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Chapter 1

Lombard Street in 1913

Bank of England

The dominant institution in Lombard Street in 1913 was, of course, the Bank of England. Many writers have pointed to the curious nature of England's Central Bank. A private corporation, organized in 1694 for purposes of war finance, it was subject to virtually no legal controls except that a limit was imposed on its note circulation, and it was debarred from engaging in merchandising operations;[1] yet this private corporation controlled the credit policy of the nation—one could almost say of the world. It had a monopoly of the note issue in England and Wales, and Bank of England notes comprised nearly two-thirds of the note circulation of the entire United Kingdom. Notes of and deposits with the Bank constituted the basic reserves of the joint stock banks and the private banks. The discount houses, bill brokers, merchant bankers, some insurance companies and stock brokers, and many foreign banks kept deposits with the Bank of England.

Nominally, the operations of this powerful institution were controlled by a Court, comprising a governor, a deputy governor, and 24 directors. The shareholders elected the directors, and the latter elected the governor and deputy governor. In practice, new directors were recommended by the Court itself and approved by the shareholders, and the Court consulted the Treasury on matters of national policy. Indeed, the Issue Department was a *de facto* government department; its liabilities consisted solely of notes issued, and its assets of gold, funded government debt, and other securities (Table 1). The fiduciary issue against government debt was fixed by law; issues against other securities were permitted only as a consequence of the replacement of the notes of other banks by the notes of the Bank under the Act of 1844. Otherwise, notes had to be backed one hundred percent by gold.[2]

The nature of the operations of the Banking Department is indicated in Table 1. On the liabilities side, the "proprietors' capital" represented the original capital of the Bank (£1.2 million) and additions per-

[1] See *Report of the Committee on Finance and Industry* (henceforth called the "Macmillan Report") Cmd. 3897 (London, 1931) p. 25.

[2] The Bank had the right to constitute a fourth of its metallic reserve in silver. Since silver coins were not full legal tender, this provision was not effective.

Table 1—BANK OF ENGLAND RETURN, SELECTED DATES[a]
(in millions)

	December 31, 1913	July 29, 1914	November 27, 1918
		Issue Department	
Liabilities			
Notes issued	£52.32	£55.12	£93.71
Assets			
Government securities	11.02	11.02	11.02
Other securities	7.43	7.43	7.43
Gold coin and bullion	33.87	36.67	75.26
	52.32	55.12	93.71
		Banking Department	
Liabilities			
Proprietors' capital	14.55	14.55	14.55
Rest	3.25	3.49	3.19
Public deposits[b]	10.26	12.71	30.43
Other deposits	61.09	54.42	143.75
Seven-day and other bills	0.01	0.01	0.01
	89.16	85.19	191.93
Assets			
Government securities	13.20	11.01	62.63
Other securities	52.14	47.31	100.99
Notes	22.72	25.42	27.72
Gold and silver coinage	1.11	1.46	0.59
	89.16	85.19	191.93

[a] From *The Economist*, January 3, 1914, p. 33; August 1, 1914, p. 249; November 30, 1918, p. 753. In some cases totals do not agree with the sums of the items because of rounding.

[b] Include Exchequer, Savings Banks, Commissioner of National Debt, and Dividend Accounts.

mitted by subsequent legislation up to 1844. The "rest" was really undistributed profits and reserves. "Public deposits" constituted the accounts of the British government. "Other deposits," the largest item on the liability side, consisted mainly of deposits of joint stock and private banks, but also, in part, of deposits of merchant banks, discount houses, foreign banks, Indian and colonial governments, and a few large commercial and financial concerns. The "seven-day and other bills," which were promises to pay on seven-days' notice, were introduced in 1738, to provide a means of payment by mail safer than notes, and to give the owners time to notify the Bank in case of a highway robbery of the mails.[3] On the asset side, "government securities" consisted of long- and intermediate-term obligations of the British government, and British Treasury bills purchased for the Bank's own

[3] The bills were originally for three days, but this proved to be insufficient time for making notifications. Cf. W. M. Acres, *The Bank of England from Within* (London, 1931) pp. 158-59, and Sir John Clapham, *The Bank of England* (New York, 1945) Vol. I, p. 144.

account. The "other securities" were commercial bills and Treasury bills discounted for customers, advances to bill brokers and other customers of the Bank, foreign and colonial government securities, and commercial bills purchased for the Bank's own account. The "notes" consisted of currency issued by the Issue Department but not yet in circulation. The "gold and silver coinage" was in fact mostly silver.

