

SUMMARY

An International Credit Conference will be held in Rome from the 18th to the 24th of October 1951. It has on its agenda the problems of bank liquidity and credit control. As a contribution, our Review is publishing a series of studies on certain practical and theoretical aspects of the two questions.

We begin in this number with a study by Prof. R. S. Sayers: «*The Concept of Liquidity in English Banking*». Obviously, Prof. Sayers' basic assumptions are derived from his *Modern Banking* deservedly familiar to all students of banking problems. But the present text is freshly written and treats the subject in a substantially new contexture, in order to illustrating the complexity of the ideas of liquidity now governing the practice of English bankers.

This complexity is not due only to the changed attitudes towards the rule of «self-liquidating paper». The fallacy of that principle from the theoretical point of view is undoubted; but its «substantial sense» and «sound basis» at the operative level are still, in Sayers' opinion, respectable — being the consequence of the limits of the banker's experience. In fact, it is always «retained as a preference» in English banking; but not in a rigid manner, and with a tendency to shift the emphasis on «temporary financing, which is not quite the same». Thus perhaps «the English banker has become less rigid in his rules of thumb but more cautious in his judgment of individual projects».

The complexity of the ideas of liquidity of English bankers is also evident in the practical application of the «shiftability» principle, and therefore in their attitude towards government paper. Here again the deep evolution that has occurred in England in the extension and technique of official support to Treasury Bonds has radically affected banking activity. The banks, however, have devised «precise practices» in the choice of maturities and the distribution of their bond portfolios, practices which reflect keen sensibility to the risks of capital loss, and contribute with well-established accounting conventions to hinder easy and profitable expansions of investments.

Thus, Prof. Sayers' clear synthesis of historical references, factual data, and technical explanations ends by focussing attention on the spirit of self-restraint and prudence which governs the present management of the English banks in general, and which inspires specifically their concepts of liquidity. «The English banker» — he concludes — has now so far forgotten the days when Advances stood at 55-60 per cent that he would probably feel uncomfortably illiquid if such a proportion were ever reached again. Nevertheless, on any reading of the facts it must be admitted that the present liquidity of the English banks makes them not merely impregnable but also highly independent of any mechanistic control from the centre. Hence, at least in part, the importance nowadays attached by the British authorities to qualitative credit control».

* * *

The first part of David Wightman's study, which appears in this number, outlines the outgrowth of «*The Sterling Area*» from the beginning of the last century to the eve of World War II, stressing the crucial events and the successive stages which transformed a mere set of commercial and financial connexions in a currency system in the nineteen thirties. «The pressing needs of war made it necessary to give the system statutory definition and subject it to a systematic regulation». This will form the subject of the second part of the article that will appear in the next issue of this Review.

* * *

War and post-war inflationary movements have profoundly modified the ratios between « net worth » and « alien funds » of the Italian banking system calling attention to the problem of bank capital; to this problem Giuseppe Menghini's article, « *Bank Capital in Italy - The Impact of Inflation and Current Prospects* », is devoted.

After due reference to some preliminary aspects (the need of bank capital and its functions; the advisability of regulation by the monetary authority; the selection of the term of reference; the required minimum; etc.), the A. deals with the central issue of his enquiry — the possibilities and the limits of a gradual strengthening of Italian bank capital —, taking into account on the one hand the several items of the bank balance-sheets which could be revalued, and on the other the changed economic and institutional conditions that would make a return to the pre-war coefficients impracticable and unnecessary. « A justification for the changed pattern of the capital-deposit ratio » — he argues — « may be found in the far-reaching innovations that occurred in most countries after the Great Depression of 1930-33... This is the case also in Italy, particularly since 1947 when a system of compulsory reserves was added to the network of legal obligations already in force (controls relating to the opening of new banks or banking branches, elimination of participations and medium and long-term loans, credit control, etc.). In this legal framework a policy aiming at guaranteeing bank creditors' claims by strengthening bank capital might, to some extent at least, be substituted by an active manipulation of the complex variety of control weapons the monetary authorities now have at their disposal ».

The A. however maintains that an effort for strengthening bank capital should come within the present aims of Italian banking policy. « Wishing to indicate » — he concludes — « a realistic and at the same time technically adequate proportion, one might consider an intermediary ratio between the "legal", pre-war one (5% of deposits and current accounts) and the present average (2%); and consider the latter as a "limit", ratio ».

* * *

In the article, « *Italy's Tariff Agreements at Torquay* », Sergio Parboni illustrates: a) the tariff reductions that have been granted by Italy to the other countries; b) the tariff facilities granted or consolidated in Italy's favour, among which of particular importance are those obtained from Germany, Austria and United States.

