainder of the analysis needs no modification to fit this case of money supply responding to changed demand.

obvious effects on the price level, but again there is a tendency for certain prices to rise. The initial effect may be simply that people try to buy more of old securities. These can, however, only be transferred. Their prices rise, and there is a better demand than before for securities newly issued by businesses wanting to extend their operations. As money for capital purposes can be obtained more easily, business men increase their money demand for raw materials and factors of production, and under this pressure of increased money demand for goods and services,[1] prices tend to rise. Whether the surplus money balances are directed towards consumption or investment, therefore, the effect of rising prices tends to appear.

People cannot, as a whole, reduce their money balances. Individuals may pass them on; but the supply of money remains unchanged. But as prices rise, holders of balances have to revise their notions of what is a comfortable balance to hold. Prices have risen, so that their former average balances have become uncomfortably small relatively to their outgoings. Accordingly people cease, as prices rise, to feel that their new high balances are unnecessarily large, and cease to increase their rate of expenditure (on consumption and investment). Prices therefore cease to rise.

The above argument can easily be adapted to describe the converse process. A reduction in the total supply of money implies uncomfortably low balances on the whole. Contraction of expenditure follows, prices fall, and as prices fall the new level of balances again becomes adequate, and things can settle down at a new (lower) level of prices, and a new (lower) level of money balances. In short, given other conditions, there is to every level of money balances (i.e. to every supply of money) an appropriate

[1] The connexion between the market for old securities and the entrepreneurs' demand for goods and services is unfortunately rather more complicated than this: the reader will find further elucidation in Chapter 7.

general level of prices: increased supply of money tends to produce rising prices, decreased supply of money tends to produce falling prices. This Quantity Theory presumption holds good in whatever way the change in the supply of money comes about: for an increased supply of money must mean that on the average people have surplus balances, and vice versa. The theory, in this form at least, is equally applicable to a private enterprise economy and to a 'planned economy' of the type towards which Britain has recently been moving.

Rising and falling prices have certain unfortunate effects. First, there are the *distributional* evils. Certain money incomes—those of judges, clergymen, *rentiers*—are fixed either by law or by custom, and other money incomes—those of civil servants, doctors—are not changed at all rapidly as other prices change. Recipients of these incomes therefore enjoy an increased real income as prices fall, and suffer a reduction as prices rise. On the other hand, business men, deriving their incomes from profits, and ordinary shareholders find their money incomes increasing faster than prices are rising, since profits result when the costs, some of which are fixed by long contract, &c., have been deducted from the rising prices.[1] Wage-earners who are in employment regularly tend to gain when prices fall and lose when prices are moving up rapidly, though their wage-rates may sooner or later be adjusted to the changed level of prices. These redistributions of real income can in no wise be imputed to varying deserts: there is clear injustice between the contrasting classes of income-receivers when prices are moving decidedly upwards or downwards.

Secondly, there are the evil effects of rising and falling prices on *production*. As certain costs, particularly the prices of certain factors of production, are fixed by long

[1] During the Second World War the normal effect of rising prices on profits was largely stultified by the wide range of governmental contracting and by special taxation.

contract, by law, or by custom, the entrepreneur who is faced by falling prices finds that production is becoming unprofitable, and, after a point, decides to reduce his output. Economic activity and the level of employment for wage-earners therefore decline. Resources that might have been used to produce useful things stand idle, while individuals suffer the distresses occasioned by unemployment. This contraction of output is by no means evenly spread. For one of the first ways in which a business man is likely to curtail his operations is by cutting down any plant extensions and suspending replacement of worn-out plant. Accordingly the depression is likely to be particularly severe in the capital goods trades, and people attached to these trades suffer most. But when prices are rising, the stickiness of costs leads to the profit margin widening, thus providing the entrepreneur with a motive for increasing his operations. Economic activity increases, unemployment declines. The 'boom' is, like the depression, more extreme in the capital goods trades, because extended operations mean full replacement and frequent additions to equipment. This looks very well, and would appear at first sight to be rather an advantage of rising prices. In some measure it is; but bitter experience has shown that a 'boom' of increasing economic activity and rising prices is always followed by a depression, and, indeed, theoretical analysis leads us to suppose that a slump must *inevitably* follow a boom that has developed to any appreciable extent.[1] The good time, though it has substantial attractions, is far from being as attractive as would be a period of full employment without an aftermath of depression.[2]

[1] For this difficult matter see especially Harrod, *The Trade Cycle*, and Hicks, *A Contribution to the Theory of the Trade Cycle*.

[2] The above passage was written before the days of Full Employment and may now seem a little out of place. Against this I would argue that success in Full Employment policies has depended upon a favourable monetary climate, the creation of which has depended upon a correct understanding of monetary economics. I would also argue that Full