The BANKS . . .
and The DEPRESSION

A large part of the case for nationalisation of the banks presented by the Prime Minister in his Second Reading Speech on the 1947 Banking Bill is based on the alleged sins of the trading banks in the past, and particularly on the supposedly infamous part they played in the dark tragedy of the Great Depression of 1929-32.

The Prime Minister said: ". . . it is correct to say that the banks fed the boom and promoted unsound development in the twenties. When the depression came, the banks as a whole restricted new lending and called in advances. Between December, 1929, and March, 1932, their advances fell by approximately £45,000,000. The effect of this was to accentuate the contraction of business and the unemployment of those years. They helped but little in recovery during the thirties, waiting rather for improvement to come from other sources instead of taking the initiative and helping to promote recovery. They followed these courses because it seemed best and safest from the standpoint of their own interests."

THE idea that the banks were specially responsible for the misfortunes and sufferings of Australia in the depression has gained a strong hold on the minds of the people. For this there are two reasons. Suffering humanity must have its scapegoat, and it is natural enough that the banks, occupying a position of peculiar prominence, should have been singled out for this dubious distinction. The lender of money, even though he may at times stretch fairness to the point of foolishness, is seldom popular. There is much more than a vestige of truth in the old adage that to lend money is to destroy friendship.

The second reason is that the opponents of the banks have, by ceaseless and largely false propaganda, endeavoured to create—and to some extent have succeeded in creating—in the minds of the public, a picture of the banks as merciless institutions pursuing their own selfish purposes with a total disregard of the interests of the community and indeed of those of their own individual clients. The Prime Minister does not keep company with the most extreme of these propagandists. But he does, as a politician, play upon the fears and distrusts which their false witness has aroused.

Responsibility for the Depression

To refute the Prime Minister's charges it is not necessary—and indeed it would be stupid—to go to the other extreme, to claim that the banks made no mistakes in the depression, that in every single instance they treated their clients with noble generosity, that their actions were exclusively inspired by the motive of the public good, or that as institutions they were models of intelligence and vision. But it can be fairly affirmed that in these respects they were definitely no worse, and perhaps a good deal better, than other institutions and other people who have escaped all blame for the consequences of the depression in Australia. The banks—including the Commonwealth Bank — are merely organisations composed of highly skilled but nevertheless fallible human beings, and in their conduct they reflect the intellectual shortcomings and moral failings of other human institutions. To ask that they should have revealed in the depression, understanding, foresight and a sense of public duty far superior to the rest of the community is to ask a great deal. If the banks are to be judged by how they measure up to some impossible ideal of human conduct, then they, **along with all other people and organisations concerned with the events of those times, must stand condemned. For the truth of the matter is this—and it is a truth that needs to be thoroughly grasped—the responsibility for the depression, or more precisely for the extent of the depression in Australia, must be shared by all the major institutions, governmental, political, industrial and financial, and in a sense by the community itself.**

History of the Depression.

No one who conscientiously examines the economic and political history of the depression can do other than conclude that the banks are completely guiltless of all the wilder accusations that have been levelled against them. Some of these are repeated in a mild form in the Prime Minister's speech—namely, that they contracted advances and thereby aggravated unemployment; that they stood for a policy of monetary deflation; and that their attitude in opposing the policy of the Labour Government was inspired by reactionary motives and was contrary to the welfare of the Australian people.

The Inflationist School.

Broadly speaking, there were two divergent schools of thought on the manner in which Australia could best cope with the depression and set itself on the high road to recovery. One school—"the inflationist school"— led by the Federal Treasurer, Mr. E. G. Theodore, represented the official viewpoint of the Federal Labour Government at that time. This school proposed a policy of very substantial expansion of credit for use by industry and governments in productive enterprises to restore employment. This policy included a proposal for a fiduciary issue of £18,000,000 of notes which were to be used to aid wheat growers and to finance public works and absorb unemployed workers. This policy came at a time when advances from the banking system to cover recurring government deficits had been carried to the point of danger, and when governments had made no really adequate efforts to balance their budgets by economies in expenditure.