* * *

In the note « *The Plans for the Development of Depressed Areas and the Supremacy of the Western World* » Prof. Corrado Gini takes up a position definitely critical of an indiscriminate application of Truman's Point IV and, in particular, to its extension to tropical and equatorial lands. This controversial attitude is based on an outright appreciation of the dangers which might arise for the supremacy of the Western peoples and Western civilisation.

The Banca Nazionale del Lavoro assumes no responsibility for opinions or facts stated by authors whose contributions are published in the present Review.

All communications regarding the Review should be addressed to Banca Nazionale del Lavoro, Ufficio Studi, Roma, Via Vittorio Veneto 119.

Editor: Dott. LUIGI CERIANI - Ufficio Studi, Banca Nazionale del Lavoro

Autorizzazione del Tribunale di Roma No. 2159

Stabilimento Aristide Staderini - Roma - Via Crescenzo, 2

The Concept of Liquidity in English Banking

by

R. S. SAYERS

I

In every kind of business there is constant need for balancing the convenience of liquid assets against the attractions of investment in more profitable but less liquid resources: an opportunity to acquire a cheap consignment of raw materials can be taken today only at the sacrifice of a cash payment that will leave the firm less able to take advantage of any unforeseen development tomorrow. This general position is shared by the banker, who is, after all, an ordinary business man in that he wants to maximise his long-run profits and strengthen his position in the industry. But for the banker liquidity is much more important than this: it is indeed a problem of life and death. For the banker's business depends completely upon his readiness at all times to offer cash — his ability to « cash the deposits » of his customers. If he fails in this he has to put up the shutters.

It is therefore with reason that bankers have always stressed the need for « a high degree of liquidity » in their assets. But unless bankers are to become mere ledger clerks, charging their customers on a turnover or similar basis, there must be some sacrifice of liquidity, some holding of earning assets, in order to secure a profit for the banker. Apart from the item « Cash » — the « 100 per cent liquid » item — all assets are imperfectly liquid: their liquidity is a matter of degree, of more or less. To his depositors the banker must be able to argue that his assets are highly liquid, while to his shareholders he must be able to argue that he is not sacrificing income to liquidity in a degree higher than is necessary for the maintenance of complete confidence. Obviously therefore his aim will be to hold assets which, while earning some income, have also a high

degree of liquidity and thus lend balance-sheet support to the cash reserve.

When we ask, what is it about an asset that gives it « a high degree of liquidity », we find that the answers given by English bankers have generally left an ambiguity about the word « liquidity », an ambiguity that has its roots in the banking conditions of earlier days. To satisfy depositors' claims a banker must be able to convert his assets into cash *quickly*. But that is not all. If the depositors' claims are to be fully satisfied the banker's assets must be convertible into cash *without loss*. When bankers have said that they aim at liquidity they have generally included *both* these attributes. The ambiguity is realised at once when we ask whether long-term British Government securities are highly liquid or relatively illiquid assets. The uncertainty of bankers' treatments of this question has its origin in the ambiguity of their use of the term « liquidity ». The securities can be turned into cash very quickly, for there is an excellent market for them on the London Stock Exchange. That is to say, these particular assets are readily shiftable on to other banks or institutions or persons willing to supply cash. But the amount of cash so obtained depends upon the market price at the moment — it may be more or it may be less than the price at which the bank acquired the asset. Only by waiting until the distant maturity date can the face value certainly be obtained. This asset is attractive to the banker in that it is shiftable and, if he can wait until the maturity date, devoid of risk of loss. But it is unattractive in that earlier realization may involve the banker in capital loss, and in that the accounting conventions may at balance sheet dates compel him to show a book loss even though no actual loss has been realized.

The security is well-nigh perfectly « shiftable » but, despite the absence of any risk that the British Government might not meet its obligations at the due date, the security has not all the qualities which the banker includes in perfect liquidity.

The two elements we have mentioned — shiftable and risk of loss — are of course not completely disentangled. If the banker can wait till maturity, there is no risk of loss attached to a redeemable British Government bond. If, therefore, the banker has a fair proportion, against deposits, of assets that have high shiftable and low immediate risk (cash being the extreme case), he can feel reasonably secure in holding some other assets that are highly shiftable but are riskless if either not shifted or accounted for as though they were being shifted. Similarly, if he has a fair proportion of the most liquid assets, he can afford to hold some assets that have a low risk degree but also low shiftable. Assets that are both unshiftable and risky will be viewed with much more disfavour, though they may occasionally be taken to avoid disobliging an old customer. The upshot of all this is that the banker must pay regard to the quality of his whole range of assets at once, and he must pay regard to both aspects of liquidity at once. He should always have some assets that have both attributes clearly. In addition he should have some assets with a high degree of shiftable which involve no risk of loss if shifting can be avoided. His remaining (less shiftable) assets should at least not involve him in losses. These are fundamental principles of sound commercial banking.

