

BANKERS AND MONEY QUESTIONS

An address by
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Money, like the weather, is a well-worn but unworn topic of discussion. People think and talk about money for different reasons. Some do it because they find satisfaction in the acquisition of money. Parenthetically, some of us seem destined to enjoy that satisfaction largely vicariously. Others are preoccupied with money because they find their greatest joy in saving it and watching their savings grow. Still others find money a pleasant topic only as they spend it and thereby command their share or more of the world's goods and services.

Aside from these personal and individualistic predilections regarding money, some people - though I fear, not enough - study money and its behavior because they recognize the need to comprehend and rightly evaluate the importance of its role in our economy. The audience I face here today is composed of people of this last sort, and for that reason among others I am glad to be here and to engage in discussion with you. Money questions are always with us, and at this particular time there are major issues in the field of money. It is appropriate to subject these issues to intensive study and to throw the searchlight of public opinion upon them. The formulation of informed and enlightened public opinion upon these money questions, some of which are fairly intricate, is indispensable if we are to reach sound conclusions.

I know of no group so well situated as bankers to furnish leadership in the task of bringing about in this country better understanding of the role of money in our money economy and better understanding of our private financial institutions which are essential to the efficient operation of that economy. I believe your attendance at this conference bespeaks your willingness and eagerness to acquire information so that you may assume such leadership in your respective communities. You

have before you, as bankers in all parts of the country have, remarkable opportunities, by reason of your key positions in your communities, to make real and long-term contributions toward sound solutions in the public interest of important money questions which are not only of immediate and particular concern to you as bankers but also will affect directly or indirectly the lives and well-being of all our citizens.

In very simple form the current money question of major importance may be phrased something like this: How can we hold the value of our money fairly stable over a period of time? Thus the basic money question has to do with the integrity of the dollar. The other matters I shall discuss have to do with various forms and methods of dealing with this major problem.

In discussing these issues I shall have to talk about some fairly complex matters of economics and political philosophy. The economic issues in particular are sometimes found difficult to grasp, even by bankers who deal with monetary matters in their daily business. I hope I can make some contribution to your understanding of these matters for, in my opinion, it is vital for the banking community to understand them and to take a leading part in making them clear and understandable to the people as a whole.

Let's begin with this point. The value of the dollar at any given time depends mainly upon two factors: the amount of purchasing power in active use and the amount of goods and services in actual supply. When the amount of purchasing power in the economy increases more rapidly than the flow of goods and services into the economy, prices tend to advance; in other words, the value of our money tends to decline. When the amount of purchasing power in the economy declines relative to the amount of goods and services flowing into the economy, there is a

tendency for prices to recede; in other words, the value of the dollar tends to increase. Inflationary forces occur when money is being created more rapidly than goods and services; when the converse situation obtains, we encounter deflationary forces.

Here I want to define some terms so as to be sure that this point is abundantly clear. There is no real need, I suppose, to tell you what is meant by the supply of goods and services in the economy. You can see the goods; they are tangible; they exist. You can experience the services. The concept of purchasing power, however, is somewhat less easy to grasp. Purchasing power is the amount of money operating in the economy multiplied by its turnover rate - what the economists call "velocity". The amount of money in the economy consists not alone of tangible currency and coin but principally of bank deposits. In this country the great bulk of financial transactions, perhaps 90 per cent or more, are consummated by means of transfers of bank deposits. Of the total money supply in this country, amounting to about \$177 billion, some \$152 billion consist of bank deposits (both demand and time) and only about \$25 billion consist of currency and coin in circulation. Thus bank deposit money, or check book money is the largest ingredient of our total money supply.

A key factor in preserving the integrity of the dollar is maintenance of a reasonable balance between the supply of purchasing power and the supply of goods and services. Let us call this relationship the money-goods equation. Theoretically, balance can be achieved through changes on either side, or on both sides, of the money-goods equation. Thus if purchasing power grows large relative to goods supply, either goods supply can be increased or purchasing power decreased or a combination of the two actions may take place. Or if purchasing

power grows small relative to goods supply, opposite actions can take place.

