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Why Lombard Street is Sometimes Very Dull and Sometimes Very Excited

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by

Walter Bagehot

Extracted from the author's 'Lombard Street : A Description of the Money Market'

First published in 1873

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Contents

Publisher's Note

Baghot's *Lombard Street*, first published in 1873, is something of a classic text on the subject of financial markets. This booklet comprises the single chapter six extracted from the original edition. It has been very lightly edited, and some text has been emphasised in bold type. The digital edition presented here is for the benefit of students of investment with a particular interest in the apparently never-ending cycle of stock market booms and busts.

The author wrote from the perspective of the late 19th century (just ahead of a long period of depression) and seems primarily inspired by the manias of 1825, 1847, 1857 and 1866. These encompassed the full range of precipitating factors and symptoms - in prices of securities, the rate of interest, availability of credit, and prices in agriculture and industry.

Bagehot addresses the fluctuating cycle of prices, trade and production, showing the interaction of credit, trade volumes, and profitability. He lays out the internal processes of the credit market ("Lombard Street" in 19th century London, and central to the modern economy) and emphasises that that the market is more vulnerable at some times than at others to the inevitable "external" events, or accidents. Thus mania and panic may be compounded from these factors and, he concludes, the need arises to maintain a "great banking reserve."

J.A.B., Hindsight Publications, 2012

Why Lombard Street is Sometimes Very Dull and Sometimes Very Excited

Any sudden event which creates a great demand for actual cash may cause, and will tend to cause, a panic in a country where cash is much economised, and where debts payable on demand are large. In such a country an immense credit rests on a small cash reserve and an unexpected and large diminution of that reserve may easily break up and shatter very much, if not the whole, of that credit. Such accidental events are of the most various nature: a bad harvest, an apprehension of foreign invasion, the sudden failure of a great firm which everybody trusted, and many other similar events, have all caused a sudden demand for cash. And some writers have endeavoured to classify panics according to the nature of the particular accidents producing them. But little however, is, I believe, to be gained by such classifications. There is little difference in the effect of one accident and another upon our credit system. We must be prepared for all of them, and we must prepare for all of them in the same way — **by keeping a large cash reserve**.

But it is of great importance to point out that our industrial organisation is liable not only to irregular external accidents, but likewise to regular internal changes; that these changes make our credit system much more delicate at some times than at others; and that it is the recurrence of these periodical seasons of delicacy which has given rise to the notion that panics come according to a fixed rule — that every ten years or so we must have one of them.

Most persons who begin to think of the subject are puzzled on the threshold. They hear much of ‘good times’ and ‘bad times' meaning by ‘good’ times in which nearly everyone is very well-off and by ‘bad’ times in which nearly everyone is comparatively ill-off. And at first it is natural to ask why should everybody, or almost everybody, be well-off together? Why should there be any great tides of industry, with large diffused profit by way of flow, and large diffused want of profit, or loss, by way of ebb? The main answer is hardly given distinctly in our common books of political economy. These books do not tell you what is the fund out of which large general profits are paid in good times, nor do they explain why that fund is not available for the same purpose in bad times.

Our current political economy does not sufficiently take account of *time* as an element in trade operations; but as soon as the division of labour has once established itself in a community, two principles at once begin to be important, of which time is the very essence. These are :—

First, that as goods are produced to be exchanged, it is good that they should be exchanged as quickly as possible.

Secondly, that as every producer is mainly occupied in producing what others want, and not what he wants himself, it is desirable that he should always be able to find, without effort, without delay, and without uncertainty, others who want what he can produce.

In themselves these principles are self-evident. Everyone will admit it to be expedient that all goods wanting to be sold should be sold as soon as they are ready; that every man who wants to work should find employment as soon as he is ready for it. Obviously also, as soon as the 'division of labour' is really established, there is a difficulty about both of these principles. A produces what he thinks B wants, but it may be a mistake, and B may not want it. A may be able and willing to produce what B wants, but he may not be able to find B — he may not know of his existence.

The general truth of these principles is obvious, but what is not obvious is the extreme greatness of their effects. Taken together, they make the whole difference between times of brisk trade and great prosperity, and times of stagnant trade and great adversity, so far as that prosperity and that adversity are real and not illusory. If they are satisfied, everyone knows whom to work for, and what to make, and he can get immediately in exchange what he wants himself. There is no idle labour and no sluggish capital in the whole community, and, in consequence, all which can be produced is produced, the effectiveness of human industry is augmented, and both kinds of producers — both capitalists and labourers — are much richer than usual, because the amount to be divided between them is also much greater than usual.