II

The shiftable of a banker's assets depends in the first instance upon the development of the institutions that form what is generally known as « the capital market ». For the capital market is a market in paper assets, capital claims, claims that is to say to future income streams, and such assets form a considerable part of the banker's portfolio. The more highly developed the capital market, the more readily

shiftable will many of the banker's assets be. But this marketability of certain assets can be greatly damaged by panic and breakdown in the capital market, and this danger has in the last hundred years led to under-pinning of certain sections of the capital market by a central bank. The central bank is always, we say, ready to act as lender of last resort, so preventing collapse of the market for certain classes of capital assets. The liquidity of bankers' assets has therefore come to depend in very large part upon the practices of the central bank — particularly upon the « eligibility rules » it imposes when operating as lender of last resort, and in the kindred matter of its policy when engaged in open market operations. The wider the net of « eligible paper » at the central bank, the more shiftable will be the commercial banker's assets. An extension of eligibility to fresh classes of paper held in bankers' portfolios will increase the liquidity of the commercial banks. Even if the extension of eligibility is not overt but is merely implied in a willingness to buy securities at all times at stated prices at the initiative of the commercial banks (as in the « stable bond market policy » of the Federal Reserve System), the effect is still to increase the liquidity of the commercial banks.

The eligibility rules of all central banks have their foundation in the ideas and practices of the Bank of England in the nineteenth century, a period when this Bank was the pioneer in central banking technique. Now it is important to remember that this pioneering in central banking was in many ways an unconscious process, and that the men who were building up the traditions thought of themselves primarily as good *commercial bankers*. They did of course regard themselves as having, by reason of the Bank of England's size and its special relation to the government, a rather special public responsibility, but this responsibility was often considered to be discharged by setting an example of prudent and circumspect banking and by guiding other banks into similar prudent practices. Even at the end of the nineteenth century, when the distinctive responsibilities of a central bank were coming to be recognised, the Bank maintained its insistence

on certain qualities in paper offered for rediscount over its counter. To this day the Bank of England continues in this tradition and by certain customary arrangements exercises a constant check on the quality of paper handled in London even at times when none of this paper is being offered for rediscount at its front door. And it is right that the central bank should by such vigilance seek to maintain high standards in commercial banking, for its task of ensuring reasonable stability in the monetary system is greatly facilitated by consistent strength in the commercial banks themselves.

It was this preoccupation of traditional central banking with the encouragement of sound commercial banking that led to the enthronement of the so-called « self-liquidating paper » as the ideal asset for transfer to the central bank. The typical bill of exchange, having its origin in a trading transaction that would be completed in a matter of months, came to be regarded as the most attractive asset for the banker to hold, and as that most proper for shifting to the central bank in case of need. Hence the sanction given to it as « eligible paper » when in 1913 the Federal Reserve System was established to give elasticity and stability to American banking. Hence also the presumption that when a bank advances money to a businessman by way of loan or overdraft (instead of discounting a bill), the advance should be for a similar purpose — *i.e.* for a self-liquidating trading transaction. The ordinary bank advance, being dependent on informal relations between banker and customer, is of course not at all shiftable; but it nevertheless is expected to conform to the same general rules as are applied to the trade paper that takes a legal shape convenient for transfer in case of emergency. The central bank's eligibility rules have, that is to say, encouraged the notion that the self-liquidating trading transaction is the proper object of banking finance; and in this way the central bank has reinforced a principle that has its roots in the necessities of commercial banking as practised long before there was any lender of last resort.

Bankers have of course often over-rated the virtues of « self-liquidating » paper. They have supposed that, because the goods financed are

destined for early sale in markets normally active, the money for repayment *must* be forthcoming at the due date. The fallacy in this has often been demonstrated in economic literature (notably by Professor D. H. Robertson in Chapter V of his *Money*). Quite briefly, the weakness in the argument lies in the tacit assumption that the stream of money coming on the markets will be maintained independently of the action of the bankers. In fact the goods can be sold at reasonable prices only if the banks maintain the total of their loans at roughly undiminished levels — if one transaction is to be « paid-off », a new one must be financed at the same time. Otherwise the money stream would shrink and the expectation of self-liquidation would be disappointed.

