THE ROAD TO DAMASCUS

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In asking me to take his place at this meeting, Judge Bakke asked me to express to you his sincere regret at not being able to be here. He unexpectedly found it necessary to be in Des Moines, Iowa, tonight. He told me the title of his address was, "The Road to Damascus," and suggested I might develop the ideas found in that story. In fairness to the Judge, I want to emphasize that only the title is his--he cannot be held responsible for what I am about to say.

I am not going to dwell on that great story of Paul's conversion except to point out that we, as bankers, are also on a road. We have a fair idea of where we have been, but we do not know for sure where we are going. Of necessity we must peer into the future and decide where we want to go and what we must do to get there. That is what I want to do tonight- take a look at where we are and make a guess as to where we will be six months or a year from now. This will be primarily a discussion of the impact of changing economic conditions on the quality of bank assets.

You probably know just as much as I do about the effect of a business slump or of a business boom on the quality of bank assets. The character of this effect is well known. In a business recession the quality of bank assets tends to deteriorate because some debtors to banks are likely to find themselves unable to meet their obligations. In boom conditions, on the other hand, business concerns generally find their profits to be better than they had anticipated and they have little difficulty in meeting their commitments.

What I want to talk about is a phase of the relationship of business conditions to bank assets which has not, I think, been given sufficient attention by businessmen, bankers, or professional economists. This is the interrelationships between the quantity of bank assets, the quality of those assets, and changes in business conditions. The first comment I wish to make is this: There appears to be a very close relationship between a change in the quality and a change in the quantity of bank assets. We all know that the quality of bank assets deteriorated badly during the early years of the 1930's. As we look back at that period we are sometimes inclined to say that the banks acquired a lot of inferior assets in the 1920's. To some extent this may have been true. But a far more important fact is that assets which were good in 1928 or 1929 became inferior in subsequent years.

An additional fact that is not so well known is that the quantity of bank assets, relative to a reasonable rate of growth, began to shrink before their quality began to deteriorate. During the prosperous years of the middle 1920's, when prices were fairly stable and there was little unemployment, bank assets increased at an average rate of about 5 percent per year. This appears to be a rate of growth which is in line with the needs of the nation for circulating medium, of which bank deposits are now the major part. The rate of growth in production over a long period of time has averaged nearly 4 percent per year. There is also a long-term trend for people to hold more deposits relative to their expenditures, and this is a little over 1 percent per year.

As I have said, in the middle 1920's bank assets increased at an average rate of about 5 percent per year. But in 1929 there was no growth in bank assets. In 1930, bank assets declined by about 4 percent, in 1931 by 13 percent, in 1932 by 9 percent, and during the early months of 1933 by another 10 percent. As we know, those were also the years when bank assets were deteriorating in quality.

The experience of the past few years is another illustration of changes in the quality and quantity of bank assets accompanying each other. As you know, bank assets increased in quantity at a rapid rate during the war period from 1939 to 1945, and during this period, the percentage of bank assets criticized by examiners decreased year by year. However, since 1945 bank assets have increased very little. In 1946 total assets of all commercial and savings banks declined by 5 percent, in 1947 they increased by 4 percent, and in 1948 there was hardly any change. With respect to quality, the percentage of assets criticized by examiners reached its low in 1946. This percentage was higher in 1947 than in 1946, and higher in 1948 than in 1947. I venture the opinion that you are finding a larger proportion of your assets subject to criticism now than you did a year ago.

This relationship between changes in the quantity and those in the quality of bank assets raises the question: If bank assets deteriorate when the quantity shrinks and improve in quality when the quantity is swollen, why is this true? What are the causal forces which produce that relationship? Before I attempt to answer this question I would like to make another observation and raise another question. We know that the times when bank assets deteriorate greatly in quality, like the early years of the 1930's are also times of economic distress, and the times when bank assets improve in quality are generally speaking times of business improvement and rising prices as in the years from 1939 to 1945. This observation leads to the question: If changes in the quality of bank assets are related to business conditions and are also predominantly sequential to the quantity of bank assets, what is the relation of the quantity of bank assets to business conditions?