And there is a partnership in industries. No single large industry can be depressed without injury to other industries; still less can any great group of industries. Each industry when prosperous buys and consumes the produce probably of most (certainly of very many) other industries, and if industry A fails and is in difficulty, industries B, and C, and D, which used to sell to it, will not be able to sell that which they had produced in reliance on A's demand, and in future they will stand idle till industry A recovers, because in default of A there will be no one to buy the commodities which they create. Then as industry B buys of C, D, & etc., the adversity of B tells on C, D, & etc., and as these buy of E, F, & etc., the effect is propagated through the whole alphabet. And in a certain sense it rebounds. Z feels the want caused by the diminished custom of A, B, & C, and so it does not earn so much; in consequence, it cannot lay out as much on the produce of A, B, & C, and so these do not earn as much either. In all this money is but an instrument. The same thing would happen equally well in a trade of barter, if a state of barter on a very large scale were not practically impossible, on account of the time and trouble which it would necessarily require. As has been explained, the fundamental cause is that under a system in which everyone is dependent on the labour of everyone else, the loss of one spreads and multiplies through all, and spreads and multiplies the faster the higher the previous perfection of the system of divided labour, and the more nice and effectual the mode of interchange. And the entire effect of a depression in any single large trade requires a considerable *time* before it can be produced. It has to be propagated, and to be returned through a variety of industries, before it is complete. Short depressions, in consequence, have scarcely any discernible consequences; they are over before we think of their effects. It is only in the case of continuous and considerable depressions that the cause is in action long enough to produce discernible effects.

The most common, and by far the most important, case where the depression in one trade causes depression in all others, is that of depressed agriculture. When the agriculture of the world is ill-off, food is dear. And as the amount of absolute necessaries which a people consumes cannot be much diminished, the additional amount which has to be spent on them is so much subtracted from what used to be spent on other things. All the industries, A, B, C, D, up to Z, are somewhat affected by an augmentation in the price of corn, and the most affected are the large ones, which produce the objects in ordinary times most consumed by the working classes. The clothing trades feel the difference at once, and in this country the liquor trade (a great source of English revenue) feels it almost equally soon. Especially when for two or three years harvests have been bad, and corn has long been dear, every industry is impoverished, and almost every one, by becoming poorer, makes every other poorer too. All trades are slack from diminished custom, and the consequence is a vast stagnant capital, much idle labour, and a greatly retarded production.

It takes two or three years to produce this full calamity, and the recovery from it takes two or three years also. If corn should long be cheap, the labouring classes have much to spend on what they like besides. The producers of those things become prosperous, and have a greater purchasing power. They exercise it, and that creates in the class they deal with another purchasing power, and so all through society. The whole machine of industry is stimulated to its maximum of energy, just as before much of it was slackened almost to its minimum.

A great calamity to any great industry will tend to produce the same effect, but the fortunes of the industries on which the wages of labour are expended are much more important than those of all others, because they act much more quickly upon a larger mass of purchasers. On principle, if there was a perfect division of labour, every, industry would have to be perfectly prosperous in order that any one might be so. So far, therefore, from its being at all natural that trade should develop constantly, steadily, and equably, it is plain, without going further, from theory as well as from experience, that there are inevitably periods of rapid dilatation, and as inevitably periods of contraction and of stagnation.

Nor is this the only changeable element in modern industrial societies. Credit — **the disposition of one man to trust another** — is singularly varying. In England, after a great calamity everybody is suspicious of everybody; as soon as that calamity is forgotten, everybody again confides in everybody. On the Continent there has been a stiff controversy as to whether credit should or should not be called 'capital' in England, even the little attention once paid to abstract economics is now diverted, and no one cares in the least for refined questions of this kind: the material practical point is that, in M. Chevalier's language, credit is 'additive,' or additional — that is, in times when credit is good productive power is more efficient, and in times when credit is bad productive power is less efficient. And the state of credit is thus influential, because of the two principles which have just been explained. In a good state of credit, goods lie on hand a much less time than when credit is bad; sales are quicker; intermediate dealers borrow easily to augment their trade, and so more and more goods are more quickly and more easily transmitted from the producer to the consumer.

These two variable causes are causes of real prosperity. They augment trade and production, and so are plainly beneficial, except where by mistake the wrong things are produced, or where also by mistake misplaced credit is given, and a man who cannot produce anything which is wanted gets the produce of other people's labour upon a false idea that he will produce it. But there is another variable cause which produces far more of apparent than of real prosperity and of which the effect is in actual life mostly confused with those of the others.