The Premiers' Plan.

The other school of thought, led by the Commonwealth Bank and leading Australian economists, and supported by the trading banks, took the stand that the first step in recovery was to restore business and public confidence by governments giving clear evidence that they would make a serious attempt to balance their budgets by reducing expenditure. It was pointed out that the government's policy did not command that confidence and that this was proved by its inability to obtain finance either on the Australian or overseas money markets. The economies proposed included large cuts in wages and salaries and in expenditure on social services. This policy supported controlled expansion of credit and bank assistance to governments in meeting their deficits, **provided a real effort was made to achieve budgetary stability.** It also envisaged reduced rates of interest, that financial institutions should refrain from exerting pressure on debtors, particularly primary producers, and that credits should be made available to sustain export production. It has been aptly described as a judicious mixture of inflation and deflation.

It should be repeated that this was the policy supported by practically all Australian economists with any claim to a national reputation at that time, and by the Commonwealth Bank. In essence it comprised the policy eventually adopted by Australian governments in the renowned Premiers' Plan which was concluded by agreement between the Commonwealth and State Governments in May, 1931. The Plan had the backing of the trading banks. On the successful completion of the Plan and after discussions

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with the Prime Minister, Mr. Scullin, the banks reduced interest rates on deposits in August, 1931, and on advances in October, 1931. In an announcement in August, 1932, the Chairman of the Associated Banks stated that "The banks are in sympathy with the general objects of the Premiers' Plan and a further reduction in lending rates . . . may be expected in the near future."

Depreciation of the Exchange.

The Premiers' Plan advised against a premature return to exchange parity with sterling. But the depreciation of the Australian £1 which existed when the Plan was drafted, was the result of action taken by a private bank—the Bank of N.S.W.—in January, 1931, in the teeth of great opposition.

Tribute by Lord Keynes.

There is no doubt — and this has been generally acknowledged by economic experts—that the Premiers' Plan made an important contribution to Australian recovery from the depression. **In 1933, no less an authority than the late Lord Keynes paid it an outstanding tribute, "I am sure the Premiers' Plan last year saved the economic structure of Australia."**

Whether the Premiers' Plan was right or wrong (whether, for instance, the mixture contained rather too much deflation and rather too little inflation) judged in the light of present-day economic thought and standards of financial and monetary technique is largely beside the point. It is quite obvious that what was done in 1931 would fail in some respects to satisfy the canons of thought and the greater knowledge of 1947. But, after all, no one today criticises the medical practitioner for not prescribing sulphanilimide for the treatment of pneumonia in 1930. The significant point is that the economic prescription applied to the Australian case in 1931 was generally regarded by orthodox economists as the best possible treatment at that time for that particular patient. Many, probably all, of the economists who took a part in the production of the Premiers' Plan, would think somewhat differently today. But the banks can hardly be blamed because they were no further advanced than the experts.

The Theodore Plan Politically Impracticable.

In any event, whatever the merits or demerits of the Premiers' Plan from the strictly economic standpoint, **the alternative proposed by Mr. Theodore was an utterly unreal and impracticable programme in 1931.** It commanded no support or confidence among the business community or indeed among the general public. This is clearly shown by the electoral downfall of the Labour Party in Tasmania in May, 1931, its defeat in a Legislative Council election in Victoria a few days later, and by the overwhelming Labour debacle in the Federal elections at the end of that year. Professor D. B. Copland, who is the chief economic historian of those eventful days, was led to comment ". . . the fear of inflation was politically an insurmountable bar to the pursuit of unsound currency measures." In their stand against the financial policy of the Labour Government, the stand which the Prime Minister now condemns, the banks were therefore in good company. Their attitude was completely in accord with orthodox economic thought, and indeed, with general public opinion.

