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## Bank Reserves and Depreciation

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Of our own group 72 had never paid, or had been last ex dividend previously to 1914, so that their difficulties had not arisen out of the war. Most of the financial, transport, and utility concerns date their passing of dividends back to this period. Of the remaining fifty which have suspended interest since the commencement of the war, the great majority—namely, forty-two—have belonged to the group of miscellaneous industrial and commercial businesses such as large shops, provisioning companies, hotels, and manufacturing firms. Of the Colonial suspensions, thirty-three occurred before 1914, as did also the two in India. Of those in the United States, the war could have affected only the six which happened in 1914–15. Among those of other foreign countries (upwards of sixty being South American or Mexican), fifty-nine, or just over half, occurred during the war period. Some of these were no doubt affected more by the disorders in Mexico than by the European war.

It is noticeable, however, that six of the ten suspensions by Colonial railways, nine out of twenty-one suspensions among Colonial land and finance companies, and nine out of twenty-three foreign land and finance companies, have happened during the war. That five out of the seven failures by foreign States to discharge their liabilities occurred during the same period, with which the internal troubles of Mexico coincided, is not surprising, since they are all Mexican or Central or South American.

The suspensions of dividend by miscellaneous commercial and industrial undertakings in the Colonies, the United States, and other foreign countries are few compared with those of the same description at home. This was to be expected, since but a small proportion of those existing outside Great Britain would be quoted on the London Stock Exchange.

C. H. D'E. LEPPINGTON

### BANK RESERVES AND DEPRECIATION

BANKING capital and deposits are employed in loans and advances. An increase of deposits, in normal times, is accompanied by an increase in loans. Conversely, when deposits are withdrawn the bank calls in its loans. In times of panic the bank might not be able, and would certainly be unwilling, to do this. It would only intensify the crisis. It is, as Bagehot says, ready lending which cures panics, and non-lending or niggardly lending which aggravates them.

An Emergency Fund or Reserve is, therefore, a requisite of

modern banking. It is so because banks may be called upon suddenly to pay certain of their liabilities at a time when it may not be possible or politic to call upon borrowers to repay their loans.

A Reserve Fund, if it is to be available in emergency, must be liquid. It may consist either of cash or of securities. If the latter, the securities must be of a kind which in the worst of times the ultimate lender, the Bank of England, would not refuse to accept as security for an advance.

The bank publishes an account of its Reserve Fund in order to satisfy the public that it possesses cash or securities sufficient to meet its liabilities. Upon the magnitude of its reserves, and the nature of the securities which compose them, depend the credit and stability of the bank. The test is the extent to which the securities are liquid. The worth of the reserve is measured by its potential cash value. If it is high, then the credit of the bank is high. If it is increased or diminished by a rise or fall in the market price of the securities, there will be a corresponding, not necessarily an equivalent, change in the credit and stability of the bank.

The banker, therefore, is always trying to maintain the potential cash or pledging value of his reserve unimpaired by purchasing with every fall in price an additional amount of securities equivalent to the depreciation in their former market value. If there is no depreciation, his object then is to augment his reserves by steadily writing them down. By that phrase is meant the provision cut of annual profits of a fund for bringing the balance-sheet value of the reserve security below the market value. It is mainly due to this procedure, namely, the retention of profits and their employment in ordinary banking business, that the proportion of securities to banking resources, which twenty years ago was 25 per cent., has been reduced to 15 per cent. to-day.

The income from the securities is not affected by the fall in their market value, so that the effect of the setting aside of profits to balance the depreciation is to add to the earning power of the bank. The amount retained out of the annual profit of any one year will ultimately be returned to the shareholder in increased dividends.

It may be said, however, that the ultimate interests of the bank do not always coincide with the immediate interest of the shareholder; what he wants is a large dividend *now*. The securities, he will argue, are not of the nature of a wasting asset like

machinery. The fall in value is merely due to market fluctuations in the rate of interest which, sooner or later, is certain to be reversed, while the rise in the market rate of interest which causes depreciation enables the bank to charge higher rates for money, and this, he will say, is in itself a source of additional profit to the bank.