Note that I said "theoretically" adjustments could be made on either side of the equation. Practically, a situation may occur where the adjustment must come mainly, if not wholly, on the money side. That is particularly true of a period such as the one we are now in. Today the American economy is operating at practical capacity. We have almost full employment of both the labor force and of our productive plant. Achievement of increases in the flow of goods and services from this point on will be a relatively slow process because increases will depend upon adding to capacity and increasing productivity. Thus with purchasing power out of balance on the up side relative to the supply of goods and services, as a practical matter we have to work on the purchasing power side of the equation, since we can do little over a short-term period to increase the goods supply. On the other hand, in periods when we have unused capacity and idle labor, balance may be achieved best by increasing goods supply.

One further point should be noted with respect to balance between money and goods. The best balance is achieved when we have balance at a high level of activity. It is possible to balance at a low level but the real task is to balance at a high level.

Now suppose we back up a little and come at this money-goods relationship from another angle. Remember that I defined purchasing power as the supply of money multiplied by its rate of turnover or velocity. Purchasing power may also be thought of as representing three major components - current income, savings, and credit extensions. Current production yields current income which, assuming equitable distribution relative to demand, should be sufficient to buy the goods

produced. Add to current income, however, the purchasing power of previously accumulated savings, and there is still more purchasing power. To say it another way, the velocity of money use is thereby increased. Add to current income also the purchasing power of anticipated future income and there is still more purchasing power. To say that another way, the money supply has been increased by the extension of credit.

The reason I have introduced this approach at this time is to try to set in proper perspective what I am going to say about monetary policy. In the achievement of balance between money and goods, monetary policy plays an important part. It is concerned primarily with the credit field as it affects the money supply and therefore is of major importance in determining quantitatively the money supply. But monetary policy is not the only factor in the situation. The basic problem is balance between purchasing power and the supply of goods. Monetary policy bears on just part of the purchasing power factor - the quantity of money. The velocity of the money supply is generated by innumerable individual, business, and Government decisions as to spending and saving. Fiscal policy which affects these decisions and which has the power directly to absorb or not absorb purchasing power also has great bearing on the money-goods relationship.

Let me put it this way. Monetary policy is a key factor in balancing the money-goods equation. Without proper monetary policy that balance would be difficult, if not impossible, to attain. But without proper action in other fields monetary policy alone cannot attain the objective. It cannot operate alone and be successful. This is a basic fact that needs far more popular understanding than it enjoys at present.

By way of summarizing the major point so far, keep in mind the money-goods equation and remember that in many instances, particularly

under present conditions, the goods side of the equation is not susceptible of appreciable change over short time periods. So, practically speaking, work has to be done on the money side. But part of the money side is the "velocity" element, which also changes relatively slowly and in any case is not very susceptible to direct monetary policy action although we do try to get at it somewhat with Regulations W and X. The major element left therefore is the quantity of money, the money supply, and that is a volatile element susceptible of change by monetary policy action.

The money supply can be changed and changed appreciably over short periods of time. It can be changed most easily by increasing the amount of bank deposits. Here is where the commercial banking system comes directly into the picture. The commercial banks as a system, create bank deposits when they increase the amount of credit extended. They decrease bank deposits when they decrease the amount of credit extended. And this is because of two factors: (1) we operate in this country primarily with bank deposit money, and (2) we operate our commercial banking system under what economists call a fractional reserve system.

Let me take that second point first. All of you know that you are required either by law or custom to maintain certain reserves against the deposits you hold. That reserve ratio varies somewhat by type of bank and by locality, but on the average banks keep approximately 15 per cent of their deposits in the form of reserves. In other words, for every \$100 of deposits, banks on the average have to maintain about \$15 in reserves. To turn the statement around, \$15 in reserves will support about \$100 in deposits. That fact gives the banking system tremendous leverage in creating new bank deposits.