In our common speculations we do not enough remember that interest on money is a refined idea, and not a universal one. So far indeed is it from being universal, that the majority of saving persons in most countries would reject it. Most savings in most countries are held in hoarded specie. In Asia, in Africa, in South America, largely even in Europe, they are thus held, and it would frighten most of the owners to let them out of their keeping. An Englishman — a modern Englishman at least — assumes as a first principle that he ought to be able to 'put his money into something safe that will yield 5 percent' but most saving persons in most countries are afraid to 'put their money' into anything. Nothing is safe to their minds; indeed, in most countries, owing to a bad Government and a backward industry, no investment, or hardly any, really is safe. In most countries most men are content to forego interest; but in more advanced countries, at some times there are more savings seeking investment than there are known investments for; at other times there is no such superabundance. Lord Macaulay has graphically described one of the periods of excess. He says :—

During the interval between the Restoration and the Revolution the riches of the nation had been rapidly increasing. Thousands of busy men found every Christmas that, after the expenses of the year's housekeeping had been defrayed out of the year's income, a surplus remained; and how that surplus was to be employed was a question of some difficulty. In our time, to invest such a surplus, at something more than three percent, on the best security that has ever been known in the world, is the work of a few minutes. But in the seventeenth century, a lawyer, a physician, a retired merchant, who had saved some thousands and who wished to place them safely and profitably, was often greatly embarrassed. Three generations earlier, a man who had accumulated wealth in a profession generally purchased real property, or lent his savings on mortgage. But the number of acres in the kingdom had remained the same; and the value of those acres, though it had greatly increased, had by no means increased so fast as the quantity of capital which was seeking for employment. Many too wished to put their money where they could find it at an hour's notice, and looked about for some species of property which could bc more readily transferred than a house or a field. A capitalist might lend on bottomry or on personal security; but, if he did so, he ran a great risk of losing interest and principal. There were a few joint stock companies, among which the East India Company held the foremost place; but the demand for the stock of such companies was far greater than the supply. Indeed the cry for a new East India Company was chiefly raised by persons who had found difficulty in placing their savings at interest on good security. So great was that difficulty that the practice of hoarding was common. We are told that the father of Pope, the poet, who retired from business in the City about the time of the Revolution, carried to a retreat in the country a strong box containing near twenty thousand pounds, and took out from time to time what was required for household expenses; and it is highly probable that this was not a solitary case.

At present the quantity of coin which is hoarded by private persons is so small, that it would, if brought forth, make no perceptible addition to the circulation. But, in the earlier part of the reign of William the Third, all the greatest writers on currency were of opinion that a very considerable mass of gold and silver was hidden in secret drawers and behind wainscots.

The natural effect of this state of things was that a crowd of projectors, ingenious and absurd, honest and knavish, employed themselves in devising new schemes for the employment of redundant capital. It was about the year 1688 that the word stockjobber was first heard in London. In the short space of four years a crowd of companies, every one of which confidently held out to subscribers the hope of immense gains, sprang into existence — the Insurance Company, the Paper Company, the Lutestring Company, the Pearl Fishery Company, the Glass Bottle Company, the Alum Company, the Blythe Coal Company, the Swordblade Company. There was a Tapestry Company, which would soon furnish pretty hangings for all the parlours of the middle class, and for all the bedchambers of the higher. There was a Copper Company, which proposed to explore the mines of England, and held out a hope that they would prove not less valuable than those of Potosi. There was a Diving Company, which undertook to bring up precious effects from shipwrecked vessels, and which announced that it had laid in a stock of wonderful machines resembling complete suits of armour. In front of the helmet was a huge glass eye like that of a Cyclops; and out of the crest went a pipe through which the air was to be admitted. The whole process was exhibited on the Thames. Fine gentlemen and fine ladies were invited to the show, were hospitably regaled, and were delighted by seeing the divers in their panoply descend into the river and return laden with old iron and ship's tackle. There was a Greenland Fishing Company, which could not fail to drive the Dutch whalers and herring busses out of the Northern Ocean. There was a Tanning Company, which promised to furnish leather superior to the best that was brought from Turkey or Russia. There was a society which undertook the office of giving gentlemen a liberal education on low terms, and which assumed the sounding name of the Royal Academies Company. In a pompous advertisement it was announced that the directors of the Royal Academies Company had engaged the best masters in every branch of knowledge, and were about to issue twenty thousand tickets at twenty shillings each. There was to be a lottery — two thousand prizes were to be drawn; and the fortunate holders of the prizes were to be taught, at the charge of the Company, Latin, Greek, Hebrew, French, Spanish, conic sections, trigonometry, heraldry, japaning, fortification, bookkeeping, and the art of playing the theorbo.

