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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 3, 1938.

To Chairman Eccles

Subject: Banking reform

From Lauchlin Currie
LBC

Attached are some reflections of mine on the whole subject of banking and monetary reform.

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July 29, 1938.
LBCurrie

AN APPRAISAL OF THE AMERICAN MONETARY AND BANKING SYSTEM WITH SOME SUGGESTED REFORMS

Tests of a Good Monetary and Banking System

In appraising a monetary and banking system it is helpful first to set up various tests which a system should meet. The major tests appear to be as follows:

1. In the interests of democracy, monetary control should be in the hands of a public body and exercised in harmony with the broad economic objectives of the Administration.

2. In the interests of efficiency, monetary control should be unified and diffusion of authority and responsibility avoided.

3. The banking system, through which monetary control functions, should be well adapted to that end.

4. The banking system should provide safety for depositors' funds.

5. The banking system should be in a position to meet the borrowing needs of the community.

6. A final test of the banking system, considered as a business, is the degree to which it provides its services cheaply while paying adequate remuneration to its employees and securing the going rate of return on equity capital for its stockholders.

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Application of Tests to American System

1. Democratic monetary control. Our system meets this test fairly well. The main monetary powers are exercised either by a member of the Cabinet or by a body appointed by the President and confirmed by the Senate. There is one serious exception, however, in open market operations where the reserve bank presidents on the Open Market Committee have an extremely remote connection with the Government. It is here that the main danger lies of a lack of harmony between monetary control and the economic policies of the Government.

The fact that the reserve banks are "owned" by member banks, even though that ownership is in many respects nominal and does not entitle the member banks to the customary prerogatives of ownership, nevertheless serves to exaggerate in the public mind the non-public character of the Federal Reserve System. Effective use of this fact has been made by popular leaders.

The main link between the Board of Governors and the Administration is afforded by the Chairman and Vice Chairman, who are appointed for four-year terms by the President. The expectation is that these officers will have the confidence of the President, will serve at his pleasure, and will normally change with a change in the Administration. While this is the

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reasonable expectation, this is not provided for explicitly in the law and the possibility does exist of a person serving as Chairman during the major part of a President's term of office who does not possess the confidence of the President and is not sympathetic to the aims of a current Administration.

There is also the possibility that a majority of the Board, during the first term of office of a President, may be out of sympathy with the Administration's aims and policies.

Under the broad heading of democratic monetary control must be listed the question of a mandate. The general instructions now contained in the law toward which monetary policy should be directed are so broad and so vague as to give color to the charge that we not only determine policy but also the ends toward which policy should be directed. It would be desirable to have a mandate sufficiently explicit to refute this charge, yet sufficiently broad as not to tie our hands in adopting policies to meet the exigencies of any particular business situation.

2. Unified authority and responsibility for monetary control.

While steady progress has been made toward securing a greater measure of unified authority and responsibility for monetary control in the Board of Governors, so far as the relation of the Board to the reserve banks is concerned, one important defect must be

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noted. This is in connection with open market operations, mentioned above. Under the present arrangement the possibility of conflict between open market and other monetary policies always exists.

Perhaps the most serious diffusion of authority and responsibility for monetary policy lies in the division of powers between the Board, Open Market Committee and the Treasury. The very heart of domestic monetary control has to do with bringing about changes in member bank reserves and all these bodies now have important powers affecting the volume of reserves or the volume of excess reserves. This diffusion of authority and responsibility has given rise to endless friction and the necessity for compromises -- compromises which result from the necessity of reconciling differences, but which may represent policies no one unified authority would have adopted. Thus it is extremely unlikely that either the Board or the Treasury would have both sterilized gold and raised reserve requirements at the time and to the amount actually experienced if either body had been solely responsible for monetary control. The coordination of open market operations with the other controls affecting member bank reserves has been accomplished only with extreme difficulty.

