A CHALLENGE TO STUDY

Address
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A Challenge to Study

I marvel at my own effrontery as I rise to address this distinguished group. If a very dear friend hadn't been drawn into the current financial discussions with the British he would be speaking here today and I would be listening to him, which, I feel sure, would have been a much more satisfactory arrangement all around. These are extremely uncertain times in an extremely uncertain world, and a speaker who attempts anything but nonsense is a most unenviable man.

For several reasons I thought I would talk to you about money. Everyone is interested in it, no one knows too much about it, and much of what is generally known probably isn't so. The processes by which money is created and extinguished, its supply expanded or contracted, are not well understood even though the consequences influence the personal and business lives of all of us.

But a more compelling reason, from my standpoint, is the fact that a comprehensive study of our money mechanism by a national monetary commission is long overdue but is not likely to be undertaken as long as the present lack of public interest in such a study persists.

Over 40 years ago, following the money panic of 1907, Congress created a National Monetary Commission from whose study and report came impetus for the Federal Reserve Act of 1913. Since then the dimensions, even the nature, of the problems involved in our money economy have changed radically, but there has been no deliberate, studied overhauling of the machinery through which governmental responsibilities with respect to them are administered. A Topsy-like growth of agencies has been our answer to new problems as they appeared.

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Man for man and in the mass, the members of the legal profession whose national association is meeting in St. Louis this week have unique leverage on public opinion in this country, and, I think, you also have real reasons to be actively interested in this subject. Most of you directly or indirectly help business management shape policy; many are concerned with estate management; and where you are active players in a game you are properly interested not only about its rules, but about the umpires and whether their set-up is workable, their authority adequate.

And finally, on that point, above any other class in this country, you make the laws. Two-thirds of the Senators, 54 per cent of the members of the House in the 80th Congress were lawyers. So I speak to you with growing confidence not only as our actual or potential legislators, but as men with real interest in the stability of our money, and its cost, availability and controllability.

When the Constitution was adopted, conferring on Congress the power to coin money and regulate the value thereof, no one dreamed of checkbook money in the modern sense. Today bank deposits account for $140 billions of our astronomical money supply of around $165 billions; currency outside banks, for $25 billions. In the year the Federal Reserve Banks were organized, total bank deposits were less than $20 billions, money in circulation out side banks less than $4 billions. Then, only 35 years ago, the public debt of the United States was less than one billion dollars; today it is over $250 billions, it is growing, and it dominates the monetary picture here at home.

Internationally, too, basic economic difficulties show their symptoms in the monetary field. The Washington financial conferences which begin tomorrow face the fact that the British are in serious financial difficulty. In this Britain is not unique. There is a world dollar shortage and the dollar

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apparently is undervalued in relation to a host of other currencies beside the pound sterling. And whether devaluation will solve the British financial crisis is another question. No legerdemain with money can erase certain stubborn factors - loss of the foreign income which before the war England received from her shipping and her investment abroad, since then liquidated by the war; high production costs; and the slow revival of the coal and textile industries, to mention only a few.

Today I ask you to take a short and inadequate look at the money scene in the United States. The governmental responsibility for managing the money supply has been delegated in large measure to the Federal Reserve System which is the central bank of this nation. Like other central banks it exercises certain natural central banking functions - it influences the volume of credit, provides an elastic currency through the note issue of the Reserve Banks, rediscounts for member banks, holds their reserves, acts as a nationwide clearing house for bank checks, and serves as fiscal agency for the U. S. Treasury and other government agencies. In organization it is not quite like any other central bank in the world. It is peculiarly a United States institution designed to work in this country.

It is a federal system - a national institution with a regional organization. It is privately owned by the member banks but except for the 6-per cent dividend on their stock fixed by law they do not share in earnings which, after reserves, pass into the U. S. Treasury. Thus the system is operated in the public interest. The Board of Governors in Washington is appointed by the President and is responsible to the Congress. The twelve regional banks (with their 24 branches) each has its own board of directors, two-thirds of whom are elected by the stockholders, the member banks, and one-third appointed by the Board of Governors. Only three of these may be

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bankers; the others represent the business and agricultural interests of the community.

Federal Reserve System policies are determined by the Board of Governors, a public body, and by the Reserve banks. In certain fields, for example the determination of legal reserve ratios, the policy decision rests solely with the Board of Governors, within the limits set by Congress. On the other hand, policy governing open market operations - the purchase of government securities to increase the volume of bank reserves, and their sale to reduce bank reserves - is determined by the Federal Open Market Committee, composed of the members of the Board of Governors and five Federal Reserve Bank presidents serving in rotation. In still other fields, for example, actual business arrangements with individual member banks, the Reserve banks have considerable autonomy. Policy thus is legally made by the Board alone, the banks alone, or by a combination of the two. In practice, of course, the System works pretty much as a unit.

