

CHANGING CONCEPTS OF BANK RESERVES

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Introduction

Purpose of words to convey thought; may be perverted to obscure thought or to hide absence of thought.

1. Words are like bottles

- a. New words for old things like new bottles for old wine - an academic fault.

Illustration:

Instructor brings chicken to biology class in 1915

1915 - an innovation

1920 - a problem

1925 - a project

1930 - unit of work

1935 - activity

1940 - integrated program

1945 - frame of reference

One cannot solve real problems by changing categories. *It was still a chicken brought to class don't give jobs by changing the definition of unemployment*

- b. Old words for new things like old bottles for new wine - the fault of the practical.

Illustration:

Means of transportation

On foot

Horseback

Automobile

Railroad

Steamship

Airplane

No guarantee it is the same thing because it bears the old label.

We have poured new wine

2. ~~New substance in~~ the bottle called bank reserves

a. Widely differing uses of the word in accounting.

Can't even tell if it is an asset or a liability.

b. This discussion concerns "cash" reserves. *kept vs dep*

(1) Commercial bank reserves

(2) Central bank reserves.

Similar in origin but greatly different now.

*Failure results
failure to
inquire divergent
banks from common origin*

I. History of commercial bank reserves

A. Early form and purpose

1. Note as well as deposit liabilities

2. Cash in vault to meet cash needs

B. Changes in amount of reserve

1. Wide fluctuations from time to time.

Wide variations from bank to bank and area to area.

2. Profits a pressure to keep at a minimum.

Demand for loans at the frontier.

3. Inadequate and minimum reserves. *lack of*
Inadequate - failure because of reserve funds, despite solvency.

D. Implications of fractional reserve system

1. Customer must have right to withdraw his deposits
2. If reserve ratio is fixed, where is the money coming from? - Central bank
3. Need of control over total means of payment.

a. Over volume of reserves

(1) Procedure

- (a) Gold
- (b) Central bank credit
- (c) Money in circulation

(2) Inadequacy of power in 1930's

b. Reserve ratio

- (1) Banks expand on basis of reserves
- (2) Power over requirements
- (3) The 100% reserve proposal

4. Services and earnings of banks

Attractiveness of industry to capital

E. Concluding remarks

1. Form of reserves has changed from cash in vault to deposit at central bank.
2. Function has changed from meeting cash needs to instrumentality of regulating volume of means of payment.

Minimum:

Self-discipline of banks - England,
Germany, France, and branch banking
Legal - United States

friction - many unit banks

4. Minimum reserves become average reserves

a. Means only small excess of reserves
can be used. *only time they can be used is
in liquidation.*

b. Stable replace fluctuating reserves *ratio*
smaller and stable

C. Changes in form of reserves

1. From cash in vault to correspondent
balances

a. Maintain local money rates and lend
the excess to money center.

b. Correspondent as a source of cash
to meet withdrawals.

2. Notion of "liquid" secondary reserves

a. Necessity for banking system to
make new loans or new investments
as old ones are paid off.

b. Primary function of short-term paper
is to reconsider the distribution of
credit.

3. Correspondents apt to be unable to meet
calls of country banks.

4. Scattered excess reserves of the system
inadequate, especially to meet calls for
cash in crises.

II. History of central bank reserves

A. Early form and purpose

1. Not distinguished from commercial bank reserves.

B. Regulation of

To assure ability to ~~repay~~ notes and deposits in gold.

I.e., to prevent excessive expansion.

1. The English system

- a. Fixed fiduciary system plus 100% reserve.

- b. Fell down in 1847, 1857, and 1866.
Formal accounting view - need to expand in crises.

2. The French system

Maximum note issue

3. Percentage system

- a. Against notes
- b. Against notes and deposits

C. The objectives of legal provisions

1. To assure central bank ability to meet its obligations.
2. To afford Governmental supervision.

*Caution to
not central banks
not member banks!*

D. Alternative methods of achieving

1. Ability to pay out reserves

- a. Remove reserve requirements
- b. Remove from notes

- (1) Make them truly elastic
- (2) Now put heavier strain than deposits of members on reserves

2. Governmental supervision

- a. Inadequacy of existing limits
- b. Benchmarks

Ideally a financial litmus.
Practically must be satisfied with substitutes.

- (1) Gold holdings
- (2) Volume of means of payment
- (3) Price level

III. Concluding remarks

- A. *original function of commercial banking reserves - to be USED in performance of central banks.*
- A. Gold reserves and inflation
- B. Necessity of meeting the real issue concerning private banking