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Still another case of diffusion of authority and responsibility has to do with banking supervision. Banking supervision and examinations have very definite monetary aspects and yet the various bodies exercising monetary controls mentioned above have only a very slight degree of control over bank supervision. While it is doubtless true that the exercise of monetary control does not require very close supervision over the affairs of each individual bank, there are certain broad policies of bank supervision which it is essential should be coordinated with prevailing monetary policies. Otherwise, there is danger that the effectiveness of an easy money policy may be in part nullified by a stringent supervisory policy, and vice versa.

3. The functioning and safety of the banking system.

It is convenient to consider the adequacy with which the banking system meets the requirements of effective monetary control, of borrowers' needs, and of safety to depositors under a single heading.

It is in this general field that our banking system has been in the past, and still continues to be, most open to criticism. Up until recently, the safety record has probably been the poorest in the world. Deposit insurance has marked a great improvement in this respect so far as the smaller deposits are concerned. Some 61 percent of demand deposits, however, are not covered by insurance. It is a question, therefore, as to how effective deposit insurance will prove in

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preventing bank closings. The Closed Bank Study indicated that the serious drain in deposits that preceded the suspension in all the banks studied took place in deposits over $5,000in size.

From the point of view of being an effective instrument for the exercise of compensatory monetary control, our banking system could be greatly improved. The semi-automatic expansion and contraction of loans, particularly the contraction, has on occasion nullified compensatory monetary policy. The tendency toward expansion and contraction of loans has operated to intensify swings in business activity and it is largely to this fact that must be attributed the perverse elasticity of our system. That this problem has not been solved by legislation since 1933 is indicated by the fact that during the latter half of 1937 total loans and investments and adjusted demand deposits of member banks declined by approximately $1 billion at a time when truly compensatory action would have called for an increase.

An additional factor complicating the problem of monetary control and rendering our banking system less effective to that end is the lack of uniform reserve requirements against deposits subject to check. In the past it has frequently happened that in the downswing of business activity the proportion of deposits subject to check in banks with high reserve requirements tended to increase relatively to those in banks with low reserve requirements. This had, of course, the effect of increasing reserve

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requirements against the same volume of deposits subject to check at a time when compensatory action would have called for different behavior.

Basic Factors in the Situation

In accounting for the defects in the American monetary and banking system enumerated above certain basic factors suggest themselves.

1. There has been only very recently any degree of popular recognition that the peculiar characteristic of banks that distinguishes them from other types of loaning agencies, is their money supplying function. In an evolutionary process, so gradual as to pass unnoticed, we shifted from a note-using to a check-using basis. The bulk of our national currency became deposits subject to check in private local banks. Up until recently the primary function of banks was believed to be that of making local loans and this has colored our national attitude toward banks and consequently legislation affecting banks. It has, above all, led us to acquiesce in a diffusion of authority and responsibility, in the existence of non-member banks, in illogical and badly functioning reserve requirements, in an insecure national deposit currency, -- in short, in a system that has exhibited marked tendencies toward perverse elasticity.

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One of the most effective means of creating a proper attitude to secure a removal of the defects of the American banking system, viewed as a medium through which monetary control must be exercised, is to stress the money-supplying function of banks. This is so obviously a matter of serious national concern, that half of the battle will be won merely through securing a wide recognition of this function.

2. Our banking system has remained localized in contrast to the tendency in other fields. This has been due in large part to the deep-seated American distrust of financial concentration. Although at times hard pressed, the individual banker has been enabled to enlist sufficient popular support to check the natural expansion of branch banking, as has occurred in other deposit-using countries.

The local character of American banking is the primary factor behind the terrific loss record, the exceptional emphasis on liquidity, the peculiarly American emphasis on examination and supervision, the wide swings in demand deposits, and the exceptionally wide diversity of interest rates throughout the country. This is a sweeping statement, but there are many facts and considerations that can be offered in its support.

