BUSINESS REVIEW

Annual Report Issue

FEDERAL RESERVE BANK OF PHILADELPHIA

Monetary Discipline: A Reappraisal

Competition in Banking: A New Old Problem

1962: Accommodation in the Political Economy

JANUARY 1963

editorial

MONETARY DISCIPLINE: A REAPPRAISAL

dis·ci·pline (dĭs′ə plĭn), *n., v.,* **-plined, -plining.** —*n.* **1.** training to act in accordance with rules; drill: *military discipline.* **2.** instruction and exercise designed to train to proper conduct or action. **3.** punishment inflicted by way of correction and training.

The American College Dictionary

In the past few years the Federal Reserve has been grappling with its most difficult problem since the days of the "pegs" over a decade ago. This is the question of how to stimulate expansion of the domestic economy and at the same time strengthen the balance of payments.

The problem has been difficult because the two objectives, at least in the short run, are in conflict. The usual prescription for a sluggish economy is plentiful and cheap money; but while this medicine may stimulate the domestic economy, it also may stimulate an outflow of short-term capital and thus aggravate the balance of payments.

Conflicting objectives, of course, are nothing new to the Federal Reserve. The problem of the pegs, for example, was a conflict between supporting prices of Government securities and restraining inflation. That conflict was finally resolved by abandoning the former objective in favor of the latter. What makes the current conflict more difficult, perhaps, is that the Federal Reserve is seeking a solution without abandoning either objective. This, in the view of some observers, flies in the face of orthodox doctrine. They would direct policy primarily toward the external problem at the expense of the internal.

The orthodox prescription for a continuing external disequilibrium has been "monetary discipline." As used in the past, this has meant tight money and high interest rates. Not only has this prescription been tested time and again in the past, but it has been applied quite recently in a number of countries. Those, and particularly those abroad, who urge us to pursue this course, therefore, have some very substantial evidence to support their view.

Why, then, has the Federal Reserve not applied this orthodox prescription? One reason is that monetary discipline, in its old sense, is not appropriate to our current problem. Ours is not a problem of inflation, but one of inadequate demand.

This is not to say, of course, that the Federal Reserve favors undiscipline. It *is* to say that the term "monetary discipline" needs to be reappraised in the light of the particular problem facing us. That is what this brief editorial attempts to do.

According to the dictionary quotation cited above, one definition of the word "discipline" has to do with acting in accordance with rules. It was in this sense that nations *(Continued on Page 26)*

BUSINESS REVIEW is produced in the Department of Research. David P. Eastburn was primarily responsible for the editorial, "Monetary Discipline: A Reappraisal;" Bernard Shull for the article "Competition in Banking: A New Old Problem;" and Jack C. Rothwell for "1962: Accommodation in the Political Economy." The authors will be glad to receive comments on their articles.

Requests for additional copies should be addressed to Bank and Public Relations, Federal Reserve Bank of Philadelphia, Philadelphia 1, Pennsylvania.

COMPETITION IN BANKING: A NEW OLD PROBLEM

> *"... free competition ... obliges all bankers to be more liberal in dealing with their customers, lest their rivals should carry them away."*
>
> *Adam Smith*

In banking, competition and regulation serve the public side by side. While regulation plays an important role, most authorities would like to rely on competition as much as possible. Yet there have been recent trends that appear to endanger the rivalry that already exists.

Bank mergers, holding companies, chain banking, and perhaps other practices have seemed to promote the concentration of market power. Banking authorities, government agencies, and courts of law have been called upon to help preserve competition.

Decisions on mergers and other kinds of proposals must be made. And they must reflect several considerations, for these decisions are not approached in an intellectual vacuum. First of all, our history, our experience, and our laws tell us that rivalry is socially beneficial. Secondly, modern economic research confirms this view, but in its analytic penetration reveals how difficult it is to identify the forces of competition. Finally, the difficulties are compounded in banking markets which, in many ways, are quite different from industrial markets.

These three considerations, which we here explore, intertwine, and fuse, not into a simple technique for making decisions, but into an approach to the problem. As yet there are no simple techniques. We must face the issues in their full complexity, for experience teaches that competition cannot survive where it is not understood.

VOICES FROM THE PAST

American democracy is opposed to the concentration of financial and economic power in private hands. Opposition to monopoly is part of our political heritage; it creates a predisposition in favor of competition.

In a society opposed to monopoly on principle, the theories of Adam Smith were sooner or later bound to find special favor. Smith had reasoned that rivalry was an automatic mechanism of social control, for while each individual "intends only his own gain . . ., he is . . . led by an invisible hand to promote an end which was no part of his intention." Throughout the world, and until the end of World War II, only the United States had antitrust laws designed to preserve and encourage competition.

Early banks and large numbers

In banking, it was never quite clear that competition alone was sufficient to promote the public welfare. Controversy dates back at least as far as the First and Second Banks of the United States.

The First Bank of the United States operated from 1791 to 1811. It was not rechartered when its 20-year life expired. The Second Bank of the United States, also chartered for twenty years, fell dead in 1832, four years before its charter ran out.

These institutions performed useful and important banking services. But, despite their achievements, or perhaps because of them, they were unpopular. For one thing, monetary restriction, though frequently necessary, has always been unpopular. In the restriction exercised by these banks, many saw the hand of monopoly and special privilege. Thomas Jefferson opposed the First Bank when Hamilton proposed it. He told George Washington that it "delivers us up bound to the national bank" which is "free to refuse all arrangements, but on their own terms, and the public not free, on such refusal, to employ any other bank." Andrew Jackson took his overwhelming presidential victory in 1832 as a mandate to destroy the Second Bank. "The present corporate body," Jackson proclaimed, "enjoys . . . a monopoly of favor and support, and, as a consequence, almost a monopoly of foreign and domestic exchange."

A tendency toward freer competition in banking grew out of opposition to alleged monopoly by the Congressionally chartered banks. As soon as the Second Bank was out of the way, New York first and then other states passed laws permitting anyone who could meet minimum administrative requirements to establish a bank. The so-called "free banking laws" opened the door to large numbers of banks and also to intense rivalry.

Even during the Civil War, when the Federal Government began chartering banks again under the National Banking Act, Congress no longer took it upon itself to grant special charters. The national banking system, in several respects, applied the free bank principle on a national scale.

The number of banks in the United States grew rapidly in the latter part of the 19th century. There were about 750 banks in 1853 and over 12,000 in 1900. If large numbers are synonomous with competition, then the banking system was in the process of becoming very competitive.

The need for regulation

This was by no means clear to some people who still believed they saw large and powerful banks restricting credit. Many farmers and businessmen in the West and South sincerely believed that their financial problems were caused by the monopolistic credit policies of Eastern bankers. William Jennings Bryan rallied these dissatisfied constituents in his presidential campaign in 1896. He lost; but in 1913 Congressman Pujo took up the issue. His committee studied banking concentration and reported that ". . . concentration of the control of banking resources and consequently credit . . . has grown apace in the City of New York . . ."

At the same time, others were concerned about the periodic overextension of credit. For time after time during these years, money panics and crises occurred. Between the two points of view —one of underextension and one of overextension of credit—it became clear that the public interest required more than just large numbers of privately owned banks. Other social controls had to be designed.

