T. ALAN GOLDSBOROUGH
FIRST DISTRICT OF MARYLAND

COMMITTEE ON
BANKING AND CURRENCY

HOUSE OF REPRESENTATIVES

WASHINGTON, D. C.

November 19, 1938

Hon. Marriner S. Eccles
Chairman, Board of Governors
of the Federal Reserve System
Washington, D. C.

Dear Marriner:

I am on my way to Chicago. On next Wednesday, November 23, if it is convenient to you, I want to discuss a purely personal matter with you.

I am going to ask you in the meantime to read the enclosure very carefully.

When I see you next Wednesday, I am not going to ask you an opinion on the enclosure. I want you to read it for an entirely different reason.

With kindest regards, I am

Very sincerely yours,

T. Alan Goldsborough

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On page 4, the statement, "Under the bill retailers take vouchers from their customers for the discount allowed, which vouchers when included with a cash deposit at a bank by a retailer is credited as part of his deposit and charged in the bank's books to its interbank currency account" is not accurate. The bookkeeping will be between the retailer and the bank. The customer will simply get his goods at a reduced price.

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Monetary Policy of Plenty Instead of Scarcity

Statement

of

Hon. T. Alan Goldsborough

of Maryland

before the

Committee on Banking and Currency of the House of Representatives

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STATEMENT

OF

HON. T. ALAN GOLDSBOROUGH

Mr. GOLDSBOROUGH. Mr. Speaker, under the leave to extend my remarks in the RECORD, I include the following statement I made before the Committee on Banking and Currency of the House of Representatives, July 8, 1937, on H. R. 7138, a bill to provide a national monetary policy which will have a definite relation to the requirements of domestic industry and trade under the conditions imposed by our power economy, which will increase production and consumption to the limit of the country's power to produce, and for other purposes:

A cursory reading of this bill may give many people the impression that it is just another measure seeking inflation. On the other hand, the more closely it is studied the more I believe it will appear to be based on the known laws that govern the phenomenon of money.

This memorandum is addressed to the banking fraternity with the hope that it will throw light upon the rationality of the bill itself, and also upon some of the more obscure monetary phenomena. It is a truism to say that the working of our monetary system has been filled with surprises and anomalies even to our best informed practical bankers. In no other way is it possible to account for the extraordinary experiences we have been through during the past decade.

As a result, much public antagonism has been aroused against the banking profession, and many demands have been made that its power be curbed. In fact, a great deal of recent legislation has been aimed at regulating and controlling the issuance of credit through which the bulk of the circulating medium comes into existence as demand bank deposits.

It may, however, be categorically stated that the majority of bankers have been greatly at sea as to the results of their own actions in the issuing of credit to the public and have been caught in the maelstrom of finance without realizing how it had come about.

The management of a people's money throws terrific responsibility upon those charged with it, and whatever truth there may be in the claim that a sinister money power exists, it is certain that few bankers are conscious of it as a concrete force, driving them whither they would not go, as responsible and public-spirited citizens.

The fact is that discarding from this argument any evaluation of the money power above mentioned there is sufficient room to study the circumstances which have been largely responsible for our recent experiences, and which lie to a very great degree in the monetary mechanism which we have inherited. At the very outset we are confronted with the fact that gold, which many people regard as an anchor to windward of any monetary system, is in itself so unstable a commodity that it is constantly creating havoc

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with the "best-laid plans of mice and men" and actually does not hold any industrial system stable. The phase of the gold problem which we are at this moment passing through is sufficient proof of this statement.

What the Nation is concerned with, and what bankers are perforce equally concerned with, and what H. R. 7188 is concerned with is to bring about a reasonably sane relationship between a credit system that actuates a power economy based on mass production and an industrial commonwealth of immense significance to civilization.

THE PHILOSOPHY OF THE BILL

The two primary principles upon which the bill is built are:

First. Money is the medium of exchange which has replaced simple barter and rendered possible the vast complexities involved in the production and distribution of wealth under modern conditions. To be effective it must circulate freely. It cannot circulate freely unless it is available in sufficient quantity to the buyers and consumers who constitute the open market for goods. It is this open market for goods which stimulates production of wealth and the general advance of civilization.

Second. The mechanism by which circulating money gets into the channels of trade is not geared to the consumption production cycle in such a way that an even flow of effective demand for goods can be maintained. The changes that have been wrought in industrial life by the introduction of power resulting in mass production are not being adequately met by the issue of credit solely for the production of goods, and a supplementary source of credit is necessary. The bill is designed to supply this deficiency through a systematized method of price adjustments based upon the relation between the natural demand for consumption goods and the national ability of our technical equipment and resources to supply those goods.

Both of these statements will be more fully discussed in the following pages in the relation they bear to the banking system. For the present they may be regarded as axiomatic, in the light of the experience of the past half century and the statistical history pertaining to it.

The two chief problems that the bill is designed to solve are:

First. The proper adjustment of the real value of the monetary unit (the dollar) in its relation to the goods offered for sale. This is something that bankers are greatly concerned with, because the majority of bankers are continually harassed by the fluctuations of dollar values; in other words, the dollar itself.

