

LOMBARD STREET

A DESCRIPTION OF THE MONEY MARKET

By WALTER BAGEHOT

NEW EDITION WITH AN INTRODUCTION BY

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• • • Like the English Constitution, the English credit system is a living thing, that has grown out of its past and is growing into its future. Past, present, and future are thus one continuing process, and no one can hope to understand its present, still less to peer into its future, unless he knows something of the past that is part of them. Bagehot's "Lombard Street" lights up, with the fire of its author's genius, the road that we have travelled, and helps us to see where we are and to wonder whither we are going. Its usefulness, as a work of reference and a standard of comparison, has been enhanced in this new edition by a careful revision of the Notes, carried out by Mr. A. W. Wright, a member of the staff of the *Economist* newspaper, long edited by Bagehot.

HARTLEY WITHERS.

February, 1915.

LOMBARD STREET TO-DAY

BAGEHOT'S "Lombard Street" was begun, as he tells us in his "Advertisement," in the autumn of 1870. It is a wonderful achievement, that a book dealing with the shifting quicksands of the money market should still, after more than forty years, be a classic of which no one who wishes to understand the subject can afford to be ignorant. Since it is so, it is evidently desirable to give, for those of its readers who are not acquainted with the money market of to-day, a brief account of the chief movements and tendencies which have altered the conditions since Bagehot wrote.

This task is all the easier, since the most notable results of these movements and tendencies have amply confirmed what he said. Lombard Street has accepted the bill that Bagehot drew on it. There are two chief outstanding facts of modern monetary development. One is the reliance of the London money market and the money markets of the world on the Bank of England as the custodian of the central gold reserve.

This is the principal theme of Bagehot's argument, to which all its digressions and excursions ultimately return. The other is the development of joint stock banking in England by the gradual diminution of the old private banking firms and the coincident expansion of the banking companies by growth and amalgamation. All this Bagehot foresaw and predicted.

The Cheque Currency of To-day.

This development has modified the problem of the money market in several important respects. Since the ordinary joint stock banks with offices in London were forbidden, by the Bank of England's charter, to exercise the right of note issue, it has been their special function to spread the use of cheques in England and to make them the predominant form of paper currency, reducing the banknote to a secondary place as currency, and at the same time raising it to a more important one as part of the basis of credit. Since the joint stock banks have covered England with branch offices, ready and eager to give banking facilities to customers of quite moderate means, the cheque has become the chief circulating medium in commercial payments, and the banknote has almost ceased to circulate. The outstanding note issues of all the English banks, other than the Bank of England, which publish balance

sheets have now sunk to slightly over £100,000, and it is significant to observe that they are habitually below the amount authorised by the Act of 1844, so that their diminution has been due, not so much to the reduction of the number of banks with the right of issue, as to a change in the habits of the people, which does not now want even as many banknotes as it might have, since it has been accustomed to the greater convenience and safety of the cheque.

At the same time what is usually described as the circulation of the Bank of England note has increased, but its actual circulation as currency in the hands of the people is probably less than when Bagehot wrote. The Bank return for the last week of 1869, which he quotes in Chapter II., shows notes issued by the Issue Department £33,288,640, and notes held by the Banking Department £10,389,690, making the amount in circulation just below 23 millions. In recent years the circulation has fluctuated from 28 to 30 millions, but it is probable that the whole of this apparent increase has been due, not to circulation in the strict sense of the word, but to the use of Bank of England notes as till money and cash reserve by the other banks. It is impossible to arrive at definite figures on this subject because the banks do not, in their published statements, give any clue to the details of which their cash holding is

LOMBARD STREET TO-DAY

composed—how much of it is coin and how much consists of Bank of England notes. But the great increase that has taken place during the last forty years, both in the number of bank offices open and in the aggregate liabilities of the banks, makes the probability of the above assumption almost amount to certainty.

The Banknote and the Fiduciary Issue.

This change in the position of the Bank of England note is highly important. It is due, not to any action by the Bank of England, but to an external process arising out of the development of the other joint stock banks and the rapidity with which they have multiplied offices, sowing their banking crop all over the country. By means of it the Bank of England note has largely ceased to be an instrument of credit passed from hand to hand in the course of commercial transactions, and has become part of the cash on which the other banks base their credit operations, and multiply the ever-growing volume of the cheque currency which is now, to an overwhelming extent, the money of modern England. This development has greatly modified the views of the commercial community on the subject of the regulations imposed by Peel's Act of 1844 on the issue of the Bank of England note. By this Act the note issue could only be increased beyond a certain