Now to the first point. When a bank makes a loan to a customer or buys a security, it creates a bank deposit, because most people in this country take the proceeds of their loans or of their securities sales in the form of bank deposits. They either hold those deposits or make payments from them. Such payments usually are made in the form of checks which transfer deposit balances from one individual to another, from one business to another, from one bank to another. When you have extended credit to a particular customer and have given him a deposit balance, his payments may draw down the balance created in your bank, but they show up again immediately in balances in other banks. Perhaps they may come right back to your own bank. The deposit remains in existence somewhere in the banking system until the loan which created it is paid off and the process is reversed. It is important not to lose sight of that fact that when you created the deposit, you had to have only a small proportion of the new deposit in the form of a legal or customary reserve.

Now what does this all mean? It means in effect that the banking system of this country has the power to expand its credit and hence its deposits by whatever amount its available reserves will support. In other words, on the present average reserve ratio the banking system can expand its deposits roughly \$6 for every \$1 of reserves. Thus the privately owned and operated commercial banking system can and does increase the money supply of the country. At other times the commercial banking system can and does decrease the country's money supply by contracting bank credit and thereby reducing the volume of deposit money.

This unique power reposing in the private banking system imposes a most grave responsibility on the system and on individual bankers. We should ponder and understand that assertion well. The power of the

commercial banking system to create and extinguish money automatically imposes on banks and bankers a correlative responsibility to assist in keeping the money-goods equation in reasonable balance. In times like these when the money side of the equation is, for all practicable purposes, the only side readily susceptible to adjustment, the responsibility of banks and bankers is to see that the supply of money is not permitted to outrace the supply of goods and services too far.

At this point it may not be amiss to emphasize a fact which needs to be comprehended by every banker everywhere. There are some earnest, conscientious individuals who entertain grave doubts about the propriety of leaving in the hands of the private banking system its unique power to create and extinguish money. These people point to the provision of our Federal Constitution which confers upon the Congress the power to coin money and regulate the value thereof. From that it is argued that the power to create and extinguish money is an attribute of the Federal Government and that its exercise by the private banking system, if permitted at all, should be subject to the strictest and sternest control, both quantitatively and qualitatively, by the Government. Some would go so far as to espouse Government ownership of the banking system as the best and surest method of preventing misuse of a governmental power by private institutions operating for profit. In my view it is appropriate to keep this point ever before us to the end that we shall conduct ourselves and the institutions we represent so as to give no meritorious cause for doubt about our recognition of banking as a quasi-public enterprise and no cause for doubt about our determined and courageous will to preserve and promote the public interest while bearing true faith and fidelity to our depositors and shareholders.

For a long time we operated on the basis of the commercial banks

bearing almost the whole responsibility for keeping the money supply in balance with the goods supply. The results were not satisfactory, and the public in general and banks in particular decided to try to create a more satisfactory arrangement. The result was the creation of a central bank - the Federal Reserve System - whose primary function is to influence the supply, cost and availability of money with a view to maintaining stable values, high employment and a rising standard of living. The central bank is in position to look at the over-all relationships in the money-goods equation and to attempt to keep the supply of money in reasonable balance with the supply of goods. It attempts to accomplish this purpose mainly through its powers to add to or subtract from the volume of reserves available to the banking system as a whole. For the ability of the banking system to expand its deposits, as I said earlier, rests largely upon the amount of reserves it has at its disposal.

I do not propose to go into the methods by which the Federal Reserve System attempts to influence the supply, cost and availability of money, beyond the mere statement that it operates through its powers to make bank reserves more or less costly and more or less available. This fact, however, should be noted. The creation of a central bank in this country resulted in that institution's taking over, in the interests of the banking system and of the general public, part of the responsibility theretofore resting on the commercial banking system alone, for keeping the money supply in reasonable balance with the goods supply. By working through the banking system and influencing the volume of bank reserves, the Federal Reserve System attempts to see that there are enough reserves available, and no more, to support a total deposit level which is about in keeping with the level of general economic

activity in this country. Then the individual banker is left to his own devices to pursue, under the traditional supervision of the banking authorities, whatever policies he wishes. To the individual banker is left the decision as to how much he shall loan and how much he shall invest, to whom he shall loan and with whom he shall invest. So long as he can get reserves to support his deposits, he can operate as he wishes.