Second. The maintenance of the volume and speed of the circulating medium in relation to its purchasing power and the volume of goods offered for sale. The volume of production should, of course, approach capacity in order to assure profitable operation to industrial plant. It is not a stable money that the bill seeks to establish, so much as a reasonably stabilized industrial system. But the one is tied so closely to the other that they constitute essential components.

Both of these problems have held the center of the national stage for close to 10 years. They have become household words amongst us as "The need for increasing purchasing power" and "The revival of production and employment."

In effect the bill seeks to establish a "national monetary policy having a definite relationship to the requirements of domestic industry and trade under the conditions imposed by our power economy"

A coordinated national monetary policy has been conspicuously lacking from our national economy both in the banking system itself and in the Federal administration. But it has been recognized as a need and has been called for time and time again. This lack may be explained by the fact that there had appeared no

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fundamental principle upon which to base one. The machine has now presented it.

The monetary policy that the bill materializes is that it is a Federal responsibility under the Constitution to so adjust the value of money that it conforms to the law of supply and demand. It therefore raises the purchasing power of money by reducing the price of the necessities and comforts of life known as consumers' goods.

Section 2 does this by establishing a general blanket discount on the price level of goods sold at retail. It is done through licenses issued to all retailers to dispense the established discount by, in effect, selling below cost. In other words, to sell at a discount fixed by a credit commission especially equipped to estimate the current flow of trade. The Secretary of the Treasury is charged with the carrying out of the provisions of the bill, and the findings of the Federal credit commission, which the bill sets up, under rigid statistical restrictions.

The resultant price level of retail goods, which include the public services such as electricity, hospitalization, transportation, and so forth, has the effect of increasing the purchasing power in the hands of the public, arising from whatever source it may, by the amount of the discount. This price level is known as the compensated price, because it compensates for the shortage of buying power as against producible goods.

The retailers who dispense the discount—which means all responsible ones—are reimbursed by the Government through the banking system by means of an issue of interbank national currency, which is not legal tender to the public, but which is used by the banks as a backing for credit and is legal tender within the system.

Under the bill retailers take vouchers from their customers for the discount allowed, which vouchers when included with a cash deposit at a bank by a retailer is credited as part of his deposit and charged in the bank's books to its interbank currency account. The bank in turn is reimbursed by the Treasury with an equivalent amount of interbank currency notes. The retailer's deposit circulates as he draws checks against it, and the interbank currency circulates through the clearinghouses in settlement of interbank balances, offsetting the circulating deposits arising in the accounts of the retailers as the result of the discount. The general level of deposits in the banking system will be increased in exact proportion to the issue of interbank currency and will be lowered correspondingly if or when it is recalled.

The cost to the banks for rendering this service is covered in the bill by a provision for fixing the service charge by the Federal credit commission. As far as the banks are concerned, the handling of the write-ups of the retailer's accounts to the amount of the vouchers received is practically the same as if they discounted a retailer's note, except that instead of charging him interest they make him a service charge and hold interbank currency as the collateral.

The financial technique involved in the application of the discount at retail will be discussed further in later pages. Suffice it to say here that it should be clearly grasped at the outset that this issue of credit through an expansion of national interbank currency is so arranged that it only gets into circulation after an actual sale has been consummated. It represents actual transactions in trade, increasing the turnover of the retailers, wholesalers, prime producers, and transportation systems by the amount of the credit issued, and as much of it as continues to circulate.

Section 3 of the bill is confined to definitions of various technical phrases used in the body of the bill.

Section 4 provides the method for the determination of the rate of the discount at retail, which initially is fixed at 15 percent. But

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thereafter the discount is varied in accordance with the ratio that goods going into consumption bear to productive capacity. A special Federal credit commission is charged with this duty. Its duty is to collect and coordinate the indexes of trade, credit, and money in circulation, and to report the findings to the Secretary of the Treasury, who has no leeway to alter their findings. He is charged with announcing the quarterly rate of discount.

The process simply amounts to this: That when wanted goods cannot be sold the retail discount is increased. If demand catches up with supply, the discount is cut or discontinued. It is an automatic way of keeping supply and demand in harmony through the price level. A margin of safety is provided in paragraph (c) by prohibiting any discount when the margin between consumption and productive capacity is less than 15 percent.

Sections 5 and 6 provide regulations for the application of the discount. They are administrative and appear sufficiently clear to pass without comment.

Section 7: Settlement of discount allowances through banks.

Some explanation of the technique involved in carrying out the monetary and credit provisions of this bill have already been given. The text of the bill appears fairly specific in these particulars. Anyone familiar with banking methods should readily see that the process of issuing this credit is precisely the same as that of discounting a retail customer's promissory note, except that instead of the note backing the write-up of his deposit account, the credit arises from a deposit of interbank currency by the United States Treasury. This relieves the retail depositor of an obligation to repay, and the bank is protected by the fact that its responsibility is that of a fiduciary. The bank is relieved of the personal responsibility that accompanies the issue of loans on its own account, but all parties are governed by current statistical records.

TITLE II

This title deals with the organization of the Federal credit commission which the bill establishes for the purpose of maintaining a balanced credit system throughout the Nation. Its duties are circumscribed by the statistics of money and trade, which it will collect and interpret. Its specific duty is to maintain a balance between production, consumption, and purchasing power.