point by the holding of actual bullion against each new note issued. As long as the Bank of England note was currency required for business circulation, this restriction was open to criticism as the infliction of a cast-iron fetter where elasticity was most of all desirable; and the advantages of the German system, which provided for an expansion in the issue of notes against securities—the fiduciary issue as it is generally called—when money is in great demand, was frequently held up as an example for England. But now that it is more clearly perceived that the money of England is the cheque, which can be multiplied to an extent which is only limited by the prudence of bankers and the security that their customers may be able to provide, and that the Bank of England note is chiefly used as part of the banking cash reserve, the opinion is commonly held in the City that the restrictions on its issue imposed by Peel's Act should be carried still further, and that that part of the issue which is fiduciary, or based on securities, should gradually be abolished, the securities behind it being replaced by gold. Since most of the profit on the fiduciary issue goes to the Government the difficulty of introducing any change tending towards its abolition is redoubled; but as a matter of theory it is safe to say that a majority of well-informed City opinion is now in favour of making the Bank of England note a pure

and simple bullion certificate. And this change of opinion concerning the only law which seriously restricts the banker in the conduct of his business is striking evidence of the extent to which English banking has been modified by the development of the use of the cheque.

It has been revolutionised rather than modified, for the cheque has freed banking from the fetters of the Bank Act. The Bank Act said that there should be no increase in the note currency except by an increase in the Bank of England's bullion. If commerce had continued to use the note currency and had expanded as it has, there would by this time have been a vast pile of useless gold in the Bank's vaults. But the Act laid no restriction on the drawing of cheques, and all the new joint stock banks, which had sprung up when it was discovered that banking did not necessarily mean note-issuing, pushed on the use of the cheque currency wherever they carried their victories. They thus developed that side of banking which was free from legal restriction and at the same time gave the commercial community the most perfectly safe, elastic, and adaptable form of currency that the world has yet seen. And in another respect the growth of these great institutions which have carried out this important development has modified in a very important respect the problem of the money market as it showed itself

to Bagehot. When he wrote, the Bank of England was at all ordinary times the most important factor in the market. "At all ordinary moments," he wrote, "there is not money enough in Lombard Street to discount all the bills in Lombard Street without taking some money from the Bank of England." This is no longer true.

The Power of the Outer Banks.

So far is the above quotation—from Chapter V. of "Lombard Street"—from being verified by modern conditions that it may be said that at all ordinary moments Lombard Street carries on its business without any necessity for taking money from the Bank of England, and that consequently the Bank rate—the rate at which the Bank will discount bills—is at all ordinary moments not a direct influence in the rate at which the outside market—consisting of the other banks and bill brokers—is working. It is only in times of special demands, such as quarter-day payments, the collection of the direct taxes in the January to March quarter, abnormally active trade, or a foreign drain of gold, that the Bank of England's assistance is required, and its rate only becomes an influence when there is apprehension or expectation in the market that it may be raised or lowered. Since Bagehot wrote, the process that he foretold of the

growth and predominance of the joint stock banks has gone so far that they have not only almost obliterated the old private firms, but have taken out of the Bank of England's hands the business of providing currency and regulating the London money market, except on special occasions. They provide the cheque currency of to-day, and in ordinary times the rate at which they lend to the bill brokers makes the price of short loans, and the rate at which they discount bills makes the discount rate in London. Between these rates made by the outer banks and the official rate of the Bank of England, there is only a slender and shadowy connection which comes into being from the fact that the rate allowed to depositors by the outer banks is usually $1\frac{1}{2}$ per cent. below Bank rate. But of the sum of money held by the banks on behalf of customers, it is probable that less than half is on deposit, the rest of it being held on current account, and so in most cases receiving no rate at all. It is impossible to be certain on this point, since very few of the banks show in their balance sheets separate statements of current and deposit accounts. But among those which do so, deposits are half the amount, or less, of the current accounts. And consequently it often happens that bankers lend money to bill brokers at the same rate at which they are paying to depositors. There is thus this loose connection

between Bank rate and the market rate for loans, that the latter is not as a rule likely to be more than $1\frac{1}{2}$ per cent. below the former, but the connection is so indefinite and untrustworthy, and the funds over which the outside market now has control are so vast, that when the Bank of England considers it necessary, owing to the threat of a foreign drain or for any other reason, to raise its rate, it often has to make this action effective by borrowing from the outside market in order to curtail artificially the supplies of the latter, and compel applications to itself, so as to make its rate an effective influence on those current in the market.

The Problem Modified.

Modified by this development, the problem of Lombard Street to-day is concerned rather with the conduct of the outer joint stock banks than of the Bank of England. The difficulties and responsibilities of the Bank of England have been increased, but at least they are recognised and provided for. If Bagehot could look back over the history of the money market through the forty years that have passed since he wrote "Lombard Street," he would see that his criticisms of the attitude of the Bank towards its position had borne good fruit. Its duty as custodian of the

