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RECENT DEVELOPMENTS IN BANKING

Mr. Davis' ...
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Before the Cleveland Chapter of the
American Institute of Banking
at the
Statler Hotel,
Cleveland, Ohio

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When Mr. Kossin and I agreed on the title for my paper tonight, we thought it was broad enough to cover anything I might want to say no matter what happened before November 29th rolled around. We were right about it; the subject is exactly as broad as the world-wide economic and political field. The banker at Mansfield or Canton or Cleveland or New York realizes that the conditions under which his bank must operate are totally different from those of ten years ago, but unless he sees his local scene in proper perspective against the gigantic background of world forces and events, he cannot fully understand nor explain why or how they have changed.

Innumerable streams of cause and effect are merged in the torrent that has changed and is still changing the course of American banking. No one can trace them all as they reach back into the remote past. If my imagination and your patience could stand the strain, I might spend the full time allotted to me in naming and following a few of them. Without sorting or classifying, I would mention the war that began 25 years ago, the terms of its settlement, the growth of nationalism, new tariff and trade policies, China, Abyssinia, Austria, Prague, Poland, and all that these terms imply as a few of the world factors bearing on our banking changes. Domestic influences are almost as varied - our international trade attitude; the growth of corporate business and changes in its methods of financing; technological change and unemployment; government taxation, borrowing, spending and lending are all in the picture.

It may be difficult, at first, to see any connection between that hodge-podge list of trends, policies and events on the one hand, and the interest

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rate, the supply of lendable funds, and the borrowing demand at your bank, on the other hand. I propose to suggest two clear and important connections by showing how some external conditions have been responsible for the growth of excess lendable funds in all of your banks, while other external forces have at the same time changed and limited the demand for those funds. Somewhere along the line I want to set forth briefly the steps by which gold, whether mined at home or imported from abroad, is handled and the extent to which it has been used in our credit and monetary system.

The reserves which member banks now have on deposit with the Federal Reserve Banks amount to about twelve billion dollars. This is the largest volume of reserves that American banks have ever had, and the sum is still mounting rapidly. In the past six years there has been an increase of nine billion dollars. So far this year alone, the increase has been three billion dollars, which is more than total reserves at any time amounted to before 1933.

On the basis of their present deposits, banks are required to have as reserves a little more than half of the twelve billions of total reserves. The remainder, approximately five billion dollars, is what the banks have on deposit with the Federal Reserve Banks as reserves in excess of what they are required to have.

Up to a few years ago there was no such thing as excess reserves in the present-day sense. If banks had more reserves than they were required to have, they promptly put the funds to use. Why don't they do the same today? Where does the superabundance of reserve funds come from and

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why does it continue? Is the supply unduly great, or is the demand unduly small?

Although the volume of excess reserves is an outstanding fact in the present banking situation, bankers do not ordinarily think of the problem in terms of excess reserves. What they complain of is that interest rates and bond yields are low and that there are not enough satisfactory outlets for funds either through loans or through investments. I have heard a number of bankers express themselves on this point. They want higher bond yields and firmer interest rates, while at the same time they are opposed to any move to reduce the volume of excess reserves. They are like some farmers I know who believe they should be able to get high prices, cost of production plus a profit, on all they can produce regardless of the size of the effective demand.

The individual banker is daily in receipt of reserve funds which come to him in the normal course of business and which bear no signs to indicate their origin. He receives currency and checks, and it is only rarely that he can identify the funds with anything farther back than the immediate transaction. There need be nothing unusual, certainly nothing abnormal, about the flow of reserve funds into his balances, and he naturally expects to maintain a normal relation between his reserves and his earning assets - that is, if funds come his way, he expects to find outlets for them.

During what bankers like to think of as the good old days, that expectation could be realized, because the aggregate volume of reserve funds shared by banks was determined by a relatively normal interplay of forces. If outlets for money were less attractive in the United States than elsewhere, funds left the United States. As a result, bank reserves tended to

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shrink and money rates to rise until the outward movement was checked. When opportunities here were greater than elsewhere, funds flowed into the country again, and bank reserves were expanded. For years the stock of gold in the country had fluctuated around three billions, and the aggregate volume of bank reserves had been also relatively stable and manageable. An excess of funds in one country and a shortage in another had tended to correct itself through changes in money rates and international trade.

