STABILIZING BUSINESS AND BANKING

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Lecture by Dr. Edison H. Cramer, Chief of the Division of Research and Statistics, Federal Deposit Insurance Corporation, before the Students and Faculty of the Economics Department, The Citadel, Charleston, South Carolina, February 13, 1958.

In discussing the topic, "Stabilizing Business and Banking", I will use economic theory, such as you are studying, and focus it on one of the important problems facing the free world--how to avoid general business depression on the one hand and price inflation on the other. Many businessmen and some economists think that this cannot be done. You will recall that George Humphrey, then Secretary of the Treasury, was reported to have said about a year ago that we might have a depression that would "curl your hair". Professor Sumner Slichter, one of our great economists, advocates a slowly rising price level to avoid depression.

There are two main reasons for the belief that capitalism is inherently unstable and subject to alternating periods of depression and prosperity. One of these is the historical fact that it has always been that way. Throughout our history, periods of full employment and prosperity have been followed by unemployment and stagnation. These periods in turn have been followed by prosperity, in a round of events that is commonly called "The Business Cycle".

The last great depression was in the early 1930's, when millions of people were without work in the midst of vast productive

powers and unused resources. I do not suppose you are old enough to remember those years, but your fathers and mothers are and they can tell you of the horrors of depression. Then during World War II there was widespread apprehension about our ability to find jobs after the war for the millions of young men in the Armed Forces, and many predicted a postwar depression of the first magnitude. As a matter of fact we have had two minor recessions--1948-49 and 1953-54. It appears that the third postwar downturn is now under way. Will this develop into a major depression?

The other reason for the belief that capitalism is inherently unstable has its roots in the very nature of the economy, with its seeming lack of coordination, direction, and control. In a totalitarian state, basic plans and decisions are made by a few people, and these plans and decisions are directed and controlled by governmental machinery. In a competitive private enterprise economy, the government exercises very little conscious direction and control. Decisions regarding production plans and the operations of factories and other types of producing enterprises are made by a multitude of persons, either on their own account as individual businessmen or as officers of business enterprises. Isn't it inevitable, some people ask, that these plans and decisions will be poorly coordinated and will result from time to time in the kind of a mess we call a business depression?

The question does indeed arise as to how the multitude of decisions by hundreds of thousands of separate business enterprises

are coordinated so that there is a reasonable degree of order in the economic system. To see how this coordination takes place we need to look at business arrangements for the purchase of materials, the hiring of labor, and the sale of goods and services. Those arrangements, or contracts, are made in terms of prices and promises to make payments in money. The prices represent the number of units of money, in the form of currency or of checks on a bank account, which will be paid for a given amount of material or labor or for a given quantity of goods or services. The system of prices which these contracts produce becomes a kind of impersonal central regulator of the economy. If businessmen make inappropriate decisions and base their contracts upon them, they find that their goods remain unsold or can be sold only at a loss. They discover that other types of goods which are comparatively scarce command relatively high prices. Consequently the prospect of making profits as a result of producing such goods acts as a force inducing businessmen to shift labor and materials to their production and away from making those types of goods which are relatively abundant and have been found to be unprofitable.

The prices which eventually govern these decisions of businessmen are those which individuals are willing to pay for the final products of the economy. As economists have often remarked, consumers cast their votes for some goods and services and against others as they go shopping every day in the market places. Thus the choices and decisions not merely of business enterprises but of all the people, expressed as preferences in the market, produce a price system which becomes the governor or

regulator of production. Professor Wallis of the University of Chicago in a talk before the Citizens Board of the University of Chicago made this statement:

> "The price system has two outstanding features. First it is by all odds the most efficient system of social organization ever conceived. It makes it possible for huge multitudes to cooperate effectively, multitudes who may hardly know of each other's existence, or whose personal attitudes towards one another may be indifference or hostility. Second, it affords a maximum of individual freedom and a minimum of coercion. And since people can cooperate effectively in production even when their attitudes on other issues are hostile, there is no need for unity and conformity in religion, politics, recreation, and language--or even in patriotism and good-will except in the very broadest senses." 1/

The supply of money. As we think about the importance of prices in this economic system, the question arises in our minds as to why they sometimes get out of order. We know from experience that in depression, as in time of 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 well-known erraticism 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 or money which is

1/ W. Allan Wallis, "The Mechanism of a Free Enterprise Economy," Marquette Memo, Sept., 1950.

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, an automobile, or a television set. 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.

