The Determination of the Volume of Bank Deposits: England 1955-56

I

The conditions determining the volume of bank deposits have been the subject of much attention in economic literature, particularly during the present century. Two circumstances, however, make a detailed treatment necessary. First, an eminent Italian economist has charged English economists — notably Keynes and Robertson — with error, at least in emphasis, in their neglect of the part played by the public in determining the volume of deposits. Secondly, there has been an important change in English monetary institutions, a change which has deprived the cash-ratio of its usefulness as a major hinge in the argument. It has become necessary to re-state the matter in terms reflecting the behaviour of the English banking system in 1955-56.

Professor Amedeo Gambino's criticism of the analysis which may now be described as the traditional English analysis is available to English readers in his article, Money Supply and Interest Rates in Recent Macro-Economic Conceptions, in No. 30 (September 1954) of the Quarterly Review of the Banca Nazionale del Lavoro. This article was prompted by a recent technical article by Professor Erich Schneider, and in developing his criticism Gambino charges English economists, primarily Keynes and Robertson, with misunderstanding the influence of the public in determining the volume of deposits.

The burden of his argument is that the public can vary its relative demand for cash, and that to assume away such variation in a ceteris paribus clause is to ignore a factor shown by his statistical analysis (for Italy and the U.S.A.) to be important. Schneider has made a further contribution, including a statistical analysis of recent conditions in Western Germany, in his article, The Determinants of the Commercial Bank's Credit Potential in a Mixed Money System (5). In the present paper I shall comment briefly, in the light of recent English conditions, on Gambino's insistence on the influence of the public in determining the volume of deposits, and I shall explain in some detail the influence of the English financial institutions as they currently operate.

II

A bank creates a deposit — i.e., enters in its books a credit balance in favour of a customer — in return for any asset it accepts from another party, whether this asset is

(4) In referring to followers of the tradition, Professor Gambino has (in 6. p. 205) cited myself as a typical case and quoted a passage which he finds contradictory. I accept his implication of vagueness. I plead that I was trying to give, in elementary terms, an explanation of the main factors in a 1939s that was in process of change and I offer the present paper in amends.


(6) I emphasize that the account given in the remainder of this paper refers to current English conditions, which are valid to change. If experience is any guide, to change rapidly, in preparing this article I have been greatly helped by the signor Dusco Roberto, Mr. R. F. Henderson, Prof. J. E. Edgerton, Mr. W. T. Newby, Prof. E. T. Tov, Mr. R. Allen and others, who commented on an earlier draft.
The determination of the volume of bank deposits: England 1905-56

In current English circumstances, the volume of deposits depends upon the actions and reactions of four parties:

1. The Bank of England acting in conjunction with the Treasury and various government "funds"; these, following current English usage, I shall refer to as "the authorities".

2. The London clearing banks; these I refer to as "the banks".

3. The discount houses.

4. The public, including banks outside the clearing ("the outside banks") and all other financial institutions.

The assets and liabilities of these four parties have, for this purpose, to be classified into:

(a) Cash.

(b) Treasury bills and government bonds short enough to be held by the discount houses.

(c) Call Loans by the banks to the discount houses.

(d) Government bonds held by the banks in their investment portfolios, but too long to be held by the discount houses (3 years is the present dividing line).

(e) Bank deposits.

(f) Bank Advances.

(g) All other assets.

(a) Cash is a creation of the authorities, and is held by the banks (as an 8% reserve against deposits), and by the public, but not by the discount houses.

(b) Treasury bills and other money market assets are held not only by the discount houses, but also by the banks and by the public.

Assets in this class are created by the authorities; by selling them to other parties, the authorities destroy cash, and vice versa.

The volume of deposits includes the Scottish banks. In view of the differences between these banks and the London Clearing Banks, Scotland is for our present purpose to be regarded as separate from England (as really is the case today). Scotland is in fact an inner Sterling Area country.

