BANKS - AND CENTRAL BANKS

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My subject today is "Banks - and Central Banks". From that taking-off point I want to point out a few major differences between central banks and commercial banks, some of the responsibilities they share in common, and to emphasize, perhaps, the effect of their operations on the level and health of our economic life. I do not intend to give you the answers to the questions I raise - as a matter of fact I am not sure of the answers myself. But I do believe that the problems involved in the relationship of the commercial banking system with the Federal Reserve should be examined clearly, objectively, and with candor and good humor. In that spirit the commercial banks and the central bank can function rationally and with mutual understanding.

The United States economy is a money economy. Most of the great civilizations of the world have used money and credit in one form or another and have found it invaluable in promoting efficiency and a higher standard of living. In view of that long experience, therefore, it is a little surprising that the general field of money, credit and banking is not well understood, that there is so much fuzzy thinking in connection with it. Someone once said that there are more people who know more things that are not so about money, credit and banking than is true of any other subject in man's experience.

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 over $165 billions; currency outside banks, for $25 billions. In the year the Federal Reserve Banks were organized, total

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bank deposits were less than $20 billions, money in circulation outside 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.

In today's complex economy even the term money is not defined in simple, universal language, so I hasten to explain that in my 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 $83 billions more - or $108 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 over $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.

This year, then, the rough total of bank deposits and currency is $165 billions; 10 years ago 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.

The reserves which made possible the wartime expansion of bank credit, of the money supply, came partly from the big gold inflow which continued

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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 national policy was carried out by the Federal Reserve System working with and through the commercial banks.

After this preliminary glance at our money supply, let us take up the role of the commercial banks in its creation and management. Their primary functions are the accumulation and the lending of funds. Thus they deal with money and credit, and in gathering and lending funds perform a basic and useful service that contributes to economic well-being. So, you might say, do insurance companies, mutual savings banks, and other financial institutions. But the commercial banking system is unique among financial institutions in that it can lend not only the funds it accumulates from thousands of stockholders and millions of depositors, but it can create new funds through its lending process. It can do this because commercial banking in this country operates on a fractional reserve principle and because our economy operates mainly with checkbook money rather than with currency and coin.

All this is so elementary that it may be out of place in this group to state the fact that 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.

The unique power of the commercial banking system to create or extinguish deposits carries with it a major responsibility to maintain the supply of money needed to carry on high level economic activity. If the supply

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is too large it will lead toward price inflation; if it is too small it will lead toward deflation. The commercial banking system makes a major contribution to the efficient functioning of our economy when it avoids either extreme; when the supply of money and credit is in reasonable balance with the supply of goods and services and the flow of income and expenditures.

This is a very large order. At times the total responsibility may conflict with the incentives and principles that ordinarily shape individual bank policy. In an inflationary period, even though restraint on further expansion of the money supply may be desirable, it is not reasonable to expect banks to overlook good loan and investment opportunities if lendable reserves are at hand. In a depression, very naturally caution becomes more pronounced in bank management policy, even though the tightening-up process enlarges over-all difficulties by contracting the supply of money.

There are more than 14,000 banks with almost 4,500 branches in the banking system in this country. These generally have a fine spirit of cooperation and an extremely high degree of organization on national, state and regional levels. Even so it is not likely that the sum of the acts of these thousands of individual banks, each with its responsibility running first to its depositors and stockholders and second to the economy as a whole, will match their total responsibility for the country's money supply.

Here's where the central bank enters the picture. The governmental responsibility for regulating the money supply has been delegated in large measure to the Federal Reserve System which is the central bank of this nation. Let me emphasize something here which I think most bankers are prone to overlook. Allan Sproul will, I think, discuss it more fully at Wednesday's general session. The development of a national credit and monetary policy is the responsibility of the Federal Reserve System, made so by Congress. This is not a divisible responsibility. In certain of its service and supervisory

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functions the Federal Reserve shares a field in which many other agencies operate, but not in its legal responsibility in the field of monetary control in which its duties cover the whole of our economy and touch the lives of all our people.

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. The Reserve Banks are 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. The system is designed to operate in the public interest.

Aside from its important but routine services, the principal purpose of the Federal Reserve System is to influence, in the public interest, the supply, availability and cost of money. The statute spells out rather meagerly the guides to Federal Reserve policy. Thus discount rate changes are to be made "with the view of accommodating commerce and business"; open market operations are given that objective with the added requirement that they be conducted "with regard to their bearing upon the general credit situation of the country". Changes in reserve requirements are to be made "in order to prevent injurious credit expansion or contraction". The Board of Governors has stated the principal purposes of the System to be regulation of the "supply, availability and cost of money with a view to

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and a rising standard of living". Any way you state it, the objective is broad.

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. To influence the supply, availability and cost of money the Federal Reserve depends mainly on its ability to increase or decrease bank reserves, which constitute the legally required basis of bank credit or money. It not only calls attention to the need for expanding or contracting credit, but it tries to see that appropriate steps are taken, working with and through the commercial banks to expand or contract bank reserves. It is an understatement to say that generally the commercial banks don't like restrictive action on their reserves.

It is not necessary to explain to this group how, under the legally required fractional reserve system in effect in this nation, 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. System action to influence the volume of bank reserves is along two lines: (1) Within the limits fixed by Congress, it may change the legally required reserve ratios. 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. (2) It may set out to increase or decrease the actual amount of reserves available to the banking system.

