

BANKING IN A FREE ENTERPRISE ECONOMY

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Lecture by Dr. Edison H. Cramer, Chief of the Division of Research and Statistics, Federal Deposit Insurance Corporation, before the Colorado School of Banking, University of Colorado, Boulder, Colorado, August 18, 1953

Yesterday we discussed the functioning of a free enterprise economy and the way by which the price mechanism channels resources, human and physical, into their most productive uses. Implicit in my remarks was the assumption that business enterprises would be so coordinated by prices there would be full employment of all resources. It was also implied that there would be stability in the value of our monetary unit. But the historical fact is that during the past two centuries our economy has only intermittently operated at full capacity. Periods of full employment and prosperity have been followed by periods of unemployment and stagnation. These periods in turn have been followed by prosperity in the continuous chain that is called "The Business Cycle". Likewise the value of our monetary unit--our economic ballot, to use yesterday's analogy--has gone up during periods of depression and down with prosperity.

Most of you recall the early 1930's when millions of people were without work in the midst of vast productive powers and unused resources. We had what appeared to be an anomalous situation of people going hungry because too much food was produced and going cold because too much coal was mined and too many clothes manufactured. Some economists called it an "over production--under consumption depression", and we tried

to cure it by paying farmers to plow under every third row of cotton and by butchering the sows that were about to farrow a litter of pigs. Our monetary unit rose in value, as it had in all previous depressions, and only a few dollars were required to buy a day's labor, a bale of cotton, or a brood sow.

In view of the importance of prices in a free enterprise economy, the question arises as to why they behave as they do during the various phases of the business cycle. We know from experience that in both depression and inflation prices do not seem to function well as a regulator of our economic activity. Why not? Could it be that there is something wrong with our monetary system rather than with the price system itself? That is to say, is the erratic behavior in the value of money the cause rather than the result of business instability? Certainly it is worthwhile to examine this hypothesis.

In making an examination of this hypothesis we may start with the fundamental economic principle, the law of supply and demand, and ask the question: Is this principle applicable only to the various types of goods and services which are bought and sold in the economy, or is it applicable also to the circulating medium which is used in making payments and fulfilling contracts? The answer to the latter question is yes. When money is in great supply relative to the need for it, as measured in an appropriate manner, it tends to fall in value and each unit becomes worth less and less in buying goods and services; if money becomes scarce relative

to the need, it tends to rise in value and fewer units will be required to buy a suit of clothes, a bushel of wheat, or an automobile. That is to say, a decline in the value of money due to an excessive increase in its quantity is the same as a general rise in prices. This is what we call inflation. Similarly, a rise in the value of money due to a decrease in its quantity is simply another way of describing a general fall or deflation of prices.

Neither inflation nor deflation occurs instantaneously. In each case some prices go up or down and this produces pressure on other prices. Moreover, many prices are fixed by contract or custom, or for other reasons are rigid and do not move readily. This creates distortions in the price structure. Generally speaking, in inflation these distortions are such as to make business unusually profitable and thereby to stimulate businessmen to feverish activity. Likewise, the distortions of the price structure during deflation tend to make business unprofitable, whereupon businessmen find it necessary or at least expedient to reduce their working forces, thus producing unemployment. It should be emphasized that changes in the price level due to a change in the quantity of money is quite different than changes in relative prices due to changes in the supply of and demand for particular economic goods.

These remarks on the role of the price system as a governor or regulator of a private enterprise economy, and on the character and impact of inflation and deflation, lead us back to the problem of business instability. If the money supply does not remain stable in quantity with a

reasonable increase in line with the growth of the economy, periods of inflation and boom on the one hand, and of deflation and depression on the other, appear to be inevitable. Consequently, many economists have concluded that maintenance of monetary stability with a reasonable rate of growth is the key to economic stability.

At this point you may be wondering what became of my announced topic, "Banking in a Free Enterprise Economy". The answer is simple: the most important single function of the nation's banking system is provision of the circulating medium with which the economy operates. This is not its only important function, but were it not for this, banking would scarcely warrant the great attention which it receives.

The plain fact is that more than seven-tenths of the nation's circulating medium has been created by the banking system. This may be shown by taking the best measure of circulating medium now available, the Federal Reserve series "Deposits adjusted and currency", and examining its construction. As of December 31, 1952, deposits adjusted plus currency totaled \$195 billion. Of this amount, about \$27 billion was currency outside of the banks and about \$3 billion represented deposits in the postal savings system. Since this \$30 billion was not created by the banking system, it may be deducted. This leaves a total of \$165 billion, which is the "deposits adjusted" portion of our circulating medium.