Notes and coin in circulation (including bank holdings)

<table>
<thead>
<tr>
<th>Year</th>
<th>£ of Notes</th>
<th>£ of Coin</th>
<th>% of total</th>
<th>% of Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>1938</td>
<td>420</td>
<td>191</td>
<td>19.7</td>
<td>37.3</td>
</tr>
<tr>
<td>1940</td>
<td>520</td>
<td>172</td>
<td>18.7</td>
<td>32.4</td>
</tr>
<tr>
<td>1942</td>
<td>510</td>
<td>151</td>
<td>19.4</td>
<td>34.5</td>
</tr>
<tr>
<td>1944</td>
<td>510</td>
<td>136</td>
<td>19.1</td>
<td>29.2</td>
</tr>
<tr>
<td>1946</td>
<td>510</td>
<td>121</td>
<td>19.3</td>
<td>28.4</td>
</tr>
<tr>
<td>1948</td>
<td>510</td>
<td>140</td>
<td>19.3</td>
<td>29.3</td>
</tr>
</tbody>
</table>
Only the banks (as creditors) and the discount houses (as debtors) are directly concerned with Call Money.

Bonds having more than 5 years to run to redemption are not held by the discount houses (with an unimportant qualification); their distribution between banks and the public is variable, though the banks have inhibitions affecting their dealings in these securities, particularly those which are long-dated. The authorities both buy and sell, creating or destroying cash as they see fit.

Bank deposits, liabilities of the banks and assets of the public, are not held significantly either by the authorities or by the discount houses.

Advances by the banks to their customers are assets of the banks, liabilities of the public.

All other assets include all other forms of wealth, including securities (other than those classed under (b) and (c) above), real estate, goods, etc.

In tabular form we may summarise as follows (L standing for Liability, A for Asset):

<table>
<thead>
<tr>
<th>Authority</th>
<th>Bank</th>
<th>Discount</th>
<th>House</th>
<th>The Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>L A</td>
<td>A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bills and other bonds</td>
<td>L A</td>
<td>A</td>
<td>A</td>
<td></td>
</tr>
<tr>
<td>Call Money</td>
<td>-</td>
<td>- A</td>
<td>- L</td>
<td>- A</td>
</tr>
<tr>
<td>Medium and long bonds</td>
<td>- L</td>
<td>- A</td>
<td>- A</td>
<td></td>
</tr>
<tr>
<td>Bank Deposits</td>
<td>- L</td>
<td>- A</td>
<td>- A</td>
<td></td>
</tr>
<tr>
<td>Bank Advances</td>
<td>- A</td>
<td>- L</td>
<td>-</td>
<td></td>
</tr>
</tbody>
</table>

"All other assets", (g) above, are excluded from this table as, with unimportant exceptions, the three monetary bodies (Authorities, Banks, and Discount Houses) are not involved.

Certain minor complications have been ignored:

(1) The Bank of England has some private customers, and therefore has deposit liabilities to the public and makes advances to the public.

(2) The banks hold a small proportion of bonds (e.g. public utility bonds) other than their U.K. government bonds, among their "Investments".

Provided that attractive opportunities to add to the total of these assets exist, the banks will in fact add to them — and so to the volume of deposits, whenever they feel able to reduce the proportion of their more liquid assets. This gives us four relevant factors:

(1) the banks' opportunities to lend to customers;
(2) the banks' view of the bond market;
(3) the conventions about liquidity ratios; and
(4) the supply of liquid assets for the banks.

Until 1951, and only in less degree until 1955, the banks had for a long time been so glutted with liquidity that they felt no compulsion to alter the qualitative control imposed by official requests, to refuse to lend to good banking borrowers. In the early post-war years, indeed, the pressure of liquidity was so strong that the banks tended to broaden their margin of what constituted a good banking borrower, and they also tended — at least between each of the various reiterations by successive Chancellors — to broaden their interpretation of what lending with government requests with the banks was. Under these conditions, the total of Bank Advances was essentially demand-determined, subject to an underlying tendency, originating on the supply side, to grow as the years went by. Bank advances, however, is too broad a concept to say, both because the highly liquid banks welcomed with open arms the increasing demand and because, in their anxiety to lend more, they broadened their views about what was "a good business". Even when liquidity considerations early in 1955 checked the growth of Advances-plus-Investments, the banks still wished, for profit and good will reasons, to continue to meet the expanding demand for Advances. Their wish to do so was so strong that they were willing to sell securities in order to meet the rising demand for Advances, and they might well have continued to follow this course, even at the price of forcing bond prices down against themselves, if the authorities had not in July stepped in with their flat restricting Advances (15). At the beginning of 1956 the position is that the banks are under official compulsion (notwithstanding the absence of statutory direction) to reduce the total of advances.