Labour Party Split.

Moreover, the Labour Party itself was split apart on the Theodore Plan. In April, 1931, at a meeting of the Loan Council, a majority of State Treasurers passed certain resolutions, which were in effect opposed to the financial plan of the Commonwealth. This majority included the Labour Treasurers of Victoria and South Australia. Under these resolutions a subcommittee, **including a majority of Labour members,** was appointed to survey the position with regard to budget economies. **The Committee recommended immediate and substantial reductions in government expenditure as a first step in financial rehabiliation and in restoring employment.**

The Prime Minister, Mr. Chifley, in his speech asserted that the banks, including the Commonwealth Bank, attempted to force upon the Government a policy of monetary deflation with curtailment of wages and social service payments. But he omits to mention that Federal Labour opinion was by no means united on the Government's inflationary proposals, nor that these proposals were opposed by political labour in the States. The principle upon which the Commonwealth Bank was prepared to co-operate with the Government—set out in the letter of Sir Robert Gibson quoted by the Prime Minister—was in effect endorsed by the sub-committee of the Loan Council, consisting of a Labour majority, and by leading Australian economists only a few months later. The suggestion of the Prime Minister (in the subsequent sentence of his speech) that the Commonwealth Bank was used by reactionary interests to oppose the Government's policy is utterly inconsistent with the facts. **The truth is that the Government's policy was opposed, not alone by the banks or so-called reactionary interests, but by expert opinion, by the business community, by the general public and even by Labour politicians. In this matter the public were on the side of the banks, not on that of the Government, and it was this fact which in the last analysis brought about the downfall of Mr. Theodore's plan.**

Advance Policy of the Trading Banks.

The advance policy of the trading banks in the depression has been the subject of much debate. The critics of the banks have consistently stated that the banks curtailed their lending in the early part of the depression and that this led to widespread business failures and to mounting unemployment.

Mr. Chifley in his speech repeated this charge. "When the depression came the banks as a whole restricted new lending and called in advances. Between December, 1929, and March, 1932, their advances fell by approximately £45,000,000."

Apart from the fact that the months and the period selected by the Prime Minister exaggerate the real reduction in advances made by the banks in the early years of the depression there are two things which should be said about this. First, the figure of £45,000,000 consists only of advances made to industry. It entirely omits the loans to governments which were being made by the trading banks at that time. Between the dates mentioned by the Prime Minister these loans had increased by £22,000,000.

In April, 1931, Professor Copland wrote: "It is admitted quite freely in all responsible quarters that funds must be provided to sustain the unemployed workers and primary producers during an acute depression. The banks have not refused to assist, indeed, some of them have been providing funds to governments at an almost alarming rate in recent months"; and in June, 1932: "In financing Government deficit or loan works the Commonwealth Bank and the trading banks are sustaining spending power, mitigating the severity of the depression and creating conditions in which the recovery of internal prices will ultimately promote a general economic recovery.

The second point is that the banks are by no means completely free agents in determining the amount of advances which they will extend to industry. In the first place they are limited in a depression in granting new loans by the difficulty of finding credit—worthy borrowers, and indeed, of finding borrowers at all in conditions where the prospects of profitable business have become exceedingly unfavourable. But more important, the banks are restricted in the amount of their lending by the volume of money deposited with them and by the need for retaining a certain proportion of their assets in liquid form to meet their obligations as they fall due. In both these respects—that is, in the ratio of their advances to deposits (even excluding advances to governments) and in the ratio of cash reserves to deposits—the position of the

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banks deteriorated seriously in the early part of the depression. For instance, the ratio of advances to deposits rose from an average of 80.6 per cent. for the period 1926-29 to an average of 90.8 per cent. for the period 1930-32. This was what forced the banks to exert a tighter control over their lending. As the Banking Commission pointed out, "The cash reserve ratio and the advance deposit ratio were both unsatisfactory and the problem for the banks was to restore liquidity. This was the main reason for the fall in advances and it inevitably involved a contraction of credits."

