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THE BRITISH BANKING MECHANISM

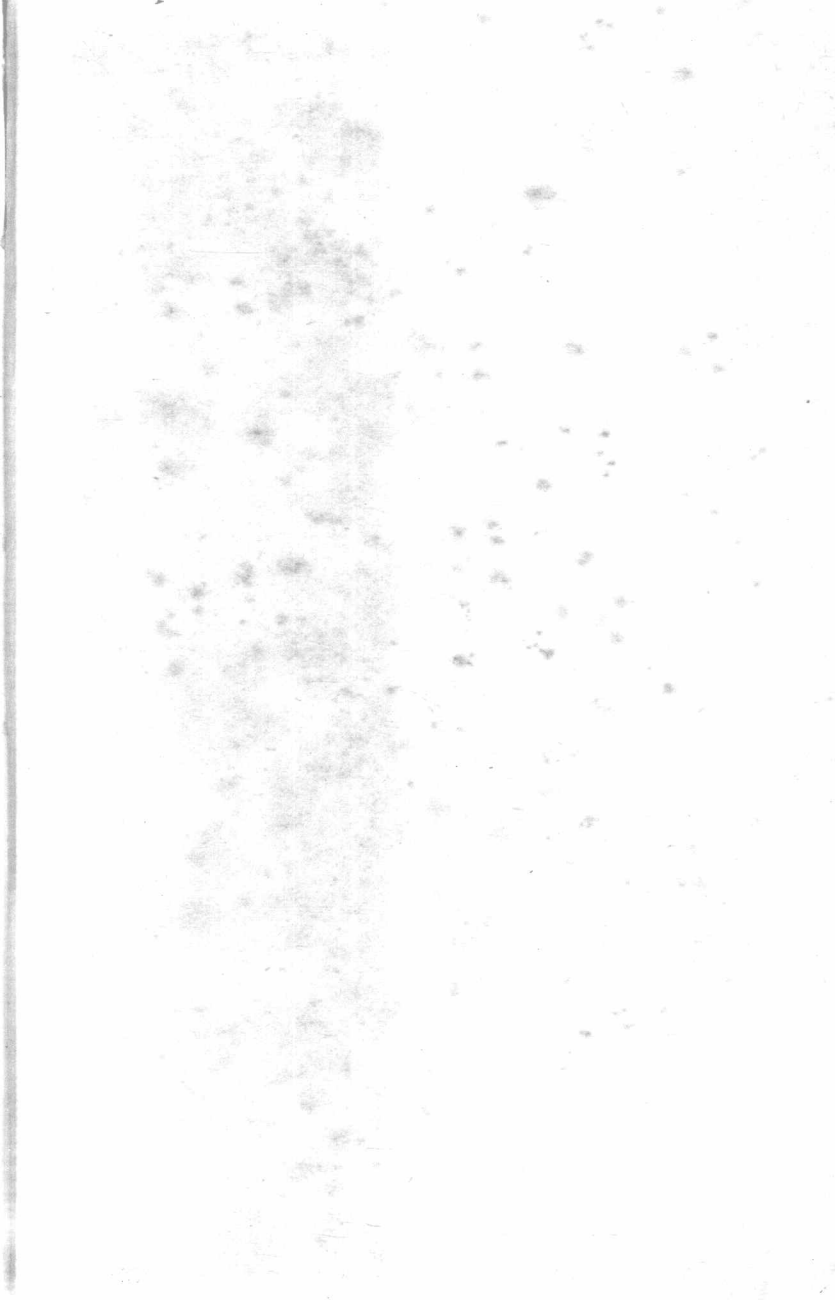


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THE BRITISH BANKING MECHANISM