To this it may be answered, in the first place, that the value of securities may be affected by causes, such as an undue extension of the national liabilities, other than a rise in the rate of interest. Consols in 1903 were £94 5s. and money at call £2 17s. 10d. In 1914 Consols were £76 3s. 1d. and money £2 6s. 10d. Consols, in fact, depreciated 19 per cent. in the period under review without any corresponding rise—on the contrary, there was a fall—in the market rate of interest.

In the case cited above it is clear that there will be no increase in the earning power of the bank from a higher market rate of interest, and if suitable provision had not been made for the market depreciation of Consols, it is probable that the earning power of the bank would have been curtailed through loss in credit and prestige. Any addition to the earning power is, so to speak, accidental and ancillary to the main purpose of provision for depreciation, which is to ensure the stability and solvency of the bank in time of panic.

If it is assumed that the depreciation is caused entirely by a rise in the market rate of interest, then it may be admitted that the profits used to balance the depreciation have permanently improved the position of the bank.

But then depreciation is not always due to a rise in interest. In that case, apart from increased earnings which are really only deferred profits, it cannot be said that the position of the bank is permanently improved by providing for the actual depreciation. The position is only restored.

Suppose a bank buys £100,000 Consols at par, which it gradually writes down out of profits until they stand in its books at 50 per cent. of their face value. Originally the bank had £100,000 Consols and an income of £2,500. It still holds the £100,000 Consols, now valued at £50,000, with the original income of £2,500, plus whatever it can earn on the £50,000 provided to balance the depreciation. Its earnings have increased, but its actuarial position is the same as it was when Consols stood at par. It may be said that there is a potential improvement, on the assumption that Consols may recover in the future, in which case there will be a surplus. But then there is also a potential

deterioration, since Consols may fall further in the future and produce a deficit. In fine, the position of a bank is determined by the actuarial value and not the potential value of its securities at any given time. Provision for depreciation out of profits does not in itself improve permanently the position of the bank. It may do so or it may not. It depends on circumstances.

C. S. ADDIS

### TURKEY'S FINANCIAL POSITION

THE following is a summary by Dr. A. Ruppin of the speech delivered by the Turkish Finance Minister, Djavid Bey, at the beginning of March during the Budget debate. (Published in the *Wirtschaftsdienst* of April 13th.)

The National Debt before the war amounted to £T.150 million (Turkish pound = 18s. 3d.). During the war it has increased by £T.180 million, and is now £T.330 million. At 6 per cent. this debt requires an annual sum of £T.21.8 million to provide the interest. The newly contracted debts of £T.180 million consist of the following individual amounts :—

(1)	...	£T.11,500,000	Gold loan from German Government.
(2)	...	19,000,000	Loans from German Government in form of a
(3)	...	27,777,940	transfer of German Treasury Notes to
(4)	...	32,000,000	cover issue of paper money by Turkish Government.
(5)	...	2,374,000	Loan from German Government for construction purposes.
(6)	About	25,000,000	Loan from German Government for various objects : Payment of transport costs on Bagdad and Anatolian Railway (Mk.25 million), of interest coupons of Turkish loan in Germany (Mk.17 million), for purchases of goods in Germany (Mk.208 million), for unspecified subjects (Mk.250 million).
(7)	...	25,000,000	Loan from German Government for purchase of munitions in Germany.
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	About	£T.143,000,000	Total amount of loans in Germany.
(8)	...	10,000,000	(Kr.240 million) loan from Austrian Government.
(9)	...	8,383,000	Unpaid interest coupons of State loans.
(10)	...	716,000	Overdue pay of officials and pensions.
(11)	About	20,000,000	For requisitions of goods against requisition vouchers.
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Total	about	£T.180,000,000	Debts contracted during the war.