The significance of unit banking is brought out by a comparison with the national branch banking systems of England and Canada. In a nationwide branch banking system, each bank is a collection of thousands of unit banks. If one branch suffers a loss of

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deposits, this is likely to be offset by a gain in another branch. The system as a whole need not liquidate so long as its total deposits keep up. The maximum shrinkage of deposits in England from the highest to the lowest point in the Great Depression was only 10 percent, as contrasted with a 40 percent decline here. In our system, the ebb and flow of deposits from one unit bank to another entails the necessity, at times other than when large excess reserves are widely diffused, of corresponding shifts in earning assets. In the downswing the unit bank gaining deposits and reserves may not wish or be able to increase its earning assets to offset the contraction going on in the bank losing deposits and reserves. The larger the number of depositors and the more diverse the geographic and economic distribution of a bank's depositors, the more likely it is that variations in its individual customers' deposits will be compensatory so that the likelihood of a serious net decline will be lessened. In general the smaller a bank, and the more the fortunes of its customers are dependent upon similar economic circumstance, the more variable are its deposits likely to be and consequently the more emphasis must it place on liquidity.

The localized and unit character of our system has resulted in thousands of local loaning markets instead of a national

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loaning market. In some localities the potential demand for loans at low rates far outweighs the amount of his funds a banker dares to loan locally or even the total of his loanable funds. The consequence is a rationing of loans at high rates and the entrance of government and other private loaning agencies. In other localities the supply of loanable funds far outstrips the local requirements for loans. In branch banking countries a nearer approach to a national loan market is secured so that interest rates are more uniform and the banks have been in a position to resist the encroachment of other competing agencies. In Canada, for example, some branches may have local loans outstanding to many times its local deposits while other branches show the opposite condition.

The local and unit character of banking not only results in a maldistribution of loaning requirements and bank resources but the situation is aggravated by the fact that since each individual banker must always be prepared for a substantial loss of deposits, he does not dare to invest too much of his funds locally. The very circumstances that may cause a loss of deposits may also prevent the liquidation of loans. Moreover, a liquidation of local loans may entail a further liquidation of deposits as the loans are paid so that the bank will not

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gain a corresponding amount of reserve funds to meet a loss of reserves through the clearing house. By holding assets that can be liquidated in a distant money center it can secure reserve funds to the full amount of the liquidation.

The more the banking system is broken up into separate units, the greater will be the combined liquidity requirements. Whereas the system, regarded as a whole, may have little need for liquidity, the combined requirements of all its isolated units may amount to a very large sum. If the volume of instruments available to meet these requirements is small relatively to the demand, rates of interest on such instruments may fall to extremely low levels, as is the condition today. Efforts of the monetary authorities to secure low interest rates are prevented, through the lack of a national money market for local borrowers, from reaching home builders, farmers and small business men.

Another consequence of our unit system of banking is a failure to identify the interests of the individual with the interests either of the group or the whole community. This is a common phenomenon in all fields where the number of separate units is so great that the actions of any one cannot be expected to influence in any significant quantitative way the whole picture. Thus in the building industry, composed of so many different groups, a

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considerable rise in the remuneration of any one group affects the total cost of a new house very little. A few illustrations will show the application of this consideration to banking.

It has often been pointed out that mass liquidation is only possible to a very limited extent and with ruinous consequences. Somebody must hold the outstanding volume of bonds and stocks and goods. Yet the possibility of liquidation is always open to any one individual. Thus any one bank feels that it can, for example, take profits in its bond portfolio without either affecting the value of its remaining bonds or the total of its deposits. When there are only a few banks in the country, this possibility is more remote. This appears to be the main explanation for the different behavior of the British and American banks during the decline in bond prices in 1937. From October, 1936 to March, 1937, the average price of 87 English bonds fell by 6½ percent as contrasted with a decline here of 4½ percent from January to April. The British banks engaged in no selling and maintained their bond portfolio intact. Our banks sold $1 billion of securities in the first half of 1937. The strikingly different behavior cannot be explained on the grounds that the British bankers are more intelligent or more public-minded. The explanation appears to be the obvious one that no one of the Big Five banks can very well help

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but realize that an attempt to liquidate will result in losses in its own portfolio and a decline in its own deposits.