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 makes direct credit available to its member banks by lending on their assets. When member banks borrow, the funds are placed in their reserve accounts and thus

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increase reserves. When the borrowings are repaid, the banks draw on their reserve accounts which thus are reduced.

There is a widely-held notion - even among bankers - that the Federal Reserve Banks get their power to buy and own investments from the reserve deposits of member banks. This is not the case. Their ability to buy investments - to extend credit either in the form of reserve note currency or deposits in the reserve accounts - is derived from a statutory grant and not from the deposits entrusted to them by member banks. This is inherent in the very nature of a central bank; it is an important distinction between the central bank and the commercial bank of deposit.

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 or its expansion halted. 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. Thus it puts on the brakes. It attempts to hold some of the inflationary forces in check.

In a deflationary situation the System adds to the volume of bank reserves to make money easier. System restrictive action tends to be more directly effective than its expansionary action. And 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.

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After all, the public agency which is given this responsibility by the government should not seek popularity, but understanding. The public, including the bankers, frequently becomes irritated over Federal Reserve actions. They should be judged in the light of the fact that as long as we have a money economy some public body will have this job to do. Perhaps some better agency can be devised than the Federal Reserve System; perhaps a better job could be done than has been or is now being done. But whatever the agency, if it met its responsibilities it would never be popular. It would be best off with public understanding and respect.

It is of extreme importance that the responsibility and purpose of the System shall be administered so as to affect the economy impartially. The Congress confers broad powers upon the Federal Reserve System, which in turn attempts to set broad limits to the money supply and the cost and availability of credit in the aggregate. Within those limits the individual banks operate as they see fit - subject, of course, to the law and bank supervisory authorities.

So far I have discussed in a hit-or-miss fashion the past and present functions and responsibilities of the banking system and the central bank. Viewed objectively they are parts of the same picture, in essential harmony both with each other and with the free enterprise system as we know it. Central bank action does not determine what an individual bank or an individual borrower may or may not do - at the most it merely sets broad and impartial limits to action.

But successful institutions must change to meet changing economic conditions. Since the outbreak of war, because of special circumstances, the Federal Reserve System has not always been equipped to deal adequately with very sharply changing economic conditions. Today we face a situation

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different from that of a year ago when the economy was still in an inflationary phase. Next year may again be different. Federal Reserve System powers to deal with ddflation, as far as monetary authority can cope with it, 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. For practical purposes 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. We also can lend to banks on many more classes of assets than was possible before 1935. The System 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 - powerless while it exercises its responsibility for stability in the government bond market, to offset forces that make for monetary inflation. I am sure I need not discuss in any detail the much disputed question of credit control vs. support of the government security market. But it brings up a point that is not too well appreciated. The Federal Reserve System has been criticized as being subservient to the Treasury, and for not acting independently, with its support of the government security market cited as an example.

I want to range myself on the side of those who say that in principle the central bank should be independent in its action. I think that control over the banking system's unique power to expand or contract the money supply can best be administered, not by one of the departments of government nor by private business, but by a central bank set up independently and made responsible to the Congress. But while agreeing with the principle,

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I must say that in practice it is impossible to separate the central bank from the impact of Treasury decisions, and equally impossible to separate the Treasury from the impact of central bank action. With a debt and a budget of the size they are today it is unrealistic to assume that the Federal Reserve System can act as though they did not exist or were of 1930 dimensions. Support of the government security market in 1947 and 1948 was a Federal Reserve policy determined after full consultation with the Treasury and carried out with full realization of its implications. To the best of my knowledge no important dissent to that policy was voiced within the System.

Treasury policy and Federal Reserve policy are inseparably linked - they cannot ignore each other. Each is dependent upon the other. There have been, and probably will be more, differences of opinion as to specific actions - perhaps as to over-all policy. These differences have to be resolved before either monetary policy or fiscal policy can be made to work.

We are going to face plenty of new problems in the years ahead. Some signs are apparent now. 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 peacetime 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.

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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? This trouble is fundamental. No monetary study could cure it. It can be corrected only by public opinion brought to bear on executive and legislative branches. At the moment the public debt and the money supply seem to be on a one-way street, which emphasizes the importance of an inventory of the traffic department.

Over forty 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. We have had a Topsy-like growth of agencies to deal with new problems - now we need to sit back and take a hard look at our money situation to see if we can come up with a better organized system.

We need a thorough-going reappraisal of the new set of circumstances that have evolved in the monetary field in the past few years. This country has grown great because it changed to meet changed conditions. Our banks today are very different from the banks of fifty years ago - they had to change as the country grew. No central bank today can operate as it did prewar - and probably fifty years from now it will operate differently than it would today, even if today's powers were adequate to meet today's problems.

The problem of harnessing the country's gigantic money supply to serve a dynamic economy is a continuing and ever changing one. Wisdom, foresight and authority to act when action is called for, are required. Above all else, an informed body of public opinion is needed. Most people, I am

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as to its dangers. The problems in this field are not easy to discuss simply. A national monetary study by an impartial and competent commission would be worthwhile if it only threw light upon an area which to most of us is hopelessly dark and confused. Until more and more people 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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