During the years of excess liquidity, while the banks were disposed to increase their Advances whenever reasonable opportunity offered, their attitude towards their holdings of government bonds was somewhat different. The income that could be drawn from these securities was attractive, though appreciably lower than that on Advances. On the other hand, owing mainly to certain accounting conventions, the banks were fearful of capital depreciation if, as seemed likely, rates of interest rose appreciably within the lifetimes of the bonds. Given these conflicting considerations, the tendency of the English bankers to cut back after the failure of the Dathan experiment, and while their liquidity continued to be abnormally high, was to hold their investment portfolios more or less stationary in absolute amount. They did tend to shorten somewhat the average life and, contrary to earlier traditions, to diversify themselves entirely out of undated stocks; these changes were however changes in the composition rather than in the size of portfolios. In these circumstances the attitude towards bonds was a factor tending to hold the aggregate of deposits where it was, and the only important factor making for change in this aggregate was the growing demand for bank advances (16).

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up and eliminated most of the remaining excess of liquid assets. The accompanying changes in monetary policy forced long-term rates of interest up, but forced the short rates (including the rates on bank advances) to rise even more, so that the relative attractiveness of bonds as bankers' assets were greatly reduced. In these circumstances the bankers were shaken out of their unwillingness to change their investment totals, and loans in the first half of 1955 considered the bond portfolio much more readily comparable than the total of advances.

IV

In the previous section we have seen how in the years before 1955 the attitudes of the bankers towards both investments and advances were highly coloured by the abnormal liquidity of those years, and that in both directions they have been compelled to be more restrictive since liquidity declined. We must now become precise about the liquidity of the banks, and explain in the conditions in which the banks are forced by insufficient liquidity to restrict their investments and advances. The liquidity ratios have to be considered: the cash ratio and the liquid assets ratio.

Since 1956 the cash ratio has been held, on a weekly basis and averaging without window-dressing, at 5 per cent (17). The liquid assets ratio, though loose forms of loan have a long tradition behind them, has become an accepted rule only in the last quarter of a century, and an acknowledged rule only in the last few years. Indeed, it is believed that it became a matter of official guidance only in 1955. It remains less rigid, in the sense that a considerable seasonal variation is tolerated (18), and the level appropriate to any season is not a straight line, but a figure parallel to the 8 per cent for the cash ratio. The position is broadly that the seasonal minimum (in the first quarter of the calendar year) (19) must not fall below about 30 per cent; hence common reference to it as the 30 per cent rule. In current conditions it is 30 per cent rule and not the conventional cash ratio which appears the limiting factor in the creation of bank deposits.

The cash ratio has lost its former sharpness as a controller of the supply of money because for many years now the Bank of England has more or less automatically kept the market supplied with just that amount of cash required to maintain the banks' cash ratio at 8 per cent of their deposits, and both banks and discount houses have become less sensitive to the appearance of a shortage of cash. The cash-creating function of the Bank of England has lost something of the purely mechanical quality it had from 1936 to 1951; but it has not gone back to the traditional practice of gold-standard days. Cash is required for the public and for bank reserves; none is held by the discount houses, but these form the channel through which the banks keep themselves supplied with sufficient cash to maintain their reserves at the agreed 8 per cent of deposits. The Bank of England always provides just enough cash, one way or another, to allow the discount houses to balance their books (i.e. to have zero cash after borrowing all they can from the banks). And everybody knows that, because the banks must have the cash, it will be forthcoming. No sense of strain in the cash position develops to the point of directly provoking a restriction of credit.

In gold standard days of long ago, the system was different in several respects. The banks' cash ratios were comparable (especially with the help of window dressing) (20) so that a decline in cash relatives to deposits did not immediately bring into operation the lender of last resort. On the other hand, pressure severe enough to force resort to the lender of last resort was viewed much more seriously, partly because it was evidence of extreme shortage and partly because the behaviour of the lender of last resort was known to depend on the state of its gold reserve. And when the market took a serious view of the situation, it had one method of restricting credit in its own hands: it would reduce the amount of bills of exchange it was willing to discount (Bills of exchange, drawn by traders for financing trade in goods, were then a large proportion of the bill market's portfolio). The banks — at least those in the City of London — would also be scared into measures of restraint. This is a highly simplified picture, and it is a long time since conditions were at all close to this; but it will be apparent that in such conditions the cash base was a very important factor in direct regulation of the state of credit. Gradually conditions have changed, in more ways than one (21), and in the years 1949-51 resort to the Bank of England became so completely innocuous for everybody that shortage of cash ceased to have any power directly to influence the state of credit.