Controls had never been entirely absent from banking in the United States. The Federal and State Governments had made periodic attempts to assure the soundness of their banking systems. But it was not until 1913 that a comprehensive system was worked out and embodied in the Federal Reserve Act. The Federal Reserve System was given considerable influence over the supply of bank reserves and, through this supply, the price of bank credit.

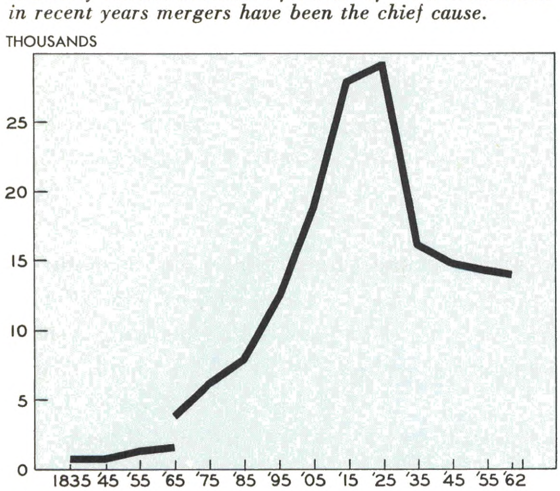
Other controls were developed subsequently —many during the turmoil of the 1930's. Since the 1930's and until recently, the questions of bank solvency and liquidity had superseded the problem of monopoly. The financial reconstruction of the thirties, the establishment of sound banking, and a decline in numbers of banks in recent years has tended to bring the question of monopoly back to the forefront.

Decline in the banking population

In 1920 there were close to 30,000 commercial banks in the United States with 31,500 offices. Both the number of banks and banking offices have since declined. After reaching a low point in the 1940's, the number of banking offices has trended upward; banks have expanded their operations by establishing new branches. In contrast, ever since 1920 the number of independent banks has declined and with amazing consistency. In 37 of the 42 years between 1920 and 1962, the number of banks has dropped. Today there are a little over 13,000 banks. There will probably be fewer next year.

THE RISE AND FALL OF BANK POPULATION

The number of banks in the United States increased rapidly through the 19th century. It reached a peak of about 30,000 in the early 1920's. Ever since, the banking population has declined. Bank failure in the late twenties and early thirties accounted for most of the decrease. But in recent years mergers have been the chief cause.*



* Includes all banks.
Source: *Historical Statistics of the United States Colonial Times to 1957;* Federal Deposit Insurance Corporation, *Annual Report, 1960.*

There is no one reason behind the decline in numbers of banks. There are several that were more or less important at different periods of time.

The Twenties. There was a net decline of about 5,500 banks from 1921 to 1929. Bank failure was a more important cause than any other. There were almost 6,000 suspensions and liquidations. Many took place in rural areas which did not enjoy the general prosperity.

While a large number of absorptions and consolidations were consummated during the period—close to 4,000—many seem to have been associated with the extremely high mortality rate. One way of avoiding liquidation was to have the bank absorbed by a going concern.

Early in the decade the number of new banks increased. As the decade wore on, however, the number of failures and mergers went up, and fewer new banks were established.

In 1929 there were still almost 25,000 commercial banks in the United States.

The Thirties. The bank failures of the 1920's were simply a forewarning of the disaster that was to come. From 1930 to 1933, over 9,000 banks suspended operations or liquidated. In addition, there were over 2,000 consolidations and absorptions. After the reorganization of the banking system in 1933, only about 15,500 commercial banks remained. The "Great Depression" was the "grim reaper" of the banking industry.

In the remaining years of the 1930's, the number of banks slowly declined. Suspensions and liquidations were cut *(Continued on Page 12)*

NEW RELEASE

Forecasts for 1963. The Department of Research has compiled and analyzed a number of predictions made by businessmen, economists, and Government officials. This compilation includes a summary of forecasts for the economy as a whole and particular sectors of the economy. The more important indicators are presented in chart form.

Copies of this release are available on request from Bank and Public Relations, Federal Reserve Bank of Philadelphia.

NEW RELEASE

Defending the Dollar. A persistent deficit in our balance of international payments has resulted in substantial drains on our gold reserve.

To help the layman understand this problem, the Federal Reserve Bank of Philadelphia has just released "Defending the Dollar." This pamphlet, written by Clay J. Anderson, Economic Advisor and officer of the Bank, is designed for the general reader rather than the expert in international economics.

Copies are available for educational purposes. Requests should be addressed to Bank and Public Relations, Federal Reserve Bank of Philadelphia, Philadelphia 1, Pennsylvania.

1962: ACCOMMODATION IN THE POLITICAL ECONOMY

In years gone by the study of man's efforts to satisfy his material wants was dubbed "political economy," thus emphasizing the important role of Government in advancing national economic welfare.

Today Government still retains an important role in the economic sphere. But the relationship between Government and the private sector of the economy is an exceedingly fluid one, constantly adjusting to the everchanging pressures of international relations and domestic wants.

In many respects economic developments during 1962 were highlighted by this flux, by the seeking of a new accommodation between private and public—a sort of feeling-out process. The events around which this process turned were varied: the steel controversy, the stock market crash, the Cuban crisis, to name a few. But before we review these developments, let's take a look at the environment in which Government, business, and the consumer functioned in 1962. For this environment greatly influenced the course of events during the year.

1962: THE SOCIAL, ECONOMIC, AND POLITICAL ENVIRONMENT

The main concern of the business community as it rode into 1962 can be summed up in two words: profit squeeze. The reasons for the squeeze were varied. Most of the gaping voids created by the war years had been filled—voids in durable consumer goods, housing, and other areas. Hence sales were not so easy to come by. Moreover, business had built up a greater capacity to produce than existing effective demand could accommodate, leading to keen competition for existing sales and pressure on prices. Finally, costs had become rigid, difficult to trim. With pressure on prices and with costs difficult to cut came the squeeze on profits, on the lifeblood of the enterprise system.

The environment in which the consumer functioned in 1962 cannot be so easily outlined. Around four million of him were unemployed, the result of structural difficulties and a less than desirable growth rate. The great majority, however, over 67 million, had jobs and seemed little worried about the future course of the economy. The stock market was still booming. Speculative profits were being made by an army of small investors. The cult of equities it was called—a cult in which growth was the byword, inflation the mainstay.

But if speculative enthusiasm marked many individuals, the environment in which Government operated in 1962 was a far more somber one. The new administration came to grips as never before with the stern realities of international relations. Moreover, Government evidenced increasing awareness that a strong, viable economy is an essential prerequisite for success in international affairs. And in a world as complex as ours an economy capable of producing armaments is not enough to assure power and security. Not only must we arm, for example, but we must keep our house in order in the process. We must not let our prices get out of line lest our foreign trade and receipts be disrupted. We need foreign earnings, among other reasons, to pay for troops abroad. Moreover, we must maintain the dollar as the bulwark of the world payments system, lest a disruption cause great difficulty if not a collapse in the free world economy.

This, then, is the setting in which Government, business, and the consumer entered 1962—business greatly concerned with the profit squeeze; many consumers and businessmen still on a speculative cloud; Government plotting a course to national survival in a jungle of competing nation states and alliances.