The panic was forgotten till Lord Macaulay revived the memory of it. But, in fact, in the *South Sea Bubble*, which has always been remembered, the form was the same, only a little more extravagant; the companies in that mania were for objects such as these : — ' " *Wrecks to be fished for on the Irish Coast — Insurance of Horses and other Cattle (two millions) — Insurance of Losses by Servants —To make Salt Water Fresh — For building of Hospitals for Bastard Children — For building of Ships against Pirates — For making of Oil from Sunflower Seeds — For improving of Malt Liquors — For recovery of Seamen's Wages — For extracting of Silver from Lead — For the transmuting of Quicksilver into a malleable and fine Metal — For making of Iron with Pit-coal — For importing a Number of large Jack Asses from Spain — For trading in Human Hair — For fatting of Hogs — For a Wheel of Perpetual Motion." But the most strange of all, perhaps, was "For an Undertaking which shall in due time be revealed." Each subscriber was to pay down two guineas, and hereafter to receive a share of one hundred, with a disclosure of the object; and so tempting was the offer, that 1,000 of these subscriptions were paid the same morning, with which the projector went off in the afternoon'*

In 1825 there were speculations in companies nearly as wild, and just before 1866 there were some of a like nature, though not equally extravagant. The fact is, that the owners of savings not finding, in adequate quantities, their usual kind of investments, rush into anything that promises speciously, and when they find that these specious investments can be disposed of at a high profit, they rush into them more and more. The first taste is for high interest, but that taste soon becomes secondary. There is a second appetite for large gains to be made by selling the principal which is to yield the interest. So long as such sales can be effected the mania continues; when it ceases to be possible to effect them, ruin begins.

So long as the savings remain in possession of their owners, these hazardous gamblings in speculative undertakings are almost the whole effect of an excess of accumulation over tested investment. Little effect is produced on the general trade of the country. The owners of the savings are too scattered and far from the market to change the majority of mercantile transactions. But **when these savings come to be lodged in the hands of bankers, a much wider result is produced**.

Bankers are close to mercantile life; they are always ready to lend on good mercantile securities; they wish to lend on such securities a large part of the money entrusted to them. When, therefore, the money so entrusted is unusually large, and when it long continues so, the general trade of the country is, in the course of time, changed. Bankers are daily more and more ready to lend money to mercantile men; more is lent to such men; more bargains are made in consequence; commodities are more sought after; and, in consequence, prices rise more and more.

The rise of prices is quickest in an improving state of credit. Prices in general are mostly determined by wholesale transactions. The retail dealer adds a percentage to the wholesale prices, not, of course, always the same percentage, but still mostly the same. Given the wholesale price of most articles, you can commonly tell their retail price. Now wholesale transactions are commonly not cash transactions, but bill transactions. The duration of the bill varies with the custom of the trade; it may be two, three months, or six weeks, but there is always a bill. Times of credit mean times in which the bills of many people are taken readily; times of bad credit, times when the bills of much fewer people are taken, and even of those suspiciously. In times of good credit there are a great number of strong purchasers, and in times of bad credit only a smaller number of weak ones; and, therefore, years of improving credit, if there be no disturbing cause, are years of rising price, and years of decaying credit, years of falling price.

This is the meaning of the saying 'John Bull can stand many things, but he cannot stand two percent' it means that the greatest effect of the three great causes is nearly peculiar to England; here, and here almost alone, the excess of savings over investments is deposited in banks; here, and here only, is it made use of so as to affect trade at large; here, and here only, are prices gravely affected. In these circumstances, a low rate of interest, long protracted, is equivalent to a total depreciation of the precious metals. In his book on the effect of the great gold discoveries, Professor Jevons showed, and so far as I know was the first to show, the necessity of eliminating these temporary changes of value in gold before you could judge properly of the permanent depreciation. He proved, that in the years preceding both 1847 and 1857 there was a general rise of prices; and in the years succeeding these years, a great fall. The same might be shown of the years before and after 1866, *mutatis mutandis*.

And at the present moment we have a still more remarkable example, which was thus analysed in the *Economist* of the 30th December, 1871, in an article which I venture to quote as a whole :—

THE GREAT RISE IN THE PRICE OF COMMODITIES.