The position in 1955-56 is in this respect little different from that of the preceding years. The cash ratio is virtually incompressible and variations in the cash supply are continuous, so that the Bank of England is constantly having to operate. But whereas in 1949-51 the Bank of England operated only «at market rates» through its operator in the market («the back door») it now reserves the right to, and frequently does, close the back door so forcing the discount houses to borrow from the Bank, its in its Discount Office («the front door»). By the extent to which it forces the discount houses to come to the front door, the Bank influences the level of market rate in relation to Bank Rate; thus by fixing Bank Rate and by its market operations the Bank virtually fixes the level of market rates (22). If it wants market rate to rise, it elevates the market less frequently through the back door so that the penalty Bank Rate is more frequently imposed (23) and if necessary the Bank raises Bank Rate itself. In these conditions the Bank of England remains, as in 1949-51, passive in deciding the amount of cash; the cash is simply fitted to the total of deposits, subject to the requirements of the public for circulation. The Bank does, however, in effect fix the terms on which just the required amount of cash gets into the market. The business behaviour of the market rate has been through the market itself. Treasury bills influence the attitude of the banks and the public towards bonds (24). A tendency of market rate to rise is likely to encourage a bearish attitude or in the case. If this results in a fall of bond prices, without any redistribution of holdings, there is no effect on the volume of bank deposits. If, on the other hand, the banks reduce their portfolios by sales to the public, deposits are reduced by that amount (25), and there will be a rise of cash rates (of now in deposits) by the banks to the discount rate.

(22) The position is that there are no restrictions on the amount of bills of exchange or other monetary instruments which can be barred from the discount market by the Bank of England. (23) The fact that the Bank of England has adopted this official practice must not be taken to mean that it is not a matter for private judgment of the Bank of England. (24) The incidence of bill rates on the market is by no means easy. Besides internal movements of cash, which may be quite erratic, international movements of funds into and out of London are known to influence the state of the market. (25) These terms are theoretically ill-defined as the size of the portfolio (bills plus bonds) held by the discount house. This ill-defined is that the discount houses, making a running profit on bills, hold at large as a unit as they get finance, while they are unwilling to add to their books (fear of future losses) and cannot afford to accept the redemption of present bank loans by selling bonds; the size of their portfolios is moreover limited by relation to their own capital resources, on a scale sanctioned by the Bank of England. In the old conditions, a movement of rates (and particularly money to borrowing in the Bank of England's penalty rate) could have big effects on the discount houses' portfolios, which depend on commercial rather than government paper. (26) As E. E. R. Thompson has pointed out in his, the repudiation of the assumed fall in bond prices by the market, the stock exchange prices of bonds and shares is likely to be more compact, and the effect upon the volume of deposits also more compact, than is assumed in the above paragraph. Those who have assumed that the bonds sold for more than their market value were bought by the public in exchange for deposits; but the fall in stock exchange prices is likely also to cause fear who were about to make sales of stock in other capital, and to cause them to increase their purchases at the expense of their bonds to the Bank. To the extent that this happens (and there are some possible vacillation) the banks will be in effect exchanging bonds for advances, among their assets, and the deposits will not fall; only when the banks are forced to lower their rates of deposit and repay their depositors will the problem arise in the earnings of their depositors and deposits fall full.

(25) The seasonal variation in the liquid assets ratio is akin to the adjusted daily variation in the cash ratio; the latter varies closely in keeping with the seasonal feature because the monthly statements are always on Wednesdays.

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market, which the Bank of England must mop up if the market rate of discount is to be held at its new level. The borrowing public may also be affected by a change in market rates of interest — both bill rates and rates charged on bank advances (overdraft rates) — to the small extent that this occurs, rates further influence the total of deposits.