gold reserve has been definitely recognised by its consistent action, and by the equally constant pressure of public opinion. Between them the Bank's sense of duty and the public's insistence on its responsibility have produced a marked advance along the line indicated by Bagehot. He pointed to ten millions as the limit below which the Bank's reserve should not be allowed to fall; now it is rarely below twenty millions. He maintained that "one third of its banking liabilities is at present by no means an adequate reserve for the Banking Department." During 1913 the average proportion of the reserve to liabilities was 49·7 per cent. And all this has been achieved in spite of the growth of banking development outside, which, as has been shown, has made Lombard Street independent of assistance from the Bank, save at exceptional times, instead of being normally dependent on it and so constantly under its control. It is this outside development that has changed the face of the problem. It has already been shown to have altered England's currency, which now consists chiefly of cheques, and it is also the cause of continued heart-searchings among the banking community concerning the adequacy of its cash reserves, in spite of the improvement achieved by the Bank of England. The increase in the Bank's reserve has been great, both absolutely and relatively to its own direct liabilities,

but it is criticised as insufficient when compared with the mass of banking liabilities of the country, which are based on the outer banks' cash holding, included in which are their balances at the Bank of England. It is the proportion of cash to liabilities shown by the outer banks which is the problem that vexes the banking world to-day, and has vexed it for nearly twenty years. This problem has been aired and discussed at bank meetings and in addresses to the Bankers' Institute ever since the crisis of 1890. No definite step has been taken towards its solution, but the discussion is very far from having been fruitless. The proportion of cash held by the leading banks has improved steadily and rapidly. Bagehot quotes, in Chapter IX., Mr. Weguelin, Governor of the Bank, as stating in 1857 that the joint stock banks of London had deposits of 30 millions and 2 millions of cash reserve. Here the proportion is 6·6 per cent. The latest statement* of the London joint stock banks shows deposits 565 millions, cash 86 millions, proportion 15·2 per cent. The improvement is remarkable, and if we could be sure that the rest of the banks were equally prudent, and that the proportion shown by the London banks were normal and habitual, and not to some extent and in some cases specially arranged for purposes of publication, critics could find little more to say on this subject.

* At the end of April, 1914.

Unfortunately, we cannot be sure of either of these things. The evidence is all on the other side. Banking reformers press continually for more frequent and clearer statements of their position by the country banks, and for the adoption of the average system in all bank statements, so that there may be no possibility of specially arranged displays. And they contend, with much good reason behind them, that, if this system were adopted, the question of an adequate cash reserve would very quickly be solved.

It should be noted that experience in this country and elsewhere has not endorsed Bagehot's view that our one-reserve system, based on a gold store held by one chief bank, is unnatural and wrong, and only to be tolerated because it is now so deeply ingrained in our banking habits that its alteration would be a dangerous experiment. It is now generally recognised that this system gives us a credit organisation of unrivalled elasticity, and banking reformers in America are now endeavouring to adopt it, with modifications necessitated by local conditions.

In his concluding chapter Bagehot states that the account of the Secretary for India in Council is contained in the public deposits in the Bank return. This was so when he wrote, but the public deposits are now only those of the various departments of the British Government. The

India Council's balance is included in the other deposits, and has been so since 1892.

Such are the main points in which the problem of Lombard Street and the relations of the various components of the money market have been modified since Bagehot wrote. It should also be noted that the progress of banking development abroad has lessened the difference which he described between England and other countries in the matter of the use of credit.

HARTLEY WITHERS.

PREFATORY NOTE TO THE TWELFTH EDITION

As more than thirty years have elapsed since the first publication of this little book, it has been thought desirable to bring the figures, and some of the examples used, up to the present time.

My best thanks are due to the friend who has placed his services at my disposal for this purpose.

The new matter is confined to notes, and the text of the original work has not been touched.

May, 1906.

ELIZA BAGEHOT.

PREFATORY NOTE TO THE ELEVENTH EDITION

IN this Edition additional Notes have been inserted by Mr. E. Johnstone, in Appendix II., and the other Notes have been revised by him, so as to bring up the work to the present date.

July, 1899.

ADVERTISEMENT

THE composition of this little book has occupied a much longer time than, perhaps, my readers may think its length or its importance deserves. It was begun as long ago as the autumn of 1870; and though its progress has been often suspended by pressing occupations and imperfect health, I have never ceased to work at it when I could. But I fear that in consequence, in some casual illustrations at least, every part of the book may not seem, as the lawyers would say, "to speak from the same time." The figures and the examples which it is most natural to use at one time are not quite those which it is most natural to use at another; and a slowly written book on a living and changing subject is apt a little to want unity in this respect.

I fear that I must not expect a very favourable reception for this work. It speaks mainly of four sets of persons—the Bank of England, Joint Stock Banks other than that Bank, private bankers, and bill brokers; and I am much afraid that neither

will altogether like what is said of them. I can only say that the opinions now expressed have not been formed hastily or at a distance from the facts; that, on the contrary, they have been slowly matured in "Lombard Street" itself, and that, perhaps, as they will not be altogether pleasing to any one, I may at least ask for the credit of having been impartial in my criticism.

I should also say that I am indebted to a friend for the correction of the final proof sheets, which an attack of illness prevented me from fully revising. If it had not been for his kind assistance, the publication of the book must have been postponed till the autumn, which, as its production has already been so slow, would have been very annoying to me.

WALTER BAGEHOT.

THE POPLARS, WIMBLEDON.

April 26, 1873.

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