Finally, the existence of thousands of individual banks enhances the difficulty of monetary control by depriving the monetary authorities of that most effective of all instruments, informal negotiation with the heads of a few systems that cover the whole field. This appears to be one important explanation of the mass of detailed and specific prohibitions and regulations in our banking laws as contrasted with England and Canada. The greater ease of controlling a few big systems arises not only from the closer identity of the individual and the general interest, but also because the fewer the banks the more politically vulnerable they are. Our thousands of small local banks have been in a position to exert powerful political opposition to back unification and other desirable reforms. Thus our unit system has contributed to the defects in the functioning of our system while at the same time making it more difficult to remove these defects.

Proposed Ways of Improving our System

Having considered the tests of a good system, the application of these tests to our system, and some basic factors that account for the failure of the system to meet satisfactorily these tests, we may now turn to the proposed remedies.

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1. <u>Greater unification of authority and responsibility for monetary control.</u>

(a) <u>Open Market Operations.</u> It appears absolutely indispensable to center the authority and responsibility for open market operations in the Board, which exercises the other monetary powers of the system. This is desirable not only on grounds of efficiency but also to ensure more democratic control.

(b) <u>Directorate of the Reserve Banks.</u> Since many of policies of the Board are carried out by the Reserve banks, it is desirable that there should be greater harmony in the views of these respective bodies. It is not only bad from the point of view of smooth functioning but also psychologically to risk the possibility of the reserve bank management and directorate being highly critical of the policy of the Board, as has been true in many particulars in recent years. Board representation on the directorates of the reserve banks should be increased, and banker representation diminished.

(c) <u>Bank Supervision.</u> Bank supervision has, as pointed out earlier, obvious monetary aspects. At the same time, it involves a wide number of individual and specific (what to do about such and such a bank) problems that the supreme monetary authorities of the country should not have to deal with. In general, so far as possible, it appears to be a sound principle

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that the Board should be a policy-formulating body rather than an administrative body. Apparently the first and most practical solution to the problem of coordinating broad policies for bank supervision with monetary policy, while avoiding immersion in specific regulation and supervision, would be through the device of interlocking directorates. This could be secured by providing that the Chairman of the F. D. I. C. should be a member of the Board while at the same time providing that the Chairman of the Board of Governors be a member of the Board of the F. D. I. C. With the elimination of the Comptroller's office the change should secure a large measure of coordination between the monetary and bank supervisory policies.

d. Relation with the Treasury. This is one of the most difficult problems to solve. On the one hand, in the interests of efficiency, the responsibility for the exercise of the various instruments of monetary control should obviously be centered in one body. It would hardly be appropriate, however, for the Treasury to take over the various monetary functions exercised by the Board of Governors. On the other hand, it would be extremely difficult to expect the Administration to give up important monetary powers relating to gold to an independent agency whose Chairman is not even a member of the President's official family, that is, in the Cabinet. A suggested solution is to make the exercise of all monetary powers of the Board subject to the approval of the Treasury while

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at the same time making the exercise of the monetary powers of the Treasury subject to our approval. While, however, in some respects this would be an improvement, it still leaves wide open the danger of a stalemate developing between the two agencies. Such a stalemate could only, as at present, be solved through a direct appeal to the President.

The danger of conflict and lack of coordination between these two agencies would be partly alleviated through the creation of the proposed Fiscal and Monetary Advisory Committee. This committee, being composed of five persons, would bring to bear on monetary policy the views of three agencies not directly charged with monetary policy. If either the Treasury or the Board found itself in the minority in this committee this fact would constitute some pressure to secure unanimity of opinion although it would not preclude appeal to the President directly.

I shall, in a later section of this memorandum, suggest another way of getting around the difficulty of the diffusion of authority and responsibility for monetary policy between the Treasury and the Board.

e. Democratic control. It would appear desirable, in order to emphasize the democratic or public character of monetary control,

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that the ownership of reserve banks by the member banks be abolished. This has been treated elsewhere and I will not go into it here. In addition to this reform some consideration might be given to making the office of the Chairman of the Board coterminous with that of the President in order to avoid any possible conflict between the Board and the Administration at some future date. With the Chairman of the F. D. I. C. an ex-officio member of the Board, and the Chairman of the Board of Governors, this should normally ensure that a majority of the Board will be appointees of the President at some time during his first term of office. It still leaves open the possibility, however, that every third Administration only three members of the Board will be appointed. I am assuming that the term of office of the Board Members would be reduced from 14 years to 12 years. I am perhaps overstressing the possible danger of conflict since with the Chairmen of the Board of Governors and of the F. D. I. C. both being Administration appointees, and with a functioning Fiscal and Monetary Advisory Committee, the danger of a serious conflict is probably remote.