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, which nowadays consists primarily of bank deposits but also includes the currency which we carry around in our pockets, does not remain stable in quantity with a reasonable increase in line with the growth of the economy, occasional periods of inflation and boom on the one hand, and of deflation and depression on the other, appear to be inevitable. Some economists who have studied the operations of our banking and monetary system have concluded that the banking system has been responsible in the past for many erratic changes in the money supply, and that those changes in the quantity of money have been the basic cause of business instability. Consequently, they have concluded that maintenance of monetary stability with a reasonable rate of growth is the key to economic stability.

Bank reserves. If an unstable quantity of money is the leading factor in producing business fluctuations, what forces initiate changes in the quantity of money? Since bank deposits form the bulk of the money supply, this is a question of what forces affect bank operations and result in fluctuations in the amount of bank deposits. Without taking time to go into a detailed examination of this question, I will simply say that banks find it profitable to maintain their operations close to the limit permitted by their reserve position. When banks have excess reserves, they can acquire additional assets and thus increase their incomes; when they have insufficient reserves, they have to dispose of assets even though income is lost in doing so. When banks increase their assets, they automatically increase their deposits; and when they dispose of assets, they thereby decrease their deposits.

That is to say, the quantity of bank deposits depends almost exclusively on the quantity of reserves available to banks. The only exception to this is when reserves expand with great rapidity, as in the latter half of the 1930's, and the sequential expansion by the banks is at a slower pace.

Since 1917, Federal Reserve policies have largely determined the amount of reserves available to banks. When the Federal Reserve banks acquire additional assets, the reserve balances of member banks are thereby increased; and when they dispose of assets, member bank reserve balances are decreased. Moreover, the Federal Reserve banks have enourmous powers of acquiring additional assets, or of relinquishing assets which they hold; and the amount of assets actually acquired or relinquished is dominantly influenced by the terms set by the Federal Reserve authorities themselves. It follows that if the Federal Reserve is going to be held responsible for controlling inflation and deflation, it must be left free to set the terms on which it will acquire or relinquish assets.

Postwar adjustment. The theory that business fluctuations are the result of inappropriate variations in the quantity of bank reserves and that these variations in reserves result from Federal Reserve policies is supported by the historical facts that are available. To illustrate, let me review the changes in reserves, prices, and business during and since the beginning of World War II. In 1942 Federal Reserve authorities announced that the System would provide the banks with all the reserves they might need as a result of increasing their holdings

of Government obligations. During the war years banks acquired a huge volume of Government obligations, and the amount of bank reserves and the quantity of bank deposits increased rapidly. Reserves continued to increase, though more slowly, for two years after V-J day. From the end of 1941 to the end of 1947 Federal Reserve bank assets nearly doubled, and member bank reserves, adjusted for changes in percentage requirements and other factors affecting their effectiveness as a base for deposit expansion, increased by about 60 percent. The money supply, measured by the Federal Reserve series of "deposits adjusted and currency", more than doubled. The money supply expanded more rapidly than effective reserves, because the extraordinarily large gold imports immediately preceding the war permitted the banking system to enter the war with substantial excess reserves. This great increase in the money supply between 1941 and 1947 led to some rise in prices during the war and to a rapid rise when wartime controls were removed. The wholesale price level rose about two-thirds and the consumers price index by about one-half from the first six months of 1942 to the first six months of 1948. This increase in prices reflects the impact of the excess of monetary expansion over the growth of production.

In the latter half of 1947 and the early months of 1948 various measures were taken for the purpose of preventing any further increase in the money supply. These measures impinged on bank reserves. By the end of 1947 the expansion of bank reserves was halted and turned into contraction. Between that date and the end of April 1949, the

effective amount of bank reserves was reduced by 15 percent relative to the normal rate of growth. Bank deposits also declined substantially though not by so large a percentage. The price level turned down and business activity slackened in the fall of 1948, several months after the peak in reserves, repeating the typical sequence and lag which prevailed between the World Wars.

By the Spring of 1949 unemployment became serious, and fears were arising that a serious postwar depression was at hand. At this point the Federal Reserve authorities reversed their pressure on reserves. Early in May they started a series of reductions in percentage reserve requirements, thus stopping the contraction in effective reserves and in deposits. In the summer and autumn business sentiment became more favorable, several of the leading indicators of revival appeared. "Deposits adjusted and currency" increased $4 billion during the second half of 1949 and at the end of the year reached $170 billion, which was the peak in the money supply reached at the end of 1947. Early in 1950 unemployment reached a postwar high of 4.7 million and then dropped rapidly and the fear of a deep depression subsided. The Federal Reserve authorities had stopped the wartime inflation and at the same time avoided a depression sufficiently severe to be a threat to our economy.