The chief instrument of central bank control was the rediscount or Bank rate. Short-term interest rates were, for the most part, directly related to the Bank rate: the rate paid by commercial banks on their deposits was usually 1½ to 2 percent under the Bank rate; the rate paid by discount houses on their deposits was usually ¼ percent higher than that paid by commercial banks; the rate on advances from the clearing houses to the discount market was usually 1 percent under the Bank rate; the rate on prime bills was accordingly slightly higher than the clearing house rate on advances; the rate on ordinary commercial loans was the Bank rate plus a variable amount. Thus a change in the rediscount rate would alter the entire complex of short-term money rates in the same direction. In addition, the Bank utilized "open market policy" (purchase or sale of securities and bills) to increase or decrease the basic reserves of the financial system. Moreover, the British financiers had what R. J. Truptil has called "a remarkable sense of discipline," and "hints" received from the Bank were "followed by the market."[4]

Before World War I, England was the guardian of the gold standard, and the Bank was the institution primarily concerned with its control. An outflow of gold from the Bank in response to an unfavorable balance of payments was the signal for a rise in the Bank rate, designed to attract foreign funds, and perhaps also to reduce British export prices through monetary contraction and so to reverse the gold flow. For this reason, the "ratio" of the Bank of England—the ratio of gold and silver coin and notes to deposits—was anxiously watched by the British money market and the entire financial world.

Joint Stock Banks

Next in importance among British financial institutions on the eve of World War I were the joint stock banks. After the crisis of 1825 and the accompanying large-scale failures of "private banks" (banks with no more than six partners, each carrying unlimited liability), the commercial banking business of the United Kingdom was gradually taken over by the large banking corporations, or joint stock banks. In

[4] R. J. Truptil, *British Banks and the London Money Market* (London, 1936) pp. 212-17. See also Macmillan Report, *op. cit.,* pp. 32-33, 92-106, and 155.

1913, only a few private banks remained, and the dozen or so joint stock banks that were members of the London Clearing House dominated the field. These banks had no legal reserve requirements, but in practice they retained reserves of currency and balances with the Bank of England equivalent to 9 to 11 percent of their deposits.[5] It is generally presumed that the hidden assets of the larger banks were nearly as great as their published capital and reserves.[6]

Money at call amounted to almost as much as cash reserves. The investments of the joint stock banks were government securities, mostly Treasury bonds of intermediate and short maturity, and constituted some 10-15 percent of total assets. Bills discounted included both Treasury and commercial bills, with the latter predominating. The chief asset, reflecting the character of the major business done by the banks, consisted of advances or commercial loans, and amounted to roughly half of total assets; they were made mainly to industrial and commercial firms, for three to six months. Deposits were by far the largest liability of the joint stock banks.[7]

Discount Market

Truptil attributed the "pleasing harmony in the 'City'" and the "absence of sudden jars in the delicate machinery of the monetary markets" largely to "the unique institution of discount houses."[8] The discount market consisted of discount houses and bill brokers specializing in the purchase of Treasury and commercial bills on their own account, using their own capital and the deposits of clients to some extent, but relying mainly on day-to-day loans from the joint stock banks with the bills as security. About half the market's capital resources was held by the three largest discount houses (Alexanders, National, and Union), which were organized as public companies and which published regularly complete balance sheets. In addition, there were in 1913 four private limited companies, ten private companies with unlimited liability, and a few "running brokers" who served as intermediaries between commercial houses and banks wishing to invest

[5] The published statements show a reserve ratio averaging close to the upper limit of this range, but these statements involve a certain amount of "window dressing" —that is, temporary withdrawal of cash from the money market for the day for which the weekly statement is published. The banks publish statements on different days of the week. Consequently, the actual average reserves of the clearing banks, as a whole, differ from those shown in the published statements. See R. J. Truptil, *op. cit.,* pp. 93-94, and Macmillan Report, *op. cit.,* p. 36, paragraph 79, and pp. 156-57. See also "End of Window Dressing," Chapter VI below.

[6] Truptil, *op. cit.,* p. 86.

[7] Selected balance sheet items for joint stock banks are given in Appendix Table B.

[8] Truptil, *op. cit.,* p. 192. See also Macmillan Report, *op. cit.,* p. 161.

in bills and willing to pay a small commission for the special knowledge of the brokers as to the reliability of various firms whose names appeared as acceptors and endorsers.

Loans and deposits were the main liabilities of the three principal discount houses, and bills discounted were the main asset. Most of the bills, however, were Treasury bills or prime commercial bills, readily discountable at the Bank of England. Cash reserves and investments—the latter comprising high-grade securities of British and foreign governments, of short or intermediate maturity—amounted to only a small percentage of total assets.[9]

The discount market provided the London banker with an ever-present outlet for surplus liquid funds, permitting him to earn a small return on them and still to be in a position to recall them whenever needed. It also provided expert knowledge of the relative safety and liquidity of the commercial bills offered in the market; the business of the discount bankers and bill brokers was to know everything possible about the firms whose paper they handled. The discount market thus permitted a day-by-day—indeed, hour-by-hour—adjustment of the supply of short-term money to the demand for it, with a speed and precision matched by no other money market. The discount houses were important also as a buffer between the joint stock banks and the Bank of England. Unlike commercial banks in most countries, the joint stock banks in England did not go to the central bank when they wished to improve their cash position; instead, they called in loans made to the discount market and so compelled the discount houses to go to the Bank of England for whatever rediscounting was necessary.