In discussing the tests of a good monetary system I mentioned the desirability of having a mandate sufficiently explicit to indicate the intent of Congress as to the major objectives

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of monetary policy, while at the same time sufficiently general as to allow the Board a large measure of discretion in adapting its instruments of policy to the ever-changing business situation in order to further these broad objectives.

2. Functioning of the banking system

a. Bank unification. It is proposed to secure this in substance, though not in form, by providing that all insured banks be entitled to credit through the facilities of the Federal Reserve System and that in return they be required to carry reserves with Federal Reserve banks and to comply with certain other system regulations. This would be a constructive step as it should do away with the fortuitous expansion or contraction of reserve requirements merely because of a shift in deposits between member and non-member banks of the same class. It would also, and this is an important point, remove the threat of defection from the System and hence permit more freedom in dealing with member banks.

b. Reserve requirements. As pointed out earlier we have a badly functioning system of reserve requirements. It would be desirable from the viewpoint of monetary control to have uniform reserve requirements against demand deposits regardless of their location. This, however, would involve raising the requirements of country banks relative to city banks, which is probably impractical for political reasons.

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One proposal is that reserve requirements be based in part by the activity of deposits. This proposal, while superficially attractive, is open to the grave objection that in practice it would involve changes in reserve requirements unrelated to the basic forces determining business activity. On occasion it might provide the proper response. On other occasions, however, it most certainly would not. Another proposal is to reclassify cities. This, while desirable, is comparatively unimportant from the viewpoint of monetary control, as it would still leave wide variation in reserve requirements.

c. Unified supervision. It is desirable that supervisory policies be applied uniformally throughout the country. While this has been accomplished recently through negotiation, the process proved difficult of accomplishment. A great step forward could be made by abolishing the Comptroller's office and centering the responsibility for supervision either in the F. D. I. C. or in the Board of Governors, while providing for interlocking directorates.

d. Conclusion. While it is not desired to minimize the importance of the various proposals enumerated above, still it must be admitted that they will accomplish little towards removing the defects of our banking system viewed either as an instrument through which monetary control must operate or as an economic group

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serving the needs of the community. They do not really solve the manifold problems arising from fractional reserves in a unit system of banking. So long as loans and investments are linked to deposits subject to check and there are wide variations both in time and as between banks in the volume of deposits subject to check, so long will there be a powerful incentive for bankers to stress their liquidity requirements. We have sought with little success to lessen this incentive by providing freer access to the reserve banks. We are, however, up against a very strong tradition and while we stand prepared to loan to banks at any time for emergency, seasonal and temporary purposes, we cannot give a commitment to make semi-permanent loans necessitated by semi-permanent declines in deposits.

3. Safety. Safety is now provided for deposits up to $5,000. The bulk of demand deposits, however, are in accounts above this size and hence are not now protected. Since it was withdrawal of these large deposits that in so many cases forced liquidation of assets and eventual closing of banks, deposit insurance as now constituted is not an effective barrier to loss in the case of large deposits and hence to bank runs and bank closings. This could be remedied in large part through providing for full insurance of demand deposits.

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More Basic Reforms

The various proposed reforms discussed up to this point are probably the most that could be hoped to be secured under present political conditions. Considered as a whole they would go a long way toward achieving unified and coordinated monetary policy under democratic control in accordance with a mandate laid down by Congress. Banking supervision would be unified and carried out in a greater harmony with the broad monetary and economic objectives of the Government. Non-member banks would become subject to the same reserve requirements applicable to similar member banks and to various other requirements to which member banks are subject.

To secure these various ends would be a noteworthy achievement. It must be admitted, however, that even should we be able to secure the above reforms in full, our monetary and banking system would still fall short of the most important requirements of a really good system in the following respects:

(a) The authority and responsibility for monetary control would still be divided between the Treasury and the Board.