Thus the amount of cash created by the Bank of England is a passive element in the situation, though the terms on which it is made available can have repercussions on the volume of bank deposits. The system works not by a volume of bank deposits and of cash being determined as desirable, but rather by the authorities' choosing a structure of interest rates and making the cash fit that structure (26). Their power over the cash position is of course the sanction that makes the enforcement of a given structure of interest rates possible: in this sense the traditional analysis is sound as ever.

V

Because it is always held at or very close to 8 per cent, the cash ratio goes virtually ignored in most current discussions of the banking position. The liquid assets ratio appears now to be regarded not as the secondary but as the primary liquidity ratio; it is by forcing this ratio down towards the critical 30 per cent figure that the authorities have lately forced the banks to reduce their total of investments and advances. The next stage of our analysis must therefore reveal what circumstances tend to raise or depress the volume of liquid assets held by the banks; since the banks can always turn bills or call money into cash on their own initiative, it is the total of bills and call money that we have to regard as the crucial factor. (The distribution of the total between bills and call money is irrelevant for our purposes: call money simply represents bills held at one remove).

If the liquid assets of the banks are to be reduced, there must be:

1. Either (a) absorption of Treasury bills and/or short bonds by the public, in replacement either of matured bills formerly held by the banks, or of bills or bonds held by the discount market;
   or (b) use by the authorities of receipts from the public to pay off Treasury bills and/or short bonds.

Each of these courses involves reduction of bank deposits and the banks' liquid assets to equal absolute amounts, implying a reduction of the ratio liquid-assets/bank-deposits.

To induce (1) — the absorption of short government paper by the public — the authorities can force up the market rate of discount on Treasury bills and the yields on short bonds, by forcing the market into the Bank more frequently or by other hints to the market. The relationship of these short interest rates to the bankers' deposit rate is the relevant factor here. Until 1954 the deposit rate was little below the other short rates, and shifts from time deposits to bills and bonds were unimportant; since 1954 the bill and bond rates have been seriously competitive with the deposit rate for temporarily idle funds of large corporations. This mechanism hinges, should be borne in mind, upon the bankers' current agreement upon a single deposit rate that is, for good reason, substantially below Bank Rate (27).

For method (2) above — net redemption of Treasury bills and/or short bonds by the authorities — the authorities must in some way obtain disposal of deposits owned by the public. They can achieve this by running a surplus on current account (taxation exceeding government expenditure), or by depleting gold or foreign exchange reserve, or by selling long bonds to the public. The first

and second of these normally occur as the result of other government policies — current policies on taxation and expenditure, and the exchange rate — decisions on which will normally be taken without regard to short-run effects upon the money market. The third course — the funding of National Debt — can also be followed for reasons independent of short-run money market effects, but in the inflationary world in which we live the tendency is to fund debt primarily for the purpose of reducing the liquidity of the economy.

When deposits are in any of these ways put into the hands of the authorities, the banks find their total of liquid assets depleted by the same amount as their total deposit liabilities are reduced. Initially this fall in liquid assets occurs through a transfer from « Bankers' Deposits » to « Public Deposits » (i.e. government balances) at the Bank of England; but banks immediately redistribute the extraordinary scarcity of cash by operations in the discount market, whereby the banks restore their 8 per cent cash ratio. They do so, however, at the expense of their proportions of bills and call-money: the fall in the total of liquid assets of the banks remains equal in absolute amount to the fall in their deposit liabilities to the public. The liquid-assets ratio is thus reduced.

When, by the operation of any of these factors, the banks find their liquid-assets ratio reduced to a level regarded as uncomfortably low, having regard to the season of the year, they have to take steps to reassert the position by reducing their investments and/or their advances. These operations themselves reduce the volume of deposits. The upshot of the efforts by the authorities is therefore a multiple reduction of deposits: the reduction which occurs as the authorities absorb deposits in exchange for taxation liabilities, foreign exchange, or bonds, and the secondary reduction due to the banks' reactions to the decline in their liquid-assets ratio. If at the outset the ratio was already at 30 per cent, and the banks re-establish that ratio, the total fall of deposits (assuming certain minor (repercussions) equal tenth-thirds of the initial government surplus, depletion of exchange reserves, or sale of bonds to the public.