For nearly ten years now the former close connection between the supply of funds and the available uses for them has been broken. Funds have flowed to this country not, as formerly, because there was a rising interest rate, and only partly because we have exported more goods than we have imported. Much of the gold has come here simply because foreigners have thought that the United States was the safest place to keep and to invest their money. And when interest rates declined, the funds did not move away to other markets, because, though in demand, they were not thought to be quite as safe elsewhere. So regardless of the domestic requirements, funds poured in and accumulated in American banks. The result from the point of view of the banking system as a whole is twelve billions of reserve funds, nearly half of which is available now for credit expansion.

In other words, the present swollen volume of bank reserves arises mainly from the abnormal accumulation of gold in this country. This fact is hard for most persons to understand. They know that gold is not in circulation, that it is not in the vaults of banks, that it is all in the possession of the United States, and that most of it is buried in the ground somewhere in Kentucky. This being the case, how can it and how does

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it enter into the reserves of banks?

The process by which gold comes into the possession of the Government and also expands bank reserves involves a number of technical steps, partly the result of custom, partly the result of law and regulation. Reduced to simple terms these steps are as follows:

1. The Treasury takes possession of the gold and issues a check in payment for it.
2. The check is deposited by its recipient at his bank, which gives him credit in his deposit account.
3. The bank deposits the check in the Federal Reserve Bank and receives credit in its reserve account.
4. The Federal Reserve Bank charges the check to the balance which the Treasury maintains with it.
5. The Treasury replenishes this balance by depositing gold certificates in the Federal Reserve Bank.

At the conclusion of these five steps the matter stands as follows: The Treasury has possession of the gold; bank deposits and bank reserves have both been increased by the amount of the gold; and the Treasury's balance, reduced by the purchase of the gold, has been restored by the deposit of certificates issued against the gold. By the deposit of gold certificates in the Federal Reserve Banks and by the issue of checks against those deposits, the Treasury makes use of the gold. Through this monetary use the reserves of banks are expanded. As a result, the growth

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of bank reserves in recent years closely parallels the growth of our gold stock. The differences are chiefly due to the fact that gold certificates have not been issued against all the gold in the Treasury's possession and that there has been an increase in money in circulation which uses up an equal amount of reserves.

There are three fallacies that I may mention at this point, because you are constantly encountering them. One is that the gold acquired by the Treasury is unused, another is that the gold comes here because we pay too high a price for it, and still another is that the Federal debt is responsible, at least in part, for the expansion of bank reserves.

The first is contrary to fact: the gold is used as a basis for gold certificates which build up the Treasury's credit on the books of the Federal Reserve Banks and when the Treasury issues checks against balances so built up, amounts corresponding to the gold are added to deposits at the disposal of the public. The gold, therefore, has been added to the country's effective money supply just as much as though it had been coined and put into circulation.

The second fallacy — that gold comes here from abroad because we pay too high a price for it — arises from the fact that an ounce of gold is worth more in dollars than it was before 1934. But since it is worth more in the currencies of all other important countries there is no advantage, on that basis, in sending gold to New York rather than to another center. The only way in which the higher price in currency paid for gold in all countries has increased the gold flow to the United States is by

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increasing the amount of gold that is mined in a year and, therefore, the amount that is available for shipment. The amount that is actually shipped, however, depends less on the available supply than on the course of international trade in commodities and on the direction of capital flow.

The third fallacy is that the Federal debt is responsible for at least part of the abnormally large bank reserves. It can not be. When the Treasury borrows, it merely transfers funds from those who buy the Government's obligations to those to whom the Treasury disburses the funds. If the lenders are banks, then new deposits are created and therefore reserve requirements are increased. Consequently, to the extent that the Treasury borrows from others than banks it merely reshuffles existing deposits, without in any way affecting the reserve position of the banking system. To the extent that the Treasury borrow from banks, it increases bank deposits and proportionately diminishes available excess reserves.

The source of bank reserves being mainly gold, the problem of the supply of reserve funds is largely a pro lem of gold. Let me mention briefly some of the theoretical possibilities for a solution of this problem.

One is that the gold may flow out to other countries. When or how likely this is to happen I need not discuss. I leave it to you to decide what countries there are in the world where money is going to be considered safer than here in the United States, or what country will be willing to give up goods which we will accept in exchange for additional gold, or to what country gold will flow, as a result of large long-time loans which the people of the United States are willing to make.

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When a better world order comes about, with prospects for a peace of some endurance, one of the results might be a more general distribution of gold stocks, producing a considerable outflow from this country. In the meantime, proposals that we extend large credits in the form of gold possess real difficulties. For if we lend abroad, and expect repayment either as to interest or principal, we must be prepared to accept from abroad more goods and services than we have heretofore been willing to take. We shall have to reverse our present policy, which is to sell more abroad than we take from abroad, accepting gold to make up the difference -- reverse and travel in the other direction, that is, import more than we export, and make up the difference by letting gold go out.

