BANKING STABILITY - THE ROLE OF DEPOSIT INSURANCE

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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 19, 1954

As a background for today's topic "Banking Stability - The Role of Deposit Insurance", I want to review some of the material you have covered in Basic Economic Principles and that we have discussed in the first three sessions of this class and summarize it in a few short statements as follows:

1. Our private enterprise economy is one in which individuals exchange the goods and services they produce for the goods and services produced by others.

2. In a primitive society, this exchange process may be effected by barter - the direct exchange of goods for goods.

3. As specialization develops, barter becomes cumbersome and goods and services are exchanged for money and the money then exchanged for other goods and services. As stated by Chandler in the text you are studying, A Preface to Economics, "an efficient monetary system can greatly facilitate exchange, thereby enhancing productivity".

4. Money has its limitations, and in our modern society goods and services are exchanged for other goods and services through the medium not only of money but of the right to claim money. 1/

1/ The word money is used here in a narrow technical sense to include only coins and currency. Money is also used as synonymous with the phrase "medium of exchange" and "circulating medium" and then includes bank deposits as well as coins and currency.

5. The primary function of banks is to make available to society the most important segment of its medium of exchange--bank deposits--the right to claim money.

6. Stability in the value of the medium of exchange is a fundamental prerequisite for business stability. In the first chapter of the text used in Money and Banking for second year students, Professor Thomas says that money "stands forth as a kind of genie with tremendous, all-prevading powers over economic good and evil."

7. Stability in the value of the medium of exchange depends upon stability in its supply, adjusted for a reasonable rate of growth, probably less than 5 percent per year.

8. Whenever commercial banks increase deposits too fast, the value of money decreases. This we call inflation. Whenever commercial banks do not increase deposits fast enough, the value of money increases. The result of this deflation is likely to be unemployment and depression.

9. Whenever commercial banks have ample reserves, they acquire additional assets in order to increase their earnings and they thus increase deposits. Whenever they lack reserves they are forced to relinquish assets and thus decrease deposits.

10. Generally speaking, the quantity of bank reserves and the requirements as to how much reserves must be held are the result of central bank policy, and the commercial banking system is helpless

to do anything about them.

The foregoing summary, I believe, is a fair presentation of the basic economic doctrine that developed during the past century and a half. To be sure, there are some economists who assign to money and bank credit only a permissive role in the instability that has long characterized our economy. However, there are many other economists who hold that instability in money and banking has been the paramount cause of instability in business. Moreover, this theory has been shared by many who are not professional economists. It has long been believed that the basic cause of all severe business fluctuations originates in some way from the operation of the banking system. In September, 1837, one hundred and seventeen years ago, President Van Buren, in a message to a special session of the Congress, attributed the great crisis of that year to the banks; and twenty years later, President Buchanan, in his annual message to the Congress in December, 1857, likewise blamed the banks for the crisis of that year. A historian of banking theory has said that the presidents were expressing the opinion of the majority of the contemporary students of the problem. 1/ If you were to go through the bills relating to banks introduced into the Congress during and following every business depression, you would see that this belief has been prevalent ever since the time of George Washington and Alexander Hamilton. That is to say,

1/ Richardson, Messages of the Presidents, III, 325 ff. and V 437 ff; and Harry E. Miller, Banking Theories in the United States Before 1860, p. 105.

political leaders, students of banking, and the general public have long recognized that if we are to maintain vigorous commercial and industrial activity, banking stability is a necessary condition.

Prior to the Civil War, to be sure, our economy was largely agricultural, and the industrial development that was to transform it was in its early stage. Banking played a somewhat less important role at that time, but even then the nation needed a medium of exchange with stability in its value. The recurring periods of unsettlement in the financial affairs of the nation affected the business and agriculture communities and the problem of banking instability was ever present. With the development of industrial specialization during the second half of the Nineteenth Century, the question of banking stability grew in importance and urgency.

This problem of banking instability and its effect on business stemmed from two main sources. In the first place, bank deposits expand and contract with the expansion and contraction of bank reserves. As we discussed yesterday, the quantity of effective reserves available to banks now depends almost exclusively on central bank policy. But prior to 1914, we had no central bank and no adequate control over the quantity of bank assets or deposits. The Federal Reserve Act of 1913 created a central banking system, and gave it power to control the quantity of bank reserves. This power was made more effective by the banking acts of 1933 and 1935.

However, the Act did not correct the other source of instability in our system of free enterprise banking. This second weakness

of our banking system to which I refer was the instability of individual banks. With thousands of independent banks--at one time close to thirty thousand--there were bound to be some that failed for one reason or another. In the event of a bank failure, the public lost not only part of its circulating medium but also its confidence in neighboring banks. During periods of money stringency when banks were contracting their assets because of lack of reserves, weak banks would fail and depositor panic would spread from bank to bank and many sound institutions would be forced to close their doors. How this situation affected our banking system and the way it has been corrected is the subject for today's lesson.

Record of instability. Chart 1 So that we could see graphically the record of bank failures in the United States over the past three quarters of a century, we studied the available statistical data and prepared a chart showing failures in banking and business during the period 1867 to 1952. The rate of failure in banking is depicted by the red silhouette, and the black curve furnishes as a point of reference the rate of failure for other types of business. The statistical problems involved in analyzing these data were such that it is impossible to say the presentation is precisely accurate. Nevertheless, the over-all picture for this period as shown on this chart, in my opinion, is a fair representation of the historical facts. You will note that for long periods of time the record of banking was substantially better than for other types of business. However, during other periods the

troublesome problem of banking instability is apparent. Generally speaking, the times when bank failures were relatively more than business failures were times of deep depression and stagnation.