It is protected from extraneous political or other influences. Its findings are to be based on the conditions of trade and industry, just as the findings of a court of law are based upon the interpretation of existing statutes.

TITLE III

This title deals with the regulations governing the issuance, circulation, and recall of the interbank currency. From the standpoint of the banker it is the most important part of the bill, because it provides the regulations for carrying out the terms of the bill through the banking system.

Interbank currency represents a recallable issue of credit which circulates throughout the banking system in support of discounts on prices of goods and services sold at retail for the purpose of bringing effective demand into harmony with full production.

It cannot be included as part of a bank's fractional reserves, but it constitutes 100 percent reserve against the credit that has arisen from it. In other words, if a bank has received from the Treasury or a clearing house $100,000 of interbank currency and has $1,100,000 deposits, the notes are 100 percent reserve against the odd $100,000 deposits. And as such they circulate everywhere within the system.

As the original credit gets diffused throughout the circulating deposits of the system the currency becomes equally diffused. Greater activity in the retail trade would call for greater produc-

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tion for replacements, and expanded private production credits. With increasing business security prices would tend upward and the demand for collateral loans would increase.

If a runaway market seemed imminent, the notice of recall of a percentage of notes outstanding would impose upon the banks the obligation of calling in sufficient money to cancel an equivalent amount of credit then outstanding, which would release the notes, in the same way that private collateral would be released, when individual loans are called. And the notes would be returned to the Treasury.

It is not unlikely that this action would result in a lowering of speculative prices, and the consequent added reduction of the loans made for the bank's own account. Normally a movement of this nature results in a general lowering of trade. But as the retired currency notes were reissued in the form of new retail discounts, the loss of buying power would be offset and demand for goods sustained. There would be a sound basis for stability and sustained confidence.

In effect the system constitutes an alternating current of credit paralleling the alternating current of electricity, now in use. The introduction of the alternating current is responsible for the benefits we now enjoy from electricity, although its adoption was strongly opposed by people who ought to have known better. At the present time we would be lost without it. An alternating credit system holds as great a potential for the improvement of the industrial and banking world as did this innovation in public utilities.

It is provided that the banks act as fiduciary agents of the Government in handling the interbank currency and the credits arising therefrom. For this service a commission is chargeable to their customers at retail, which should offset the loss of income now being experienced by them, through the curtailment of trade credits, which was always considered the most legitimate and reliable source of banking income.

Another provision for the protection of the banks is in regard to conversion of deposits into currency on depositors' demands. There is no reason to suppose that the volume of currency in circulation would be increased. In fact, it would probably be reduced as banking activity and confidence would result. Individual banks, however, can always get into trouble, resulting in hasty withdrawals of their depositors' money. Banks thus caught can, on application to the Secretary of the Treasury, convert any interbank currency notes into national currency for their customers. This proviso augments the deposit-insurance provisions of the 1935 Banking Act in the degree that interbank currency notes have increased demand deposits.

Any bank holding these notes can use them for the liquidation of its own Federal taxes. But if it does so, it must, of course, have other surplus resources to support its outstanding credit reserves. It is the design of this bill to establish a fund of permanent bank money that cannot be recalled through a fall in the price level, and that will circulate continuously in the channels of trade. Some of it will constantly accrue to inactive bank accounts through profits and savings. The loss of this money to the blood stream of trade would be replaced automatically under the bill, and if the accumulations of liquid capital became too great, it could be called in by any of the means provided or by increased inheritance taxes, which are probably the most wholesome and least objectionable means of taxing the rich.

Paragraph (g), section 301, title III, provides several safeguards against inflationary conditions. It confirms the existing open-market operations and rediscount rate control and expands the control of the ratio of fractional reserves by so adjusting the regulations that this element of inflation prevention is established on a sliding-scale basis, the same as the rediscount rate.

31344—14469

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There are good reasons for feeling that an elastic system of reserve ratios will be a safeguard against the creation of an excess of speculative money.

In this connection it is well to recall certain elements in the situation that culminated in 1929. In the 7 years preceding a serious credit inflation developed, and bank deposits increased approximately 27 percent, from 43.4 to 55.3 billions of dollars (1924 to 1929). Loans increased at the same time over 30 percent, or from 31.5 to 42.2 billions (Federal Reserve Bulletin).

Other significant statistics are:

Commodity price index, 1924, 98; 1928, 97; 1929, 95.

Eligible paper in member banks June 1926, 4.9 billions; June 1929, 4.5 billions.

Value of bonds on New York Stock Exchange January 1925, 13½ billions; January 1929, 17½ billions.

Value of stocks on New York Stock Exchange January 1925, 27 billions; September 1929, 89½ billions.

Commercial loans, national banks, 1924, 8.33 billions; 1929, 8.12 billions.

Security loans (excluding United States obligations), 1924, 3.64 billions; 1929, 6.67 billions.

These statistics prove that the inflation that occurred was an inflation of monetized capital values, and that there was not only no inflation in commodities or the cost of living but that in spite of the plethora of money in the banks and the security markets the production of consumer goods was not being fully supported.