1962 IN REVIEW

Nineteen hundred and sixty-two passed into the statistical record books as a year of slow growth, uncomfortably high unemployment, and relatively easy credit conditions. Though early predictions had gross national product expanding as much as 10 per cent, this measure of total spending for current output rose from about $519 billion in 1961 to an estimated $553 billion in 1962, 6.7 per cent in current dollars or 4 per cent in constant prices, a good but far from spectacular year. Meanwhile, unemployment remained well over 5 per cent of the labor force and credit conditions remained relatively easy.

But 1962 will not be remembered primarily for its contributions to gross production and financial statistics. In the economic sphere the year was highlighted, as already mentioned, by a shifting in the ever-fluid relationship between the private and public sector—a process of feeling out and accommodation—an attempt at reconciliation of the approaches toward mutual objectives.

The most important manifestation of this process came in the early spring. Contract negotiations in the steel industry began and a strike was threatened. Yet, with round-the-clock negotiations and a real desire by all parties to avoid the economic consequences of a work stoppage, a strike was avoided and a settlement was reached. But in little more than a week after the settlement, several of the large steel companies announced price hikes and Government leaped into the fray to secure a roll-back of prices to previous levels. Government felt that a price hike might set off another cost-price spiral, thus making it more difficult to compete with foreign goods, harder to improve our balance of payments and stem our gold outflow.

The events that followed resulted in a retraction of the price hikes. Both Government and business agreed on the need for profits and modernization. They disagreed on means to attain these ends. An accommodation was reached.

But this accommodation was to have an important impact on another economic sector—on the millions of investors who were just now becoming a bit disenchanted with the pink cloud of the equity cult.

In December 1961, the Dow-Jones industrial stock average hit an all-time high of 734.91. During the first quarter of 1962 it see-sawed around the 700 level. In April it dipped down to the 670 area. It appeared that an orderly reaction was occurring in an over-priced stock market.

Then came the steel controversy, the price hike, the retraction, and the selling wave that approached panic proportions. Most observers felt the sequence of events signified a new and profound realization on the part of investors, a realization that many of the forces promoting the postwar inflation had been spent and that Government was prepared to take vigorous action to prevent price hikes which might damage our competitive position and undermine the international financial position of the dollar. Thus the cult of the equity received a serious blow, based largely as it was on the premise that inflation would continue to boost corporate profits and that common shares would provide a haven in the inflationary gale.

Inflation did not now seem inevitable. The strong Government stand on prices had been a significant factor in the break, according to most observers. The feeling out and accommodation between public and private had had its effect on the investor.

Then came a series of moves on the part of Government to assure business that Government shared its concern for profit margins and modernization and that Government was willing to take steps to secure these objectives.

In July, the Treasury announced approval of a broad program which allowed business firms to take greater depreciation allowance on plant and equipment. This meant that firms could reduce their tax payments and utilize these tax earnings for modernization purposes if they so desired. In September, Congress approved legislation allowing businesses investing in plant and equipment to take a 7 per cent income tax credit. And all the while the administration voiced its desire to see a flat reduction in corporate and individual income tax rates in the coming year, aimed at giving business a shot in the arm and improving our lagging growth rate.

Despite these developments, however, business sentiment remained somewhat less than buoyant. Then came a stroke of lightning which was to have a sobering effect on the nation, but which later was to bring a ray of sunlight into the economy. That bolt was the deepening concern over developments in Cuba.

Despite pledges to the contrary, intelligence reports confirmed that the Soviet Union was constructing offensive missile installations on the island aimed, many observers felt, at a quick about-face in the world balance of power. Tension grew, then the quick action of the United States Government had its effect. On a quiet Sunday morning, the Soviet Union agreed to dismantle the installations. One of the most critical confrontations of the nuclear powers had ended and the decisive action of the American Government had yielded distinct dividends.

The economy, which had been waiting since the stock market crash for, as one analyst put it, the other shoe to drop, now felt a renewed coursing of blood through its fiscal veins. An intangible feeling spread that this nation was still young and vigorous, that the future course of political and economic events was by no means predetermined, that this nation could make the future. The feeling-out, sizing-up process between public and private was complete for 1962.

A LOOK AHEAD

Though the relationship between Government and the private sector of the economy is a fluid, ever-changing one, the form this relationship assumes in the long run will be determined by what the people want. People, of course, are a diverse group with different views and different wants. It is quite possible that this very diversity may represent one of the main problems confronting our economy in 1963.

For years the forward momentum of the American economy was largely the result of economic voids created during World War II. Now many of these voids have been filled. The economy must depend on other sources of strength in the years to come if it is to move ahead. A tax cut could do much to stimulate economic activity. Economic ties with an enlarged European Economic Community would open up a market for American goods rapidly approaching

300 million persons. And here is where the problem of national diversity comes in.

Within each nation there are geographic regions and income classes. Regions often specialize in one or more types of economic activity—say, coal production or textiles. The interests of one region do not necessarily mesh with those of another when it comes to questions such as foreign imports and taxes. Nor will the interests of wage earners, capital, and management.

This clashing of interests is, of course, a natural thing in a diverse society, perhaps even a desirable thing. But for the good of the nation we must reconcile our desires through the political process if we are to avoid an inertia impossible to overcome in our efforts to move ahead economically.

LOCAL BUSINESS INDICATORS

Third Federal Reserve District
Percent change 1961 to 1962

Employment (15 areas)*	+ 1%
Factory payrolls*	+ 5
Factory working time*	+ 2
Electric power consumed by manufacturers*	+ 8
Anthracite coal output*	— 4
Construction contracts:	+15
Residential*	+10
Nonresidential*	+26
Public works and utilities*	+ 6
Car loadings (Philadelphia region—52 weeks)	+ 8
Retail sales, total (excluding national chains)**	+10
Department store sales*	+ 4
Automobile registrations (48 counties, eastern Pennsylvania)**	+10
Bank debits (20 cities)*	+13

* First eleven months.
** First ten months.

THE THIRD DISTRICT IN 1962

Business

Within the Third Federal Reserve District in 1962 business activity paralleled that of the nation in many respects. The pace of economic activity started off on a brisk note, slowed down in the third quarter, then picked up in the final three months.

All district business indicators rose during the year, as shown in the table, with the sole exception of coal output. Notably, construction went ahead at a rate comparable to that in the nation as a whole, paced by nonresidential building. Retail sales and department store sales rose at a rate slightly higher than that in the nation.

In the manufacturing area, electric power consumption rose 8 per cent, while employment, payrolls, and working time showed gains of one, five, and two percent respectively.

Unemployment was still a big problem, with the rate in the Philadelphia metropolitan area pegged solidly above that in the nation. Within the 15 major labor market areas in the District, the picture was perhaps a bit better. Two areas were in the 12 per cent or more unemployed class compared to one area at the same time last year. Only three areas were reported in the 9 to

UNEMPLOYMENT IN MAJOR LABOR MARKET AREAS

Third Federal Reserve District

	Number of areas		
	Nov. '62	Nov. '61	Nov. '60
Percent of labor force unemployed:			
1.5 to 2.9%	1	0	0
3.0 to 5.9%	7	7	5
6.0 to 8.9%	2	2	4
9.0 to 11.9%	3	5	1
12% or more	2	1	5
Total number	15	15	15

THIRD DISTRICT BANKING

(Millions $)

	Dec. 31, 1960	Dec. 31, 1961	Change in 1961	Dec. 26, 1962	Change in 1962
Reserve City Banks					
Loans	2,292	2,430	+138	2,615	+185
Investments	928	1,085	+157	1,017	— 68
Deposits	4,007	4,256	+249	4,169	— 87
Country Banks					
Loans	3,032	3,317	+285	3,454	+137
Investments	2,433	2,531	+ 98	2,717	+186
Deposits	5,792	6,152	+360	6,418	+266

11.9 per cent category, however, compared to five last year. Other categories remain unchanged with the exception of the 1.5 to 2.9 range where one labor area was added over last year.

