DEPOSIT TRENDS AND THE POSSIBILITIES OF INFLATION

Summary of Remarks

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Bank supervisors are greatly interested in the future of bank deposits. They are interested in whether the total volume of deposits will decline, will greatly expand or will remain approximately as at present. They are also interested in what will happen to the distribution of deposits among the regions of the country and among various banks.

To a very considerable extent government policy and action determine the volume of deposits and the price level. If the government maintains certain practices with respect to taxation, expenditures, bank reserves and the management of the government debt, we may have declining deposits or falling prices. If certain other policies in these various fields are followed, we may very likely experience still further increases in deposits and higher and higher prices. Control of the volume of deposits is a major factor in determining the price level. A great increase in the volume of deposits tends to produce price inflation, while a great reduction in the volume of deposits tends to induce price deflation. Thus the volume of deposits and the price level are not something like the weather to which we must adjust ourselves but about which as such we can do nothing. On the contrary they are greatly affected by government practices.

Since 1939 the practice of this government has been such as to permit and increase bank deposit inflation. From December 31, 1939 to December 31, 1945 bank assets increased 131 percent and bank deposits increased 130 percent. The increase in deposits was the direct result of the increase in assets. The banks purchased government securities and gave the government credit in the banks' books in the form of deposits. The government in turn paid for what it needed with these deposits and the deposits flowed into the hands of the general public. Along with this great increase in deposits there was a still greater increase in money in circulation, amounting to over 300 percent. The increase in deposits and, to a considerable extent, the increase in money was primarily a result of deficit financing by the Federal Government. If higher taxes had been levied, the government could have avoided the creation of so great a volume of deposits. Very likely somewhat different borrowing policies could also have assured that a greater volume of the financing of the government would have been out of the savings of the public and less by the creation of bank credit.

Some increase in deposits during the war was probably desirable and necessary. To the extent that there was more business to be done and to the extent to which the public chose to save in the form of cash, it was appropriate that more deposits and money be created. However, deposits were created in an additional volume such that prices rose substantially. Since the end of 1939 an index of the cost of living has risen 30 percent, wholesale prices 35 percent, construction costs 38 percent, the stock market

45 percent, and farm land prices 71 percent. Indeed it is possible that these indicators do not show the entire increase in prices and that when consideration is given to the black market, deterioration in quality, and other factors, prices have risen much more. However, if we had not instituted a system of price control and rationing, it is very likely that prices would have risen much more than has been the case. Price control was in large measure an alternative to deposit limitation. If less deposits had been created, price control in considerable measure would have had less to do and could have done that which it did have to accomplish more effectively.

In any case we are left with a large volume of deposits and money which threaten to result in a further great increase in prices whenever control may be lifted. Our problem now is to so adjust the volume of deposits and money that we can dispense with price control without a great price rise. There is every indication at the present time that we need to prevent any further increase in bank deposits and very possibly that we need to induce a contraction. Preventing an increase in deposits means that banks must not expand their total assets. Such expansion might come through deficit financing, through transfer of government debt from the public to the banks or through increasing other bank assets, particularly loans.

Present indications are that the government will not have occasion to finance a deficit through borrowing from the banks. While the last quarter of this fiscal year is expected to show a slight deficit, the cash now held by the Treasury is so great that it can not only provide for this deficit but also for some retirement of outstanding debt. Banks will consequently not expand in the near future by financing government deficit, but in subsequent periods such expansion might take place if taxes were reduced or government expenditures not kept under control. A prime key to any possible contraction of bank deposits would be a large excess of government receipts over government expenditures. For the immediate future this would seem to be a most desirable procedure.

To the extent that the banks may in the future take over government debt now held by the public, inflation will be promoted. On the other hand for government debt to move from the hands of the banks to the general public would be an anti-inflationary influence. Generally speaking, a strengthening of interest rates would be conducive to the movement of debt to the public, while any softening of interest rates would be an inducement to the movement of that debt into the banks. To the extent that we are at any moment experiencing a substantial rise in prices, this factor in itself will tend to cause the debt to move toward the banks, thus increasing the money supply and still further promoting price increases. To the extent to which the public may be very optimistic about the future of employment and believe there will be future price rises, the debt will move from the public to the banks. Contrarywise, stability of prices and confidence in stability of prices will be conducive to a movement of debt into the hands of the public. If the Treasury can issue more long term securities attractive to others than the banks, price stability will be promoted.