We have, then, two questions -- the nature of the causal relationship between the quantity and the quality of bank assets and the relation of the quantity of bank assets to business conditions. In answering these two basic questions let us consider the fundamental nature of banks. When a bank makes a loan or an investment it acquires and places in its portfolio a promissory note or a bond or some other form of obligation of an individual, a business concern, or a government. In exchange the bank issues its own credit, or promise to pay, usually in the form of a deposit account subject to check. These deposits are useful primarily as means of making payments. To the individual or enterprise a bank deposit is a form of money. Just as mining and coining gold or silver is a process of producing money, or circulating medium, so the acquisition of assets by banks and the simultaneous creation of bank deposits is also a process of producing money, or circulating medium. As Erick Bollman said in a little book on banking which was published about a hundred and forty years ago: "...this is the principal advantage of banks that they always supply circulating medium...and therefore I have called them Mines and Mints." 1/ Banks, like the Treasury vaults for gold and silver, are places at which assets are stored and held as the basis for the issue of circulating medium. Mr. Szymczak, a member of the Board of Governors of the Federal Reserve System has accurately described the nature of banks as follows:

> "Taken as a whole, the commercial banking system is fundamentally a mechanism for creating money..." 2/

Everyone is familiar with the fact that when something which people need or want becomes very plentiful its value drops; and when it becomes scarce its value rises. Economists call this the law of supply and demand. This principle of value, or law of supply and demand, applies to money, (and I am using the term money to include bank deposits) just as it does to other things which are used by human beings. When money becomes more plentiful, it becomes less valuable per unit. When money becomes less plentiful, it becomes more valuable per unit. That is to say, monetary shrinkage, relative to a reasonable rate of growth, is almost certain to result in a falling level of prices. But with falling prices business prospects become adverse and business depression is sure to follow. On the other hand, monetary expansion, relative to a reasonable rate of growth, is almost certain to result in a rising level of prices.

1/ Erick Bollman, Paragraphs on Banks (Philadelphia, 1811), p. 80.
2/ M. S. Szymczak, address at Federal Home Loan Bank of New York (1948).

When prices are rising business prospects become more favorable and prosperity ensues. During periods of depression, the obligations of business concerns become risky and precarious. This means that the quality of the assets of banks--which consist to a very large extent of the obligations of business--falls. During periods of prosperity just the opposite takes place. So we conclude that there is a very real causal connection between the quantity of bank assets on the one hand, and business conditions and the quality of bank assets, on the other. This causal relation runs from the change in the quantity of bank assets, in the form of deviation from a reasonable rate of growth, to change in quantity of deposits, to change in prices and interest rates, to change in business conditions, and to change in the quality of the assets of the banks. That is to say, an increase in the quantity of bank assets at more than a reasonable rate of growth leads to price inflation and an unhealthy business boom, but also an improvement in the quality of bank assets. A contraction in bank assets, or even the absence of growth, leads to a decline in business and deterioration in the quality of bank assets.

Do you realize the significance of this analysis? What I have said in effect is that the failure of our banking system to function properly is the cause of business depression. This is contrary to the thinking of most modern economists, but is in accord with the teaching of economists in the 19th and early 20th centuries. This is what I was taught 25 years ago. Modern economists, like Paul on the road to Damascus, have been blinded by the light because their minds have been closed to the truth.

Granting this relationship between the quantity of bank assets, on the one hand, and business conditions and quality of bank assets, on the other, we need to ask another important question. What is it that causes changes in the quantity of bank assets? If changing business conditions are primarily the result and not the cause of changes in the quantity of bank assets, how do changes in the quantity of bank assets occur? To answer this question we come back to the fundamental characteristic of banks as storage places for assets which are monetized. This kind of business is inherently expansionary. The reason for this is that the more assets in storage on which the storage concern receives an income the greater is its profit. Consequently the more assets banks can acquire, the better.

