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Chairman Eccles

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The Relation of Monetary Policies to Other Government Policies

The attached memorandum, prepared jointly by Mr. Despres and me, was undertaken at the request of Governor Ransom, transmitted to Mr. Despres through Dr. Goldenweiser. The memorandum forms part of the material being prepared for the Wagner Committee Hearings.

Attachment

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CONFIDENTIAL

# THE RELATION OF MONETARY POLICIES TO OTHER GOVERNMENT POLICIES.

## Outline



## Chart



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THE RELATION OF MONETARY POLICIES
TO OTHER GOVERNMENT POLICIES

## Functions of the Banking System

Banking problems, and their relation to the problems of economic organization in general, are complicated by the fact that banks fulfill two logically distinct but intimately connected functions. On the one hand, viewed collectively, they create deposits, which are the most important component of the monetary supply. On the other hand, they exert a strategic influence over the volume of capital expansion and the direction that it is to take. Bankers have a large part in deciding who is to borrow money and what use is to be made of it. Since these decisions affect the degree of utilization of the national resources as well as the type of productive equipment provided for use in the future, we may say that in this sense the banking system is an organization for economic planning.

It is impossible to separate these two functions -- the supply of money and the regulation of investment -- under our present banking structure, nor do we suggest that separation would be desirable; but we must take care not to apply to one function principles appropriate only to the other. The importance of this warning should become clear as the testimony proceeds.

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## The Supply of Money

### Protection of Depositors

Originally deposits were, as their name suggests, merely receipts for currency actually deposited with the banker. The funds thus represented could be spent only by drawing them out in cash. Even today the practice of payment by check -- that is, by the transfer of title to deposits, without the use of cash -- is general only in highly industrialized countries, although it is spreading rapidly. Thus assurance of the convertibility of deposits into currency was of paramount importance to the depositor -- and therefore, indirectly, to the community at large.

It is understandable, then, that banking legislation prior to the establishment of the Federal Reserve System in 1914 was dominated by a desire to maintain the convertibility of deposits into cash. Even in recent years this objective has remained important.

The nature of this problem may be made clear by considering earlier legislation for insuring the convertibility of bank notes into metallic currency. This question hardly exists at present. Bank notes are simply accepted by the public as the customary means of payment. Few people would think of demanding silver dollars in place of paper bills. Yet prior to the establishment of the national banking system in 1863, the privilege of issuing notes was granted by the State governments to hundreds of banks, each responsible for the redemption of its own notes on demand. The failure of a bank left the holders of its notes with nothing but worthless paper.

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By the National Banking Act of 1863 and the supplementary act of 1865, the privilege of note issue became in effect a monopoly of the national banks. This monopoly was transferred to the Federal Reserve Banks by the Federal Reserve Act of 1913, (although a small quantity of national bank notes continued in circulation for many years). This series of enactments was a necessary preliminary to complete public acceptance of the bank note as a substitute for metallic money. The fact that the privilege of creating deposits still rests with private institutions explains the even now incomplete acceptance of payment by check and the persistent belief that deposits must be convertible into currency in order to be safe. This belief was fully justified, from the point of view of the individual depositor, before the organization of the Federal Deposit Insurance Corporation; and it is still justified to a considerable degree for the holder of large deposits, since insurance is limited to a maximum of $5,000 for any one depositor. Deposits in closed banks were of no more use to their owners before the Banking Act of 1933 than the bank notes of closed banks were before the National Banking Act.

There has been an intimate connection between financial panics and banking legislation in the United States. This is a partial explanation for the dominance of the desire to insure convertibility. During a financial panic, the function of the banking system as a supplier of money outweighs its function as regulator of investment. The public has, for one reason or another, lost confidence in the banks, and demands cash in place of deposits. A typical manifestation of panic is the

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inability of banks to meet these demands. There are failures, and depositors suffer. Thus, when the inadequacies of the banking structure are examined after the panic, it is natural to look upon convertibility as the central problem, or at best to take steps towards providing what seems to be a "sufficient" quantity of money, under some definition.