Expansion of bank loans is an inflationary influence. In the last half of 1945 the business loans of insured commercial banks rose 25 percent. If this movement should be resumed, a still further impetus would be given to purchasing power in relation to goods available and inflation would be promoted. Consumer credit controls, stock market controls, and comparable devices are, within limits, useful in preventing inflation.

When prices are rising, borrowing from the banks will expand in order to carry on business activity at higher and higher price levels. This borrowing will result in the creation of further deposits and thus contribute still further to price rises. On the other hand, under stability of prices business can, for the most part, be financed out of funds now held by business and consumers and by the sale of securities to investors.

The basic device for preventing unlimited expansion of bank deposits and unlimited inflation is bank reserves. This is not a new concept but a very old fashioned one. Under the gold standard, particularly as it existed before World War I, reserve requirements in the form of gold prevented, in a crude way, unlimited bank expansion. Under the Federal Reserve System requirements for reserves in the form of deposits in the Federal Reserve banks have served a comparable function. The Federal Reserve System has prevented unlimited expansion of such reserves by limiting the expansion of Federal Reserve credit. The important question now is whether the Federal Reserve can, consistent with the present low level of interest rates, adequately limit expansion of Federal Reserve credit. If the commercial banks see fit to expand their credit through expansion of loans or through acquisition of additional securities, they are in a position to expand their reserves to the degree necessary by disposing of government securities which they may hold so long as the Federal Reserve is committed to maintaining the prices of government bonds at their present levels and keeping down the interest rate. The traditional Federal Reserve devices of selling governments or raising rediscount rates are not effective or their application is not consistent with maintenance of the current low cost of servicing the Federal debt. Government bonds held by the commercial banks, expecially the short terms, can be turned into reserves if the Federal Reserve System supports the bond market.

If the Federal Reserve System did not support the market or supported it at lower levels, the Treasury would have to refinance at higher interest rates. Would this be an undue price for inflation control? There is a popular opinion that aside from the increased cost of servicing the Federal debt, a rise in interest rates and a fall in the price of government securities would have a bad effect upon investors in government securities, particularly financial institutions such as the banks and the insurance companies. A fall in the price of government securities would be harmful to these institutions only on the assumption that it would be necessary for them to sell their holdings. While this would be true in some cases, generally speaking there would be no need for taking such a loss except when it was anticipated that the higher yields on new investments would more than compensate for the loss incurred. Generally speaking, financial institutions would profit from the rise in interest rates, since their new investments would bring them higher returns. The institutions which currently hold relatively large amounts of cash and of short-term securities would of course benefit more from the change than would the institutions which hold large amounts of long term securities.

While relaxation of support for the securities markets would be the most orthodox method of limiting bank reserves, there are alternative suggestions for limiting the reserves of the banks while permitting the Federal Reserve System to continue to support the market and maintain low interest rates. The simplest or most obvious of these methods would be to raise the required ratio of deposits in the Federal Reserve banks to the deposit liabilities in the commercial banks. The banks would have to sell some or all of their government securities to the Federal Reserve banks in order to bring up their deposits with those banks. This procedure would lower bank income unless interest were paid on deposits with the Federal Reserve banks. Such a policy would be consistent with a view held by some people that bank income is currently unreasonably high.

The second possibility is to require the banks to keep a supplemantary reserve in the form of special non-negotiable government bonds. Some banks would find the adjustment difficult. This is also true in the case of higher deposit requirements.

There is a widespread view that the cure for the present inflation potentialities is not so much a monetary or fiscal problem as it is a problem of securing full employment and maximum production. However, it is not certain that a condition of full production, desirable as it is, may not be more inflationary than a condition of ~~over~~UNDERproduction if fiscal and monetary matters are not properly handled. When there is full production the recipients of income equivalent to the production may feel so optimistic that they are not only willing to spend the entire income received, an amount just sufficient to buy the production of the country, but they may also attempt to reduce their accumulated savings and borrow newly created credit from the banks, thus attempting to spend an amount more than equal to the goods produced and consequently create inflation. On the other hand, when production is somewhat less than full production and unemployment prevails, the recipients of income may be so pessimistic that they will not spend their entire incomes, will attempt to build up their accumulated savings, will pay off their bank loans, and consequently demand will not be so great as production, even though that production is low. Thus while every attempt should be made to achieve full production, such a goal is not a cure for the inflation problem.

In conclusion, the current situation seems to be such that we must choose between (1) inflation (2) indefinitely extended price controls and rationing, and (3) preventing bank expansion. If the third policy is followed, we must choose (1) higher interest rates or (2) higher reserve requirements of the banks.