Short of cash

The Northern Rock affair tested to destruction the proposition that it is a bank's solvency that matters, not its liquidity, says **Tim Congdon**

Bank runs are of two kinds. In the first a loss of confidence in the banking system as a whole causes banks' customers to convert deposits into legal-tender notes. (Legal-tender notes are, by law, worth 100p in the pound; deposits may not be worth 100p in the pound if too many bank loans go bad.)

The second type of run is more limited and arises when the loss of confidence in only one bank results in customers' transferring money from the stigmatised bank to other banks deemed to be safe and sound.

The Northern Rock crisis in September 2007 was of the second kind. Northern Rock's depositors did take their cash out of Northern Rock, but immediately they put it back into other institutions' accounts. The British public remained relaxed about the safety of deposits in UK banks other than Northern Rock, which amounts to 97 per cent of the system.

But the question has to be asked: "What would have happened if the run had been of the first kind?", with the public becoming anxious that a large number of banks might not be able to repay deposits at par.

The question is not entirely hypothetical, as other advanced industrial societies – such as Japan and Sweden – have had to worry about system-wide bank insolvency for extended periods within the last 20 years.

The truth may at first seem alarming, and it is this: that in a meaningful, far from silly sense Britain's banks are in fact *bust*. In the UK at present banks' sight deposits approach £800bn ($1,600bn) whereas their holdings of vault cash are under £7bn. Sight deposits, i.e. deposits that can be converted immediately into cash, are therefore over 100 times larger than the cash in the banks' tills and vaults.

Admittedly that is not the full story. Banks also maintain non-interest-bearing "cash reserve deposits" and further cash in interest-bearing reserve balances at the Bank of England. These can, in principle, be converted into notes in short order.

However, it is a safe conjecture that, if the public's confidence in UK banks were totally shattered, the commercial banks and the Bank would not have the technical ability immediately to repay the sight deposits with cash. At the crudest level, if members of the public decided to take out, say, £200bn of sight deposits within two days, the Bank of England could not manufacture £200bn of bank notes in such a short period of time. Quite simply, its printing presses could not perform the task.

> In the event of a major run on the banking system it would not be possible for the Bank to print enough notes

Last August, the Treasury published paper, entitled *The Cash Ratio Deposits Scheme: a Consultative Document*, which might seem to be concerned with the subject under discussion.

However, the paper said the scheme's objectives were "funding the Bank of England's policy function". (Under the cash ratio, or CRD, scheme, the non-interest-bearing deposits that the banks leave at the Bank are reinvested in interest-bearing securities, which generate the profit that covers the bulk of the Bank's costs.) The authors of the consultative document appeared not to have the first notion of the relevance of commercial banks' cash reserve at the central bank to meeting deposit withdrawals or, indeed, to their importance in settling inter-bank business.

Does any of this matter? Sophisticates might say that, no, the regulators can ignore it, because as long as the commercial banks are solvent, the central bank can lend to them without limit against the collateral of their high-quality assets. There is no risk that depositors will – eventually, when the notes have been printed – fail to get their cash back. The underlying philosophy, in a nutshell, is that banks' solvency matters, but their liquidity does not.

That proposition was to be tested in the Northern Rock affair in autumn 2007. As far as Northern Rock's shareholders were concerned (myself included), it was to be tested to destruction. When push came to shove, the Bank refused to accept mortgage-related paper, and certainly not a portfolio of mortgage loans, as collateral for conventional loan facilities. The size of banks' holdings of cash and near-cash, and of securities supposedly easy to sell in the capital markets, suddenly became of vital concern to management.

One powerful conclusion emerges, and it is this – that in the event of a general collapse of confidence in British banks and a consequent major run on the banking system as a whole, it would not – repeat, not – be possible for the Bank to print sufficient notes to satisfy the public's conversion of deposits into notes.

A government guarantee on all deposits would be essential, as with Northern Rock, to check the run. Would that then justify the nationalisation of the entire banking system, even if banks were in fact solvent and profitable, and the run were entirely without foundation?

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