The discussions leading up to the Federal Reserve Act developed out of the panic of 1907, and the insurance of convertibility was one of the several objectives embodied in the Act. It was specified that bank notes must be backed by gold or commercial paper and that member bank deposits must be backed by fixed ratios of reserves in the form of deposits in the Federal Reserve banks. These provisions were clearly designed for the protection of depositors. Furthermore, the concentration of ultimate bank reserves -- that is, gold in the Federal Reserve banks (completed by the Amendment of 1917) was intended to prevent bank failures by facilitating the mobilization of these reserves where needed.

## The Correct Amount of Money

Commercial loan theory. The banking theory embodied in the Federal Reserve Act was dominated, however, by the objective of providing in some sense an adequate quantity of money, a quantity adequate to meet the "legitimate" needs of agriculture, industry, and commerce. A group of economists, who have come to be known as the commercial loan school, believed at the time that a proper quantity of money would result if the banks confined themselves to making commercial loans -- loans, that is, for meeting the operating expenses of business, for carrying inventories,

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or for financing the production, storage, or marketing of agricultural commodities, but not for plant expansion or any other form of "new investment". Commercial paper was therefore made eligible for rediscount at the Federal Reserve banks, while the making of loans collateraled by securities was prohibited. Commercial paper was also specified, together with gold certificates, as backing for Federal Reserve notes.

From the experience of the Federal Reserve System since its founding, we have learned the futility of this type of restriction. Member banks may rediscount commercial paper, only to purchase securities with the proceeds. The use that is made of funds does not depend upon the type of collateral offered. Furthermore, there has been, especially since 1929, a shortage of new capital outlays, and it has been an object of policy to encourage the purchase of securities by the banks in an attempt to stimulate such outlays. As we have seen in previous testimony, the relative importance of the commercial loans has been declining in recent years. This is due largely to the fact that corporations are becoming increasingly independent of the banks for their current financing.

Thus we have come to understand that restricting the rediscount privilege to commercial paper serves no useful purpose. With the passage of time the definition of acceptable collateral for loans from the Federal Reserve banks has been steadily broadened. Thus in 1916 loans secured by obligations of the United States Government were authorized; in 1923 agricultural factors' paper became eligible for discount; and

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finally, since 1932, a Reserve bank has been allowed to make loans "which are secured to the satisfaction of such Federal Reserve bank". In 1933 U. S. Government obligations were made acceptable as collateral for Federal Reserve notes. This development implies a recognition of the fact that a central bank cannot function properly if it is restrained by minute regulations; for a type of borrowing that is healthy under one set of conditions or at one level of business activity may be undesirable under different circumstances.

Gold standard theory. The orthodox theory of the gold standard represents an amalgam, from a slightly different point of view, of the two principles underlying the Federal Reserve Act. It was believed by advocates of the international gold standard that a currency and deposit structure based upon fairly inflexible ratios with gold would provide reasonable security for depositors and at the same time a correct amount of money -- correct at any rate in the sense that the resulting structure of incomes and prices would reflect accurately the underlying real cost conditions as between nations.

The business collapse and succession of bank failures from 1929 to 1933 demonstrated, however, even if the panics of 1893 and 1907 had not, that the gold standard -- however useful it may be as a framework -- will not automatically insure either security or prosperity. This conclusion is now generally accepted and need not be elaborated here, especially since the reasons for it are suggested by implication in our next section, on the regulation of investment.

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Economic stability theory. During the 1920's a third theory of monetary control came to the fore. This view was based on a denial that the correct quantity of money could be assured by the automatic or quasi-automatic functioning of any system of banking principles -- whether based on the supremacy of the commercial loan or on the ebb and flow of gold reserves. It asserted the duty of the Federal Reserve System to regulate the volume of deposits in a conscious attempt to prevent depressions on the one hand and unhealthy booms or incipient inflation on the other.