But appreciation of the fallacy involved in extreme claims of the virtue of self-liquidating paper must not blind us to the substantial sense in the bankers' preference for this class of finance. The sound basis of the banker's preference lies in the short-term nature of such loans. The banker has to deal with many industries and many trades at once and, however great his local experience and knowledge, he cannot ordinarily be expert in any one of them. He is therefore not really in a position to judge the long-term earning capacity of a firm in any industry: even exceptionally able bank managers in highly specialised areas would not be reliable judges on more than one or two trades. On the other hand, experience in dealing with many trades does help a banker to estimate the balance-sheet position of a businessman in any industry or trade, and the balance-sheet position is a useful guide to the chances of repayment of a short-term loan. The banker does well, therefore, to concentrate on short-term finance, where his general experience is of great value, and to eschew the long-range ventures where reliance has to be placed on the long-range earning capacity of specialist firms.

III

Thus far we have seen how the central bank's eligibility rules, and therefore the shiftable of bank assets, are related to the liqui-

dity considerations that govern a banker's treatment of all propositions of business finance, the eligibility rules and the banker's conventions alike springing from tacit recognition of the limitations of the banker's judgment. Between these considerations and those that govern the banker's attitude towards government paper, there is very little connection. In England the excellent market for bills of exchange and the recognised responsibility of the Bank of England to act as lender of last resort (and thus to prevent collapse of the bill market) led to the creation of short-term government paper — the Treasury Bill — as a cheap and convenient instrument for government borrowing. It is like the ordinary bill of exchange only in that its form was adapted to convenient handling by the bill market. It is payable in 91 days and so is superficially for short-term finance; but the certainty of repayment depends upon knowledge that the central bank (or the government itself) can always create cash in order to meet the government's liabilities if tax and other receipts fail. There is no room here for the bankers' preference for a risk he can judge; and there is no greater certainty that the British Government will pay cash 91 days hence than that it will pay cash 20 years hence.

Because of its obligations to the government as well as to the discount market, the Bank of England has always regarded Treasury Bills as eligible paper, and this custom has generally (though not universally) been followed by other central banks. Where this is so, the shiftability of Treasury Bills has always been at the maximum, though in liquidity they have fallen short of cash in that a risk of loss has been implicit in the possibility of a rise in interest rates. This eligibility for discount at the central bank has not, however, been automatically extended to all government paper. Although central banks have often been active in the markets for longer-term government securities, they have usually preferred to keep the initiative in their own hands: they have preferred, that is to say, to retain their freedom to deal or not to deal at the ruling price. Traditionally this attitude has been due to the fact that long-term securities stand to lose more in current capital value when rates of interest rise, and in early

days central banks (not far removed from strict commercial principles) desired to avoid such risks of loss. This longer-term paper has therefore had a shiftability almost as high as that of the Treasury Bill, but the risk of capital loss has been attached in much higher degree to the longer-term security than to the Treasury Bill.

During the last twenty years there has been a tendency for central banks (under governmental pressure) to extend their willingness to deal automatically in government securities much beyond the short Treasury Bills. This has been carried furthest in the United States, where the «stable bond market policy» has involved the Federal Reserve Banks in the responsibility of buying or selling government bonds of all maturities at steady prices. Indeed, for many years the prices were held almost completely rigid, with the consequence not merely that shiftability was at all times perfect but also that the risk of loss was completely removed. The bonds became practically as good as cash: in fact, as good as cash, provided that the banker believed that there would be no change of policy without sufficient notice to allow him to unload his bonds on to the Reserve Banks. In Britain there has been no such extreme practice in the central bank's handling of the bond market, although Treasury Bill rates have been completely stabilised. The central bank has, however, given high liquidity to bonds within five years of maturity, by regarding such bonds as eligible for holding by discount houses and as security for Bank of England advances to these discount houses. This special treatment of the «shorts» has given them a very good market, with perfect shiftability and some assurance against panic price movements. There is no comparable treatment of the market in bonds having more than five years to run, though the Bank of England has upon occasion (notably in November 1949) stepped in to steady a demoralised market. This distinction, drawn by the Bank of England, between bonds shorter than and those longer than five years naturally has, as will be seen below, some effect on the attitude of the commercial bankers towards these bonds.

IV

With these considerations in mind, we may now consider in detail the liquidity of the assets held by English banks.

The London Clearing Banks issue monthly balance-sheets, which since 1947 have shown the true average position of the banks — there is now, that is to say, no «window-dressing». As between the leading banks differences in the asset-distribution are unimportant, and the propositions shown in the following Table may be taken as approximately those of any one of the main English banks.

LONDON CLEARING BANKS

March 1951

	£ Mn.	Percentage ratio to published deposits
Cash	489	8.1
Money at Call	537	8.9
Bills	1,313	21.8
Treasury Deposit Receipts	234	3.9
Investments	1,552	25.7
Advances	1,754	29.1

Cash (in hand and at the Bank of England) is of course the perfectly liquid asset, since tender of it fully satisfies depositors' claims. The banks now, in accordance with their understanding with the Bank of England, aim at a true average of 8 per cent of deposits. The origin of this figure is historical; it was fixed at the end of 1946 probably as approximating to the then average cash ratio, and as lying between the convenient minimum and the respectable minimum to show which balance-sheets used before that date to be window-dressed.