Banking

Net loans of Third District reserve city banks forged ahead during 1962 at a rate roughly comparable to that in the nation as a whole. The growth rate of net loans at country banks, however, fell behind those of similar institutions in the nation as a whole. District country banks added sizeable volumes of securities to their portfolios while reserve city banks liquidated securities on balance.

The rate of growth in total deposits for both reserve city and country banks fell behind that in the nation as a whole, primarily because of slackening in the rate of growth of time deposits after midyear.

Loan deposit ratios at District reserve city banks rose from slightly above 65 per cent to around 70 per cent, while loan deposit ratios at country banks remained around 55 per cent throughout the year.

Reserve bank operations

During the year 1962, 158 member banks, about 35 per cent of the total number, borrowed from the Reserve Bank. The average daily balance extended to member banks declined to $2.8 million in 1962 from $4.2 million in 1961.

Collection of checks showed an increase over 1961. In all, almost 197 million ordinary checks were cleared, with an aggregate face amount of over $66 billion. Transfers of funds and currency counted also increased over last year, though coins counted declined slightly. Over $12.4 billion in marketable securities were delivered or redeemed.

COMPETITION IN BANKING

(Continued from Page 5)

to about one-tenth the rate of the 1920's; mergers continued substantially below the level of the 1920's, and even a few new banks were established. In 1939 there were still over 14,500 banks in operation.

Recent Years. The decline in bank numbers during the 1940's continued at a very slow pace. Suspensions and liquidations, following the reforms of the 1930's, have been insignificant. There were fewer than 100 mergers in each year of the decade.

But few new banks have been chartered in recent years. Banking authorities have felt that much of the distress in the 1920's and 1930's had been brought about by too many banks and have been cautious in approving new banking charters.[1] Stability has generally been a more important consideration than rivalry; stability sometimes has seemed to require one bank in a community, rather than two or three.

The major change, which accelerated the decline in bank numbers in the 1950's, was a revival of merger activity. Between 1952 and 1961 there were almost 1,600 mergers. The movement picked up speed after 1953. There was a net decline of about 670 banks over the decade.

As large banks absorbed small banks and converted them to branches, local, state, and federal authorities began to express concern about the impact. As banks that had grown large through merger began to merge with one another, consolidations took on added importance. It became significant to some that less than half the number of banks operating in 1920 were in business in 1961.

[1] Annual Report of Federal Deposit Insurance Corporation, 1960, p. 36.

OF NUMBERS AND MARKETS

It is a long way from a general concern about numbers of banks to a careful analysis of the intensity of competition in banking markets. But it is only on the basis of careful analysis that recent trends can be evaluated and specific cases settled.

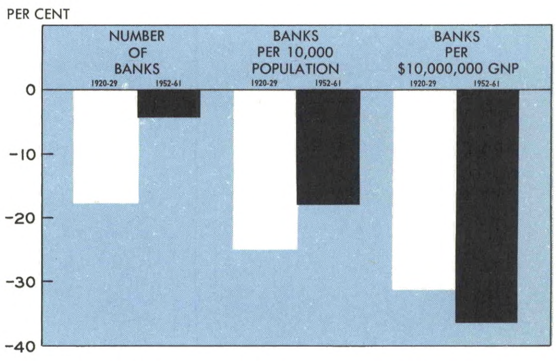
The numbers

The merger movement of the 1950's has played only a minor role in the decline in bank population. Moreover, the merger movement of recent years seems rather unimportant when compared to that of the 1920's.

But this comparison should not be taken as proof that the recent tendency toward concentration is unimportant. It is true that the number of banks declined only 4 per cent from 1952 to 1961, compared to an 18 per cent decline in the twenties. But when the recent declines in bank population are adjusted for growth in the human population and the economy banks serve, the declines of the last decade and the twenties are roughly comparable.

TWO DECADES OF DECLINE

The decline in numbers of commercial banks in the 1920's was significantly greater than over the last decade. But when the declines are adjusted for increases in population and gross national product, they are roughly comparable.



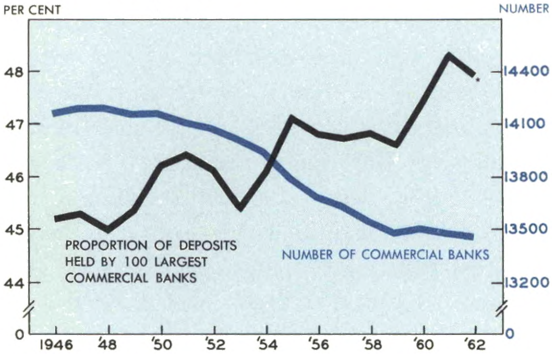
Source: Board of Governors; U.S. Department of Commerce.

In the 1920's the number of banks per person in the United States fell 25 per cent; from 1952 to 1961, 18 per cent. In the 1920's the number of banks per dollar of Gross National Product fell 31 per cent; in recent years, 37 per cent. Moreover, even these comparisons tend to underestimate the recent decline in the number of independent banks. For bank holding companies, in recent years, have expanded and eliminated the actual independence if not the appearance of independence of many banks absorbed into their networks.

Fewer banks, and large banks that are growing rapidly, have resulted in an increase in the proportion of total deposits owned by the largest banks. In 1948 the 100 largest banks in the United States held 45 per cent of total bank deposits; in 1962 the 100 largest held 48 per cent of total deposits. To some observers, looking at the past and into the future also, this increased concentration in recent years is a matter of concern. The trend seems to reflect an incipient, if not actual, growth of monopoly power by the largest banks.

NUMBERS AND CONCENTRATION

As the number of banks has declined in recent years, the proportion of deposits held by the 100 largest banks—a concentration ratio—increased. To some observers, a rising concentration ratio suggests increased market power for the largest banks.



* As of June 30, 1962.
Ratios are as of end of year; number of banks, midyear.
Source: Board of Governors; *Recent Developments in the Structure of Banking*, A Special Staff Report of the Federal Reserve System submitted to the Select Committee on Small Business, U.S. Senate, January 5, 1962.

The market

Mere numbers, however, no matter how they are handled, processed, turned, or twisted can never alone reveal how much rivalry exists or how effective competition is. For the rivalry that counts is the economic rivalry that takes place in markets—loci of space and time where buyers and sellers meet.

In Theory. A monopoly exists when only a single seller occupies the market. A single seller facing many buyers across the market has a distinct bargaining advantage. He can demand an advantageous price and earn a very high profit. A monopolist, by virtue of his isolation, is simply in a better position to "buy cheap" or "sell dear" than most others.

Competition exists when there are many independent sellers vying for the patronage of the same customers. Each customer is then protected from exploitation by his ability to take his business elsewhere.