At the same time that the production index was rising from 100 to 119, the commodity-price index was falling from 98 to 95, the eligible commercial paper was falling from 4.9 to 4.5 billions and commercial loans from 8.33 to 8.12 billions.

In these years also technological unemployment appeared and increased, whereby hundreds of thousands of highly trained artisans and experts were unable to earn a living, while the production index climbed 20 percent.

It seems almost superfluous to point out that the apparent overproduction, which was one factor amongst several others that started the downward spiral, was nothing but camouflaged underconsumption.

The question therefore of controlling the money of the country so that the capital values that have been created may be justified and inflationary conditions avoided, becomes from the bankers' standpoint one of restoring the flow of money through the channels of trade.

A NEW TYPE OF CURRENCY

The idea behind this type of currency is the need for increasing the flow of commercial credits which have been the backbone of commercial banks, and out of which the many ramifications of the modern banking system have developed. The volume of commercial credits flowing continuously is one measure of the spendable income of the Nation. It is the savings conserved out of this spendable income that give solidity to all forms of capital credits and eventually liquidate them.

If capital values and earnings are to be permanently restored, it can only be through the revival of trade in nondurable goods to a point where debt charges and amortization can be "saved" out of the flow of new wealth into consumption.

To attain this the ratio of commercial credits will of necessity have to be increased, and so far no way has been found to do this except by Government borrowing and spending and ignoring the threats that inhere to an unbalanced series of Budgets.

This statement may be challenged by those who still maintain that private initiative can achieve the same result, and point for proof to the 7 years preceding 1930. But the facts of the case refute any such contention, because reference to statistical records shows that while the Federal Government did not at that time

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borrow and spend beyond its means, the great mass of the active public, and also the minor units of government, did that very thing. It makes no difference whether the Government or industry follows this route to prosperity, the end is the same—inflation followed by deflation.

Hence the primary purpose of the issue of interbank currency provided in this bill is designed to restore the flow of commercial transactions to a sound ratio with capitalization and capital charges, by injecting into the arteries of trade the ratio of purchasing power that is lacking. It enters the commercial credit stream at such a point and in such a form that every dollar of it inevitably means an immediate increase in trade of that amount.

To repeat—this currency is a limited issue and is designed to circulate throughout the banking system as the backing for the circulating deposits it has given rise to. In this respect it becomes a revolving fund of permanent deposit money for the support of trade. It can only be recalled if or when there appears to be an excess of spendable money over the volume of goods, that would cause an unwholesome rise in prices. The Government, under advice of the Credit Commission, would notify banks that they should reduce their outstanding credits so as to establish surplus reserves sufficient to permit the return of the required quantity of notes to the Treasury. The process would parallel the increase of reserve requirements or the sale of Government bonds in open-market operations to curtail excess credit.

The bill retains the open-market operations in Federal securities and the control of the rediscount rate as part of a soundly managed credit mechanism to which the interbank note issue is added. But the notes have another function which is equally important; that is to maintain public purchasing power and stabilize the productive income.

It seems unnecessary in this paper to refer to the other administrative and regulatory features of the bill. My main purpose is to try to relate the financial features it proposes to the monetary system as it is and to show how and why it deserves the support of public-spirited bankers in the interest of profitable banking and a sound monetary system.

GENERAL DISCUSSION

The origin of money was to facilitate the exchange of goods and services between individuals and groups. The origin of banking was to conserve, protect, and facilitate the transfer of money. As transportation facilities increased and the volume and size of shipments of merchandise expanded, bank credits developed in harmony and provided the medium of exchange that monetized goods in bulk as they passed from hand to hand or place to place.

Without the aid of bankers' credits the growth of centers of population and group industrialism would have been retarded. The business of banking became profitable and essential. But practically the whole of this financial business was built upon the trade in consumable or semidurable goods. And the credits which established the medium of exchange in them were virtually self-liquidating. They came into existence as goods were produced and transferred and went out of existence as the goods disappeared through consumption, to be reissued for new production.

Metallic tokens of exchange and bullion facilitated these operations on balance, and also as a storage of value. Out of this trade in consumable goods came monetary savings and the growth of material wealth. This trade has been the foundation of banking, finance, and capital as we know it today.

Cooperation between the banking system and the Government is, of course, just as essential in the carrying out of the technique of the bill as it is in other fiscal operations. But by the use of the type of credit expansion provided by the interbank currency notes the banks are relieved of the serious consequences that may

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follow credit expansion through the discounting of Federal obligations to excess on the basis of an imaginary market.

The only real wholesale market for Government bonds in the event of a serious credit squeeze is the ability of the Government to issue billions in currency in the process of buying them back. That is generally recognized as the inevitable outcome of the present monetary policies, if continued, and is the essence of disastrous inflation.

On the other hand, the limited currency provided by interbank currency notes is governed in quantity by transactions in trade and throws no strain on the resources of the banks. They would conduct their business as usual, without the danger of forced liquidation, and with an assurance of a demand for goods that would put their industrial customers onto a profitable basis. In other words, the other departments of the business of banking would become increasingly profitable.