Another way to offset the huge excess reserves that have come from the gold accumulation would be for the Government to sterilize the gold. The Government could do it by borrowing about five billion dollars and retiring the certificates issued against the gold. But I leave it to you to determine the political feasibility of such a course.

Another possibility is that the Government might cease to accept gold. That would check the further growth of reserves, but it would not do anything about the excess we already have. Furthermore, it would deprive other nations of their ability to buy from us more than they can sell. It would disrupt foreign exchanges and put foreign trade on a barter basis, forcing us either to reduce our exports or increase our

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imports. It would adversely affect our price structure.

Another possibility is that reserve requirements might be raised. This would not change the total amount of reserves but would make a smaller amount of them available for credit expansion. Such a course would have to be authorized by amendment to the law. It would create many new problems in bank management and operation.

I am merely mentioning these possibilities, partly to indicate the complexity of the problem, partly to stimulate your constructive thought. I hope you will see more in the present situation than the difficulty for you to keep your funds profitably employed. That is, of course, the aspect of the problem which is nearest you.

Apparently what the individual banker wants is not smaller reserves but greater opportunity to use them. He is not thinking how to reduce his reserves, but how to put them to work. Yet actually the two problems are the same, looked at differently. In a situation where there are no excess reserves, there is a ready use for all available funds. Excess reserves are, therefore, a reflection of insufficient outlets for available funds. This situation will end either when outlets for funds catch up with the available supply or when this supply is cut down to the level of existing outlets.

Either of these alternatives offers great difficulties. I have mentioned some of those standing in the way of a reduction of reserves through gold withdrawals. On the other hand, to use up the existing supply of funds on the basis of present reserve ratios, bank loans and investments would have to be doubled. Instead of portfolios aggregating about fifty billions,

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the banks of the United States would have portfolios aggregating one hundred billions. If this meant merely that your particular individual bank were twice the size it is now, I don't suppose you would see anything to worry about, but in fact such a situation would mean far more. It would mean not merely that banks' portfolios would be doubled, but that the total indebtedness to banks was twice its present size. Where would this increased borrowing come from? Would the United States Government double its present indebtedness to banks while at the same time corporate and individual borrowers doubled theirs? To what uses would these borrowed funds be put? What use would be made of the deposits that would be created by such an expansion of bank credit?

Before the boom broke ten years ago, loans and investments of American banks aggregated about $58,000,000,000; but I am now asking you to imagine loans and investments of nearly twice that much. I think you will agree with me that few bankers would be happy to contemplate a doubling of the size of their business if the doubling were merely their part in a general expansion of credit and of deposits available for making payments without a corresponding growth in the country's real business.

It is not my intention tonight to dwell on the basis for runaway credit expansion that potentially exists in the volume of excess reserves. Rather, I wish to establish in your minds the relation of the reserves to present banking problems. But we should be aware of future danger even though we see no immediate prospect that bank loans and deposits will expand dangerously on the basis of the idle reserves. We should recognize that the existing powers of the Federal Reserve System are not adequate to prevent a dangerous

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situation if other conditions become favorable to the full use of the reserves.

I should like to add that the problem may solve itself in the course of time. A gradual expansion of credit and currency may eventually restore an equilibrium between bank reserves and their uses. Reconstruction of international trade and of security abroad may stop the further flow of gold to the United States. But these solutions, as you can readily see, will require much time. In the meanwhile we must be thinking of ways to prevent the gold invasion that has occurred and is still in progress from playing havoc with our banking system and with our general economy.

I have spent far more time than I had intended on this general theme. The subject of excess reserves and how they have been created is so absorbing that one of my associates often complains that its contemplation has become a disease with us. So I cheerfully lay it aside to spend a few minutes considering how external forces have changed the conditions under which banks function as lenders and investors.

There is abundant evidence of decreased demands for bank credit of the types that banks have customarily supplied. The decline in commercial loans has been so fully discussed at various times in recent years that it hardly seems necessary to devote much time to it in this connection. Probably the principal reason for this decline is that the growth of the corporate form of business enterprise has enabled business concerns to finance themselves without borrowing from banks. This tendency has been

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accentuated in recent years with the growth of idle money in the hands of business concerns, so that most large companies now have abundant cash resources and do not need to borrow from banks.