The finding of monopoly or competition always hinges on the definition of the "market." And the market is always difficult to define. It includes those sellers who compete with one another in offering a specific product to a given group of customers. But the market can be defined narrowly to exclude many sellers who transact business on the fringe of the market; if it is, the market may seem to be dominated by only a few sellers. If, on the other hand, the market is defined broadly to include sellers on the fringe, it will usually appear more competitive.

There are several kinds of fringe sellers who might be thought of as "not quite" or "just about" belonging to a particular market. There are those, first of all, whose products are a little different. In most markets, each seller's product tends to be a little different, if only because of different brand names and trade-marks. The practical question that frequently arises is how to distinguish between products that purchasers feel they can easily substitute for one another—and which therefore are competitive—and products which they do not feel are close substitutes. For example, some years ago, a District Court had to draw a line between close and distant substitutes for cellophane. The Court held that wax paper and aluminum foil, among other products, were sufficiently close to cellophane to compete in the same market. In fact, the Court found that all flexible packaging materials were close enough substitutes to be classified as a single product. The Court might have found a monopoly in the production and sale of cellophane; instead it found competition in the production and sale of what it considered the appropriate product—flexible wrapping paper.

Another kind of line must frequently be drawn. Some producers may be geographically remote from the principal market. Their remoteness may reflect the high cost of transporting their product. It follows that these producers are only partially, if at all, competitive with others even though they may sell identical products. Thus, in a number of investigations it has become clear that the manufacture and sale of cement is carried on in regional markets. The costs of shipping the product are so high as to preclude national competition. While national rivalry does not exist, it is still difficult to draw a geographic line, setting one market off from another.

The *market* is the crucial concept in evaluating the forces of competition. The effective rivalry a firm faces comes from other firms that produce the same or similar products and sells to the same group of customers. It is in the crucible of the market that the forces of competition must be examined.

In Banking. A commercial bank is not a product. It is an institution that produces and sells a number of products. It is the rivalry a bank faces in selling each product that must be evaluated.

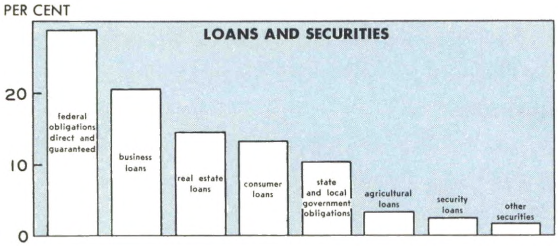
The traditional and semi-unique products that banks deal in are demand deposits and short-term business loans. For many years most authorities believed that banks should confine their lending to short-term commercial credit. These business loans are relatively liquid assets; a banker, whose liabilities are payable on demand, must first learn, Walter Bagehot said, to distinguish between a mortgage and a promissory note, his business being concerned with the latter.

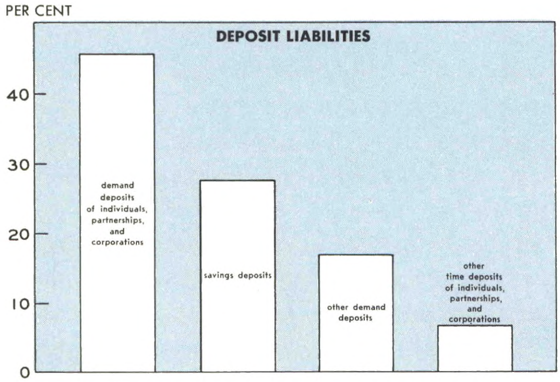
Commercial bankers who are today competing vigorously for time deposits and investing heavily in real estate loans do not tend to look at their business as being so confined. Today it is difficult to conceive of banks as specialists in the production and sale of any one or two products. Banks obtain funds from individuals and businesses that want checking accounts, individuals who want savings accounts, and governments and businesses that want to invest their excess cash for brief periods of time. With these funds, they purchase Government securities, promissory notes from businesses and individuals, mortgages and other kinds of earning assets. In a recent court case involving the merger of two banks, the Justice Department isolated 8 or 9 separate and distinct product lines.

In the purchase or sale of some products, banks face intense rivalry from nonbank financial institutions. In attempting to induce individuals to

THE PRODUCT LINES OF BANKING

Banks deal in many types of "products," as this percentage distribution of assets and liabilities in June 1962 shows. At one time most bank assets were business loans and most liabilities were demand deposits. While business loans and demand deposits are still important, banks have diversified and expanded their operations in other areas.





Source: Board of Governors.

place their money in savings deposits, many commercial banks may have to compete with mutual savings banks and savings and loan associations. To most customers, today, there is little difference in the quality of a savings deposit at any of these institutions. In extending consumer credit and in purchasing mortgages, the commercial bank may find other financial institutions competing for the same earning assets.

Since a variety of substitutes exists for many products in which banks deal, the mere number of commercial banks in a market does not fully measure the degree of rivalry in the sale of at least some products. On the other hand, the geographic extent of the market must be carefully limited if the intensity of competition is not to be exaggerated.

The large number of banks scattered throughout the nation—and 13,400 is still a large number despite the recent declines—are not all competitive with one another in any meaningful sense. These banks transact most of their business in a patchwork quilt of small local and regional areas. In any one area, a bank tends to be isolated from the rivalry of other banks located in other areas.

There are several principal reasons for this. Bank depositors are generally limited, by the costs of inconvenience, to banks in the immediate vicinity of their daily journeys from home to work and back home again. A bank borrower, whose principal asset when he goes to borrow is his character, is frequently limited by his friendship and acquaintance with the local bankers.

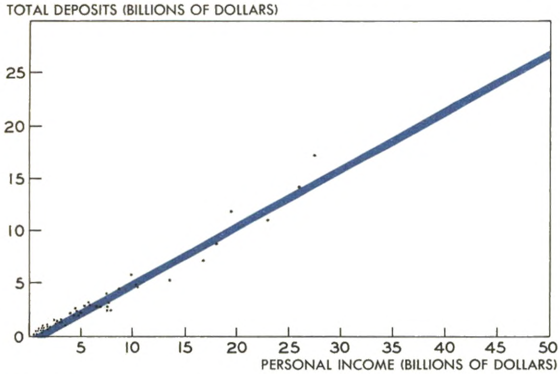
While it is difficult for many bank customers to go to banks outside their local area, it is often impossible for a bank outside the local area to go to the potential customer. Banking offices, even of national banks, are confined within state borders and by state laws. There are 51 jurisdictions, each with a different set of banking regulations. In practice this means that a bank in California may not open a branch in any other state; a bank in Pennsylvania may not open a branch in a county outside those contiguous to the county in which it has its main office; and a bank in Illinois may not have any branches at all. The relative immobility of both banks and many types of bank customers serves to break up the United States into a series of geographic sub-areas.