The proponents of this theory of economic stability pointed out that the national income may be represented as a certain quantity of money circulating a certain number of times per year. The number of circuits (the circuit velocity), they reasoned, cannot easily be controlled by central bank action, but the quantity of money can be. Therefore policy should be directed towards regulating the quantity of money in such a way as to offset fluctuations in velocity, thus maintaining a stable or steadily expanding national income.

The quantity of money can be varied, however, only by making it available to, or withholding it from, particular persons or institutions. Although the banking system does participate in consumer financing, by far the larger part of its operations is concerned with the financing of production. Thus control over the quantity of money can be exerted in practice only to the extent that the monetary authorities control the investment markets.

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During the 1920's the Federal Reserve System did have extensive power over the short term loan market. Excess reserves were small, so that the member banks were usually dependent upon the Reserve banks for periodic aid in carrying their short-dated paper. The terms on which the Reserve banks were willing to lend affected the terms on which the member banks would extend this type of credit. That is, the cost of obtaining cash when necessary from the Reserve banks influenced the price for which the member banks were willing to surrender a degree of liquidity by holding short-term paper instead of cash. Thus the Reserve System was in a favorable position to check the development of an inventory boom.

Control over the market for longer-term securities was slight, however. The volume of Reserve bank credit outstanding was determined in substantial part by the member banks, through their decisions regarding the volume of rediscounts, and by the bill market. As we have seen, the uses to which the resulting funds were put were largely beyond the control of the Reserve System. Furthermore, the increasing importance of corporate cash reserves implied that a large volume of capital expenditure was now independent not only of the Reserve System, but of the member banks themselves.

Without a more effective control of the long-term capital market, the Reserve System could not succeed in regulating the quantity of money. If control over the investment markets had existed, however, it would have carried with it a direct influence over the national income. In this case it would not have appeared necessary to separate quantity

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of money from circuit velocity, concentrating one's attention on the first. For new investment, whether reflected in an increased quantity of money or in a more rapid turnover of the already existing stock, generates income. It is therefore itself the essential variable to be controlled in the interest of economic stability.

Conclusion. Of the two problems that have dominated monetary theory in the past -- the protection of depositors and the provision of an adequate quantity of money -- the first is psychological rather than economic, and the second is largely illusory. In principle any volume of national income can be financed from any quantity of money. All that is necessary is that the rate of turnover be sufficiently rapid. Of course, this principle can be pushed to absurd lengths; the business of the country could not easily be carried on with only two one-cent pieces, say; but nonetheless, within the limits of practicality, all degrees of prosperity or depression can exist whatever the quantity of money may be.

The function of the banks as suppliers of money may be seen to be chiefly that of exchanging one type of money for another -- deposits for banknotes or coin for deposits -- so that economic life may be carried on with a maximum of convenience. This function they already fulfill satisfactorily in normal periods, and it seems probable that the extension of the F.D.I.C. will in time enable them to fulfill it even in a period of crisis.

During a financial panic, the apparent shortage of money often indicates that convertibility -- particularly of deposits into other

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forms of money -- has been impaired. The idea of an insufficient supply of money has also, however, been associated with continuing business depression. This view is less plausible now than ever before. The volume of deposits is at the highest level in history, having risen steadily since 1933 with only a slight decrease in 1937, but unemployment remains around nine million. What has been called a shortage of money is really an inadequate flow of capital expenditure. We shall now turn to the examination of this problem.