The Prime Minister and Professor Copland.

The mere story of the movement in the total advances of the banks is thus totally misleading and quite unfair to the banks. The picture of the banks advance policy during this period painted by Professor Copland contrasts markedly with that given in the Prime Minister's speech and is worth repeating at length.

> "In the depression of 1930 the advances (not including securities representing advances to governments) showed an increase from £A246.7m. at June 30, 1929, to £A260.2m. at June 30, 1930. Over the same period total deposits declined from £A284.5m. to £A265.9m. The ratio of advances to deposits rose from 86.7 per cent. to 97.8 per cent., whilst the cash reserves fell by almost £A20m. This indicates that the banks were making credits available to industries that had been adversely affected by the depression, especially primary producers. In fact, between 1927 and 1931, advances to agricultural and pastoral industries increased by about £A16m. Such a condition of affairs could not continue indefinitely without unduly increasing the proportion of non-liquid assets held by the banks, and therefore compromising the credit structure for which the banks are responsible.
>
> With the reduced cash ratio in 1930 (about 22 per cent., compared with a ration of over 30 per cent. on the average in the years 1926 to 1928) and much higher ratios of advances to deposits, a decline in advances in 1931 and 1932 was inevitable. Thus, on 30th June, 1931, advances had fallen to £238m. and at 30th June, 1932, to £227m."

Prime Duty of Banks is to maintain Public Confidence.

When the banks restrict their lending it is primarily for the purpose of protecting the interests of their depositors, who amount in all to over one million. The banks have indeed a cardinal obligation to maintain the confidence of their depositors and of the public in their ability to meet their liabilities. **The slightest suggestion that the banks were lending beyond their real capacity would spread through the community like a bush fire through dry grass on a north-wind day, could easily precipitate a collapse of general confidence in the solvency of the banks and bring about national economic chaos. A first duty of the banks to the community is to maintain public confidence in their solvency. In acting as they did in the first part of the depression the banks might possibly be criticised for treading perilously close to the financial abyss; they certainly could not be accused of playing for safety at the expense of the community.**

The Banks and the Boom.

There remains to be considered the Prime Minister's assertion that "the banks fed the boom and promoted unsound development in the twenties."

That there was a great deal of unsound development in the twenties is generally conceded by those who have studied the economic progress of Australia during this period. But where did this development take place? It took place first in manufacturing industry under the protection provided by a high tariff policy, which, in some cases, encouraged forced development of an inefficient kind. It took place in the field of public works under the direct control of governments who were borrowing at the rate of £40m. a year on the Australian and overseas money markets for this purpose. Finally, it took place in primary industry where uneconomic settlement was often encouraged by government-sponsored schemes of land settlement and by the assistance of financial institutions of which the trading banks comprised only a comparatively small proportion.* Moreover, as the Wheat Commission pointed out, the type of assistance provided by trading banks to farmers is not mainly for the development of new land but to assist farmers in well-developed areas or farmers who have passed through the developmental stage.

There is only one fair conclusion to draw from this—that for any uneconomic industrial development which took place in the twenties, the banks bear a comparatively minor responsibility, that on the contrary the main responsibility falls on Commonwealth and State Governments.

It should also be noted that there was no large increase in the total of bank advances from the end of 1926 till the beginning of 1929, although the liquid position of the banks was improving rapidly. In a time of great business buoyancy this does not indicate that the banks were feeding the subsequent boom in the manner suggested by the Prime Minister.

Insofar as the banks participated in the twenties in contributing to the subsequent boom, they did so in company with most other major financial institutions and with Australian governments. **To imply that the banks were solely, or even chiefly, responsible for the 1928-29 boom is utterly unfair and quite inconsistent with the facts.**

Finally, the banks in this period did not follow their usual practice of lending to the full extent of their liquid resources, although they could have done so without much difficulty. Professor Copland points out that in 1929 Australia was in possession of very substantial reserves of gold and London funds, and that these reserves enabled the financial position of Australia to be held against the first blasts of the depression while an acceptable recovery policy was in process of being evolved. These reserves were the result of the prudent policy pursued by the Commonwealth Bank and the trading banks. This was a positive and significant contribution by the banks to the alleviation of the consequences of the depression.