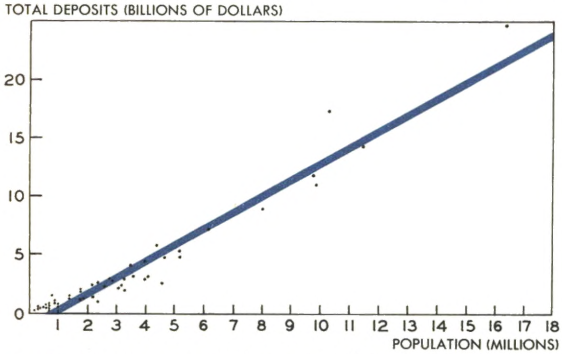
As a result, we would expect banking business throughout the United States to conform highly with the geographic distribution of income and population. And this is indeed the case. The number of people in an area and their income go a long way toward explaining differences in bank deposits among areas.[2]

It is true, nevertheless, that in the sale of any particular product a bank may deal with differently restricted customers. The geographic limit of the market is not necessarily the same for all in a given locality. Some, perhaps most, will be restricted to local sources of credit. Others may

PEOPLE, INCOME, AND DEPOSITS

The distribution of bank deposits among the several states in the United States largely reflects the distribution of population and income. In the first scatter diagram, the "average" increase in deposits as income goes up is shown by the fitted line. The dots represent the actual data for each state. In the second diagram it can be seen that deposits also rise as population increases.





Equations for the regression line and coefficients of determination:
Deposits = —366.1 + .55 Income; $r^2 = .97$
Deposits = —930.6 + 1.37 Population; $r^2 = .94$
There were 50 observations including District of Columbia but excluding New York.
Source: Board of Governors; U.S. Department of Commerce.

have broader and more distant alternatives. In a somewhat arbitrary way, we may say that a bank may deal with locally limited customers, regionally limited customers, and geographically unlimited customers. Of course, these customer categories do not do justice to the variety of customers that actually exist. But they demonstrate a principle. A bank that handles nine products and deals with three different classes of customers in the sale of each, is operating in 27 distinct markets. It may be able to exercise monopoly power in some and may have to compete vigorously in others.

In the sale of some products, at least, banking markets seem to be geographically expanding. Improved transportation and communication in recent years have given bank borrowers and depositors access to banks that they could not make contact with 20 or 30 years ago. In fact, the merger movement and branch banking can be seen as part of a larger movement—the expansion of bank markets. When markets expand, banks formerly protected from one another by distance find themselves seeking patronage from the same customers.

There are no certain lines that can be drawn between geographic market areas, nor between close and distant substitute products. There are no sure fire techniques to compensate for distorted images when lines are misdrawn.

THE DIFFERENCES IN BANKING

The difficulties of identifying and evaluating the forces of competition in banking markets are further complicated by the "differentness" of banking. Special characteristics tend to veil the true extent of rivalry.

[2] Simple correlation analyses associating deposits and income, deposits and population among the 50 states in 1961 and deposits and population for 188 metropolitan areas in 1960 yielded extremely high coefficients of determination. For states, the deposit variance explained by income or population was over 93 per cent. For metropolitan areas, the deposit variance explained by population was close to 75 per cent.

As already mentioned, banks deal in many markets. The extent of their involvement means that we must study the numbers, sizes, and locations of financial institutions—not only commercial banks—in the sale of a variety of products to different classes of customers. In reaching decisions, we cannot simply determine the intensity of competition in one product market; for we are concerned with a summary judgment on the intensity of competition faced by the institution as a whole.

Regulation tends to conceal the potential as well as limit the actual forces of competition in banking. All states carefully regulate new entry into banking. Branching is also regulated and all states prohibit banks from having branches that straddle state lines. A market might potentially be highly competitive and yet show little evidence of this rivalry because of supervisory policies established to meet other objectives.

There are other ways, besides looking at the structure of banking markets, however, to observe the forces of competition. We expect effective competition to result, for the most part, in certain kinds of performance; we expect a lack of competition to result in different kinds of performance. For example, we would normally expect competitive sellers to charge lower prices and have smaller profits than noncompetitive sellers. But in banking markets, no matter how intense the rivalry, the extent of the differences are restricted in various ways. Regulation once again, and the character of the business are great homogenizing forces that make it difficult to distinguish between competitive and noncompetitive results.

In most states, usury laws set maximum rates banks can charge for loans. Federal regulations prescribe maximum interest rates on time deposits and prohibit the payment of interest on demand deposits. Within the limits set by these direct regulations, monetary policy has an influence on the level and changes of rates in all financial markets; for the monetary authority has an influence over the total amount of banking resources through bank reserves.

We would normally expect a noncompetitive bank to earn larger profits than a competitive institution. But all banks are limited by regulation over the prices they can charge for credit and the prices they can pay for deposits. For this reason alone, profits of banks facing different competitive situations might be difficult to distinguish.

There is still another reason why profit differences might not reflect competitive differences. While banks, like other enterprises, seek profit, they have higher liquidity requirements than most; they have obligations to their depositors as well as to their stockholders. It is conceivable that banks not really challenged by intense rivalry will have exaggerated notions of their liquidity requirements. These are the ones who can "afford to play it safe." In other words, the noncompetitive banker may choose to "rest easier" rather than "live better." He may actually have lower profits than the competitive banker.

That policies and practices tend to conceal evidence of rivalry is clear; but the evidence should only be hidden, not absent. It should be found in the kinds of things we want banking competition to do for us.

As in Adam Smith's day—recalling the quotation at the beginning of the article—rivalry can protect the customer from the abuses of monopoly. The protection offered by competition in banking today is not so much from a high monopoly price as it is from price discrimination and, perhaps, an unjustified exclusion from credit altogether. If a bank customer has access to many alternative sources of credit—and this is what we mean when we say a bank is faced with competition—his bank would have to charge him no higher price for credit than justified by costs, or run the danger of losing his patronage to a rival bank. If all customers have access to alternative sources of credit, all must be dealt with equally and in accordance to the costs of doing business with them. When, on the other hand, some have alternative sources and others do not, price differences and perhaps unjustified exclusion from credit become possible and, at times, profitable. Price discrimination—price differences not based on differences in cost—to the point of exclusion from credit is not only unfair; it could seriously injure competition by hampering competitive businessmen whose deficiency is not incompetence or a lack of foresight, but only a lack of alternative sources of credit. The extent of price discrimination is, perhaps, one measure of the degree of monopoly power in banking markets.

Competition may be measured in another way. It is conceivable that competitive banks are more responsive to changes in monetary policy than noncompetitive banks. For monetary policy works through the supply of reserves a bank has at its disposal. Competitive banks would tend to adjust their prices—interest rates—quickly, perhaps altomatically, to changes in supply conditions as well as to changes in demand; noncompetitive banks might well react more slowly —particularly when the supply of funds increases and free market rates tend to fall.

CONCLUSIONS

The existing mixture of free enterprise and public regulation in banking evolved out of an American preference for competition and special problems that called for controls. When banking instability became especially serious, competition as an objective was more or less relegated to the background. The establishment of a sound banking system over the last quarter of a century and a decline in the number of independent banks has revived a concern for rivalry in banking markets.

Along with the fear that mergers and other developments will reduce competition, there is a growing feeling that competition should be given a greater role to play in banking. Many people believe that banking can now safely be unleashed from the type of regulation that tends to prevent intense rivalry—that protect banks from one another. Interest rate maximums on time deposits and entry restrictions grew out of problems that may no longer exist.

Numerous problems arise in judging the intensity of competition faced by banks. Banks, locally oriented institutions primarily, operate in many markets. Some of the markets are geographically growing. And in some, banks compete with other financial institutions. Judgments, based on a careful analysis of the facts, have to be made to set off markets—to draw the appropriate lines between effective and ineffective rivals.

