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# CHANGING BUSINESS CONDITIONS, BANKING, AND THE FEDERAL RESERVE SYSTEM

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With the ending of a record capital goods boom, 1957 will go down in economic history as a year that saw the peak of a strong upward cyclical movement. The evidence of receding business activity that came into view during the fall months has extended into 1958: The rate of industrial production dropped; inventories were reduced; unemployment rose; and personal incomes fell. Such pronounced changes in key economic factors that had registered the state of prosperity during their previous sweep upwards have been, and are, a matter of national concern. The contractive effects of a downswing in business activity in the United States is also a matter of concern to the great trading nations abroad, whose foreign and domestic trade is affected by economic conditions in this country.

A cool, considered and realistic appraisal of what is happening to our economy is necessary to a survey of what deliberate banking measures can be taken to promote recovery and help lay the foundation for a new period of sustained economic growth.

Prompt adaptability to changing economic conditions -- a propensity to accept every stage of change as being permanent -- is a very human trait that helps set the pace of economic activity. It is a trait that is stimulating or depressing, depending on whether the economic climate savors of optimism or pessimism. The existence in human nature of a trait that is so essentially psychological suggests that a greater awareness of its presence and recognition of the inevitability of change, would help to dissipate some of the concern that is felt when economic activity unexpectedly turns downward. The fact that a sudden change in economic conditions, especially if it is downward, should arouse surprise and consternation may be due to a sort of perverseness in this otherwise praiseworthy trait of adaptability that tends to make people, who have magnified in their own minds the idea of the permanence of the conditions to which they have become accustomed, then exaggerate the effects of a change from those conditions. Adaptability under present circumstances should take the form of resistance to an adverse turn of developments in ways that will turn the process of adjustment to constructive economic advantage. A look at where we stand now is a good starting point for future planning.

In recent months unemployment, especially in the durable goods industries, rose sharply when the investment boom passed its climax. That this should have been the case, as manpower and the production factors that had been engaged in its expansion phase were released, is not remarkable. Neither should the multiplier effects of this situation, making for the reduction of inventories, lower personal incomes and a contraction in consumer purchasing power, have been unexpected. What is too often forgotten is that the rate of capital expenditures, total employment, and consumer incomes and spending are all at high levels as measured by historical standards.

What is needed, then, is to redress the economic balance that was primarily unsettled by the lapsing of the investment boom so as to take best advantage of the strength that is inherent in an economy having a vigorous and resourceful people as its motive force. What must be done is to reorient the nation's economic energies through the mechanism of the free enterprise system in ways that will bring into full production the enlarged and improved plant capacity that has been put in place and, in so doing, generate the added saving and spending that ultimately finds expression in the satisfaction of consumer wants. Private and public policies should be followed that will look on a growing population in the perspective of an invaluable national asset that is certain of yielding a rich economic return if adequate preparation is made for its expanding needs. Human wants are insatiable and are proportionate to population size.

Ways and means for their satisfaction must be sought that will bring nationwide production and consumption into the kind of harmonious balance that fosters economic stability and orderly growth. Put in a nutshell, the future's golden promise lies in getting on with the multitude of things that are waiting to be done if our population is to be fed, clothed, housed and educated in ways that will contribute to a maximum national efficiency and a continuously improved standard of living.

Bank participation in the national effort necessary for reaching these goals is essential. In fact, stewardship over so dynamic an economic force as bank credit obligates the banking community to give its utmost help. Appreciation of the vast number of business transactions that can only be completed through the use of commercial bank created credit, and of the myriad of subsidiary transactions that in turn flow from them, highlights the importance of bank credit to our complex economy and the responsibility that bankers have to use their credit-creating powers in the public interest. The public interest factor in banking has long been recognized, impersonally by its subjection to public supervision and regulation, and personally in the attitude of bankers themselves who, as a professional elite, look to the public interest as the truest guide to the performance of their duties.