## The Regulation of Investment

### The Changed Purpose of Control over Banking

The establishment of the Federal Deposit Insurance Corporation in 1933 did not solve once and for all, the problem of guaranteeing the convertibility of deposits. There is reason to believe, for example (on the basis of a study of the records of suspended banks conducted by the Federal Reserve System and financed by the WPA) that larger depositors, not fully insured at present, have a disproportionate importance in the drain of deposits that culminates in bank failure. (In the months preceding suspension, for the sample of banks studied, accounts of $25,000 and over were reduced 64 per cent, as compared with a reduction of 40 per cent in total demand deposits and of 6 per cent in accounts smaller than $500.) Nonetheless, the F.D.I.C., by protecting the smaller depositor, has taken the most important first step towards a solution, and has indicated a type of approach that should eventually succeed if the insurance becomes more inclusive in coverage.

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This insurance is very largely costless, since the very fact that the Government guarantees convertibility in itself removes the incentive to convert. Checks are, at least for most business purposes, more convenient than cash, and all that depositors demand is the assurance that cash would be available if they wanted it, even though they never will. Unfortunately it is not yet generally realized that our outstanding banking problems are now of a different nature. Many people continue to discuss banking regulation as if its objective were still simply the protection of depositors.

Before 1933 bank examinations, for example, were an essential protection from the point of view of depositors. If bank funds were invested in highly speculative schemes, the depositor ran the risk of losing his money. Since 1933 it remains important to scrutinize the assets of banks, but it is important for different reasons. However unsound individual investments may be, at least the smaller depositors are protected. The community as a whole is concerned, however, with the use that banks choose to make of their funds. The banking system, along with those who borrow, is responsible for the utilization of the nation's productive resources. Therefore we are all concerned that it use its powers wisely. The criterion, however, is not now simply that its investments be easily disposable, in the interests of depositors, but rather that they be adequate in volume and of a desirable character, in the interests of all of us.

The Quantity of Investment

The productive power of the nation might be divided into three categories. The largest of these represents the resources used in mak-

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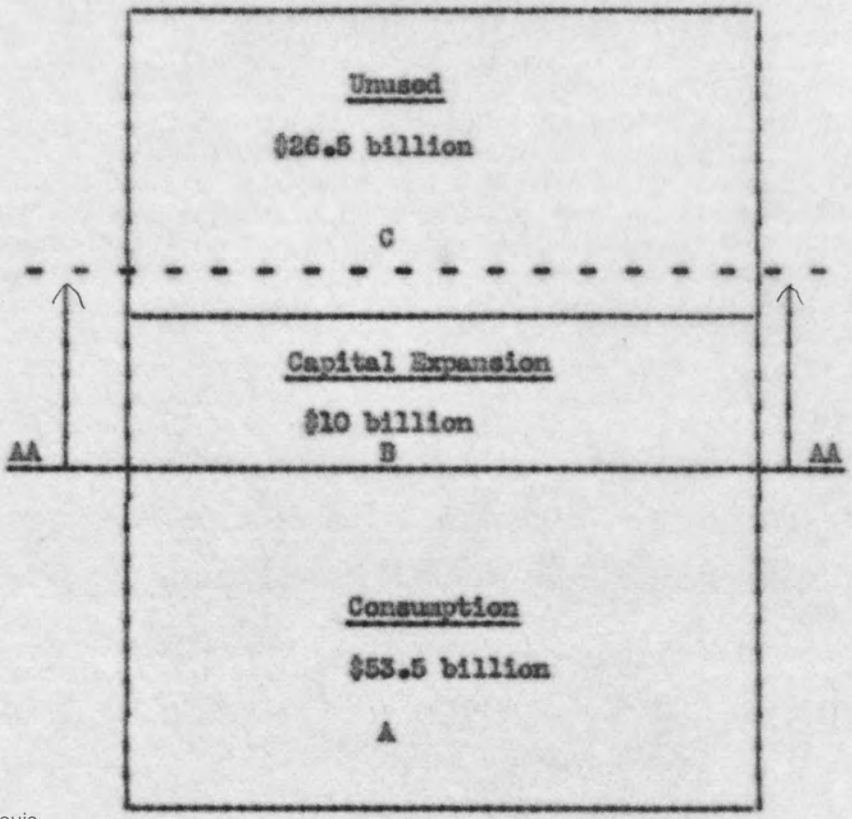
ing goods for consumers. This includes the materials and energy necessary for repair and maintenance; that is, it includes the resources actually used to offset depreciation in the consumer goods industries. In addition to this, a smaller fraction of our resources is used for expanding our capacity to produce. The third category is the most important from the point of view of economic control. This is the fraction of our manpower and equipment that at present remains unused. The chart is intended to give simply a rough idea of the relative magnitudes of these three divisions. It is based on estimates of the national income and productive capacity for 1938. Obviously the money value of unused resources must be largely a guess, and for our present purpose the figures may be considered merely as illustrative.