And this truth holds good in our time, and will continue to hold good under any free economy. The trade in consumption and semidurable goods, and the circulating credits arising therefrom, have made sound banking possible, and without them in excess ratio to other forms of finance, such as is involved in the growth of capital, we cannot progress.

I believe this statement will not be denied by any competent banker. It has been asserted time and time again that the recent bank debacle was due to the shortage of these trade credits in relation to general financial conditions that forced the banking system to use its surplus credit for financing long-term obligations. It is certain that the available records furnish ample proof of it.

If we restore our national productive income by means of new long-term credits (which we are now trying to do) and fail at the same time to restore our national spendable income to a parity with them, we face the certainty of greater inflation and greater deflation than we have ever known.

The bill that we are discussing (H. R. 7188, 75th Cong.) proposes a way to do this, based upon monetary principles which history has proven sound, and which I have tried to outline above. In a nutshell, it is to restore the flow of trade by restoring the flow of commercial credits through the banking system in such a way as to augment the spendable income and bring it into harmony with our reasonably possible productive income.

Nothing would do so much to give us a sound banking system and profitable capital investments.

BANKING—FINANCE—MONEY

In the days when banking consisted chiefly of commercial credits the system of issuing money possessed inherent characteristics that guarded against booms and depressions, except when forced by deliberate Government mismanagement induced by wars, or an occasional speculative boom like the South Sea bubble, and other minor ones, in some of which the colonial concessionaires in London and their companies were involved in the early days of this continent.

The principle underlying the system still persists and may be tersely expressed in the bankers' dictum, "Put money out when prices are rising and pull it in when they fall." In any economy where production is achieved mainly by hand labor, and where large mechanical equipment is not the dominating feature of production, this dictum is "just fine." It follows the provisions of nature.

When nature was lavish and peace prevailed, large production needed more money to distribute it. When crops failed and floods and pests were rampant and possibly famine threatened, money must be called in to prevent famine prices aggravating the shortcomings of nature.

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But these conditions have ceased to exist The whole system of production and consumption has changed. Power and the machine plus the vast monetization of capital equipment has changed it.

The worst thing a banker can do now is to start calling in money when prices begin to fall. Carried to excess, as it was in 1929–33, few bankers escaped a serious blow along with the ruin of their friends and neighbors. They were wise in their generation to protect their depositors. They had no alternative. But any system that has that story to tell is obsolete and unsocial under existing conditions.

The reason it is obsolete (and destructive to an effective power economy) is because science and the machine have made the available supply of goods, both agricultural and durable, a relatively stable item. The volume of merchandise producible is now more a matter of human will than of Nature's vagaries. But in order that humanity should gain this control of Nature it has been necessary to expand the monetary system in the direction of monetizing capital values and equipment.

The consequence is that unless there is a dependable supply of money available constantly to the buying public, the demand for the products of industry, which ought also to be a stable factor, has by force of circumstances become highly unstable. It has become unstable because the supply of money available to it is unstable. The supply of money is unstable because the money issued is based entirely upon the general price level and must be recalled when prices begin to fall.

It was stated above that in the time when the forces of Nature were the chief governing factor of the volume of production the issue and recall of trade credits were a necessary stabilizing factor, because a shortage of goods necessitated a reduction in the money supply to prevent the kiting of the cost of living. In those days the great mass of bank credit was issued against goods in trade, which always has been the backbone of sound banking. But in our day the greater part of the credits issued circulate as capital credits, although their validity is based upon the savings arising from the trade in usable goods, which savings liquidate them and provide new capital credits for replacements and improvements.

While bankers still realize the importance of the trade credits to a stable banking system, force of circumstances has driven them into dealing in too great a proportion of capital credits, i. e., credits issued against and dependent for their validity upon the earnings of capital. Obviously the earnings of capital are dependent upon the volume of goods passing to consumption, and thus creating replacement demand, continuously and unfailingly. Reliance cannot be placed upon the production of durable goods because it is so easy to glut the market with them. The demand for durable goods has a narrow horizon compared with the perpetual, and necessitous demand for consumable goods.

It would be difficult to glut the markets with consumable goods provided that the purchasing power is adjusted to their volume. It should be clear to anyone familiar with money and banking that if the great mass of capital credits now in existence are to be validated, it must be done through legitimate trade channels; and that these trade channels cannot be supported by credits for capital account.

Recent experience goes to prove this statement.

The Reconstruction Finance Corporation has revived at least $5,000,000,000 of what was moribund capital credits, and in addition the Government has pledged its credit for $15,000,000,000 more. The result is an increase of perhaps $25,000,000,000 in national income. From $40,000,000,000 in 1933 to $65,000,000,000 this year.

We have won, then, through the capital markets an increase of $25,000,000,000 in national income of doubtful dependability by perpetuating and increasing long-term debt to the amount of $20,-

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000,000,000. This is not an encouraging result; in fact, there are few bankers who do not regard it as a very dangerous result, especially as another twenty billions will be needed to reach the per capita income of 1929.

We now have about $55,000,000,000 of deposits. By that time we would have close to $75,000,000,000. But what use would they be? Any more than our twelve billions of gold is useful. Both the deposits and the gold are costly extravagances.