A word about "deposits adjusted" before going on. This simply means that from total deposits in all operating banks, there has been

deducted interbank deposits, U. S. government deposits, and cash items in process of collection. This was done so as to arrive at a deposit total which most nearly represents the sum held in the banking system and available for use as circulating medium by the public.

But surely, you might say, this \$165 billion of deposits simply represents money deposited with banks and was not created by them. To a limited extent this is true. Even though we have already taken out cash items in process of collection and an amount roughly equivalent to balances with other banks, there is still other cash in the banking system, such as currency and coin, and member bank reserves with Federal Reserve banks. In all, these other cash items amount to about \$23 billion and when we deduct this sum from our "deposits adjusted" of \$165 billion, the result is \$142 billion. This is the basis of my statement that over seven-tenths of the nation's circulating medium has been created by the banking system. In other words, there is \$142 billion of deposits in the banking system which is not represented by cash in the banks but, instead, is represented by other assets held by them. It was through the acquisition of these assets that the \$142 billion of circulating medium was created.

This is all very well, you might say, but is it not true that an individual bank never makes loans without first having more than sufficient funds. And if this is so, by what magic can you make it appear that the banks collectively do something which none of them does individually.

As a matter of fact, there is no magic to it at all. To illustrate the process, let us assume that instead of 15,000 banks, our banking system consists of three banks. Let us further assume that each of these banks is "loaned up", that is, their cash and reserve positions are such that they would hesitate to make any new loans until some of the old loans run off. Finally, let us assume that a new depositor walks into Bank A with \$1,000 in currency which he uses to open an account. Now let us follow a series of events which are typical of those that are likely to occur.

Bank A may feel, with an additional \$1,000 in cash, that it is now possible to accommodate a farmer who has applied for a \$600 loan with which to purchase seed. In doing so it gives him a \$600 deposit, and within a few days the farmer's check is deposited by the seed merchant in Bank B. So far as Bank A is concerned, its deposit liabilities have increased by \$1,000 and its assets by \$400 in cash and the farmer's \$600 note.

Bank B, receiving the \$600 check from the seed merchant, goes through essentially the same procedure as Bank A. It feels that a loan of \$400 to be used by one of its customers to purchase a television set is warranted. The \$400 is placed to the credit of the borrower, and promptly checked out to the appliance dealer who, in turn, deposits the check in his bank, Bank C. Note that the net result to Bank B is that it has increased its deposit liabilities by \$600, and its assets by \$200 cash and the note of \$400.

Bank C receives the \$400, and is in position to make additional loans up to some fraction of this amount. But in order to hold the example to a reasonable length, let us say it delays making use of this new money.

What has been the result of this sequence of events. First, note that in each case the bank did not make a loan until it had received some additional cash and, further, each loan was for a smaller amount than the cash received. Each bank might therefore deny emphatically that it "created" any money.

Now let us look at the banks together, our hypothetical "banking system". There is a deposit of \$1,000 in Bank A, a deposit of \$600 in Bank B and of \$400 in Bank C. Thus, we have \$2,000 on deposit in the three banks which is available for spending by the original depositor, the seed merchant and the appliance dealer but, note carefully, that only \$1,000 of this represented new cash coming into our banking system. The remainder, \$1,000 was, in the true sense of the word, "created". It did not exist prior to the original deposit and could not have come into existence unless the banks had acquired the assets they did.

The relationship between banking and circulating medium also helps to explain why a bank failure was usually so much more disastrous to a community than the failure of a business concern of comparable size. The loss to the community of the income of the failed bank's employees was important, but of even more importance was the fact that a portion of the community's circulating medium was literally wiped out. Usually

only a portion of the deposits in the bank was eventually returned to the community by the liquidator and the balance, represented by worthless assets in the bank's portfolio, was forever lost to the depositors.

Today, with Federal deposit insurance, this particular problem has to a great extent been solved. However, we can by no means become complacent about bank failures since it is the function of operating banks which remains of primary interest. With seven-tenths of the nation's circulating medium consisting of bank-created funds it is clear that banking indeed plays a crucial part in the operation of a free-enterprise economy. How crucial, may be illustrated by a brief review of our banking history.