Next in order of liquidity comes *Money at Call*. This consists of loans in the discount market. Almost the whole amount is nominally callable each morning, though in practice the banks only call the marginal amounts they deem sufficient to give them elbow-room in adjusting their cash ratios to 8 per cent at the end of the day. A large part of this Money at Call is secured by Treasury and other Bills, and the remainder by approved bonds (*i.e.* British government paper within 5 years of

maturity). The Money at Call is rightly classed as next to cash in order of liquidity, and before Treasury Bills etc. because, though there is an interest payment, the sums are callable in full on any morning and the Bank of England as lender of last resort in effect guarantees that any calls will be met. There is thus no question of capital loss, and this asset is inferior to cash only in being not available until tomorrow, for meeting depositors' claims.

Treasury Bills and «eligible» bills of exchange — *i.e.* bills of exchange bearing two unquestionable names — stand next. Since the Bank of England is always prepared, as lender of last resort, to take over these assets, they are very nearly as good as Money at Call. But not quite as good — for if the rediscount rate is above the rate at which the bills were discounted by the bank concerned, there will be a small capital loss on the transaction. To minimise this risk, it is the custom of the banks to weight their bill maturities in favour of the near dates. For example, in September a bank will endeavour to hold much more than one-third of its bills in September-October maturities. The banks do not tender for Treasury Bills when these are newly-issued, but buy them — and other bills — gradually from the discount houses. The younger (or «hotter») bills — those furthest from maturity — are thus held more by the discount houses, whilst the bills close to maturity are held more by the banks. This distribution of maturities puts the main weight of the risk of an adverse movement of discount rates on the discount houses, the bill holdings of the banks themselves thus being very highly liquid. Although the banks would ordinarily dislike rediscounting any bills they hold, the risk of loss, if they should be forced to do this, is minimised by the closeness of most of their bills to maturity.

Treasury Deposit Receipts, which now stand equal to only 3.9 per cent of the deposits, are an innovation of the last ten years, and now stand at much lower levels than in the late war and early post-war years. Their shrinkage in recent years, when the Treasury has been replacing them by Treasury Bills, is no doubt partly due to the bankers' dislike of the Treasury Deposit Receipt (commonly referred to as the «T.D.R.») as a newfangled Treasury instru-

ment that lacks the liquidity of the Treasury Bill. There is no public issue of T.D.R.s nor is there any market for them. The banks, as a group, are called upon each week to take up an amount of 5, 6, or 7 months' T.D.R.s, both the total amount and the life of the T.D.R.s being determined by the Treasury; the total amount is shared between the banks in accordance with a formula agreed among the banks themselves. A bank may part with a T.D.R. before maturity only in one of two circumstances: 1) instead of cash as a subscription (on behalf of a customer or of the bank itself) to a new government bond issue, or 2) in case of need by rediscount at the Bank of England at Bank Rate. The former provision was important during the war, but is rarely of use nowadays, when new bond issues are rare events. The second possibility — rediscount at Bank Rate — is one to which resort has upon occasion been made on a small scale, but banks would look upon this as an unattractive means of escape, even if no loss were involved. In fact the loss would be substantial, since Bank Rate is 2 per cent whereas the T.D.R. rate is only 5/8 per cent. Moreover the banker runs the risk that loss on rediscounting will be increased by a rise in Bank Rate within the life of the T.D.R.; and whereas the parallel risk attached to Treasury Bills is limited to three months (or less, in so far as the banks acquire these Bills only after part of their life has been spent in a discount house's portfolio), that of the T.D.R. extends over 5, 6 or even 7 months. All these circumstances — the absence of marketability, the sanction of the penal rate, the relatively long exposure to the risk of rising interest rates — combine to make the bankers feel much more uncomfortable about this government paper than they do about Treasury Bills, which at first glance seem little different. The T.D.R. is, the banker therefore says, very much less liquid; and he feels the extra 1/8th of one per cent (above the Treasury Bill rate of one half of one percent) is scant compensation for the comparative illiquidity. His distaste for the T.D.R. is no doubt enhanced by the fact that, instead of acquiring it voluntarily, he is obliged by the Treasury to take it up, whether he likes it or not.

This analysis of the bankers' feelings about T.D.R.s will no doubt appear quite unnecessarily complicated to many people, who will imagine that the T.D.R. must really be practically the same as a Treasury Bill. The truth is, however, that these complexities serve rather to illustrate the delicate nuances that enter into the notion of liquidity in the mind of the English banker.