Utilization of Productive Power
Estimated as of 1938

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Since government policy is concerned with the future rather than with the past or the present, it is the two top divisions of the chart to which we should direct our attention. These represent the resources not needed to maintain the existing level of consumption. Whether these "surplus" resources are used and what specific uses they are put to depends upon the decisions of those who hold, or can obtain or create, money.

Money gives its holder the right to command a certain quantity of the national resources. To spend a thousand dollars on an automobile means that a thousand dollars worth of labor time, steel, rubber, aluminum, etc., (plus profit) has been embodied in an automobile. These particular units of labor power and materials have not lain idle, nor have they been used for something else. They have been made into one identifiable automobile, which the purchaser now owns in place of his thousand dollars. Goods do not continue to be produced unless someone -- either a final consumer or a business purchaser -- is willing to pay for them. Our automobile, for example, was paid for first by the manufacturer, in the form of wages, materials cost, maintenance expense, etc. It was then paid for by the dealer and finally by the consumer, perhaps with the help of a bank or finance company.

Holders of money, or those who can obtain money, have the power to direct the utilization of the national resources. If they are unwilling to exercise this power, resources lie idle. In this case it is necessary, in order to approach full employment, to put money into the hands of those who <u>will</u> exercise their legal right of spending it. One channel

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for accomplishing this is the banking system.

No one is likely to borrow money merely to let it lie idle. Loans are usually made for a specific purpose. The proceeds are used for making something or buying something. The purchase of already existing assets may not stimulate business activity, but loans that finance orders for new goods do generate income, help bring about prosperity, and decrease unemployment.

This fact explains the connection under certain circumstances between business activity and the quantity of money. The relation between bank loans and the volume of deposits has been fully explained in previous testimony. Briefly, when loans or investments are expanding, deposits automatically expand also. The banks in effect make new money available to borrowers.

The government has attempted to stimulate incomes -- to put money into the hands of those who will spend it -- by encouraging the banks to make loans freely and on easy terms. Such agencies as the RFC, the FHA, the Export-Import Bank -- in short, all of those now consolidated in the Federal Loan Agency -- are also concerned with facilitating the flow of income by lending money. But since funds can be used for productive purposes only if someone is willing to borrow them, the government has also since 1933 attacked the same problem from the other end. It has obtained command over idle resources by borrowing funds through regular banking channels, and has put them to work on public works projects and in other ways. The USHA is an excellent example of this process, since its influence has been exerted on both sides of the investment market.

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It has lent to local housing authorities, but at the same time it has stimulated these local authorities to borrow.

The terms on which the government decides to borrow exert an important influence over the capital markets. By increasing the supply of short-dated paper, for example, the Treasury may decrease the willingness of banks to hold long-term securities.

The logical connection between government banking policy and its direct lending and borrowing operations is clear. If we remember, in addition, that the general objective is, as we said before, to put money into the hands of those who will spend it, several other aspects of government activity may be fitted into a consistent pattern.