However, in relation to banking, the term "public interest" must be examined in two aspects -- the first having to do with a bank's responsibility to its depositors, and the second to that of its borrowers. A saying has been handed down through generations of bankers that, "You can't run a bank for your borrowers." The implication, of course, is that a banker should never be so intent on lending and investing as to make the mistake of relegating the senior rights of his depositors to a junior position in the conduct of the bank's affairs. A bank's contractual obligation to its depositors lies at the very heart of banking and is an undertaking by whose terms depositors place their funds in the bank's custody and consent to their use for the bank's own profit advantage in consideration of an indisputable right to their withdrawal when desired. This relationship clearly establishes the premise that a banker's first duty is always to be in a position to honor this obligation to the bank's depositors and to manage the bank's affairs accordingly.

The fact that a commercial bank's operations are conducted predominantly through the use of depositors' funds, and only to a much smaller extent through the use of privately subscribed capital, and the further fact that deposits are principally demand liabilities, emphasize the need for arranging a bank's affairs in ways that will automatically provide for the prompt repayment of deposits as demanded. This explanation of the relationship between bank and depositor is closely connected to the need for observance of appropriate "bank liquidity" standards and the fundamental importance of managing a bank in the light of its own particular liquidity requirements. In that regard, nothing has occurred in banking experience to challenge the sound principle of setting up primary and secondary assets reserves from which to meet such contingent obligations as abnormal deposit withdrawals or an unusual loan demand that by law and equity are entitled to be asserted as a first claim on a bank's resources.

Short-term United States Government and high grade short-term public and corporation obligations are eligible for primary reserve investment purposes, as is also prime quality commercial paper. Intermediate term securities of the same types are generally considered proper investments for secondary reserve purposes, with which can be included over-the-counter loans approaching maturity and certain of payment. Following the practice of staggering the maturities of the securities that are held in a bank's portfolio, in order to produce a constantly rotating return flow of funds, helps further to provide against the most exacting contingencies to which a bank can be exposed by giving background support to its primary and secondary reserve position. Furthermore, on the side of income, staggered maturities permit a bank to earn a good average interest return over a period of time on the funds invested in its bond account at the same time that the return flow of funds from maturing bonds affords a species of automatic insurance against the possibility of having to dispose of bonds at depreciated values in order to meet some pressing obligational contingency.

Altogether, it is a form of preparedness for a bank to adopt appropriate primary and secondary reserve policies that provide the degree of liquidity necessary to the fulfillment of its deposit and loan responsibilities. By always adhering to a uniform standard of liquidity as a minimum base over and above which the total depth of liquidity reserves can be varied as circumstances require, bank management can guard against the emergence of unusual customer deposit and loan demands at the same time that provision has been made for their satisfaction.

From what has been said, it might be surmised that a bank would be defenseless against the difficulties that could arise if deposit withdrawals should bear so heavily on its liquid assets reserves that the forced liquidation of other less liquid assets became necessary to meet the situation. That this is not the case will be brought out shortly when discussing the position of the Federal Reserve System and the Federal Deposit Insurance Corporation relative to their member banks. What needs now be done is to emphasize that self-reliance is in the spirit of the American free enterprise tradition, and that the bank whose affairs are handled in that spirit and with the least dependence on outside support, except for an emergency, is acting in the truest concept of the public interest. A bank cannot be self-reliant unless lending and investment policies are followed that of themselves insure that depositor funds are soundly handled and contributing their part to the attainment of an over-all national goal of economic stability and sustained growth.

Fundamentally, the Federal statutes under whose authority the Federal Reserve Banks and the Federal Deposit Insurance Corporation are operated contemplate that what might be called their emergency services will always be available, but rarely used. Broad bank adherence to the principle of, and practice of the methods necessary to, maintaining appropriate liquidity insures that this will always be the case. Nevertheless, as to emergency services, in the instance of the Federal Reserve Banks the borrowing facilities placed at the disposal of the member banks in effect permit an immediate conversion of their qualified assets into cash, thereby forestalling the undesirable consequences that could otherwise occur if the forced liquidation of assets became necessary in order to realize cash with which to meet deposit withdrawals. It was the lack of any immediate and emergency mechanism for getting access to ready cash that in the past provoked the kind of forced liquidation of assets problems that spread contagiously from bank to bank and helped set in train a deflationary economic spiral.