The earning assets so far discussed — the Money at Call, Bills discounted, and Treasury Deposit Receipts — are frequently referred to as « quick assets » — *i.e.* those that can quickly be exchanged for cash in case of emergency. The term « Money Market Assets » is also sometimes used, but this should be and usually is intended to exclude the Treasury Deposit Receipts, since these are not in any way handled in the « Money Market ». The remaining assets — Investments and Advances — are universally regarded as less liquid, the banks regarding the sacrifice of liquidity as justified for the sake of the relatively high returns yielded by these two classes of assets.

V

The *Investments* consist very largely of British Government bonds, with a small « mixing » of other very high-grade securities having an excellent market on the London Stock Exchange. All these having such a ready market on the Stock Exchange have one of the attributes of liquidity — shiftability — in very high degree; but during the time before they reach maturity their prices may vary very considerably. The banker has therefore to reckon that if he were compelled to sell such bonds, he might incur heavy capital losses — losses that could much more than absorb a year's interest on the bonds. Now, apart from occasional reshuffling operations — the exchange in effect of one group of securities for another — English banks do not ordinarily sell their government bonds on any considerable scale. Once bought, the bonds are largely held to maturity, and with a wide margin of quick assets standing as a second line of defence against possible withdrawals by depositors, it would seem extremely unlikely that the banks would ever need to

sell securities and so realise market losses. It might therefore be supposed that bankers could afford to ignore the market fluctuations in the prices of their government bonds. A 20-year bond bought at price 90 might, for instance, be written up in the books by 1/2 a point each year, irrespective of movements in Stock Exchange prices. Given the disposition of bankers to hold tightly their government bonds, it might be supposed that they could largely ignore the risk of loss due to variation in market values.

But this is not at all how the bankers behave. Their attitude towards government securities is affected deeply by the well-established accounting conventions, according to which all securities should be valued, for balance-sheet purposes at the end of each half-year, at cost of acquisition or current Stock Exchange value, « whichever is the lower ». The possibility of a fall in Stock Exchange prices of gilt-edged securities before the end of the current half-year therefore operates on the banker practically as strongly as if he were compelled to sell the bonds and so realise an actual loss. This has been a very powerful force in governing the banks' activities in recent years. For more than a decade the Bank of England has stood ready to create cash upon demand through the discount market, in order to support whatever total of deposits is brought into existence by the commercial banks. If the latter wanted to hold more government bonds (yielding up to 3 per cent and even more) they had merely to refrain from absorbing Treasury Bills (at 1/2 per cent) to an amount equal to 8 per cent of the bonds they wished to add to their portfolios. That the banks have not taken advantage of this apparent opportunity of greatly increased profits is largely due to their fear of falling bond prices coupled with the accounting conventions that would oblige them to disclose unrealised losses that would on paper wipe out their shareholders' capital.

The restraint imposed on the bankers by their sense of the instability of bond prices is of course greatest in relation to the bonds that have the longest terms to run. For this reason the banker arranges the maturity-distribution of his bond portfolio with a strong presumption in favour of shorts, and in favour of a continuous stream of maturities over the years.

Precise practices in this matter vary from bank to bank, and the reasons given by individual bankers for their practices show some variety. It is, however, universal for bankers to aim at having some bonds falling due for redemption over as many as possible of the next twenty years. Unavailability of bonds falling due say eight and nine years hence will leave the bankers uncomfortable, because of the gap in the maturity-distribution of their portfolios; and they will welcome a new government issue of bonds redeemable at these dates. The other general principle — the heavy weighting in favour of « shorter » bonds — takes a more precise form in relation to bonds within five years of redemption. Some banks go so far as to aim at having half their total bond-portfolio falling within this limit. These short bonds have the special protection, as we have seen, of the activities of the discount houses. The Bank of England is known to be willing to support, as lender of last resort, the operations of the discount houses in bonds of less than five years' life, and the bankers therefore consider these bonds as approaching bills in liquidity. This preference is based solely, it will be noticed, on the differential shiftability. Although this differential shiftability implies some assurance against panic price movements, it cannot make the short bonds as liquid as bills, because their longer life still leaves open the risk of changing interest rates: a rise in interest rates is obviously more likely to happen in three, four, or five years than in two or three months.

This care for the precise maturity dates of bonds naturally makes the banker prefer bonds with fixed maturity dates to those giving the government a wide option of redemption. If a bond is due for redemption on 1st January, 1960, without qualification, the banker knows just where to reckon the bond in the maturity-distribution of his portfolio. But if the Treasury has the option to redeem at any date between 1955 and 1965, the banker will not know, in 1951, whether to reckon the bond as a 4-year bond or a 14-year bond — and his general attitude to bonds makes this doubt a serious factor.