It is generally true that lower income groups spend a larger proportion of their incomes than do wealthier groups. Social Security benefits increase the incomes of those at the lower end of the scale, as do WPA expenditures and farm benefits. Thus they have the net effect of giving money to those who will spend it. This result is to some degree independent of whether the outlays are financed by borrowing or by taxation, although in the latter case they are not independent of the type of tax system in force. There are two methods by which money can be made available to those who will spend it: they may be given newly created money (that is, either the government or a private borrower may borrow from the banks, or the government may simply make new money by purchasing gold or silver, by running the printing presses, or by other methods) or already existing money may be transferred from those who would not spend

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it (this involves either a certain type of taxation, borrowing from non-banking sources, or gifts). Not all taxes, of course, reach only incomes that would not otherwise be spent: to approach this, the general criterion is that they should fall more heavily upon the rich than upon the poor and more heavily upon saving than upon spending.

The banking system thus takes its place as one element in a structure that includes government lending agencies, the tax system, wage policy, the Social Security program, assistance to farmers, public works, and private investment, consumption, and saving decisions. The banks can do rather little to stimulate incomes unless someone is willing to borrow, but they have an important negative power to prevent borrowing even when other conditions are favorable. Thus a correct banking policy is a necessary condition for prosperity, but it is not sufficient. Indeed, the banking system has been compared to a piece of string: you can pull with it, but not push; restrain, but not encourage.

The Meaning of Inflation. The preceding analysis bears directly upon the problem of potential inflation. We can now see that this danger, when it exists, does not depend upon the volume of excess reserves or even upon the quantity of money. The resources of the nation are limited, although unfortunately the limits have not even been approached in the last ten years. Dangerous inflation occurs only when the rate of expenditure for consumption and capital expansion taken together exceeds the maximum output of our working population. This situation seems conceivable only at the height of a great wave of prosperity or as the accompaniment or aftermath of a war. It is at any rate not likely to

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spring upon us without warning, but would develop progressively as the limits of capacity were approached.

Anti-inflationary situations may appear when capacity in certain lines is strained even though output over the economy as a whole has not reached its maximum. Because resources are fairly mobile over time, so that capacity in most lines can be rather quickly increased, such a situation is usually only temporary. If it persists, the harm done generally takes the form of undue profits in the particular industry. This might be undone to a large extent by appropriate taxation. If the commodity in question is an important one, so that an increase in its price will be reflected in the prices of a large number of other commodities, some further action may be desirable -- either to hasten the expansion of output or to restrain demand by some means other than price advances. Banking policy at any rate is not an appropriate method for dealing with such a problem, since it is not sufficiently selective; a restriction of credit facilities tends to decrease the demand for all or most kinds of commodities, and its effects cannot be confined to the appropriate industry.

Even a general price rise may occur while unused capacity and unemployment remain at a high level. If the national income is expanding for any reason, or is expected to expand, business men may attempt to increase their profits by raising prices. By doing so they discourage purchases and therefore retard the expansion of incomes. For this reason it is desirable that price increases be combatted unless they are clearly associated with capacity operation. We must take care, however, that the

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remedy does not itself retard the flow of incomes. If rising prices are to be taken as the sign of inflation, full prosperity may never be reached, for there is usually some price advance associated with an upswing. A policy of credit restriction in an attempt to prevent the type of price advance associated with rapidly expanding output may succeed, but it is likely to kill the recovery along with the price boom. It amounts to shooting the baby so that he won't grow up and die of apoplexy.

Control of Inflation. The volume of consumption (marked A on the chart) is far more predictable than the volume of investment expenditure (B). It depends largely upon the amount and distribution of the national income. The problem of preventing inflation, if such a problem should ever arise, would therefore be one of controlling investment. As the level of national monetary income rises, the volume of consumption also rises, almost automatically. Thus if inflation is to be prevented, it is necessary that the rate of investment be kept below the output possible within the narrowing limits of "surplus" resources. That is, as consumption increases, the line marked AA on the chart tends to rise, leaving a decreasing amount of productive power available for making capital goods. Control over investment rather than over member bank reserves or the volume of money is thus the crux of the problem.

