THE BANKERS' INTEREST IN FIGHTING THE HIGH COST OF LIVING

(Remarks by R. M. Evans, Member, Board of Governors, Federal Reserve System, at meeting of National Instalment Credit Conference, ABA, Chicago, Illinois, on March 12, 1951.)

I am very glad to be here and I welcome the opportunity to discuss the credit picture with you. It is not my intention to confine my remarks to instalment credit, as I did when I appeared on your program in St. Louis several years ago.

I don't think it is necessary for me to talk to this audience about the present dangers of inflation. You have all heard and read many statements recently dealing with this insidious process, so pleasant to some for a while--- so disastrous to all in the long run. The danger is here and I think everyone knows that such is the case. Most of you have inside information on the subject. I want to discuss with you today some special effects of inflation on the banking industry.

At the outset, I want to make it crystal clear that I don't think we have attacked this problem of the purchasing power of the dollar soon enough or vigorously enough. We should certainly not permit any further erosion of the dollar's buying power. And we should put forth every effort to improve that buying power. Measures to protect the value of the dollar are essential to protect the general welfare and to protect the banks themselves.

When we stop to think that one of the principal functions of money is to serve as a storehouse of purchasing power for use at some future time, we realize the importance of maintaining a sound dollar. When people save money, whether through the purchase of savings bonds, insurance policies, or deposits in the bank, they have in mind the use of that money at some future time. They have a right to expect, in ordinary times, that the purchasing power of their savings will not fluctuate more than normally takes place in the ups and downs of business. During a time of national emergency, they have a right to expect that the purchasing power of the dollar will not be depreciated through lack of proper protective measures.

If we could see the end of this emergency period, we would be better able to gauge the size of our problems and thus better able to provide for their solution. Unfortunately, no prophet is gifted enough to forecast how long the defense effort will be with us. Just recently General Bradley said, "If our country is to survive, our citizens will have to face the hard fact that the conditions under which we labor may persist for ten, fifteen, or twenty years." If this is correct or even reasonably so, then our major domestic problem for years to come will be how to keep inflation from sapping the will of the people to save and to produce and thus from weakening the basic strength of our economy. A progressively rising cost of living steals the stored-up labor of people who are the possessors of various forms of savings.

Lenin is reported to have once said that the best way to destroy the capitalist system is to debase the purchasing power of its money. There is no subtler, surer means of overturning existing society than to debase our money. The process uses forces of economic, moral, and social destruction in a way which very few of us are capable of understanding because

Americans are forthright people and not used to devious methods.

Everyone in this audience, I'm sure, is just as opposed to socialism or communism as I am. But are we doing the things we should do to prevent the rise of socialism? Is our domestic policy as one-minded as our foreign policy? I doubt it. For example, if we permit a further rise in the cost of living, we will be plowing and preparing the field and sowing the seeds of socialism or some form of communist dictatorship. Communism is something that all property-owning people rightly dread. Whenever the communists take over, the people who have their savings in real property are the ones who are first liquidated.

We are all very much interested in preserving the banking industry because it is one of the fields in which the small businessman has an opportunity to participate both as to ownership and as to management. In a great many instances, banks are owned and operated by a local group of people who are also engaged in agriculture, industry, and commerce. Moreover, the small businessman is often a borrower of the banks. Our banking system in this country is particularly well-adapted to serve the financing needs of small businesses, whatever the industry in which they are engaged.

We Americans are busy people. Most of the time our thoughts are occupied with the personal problems of today or possibly with those of tomorrow. Ordinarily, we give very little thought to what happened 50 to 100 years ago. There are times, however, when we ought to take heed of the past and today is one of them. I do not consider it out of place, therefore, to refresh our memories about a little of the history of the banking industry.

I am from the State of Iowa. I did not know until a short time ago, when I read a paper prepared by Mr. Bray Hammond, published in the Journal of Economic History in 1948, that when Iowa became a State in 1846 its constitution forbade commercial banking. Nor was Iowa unique in this respect. Mr. Hammond quotes the Secretary of the Treasury's report of 1852 to the effect that the States of Arkansas, California, Florida, Illinois, Texas, and Wisconsin either constitutionally prohibited corporate banking or kept it out by other means. At the same time, banking was a state-controlled monopoly in Indiana and Missouri, as it was a little later in Iowa.

Mr. Hammond, in summing up the experiences of the mid-western States with banking in the period to 1865, comes to the startling conclusion that those States which prohibited banking or made it a State monopoly were better off, in this period, than those States which chartered private banks. Badly as the need was for more and more credit and currency, there was a greater need apparently for a sound currency and sound credit.

The Governor of Iowa is quoted as saying in 1850 that the growth and prosperity of the new State were largely due to its having no banks of issue. In 1858 Arkansas ascribed her avoidance of the panic to her freedom from banks. Iowa, writes Mr. Hammond, was better off in 1850 with no banks than she was seventy-five years later when she had about 1600 of them, and more than 1200 were to fail in less than ten years.