Aside from its important but routine services, the principal purpose of the Federal Reserve System is to regulate the supply, availability and cost of money with a view to contributing to the maintenance of a high level of employment, stable values and a rising standard of living. As you can see, that is a very broad objective. Right here I want to make the point that Federal Reserve action alone obviously cannot provide for economic stability. It can, and we in the System believe it should, contribute to the best of its ability to that objective.

To influence the supply, availability and cost of money the Federal Reserve depends mainly on its ability to increase or decrease bank reserves. Now I come to the most difficult part of my talk, or of any talk or article about money - the part bank reserves play in the contraction or expansion of the money supply.

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In today's complex economy even the term money is not defined in simple, universal language. In earlier figures I lumped currency in circulation and bank deposits together and called the total our money supply. Most people would classify as money the currency and coin held outside the Treasury and the banks - that's $25 billions. But you can convert your demand deposit at the bank to currency merely by signing your name, and 95 per cent of all money settlements are made by check, anyway, so obviously the deposits subject to check have to be counted as part of the money supply. That's $82 billions more - or $107 billions. You might draw the line here, but there's another $58 billions or so in savings accounts which can be converted into currency or checking accounts without much trouble, and some would think of that as money, too - bringing the supply to $165 billions. Then there are $56 billions in savings bonds outstanding, redeemable on demand. Are they money? Let's stop before we get that far.

On June 30 this year, then, the rough total of bank deposits and currency was $165 billions; 10 years ago on that day, the total was $60 billions. How did the increase come about? Bank loans and investments increased $83 billions in that decade, from $50 billions to $133 billions, mostly in U. S. Government securities. Federal Reserve Bank holdings of government securities increased more than $20 billions in the decade, from the $2½ billions owned in 1939. The answer lies in that combined total increase of over $100 billions in debt owed to the private banks and the Reserve banks, mostly by the government.

Deposits are created as bank credit expands, as loans and investments by banks increase. Deposits are erased as bank credit contracts, as their loans and investments shrink. The growth of deposits is made possible by the availability of reserves to the banking system for loans and investment; conversely the contraction of deposits may be caused by the withdrawal of reserves.

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The reserves which made possible the war-time expansion of bank credit, of the money supply, came partly from the big gold inflow which continued through the 'thirties until the war checked it, but mostly from deliberate Federal Reserve policy to keep the banks supplied with reserves in order that they might be in position to finance the war to the extent not covered by taxation and by bond sales to private investors.

That was deliberate national policy, implemented through the Federal Reserve. Then, as always when attempting to regulate the supply, availability and cost of money, the Federal Reserve had to depend chiefly on its ability to work with bank reserves, which constitute the legally-required basis of bank credit or money. Here is how it operates: each Federal Reserve member bank in the United States holds a certain proportion of its deposits as a legal reserve with its Federal Reserve Bank. This legally-required fractional reserve system which we have in effect in this nation means that total bank credit, that is total loans and investments of banks, can be expanded to a point several times the amount of the reserve required but cannot go beyond that point unless new reserves become available. Currently, deposits can expand to about seven times the amount of reserves held by the banking system as a whole. It is a little complicated to trace this process exactly so I ask you merely to accept my statements as true; actual demonstration would require too much time.

System action to influence the volume of bank reserves is along two lines. First, the Reserve authorities have the power to change the legally-required reserve ratio within a range from its minimum legal limit to twice that minimum. In other words, it can change the legal multiple for deposit expansion, Given the same volume of reserves, a legal reserve ratio of 20 per cent obviously will support only half as large deposits as one of 10 per cent.

The other major way in which the System influences the supply of money is through changing the actual <u>amount</u> of reserves available to the banking system.

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It does this mainly by buying or selling government securities in the open market - this is called the "open market operations." When the System buys government securities, it adds to bank reserves; when it sells government securities, it contracts bank reserves Or it can make direct credit available to its member banks by lending on the assets member banks bring in to it. When member banks borrow, the funds are placed in their reserve accounts and thus increase reserves. When the borrowings are repaid, the banks draw on their reserve accounts which thus are reduced.

In the early days of the System when banks borrowed heavily at Federal Reserve Banks to obtain reserves, the rate of interest they were charged, called the discount rate, was an active and important instrument of central bank action. Today, when bank borrowings from the Reserve banks are occasional and relatively small, the discount rate is much less important.