Expert Evidence Before the Banking Commission.

In the immense mass of evidence given before the Banking Commission by recognised economic experts, hardly one violent criticism of the depression policy of the banks of the kind repeatedly made by their critics, can be found. Some statements to the Commission by Professor E. R. Walker (who held the post of Deputy-Director of War Organisation of Industry during the war) give a fair reflection of the general views of the economists:

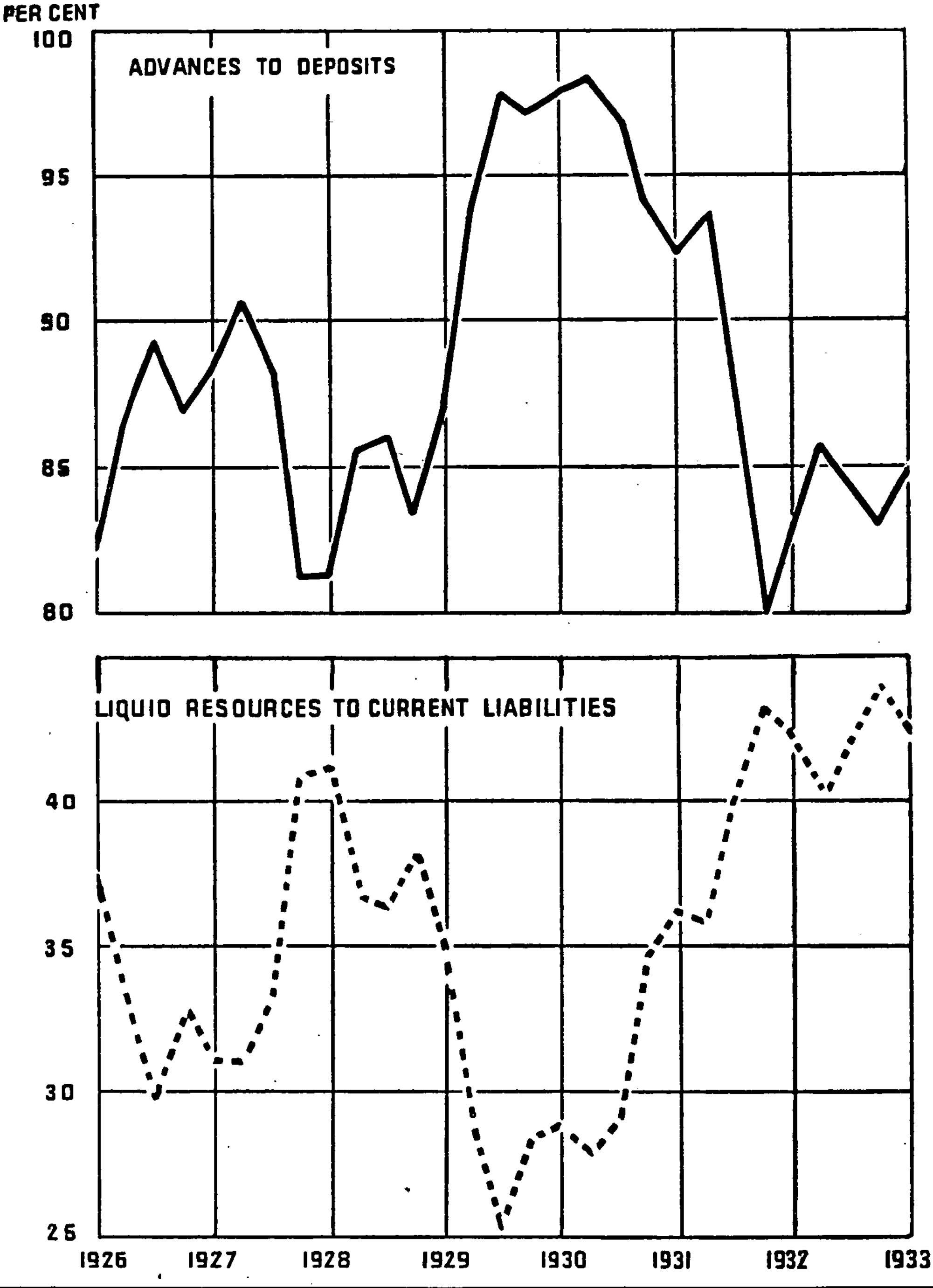
> "I do not suggest that the banks set to work to cause the depression, because it was not in their interests to to so. The loss of liquid assets was imposed upon them by the adverse movement of the balance of trade and that loss according to the usual practice of the banks, imposed upon them the necessity of reducing their advances. If they had not contracted credit, their ratio of liquid assets to banks deposits would have fallen dangerously low."