This element of doubt about the maturity dates of particular bonds can upon occasion be a major factor in the behaviour of the gilt-edged

market and so in the movements of interest rates. Such an occasion arose a short time ago, owing to the existence of a very large block of $3\frac{1}{2}$ per cent bonds which the Treasury has the option to redeem in 1952 or later. As is well known, there is a necessarily close relation between current interest rates (for medium- and long-term loans) and those expected to prevail in two or three years' time. While, therefore, long-term rates stood at little more than 3 per cent (as they did for two years after the Dalton fiasco) it was assumed that the Treasury would call these bonds for redemption in 1952, the earliest possible date, in order to convert them into bonds on which the Treasury might have to pay only 3 or $3\frac{1}{4}$ per cent. While these conditions held, the bankers regarded these bonds as falling within the five years to which the bankers attach, as we have seen, special importance. Then in 1949 the gilt-edged market slumped and the long-term rate broke through the critical level of $3\frac{1}{2}$ %. The presumption that the rate would in 1952 be below $3\frac{1}{2}$ per cent disappeared, and with it the presumption that these bonds would be redeemed in 1952. This whole huge block of bonds was therefore moved overnight from the « within-5-years » category and became, from the bankers' liquidity point of view, an altogether less desirable maturity. The total amount of bonds of this issue being so large, the disturbance in the maturity-distribution of portfolios was substantial, and the blow to the bankers' liquidity undoubtedly accentuated the bankers' reluctance to buy gilt-edged securities at that time and so hastened the demoralisation of the market which was eventually steadied only by the extraordinary intervention of the Bank of England.

VI

In relation to *Advances* to customers the bankers' attitudes are even less susceptible of reduction to a general rule. The considerations affecting this class of asset are completely different from those affecting Investments, the most fundamental difference being that, whereas government bonds have high shiftability but are continuously subject to change in capital value, the Advances have no shiftability at all, but on

the other hand are not subject to variation in capital value except when major errors of judgment lead to bad debts.

The Advance — whether by loan or by overdraft facility — is a matter for individual negotiation between banker and customer and the terms depend very largely on the banker's detailed knowledge of his customer's business and his judgment of the customer's integrity and capacity: there can therefore be no question of shifting the customer's debt (the banker's asset) on to another institution. Once made, the advance figures in the banker's portfolio until it is paid off by the customer's own operations. Because of this absence of shiftability, the banker habitually emphasises to the customer the need for liquidity in the customer's own trading position, for it is only in this indirect way that the banker can secure any element of liquidity in his asset. Nominally all advances are repayable on demand; but the lawyers have softened this in practice and the principle is in fact seldom put down on paper — the custom is rather for the whole business to be discussed and settled by word of mouth without any formulation of a legal contract. Moreover the bankers know perfectly well that their customers cannot repay on demand — if they could do so, they would generally have no occasion to borrow from the bank!

For reasons explained in Section II above, the English banker has traditionally liked to think of his advances as being, like his bills of exchange, « self-liquidating assets », in the sense that they should be used by customers only for transactions the closure of which would automatically bring to the customer the funds with which to repay the advance. Though this principle is retained as a preference, there is no pretence nowadays that it is a rigid condition. The stress now is on *temporary financing*, which is not quite the same. It may be that the customer is going to use the money for building an extension of his factory — a purpose that under more rigid views would be thought improper use of a bank advance — but he cannot conveniently raise the money otherwise (e.g. by the issue of debenture stock) at once. In this case the bank might be willing to finance the extension temporarily — *i.e.* until more permanent arrangements could be made.

A bank advance in this case would be for temporary financing but it would not be self-liquidating. It is of course as true in banking as elsewhere that « nothing is so permanent as the temporary », and temporary financing has a habit of running on year after year. Much of a banker's skill lies in judging how far he can safely go in meeting his customer's convenience by loans of this kind. Under pressure of the desire to counter the falling tendency in the demand for Advances, English bankers have tended to take more elastic views about temporary financing, going no further in formal restriction of the customer than a general statement that the advance will be « subject to review every twelve months ».

Though English bankers are in this way taking a much less rigid line about the need for liquidity in their Advances, it must not be supposed that they are becoming more lax in every way. On the contrary, even before the restrictions imposed by the Government (parallel to the activities of the Capital Issues Committee), customers were already finding bankers more difficult about advances for speculative projects. The position may perhaps be summarised by saying that the English banker has become less rigid in his rules of thumb but more cautious in his judgment of individual projects.