The havoc that was formerly raised when banking difficulties spread from community to community now is guarded against by the mechanical means for conserving bank liquidity that are provided through the services of the Federal Reserve Banks and the Federal Deposit Insurance Corporation. Beyond the area of mechanical protection, the deposit insurance function of the Federal Deposit Insurance Corporation is of overriding public importance because of the confidence that is instilled in bank depositors by the knowledge that their deposits have been insured through mutual actions of the member banks themselves, and all under the aegis of the United States Government.

Overmuch discussion of a bank's responsibility to its depositors might seem to overshadow the responsibility due to its borrowers. In fact, the expression, "responsibility to a bank's depositors," is not a good way in which to express what is meant, which is that a bank has a social and community responsibility to make loans that will contribute soundly to economic stability and sustained growth. As has been mentioned, the total of commercial bank loans exerts a dynamic marginal influence on business affairs through the ramifications of the enormous number of transactions that are completed through the use of bank-created credit. However, under the workings of a free market, who shall or shall not have access to bank credit is a responsibility that falls to the lot of the individual banks when allocating the use of the credit resources at their disposal. The lasting value of the contribution that banks can make to economic stability is in a blending of their lending and investment policies with a proper deference to the ultimate responsibility owed to the depositors on whom their very existence depends. Viewed in this light, it is obvious that prudent and constructive loan and investment policies are the genesis of the kind of high banking standards that are essential in their own right to the preservation and fostering of sound economic conditions.

Judging from the findings of the bank supervisory authorities, the quality of commercial bank assets is excellent, which is a tribute to the expertness and diligence of bank managements. However, recognition by commercial bankers of their public responsibility cannot stop at making individual loans of high quality, but must go on to a realization of the impact that the total of all bank loans has on economic activity. The individual and general response of banks to the objectives of Federal Reserve System monetary and credit policy must reflect awareness of this situation.

Control over the fractional reserve system, through which central banking policy is effectuated in the United States, is vested by Congress in the Federal Reserve System. By regulating the size of the supply of reserves at the disposal of the commercial banks, the Federal Reserve System has a leverage power over the total amount of bank loans that can be outstanding at any time. Through the use of that leverage power, it is in a position to restrain or to encourage the expansion of commercial bank credit as deemed necessary by the state of the economy, but with discretion left to the individual banks as to how the credit resources at their disposal shall be employed. Because the banks are in effect the direct but independent agents through which Federal Reserve System policy is conducted, an important part of their public service responsibility is to be conversant with and to aid in attaining the System's policy objectives.

That being the case, and as the form and direction of Federal Reserve credit policy is shaped to an important degree out of the economic effects that derive from the total of all bank lending and investing activities, the commercial banks share a mutual policy-making responsibility with the Federal Reserve System. Fulfillment of that responsibility necessitates an integration of commercial bank lending and investing policies with the spirit of the Federal Reserve System's monetary and credit policies. However, it is the bounden duty of commercial bankers to voice their disapproval of Federal Reserve System policies that, in their judgment, do not pass the test of timely appropriateness. It is then up to the Federal Reserve to produce the kind of visible proof of the economic justification of its policies that will rally their full support.

I doubt that there are many who dispute the necessity for a Federal Reserve policy aimed at restraining the expansion of credit during 1955, 1956 and most of 1957, when the nation was exposed to the disrupting economic influences of inflationary pressures. I also believe that the purposes of the System's present policy to encourage the expansion of bank credit as an anti-recessionary measure has found favor in bankers' eyes, proof of which is evidenced by the expansion of bank assets that has been built on the basis of the new reserves that have been supplied by Federal Reserve System policy actions.

In conformity with the purposes and functions of the Federal Reserve System, discretion as to how banks employ the reserve resources placed at their disposal rests with them. The most effective application possible of banking resources to the task of energizing the full potentialities of our wealth of human and physical resources for the general welfare must come from a deep understanding and careful observance of the principles that enter into a bank's dual responsibility to its depositors and its borrowers.