To summarise, we may list the factors most directly relevant to the determination of the volume of bank deposits:

1. The level of prices and the volume of business activity.
2. The public's inclination to hold cash.
3. The public's inclination to use bank advances.
4. The banks' willingness to make advances (in the sense of the standards they require of borrowers).
5. The banks' willingness to hold bonds.
6. The banks' ideas about the proper ratio of liquid assets to deposits.
7. The banks' ideas about their cash ration.
8. The public's willingness to hold bills and bonds.
10. The government's foreign-exchange policy and the resultant changes in exchange reserves.
11. The inclination of the authorities to fund or unfund debt (strictly, to lengthen or shorten the average life of outstanding dated securities).
12. The authorities' willingness to create cash, and the price at which they make the marginal requirements of cash available.

Of these factors, 9, 10, 11 and 12 are all matters of direct decision by the authorities, though 9 and 10 normally, and 11 sometimes, are settled by reference to circumstances other than effects upon the monetary situation. It is within the power of the authorities to act directly on 4, as they have done ever since the war, and especially in 1955-56; it is also within their power to act directly on 5, as they did in 1951 and 1952. They can also decide 7, as they have done since 1945, and 6, as they are understood to do in 1955-56.

This leaves 1, 2, 3 and 8 as the factors upon which the authorities cannot operate directly; but all these, and sometimes 5 and even 4 as well, are subject to influence by the structure of interest rates, which the au-
The French "Money Market"

1. Definition of the "Money Market" ("marché monétaire" and "marché hors banque").

The chief function of the so-called "money market" in France is to enable the banks to cover their cash requirements or to employ their excess liquid resources by buying Government securities or commercial bills from other banks or lending to other banks against such securities.

The expression "money market" (le marché monétaire) is relatively new, although for a long time past the banks have dealt in short-term money with each other. Before the international banking operations were initiated in the establishment of a "marché hors banque", which meant the inter-bank market outside the Bank of France. Terrel and Lejeune, whose "Traité des opérations commerciales de banques" was the first work on the only French book on banking matters on the subject, define the "marché hors banque" as follows: "the banks have come to offset between themselves the surpluses of the supply over the demands for money reaching them, or in other words the surplus of their resources over their lendings. Since their commercial bill holding, being rediscountable, is the easiest of their assets to mobilise and to transfer, is their commercial bills which they use for the purpose of such offsetting. The "marché hors banque" or private market is given to the whole of such business taking place outside the Bank of France".

This definition of the "marché hors banque" would apply quite closely to the present "marché monétaire" as regards the object in view, namely the offsetting between banks of the supply and demand for money.

2. Establishment of the Money Market.

Up till 1926 the "marché hors banque" worked on the same lines as before 1914. The business done took the form of discounting bank acceptances and prime commercial bills; the bills discounted had to be first-class signatures, to be of not less than a certain

(1) Courcelle-Seneuil's book, "Les opérations de banque" had been published in 1895 and was beginning to be out of date, despite successive revisions by André Inness.

The difference comes in the means used, those being much more varied for the present "marché monétaire" or money market than for the former "marché hors banque". There is a further difference inasmuch as the "marché hors banque" used to have a rate known as the rate "hors banque", or private rate (2), which was lower than the discount rate of the Bank of France. Since liberation on the other hand the rates in the money market have nearly always been higher than the official discount rate (2).

The change in the market's name took place between 1928 and 1939. It was due to a number of reasons. In the first place the "marché hors banque" had changed its character, having grown in size while fresh types of business were being done in it. In addition the authorities responsible for monetary policy wanted to set up in Paris a wide market for short-term money, not merely French but also international; and for this purpose the name "money market" was more suitable than the old "marché hors banque".

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The change in the market's name took place between 1928 and 1939. It was due to a number of reasons. In the first place the "marché hors banque" had changed its character, having grown in size while fresh types of business were being done in it. In addition the authorities responsible for monetary policy wanted to set up in Paris a wide market for short-term money, not merely French but also international; and for this purpose the name "money market" was more suitable than the old "marché hors banque".

2. Establishment of the Money Market.

Up till 1926 the "marché hors banque" worked on the same lines as before 1914. The business done took the form of discounting bank acceptances and prime commercial bills; the bills discounted had to be first-class signatures, to be of not less than a certain