by

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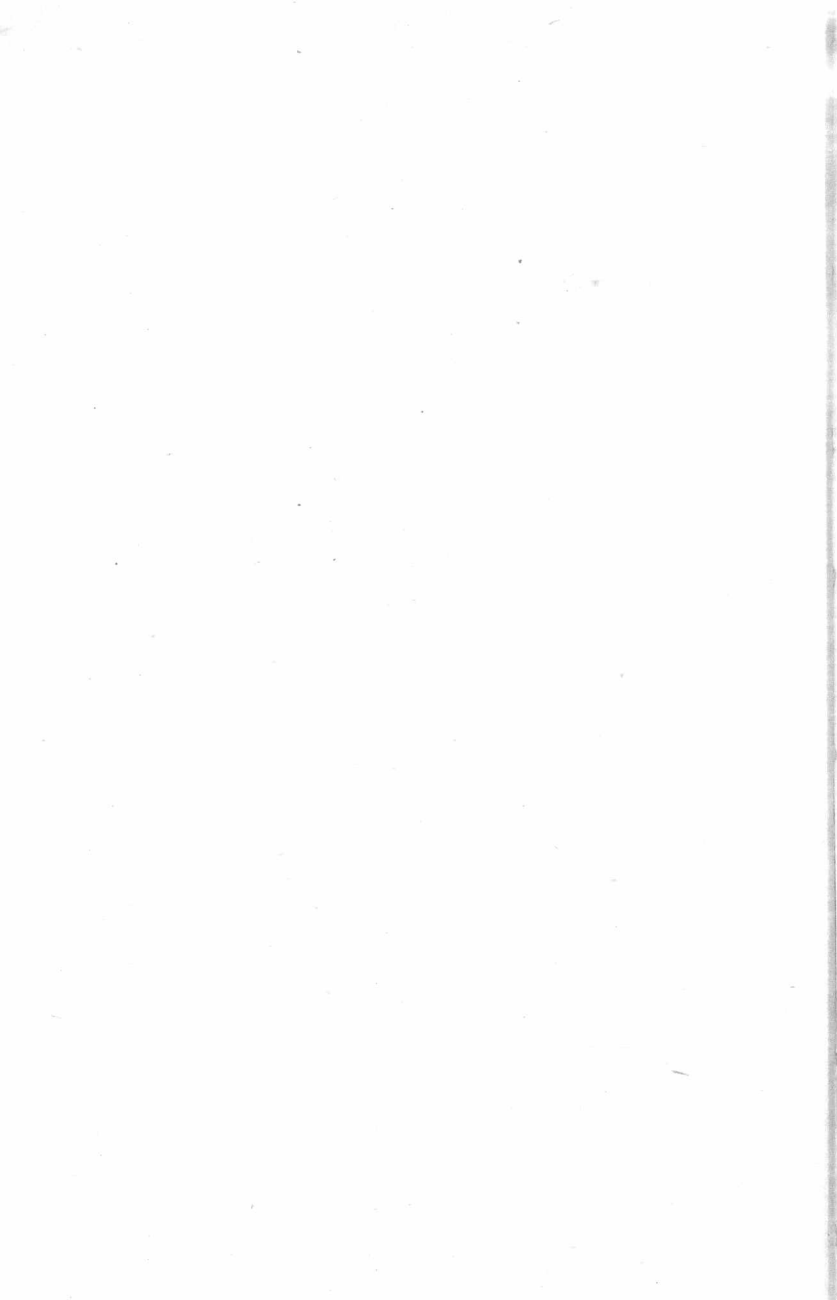
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FOREWORD