Chart 2 Now I should like to picture the facts regarding bank failures in a somewhat different form. On this map is a dot representing each bank failure for the period 1915-1933. The total suspensions during this 19-year period were over fifteen thousand. The distribution, as you can see, was widespread. Agricultural States appear to have been particularly vulnerable but no area really escaped, irrespective of the economic bases supporting the economy. The problem became acute in the great depression in the early 1930's.

It is apparent from these charts that the problem of bank failure was not solved in 1913 by establishment of a central banking system. As a result there were those who contended that instability in banking was an inherent characteristic of our dual banking system with its multiple chartering authorities and thousands of individual banks. The proponents of that theory pointed to the structure of banking in other commercial nations where instead of 14,000 or 15,000 individual banks, there were a few huge institutions operating elaborate systems of branches. The critics of the dual banking system placed great emphasis on the record of banking instability for three quarters of a century, and particularly in the 1920's and early 1930's. This record, it was contended, was so bad that something had to be done to correct it, and very drastic plans for changing our banking system were

proposed. Many economists recommended unlimited branch banking as the most practical solution, others worked out schemes for requiring banks to keep 100 percent reserves against deposits, and still others suggested nationalization of our banking system.

Deposit insurance legislation. Fortunately, a few students of banking realized that the cause of so many bank failures could be traced to the two sources mentioned earlier--central bank operations and individual bank weaknesses. Before discussing the solution based on this analysis of the problem, I want to turn briefly to another historical factor. Prior to the Civil War, bank notes were the principal medium of exchange. The National Bank Act of 1863 placed a Federal guarantee on this circulating medium. But bank deposits gradually replaced bank notes and other forms of currency, and the guaranteed portion of the money supply declined in importance.

By the middle of the 1880's, deposits had become over four-fifths of the circulating medium. The problem of protecting them was sufficiently acute to bring about the introduction in the Congress of bills providing for the guarantee of deposits. Four bills for this purpose were introduced in the House of Representatives in 1886. Fourteen more were introduced in the Congress prior to 1900. In the 60th Congress, following the panic of 1907, about thirty proposals were made for deposit guarantee legislation. The Democratic platform of 1908 contained this plank, "We pledge ourselves to legislation under which

the national banks shall be required to establish a guarantee fund for the prompt payment of the depositors of any insolvent national bank, under an equitable system which should be available to all State banking institutions wishing to use it." The Senate version of the Federal Reserve Act in 1913 carried such a provision, but the banking and currency committee of the House was instrumental in taking it out of the Act.

For the entire period from 1886 to the establishment of the Federal Deposit Insurance Corporation in 1933, 150 bills for the guarantee or insurance of deposits are known to have been introduced in the Congress.

The foregoing figure does not include bills proposing the establishment and operation of banks of deposit by the government itself. Numerous proposals of this type were introduced. Some called for a Bank of the United States with a system of branches and others for the expansion of the Postal Savings System to provide for receipt of deposits and their transfer by check at Post Offices throughout the nation. The number of such proposals has never been tabulated.

The great depression and the banking debacle in the spring of 1933 convinced the Congress that insurance of bank deposits--our principal circulating medium--could no longer be delayed. It was in this atmosphere of desperate emergency that the Federal Deposit Insurance Corporation was created. Many students of banking and most bankers believed it could not possible succeed, but were willing to try it as a last resort.

Solution to bank failure problem. Adoption by the Congress in 1933 of the principle of deposit insurance was an exercise of its sovereign power to provide and control the nation's circulating medium or supply of money, and the responsibility imposed upon the Congress by the Constitution of the United States to regulate the value of money. The monetary responsibility which the Congress has given the Federal Deposit Insurance Corporation is definite and precise. The Corporation has been given the duty of preventing the destruction of the circulating medium by reducing the number of bank failures, and the restoration to a community in which a failure occurs of a portion of the money supply extinguished by the failure.

Chart 3 Now I should like to picture the facts regarding bank failures for another 19-year period, beginning with 1934 when deposit insurance became effective. You will note that there are not many black spots on the map. The total number of bank failures was only 520, of which 420 were insured and 100 noninsured banks. Two more insured banks have failed in 1953 making a total of 422 since the inception of the Corporation. Of these failing insured banks, 177 were merged with other sound banks with the financial assistance of the Federal Deposit Insurance Corporation. In these cases no depositor suffered any loss. This method of aiding depositors has been used exclusively since May, 1944. For the first 20 years of Federal deposit insurance the record reads: 395 insured bank failures during the first decade of its operation and 27--an average of less than 3 per year--during the second decade.

Charts 4 and 5

These facts point to a conclusion which, so far as I can see, is inescapable. The long recognized and troublesome problem of bank failure was faced in the early 1930's. A way to solve the problem was developed and it was a typically American solution. The banking structure was strengthened and stabilized both by improving the central banking system and by the adoption of Federal Deposit Insurance legislation. Deposit insurance has fostered the confidence of depositors in banks, and it seems reasonable to expect that never again will multitudes of sound banks be swept away because depositors are panicky. Continuation of appropriate central bank policy such as we have had since 1947, along with stability of individual banks because of deposit insurance will give us business stability, and we need never again have a long serious depression like that of the early 1930's. As time goes on our experience with continuous prosperity will convince the world that our private business enterprise economy and our dual system of free enterprise banking are not inherently unstable, but are extremely flexible and responsive to changing conditions and changing times.