The uniqueness of banking also complicates the problem. For it tends to cloak the forces of competition. The threat of rivalry from new banks has been curtailed by regulations designed to insure the soundness of banks. Regulation and the need to maintain liquidity may tend to make at least some kinds of bank performance quite similar, regardless of the degree of competition in the markets.

If we do take the road toward more enterprise and less regulation in banking, it becomes increasingly important to devise means to preserve rivalry and to prevent the development of excessive market power. Not everything that injures competitors, or eliminates them from business, injures competition. On the other hand, competitors are a necessary ingredient for competition and we cannot blithely assume that their wholesale elimination is consistent with the preservation of the competitive system. We must recognize competition in banking for what it is; not a self-perpetuating system, but one that must be conscientiously supported and encouraged.

DIRECTORS AND OFFICERS

At the election held in the fall of 1962, two new directors were elected by member banks to serve for three-year terms beginning January 1, 1963. Benjamin F. Sawin, Vice Chairman of the Board and Chairman of the Executive Committee of Provident Tradesmens Bank and Trust Company, Philadelphia, Pennsylvania, was elected as a Class A director by banks in Group 1. He succeeds Frederic A. Potts. Banks in Group 2 elected Ralph K. Gottshall, Chairman of the Board and President of Atlas Chemical Industries, Incorporated, Wilmington, Delaware, as a Class B director to succeed R. Russell Pippin.

The Board of Governors of the Federal Reserve System reappointed David C. Bevan as a Class C director for a three-year term. Walter E. Hoadley was redesignated as Chairman of the Board of Directors and Federal Reserve Agent, and Mr. Bevan as Deputy Chairman of the Board of Directors for the year 1963.

The Board of Directors reappointed Howard C. Petersen, President, Fidelity-Philadelphia Trust Company, Philadelphia, Pennsylvania, to serve as a member of the Federal Advisory Council to represent the Third Federal Reserve District for the year 1963.

Wallace M. Catanach, Vice President in charge of Accounting, Budget, and Emergency Planning functions, retired on September 30, 1962 and Harold M. Griest, an Examining Officer, retired on December 31, 1962.

Effective October 1, 1962, Hugh Barrie, Assistant Vice President, became Vice President. He is the Bank's Planning Officer and is in charge of Data Processing. John R. Bunting, Jr., formerly Business Economist, was made Vice President in charge of the Bank and Public Relations and the Credit-Discount functions. Harry W. Roeder, Assistant Vice President, became Vice President with responsibility for Accounting and Cash functions. He also is senior officer in charge of Emergency Planning and serves as the Bank's Budget Officer. Also effective October 1, 1962, Russell P. Sudders, Assistant Cashier, became Assistant Vice President assigned principally to Accounting operations, and Lawrence C. Murdoch, Jr., Economist, became an officer in the Bank and Public Relations function, with the title of Business Economist.

DIRECTORS AS OF JANUARY 1, 1963

Group		Term expires December 31
	CLASS A	
1	BENJAMIN F. SAWIN Vice Chairman of Board and Chairman of Executive Committee, Provident Tradesmens Bank and Trust Company, Philadelphia, Pennsylvania	1965
2	J. MILTON FEATHERER Executive Vice President and Trust Officer, The Penn's Grove National Bank and Trust Company, Penns Grove, New Jersey	1963
3	EUGENE T. GRAMLEY President, Milton Bank and Safe Deposit Company, Milton, Pennsylvania	1964
	CLASS B	
1	FRANK R. PALMER Chairman, The Carpenter Steel Company, Reading, Pennsylvania	1964
2	RALPH K. GOTTSHALL Chairman of Board and President, Atlas Chemical Industries, Inc., Wilmington, Delaware	1965
3	LEONARD P. POOL President, Air Products and Chemicals, Inc., Allentown, Pennsylvania	1963
	CLASS C	
	WALTER E. HOADLEY, Chairman Vice President and Treasurer, Armstrong Cork Company, Lancaster, Pennsylvania	1963
	DAVID C. BEVAN, Deputy Chairman Vice President, Finance, Pennsylvania Railroad Company, Philadelphia, Pennsylvania	1965
	WILLIS J. WINN Dean, Wharton School of Finance and Commerce, Philadelphia, Pennsylvania	1964

OFFICERS AS OF JANUARY 1, 1963

KARL R. BOPP
President

ROBERT N. HILKERT
First Vice President

HUGH BARRIE
Vice President

JOHN R. BUNTING, JR.
Vice President

JOSEPH R. CAMPBELL
Vice President

NORMAN G. DASH
Vice President

DAVID P. EASTBURN
Vice President

MURDOCH K. GOODWIN
Vice President, General Counsel and Assistant Secretary

HARRY W. ROEDER
Vice President

JAMES V. VERGARI
Vice President and Cashier

RICHARD G. WILGUS
Vice President and Secretary

EVAN B. ALDERFER
Economic Adviser

CLAY J. ANDERSON
Economic Adviser

LAWRENCE C. MURDOCH, JR.
Business Economist

EDWARD A. AFF
Assistant Vice President

ZELL G. FENNER
Assistant Vice President

RALPH E. HAAS
Assistant Vice President

GEORGE J. LAVIN
Assistant Vice President and Assistant Secretary

HENRY J. NELSON
Assistant Vice President

RUSSELL P. SUDDERS
Assistant Vice President

JOSEPH M. CASE
Chief Examining Officer

JACK H. JAMES
Examining Officer

LEONARD MARKFORD
Examining Officer

G. WILLIAM METZ
Examining Officer

JACK P. BESSE
Assistant Cashier

WILLIAM A. JAMES
Personnel Officer

WARREN R. MOLL
Assistant Cashier

FRED A. MURRAY
Director of Plant

HERMAN B. HAFFNER
General Auditor

STATEMENT OF CONDITION

FEDERAL RESERVE BANK OF PHILADELPHIA

(000's omitted in dollar figures)	End of year 1962	End of year 1961
ASSETS		
Gold certificate reserves:		
Gold certificate account	$ 917,611	$ 906,959
Redemption fund—Federal Reserve notes	75,965	71,517
Total gold certificate reserves	$ 993,576	$ 978,476
Federal Reserve notes of other Federal Reserve Banks	52,668	43,635
Other cash	16,465	12,852
Loans and securities:		
Discounts and advances	663	2,185
United States Government securities	1,679,215	1,658,963
Total loans and securities	$1,679,878	$1,661,148
Uncollected cash items	475,946	439,443
Bank premises	3,282	3,521
All other assets	19,837	13,590
Total assets	$3,241,652	$3,152,665
LIABILITIES		
Federal Reserve notes	$1,863,328	$1,890,074
Deposits:		
Member bank reserve accounts	824,688	829,237
United States Government	44,812	10,696
Foreign	15,080	15,370
Other deposits	5,257	3,211
Total deposits	$ 889,837	$ 858,514
Deferred availability cash items	404,360	323,808
All other liabilities	3,473	3,347
Total liabilities	$3,160,998	$3,075,743
CAPITAL ACCOUNTS		
Capital paid in	$ 26,885	$ 25,641
Surplus	53,769	51,281
Total liabilities and capital accounts	$3,241,652	$3,152,665
Ratio of gold certificate reserves to deposit and Federal Reserve note liabilities combined	36.1%	35.6%