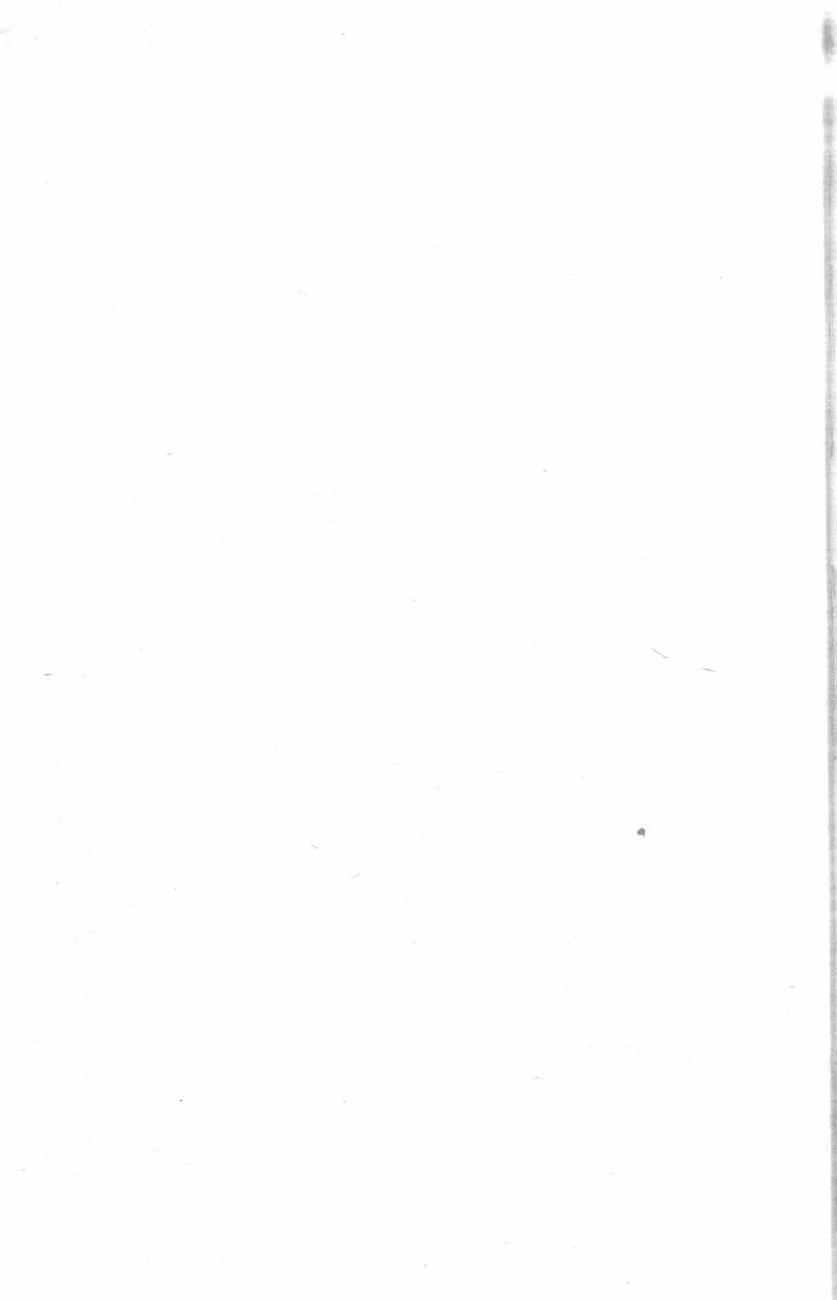
THIS book seeks to explain the working of our financial system as it has existed since 1931. Lest that should raise unfounded expectations, however, it should be emphasized that it is the *principles* on which the modern banking mechanism functions that we are seeking to elucidate. That cannot be done without some description of actual institutions and procedure, and some excursions into theory; but description and theory alike have been kept down to the indispensable minimum needed to illustrate the principles involved.

There is relatively little discussion of the problems of monetary policy, for the reason that a mere change in the objective of policy, however radical, does not in itself imply the need for change in our monetary *system*. In detail, no doubt, our financial institutions are as susceptible as any others of criticism and improvement. Basically, they are unquestionably well adapted to meet any demands that may be made on them. Given a sensible policy, the existing machinery will always produce sensible results.

Great misunderstanding would be caused if my position as economic adviser to Lloyds Bank should lead anybody to suppose that the volume is the work of a practical banker, or that it represents the views of anybody save the author. The function of an economic adviser is to keep at least abreast of general economic developments; the banking is done by bankers. It should be added that the book is based entirely on data available to the public.

My grateful thanks are due to Dr. W. T. C. King, whose meticulous reading of the manuscript saved me from many inaccuracies, to my secretary, Miss A. Nye, and to other colleagues for their ungrudging help.

W. M. D.



CHAPTER I

SOME FUNDAMENTALS OF DEPOSIT BANKING

FOR our purposes, it will normally be sufficiently near to the truth to think of the stock of money in present-day Britain as consisting of two parts: Bank of England notes and clearing bank deposits. The facts are, of course, more complicated. For small transactions we use, in addition to notes, coin of various denominations, while in some parts of the United Kingdom notes other than those of the Bank of England remain in circulation, notably those issued by the Scottish banks. That itself is a reminder that the London clearing banks do not make up the whole of our system. But the fact that other banking institutions exist does not give rise to any important monetary problems and can easily be fitted into the general picture at a later stage.