What we need is an adequate flow of trade to validate our capital investments and debts. One-third of the money we have already used to "prime the pump" would have done the trick if it had been strictly confined to trade channels. In other words, if we had gone back to fundamental banking principles and injected the money into trade channels. On the basis of trade money revolving three times a year, which is a generally accepted economic factor,[1] one-third of the money we have already used would have inevitably produced the same result. That is $8,000,000,000 revolving three times a year for the purchase of new production would have increased the productive income of the Nation $24,000,000,000, against $25,000,000,000, won by increasing and maintaining long-term debt by three times that amount.

The effect on our whole financial fabric of such a revival of trade would have cured the dry rot that now envelops the $55,000,000,000 of deposits, which are molding from stagnation Furthermore, it is a pretty safe conclusion that if anything like the $20,000,000,000 of new deposits referred to above have to be created in line with our present fiscal policies, a 100-percent reserve will be forced upon the banking system. On the other hand, if trade credits are revived, without recourse to perpetuating the long-term debt as at present, higher reserves than at present may become necessary, but the volume of capital credits can be controlled by open-market operations and the rediscount rate and thus avoid the difficulty that the bankers would be confronted with if the 100-percent reserve were suddenly forced upon them.

The philosophy of the bill we are discussing is that provided the national industry is maintained upon a balanced production schedule by maintaining orderly markets through the price of goods, the control of investment—that is, capital credits—will be a matter of intelligent management and the judicious use of the credit expansion safeguards provided in the bill, in the Banking Act of 1935, and in the rules of the S. E. C.

Recent legislation endorsed by responsible bankers and the public has been designed to control the "get rich quick" tendencies of humanity and should, in conjunction with the provisions of this bill, provide a monetary system and source of credit for all purposes in ample volume for any justifiable objective.

SOME SUPPORTING EVIDENCE

Dr. Edward Kemmerer was reported as making the following statement in an address before the Pennsylvania Bankers Association at Atlantic City on May 26 last:

"Probably the outstanding change in American commercial banking during the last half century has been the pronounced shift in banking portfolios from business paper to investment securities. This shift has been particularly pronounced since the World War. For all of our commercial banks in 1915, for example, investments constituted 23 percent of earning assets and business loans 40 percent. By 1936 the investment percentage had increased to 60 percent, while the business-loan percentage had declined to 19."

This statement bears out the contention on which I have based the main argument of this thesis, namely, that commercial credits are the lifeblood of the financial system and that the flow of

[1] Not to be confused with the velocity of money, which involves the transfer of billions of dollars not related directly to production.

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money through the channels of trade in sufficient ratio is the only means of validating credits issued against securities.

One of the old rules of banking, which still holds good to a greater degree in Europe, is that commercial credits should always exceed loans on other collateral and investments by 2 to 1. The enormous capitalization of industry which has developed here is responsible for this change and is due to the growth of our power economy.

This change must be offset in some way so as to bring the source of earnings of industry up to an adequate ratio without capitalization. It is clearly not sufficient for bankers to rely upon the security markets for validating the capital credits they issue unless they are assured that the actual earnings accruing to the capital assets they have monetized are maintained in sufficient ratio to assure a reasonably stable market for securities they hold as collateral.

The fact is that there are two types of credit and two separate uses for money, viz, money for moving goods and money for developing capital assets. The second is dependent for its validity on the first. For the most part they are independent of each other, and their velocity of circulation differs widely.

They impinge upon each other at certain points in the industerial cycle, but in the main credits issued on capital account through security issues lead an independent life from credits that produce and transfer goods. They impinge upon each other through the price levels, as when new capacity for production is undertaken, or when speculation increases or depresses the commodity price level. But the source of real income and real savings that is the warrant for both types is dependent upon the flow of trade, which is synonymous with trade credits.

Mr. Marriner S. Eccles, at a hearing before the House Committee on Banking and Currency February 16 last, made the following remark when discussing the proposal to extend the use of Government obligations for collateral security for Federal Reserve notes, which is deemed necessary to guard against a "disastrous deflationary development."

Asked by Representative FORD of California, "Is not this extension a sort of stand-by measure—a shotgun in the corner—to be used against a sudden withdrawal of foreign investments?" Mr. Eccles replied, "Yes; it is available for that purpose, but it is more important for the present position because there is no eligible paper available."

The fundamental credit base of the Federal Reserve System was the adequate flow of eligible paper; in other words, paper arising from trade. According to Dr. Kemmerer, this paper constitutes only somewhat over 20 percent of the oustanding credit in the banks, and it is the only type that is self-liquidating. It must not only liquidate itself, but it must provide the charges necessary to liquidate the other 80 percent.

At the present time we are trying to rebuild our financial system on credit issued against long-term debt, although our experience proves that this source of money is ineffective in restoring purchasing power for commodities, except in a minor degree and at great cost.