Professor Walker stated that the chief failure was the failure to act of the Central Bank and not a failure by the trading banks.

> "I am not suggesting that it did not have the general support of governments and a large part of the community in its failure to act . . . . As a lecturer in economics going about one hears a lot of scandal about the banks, but generally it is second-hand and of no scientific value."

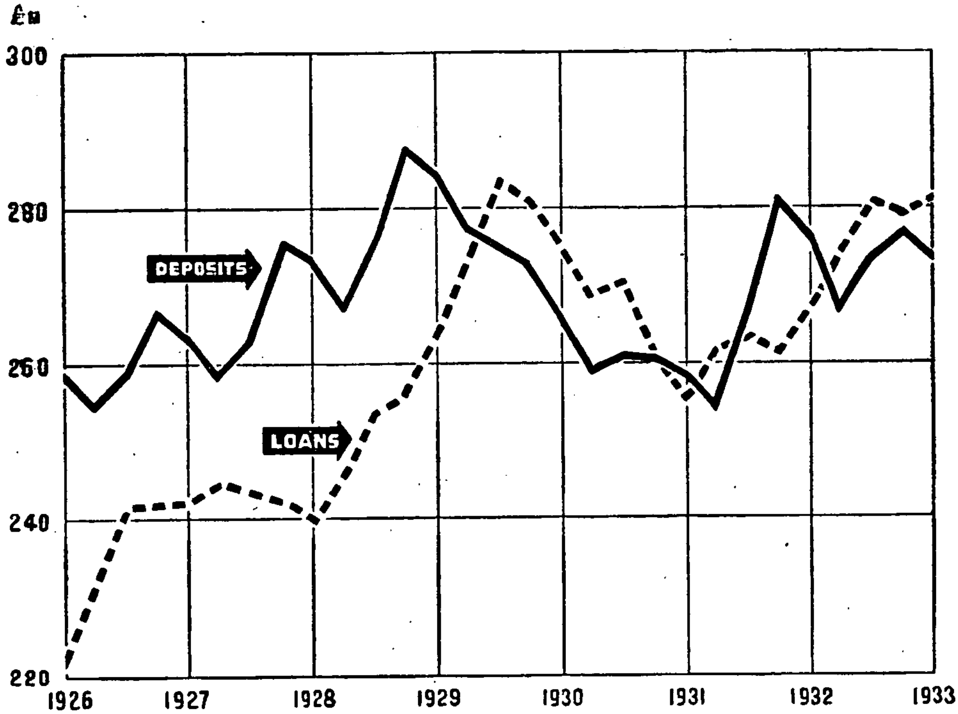
* For instance the report of the Wheat Commission disclosed that the advances of the trading banks to wheat growers comprised only 20% of the total debt of wheat growers, the remainder being covered by State banks and other government organisations, by trustee and finance companies, and by private mortgages.