This fundamental characteristic of banks has been recognized for more than a century. It is the inherent tendency of banks to expand their assets and therefore their obligations used as circulating medium which has made it necessary for governments to place so many limitations on the operations of banks. The main purpose of banking legislation has always been to provide a guide to the acquisition of assets by the banks in order that the banking system will provide a suitable amount of circulating medium--neither too little nor too much.

In the early history of banking legislation in the United States, limitations were placed on the kinds and amounts of assets which banks could acquire, and banks were generally required to hold a portion of their total assets in the form of gold or silver. The limitations on kinds of assets never provided a suitable restraint to the quantity of bank assets; reserve requirements proved to be much more effective for this purpose.

Under the National Bank Act of 1863, national banks were required to hold specified reserves in proportion to their deposits. These reserves consisted in part of deposits in other banks and in part of lawful money. From that time to establishment of the Federal Reserve System the major limitation on the expansion of banks was the amount of their lawful money reserves. These were in part gold and silver money in the form of coin or certificates but they also included several types of United States government obligations--the greenbacks, certain other obligations issued during the Civil War, and the Treasury notes of 1890 issued on the basis of silver bought by the Treasury.

With establishment of the Federal Reserve System in 1914 and the amendments to the Federal Reserve Act of 1917 the character of bank reserves was changed. Reserves of banks which are members of the Federal Reserve System consist only of deposits in the Federal Reserve banks. Changes in these deposits occupy the position in the banking system and in the economy which changes in lawful money reserves of national banks occupied from 1863 to 1914. Since 1917 the dominant factor limiting the expansion of bank assets and deposits has been the amount of member bank reserve balances; and during most of this time the banks have kept their assets and deposits close to the limit permitted by their reserves. The great contraction in bank assets from 1928 to 1933 was made necessary by a shrinkage in bank reserves. Similarly, the absence of growth in bank deposits since 1945 reflects an absence of growth in bank reserves, when the dollar amount of those reserves is adjusted for changes in percentage requirements.

These considerations lead us back to another question. What are the forces which influence the quantity of bank reserves?

As I have said, under the present situation the significant part of bank reserves consists of the member bank reserve balances in the Federal Reserve banks. When we look at the Federal Reserve banks we find the same type of operation as in the commercial banks; they also are storage concerns for monetized assets. The Federal Reserve banks hold, or store, gold certificates, United States government obligations, and a small amount of bankers acceptances, commercial paper, and loans to industrial enterprises. In the early years of the system, the Federal Reserve banks held much larger amounts of business obligations which they had discounted for member banks.

The monetary liabilities of the Federal Reserve banks are of three sorts: (1) Federal Reserve notes, which we all use as pocket money; (2) deposits of the United States Treasury and of foreign banks and governments and some miscellaneous deposit accounts; and (3) member bank reserve balances. The amount, or quantity, of the first two of these types of monetary liabilities--the Federal Reserve notes, and the Treasury, foreign and miscellaneous deposits--depend respectively upon how much currency people want and what balances the Treasury and foreigners keep in the Reserve banks. The Federal Reserve has little control over them.

However, the Federal Reserve authorities have wide powers to change the quantity of assets held by the Federal Reserve banks. On the one hand, they can reduce discount rates and encourage member banks to borrow, or they can go out and purchase United States government obligations in the open market at whatever price is necessary to pay to get them. On the other hand, the Federal Reserve authorities can raise discount rates and discourage borrowing by member banks, or they can sell some of their own holdings of United States government obligations in the open market.

You are, I presume, familiar with the process by which these transactions affect member bank reserve balances. Without tracing this process in detail, we can sum up the results of all such transactions by saying that the quantity of member bank reserves is the difference between the quantity of the assets held by the Federal Reserve banks and the sum of Federal Reserve notes, Treasury and foreign and miscellaneous deposits in the Federal Reserve banks, and the capital accounts of the Federal Reserve banks. Inasmuch as the Federal Reserve authorities have ample powers to change the terms on which they acquire or relinquish assets, they have the advantage in all transactions in which the Federal Reserve banks are engaged. That is to say, changes in the quantity of assets of the Federal Reserve banks in excess of changes in their liabilities other than member bank reserve accounts are causally dependent upon the policies adopted by the Federal Reserve authorities themselves. The actions of the Federal Reserve authorities are therefore the ultimate causal determinant of the quantity of member bank reserves. In addition to these powers to control the quantity of bank reserves, Federal Reserve authorities have the power--within fairly wide limits--to control their effect on the quantity of bank deposits by changing the legal reserve percentage requirements.