Most persons are aware that the trade of the country is in a state of great activity. All the usual tests indicate that the state of the Revenue, the Bankers' Clearing-house figures, the returns of exports and imports are all plain, and all speak the same language. But few have, we think, considered one of the most remarkable features of the present time, or have sufficiently examined its consequences. That feature is the great rise in the price of most of the leading articles of trade during the past year. We give at the foot of this paper a list of articles, comprising most first-rate articles of commerce, and it will be seen that the rise of price, though not universal and not uniform, is nevertheless very striking and very general. The most remarkable cases are :—

		January			December		
		£	s.	d.	£	s.	d.
Wool—South Down hogs	per pack	13	0	0	21	15	0
Cotton—Upland ordinary	per lb.	0	0	7¼	0	0	8⅜
No. 40 mule yarn, &c.	,,	0	1	1½	0	1	2½
Iron—Bars, British . . .	per ton	7	2	6	8	17	6
Pig, No. 1 Clyde . . .	,,	2	13	3	3	16	0
Lead	,,	18	7	6	19	2	6
Tin	,,	137	0	0	157	0	0
Copper—Sheeting . . .	,,	75	10	0	95	0	0
Wheat (GAZETTE average)	per qr.	2	12	0	2	15	8

— and in other cases there is a tendency upwards in price much more often than there is a tendency downwards.

This general rise of price must be due either to a diminution in the supply of the quoted articles, or to an increased demand for them. In some cases there has no doubt been a short supply. Thus in wool, the diminution in the home breed of sheep has had a great effect on the price :—

In 1869 the home stock of sheep was . . .	29,538,000
In 1871 ,, ,, ,, . . .	27,133,000
Diminution	2,405,000

Equal to 8·1 per cent.

— and in the case of some other articles there may be a similar cause operating. But taking the whole mass of the supply of commodities in this country, as shown by the plain test of the *quantities* imported, it has not diminished, but augmented. The returns of the Board of Trade prove this in the most striking manner, and we give below a table of some of the important articles. The rise in prices must, therefore, be due to an increased demand, and the first question is, to what is that demand due ?

We believe it is due to the combined operation of three causes — cheap money, cheap corn, and improved credit. As to the first it might be said at first sight that so general an increase must be due to a depreciation of the precious metals. Certainly in many controversies facts far less striking have been alleged as proving it. And indeed there plainly is a diminution in the *purchasing power* of money, though that diminution is not general and permanent, but local and temporary. The peculiarity of the precious metals is that their value depends for unusually long periods on the quantity of them which is in the market. In the long run, their value, like that of all others, is determined by the cost at which they can be brought to market. But for all temporary purposes, it is the supply in the market which governs the price, and that supply in this country is exceedingly variable. After a commercial crisis — 1866 for example — two things happen: first, we call in the debts which are owing to us in foreign countries; and we require those debts to be paid to us, not in commodities, but in money. From this cause principally, and omitting minor causes, the bullion in the Bank of England, which was 13,156,000*l.* in May 1866, rose to 19,413,000*l.* in January 1867, being an increase of over 6,000,000*l.* And then there comes also a second cause, tending in the same direction. During a depressed period the savings of the country increase considerably faster than the outlet for them. A person who has made savings does not know what to do with them. And this new unemployed saving means additional money. Till a saving is invested or employed it exists only in the form of money: a farmer who has sold his wheat and has 100*l.* 'to the good' holds that 100*l.* in money, or some equivalent for money, till he sees some advantageous use to be made of it. Probably he places it in a bank, and this enables it to do more work. If 3,000,000*l.* of coin be deposited in a bank, and it need only keep 1,000,000*l.* as a reserve, that sets 2,000,000*l.* free, and is for the time equivalent to an increase of so much coin. As a principle it may be laid down that all new unemployed savings require *either an increased stock of the precious metals, or an increase in the efficiency of the banking expedients by which these metals are economised*. In other words, in a saving and uninvesting period of the national industry, we accumulate gold, and augment the efficiency of our gold. If therefore such a saving period follows close upon an occasion when foreign credits have been diminished and foreign debts called in, the augmentation in the effective quantity of gold in the country is extremely great. The old money called in from abroad and the new money representing the new saving co-operate with one another. And their tendency is to cause a general rise in price, and what is the same thing, a diffused diminution in the purchasing power of money.