Merchant Banks

The merchant banks, or acceptance houses, were firms originally engaged in trade, and especially foreign trade. Most of them were established early in the nineteenth century by continental merchants. Their banking function consisted mainly of accepting foreign trade bills, and thus making them discountable at the banks. In addition, some of the larger houses made loans to foreign governments and firms. By 1913, most of them had abandoned merchandising and had evolved into bankers specializing in international finance; they were accepting deposits, making loans, floating and underwriting new capital issues, and investing in securities.[10] The majority of the houses were organized as partnerships, with unlimited liability for each partner.

[9] Balance sheet statements of discount houses are given in Appendix Table D.
[10] Balance sheet statement for Baring Brothers, 1913, is given in Appendix Table E.

The merchant bankers were by no means restricted to financing British trade with the rest of the world. Through their acceptance functions, they financed much of the trade between countries far from English shores. Indeed, so common was this kind of transaction that the pound sterling was, for all practical purposes, the international medium of payment.

Capital Market

As ordinarily used, the term "Lombard Street" refers only to the institutions in the City of London providing short- and intermediate-term credit. In fact, however, a hard and fast line cannot be drawn between the short- and long-term money markets. The merchant banks —surely as indigenous to Lombard Street as any institution—engaged in long-term foreign lending before World War I. Moreover, the joint stock banks provided long-term capital indirectly, since the facilities they offered enabled their clients to economize in the amount of long-term capital which they employed. Therefore, although this study is concerned primarily with the market for short-term funds, the long-term capital market cannot be ignored altogether.

Certain institutions in the capital market, in 1913 as well as today, were quite distinct from those already discussed. The most obvious were the stock exchange and the stockbrokers. In addition, there were syndicates formed occasionally for the flotation of a particular new issue. Conspicuously absent from the London capital market were large industrial banks of the Continental type, or investment banking houses of the American type.

Actually, much of the long-term financing of British industry was provided directly by private individuals and nonfinancial concerns. A large proportion of British industry consisted of private companies and partnerships. Such concerns were unable to borrow from the general public, and relied chiefly on family savings or on the accumulation of their own profits. If they borrowed long-term funds at all, they went directly to the lender and not to the organized capital market. Loans from friends and acquaintances, safeguarded only by common-law contracts, were the chief sources of outside long-term capital for domestic enterprise. Prior to World War I, new issues in the capital market were primarily for overseas borrowers, with railways the largest single category of such borrowers; domestic issues amounted to about 20 percent of the total floated on the London market, even when issues of central and local government authorities are included.

The financial institutions of Lombard Street in 1913 formed a complicated, delicate, but highly efficient machine, and this machine was without rival in its scale of operations. International trade and finance centered in London. The activities of the City were based to a large extent on trade between countries producing manufactured goods (such as Great Britain) and countries producing raw materials and foodstuffs (such as countries of the British Empire). Britain's foreign lending went a long way toward financing her own exports and developing raw materials markets. So widely accepted was sterling as an international means of payment that Lombard Street financed much of the trade between non-British countries as well.

W. A. Brown has presented a convincing case for the contention that the period of British pre-eminence in international trade and finance coincided with the period of successful operation of the international gold standard; and that the international gold standard was successful chiefly because it was in fact a "sterling exchange standard system."[11] This system provided an efficient distribution of credit and gold, a common medium of payment (sterling), and an international clearing house and foreign exchange market, all organized and operated through London. London was the center for distributing newly mined gold, and world markets were bound together by movements of gold and capital through London.

Even before World War I, there were signs that this sterling exchange standard system was beginning to break down. The industrial basis of Britain's international trade position was dangerously narrow. Over half her exports consisted of textiles and iron and steel, but the development of efficient industries for manufacturing these products in other countries, notably the United States, Germany, and Japan, was threatening Britain's superiority in these fields. Her share in world trade was declining, and the deterioration of Britain's terms of trade, which was to be an important factor in Britain's international problems at a later date, was already making its appearance. The positions of New York, Paris, and Berlin as financial centers, while still subsidiary to London's, were nevertheless assuming greater importance. World War I accelerated these basic trends, and disrupted both national and international trade and finance in a manner that left a permanent imprint on Lombard Street.

[11] William Adams Brown, Jr., *The International Gold Standard Reinterpreted, 1914-1934* (National Bureau of Economic Research, 1940) Vol. I, p. xiii. The discussion in this section is based primarily on Professor Brown's study.