Before I close these remarks, or apply them to the situation during the coming year, let me summarize the processes and causal sequences which I have described. In my talk, I have moved, step by step, from the quality of bank assets to the policies and actions of the Federal Reserve authorities. In summary, let us reverse the order and start with the policies of the Federal Reserve authorities.

When we do this, we have the following steps or events in causal sequence: (1) decisions of Federal Reserve authorities which affect the quantity of assets in the Federal Reserve banks or which change percentage requirements; (2) changes in the quantity of Federal Reserve bank assets which result from those decisions; (3) changes in member bank reserve s which accompany the changes in Federal Reserve bank assets; (4) adjustments made by commercial banks as a result of changes in their reserve balances, that is, acquisition of additional assets when their reserve position is favorable or relinquishment of assets if their reserve position is unfavorable; (5) changes in the quantity of bank deposits which accompany the changes in commercial bank assets; (6) pressure on interest rates and on the price level which results from changes in the quantity of bank deposits--higher interest rates and a falling price level when the quantity of deposits contracts or fails to grow at a reasonable rate, and lower interest rates and higher prices when deposits increases at more than a reasonable rate; (7) changes in business prospects and profits and in the volume of sales of output which result from the changes in quantity of circulating medium and its pressure on prices; and (8) changes in the quality of bank assets which result from changes in the prosperity of the business concerns whose obligations comprise a large part of the assets of the banks.

Now we come to the question on which you are most anxious, I am sure, to have an opinion expressed. What are the prospects for change in the quantity and quality of bank assets during the next six months or a year. From my resume of the causal sequence leading to changes in the quantity and quality of bank assets it is clear that to answer this question I must forecast the decisions of the Federal Reserve authorities. I hesitate to make such a forecast. All that I can say is this: first, the Federal Reserve announcement on June 28 implied that the decisions of the Federal Reserve authorities during the next few months would be in the direction of monetary expansion; and second, the record since June 28 shows that the rate of expansion has been quite moderate.

On June 29 of this year, total member bank reserve balances amounted to $18.0 billion. The announcement of the preceding day suggested that the reduction in percentage requirements going into effect on June 30 would permit the member banks to expand in proportion to the reduction in requirements. However, six weeks later the amount of reserves was down to $17.3 billion, which was the equivalent of $18.2 billion under the requirements in force when the June 28 announcement was made. Most, but not all, of the reduction in percentage requirements had been offset by the Federal Reserve selling government obligations and thus reducing the amount of bank reserves.

Further reductions in percentage requirements went into effect on August 11, 18, 25, and September 1. Following each reduction in requirements the dollar amount of member bank reserves has fallen, but not quite in the same proportion. On October 12 reserves were down to \$16.1 billion, which is the equivalent of \$19.0 billion under the requirements in force in June. We do not know what policy will be followed between the present time and the end of the year. If we should assume that no more reduction in the actual amount of reserves takes place but that on the other hand the amount of reserves is not increased, the effective amount of reserves at the end of 1949 will be about $5\frac{1}{2}$ percent larger than in the middle of the year. This is about twice the normal rate of growth. But during the first half of the year the reserves--using the same type of computation--declined by 5 percent. That is, for the year 1949 as a whole, as in 1948, there would be very little change in the effective amount of member bank reserves. If the effective amount of bank reserves shows no change, the amount of deposits at the end of the year should be about the same as at the beginning. Without a reasonable rate of growth in deposits of about five percent, we may expect the general level of prices to be a little lower, general business conditions to be slightly less favorable, and the slow deterioration in the quality of bank assets to continue.