Undoubtedly this shift in emphasis is in tacit recognition of the fundamental illiquidity of Advances to customers, and the same consideration has tended to reduce the part played in these transactions by collateral security. The bankers recognise that only the very highest grades of collateral substantially protect the banker against ultimate loss, and even such high-class collateral does not render an advance quickly repayable without damage to the banker-customer relationship. The banker therefore tends to act very much as though there were no collateral, although he takes what protection he can easily get in this way. His habit is to size up the proposition, judge his man, consider what sum is necessary to finance the project comfortably, and then lend the required sum, merely taking such collateral as the customer can conveniently offer. It would be no great exaggeration to say that, in making advances to customers, the English bankers

tacitly acknowledge that the liquidity of these assets is generally low, but that they do seek to restrict advances to the kind of risk the bankers are competent to judge.

VII

In Sections IV, V and VI we have been reviewing one by one the main classes of banking assets. But, as we remarked on page 52 the banker has to pay regard to the quality of his whole range of assets at once. His attitude to any one class of assets is, that is to say, affected by his feelings about all his other assets: his willingness to hold more of any one class depends upon his general liquidity position as indicated by the distribution of his assets between the main classes.

One important historical application of this principle was the « 30 per cent of quick assets » rule (1) that was in the inter-war period perhaps more rigid than the 9 per cent cash ratio. In those days the bankers generally aimed at 9 per cent cash and 21 per cent « money market assets », making 30 per cent in total quick assets; but if money market assets were scarce (*i.e.* if few bills were being issued by the Treasury or drawn by traders), the bankers would raise their cash ratios above 9 per cent rather than allow the total of quick assets to fall below 30 per cent. Similarly, abundance of bills at favourable rates would occasionally induce them to allow their cash ratios to fall below 9 per cent. In the same period 55-60 per cent was regarded as the maximum permissible for Advances, though after 1929 the demand fell off to such an extent that these ratios were never again approached. In fact the fall of the Advances far below the customary ratios did much to undermine the old rigidities about the proper purposes of bank finance, and to stimulate competition between the banks and so the crumbling away of the old 5 per cent minimum overdraft rate, now replaced by a broad range of rates around $3\frac{1}{2}$ -4 per cent.

During the war the great expansion of the volume of short government paper which the banks were obliged to take up, and the simul-

(1) In this paragraph the term « quick assets » includes cash.

taneous decline in the demand for ordinary business advances, caused the ratios to undergo further radical changes. Since the war there has been some reversal, but as will be seen in the Table on page 55 the distribution is still very different from the pre-war ideal. « Quick assets » (even when we exclude Treasury Deposit Receipts) are still 39 per cent — well above the old 30 per cent, while Advances are still below 30 per cent, as compared with the old 55-60 per cent maximum and the 45 per cent which ruled in some of the more prosperous years just before the war. With such a relatively high proportion of quick assets, and with the established readiness of the Bank of England to turn quick assets into cash at the fixed rate of $\frac{1}{2}$ per cent, the banks are under no restraint from the centre in expanding their total assets. Their profit motive would appear to be urging them to expand their Advances towards the pre-war 45 per cent, if not as far as the older 55-60 per cent ratio; and, failing outlet for Advances, one would suppose that the banks would take up more medium and long-term government bonds, on which they could earn $2\frac{1}{2}$ to $3\frac{7}{8}$ per cent.

In practice the banks are not expanding anxiously in either of these directions. We have already seen how the fear of book losses, resulting from falling gilt-edged prices, restrains them from rapid acquisition of Investments. In their Advances to businessmen, they are of course restricted by the informal government control which runs parallel to the activities of the Capital Issues Committee. But they have also very much in mind, in current circumstan-

ces, the recent phenomenal rise in raw material prices, and are fearful of financing stocks of materials at prices that are so new and may be so ephemeral. Much as they would like to see their Advances rising above 29 per cent of their deposits, they would feel very uncomfortable indeed if their Advances ratio stood at the old 55 per cent when a collapse in prices might quickly involve them in heavy losses by bad debts.

For such reasons as these, the banks do not feel themselves so highly liquid as to justify their adding greatly and rapidly to their total assets, although a comparison of present with pre-1929 or even pre-war ratios would seem to indicate a very high degree of liquidity. To reconcile this high liquidity with the hesitation over expansion it has been necessary in this paper to make a comprehensive review of English banking assets. English bankers' ideas of liquidity are, as we have seen, highly complex. Comparisons with the inter-war period may also suggest that ideas on this subject are subject to change in course of time — the English banker has now so far forgotten the days when Advances stood at 55-60 per cent that he would probably feel uncomfortably illiquid if such a proportion were ever reached again. Nevertheless, on any reading of the facts it must be admitted that the present liquidity of the English banks makes them not merely impregnable but also highly independent of any mechanistic control from the centre. Hence, at least in part, the importance nowadays attached by the British authorities to qualitative credit control. That, however, is another story.