In the Formation of Capital, one of the three volumes of studies recently published by the Brookings Institution, Dr. Moulton, the author, says on page 71, "The general conclusion reached in this and the preceding chapter, that the growth of capital does not take place, unless expansion of consumption is also occurring, does not appear upon close analysis to be surprising. The motivating force in all economic activity, under a system of private initiative, is the wants and demands of people. The base of the economic pyramid is the production of consumption goods—first, primary necessities and then comforts and luxuries. In the

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ascending scale of goods that are relatively indispensable we find new plant and equipment at the top. This is because the demand for plant and equipment is derived from the demand for consumption goods which such plant and equipment can produce. * * * A slight shrinkage in the base of the pyramid very nearly eliminates the top."

The conclusion expressed in this quotation bears out the fundamental contention upon which this memorandum is built. Its intimate relation to a comprehensive monetary system is obvious. Looked at from the financial standpoint it emphasizes the necessity for a free flow of money in the channels of trade which will permit the free flow of goods in harmony with actual demand.

Without reasonable stability in the consumer markets capital credits issued against securities become increasingly dangerous. As they now constitute the greater part of the business of banks, and as the growing demand for capital for technological improvements, and improved housing continues, it can only be the part of wisdom for the banks in their own interest as well as in the general welfare to see to it that the base of the pyramid is always wide enough to support the superstructure of capital credits.

As the formation of liquid capital has now become the dominating element in banking, there appears no escape from the deductions arrived at herein. Dr. Moulton emphasizes this conclusion when he says on page 157, "The facts show incontrovertibly that new capital is constructed on an extensive scale when consumption is expanding rather than when it is contracting." And page 158 idem, "The available evidence also supports the view that the growth of capital is directly related to the demand for consumption goods."

Surely in a capitalistic country like ours, where each young citizen is supposed to carry a capitalist's checkbook in his school bag, it would be well to shape our course in the direction that the laws of finance indicate.

In Appendix A of Dr. Moulton's book he reviews the analyses of our situation by Dr. Benjamin M. Anderson, E. F. M. Durbin, John A. Hobson, Foster, and Catchings, and others.

On page 181 he summarizes his conclusions as follows:

"The analysis which we have made in America's Capacity to Consume, revealing a demand for consumption goods insufficient to call forth the full output of our productive establishment, is not to be regarded as supporting the position of * * * Foster and Catchings. Our analysis did not show that the aggregate disbursements of national income to individuals were less than the prices of goods and services turned out; on the contrary, we contended that they were virtually identical. We were concerned with the allocation of the national income as between savings for investment and expenditures for consumptive purposes, and we showed merely that the proportion of the total income received by individuals which found its way into consumption channels was inadequate to induce full capacity production."

And, page 184, idem, "The maladjustment between savings and consumptive expenditures did not, as our analysis shows, lead to a proportional expansion of capital goods, and in due course to an excessive output of consumer goods which ultimately broke the commodity markets. On the contrary, the restricted rate of expansion of consumptive demand held the growth of capital in check, while the excess savings wrought havoc in the financial markets."

It is pertinent to this discussion to make one more extract from this important and judicial work, viz, from chapter X, page 136. Under the heading "The Disproportionate Increase of Investment Funds" is found the following: "It was found that in 1929 the savings of the great mass of the population constituted a negligible proportion of the total savings. For example, 59 percent of

31344—14469

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the population, or 16.2 million families, saved in the aggregate only $250,000,000, while 91 percent of the families comprising all those with incomes below $5,000 saved only about $4,000,000,000, or a little over 25 percent of the total. On the other hand, 2.3 percent of the families, those with incomes in excess of $10,000, contributed over two-thirds of the entire savings."

Taken together these three quotations offer a significant explanation of why our banking system finds it hard to meet the conditions imposed upon it by the new production technology. If one eliminates any consideration of the controversial doctrines of the various economists, and confines one's self to the realities here presented, it must be clear that the production of new capital must follow the production for consumption. And that the production for consumption must be met by purchasing power adequate to its abilities.

And as the production of capital is first and last a fundamental function of banking, it becomes an essential of successful banking to so order the production for consumption, and the production of permanent wealth in those ratios which will assure a sound money system and a permanent balance between these factors.

It is a recognized truism that 90 percent of the money used in the conduct of business is borrowed money, created and issued by the banking system against (supposedly) adequate security, and when it is paid off it must be promptly reissued to permit the industrial system to function.

A fact that we all know is that when any commercial credit is canceled it must be promptly replaced with another circulating credit; otherwise the supply of money would soon fail. Even if we conceive of a national economy, in which all industry were on a cash-and-carry basis, the accruals of profits and losses would soon upset the balance and borrowers would reappear.

An effort was made in the earlier part of this memo to differentiate between cash credits issued for the purposes of trade and those issued against capitalized values as monetary and economic factors. In a smoothly working production-consumption cycle, trade credits are practically automatic in their functions. But there are many economic and psychological factors entering into the creation and repayment of long-term debt. The subject is too complex to discuss adequately here. I must confine myself to the repetition of the statement that the amortization of long-term debt is a function of the volume of credits in trade from which real profits and savings evolve.

Maintenance of long-term debt within the limits of our earnings to meet its charges is one of the greatest problems of the banking system; another being the maintenance of adequate purchasing power to validate our investments of productive capital.