Up to this point there is nothing special in the recent history of the money market. Similar events happened both after the panic of 1847, and after that of 1857. But there is another cause of the same kind, and acting in the same direction, which is peculiar to the present time; this cause is the amount of the foreign money, and especially of the money of foreign Governments, now in London. No Government probably ever had nearly as much at its command as the German Government now has. Speaking broadly, two things happened: during the war England was the best place of shelter for foreign money, and this made money more cheap here than it would otherwise have been; after the war England became the most convenient paying place, and the most convenient resting place for money, and this again has made money cheaper. The commercial causes, for which there are many precedents, have been aided by a political cause for the efficacy of which there is no precedent.

But though plentiful money is necessary to high prices, and though it has a natural tendency to produce these prices, yet it is not of itself sufficient to produce them. In the cases we are dealing with, in order to lower prices there must not only be additional money, but a satisfactory mode of employing that additional money. This is obvious if we remember whence that augmented money is derived. It is derived from the savings of the people, and will only be invested in the manner which the holders for the time being consider suitable to such savings. It will not be used in mere expenditure; it would be contrary to the very nature of it so to use it. A new channel of demand is required to take off the new money, or that new money will not raise prices. It will lie idle in the banks, as we have often seen it. We should still see the frequent, the common phenomenon of dull trade and cheap money existing side by side.

The demand in this case arose in the most effective of all ways. In 1867 and the first half of 1868 corn was dear, as the following figures show : —

GAZETTE AVERAGE PRICE OF WHEAT.

	s.	d.		s.	d.
December, 1866	60	3	October, 1867	66	6
January, 1867	61	4	November "	69	5
February "	60	10	December "	67	4
March "	59	9	January, 1868	70	3
April "	61	6	February "	73	0
May "	64	8	March "	73	0
June "	65	4	April "	73	3
July "	65	0	May "	73	9
August "	67	8	June "	67	11
September "	62	8	July "	65	5

From that time it fell, and it was very cheap during the whole of 1869 and 1870. The effect of this cheapness is great in every department of industry. The working classes, having cheaper food, need to spend so much less on that food, and have more to spend on other things. In consequence, there's a gentle augmentation of demand through almost all departments of trade. And this almost always causes a great augmentation in what may be called the instrumental trades — that is, in the trades which deal in machines and instruments used in many branches of commerce, and in the materials for such.

Take, for instance, the iron trade—

			tons	tons
In the year	1869	we exported . .	2,568,000	
„	1870	„ . .	2,716,000	
				5,284,000
	1867	„ . .	1,882,000	
„	1868	„ . .	1,944,000	
				3,826,000
	Increase			1,458,000

— that is to say, cheap corn operating throughout the world, created a new demand for many kinds of articles; the production of a large number of such articles being aided by iron in some one of its many forms, iron to that extent was exported. And the effect is cumulative. The manufacture of iron being stimulated, all persons concerned in that great manufacture are well off; have more to spend, and by spending it encourage other branches of manufacture, which again propagate the demand; they receive and so encourage industries in a third degree dependent and removed.

It is quite true that corn has not been quite so cheap during the present year. But even if it had been dearer than it is, it would not all at once arrest the great trade which former cheapness had created. The "ball," if we may so say, "was set rolling" in 1869 and 1870, and a great increase of demand was then created in certain trades and propagated through all trades. A continuance of very high prices would produce the reverse effect; it would slacken demand in certain trades, and the effect would be gradually diffused through all trades. But a slight rise such as that of this year has no perceptible effect.

When the stimulus of cheap corn is added to that of cheap money, the full conditions of a great and diffused rise of prices are satisfied. This new employment supplies a mode in which money can be invested. Bills are drawn of greater number and greater magnitude, and through the agencies of banks and discount houses the savings of the country are invested in such bills. There is thus a new want and a new purchase-money to supply that want, and the consequence is the diffused and remarkable rise of price which the figures show to have occurred.

The rise has also been aided by the revival of credit. This, as need not be at length explained, is a great aid to buying, and consequently a great aid to a rise of price. Since 1866, credit has been gradually, though very slowly, recovering, and it is probably as good as it is reasonable or proper that it should be. We are now trusting as many people as we ought to trust, and as yet there is no wild excess of misplaced confidence which would make us trust those whom we ought not to trust.

The process thus explained is the common process. The surplus of loanable capital which lies in the hands of bankers is not employed by them in any original way; it is almost always lent to a trade already growing and already improving. The use of it develops that trade yet farther, and this again augments and stimulates other trades. Capital may long lie idle in a stagnant condition of industry; the mercantile securities which experienced bankers know to be good do not augment, and they will not invent other securities, or take bad ones.