(b) We will still be left with a system of thousands of individual banks operating under fractional reserves.

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Consequently little will have been done to lessen the disparity in interest rates, the emphasis on liquidity and all the factors that make up the perverse elasticity of our system.

The most feasible way of removing these defects appears to be to divorce deposits subject to check from bank loans. It has often been pointed out that the basic difficulties of banking arise from the association of demand liabilities with bank loans and investments. Under a nationwide branch banking system, with the consequent stability in the total level of deposits, these difficulties are greatly lessened. There is, however, no prospect of the development of nationwide branch banking in this country. Therefore, we are forced back to the proposal to divorce the creation and liquidation of deposits subject to check from the making and liquidation of bank loans and investments.

Brief Outline of a Basic Reform

1. Require all banks to maintain in cash or at the reserve banks reserves equal to their non-bank deposits subject to check.

2. The necessary reserves, over and above the total reserves at present held at the reserve banks plus vault cash would be obtained by borrowing from the reserve bank on non-interest

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bearing notes.

For illustrative purposes, the effect of the two points above may be shown by reference to the balance sheets of all insured banks and the reserve banks as of December 31, 1937.

Principal Assets and Liabilities of Insured Banks, December 31, 1937. (In millions of dollars)

Assets	
Reserve at reserve banks and vault cash	$7,795
Earning assets	37,194
Liabilities	
Adjusted demand deposits	24,537
Time deposits	14,674
Capital account	6,404

After the inauguration of the proposed plan the consolidated balance sheet would show the following changes:

Assets	
Reserve at reserve banks and vault cash, $7,795 + $16,742	$24,537
Earning assets	37,194
Liabilities	
Adjusted demand deposits	24,537
Time deposits	14,674
Capital account	6,404
Non-interest bearing debt	16,742

The balance sheet of the reserve banks will show an increase in liabilities in the form of deposits of $16,742 million and in assets in the form of non-interest bearing advances of $16,742 million.

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The effect of these changes can be seen by regarding the consolidated balance sheet above as the balance sheet of an individual bank and then assuming a decline in demand deposits. Reserves will decline correspondingly and earning assets will be left unaffected. Similarly an increase in demand deposits would be reflected in a corresponding increase in reserves and not in earning assets. While it is desirable to avoid the necessity for liquidating loans as demand deposits decline, some provision might be made for eventual liquidation if a long-continued decline in demand deposits occurs. Therefore,

3. Provide, for those banks that experience a long continued decline in demand deposits below the level existing when the plan goes into effect, for a gradual liquidation of their notes to the reserve banks.

4. Provide that the deposit insurance premium now collected against demand deposits be assigned to the Federal Reserve banks to build up a guaranty fund against eventual loss on the reserve banks' unsecured advances to commercial banks. Deposit insurance would be confined to time deposits and the F. D. I. C. would collect premiums levied on time deposits for that purpose.

5. Provide rediscounting facilities at the reserve banks for advances to meet the requirements of local borrowers. With

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the possibility of multiple expansion of deposits removed, it would be safer to encourage borrowing from the reserve banks. This would constitute a means whereby new money, on a one-for-one basis, could be created; it would provide a way of meeting any unsatisfied demand for local credit; and it would provide a source of revenue for banks experiencing an increase in demand deposits with no increase in available loanable funds.

6. Require no reserves against deposits of domestic banks. The incentive for banks to maintain such deposits would be greatly diminished when the incentive for liquidity passes. Deposits of foreign banks with domestic banks would be treated as individual deposits subject to check, since no double-counting of deposits is here involved.

7. Require no reserves against deposits not subject to check. This will appear to many as a radical suggestion. However, it is now widely recognized by students of banking that deposits not subject to check are investments rather than media of exchange. An expansion of such deposits has different implications and significance than an expansion of the media of exchange. It represents the passing over of existing deposits subject to check (and currency) to bankers for loaning or

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investment. In this respect it does not differ from an expansion of postal savings, Government baby bonds, building and loan shares or deposits, life insurance premiums, etc. To require the same reserves against time deposits as against deposits subject to check would be highly deflationary. It would mean that a part of the current savings of the community would be withdrawn from the monetary circulation, -- that money disbursed in the making of goods and "saved" would not in turn furnish a demand for goods.