AUSTRALIAN TRADING BANK RATIOS



Source: Tables prepared by the staff of the Institute of Public Affairs—Victoria from statistics published in the Banking Commission's Report (1937).

AUSTRALIAN TRADING BANKS: TOTAL LOANS AND TOTAL DEPOSITS



Source: Tables prepared by the staff of the Institute of Public Affairs—Victoria from statistics published in the Banking Commission's Report (1937).

INTERPRETATION OF GRAPHS

The three graphs serve to depict the financial position of the private trading banks between June, 1926, and June, 1933. Graphs Nos. 1 and 2 show the ratio of advances (excluding loans to governments) to total deposits and the ratio of liquid resources to current liabilities, and Graph No. 3 shows the rise and fall of total deposits and total loans over the period.

Total loans comprise advances to Australian borrowers, government and semi-governmental securities and treasury bills. Liquid resources include cash in Australia, deposits with the Commonwealth Bank, treasury bills and London Funds. Current liabilities are total deposits (fixed and current) and amounts due to other banks.

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From June, 1926, to June, 1928, may be regarded as a fairly normal period from the standpoint of the liquidity of the banks. Deposits fluctuate around £260m., the ratio of deposits to advances is maintained at 80 per cent. to 90 per cent., while the ratio of liquid resources to current liabilities is on average well over 30 per cent.

Towards the end of 1928 deposits and advances both show signs of an upward trend. Although deposits start to fall early in 1929, advances continue to expand rapidly in the latter half of the year. It is quite evident that some abnormal factor had interposed on the usual credit expansion necessary to this period. All the evidence indicates that this situation was brought about by a deterioration in the financial position of primary producers, through falling export price levels and unfavourable seasonal conditions and the consequent necessity for increased accommodation from the banks.

From Graph No. 3 it is apparent that the only time when the rate of advances could be called excessive was in 1929. In discussing banking policy during this period the Banking Commission stated that "during 1929 and especially in the latter half of the year the banks severely restricted new lending whilst endeavouring to assist old customers, especially primary producers." In their efforts to meet the emergency the trading banks allowed the ratio of advances to deposits to rise to 98 per cent. (Graph No. 1) and their liquid resources to fall to the dangerous level of 25 per cent. of current liabilities (Graph No. 2).

However, in 1930-31, the low level of London Funds, added to an alarming drift in governmental finances, with pronounced deficits in both Commonwealth and State budgets, threatened financial stability. In such circumstances the banks were obliged to consider the interests of depositors and take immediate steps to improve their liquid position. Advances were called in to avoid disaster. The position in 1930 and 1931 was one of dire emergency. Total deposits and total lending each fell about £30m. from their 1929 peak levels. The liquid position of the banks was restored and the ratio of advances to deposits reduced to a satisfactory figure. It should be noticed that at no time during the crisis did total lending fall below the 1928 level. Total deposits did fall considerably below their 1928 volume and, indeed, were still falling when lending had commenced to rise again. 1932-33 were considerably better years. Advances steadily increase, deposits show a rising though somewhat fluctuating trend, and safe ratios are constantly maintained.

The main conclusions to be drawn from these graphical studies are that the banks did not feed the boom in the manner of which they have been accused. Nor did they restrict lending in 1930-31 without substantial reason. The extraordinary rise in total lending in 1929 was due to the pressing financial exigencies of primary industry. Failure of governments and the Central Bank to relieve a serious financial position necessitated the curtailment of advances in 1930-31, in order to restore liquidity.

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NOTE: The remaining articles in the series dealing with four major changes in the Australian economy since 1938/9 have, for reasons of space, been held over for publication in later issues of "The Review." The first two articles in the series "Full Employment" and "The Redistribution of the National Product" appeared in the August and October numbers respectively. The other articles will discuss the increase in government expenditure and the development of government control and planning.