One could wax metaphysical about the nature of money, but for our purposes, again, it will be sufficient to define money as anything which is widely accepted in settlement of debts. Important consequences, however, flow from the fact that Bank of England notes and other forms of cash are legal tender money while clearing bank deposits are not: that is to say, a person to whom money is due is not bound to accept a cheque in settlement but is entitled to demand cash.¹ For some types of transaction payment by cheque would require the creditor unreasonably to accept a certain degree of risk: for example, in casual transactions, such as payment for a taxi or an isolated

¹ If the creditor refuses an offer of legal tender the debt is not extinguished, but the debtor will have fulfilled his duty of seeking out the creditor to effect payment; the onus—and expense—of collecting the debt then fall upon the creditor.

purchase at a shop where the debtor will not normally be known to the creditor. But even when the credit-worthiness of the drawer does not come in question, payment in cash may be more convenient to one or other of the parties—for wage payments in most cases, or for very small purchases.

Where the creditor is willing to accept payment by cheque (and that applies, of course, to the vast bulk of the country's transactions), then the credit balance which is transferred from the account of the drawer of the cheque to that of the payee is "performing money work"—acting as a medium of exchange—just as efficiently as actual cash. But the creditor is entitled to demand cash in all cases and likely to do so in some. Hence, it is obviously vital to the owner of a bank deposit that his balance should at all times be convertible into cash on demand. The primary duty of any bank is therefore always to maintain a cash reserve sufficient to meet any demands that its customers may make upon it.

One way to be certain of meeting that obligation would be for the bank to hold coin and Bank of England notes equivalent to the whole of its deposit liabilities; in other words, to invest the whole of its assets in cash. In that event, however, the bank would not be earning any income from its assets and would have to recoup the expenses of administering its customers' accounts from some other source, such as specific charges for collecting cheques and for all other services. That is one feasible solution, but it would produce a very different monetary system from the British system we are proposing to describe.

In such a system of pure "cloakroom" banking, to use Edwin Cannan's expressive phrase,¹ the emergence of the banking habit would not increase the stock of money by a penny, since bank deposits could come into existence only by the withdrawal from circulation and the complete immobilization of an exactly equivalent amount of cash. And the banking habit itself would necessarily be circumscribed, since the depositors would have to bear the full cost of maintaining the banking system. The public would still find it worth while to

¹ Without in the least accepting Cannan's view that the actual British system is of that nature.

hold some part of its liquid assets in the form of bank deposits, owing to the risks of loss or theft involved in holding large quantities of notes, the risk and inconvenience of making large payments in notes, the advantage of a bank account as a record of transactions, and so on. But these various conveniences of possessing a bank account would cost the depositor a great deal more than under the present system in which, if he holds a sufficiently large balance, these services and other benefits cost him nothing at all, other than the sacrifice of the interest he might have earned on the money by investing it in some less liquid form.¹

This cheapness of banking services is directly due to the fact that under the present system the banks themselves do not follow the safety-first rule to the extent of investing the whole of their assets in cash. On the contrary, they find that in practice they can meet all demands for cash made upon them while holding only a very small proportion of their assets in the form of cash. The remainder they invest in various claims to receive cash at some future time, which at this stage we can describe generically as "securities." The majority are in fact securities in the ordinary sense, such as short-dated Government bonds; but the term will serve to cover also advances to business firms and other private customers—that is, loans and overdrafts. On these deferred claims to cash, the banks, like any other investors, receive income in the form of interest or dividends. If all goes well, part of these asset earnings will form the banks' profits; the bulk goes to defray the cost of maintaining the organization and providing services to customers either free of specific charges or at less than their true cost.

Consequences vastly more far-reaching than a lowering of the cost of banking services to the depositor flow from this practice of investing bank assets in forms other than cash.