At the present time the overwhelming bulk of time deposits are made up of comparatively small savings accounts which exhibit a remarkable degree of stability. In my study of the economic distribution of demand deposits at the end of 1935, based on corporation balance sheet returns and other data, it was calculated that the time deposits of business and finance comprised about five percent of total time deposits. This is confirmed by the fact that 82 percent of time deposits are covered by deposit insurance.

In a study made for the latter part of 1934 it was discovered that time deposits in Boston banks turned over at the rate of less than once a year. For banks in a number of cities outside of Boston time deposits turned over at the rate

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of less than once a year. For banks in a number of cities outside of Boston time deposits turned over at the rate of once every two years. Every maturity and payment or renewal of a certificate of deposit was counted as a withdrawal. Even this low rate of turnover was attributable to cash withdrawals or transfers to demand deposits rather than checks passed to a third party and cleared through clearing houses.

Some fears have been expressed that the plan here proposed would have the initial effect of inducing large transfers of demand deposits into time deposits. Though this possibility can be easily overstressed, since a banker would have to be prepared for a countershift of these presumably large deposits and hence a full liquidation of earning assets held against them and consequently would have to invest in the most liquid securities, it can be easily guarded against by setting a limit on the size of time deposits. Many banks do this now as a matter of policy. Other safeguards, such as the prohibition of interest until the time deposit has remained a year, and negotiability only through the depositor in person or his previously designated agent, could insure stability and even growth in the volume of time deposits and hence would permit their investment in longer-term earning assets.

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Advantages Claimed for Plan

1. Removal of present incentive for liquidity. When banks no longer have to liquidate loans and investments to meet a loss of deposits, they will be in a position to pay more attention to ultimate soundness rather than to liquidity and marketability. They will be more in the position of life insurance companies and mutual savings banks. This lessened emphasis in liquidity should have the following consequences:

(a) More adequate meeting of local loan requirements.

(b) Lessened disparity in interest rates. Local customer and mortgage rates will have a tendency to decline while commercial paper, acceptances and the rates on short-term Governments should have a tendency to rise.

(c) Fuller utilization of available loanable funds of banks.

2. Better functioning monetary system. The proposed reform should do much to remove the present perverse elasticity of the system. With the removal of the liquidity incentive, much of the present automatic tendency to expand and contract loans and investments with expanding and contracting business activity should disappear. Under the proposed system a contraction of bank earning assets would give the banks a corresponding amount of excess reserves, rather than a fraction of that amount as at present, while at the same time they would feel less need of excess reserves. On the

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upswing any utilization of excess reserves or the acquiring of new reserves from the reserve banks would permit only a one-for-one expansion instead of multiple expansion as at present. The system is at present so sensitive that the volume of the media of exchange is not subject to any precise control but is the resultant of many, and in large part, fortuitous, changes in the location of deposits, in the demand for loans, in currency requirements, etc. An increase or decrease of currency in circulation would change the composition of the total money supply but would no longer have the tendency, as at present, of altering the total itself. Changes in the total volume of money would become much more the result of deliberate policies of the Board.

3. Shifting of center of gravity of monetary control from the Treasury to the Board. The basic cause of the present importance of the Treasury in monetary control is our fractional reserve system. The possibilities of expansion on the basis of excess reserves are at present so serious, and the capability of the Board to mop up these excess reserves so limited, that the aid of the Treasury had to be invoked. With the revival of business and the renewed attractiveness of the United States to foreign capital, and hence the likelihood of a steady inflow of gold, the Treasury's position will become more, rather than less, dominant.

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At the present time, excess reserves amount to over $3 billion. The Treasury's balance at the reserve banks plus its free gold, amounts to nearly another $1 billion. Should the system sell all its securities and raise reserve requirements to the limit now permitted by law, these actions would absorb only a little over $3 billion. The situation cannot be much alleviated through an increase in reserve requirements consequent upon a growth of deposits since the volume of money is at present near its all-time peak and it is questionable whether the degree of expansion necessary to absorb any significant quantity of excess reserves would be consistent with the long-term public interest.