Industry can obtain outside funds conveniently for purposes of long-run plant expansion only through the flotation of securities. Once the securities have been floated, those that represent fixed obligations may be sold to banks, but the necessary preliminary is that they at least

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be offered through the organized exchanges. Industrial borrowing, therefore, comes under the surveillance of the Securities and Exchange Commission. There is thus a much more effective safeguard against undesirable types of investment than has existed at any time in the past.

The willingness of the banks to hold large quantities of long-term bonds is dependent largely upon the volume of excess reserves and the availability of more liquid assets. As excess reserves are reduced, the banks are likely to sell bonds in an effort to maintain liquidity. This tends to raise long-term interest rates and, if carried out rapidly enough, may even destroy the market for new issues entirely. Thus the Reserve system, although it might not be in a position to absorb excess reserves entirely, may contract them enough to depress the long-term bond market to any degree desired. Even the suggestion that excess reserves are to be reduced in the near future might well have a similar effect.

Since 1934 the Board of Governors of the Federal Reserve System has had power to fix margin requirements for loans by brokers to their customers. Thus the receptivity of markets for new equity securities may be restricted, even after the SEC has allowed them to be floated.

The very fact that an increasing fraction of the national income passes through government channels means that control over possible inflation is strengthened. An important part of total investment is made directly by the government and can therefore be regulated without relying upon the instruments of credit control.

The most important loophole in this control over investment is the reinvestment of corporate surpluses and depreciation accounts. Corporations often build up large cash reserves out of operating profits, and the

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use that they make of these funds can be influenced by the government or banking authorities only indirectly, if at all.

Borrowing to meet operating expenses or to finance inventory accumulation does not ordinarily pass through the investment markets, of course. The cash reserves of corporations are of even greater importance for this type of financing than for plant expansion -- as evidenced by the decline of the commercial loan. It is probably true that even the most drastic action by the Federal Reserve System could not directly prevent an inventory boom at present, although such action, by serving as a portent of other steps by the government, might achieve its purpose by indirection. This is no cause for despair, however, for it is doubtful if any central bank was ever in a position to control inventory booms without at the same time destroying prosperity. The reason again is that credit control is not sufficiently selective: when loans are not easily available for inventory accumulation, they are not easily available for other purposes either. (The efforts of the Federal Reserve System to curtail the use of bank credit for stock market speculation in 1929 may perhaps be seen as a first step towards a new type of control.)

The Direction of Investment

Since the Federal Reserve Banks have rarely sought to control the uses to which funds are put, this power remains largely with the member banks. Every loan is made to a particular person or firm, usually for a particular purpose. The decisions made by banks help to determine the type of productive equipment that will be provided for future use, and are

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therefore of vital importance to the community. The outstanding duty of the banking system at present is to cooperate with all those who would borrow for desirable purposes. In time of full prosperity, however, the banks must fulfill a censors' role, selecting from along alternative projects those that seem likely to be most useful. This last function might be of paramount importance in a period of war abroad, since the demands resulting from war are of a different pattern from those of normal peacetime prosperity. The response to them might result in the building up of capital equipment not wanted in the future. It might also result in diverting our labor force to localities and occupations in which they would later be stranded. This sort of unbalanced development could be at least retarded by far-sighted policy on the part of banking executives.

## Conclusion

There is a developing realization among economists that many of the problems that have been regarded as monetary result in fact from an inadequate flow of investment expenditure. The banks alone cannot generate such a flow, but they may impede it by inappropriate policy. Besides facilitating the flow of investment, the banks have the further duty of directing it into the most desirable channels. There need be no fear of dangerous inflation, at least during peacetime, since control over the investment markets is more effective than ever before. The government's role should therefore continue to be one of supplementing as well as cooperating with the banking system -- stimulating and directing investment in all the various ways that are open to it.

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