¹ Where the account is sufficiently attractive for the bank actually to pay interest to the customer, the rate will normally be lower than that the customer could earn by investing in long-term form. Since October 1945 the London clearing banks have paid no interest on "current" accounts, while the rate on "deposit" accounts (i.e., where the customer has agreed to give a period of notice before withdrawing the funds), has been limited per cent.

The smaller the cash reserve the higher the bank's asset earnings will be, but the less the certainty of its being able to meet demands for cash at a moment's notice. Hence, from the point of view of the bank, a constant tug-of-war between the competing aims of liquidity and profitability. The conflict is resolved in practice by the maintenance of a well-defined conventional assets structure, which varies little from one joint stock bank to another and is usually fairly stable over long periods. Secondly, this division of bank assets between cash and "securities" introduces the element of pyramiding, which is a basic feature of the British and, indeed, of all other developed banking systems.

It means that the emergence of the banking habit will tend greatly to increase the stock of money, since the creation of a bank deposit no longer involves the withdrawal from circulation of anything like an equivalent volume of cash. Instead of merely replacing notes pound for pound, in other words, bank deposits will now represent for the most part a net addition to the stock of money. Indeed, if only a very small proportion of bank assets are held in the form of cash, and if the banking habit is widespread, bank deposits will make up by far the greater part of the total money stock.¹

Moreover, the proportion of bank assets held in the form of cash is very stable—a great deal of banking practice is in fact now based upon the attempt to maintain an absolutely constant cash ratio. This means that the authority controlling the note issue can, by expanding or contracting the volume of cash available as bank cash reserves, sooner or later bring about a much larger variation in the amount of bank deposits and therefore in the total stock of money. Finally, the practice of investing some part of bank assets in advances to industry and in long-term securities gives the banks a far more significant rôle in the national economy than could ever be the case under mere cloakroom banking.

¹ Recent figures for this country are given on p. 23. See also Chapter XVI.

CHAPTER II

THE PYRAMID OF CREDIT

I

ONE of the most confusing things for the beginner is to learn that under modern conditions the principal kinds of money—which we have defined as anything widely accepted in settlement of debts—themselves consist of debts or acknowledgment of debt. That is, of course, true both of bank deposits, which are the banks' debts to their customers, and of bank notes, which embody the issuing bank's promise to "pay bearer on demand." If this is confusing, it nevertheless has the advantage that it disposes straight away of any mistaken idea that the value of money—as money—derives from any intrinsic value it may possess as a commodity (e.g., a gold coin), and focuses attention on the fundamental characteristic of acceptability.¹

No confusion need arise if we bear firmly in mind the principle which underlies all double-entry book-keeping: namely, that one man's liability is another man's asset. If you lend me half-a-crown, then I acquire an asset, the half-crown, together with an equal and opposite liability, to repay you the half-crown; so that my books are balanced and my "net worth," as the Americans call it, is unchanged. You, on the other hand, have exchanged one asset, the half-crown, for a different asset, namely, my undertaking to repay the half-crown. If the loan was well-advised, then the asset which you

¹ Subsidiary coins, of course, have some commodity value, but this is less than their monetary value. From the monetary point of view token coins may most usefully be thought of as "notes stamped on metal"; and it is helpful to think of notes, as Professor Sayers suggests, as a page torn out of a bank's ledger and passed from hand to hand.

have acquired (i.e., my liability to repay), will be worth exactly half-a-crown. However, the original half-crown represented cash in hand, whereas my promise to repay relates to a future time, and there is always the possibility that I may be run over by a bus before the promise is fulfilled; so you are out of your money for a time and are not absolutely certain of coming into it again. Hence the transaction involves you in a sacrifice of liquidity and an element of uncertainty which, if this were a commercial deal and not just a little temporary accommodation between friends, would justify your charging interest on the loan.

Let us make use of this elementary concept to see what would happen if a commercial banking system (and a discount market) were suddenly to spring into existence in a community whose only money had hitherto consisted of notes issued by a government or central bank. From the realistic viewpoint, of course, this illustration does not hold water for a moment. To suppose that a community without commercial banks could possess a central bank is rather like conceiving of an amœba with a nervous system; nor is the banking habit an overnight growth. But we are concerned at present only with principles, not with empirical realism or historical accuracy.