A comparatively recently recognized monetary phenomenon is the growth of long-term debt in excess of the increase in production of real wealth, measured in real dollars. Attached to this memo as appendix A is a copy of the summary of Evans Clarke and associates sponsored by the Twentieth Century Fund.

It shows an increase of long-term debt between 1921 and 1932 from $65,000,000,000 to $134,000,000,000. If we add the increase of Federal debt, we get for 1936 upward of $154,000,000,000. At the same time business debts fluctuated between $93,000,000,000 in 1921 to $128,000,000,000 in 1929 and $89,000,000,000 in 1932–33.

In view of the fact that the economic base of this pyramid, namely, national productive income, rose between 1921 and 1929 from about $65,000,000,000 to $85,000,000,000 and then fell below $40,000,000,000 it is easy to see why the forced liquidation of the early thirties failed to clear up the financial situation and left the banking system virtually bankrupt. The fact is that the country has been living off of the fixed capital that it has monetized for several years past. First that monetized by the bank-

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ing system, and later that which the Federal Government in partnership with the banks has monetized through increasing the Federal debt.

This persistent increase of long-term indebtedness is an economic phenomenon that is comparatively new It is inherent in the growth of the machine age and power production. It is due to the need for vast amounts of new capital, which cannot be adequately amortized within the life of the values that give it birth.

This memorandum would not be complete without some reference to the pressing problems of balanced budgets and taxation.

When I addressed the House on June 8 last I stated that our tax rate from all governmental units is the second highest of those countries whose records are available, Great Britain only taking precedence of us. But in spite of this our national Budget is further out of balance. And that the only way to balance our Budget and pay our taxes is to increase our productive income.

I said then, "The income of the people of the United States is now about $65,000,000,000 a year. That income, by operation of the legislation I suggest, could be increased as gradually as necessary to $100,000,000,000 in at least 18 months. What would be the result of that increase? The percentage now of taxes in relation to income is about 6½ percent, yielding now about four and one-fourth billion dollars. Without increasing the percentage of taxation on an income of $100,000,000,000 a year we could raise six and one-half billion dollars in taxation. By introducing that other £35,000,000,000 of wealth we would be able to release from relief and from governmental support about $2,000,000,000 of labor and services. In other words, the Federal Government would be relieved of about $2,000,000,000 of pressure that is now brought upon it, so that by increasing the national income to $100,000,000,000 you could balance the Budget and begin to pay of nearly $4,000,000,000 a year of national debt."

It may be well to point out here that a national income of $100,000,000,000 a year would be just about equivalent to the per-capita income of 1929, allowing for the increase of population. Also the increase of income of $35,000,000,000, which I referred to as the introduction of new wealth, means, under the operation of this bill, real wealth, not inflationary money.

The money provided is limited to $10,000,000,000. The warrant for it comes from exactly the same source as any other type of trade credit, namely, the production and distribution of goods.

While it cannot be said how much of this fund would be needed, there is good ground for the assumption that it would be less than the full amount provided, because it would bring about trade activity now dormant and tend to encourage the flow of credit through the normal channels of banking and commerce.

The point is that it would be an antidote to the otherwise inevitable growth of long-term debt which is now out of all proportion to the fundamental credit base of the economic pyramid.

In this memorandum I have tried to outline some of the basic financial problems of today, and to clarify the means by which this piece of legislation (H. R. 7188) proposes to meet them.

A necessary part of the work of industrial engineers and executives is to study and adjust their so-called production flow sheets to the advances in techniques. H. R. 7188 visualizes a financial flow sheet to meet the needs of the flow sheets of industry and trade.

Every good industrialist knows that if he can so order his plant that he can raise wages and at the same time lower prices he is on the road to success. Every retailer knows that lowering prices stimulates sales. The railroads have recently learned the same thing. No system that does not take into account the relation of

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"dollars to goods" at the base of the economic pyramid will succeed, and, as far as I have been able to learn, this bill is the only coordinated attempt to do this thing without disturbing our social order in one way or another.

It does not solve all social and labor problems. But I hope it lays a stable foundation for their orderly solution. It is not a panacea, it simply attempts to follow the dictates of technological advance throughout the world with a heed to realities.

The choice of our times lies between democracy, dictatorship of the proletariat, or dictatorship of the autocrat. A few years more of our present course may land us with one or the other of these dictatorships, or still more probably, in a maelstrom of both.

APPENDIX A

Table showing long-term and short-term debts, national wealth and income

[Taken from "The internal debts of the United States," Twentieth Century Fund, Inc., pp. 13–301]

	1913-14	1921	1929	1932-33
Long-term debt........billions of dollars..	38	75	126	134
Short-term debt:				
Business debt.................do....	47	93	128	89.2
Personal and household........do....	4	9	22	14.4
Total..............................	89	177	276	237.6
Population...................millions..	98	110	121	125
National wealth.......billions of dollars..	192	321	385	300
National income..................do....	36	66	85	40
Total debt service.................do....	2,143	4,953	7,642	7,910
Per capita debt.....hundreds of dollars..	387.76	681.82	1,041.32	1,072
Percent of national wealth represented by debts, long term..............................	19.7	23.4	32.7	44.7
Percent of national income represented by debt service..............................	6	7	9	19.8

31344—14469

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