Another cause of the decline in loans has been the changed status of loans on securities. In the past, particularly during the 1920's, banks made large amounts of such loans. Some of these were made to brokers to carry margin account customers and some were made directly to individuals borrowing for the purpose of purchasing and carrying stocks and bonds. It was customary for banks to send their idle funds to New York to be loaned on the Street. Partly because of unfortunate experiences with this type of credit, the demand for it has diminished considerably, and in addition special legal restrictions have been placed upon stock-market activity and upon stock-market credit. Thus another important source of demand for bank loans has diminished.

Banks have shown considerable initiative in trying to find uses for their available funds. They have bought large amounts of Government securities, the principal investment medium which has been available in increasing supply. They have also ventured into new fields of lending — they are making longer-term loans to business and on real estate mortgages and are increasing their personal loans and their participation in installment credit. These new activities by banks have been more or less scattered and it is likely that a considerable amount of expansion in bank credit might result by entrance into these fields of a larger number of banks and of a growth in the activities of banks now in the field.

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There is question as to whether, in view of changes in the nature of their liabilities, banks have not been too hesitant about the purchase of long-term investment. Banks have endeavored to follow standards of liquidity which may prove to be stricter than necessary.

I now find myself in a field where it is clear that I must step very cautiously. It is not necessary for me to confess to this audience that my remarks on banking problems do not spring from any intimate personal experience in the business of banking. So please accept what I am about to say as the expression of a well-intentioned novice, its merit, if any, being intrinsic and not because it is the opinion of an authority - which it most emphatically is not.

If our banking system were well-ordered, bankers would be worrying far less about liquidity than they do today. Understand, I am including the Federal Reserve, and the other national and state authorities in the term "banking system."

No banker can insure his bank's liquidity by the nature of the investments in its portfolio. The rule that would be good for one institution alone, falls down when applied to all institutions. Even the best of investments are not liquid if all banks are trying to sell or collect on them at the same time.

In a well-ordered system, I repeat, bankers would be concerned more with the inherent soundness and re-payability of investments and loans rather than primarily with their short maturity. It should be the function

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of the Federal Reserve Banks to supply the liquidity when there is need for it.

The various potential uses of bank funds — long-term bonds, mortgages, personal loans, long-term loans to industry, and more abundant credit for smaller business enterprises — all involve questions of bank credit standards. In many cases banks in order to make loans and investments of these kinds have to change their customary standards of the past.

Partially for the purpose of encouraging banks to put their idle funds to use, the Federal Reserve and other bank supervisory authorities last year adopted a new examination procedure designed to remove undue restrictions that may have been imposed on banks by previous rules and regulations of examiners. There has been some misunderstanding about this new examination procedure — it has been interpreted by some as meaning a lowering of standards with a consequent threat to the future solvency of individual banks and to the interest of depositors. This is not true. What the new procedure endeavors to achieve is a removal of regulations and criticisms that have unnecessarily restricted banks in making sound loans. Some of these rules were adopted when conditions were different and are no longer applicable; the use of the term "slow," for example, as an indication of criticized loans, raised questions as to the classification of perfectly good long-term loans. Some of the old practices, I am inclined to believe, represented hindsight; because some loans made in large amounts by many banks in good times went bad

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during a severe economic collapse, there developed a tendency to discourage all loans of the same type without proper consideration of the effects of more favorable economic prospects on borrowers' ability to pay.

The fact that banks are going into new fields indicates that many of them are adjusting themselves to changed conditions. This does not mean that they have lowered their standards. In many instances new safeguards against future losses have been adopted. For example, in the longer-term business loans, in mortgage loans, and in personal loans banks are now requiring regular amortization payments, a practice which was not so widely followed in the past when loans of this nature were often renewed and payment was not requested except when doubt as to the borrowers' ability to pay developed.

Long before reaching this point in my paper I recognized that the broad topic I had chosen as a precaution, had turned out to be a trap. The subject is too big to crowd into a single session. So I shall have to conclude with no more than a mention of some important matters in which we have mutual interest.

The greatly increased holding of government securities by banks makes the condition of the bond market a matter of real concern to the Federal Reserve Open Market authorities, and to you.

The complaint that, notwithstanding the great pool of idle funds, banks are not adequately serving the credit needs of business, particularly "small business," is being widely debated, and in itself would

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provide an evening's discussion.

These and many other parts of our subject which cannot be covered tonight indicate that the whole money and credit field is dynamic, not static. Continual change and evolution are necessary in the institutions that are to survive in the new conditions, so radically different from those existing up to ten years ago.

It may be comfortable, but it is dangerous, to rest secure in the conviction that these are disordered times which, in some way or other, will soon give way to the return of the old, familiar conditions. The old conditions may not return just as we have dreamed them.

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