In most great periods of expanding industry, the three great causes — much loanable capital; good credit, and the increased profits derived from better-used labour and better-used capital — have acted simultaneously; and though either may act by itself; there is a permanent reason why mostly they will act together. They both tend to grow together, if you begin from a period of depression. In such periods credit is bad, and industry unemployed; very generally provisions are high in price, and their dearness was one of the causes which made the times bad. Whether there was or was not too much loanable capital when that period begins, there soon comes to be too much. Quiet people continue to save part of their incomes in bad times as well as in good; indeed, of the two, people of slightly-varying and fixed incomes have better means of saving in bad times because prices are lower. Quiescent trade affords no new securities in which the new saving can be invested, and therefore there comes soon to be an excess of loanable capital. In a year or two after a crisis credit usually improves, as **the remembrance of the disasters which at the crisis impaired credit is becoming fainter and fainter.** Provisions get back to their usual price, **or some great industry makes, from some temporary cause, a quick step forward.**

At these moments, therefore, the three agencies which, as has been explained, greatly develop trade, combine to develop it simultaneously.

The certain result is a bound of national prosperity; the country leaps forward as if by magic. But only a part of that prosperity has a solid reason. As far as prosperity is based on a greater quantity of production, and that of the right articles — as far as it is based on the increased rapidity with which commodities of every kind reach those who want them — its basis is good. Human industry is more efficient, and therefore there is more to be divided among mankind. But in so far as that prosperity is based on a general rise of prices, it is only imaginary. A general rise of prices is a rise only in name; whatever anyone gains on the article which he has to sell he loses on the articles which he has to buy, and so he is just where he was. The only real effects of a general rise of prices are these: first, it straitens people of fixed incomes, who suffer as purchasers, but who have no gain to correspond; and secondly, it gives an extra profit to fixed capital created before the rise happened. Here the sellers gain, but without any equivalent loss as buyers. Thirdly, this gain on fixed capital is greatest in what may be called the industrial ‘implements’ such as coal and iron. These are wanted in all industries, and in any general increase of prices, they are sure to rise much more than other things. Everybody wants them; the supply of them cannot be rapidly augmented, and therefore their price rises very quickly. But to the country as a whole, the general rise of prices is no benefit at all; it is simply a change of nomenclature for an identical relative value in the same commodities.

Nevertheless, most people are happier for it; they think they are getting richer, though they are not. And as the rise does not happen on all articles at the same moment, but is propagated gradually through society, those to whom it first comes gain really; and as at first every one believes that he will gain when his own article is rising, a buoyant cheerfulness overflows the mercantile world.

This prosperity is precarious as far as it is real, and transitory in so far as it is fictitious. The augmented production, which is the reason of the real prosperity, depends on the full working of the whole industrial organisation — of all capitalists and labourers ;— that prosperity was caused by that full working, and will cease with it. But that full working is liable to be destroyed by the occurrence of any great misfortune to any considerable industry. This would cause misfortune to the industries dependent on that one, and, as has been explained, all through society and *back again*. But every such industry is liable to grave fluctuations, and the most important — the provision-industries — to the gravest and the suddenest. They are dependent on the casualties of the seasons. A single bad harvest diffused over the world, a succession of two or three bad harvests, even in England only, will raise the price of corn exceedingly, and will keep it high. And a great and protracted rise in the price of corn will at once destroy all the real part of the unusual prosperity of previous good times. It will change the full working of the industrial machine into an imperfect working; it will make the produce of that machine less than usual instead of more than usual; instead of there being more than the average of general dividend to be distributed between the producers, there will immediately be less than the average.

And in so far as the apparent prosperity is caused by an unusual plentifulness of loanable capital and a consequent rise in prices, that prosperity is not only liable to reaction, but *certain* to be exposed to reaction. The same causes which generate this prosperity will, after they have been acting a little longer, generate an equivalent adversity. The process is this: the plentifulness of loanable capital causes a rise of prices; that rise of prices makes it necessary to have more loanable capital to carry on the same trade. £100,000 will not buy as much when prices are high as it will when prices are low, it will not be so effectual for carrying on business; more money is necessary in dear times than in cheap times to produce the same changes in the same commodities. Even supposing trade to have remained stationary, a greater capital would be required to carry it on after such a rise of prices as has been described than was necessary before that rise. But in this case the trade will *not* have remained stationary; it will have increased — certainly to some extent, probably to a great extent. The 'loanable capital' the lending of which caused the rise of prices, was lent to enable it to augment. The loanable capital lay idle in the banks till some trade started into prosperity, and then was lent in order to develop that trade; that trade caused other secondary developments; those secondary developments enabled more loanable capital to be lent; and that lending caused a tertiary development of trade; and so on through society.