Then in June 1950, the Red forces of North Korea invaded South Korea, and it was decided that the United Nations could not permit the unprovoked act of agression to go unchallenged. Soon American

soldiers, under the banner of the United Nations, were fighting side by side with the South Koreans. The widespread belief that large government deficits were unavoidable and that they would inevitably result in inflation led to a vast amount of anticipatory and speculative buying. This, together with hurried acquisition of supplies by the government to pursue a military campaign for which it was unprepared produced substantial rises in the price indexes during the last half of 1950. Moreover, the Federal Reserve hesitated to change from the easy money policy it had used to stop the deflation of the year before. Deposits adjusted and currency increased from $170 billion at the end of 1949 to $177 billion at the end of 1950. Doubtless, during this time the Federal Reserve authorities were weighing the advantage to the Treasury of low interest rates against the evil of inflation if the easy money policy was continued.

The famous accord between the Federal Reserve and the Treasury early in 1951 was not fully appreciated at the time. The joint announcement on March 4, 1951, stated:

> "The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."

This policy of minimizing the monetization of the increase in the public debt meant a continuation of the monetary policies that had been in effect since 1947. That is to say--provision of enough growth in the money supply to assure full employment in an expanding economy but not enough to result in price inflation.

Events following the accord indicate that the Federal Reserve authorities have been remarkably successful. In 1951 and 1952, effective reserves increased 4.0 percent and 5.0 percent respectively. Even though these increases made liberal allowance for the normal growth in the output of the economy, they were small enough to bring to a halt the inflation in evidence during 1950.

The Wholesale Price Index, which was at an all time peak in March of 1951, at 116.5 percent of the 1947-49 average, slowly declined and was 110.0 percent two years later. The Consumer Price Index, which was also at an all time peak at the time of the accord, continued to increase but at a much slower rate than it had during the last six months of 1950. A peak of 115.4 percent was reached in October, 1953, which was not surpassed for three years.

During 1951 and 1952, business was booming and most of the time unemployment was less than 2 million. The presistence of inflationary pressures through these years indicated bank reserves were growing faster than necessary, and the Federal Reserve authorities adopted restrictive policies early in 1953. For the year as a whole, effective reserves were increased less than 2 percent. This stopped the inflation but also brought on the slight recession of 1954--the second one since the end of the World War. Unemployment reached a peak of 3.7 million in March of 1954.

Effective reserves were increased over 6 percent in 1954, and deposits adjusted and currency increased from $200 billion to

$209 billion during the year. Business quickly revived and unemployment decreased. When inflationary pressures again developed, a restrictive monetary policy was called for. For three years now a moderately restrictive policy has been followed, and again inflation has been stopped.

Now some signs point to the possibility of the third minor recession. It is my judgement that it will not be severe enough to be a threat to our economy. For the Federal Reserve authorities are again taking steps to give commercial banks more reserves.

With conspicuous stability, business and banking have gone from an all out war economy in 1945 to practically all out peace, then to the Korean episode and the cold war. In my opinion, the stability of the economy during these periods of transition demonstrates that the free enterprise system is not inherently unstable. When it is given stability in its medium of exchange, it is extremely flexible and responsive to changing conditions and changing times.

So far as we can see into the future, there is good reason to believe that the monetary authorities can continue to use the powers given to them by the Congress in a manner that will result in banking stability, without price inflation, and thus in business stability.

TABLE 1

MEMBER BANKING SYSTEM
CONDENSED STATEMENT OF CONDITION
(In Billions)

Resources		Liabilities	
Legal reserves:		Deposits	$170.0
Required	$ 20.4	Capital funds	14.0
Excess	0	Other liabilities	3.0
	20.4		
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(1)

Central bank reduces reserve requirements one percentage point, from 12 to 11 percent.

Reserves:		Deposits	$170.0
Required	$ 18.7	Capital funds	14.0
Excess	1.7	Other liabilities	3.0
	20.4		
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(2)

Member banks acquire assets to extent permitted by new reserve position.