Banking was still in its infancy in this country when it became apparent to the various State governments that banks had an inherent tendency to acquire as large a volume of earning assets as possible and, consequently, to expand their liabilities to the public. Since, in this early period, these liabilities were generally circulating banknotes, rather than deposits, the relationship between bank lending and the creation of circulating medium was more apparent than is the case today. Thus the inevitable inflations, which were generally followed by spectacular crashes whenever the banks were subject to even relatively mild shocks, led the States to enact into law certain limits to the expansion of bank liabilities.

These limits were frequently in the form of requiring that circulating banknotes not exceed a given multiple of bank capital. It is interesting to observe that in the early 1800's legislators often

considered bank capital the equivalent of cash, that is, gold or silver, in the bank. Consequently, we can see in these early laws the forerunners of our modern requirements, that banks maintain minimum reserve balances behind deposits.

While helpful, such regulations were not a complete solution. As the country developed, new banks were rapidly formed. One of the first great and prolonged depressions in our history, which began with the panic of 1837, is largely attributable to the collapse of the banking system, following a spectacular period of expansion in the early 1830's. Apparently the most important direct cause of this collapse was the decision of the Federal government in 1836, first, that only gold and silver would be accepted for government land sales, rather than banknotes and, second, that the very substantial government surplus, which at that time was deposited in a selected group of State banks, be distributed among the various States. The result was tremendous pressure on bank reserves with a consequent cessation of the growth of circulating medium and, finally, complete collapse. Other depressions during this period, most notably the ill-famed Panic of 1857, can also be directly attributed to the inability of the banking system to withstand sudden pressure on its reserves.

It was about this time that renewed efforts were made by the various States to secure stability and safety of the circulating medium through the regulation of banking. Some of the attempts took the form of insurance of bank obligations, and other plans sought to assure the

safety of circulating banknotes through the posting of collateral. Between 1829 and 1858, six States adopted plans for the protection of bank creditors by one or both of these methods, and a limited measure of success was obtained. Finally, the Federal Government took action and a rather drastic solution was adopted by the Congress: between 1863 and 1865 the notes of State chartered banks were taxed out of existence and the note-issuing function was made a monopoly of the newly formed national banks. The notes of the latter group of banks were, of course, guaranteed by the U. S. Treasury and were restricted in amount to 90 percent of the face value of those U. S. bonds bearing the circulation privilege.

It was rather ironic that this solution was achieved just at the time when deposits, rather than circulating notes, were coming to comprise the major part of bank obligations. Following the Civil War, deposits, which had been about equal to circulating notes just prior to 1860, grew rapidly, and as early as 1885 they constituted about four-fifths of the nation's circulating medium. Thus, the problem of excessive expansion and contraction in bank liabilities which had been "solved" by 1865 was once again before the country after only two decades.

It is hardly necessary for me to detail the instances of erraticism in business and banking since that time--everyone here certainly has seen one or more of the various charts that purport to show the course of general business over the last century or century and a half. On these charts, times of full employment are given such designations as war

prosperity, Coolidge prosperity, merger prosperity, or gold resumption prosperity. On the other hand, deflation years are called by such terms as primary post war depression, secondary post war depression, debt repudiation depression, and the rich man's panic.

What are we to conclude from this brief survey of the record of banking instability? Certainly not that all our troubles would have been avoided if we had possessed a different banking system, or even no banks at all, for it must be emphasized that despite the periods of undue expansion and contraction, banking on the whole played a most important role in the economic development of the country. If we had not had an independent banking system comprised of many individual units and oriented to the needs and wants of their respective communities, the rate of economic development of this nation would have been much slower. And, of course, continuation and preservation of such a system today is of great importance.

Secondly: the fact that banks create circulating medium through their lending and investing operations is not to be condemned. On the contrary, it is a normal characteristic of a free enterprise economy. What is important is that we understand the banking and monetary policies which will result in banking stability and which will thus produce business stability. That is to say, we must preserve the independence of our banks so that they can continue to serve the commerce and industry of their communities, but at the same time we must make sure that the banking system

as a whole neither creates so much money as to cause inflation nor so little as to cause depression. Putting it still another way, we must assure banking stability without sacrificing banking independence. How this is being accomplished will be discussed at the next two sessions of this class.