We will suppose that on the day our bank is established the public pay in £800,000 in notes. The position of the bank is then comparable in kind to mine after the loan of half-a-crown. Its balance sheet, a simple document, would appear as follows:

<i>Liabilities</i>			<i>Assets</i>		
Deposits	..	£ 800,000	Cash in hand	..	£ 800,000
Total	..	800,000	Total	..	800,000

On the following day the bank starts activities. It lends £100,000 to the discount market repayable on demand; uses £100,000 to buy three-months Treasury bills from the Government, which takes payment in cash; and it lends £500,000 to commercial firms who promptly draw out the entire advance in notes, which are used for the payment of wages. This leaves

the bank with £100,000 in cash, and its balance sheet now reads:

<i>Liabilities</i>			<i>Assets</i>		
	..	£		..	£
Deposits	..	800,000	Cash in hand	..	100,000
			Money at call	..	100,000
			Discounts (Treasury bills)	..	100,000
			Loans and overdrafts		500,000
Total	..	<u>800,000</u>	Total	..	<u>800,000</u>

On the third day the bank carries out one more operation. It buys £200,000 of short-dated Government bonds from members of the public who do not draw out the proceeds in cash, but prefer to leave them on deposit with the bank. This is not an unrealistic assumption. The sellers of the securities are admittedly parting with an interest-bearing asset in exchange for one that yields at best a very small return and may even involve them in payment of bank charges. But they may well regard the convenience of holding some part of their assets in cash or its equivalent—which, unlike the securities, is not exposed to the risk of fluctuations in capital value—as adequate compensation for the sacrifice of interest; in the same way that, as we have already seen, the greater convenience of holding a bank deposit instead of notes may make it worth while not only to forgo interest but even to make some payment to the bank for holding the funds.

Our object in assuming that the funds are left with the bank is to demonstrate that a bank deposit can come into existence without the prior deposit of *cash*. If the seller of an asset is prepared to leave the proceeds on deposit with the bank, and does not use the money to repay an advance previously granted by the bank, then the acquisition by the bank of that asset, whether it be cash or securities, will clearly bring an equal and simultaneous increase in the bank's liabilities. This is, of course, the essence of the pyramiding process. For the moment let us take the principle for granted and return instead to the bank's balance sheet, which now takes the following form:

<i>Liabilities</i>			<i>Assets</i>		
	..	£		..	£
Deposits	..	1,000,000	Cash in hand	..	100,000
			Money at call	..	100,000
			Discounts (Treasury bills)	..	100,000
			Investments (Government bonds)	..	200,000
			Loans and overdrafts	..	500,000
Total	..	<u>1,000,000</u>	Total	..	<u>1,000,000</u>

In its brief life of three days, in other words, our hypothetical bank will have arrived at a position almost exactly resembling that of the London clearing banks in the years before 1939. It has a cash reserve equal to 10 per cent of its deposits. A further 20 per cent of its assets are invested in bills and call money, making a total of 30 per cent in the three so-called "liquid assets." The remaining 70 per cent comprise investments and advances, the two main "earning assets," loans and overdrafts to customers accounting for a full half of its assets as a whole.

We will leave to a later stage¹ any discussion of the important implications for banking policy and practice of this conventional assets structure, and its abrupt transformation by the exigencies of deficit finance during the war years. Nor will we spare more than a glance at the facts that this remarkable institution appears to possess neither premises nor a penny of capital of its own, to say nothing of any reserves. Instead, let us look a little more closely at our bank's cash reserve in order to complete our picture of the pyramid of credit. We have already seen that the deposit *liabilities* of our commercial bank represent part of the liquid *assets* of the public. It is equally true that the cash *assets* of our commercial bank represent the *liabilities* of the central bank.² Such liabilities may take two forms: banknotes issued by the central bank or a credit balance in the books of the central bank. Commercial banks hold part of their total cash reserve in each of these forms. Holdings of notes constitute their till money, ready at hand to meet the

¹ See Chapters VIII and IX.

² It will be remembered we assumed that, prior to the formation of the bank, notes represented the only form of money, i.e., coin is ignored for the present purpose.