Under the proposal under discussion, excess reserves would cease to constitute a serious problem since they would permit only a one-for-one expansion of deposits subject to check. If the plan were adopted, member banks could be left with all, none or part of their existing excess reserves, depending upon political exigencies and the further expansion of deposits subject to check thought desirable. An inflow of $1 billion of gold annually would create only approximately a 3 percent expansion of deposits subject to check. In default of gold inflows the Treasury could gradually desterilize its Stabilization Fund without danger of excessive expansion of the

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volume of deposit currency.

Similarly, an outflow of gold would result not in a need for liquidation of bank earning assets, or recourse to borrowing from the reserve banks, but merely in a one-for-one contraction of demand deposits, which could be restored by an equal amount of purchasing of Government securities by the reserve banks.

4. Safety of deposits and the prevention of the type of forced liquidation consequent upon bank runs.

With complete safety provided for all deposits subject to check through the backing of a corresponding amount of reserves, deposit currency would become as secure as actual currency.

Deposit insurance could then be confined to time deposits, -- the savings of the people. It would still probably be desirable to have one supervisory agency, unless it was desired to bring about a segregation of assets securing time deposits and securing Federal Reserve advances to banks. In such a case our interest in supervising the assets securing our advances to banks would be strong.

5. The solution of the problem of bank unification.

Objections to the Proposal

1. The chief, and perhaps insurmountable objection to the proposal outlined above, is the name "100% reserve" and the

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antagonism this name immediately evokes. Bankers immediately interpret this to mean a progressive rise in reserve requirements similar to our action in 1937 with the consequent necessity to liquidate earning assets. Some of this opposition might be overcome by calling the plan "The Sound Money Plan" and securing wide publicity of the fact that banks would be left with their existing earning assets intact. Certainly the opposition should be much diminished if it were fully understood that banks need no longer worry about liquidity and could safely put their money into higher yielding local and long-term assets.

2. Even when the plan is understood, there will still be opposition on the ground that any further acquisition of deposits subject to check will not permit a proportionate expansion in earning assets. The opposition on this score would come particularly from the large metropolitan banks having relatively few time deposits. Country banks generally have more time deposits whose growth would permit expansion of earning assets. In addition, with the pressure for liquidity removed, they would be in a position to secure higher yields on the earning assets now back of demand deposits.

The opposition of the large metropolitan banks might be lessened by pointing out that no reserves will be required

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against interbank deposits, and that their earning assets can also be expanded through borrowing on longer terms from the reserve banks at a lower rate than on customer loans.

3. Over a longer period of time expenses on account of the growth of deposits subject to check will increase with no increase in earning assets. This objection can be met by pointing out that banks will permanently be able to secure a better return than they could when they had to be prepared to meet deposit drains; that they will be able to borrow from the reserve banks, and finally, that they can be compensated for the additional expense arising out of new deposits by imposing service charges.

4. The Treasury will have to pay more on its short-term borrowing. In compensation for this, however, the yield on the long dated issues may be less than it otherwise would be since such issues will become more attractive to banks. The Treasury should also welcome the prospect of a more stable Government bond market as the danger of forced bank liquidation is removed.

Concluding Remarks

The basic idea of the reform discussed above is not new. Since 1933 it has received a wide measure of academic and popular support. As an Administration measure it should experience little

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difficulty in getting by the House. Its chances in the Senate are more dubious.

Although the occasion is perhaps not yet ripe, a basic reform of the nature herein presented appears, in the absence of a development of nationwide branch banking, inevitable. The diffusion of authority and responsibility for monetary control, the excessive sensitivity of a fractional reserve unit banking system, the excessive emphasis on liquidity at a time when the supply of liquid instruments is declining, and hence the failure to meet the changing needs of the community, and the consequent vulnerability to encroachment from other private and government agencies, all call for reforms of a basic nature.

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