In consequence, a long-continued low rate of interest is almost always followed by a rapid rise in that rate. Till the available trade is found it lies idle, and can scarcely be lent at all; some of it is not lent. But the moment the available trade is discovered — the moment that prices have risen — the demand for loanable capital becomes keen.

For the most part, men of business must carry on their regular trade; if it cannot be carried on without borrowing 10 percent more capital, 10 percent more capital they must borrow. Very often they have incurred obligations which must be met; and if that is so the rate of interest which they pay is comparatively indifferent. What is necessary to meet their acceptances they will borrow, pay for it what they may; they had better pay any price than permit those acceptances to be dishonoured. And in less extreme cases men of business have a fixed capital, which cannot lie idle except at a great loss; a set of labourers which must be, if possible, kept together; a steady connection of customers, which they would very unwillingly lose. To keep all these, they borrow; and in a period of high prices many merchants are peculiarly anxious to borrow, because the augmentation of the price of the article in which they deal makes them really see, or imagine that they see, peculiar opportunities of profit. An immense new borrowing soon follows upon the new and great trade, and the rate of interest rises at once, and generally rises rapidly.

This is the surer to happen that Lombard Street is, as has been shown before, a very delicate market. A large amount of money is held there by bankers and by bill-brokers at interest: this they must employ, or they will be ruined. It is better for them to reduce the rate they charge, and compensate themselves by reducing the rate they pay, rather than to keep up the rate of charge, if by so doing they cannot employ all their money. It is vital to them to employ all the money on which they pay interest. A little excess therefore forces down the rate of interest very much. But if that low rate of interest should cause, or should aid in causing, a great growth of trade, the rise is sure to be quick, and is apt to be violent. The figures of trade are reckoned by hundreds of millions, where those of loanable capital count only by millions. A great increase in the borrowing demands of English commerce almost always changes an excess of loanable capital above the demand to a greater deficiency below the demand. That deficiency causes adversity, or apparent adversity, in trade, just as, and in the same manner, that the previous excess caused prosperity, or apparent prosperity. It causes a fall of price that runs through society ;

that fall causes a decline of activity and a diminution of profits — a painful contraction instead of the previous pleasant expansion.

The change is generally quicker because some check to credit happens at an early stage of it. The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. **Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. They altogether overestimate the demand for the article they deal in, or the work they do. They all in their degree — *and the ablest and the cleverest the most* — work much more than they should, and trade far above their means.**

Every great crisis reveals the excessive speculations of many houses which no one before suspected, and which commonly indeed had not begun or had not carried very far those speculations, till they were tempted by the daily rise of price and the surrounding fever.

The case is worse, because at most periods of great commercial excitement there is some mixture of the older and simpler kind of investing mania. Though the money of saving persons is in the hands of banks, and though, by offering interest, banks retain the command of much of it, yet they do not retain the command of the whole, or anything near the whole; all of it can be used, and much of it is used, by its owners. They speculate with it in bubble companies and in worthless shares, just as they did in the time of the South Sea mania, when there were no banks, and as they would again in

England supposing that banks ceased to exist. The mania of 1825 and the mania of 1866 were striking examples of this; in their case to a great extent, as in most similar modern periods to a less extent, the delirium of ancient gambling co-operated with the milder madness of modern overtrading. At the very beginning of adversity the counters in the gambling mania, the shares in the companies created to feed the mania, are discovered to be worthless; down they all go, and with them much of credit.

The good times too of high price almost always engender much fraud. All **people are most credulous when they are most happy**; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity. Almost everything will be believed for a little while, and long before discovery the worst and most adroit deceivers are geographically or legally beyond the reach of punishment. But the harm they have done diffuses harm, for it weakens credit still farther.

When we understand that Lombard Street is subject to severe alternations of opposite causes, we should cease to be surprised at its seeming cycles. We should cease too to be surprised at the sudden panics. During the period of reaction and adversity, just even at the last instant of prosperity, the whole structure is delicate. The peculiar essence of our banking system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it.

Now too that we comprehend the inevitable vicissitudes of Lombard Street, we can also thoroughly comprehend the cardinal importance of always retaining a great banking reserve. Whether the times of adversity are well met or ill met depends far more on this than on any other single circumstance. If the reserve be large, its magnitude sustains credit; and if it be small, its diminution stimulates the gravest apprehensions. And the better we comprehend the importance of the banking reserve, the higher we shall estimate the responsibility of those who keep it.