Reserves:		Deposits	$185.4
Required	$ 20.4	Capital funds	14.0
Excess	0	Other liabilities	3.0
	20.4		
Loans and investments	155.4		
Other assets	26.6		
	$202.4		$202.4

Loans and investments increased $15.4 billion and deposits $15.4 billion.

TABLE 2

MEMBER BANKING SYSTEM
CONDENSED STATEMENT OF CONDITION
(In Billions)

Resources		Liabilities	
Legal reserves:			
Required	$ 20.4	Deposits	$170.0
Excess	0	Capital funds	14.0
	20.4	Other liabilities	3.0
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(1)

Central bank acquires enough government bonds ($2.1 billion) from non-bank investors to permit loans and investments of member banks to increase $15.4 billion.

Reserves:			
Required	$ 20.7	Deposits	$172.1
Excess	1.8	Capital funds	14.0
	22.5	Other liabilities	3.0
Loans and investments	140.0		
Other assets	26.6		
	$189.1		$189.1

(2)

Member banks acquire assets to extent permitted by new reserve position.

Reserves:			
Required	$ 22.5	Deposits	$187.5
Excess	0	Capital funds	14.0
	22.5	Other liabilities	3.0
Loans and investments	155.4		
Other assets	26.6		
	$204.5		$204.5

Loans and investments increased $15.4 billion and reserves $2.1 billion; deposits increased $17.5 billion.

TABLE 3

MEMBER BANKING SYSTEM
CONDENSED STATEMENT OF CONDITION
(In Billions)

Resources		Liabilities	
Legal reserves:		Deposits	$170.0
Required	$ 20.4	Capital funds	14.0
Excess	0	Other liabilities	3.0
	20.4		
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(1)

Central bank acquires enough government bonds ($2.1 billion) from member banks to permit their loans and investments to increase $15.4.

Reserves:			
Required	$ 20.4	Deposits	$170.0
Excess	2.1	Capital funds	14.0
	22.5	Other liabilities	3.0
Loans and investments	137.9		
Other assets	26.6		
	$187.0		$187.0

(2)

Member banks acquire assets to extent permitted by new reserve position.

Reserves:			
Required	$ 22.5	Deposits	$187.5
Excess	0	Capital funds	14.0
	22.5	Other assets	3.0
Loans and investments	155.4		
Other assets	26.6		
	$204.5		$204.5

Loans and investments increased $15.4 billion and reserves $2.1 billion; deposits increased $17.5 billion.

TABLE 4

MEMBER BANKING SYSTEM
CONDENSED STATEMENT OF CONDITION
(In Billions)

Resources		Liabilities	
Legal reserves:		Deposits	$170.0
Required	$ 20.4	Capital funds	14.0
Excess	0	Other liabilities	3.0
	20.4		
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(1)

Central bank lends $1.8 billion to the member banks.

Reserves:		Deposits	$170.0
Required	$ 20.4	Borrowed money	1.8
Excess	1.8	Capital funds	14.0
	22.2	Other liabilities	3.0
Loans and investments	140.0		
Other assets	26.6		
	$188.8		$188.8

(2)

Member banks acquire assets to extent permitted by new reserve position.

Reserves:		Deposits	$185.4
Required	$ 22.2	Borrowed money	1.8
Excess	0	Capital funds	14.0
	22.2	Other liabilities	3.0
Loans and investments	155.4		
Other assets	26.6		
	$204.2		$204.2

Loans and investments increased $15.4 billion and reserves $1.8 billion; deposits increased $15.4 billion and borrowed money $1.8 billion.

TABLE 5

MEMBER BANKING SYSTEM
CONDENSED STATEMENT OF CONDITION
(In Billions)

Resources		Liabilities	
Legal reserves:		Deposits	$170.0
Required	$ 20.4	Capital funds	14.0
Excess	0	Other liabilities	3.0
	20.4		
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(1)

Member banks sell stock or retain earnings to permit increasing loans and investments $15.4 billion.

Reserves:		Deposits	$154.6
Required	$ 18.5	Capital funds	29.4
Excess	1.9	Other liabilities	3.0
	20.4		
Loans and investments	140.0		
Other assets	26.6		
	$187.0		$187.0

(2)

Member banks acquire loans and investments to extent permitted by new reserve position.

Reserves:		Deposits	$170.0
Required	$ 20.4	Capital funds	29.4
Excess	0	Other liabilities	3.0
	20.4		
Loans and investments	155.4		
Other assets	26.6		
	$202.4		$202.4

Loans and investments increased $15.4 billion and capital funds $15.4.