

AN ANALYSIS OF THE PRESENT BANKING SITUATION
AND THE EFFECT OF A BANK DEPOSIT GUARANTEE LAW

By M. S. Eccles -- March 8, 1933

Referring to the manner in which our new administration is handling the present financial crisis, it seems to me that if the proposed policy is carried out it can only result in further drastic deflation, decrease in buying power and greater unemployment. These conclusions are arrived at on a basis of my analysis of the situation, which is as follows:

The present financial collapse is due entirely to the failure of the Government to stop the devastating effects of further deflation. During the period of the last four years this country has gone through possibly the greatest deflation in the history of the world. With all of the agricultural products selling at less than 50% of the four-year pre-war average and real estate values almost completely destroyed, with the national income reduced by more than 50%, is there any wonder that we have had thousands of bank failures during the past two years and that possibly 75% of all banks which were operating just before the present emergency are technically insolvent, i. e., that their capital structure on a basis of today's values is impaired and in many cases wiped out? This condition is not the fault of the average banker, who had no way of controlling the price structure, and hence the value of assets. The banking collapse of 1907 was an entirely different situation from the present as it was the result of a shortage of a circulating medium due to an inelastic currency. Such is not the case at the present time.

There is plenty of money to bring about a restoration of prices. We have nearly two and a half billion currency more in circulation at the present time than we had at the peak of 1929. There is sufficient money available in our present system to adequately adjust our present price structure if deposit money is not tied up. Our price structure depends more upon the velocity of money than it does upon the volume. The velocity is measured by the annual turn-over of bank deposits or what is termed bank debits, representing checks issued. Ninety per cent of our business is done by the bank check; currency, augmented by silver, normally is largely used as pocket money and represents 10%; gold is held in Reserve Banks to support our currency.

In 1929, the high level of prices was supported by a corresponding velocity of credit. The last Federal Reserve Bulletin gives an illuminating picture of this relationship as shown by figures of all member banks. From 1923 to 1925, the turn-over of deposits fluctuated from 26 to 32 times per year. From the autumn of 1925 to 1929 the turn-over rose to 45 times per year. In 1930, with deposits still increasing

the turn-over declined at the year-end to 26 times. During the last quarter of 1932 the turn-over dropped to 16 times per year. Note that from the high price-level of 1929 to the low level of the present, this turn-over has declined from 45 to 16, or 64% -- before the banking holiday this had increased to at least 75%. While during the same period, the volume of money represented by total bank deposits and currency has declined approximately 22%. It is clear, therefore, that the velocity, rather than the quantity of money, supports the price-structure and that our problem today is not one of increasing the volume of money, but its velocity. Several factors today stand in the way of increasing our money velocity.

I repeat there is plenty of money today to bring about a restoration of prices, but the chief trouble is that it is in the wrong place; it is concentrated in the larger financial centers of the country, the creditor sections, leaving a great portion of the back country, or the debtor sections, drained dry and making it appear that there is a great shortage of money and that it is, therefore, necessary for the government to print more. This mal-distribution of our money supply is the result of the relationship between debtor and creditor sections and the development of our industries into vast systems concentrated in the larger centers. During the period of the depression the creditor sections have acted on our system like a great suction pump, drawing a large portion of the available income and deposits in payment of interest, debts, insurance and dividends as well as in the transfer of balances by the larger corporations normally carried throughout the country. This makes for a shortage of funds in the agricultural areas and an excess of funds in the cities. During our period of prosperity funds were flowing from the creditor sections into the debtor sections in the extension of new credits and capital expansion as fast or faster than they were flowing out. There is no way of reviving the return flow through the operation of credit or investment until there is a basis for credit brought about through an increased price level and until there is an opportunity of profit through further investment of capital. The agricultural areas during the period of prosperity did not share in their portion of the national income and this made for further concentration of money in the creditor sections, with too large a portion of our aggregate debts in the agricultural areas. This explains the reason for a greater financial collapse as shown by the bank failure record throughout the entire back country, represented largely in the agricultural areas.