It is natural to ask why the State of Iowa and other mid-western States had such a fear of chartered banks. It is a long story but the essential reason is quite simple. Ordinarily, chartered banks of that day were permitted to issue their own bank notes. Many banks abused the privilege.

Bank notes depreciated in value -- in many cases, drastically so. As a result, the people who stored up their savings with the hope that their money could be used at some future time, found they had stored something considerably less than they thought and on many occasions, nothing at all.

There is a lesson here not to be forgotten by the banking community just as there have been other experiences in subsequent banking development which have been invaluable in shaping our policies. We are, of course, no longer concerned with a depreciated currency brought about by the reckless issue of bank notes. Rather is it the reckless creation of bank deposits. Taking the long view, however, one wonders if the problem has not changed more in form than in character.

Our banking and monetary structure has evolved as have so many of our institutions, by trial and error rather than by correctly anticipating future developments. The National Banking Act of 1863-65 effectively put a stop to wild-cat banking and the irresponsible issue of bank notes, where States had not already abolished this privilege, and substituted therefore a national currency. But as a result of alternating periods of credit inflation and credit stringency, in instances culminating in money panics, it became evident that the National Banking System, for which such high hopes had been held, left much to be desired.

In retrospect it is easy to see why. The National Banking System was designed to meet the particular problems of a phase of our banking and economic development which was already passing. Briefly put, it was designed for a period when the lending capacity of banks was heavily dependent on their own capital and when borrowers carried away cash rather than a deposit credit. Modern deposit banking was developing at an extraordinary rate in response to business requirements at the very time the new system was inaugurated. More and more of the nation's business was based on credit as we now understand the term and more and more transactions were paid by check.

The shortcomings of the National Banking System in these circumstances ultimately became so intolerable that the people demanded and obtained relief. One of the chief defects of the System was that the supply of the national bank currency was inelastic. The amount of currency that could be issued was restricted by legal limitations that were not directly related to the public's need or desire for currency and there was no central bank which could expand the supply in periods of seasonal, cyclical, or emergency demand.

Another major defect of the National Banking System was that the limited amount of national bank currency had to do double duty -- that is, as hand to hand money and as legal bank reserves against deposits. Under the National Banking System a large part of the legal reserves of country banks could be deposited with Reserve City Banks or Central Reserve City Banks. Similarly, a large part of Reserve City Bank's legal reserves could be held with Central Reserve City Banks. In this way the nation's bank reserves, both required and excess, tended to be concentrated in the large city banks and particularly those in New York City, where it tended to be loaned out at call in the stock market. This is what has been referred to as pyramiding reserves, and many of our pre-Federal Reserve banking difficulties developed because of this pyramiding.

Within this framework, financial disturbance of a local nature and sometimes only of a seasonal character inevitably spread to all parts of the country and periodically developed into money panics and on several occasions into economic depression. Why and how such disturbances were inevitable under the National Banking System is well known and needs no elaboration here. Suffice it to say that banks grew more interdependent and that bank reserves were needed on an increasing scale for the use and safety of the banking system as a whole as well as of individual banks. What was required in view of the rapid development of deposit banking and the nation's business was a central banking organization where reserves could be held in a common reservoir and which would have authority to restrain undue credit expansion and on the other hand to provide additional reserves for credit expansion and bank liquidity when the economic situation required.

The Federal Reserve came into being in 1913 and was specifically designed to meet the weaknesses of the National Banking System. The Act has been modified as events demonstrated the need for change. Very substantial progress has been made. For the first time in our financial history the public's seasonal currency and credit needs can be met without disruptive effects in the banking system. Since the early Thirties for the first time in our financial history it can be said that by and large the public can hold its money with greater safety in bank deposits than in currency. With the additional powers granted to the Federal Reserve Board, the Federal Open Market Committee, and with the establishment of the Federal Deposit Insurance Corporation, depositor runs on banks have become a thing of the past.

But such legislative progress towards a stable banking system may not be as real today as it seemed to be fifteen years or even ten years ago despite the solution of many of the currency and banking problems which have plagued us over the years. Even though our banking system is stronger today than ever before in its history, it is its very strength that, paradoxically, is the chief source of danger. How can this be? The answer is simple and is well known to this audience.

Because of the decision to finance the last war in large measure by deficit financing and to permit financial institutions to participate in this deficit financing, these institutions, including banks, acquired large amounts of marketable United States Government securities. And the Federal Reserve System acquired a responsibility for maintaining an orderly market for these securities, and in the view of some people a responsibility for supporting the market rigidly. So long as the Federal Reserve is expected to buy these Government securities at par at the will of the holder, bank holdings of these securities become in effect interest bearing reserves and other holdings interest bearing cash. Moreover, in these circumstances, banks and other financial institutions are so liquid that ordinary standards of liquidity no longer apply and the Federal Reserve becomes an engine of inflation. The consequences are too familiar to this group to need recounting. But I want to make this point.

Whenever the central bank -- the Federal Reserve -- is unable to influence the availability of its credit for reserves there is very little more restraint over the creation of money than there was one hundred years ago. Bankers, who by their lending activities, are the principal creators of money and credit, must face the fact that, to the extent that the central bank is unable to do what it is intended to do, or is unable to do this in the degree originally intended, bankers must individually be more vigilant and bear a more direct responsibility to see to it that their lending does not contribute to a further depreciation of the dollar.

