THE WAR AND OUR FINANCIAL FABRIC

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BY

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PREFACE

In this work I attempt to gather up some of the lessons to be learnt from the experiences of the greatest of financial crises. Many predictions have been unrealized and many theories destroyed, and we are able, I think, to see with greater clearness and to grasp with more boldness the problems that perplexed us in the past. Banking, credit and currency problems have ever been subjects of contentious controversy, experts and academic critics alike being unable to agree upon their reading of phenomena and upon right interpretations. The problems are indisputably complex, the most complex, probably, in the vast domain of economics, and vision and logic have not guided us with sureness amidst their intricacies. Hence we have groped and gone our different ways, finding ourselves at no common goal. Royal Commissions have been asked for in order to tackle and, if possible, to find solutions that will be universally acceptable. For some time before last year's crisis a small committee of bankers had been sitting in order primarily to deal with the reserve problem and the provision of emergency currency. It is believed they were on the point of presenting a scheme to deal with future crises when the sudden outbreak of the war put an end to their labours. Whether or not their scheme will ever be made known to the public may depend upon future developments. Perhaps the public may never be enlightened, for it may now be thought that inspiration and genius discovered the most practical solutions at the right moments. Something had to be done swiftly. And that which was decided upon swiftly revealed deeper insight, maybe, than slower deliberation.

This is not uncommon, however, in the career of genius. Civilization has profited more, perhaps, from flashes of inspiration than from uninspired controversy.

In order to build up my arguments I start from the foundation, and in the earlier chapters deal with the monetary problem and the general working of the banking system. These lead us into the region of dialectics and controversy and to a survey of the happenings during the crisis.

I urge amongst other contentions that banks do not in the true connotation of the word create credit. If it be possible to convince ourselves that they do not create credit, that credit is a something existing prior to and independently of banking, it will, I think, make the gold reserve problem easier to solve.

What we gaze upon is not an unsubstantial structure called in Lombard Street "the superstructure of credit," but is something more solid. It is a superstructure of wealth. All that banks do is to transform this wealth into liquid capital, resolve it into its constituent, or original, elements. This enables wealth to perform its fructifying functions, to reproduce itself, just as the mature fruit reproduces itself when re-sown. Were the wealth to remain in its fixed, or, as the market would say, its frozen form, what sort of wealth-harvest could we hope to gather from it? Unless it be made liquid it cannot flow. And if it did not flow, but remained frozen, sterility would result. If this transforming machinery were not provided by banks, the Government, on the nation's behalf, would have to provide it, or the nation would become inert. As there is not, and never can be, enough legal tender coinage for this work, other legal tender currency should be provided.

In answer to those who have ever clamoured for high gold reserves I have endeavoured to show the impossibility, in the present system, of this realization. What critics have at the back of their consciousness is, not quantity *per se*, but proportion. They do not mean a mere counting of sovereigns, but the ratio of an individual bank's reserve to its liabilities. A small bank cannot have as much gold as a large bank, but it can have as high a proportion. Now, a high proportion can be attained only by keeping down the loan-deposits. It cannot be attained by getting a larger quantity of gold if the loan-deposits grow correspondingly. When banks see these deposits rising and the proportion falling, they cease lending, call in their loans, and allow the proportion to rise. We then see what we fallaciously call the loan-fund of Lombard Street diminish, showing that the loan-fund is not in the deposits, but in the gold reserves and in the totality of the wealth in the keeping of the banks at any given moment.

When banks cease to lend they drive borrowers to the Bank of England. Borrowing there causes a drop in the Bank's proportion. Therefore, we cannot have simultaneously high proportions of joint stock bank reserves and a high proportion of a Bank of England reserve unless both stop lending simultaneously. As the Bank's reserve is the reserve of the joint stock banks collectively and the national reserve, then, if its proportion falls, the reserve-proportion of the entire system falls. The only way to keep it high is for all to stop lending and for the whole money market to lapse into a state of stagnation. So far as my knowledge extends, this has not been pointed out.

We know that efforts are made, by raising the Bank rate, to replenish the reserve automatically from outside sources. But whether the gold flows in or not, it does not disprove the fact that a high proportion in the independent joint stock banks and in the independent Bank of England cannot be maintained at simultaneous moments except by a simultaneous refusal to lend. It needs no exceptional power of imagination to picture what would result from this action. It would have the same consequences as a great destruction of capital by war or any other calamity. If we had an elastic legal tender system, to provide for what I call a supplementary inflow of legal tender, we could avoid many inconveniences from which the money market and the nation suffers.

The supply of liquid capital in a perfect economic system should keep pace with the output of wealth. But our system is not perfect. Progress must necessarily be impeded by artificial and arbitrary restrictions.

I think, too, we could simplify the problem by segregating the composite deposits of a bank. These deposits are an aggregation of what I call, for lack of something more precise, pure deposits and loan-deposits. The loan-deposits are debts to the bank, which the bank has power to call in. If these loan-depositors have legal power to withdraw money on demand, the banks have power to withdraw from many of them on demand. On the approach of a crisis, or stringency, they do this, though in certain contingencies such withdrawals might precipitate a