Traditionally a central bank works as follows. If the general economic situation seems to be inflationary - in other words, if the supply of money seems to be outrunning the supply of goods and services immediately available - the central bank wishes to see that supply of money contracted. Therefore, it attempts to put pressure on bank reserves. It attempts to reduce their volume by selling government securities, by making it more difficult for banks to borrow, or it attempts to raise reserve ratios so that credit can expand by a smaller amount on the same volume of reserves. This action of contracting bank reserves tends to make interest rates rise and thus deter prospective borrowers from borrowing. It puts on the brakes. It attempts to hold some of the inflationary forces in check.

In a deflationary situation the System attempts to add to the volume of bank reserves to make money easier and therefore to make it more attractive to borrow to start new ventures and increase inventories and so on. System restrictive action tends to be more directly effective than System expansionary

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action. As former Chairman Eccles of the Federal Reserve Board put it once: "You can pull a piece of string back but you can't push it where you want it to go." And another point - since Federal Reserve action normally runs counter to the way the economy is running, the central bank tends to be unpopular all of the time. It is always going against the stream. When times are booming, its policy is to tighten down and hold the boom to reasonable proportions as far as monetary action can affect it. That obviously is not the best course if one is looking for popularity.

Successful intitutions must change to meet changing economic conditions. Since the outbreak of war, because of special circumstances, the Federal Reserve System has not been in position to change as much as it would like to meet the very sharply changed economic conditions. And because these new, war-induced conditions found the System unequipped to deal adequately with the changed economic problems, the System has attempted for the past few years to get a Congressional reappraisal of banking legislation in general and the Federal Reserve System in particular. It has asked for some extension of its powers in the light of new problems ahead. But most of all it would like to see the citizens of this country, non-bankers as well as bankers, start thinking about these things.

Today we face a situation different from that of a year ago. The economy is no longer in an inflationary phase. Federal Reserve System powers to deal with deflation are much more adequate than they were 20 years ago when the depression of the 'thirties set in. We can provide funds when needed by the market. A major deficiency of the banking system that aggravated business conditions in the past thus no longer exists. We have virtually unlimited means of supplying the market with additional reserves. On the basis of existing legal requirements we could more than double our outstanding note and deposit liabilities.

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We also can lend to banks on many more classes of assets than was possible before 1935. We also can reduce reserve requirements substantially if that should prove to be necessary. But sometime in the future should inflationary conditions resume, the System will find itself back in the straight-jacket which it occupied recently - impotent to take effective action to control monetary inflation because of its responsibility for stability in the government bond market. I wish I had time to spell that out more clearly.

I think the main thing that kept us out of trouble in the past was the horse sense and self-restraint of the American people. We didn't reach the point where we were ready to throw the dollar overboard in a speculative scramble for goods. As individuals we still exhibit that restraint. Collectively, acting through government, we aren't doing so well. Let's take a look at the record.

With production, employment and national income at an extremely high peace-time level, highest on record except when compared with 1948, the central government is spending more than it collects in taxes. In other words, we are adding to our national debt when we ought to be paying it off. Item by item, the purposes that call for the staggering total of public expenditures have their strong supporters, but we can't afford them all - not unless we are ready to pay a lot more in taxes than we are paying.

This is no time to be adding to the public debt. If we can't make ends meet now, what resistance can we possibly oppose to far greater deficits under less favorable economic conditions than now? If the public debt is going to be endlessly a one-way street, it is time to take inventory of the traffic department.

We need a thorough-going reappraisal of the new set of circumstances that have evolved in the monetary field in the past few years. If a central

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bank and related agencies are to be effective they must be prepared to deal with both deflationary and inflationary situations. A thoughtful and impartial national monetary commission could consider the current and prospective problems against the background of the world today and help point the way for effective future action.

The problem of guiding the country's economic forces with a view to stability of output and employment is a continuing and ever changing one. Wisdom, foresight and authority to act when action is called for, are required to carry out this objective. Above all else, an informed body of public opinion is needed. Most people, I am convinced, take money for granted, uniformed as to its nature and unconcerned as to its dangers. The problems in this field are not easy to discuss simply, certainly not in a 25-minute luncheon talk, and if I have succeeded only in confusing you, that may be good, in a way, if it points up the great contribution which a thorough and impartial study could make if it led people to study and think about the subject. No matter what else a national monetary study in 1950 by an impartial and competent commission might give us, it would be worthwhile if it only threw light upon an area which to most of us is hopelessly dark and confused. Unil more and more people - thoughtful, well-informed citizens such as the delegates in convention here this week - can be brought to understand some of these essentially dull but very important economic facts, central monetary authorities cannot perform an adequate job. Unless we move soon to take stock and make the necessary repairs, we will continue to be like the lazy man with the leaky roof - when the weather is nice the roof doesn't need fixing, and when the storms hit, he can't get out to fix it.

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