A large part of that responsibility could be discharged if the banking community were to support measures and policies adequate to control bank reserves or would come forward with a program on its own initiative. In measuring up to this task bankers should remember that the people will not forever tolerate a debasement of their currency and an erosion of their savings any more than the people of Iowa did 100 years ago. There is a need, greater than ever before in our history, for bankers to take the lead, through individual and collective action, through word reenforced by action, and through support of effective public policy, in restraining those forces of inflation over which they have some control. The efforts of representatives of the financial community to come forward with a workable program for cooperative restraint of credit is a step in the right direction and it is to be hoped that all members of the financial world will give this constructive program full support. Such voluntary efforts reduce the burden which other measures may need to carry but they can not be expected to do the whole job.

Sometimes bankers say they are in favor of credit regulation but they do not see why the banks should be singled out when credit curbs are suggested. I ask you this simple question -- why shouldn't you be singled out if you want to call it that? After all, the banks are institutions doing business under a charter granted either by a State or by the Federal Government. With this charter you have the power to create money.

By virtue of your business, you are the financial leaders in the territory you serve. You deal in money and credit. When people think of finance, those are the two things they have in mind. When people have health problems they naturally feel that the doctor in their community is the best one to consult, and, likewise, when financial questions are involved people seek the advice of the banker. The banker is more intimately acquainted with the conditions, financial and otherwise, of his customers than any other business man and he is a trusted person in the territory he serves.

In order that my position may be very clear, I want to digress for a moment right here to say that I have never had any desire to change this so-called dual banking system, and I can go even farther than that. In the nine years I have been a Member of the Board of Governors I have never heard any proposal discussed or advocated at a Board meeting to do away with the dual banking system. We accept the dual banking system as provided by law and unless it is changed by Congress or the State legislature, we will support it.

The connection between credit and money -- of finance, in general -

and prices is not always obvious to the public and, more to the point, to your customers. As recognized and respected dealers and experts in finance, you can do a very great service to your country if you take some time to explain to your customers the extent of the inflationary problem and some of the things we must do to maintain and enhance a strong economy.

Instalment credit regulations are a case in point. Such regulations constitute a very useful tool in helping to check the constant rise in the cost of living. They have demonstrated their value over a long period of time and, vigorously applied, they will effectively do the job they are intended to do. But the public must understand that instalment credit regulations are only a part of an anti-inflationary program and are no substitute for voluntary restraint in other credit sectors, for the traditional general credit instruments, for a supplementary reserve requirement authority, and for a constructive fiscal program.

I might say at this point that there seems to be a growing disposition among some groups, including some bankers, to favor an extension to all categories of loans of selective regulations like the ones we now have covering the instalment credit and real estate credit fields. Apparently the basis of this disposition is the feeling that such methods of credit regulation are less onerous than other alternatives; for example, some form of additional authority over reserve requirements.

I'm sure that no one of you would disagree that this is a matter that has to be approached realistically. Selective credit regulations are applicable to, and can only be effective in, credit areas where the credit is used for well defined purposes and where the terms and conditions of credit extended are customarily related to the purpose of the loan.

It seems to me that with these criteria in mind that we've gone about as far in the direction of selective credit controls as we can go, intelligently. For there are not enough words in the lawyer's vocabulary to draft intelligible regulations that would do the job in the loan categories not now covered by selective controls.

It seems to me that you bankers should take the long view when you weigh the advantages and disadvantages of alternative programs for regulation of bank credit. Further authority there must be and the sooner the better for all of us but you should bear in mind that if this selective credit regulation is carried far enough and in each case is as tough as the inflationary situation calls for, too much of the management of banking will be transferred from your shops to Washington.

In conclusion, let me say that if we are going to prevent the further depreciation of the dollar, it will be necessary, above all, to have a fiscal program that will enable us to pay for the cost of defense as we go along and a debt management program that will encourage investors to buy and hold Government securities. And it will be equally necessary to have a regulation of credit and money creation that is really effective, for if you are going to curb spending power it doesn't do much good to tax a dollar out of a man's pocket if he replaces it at once with a borrowed dollar.

Everyone realizes the inconvenience of restraints on bank and other credit. We know it is particularly annoying to potential borrowers and we know it is particularly annoying to you lenders. From personal experience, I can tell you it is no picnic for us. But the over-all gain to the whole public and to your industry, as well as to financial institutions generally, far outweighs these temporary annoyances.

Let me repeat that your customers and the people who have their money invested in various forms of savings are entitled to look to the bankers in their community for leadership in this time of crisis. If you do not support a strong fiscal, debt management and credit and monetary program, it would seem to me that you are not serving your community and the best interests of the country.

On the other hand, if bankers take the lead in this fight against inflation and in so doing contribute to the defense of our way of life, they will have earned and will get the respect of the people. And in so doing they will provide the best possible bulwark against those who might otherwise gain support for measures inimical to the American tradition.