One of the reasons for the present deflation is the large amount of deposits already tied up in closed banks, and to add to this would only make for further distress. Now to carry out the present banking program will mean freezing the deposits of at least 50% of the banks of the nation, thus greatly reducing the deposit money and velocity, and making for greater deflation and distress, and helping to

destroy the assets in those banks which are considered solvent and allowed to open. By far the greater percentage of the insolvent banks are in the agricultural areas, which have already suffered the most and are in greater need of money than other sections of the country. To carry out the program of the Administration simply means to make for a further mal-distribution of the available money in this country. It will mean further that losses to depositors will be forced upon those people least able to stand such losses. Most of our wealthy people and large corporations have their funds concentrated in New York, Chicago, San Francisco, and the other large financial centers, generally speaking, in the banks which will be able to open without loss to their depositors, the banks which have been responsible for flooding the country, and particularly the country banks, with foreign and other worthless and depreciated securities. Depositors have already suffered all of the losses which they should be forced to take. Further losses should be socialized through a government guarantee of bank deposits. This would immediately re-establish confidence; would bring out of hoarding at least two and a half billion to three billion dollars of currency; would increase the reserve of our Federal Reserve Banks from 45% to possibly 75% by releasing the gold supporting this currency; would without question increase the volume of business and raise prices; would also make available large sums of money for the government to carry out its reconstruction program, which would further raise the price level by increasing employment, raising farm prices, and thus making many banks solvent which on a basis of today's values are frozen and insolvent.

Such a program of government guarantee of deposits should be followed by the Glass Banking Bill permitting branch banking and should require that all banks either become members of the national system or members of the Federal Reserve, thus unifying the banking system. Those banks which were unable to meet the requirements of membership within a period of one year should be closed, their assets taken over by some agency of the government for liquidation and any loss to depositors made up from the guarantee fund. This guarantee fund could be created by an appropriation from the Federal Government of at least Seven Hundred Fifty Million Dollars, One Hundred Twenty Five Million Dollars from the Federal Reserve Banks and One Hundred Twenty Five Million Dollars from the banks themselves through an assessment on a basis of deposits. If more were needed, which it is not likely would be the case, with the necessary inflation of prices, which in any case must ultimately be brought about, the government and the banks themselves should provide it. Such a law would not make for sloppy banking -- it would do just the reverse and it would in no manner be saving the skins of stockholders, officers and directors of the banks themselves for the reason that the guarantee fund would only cover the loss to depositors after stockholders' interest had been entirely wiped out and as much as possible collected from officers, directors and stockholders.

Why should the depositors be forced to suffer any further losses

through bank failures due to no fault of theirs? The loss to the Government as a result of a guarantee of bank deposits would be a small matter as compared with the loss in national income due to the stagnation of business if the proposed banking program is carried out. The banks which have been the most drastic in the curtailment of credit and the enforcement of collections, both of which have made for increasing distress, will be those banks which now will likely be rewarded by being able to open, and those depositors who have withdrawn their money and hoarded it, helping to bring about the present collapse, will now be rewarded by having their deposits preferred or be placed in banks which are allowed to open without any restrictions, thus putting a premium on hoarding.

It seems to me that the government is attacking our economic problem in the usual orthodox manner and I see little fundamental change in the methods they are pursuing and those pursued by the Republican Administration. The equities of farmers and home-owners, unless our banking structure is saved and prices raised, will be wiped out. This will effect the great mass of the American public. New York, as usual, seems to be in the saddle, dominating the fiscal policy. Government credit can be no better than national income. Anything which will increase the volume and velocity of money will increase the national income and improve the credit of government by making taxes collectable. The present problem should be met as this country would meet a crisis of war, in which case it would not be concerned about government credit, but only the protection of the lives and properties of its citizens -- that is the only concern which the government need have at the present time.

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The predicted deflationary effects of the banking situation have been moderated temporarily as a result of a very liberal policy on the part of Government and State banking authorities in allowing a very large percentage of all banks to open on an unrestricted basis and by the Government passing legislation giving to nonmember state banks the privilege of borrowing from the Federal Reserve Banks on all sound assets.

However, the course of deflation can not be stopped by anything that has yet been done by the Government and the financial situation is again becoming more acute each day. I believe some form of bank guarantee in connection with a unification of the banking system, followed by an inflationary fiscal policy on the part of the Government, is inevitable if a further and more serious financial crisis is to be avoided.