7 Liquidity and Credit Creation

In countries where a central bank exists, the traditional theory of money and credit is that it is a quantity uniquely controlled by the monetary authorities. Given the banks’ reserve ratio and the public’s cash ratio ($b$ and $p$ in the previous chapter), the central bank is said to be able to control the total quantity of money and credit by manipulating the reserve base (vault cash plus balances with the central bank).

This theory does not take into account those economies, such as Hong Kong, where there is no central bank and currency is issued by private commercial banks. The simple and direct relationships envisaged in this theory therefore may not hold. Further, even under a central banking system it does not necessarily follow that money supply is exogenously determined. In the words of Patinkin, ‘in most discussions of monetary theory the nominal quantity of money supplied is taken as an exogenous variable. But though we continuously shy away from this fact in our theoretical work, we do nevertheless know that in the real world this is not the case: for money is largely the creature of a banking system which responds to such endogenous variables as the rate of interest, the wages of clerks, and so forth.’

H. G. Johnson has also observed that both the public’s cash ratio and the banks’ reserve ratio ‘are not technically determined or legally fixed coefficients, but are instead behaviour relationships’. Thus the decision of the public as to whether to carry currency or hold bank deposits is determined by the rate of return on deposits compared with the implicit return on currency, confidence in the bank’s solvency etc. Similarly, banks’ reserve ratio is not only determined by legal requirements but also by the banks’ own desired level of reserves, which in turn depend on their expectations, risk and...
uncertainty, and competition with other banks. Recent empirical studies tend to show that even under a central banking regime commercial banks are constantly striving to adjust their actual reserve ratio to desired ratio independently of the legally required ratio.⁸

In attempting to adjust the actual level of reserves to the desired one, the banks may increase or decrease their holdings of earning assets—primarily loans and investments—thus causing total deposits and money supply to change. In an economy without a central bank money supply is *a fortiori* endogenously determined by the profit-maximising behaviour of the commercial banks. While this proposition has been argued in the last chapter, the mechanism through which such changes are brought about is examined in this chapter.

**COMMERCIAL BANK AS A FIRM**

As an economic unit, a bank may best be regarded as a firm which specialises in the custody and creation of money. Under a market economy it is motivated by profit maximisation just as any other firm. To achieve this objective, it will constantly strive to reach an optimum portfolio of earning assets with maximum yield and minimum risk of default and illiquidity. Its decisions on the composition of these assets will ultimately determine total credit outstanding and money supply. There are however different views on the role of the bank in the process of credit or money creation. The private banker, influenced by the ‘cloakroom’ view of banking, will always insist that the amount he can lend and invest is limited by the money entrusted to him. The economist, taking an overall view, reaches the conclusion that since one bank’s loans or investments end up as another bank’s deposits, in the final analysis it is the depositors that entrust to the bankers whatever amounts the bankers lend or invest. In other words, the banking system as a whole can create deposits that are some multiples of a given amount of cash or liquid assets. This of course has long been made familiar in texts on money and banking.⁴

While the banker’s view has been rightly exposed as a fallacy of composition, it does not follow that the credit creation process bears a mechanical relationship with a predetermined reserve ratio. As a firm the bank is subject to many complex