EARNINGS AND EXPENSES

FEDERAL RESERVE BANK OF PHILADELPHIA

(000's omitted)	1962	1961
Earnings from:		
United States Government securities	$ 58,880	$ 53,954
Other sources	377	180
Total current earnings	$ 59,257	$ 54,134
Net expenses:		
Operating expenses*	$ 8,584	$ 8,119
Cost of Federal Reserve currency	434	624
Assessment for expenses of Board of Governors	383	364
Total net expenses	$ 9,401	$ 9,107
Current net earnings	$ 49,856	$ 45,027
Additions to current net earnings:		
Profit on sales of U.S. Government securities (net)	$ 111	$ 200
Transferred from reserves for contingencies (net)	—	—
All other	33	1
Total additions	$ 144	$ 201
Deductions from current net earnings:		
Miscellaneous non-operating expenses	$ 84	$ 1
Total deductions	$ 84	$ 1
Net additions	$ 60	$ 200
Net earnings before payments to U.S. Treasury	$ 49,916	$ 45,227
Dividends paid	$ 1,565	$ 1,472
Paid to U.S. Treasury (interest on Federal Reserve notes)	$ 45,863	$ 40,136
Transferred to or deducted from (—) Surplus	$ 2,488	$ 3,618

*** After deducting reimbursable or recoverable expenses.**

VOLUME OF OPERATIONS

FEDERAL RESERVE BANK OF PHILADELPHIA

	1962	1961	1960
Number of pieces (000's omitted)			
Collections:			
Ordinary checks*	196,700	181,100	176,700
Government checks (paper and card)	27,300	26,300	25,000
Postal money orders (card)	14,100	16,200	17,200
Non-cash items	734	732	707
Clearing operations in connection with direct sendings and wire and group clearing plans**	682	677	698
Transfers of funds	163	149	145
Currency counted	264,300	260,300	295,000
Coins counted	444,400	476,200	451,200
Discounts and advances to member banks	1	1	2
Depositary receipts for withheld taxes	566	544	529
Postal receipts (remittances)	310	317	326
Fiscal agency activities:			
Marketable securities delivered or redeemed	439	406	419
Savings bond transactions— (Federal Reserve Bank and agents)			
Issues (including re-issues)	7,699	8,650	7,872
Redemptions	6,856	6,756	6,657
Coupons redeemed (Government and agencies)	1,221	1,119	1,043
Dollar amounts (000,000's omitted)			
Collections:			
Ordinary checks*	$ 66,200	$64,600	$64,500
Government checks (paper and card)	6,165	5,866	5,131
Postal money orders (card)	254	274	283
Non-cash items	164	166	150
Clearing operations in connection with direct sendings and wire and group clearing plans**	39,031	36,395	34,707
Transfers of funds	108,662	90,676	87,251
Currency counted	1,844	1,783	2,072
Coins counted	52	55	54
Discounts and advances to member banks	485	564	2,712
Depositary receipts for withheld taxes	2,406	2,240	2,182
Postal receipts (remittances)	872	851	861
Fiscal agency activities:			
Marketable securities delivered or redeemed	12,807	10,998	10,557
Savings bond transactions— (Federal Reserve Bank and agents)			
Issues (including re-issues)	396	405	386
Redemptions	468	377	405
Coupons redeemed (Government and agencies)	158	156	142

*** Checks handled in sealed packages counted as units.**
**** Debit and credit items.**

MONETARY DISCIPLINE

(Continued from Page 2)

applied monetary discipline under the international gold standard. The logic and elegance of this system of rules had—and still have—immense appeal. Symptom, prescription, cure—one flowed inevitably from the other. Loss of gold reserves called for monetary restriction; this in turn raised interest rates and reduced costs and prices; hence, balance would be redressed through imports of capital and net exports of goods and services.

According to the dictionary, another definition of discipline is "punishment inflicted by way of correction. . . ." Under the international gold standard, monetary discipline came to have this further connotation. If, for example, one nation behaved prodigally, the rules forced it to retrench. And, in fact, the rules helped to prevent prodigality. From experience, nations learned that if they misbehaved they would be punished. In this sense, monetary discipline picked up moral overtones—walk the straight and narrow or else. . . .

But the discipline of this system proved to be inequitable. One nation was likely to be punished for another's wrongdoing. It was forced to make adjustments in its own domestic economy in order to help correct the imbalance caused by others. It might have to restrict not because it had inflated its economy but because others were experiencing deflation. And the discipline was harsh; it sometimes meant recession and unemployment. As considerations of social welfare grew more important, nations were unwilling to tolerate these remedies. They became reluctant to entrust themselves to the workings of mechanical rules. They insisted on being masters of their own destiny.

Yet discipline cannot be thrown overboard. Our balance of payments difficulties have brought this home to us. So long as we live in a community of nations and enjoy the kind of free economic institutions that we do, we cannot pursue domestic expansion regardless of its effects on our external relations. So we have been groping for a solution somewhere between rigorous rules and complete freedom of action.

In his last article, published posthumously in the *Economic Journal,* Lord Keynes made a sage observation that is helpful in our pursuit of this solution.* He wrote:

> . . . I find myself moved, not for the first time, to remind contemporary economists that the classical teaching embodied some permanent truths of great significance, which we are liable today to overlook because we associate them with other doctrines which we cannot now accept without much qualification. There are in these matters deep undercurrents at work, natural forces, one can call them, or even the invisible hand, which are operating towards equilibrium. If it were not so, we could not have got on even so well as we have for many decades past. . . .
>
> But in the long run these expedients will work better and we shall need them less, if the classical medicine is also at work. And if we reject the medicine from our systems altogether, we may just drift on from expedient to expedient and never get really fit again.

One can find many evidences of these strong "natural forces" at work. Just recently Nikita Khrushchev was quoted as saying:

> We should remember Lenin's injunction to be able, if necessary, to learn from the capitalists—to imitate whatever they have that is good and profitable.

* June, 1946, pp. 185–186.

No matter how thorough the controls, a planned economy which goes against economic forces faces an uphill battle. Evidences of natural forces are clearly apparent in our balance of payments.

The lesson from Keynes' preachment is not that we must resign ourselves to these natural forces; not that we can exercise no influence over the course of events. The discipline which we seek must recognize the strength of fundamental economic forces, but within this limit it must also allow for the intelligent exercise of discretion.

The solution, it turns out, is nothing new. In fact, it is as old as economics itself. The essence of economics, after all, is the satisfaction of unlimited desires by means of limited resources; and in the process we must make choices. Because we cannot have everything at once, we must exercise discipline in making these choices. This is the kind of discipline needed in our present situation.

Monetary discipline, in the old sense, implied a choice—less domestic income and employment. This choice was called for when a nation inflated or over-expanded. But our situation is different. The balance of payments problem has more complex causes. And resources in our economy are not over-expanded but underutilized.

We need discipline in a whole wide range of choices, therefore, not just in money. We must, for example, decide which items in the balance of payments are most important to us—for political and military as well as economic reasons. We cannot have unlimited foreign and military aid and investment abroad and still expect a trade surplus to make up the difference.

In short, the solution is not just monetary discipline but *economic* discipline. It is not the indiscriminate application of rules; but, recognizing the strength of fundamental economic forces, it is the application of intelligence to the making of choices. This type of discipline may not enable us to achieve complete success in the twin objectives of domestic growth and balance of payments equilibrium, but it offers more promise than automatically putting the brakes on money and credit.