The banker still bears great responsibilities, of course. He has to determine, and this is his basic economic function, who are the more efficient producers, who are the people worthy of commanding credit. He plays a key role in the business life of his community and in its development. But he is relieved under ordinary circumstances of responsibility for attempting to determine what the effect of his actions will be on the total money supply, because that is determined by the amount of reserves he can obtain. In my humble view this kind of system represented and remains a most desirable development in a free democratic society. It preserves the maximum degree of freedom consonant with the general, economic public interest. It preserves individual responsibility while at the same time guarding against individual irresponsibility.

I want to return to this point in just a moment, but before doing so I would like to make another most important point.

Consistent with the American way, the Federal Reserve System - the central bank of the United States - was established, a little less than 40 years ago, as an independent institution and not as a full-fledged Government agency. However, I want to point out and emphasize that independence, in this sense, does not mean that the Federal Reserve is or should be irresponsive to the will of the people. On the contrary,

the System is directly and properly responsible to the Congress. It was to be independent, however, of day-to-day pressures all too often brought to bear upon strictly Government agencies. In other words, the independence of the Federal Reserve means non-partisan objectivity and freedom to make appropriate decisions as to national monetary and credit policy in the light of broad economic considerations.

To accomplish this purpose the Congress in establishing the Federal Reserve did certain things in keeping with our general American tradition of constitutionalism. First it recognized the principle of independent thought and objectivity of which I have spoken. Then it proceeded to lay down certain specific legislative safeguards for that kind of independence. I do not propose to go into the entire history of the creation of the System nor to tell you in detail about the safeguards so laid down by the Congress, but perhaps I can round off the point with two or three examples.

To preserve the kind of independence which is vital to objective opinion and action, the Board of Governors of the Federal Reserve System was established. Each member is appointed by the President and confirmed by the Senate for a term of 14 years. The terms are staggered. By this action the Congress attempted to insure (1) that the Board would be responsible to the Congress and be influenced by Congressional opinion in a broad sense, but (2) that it could not be dominated and its objectivity destroyed by any particular administration or Congress. Similarly the law provides for ownership of the stock of the Federal Reserve Banks by the member banks themselves and for a board of directors in each Reserve bank, six of whom are elected by the member banks and three appointed by the Board of Governors in Washington.

All these steps and others were merely devices set up to

insure the kind of independence in the central bank that the Congress believed to be desirable. Insurance that the public interest would be served was provided by fixing responsibility of the Federal Reserve System to the Congress but in such a way as to insure at the same time the System's non-partisan objectivity. These provisions have worked out pretty well as I see the matter, and I would not like to see them changed.

Now let me return briefly to an earlier point, the fact that the central bank has taken over from the commercial banking system a major part of the responsibility for maintenance of stability in the money-goods equation. The character of this arrangement is in keeping with the best traditions of our democratic capitalistic society. By abstaining from interference with the maximum possible degree of individual freedom of action, central banking policy contributes to the dynamic strength of a free economy.

The system of democratic capitalism under which we operate has two major virtues as I see it. First it is in keeping with the broad principles upon which this nation was founded and which we continue to hold dear. The cornerstone of our system is a high degree of individual freedom - the maximum freedom possible for the individual. This is what the founding fathers believed in - this is what we continue to believe in. It is a profession of faith and a basic philosophic approach to the relations of man with society. The principle may be regarded as absolute, even though the degree to which individual freedom may be carried is a product of times and institutions. At various times of emergency the people voluntarily permit some loss of individual freedom in order to maintain the general principle over the long pull.

However, the essential point is always individual freedom. Of course no one is ever wholly free; he has responsibilities to his

immediate community, to the nation as a whole, to man in general. In our kind of society the wise discharge of these responsibilities determines how much individual freedom must be given up to maintain a free society, and how much can be retained. The problem is one of balance.

Forty years ago, speaking at Yale University, the great English historian, Lord Bryce, laid down three requisites for citizenship in a free community. These, he said, are intelligence, self-control and conscience. The citizen must be able to understand the interests of the community, must be able to subordinate his will to the general will, and must be prepared to serve his community by voting, working, and (if need be) by fighting. And he said further:

"Upon the extent to which these civic capacities are present in the community, the excellence of its government will generally depend. Such as are the stones, such will be the temple into which they are fitly compacted together".

The second major virtue of our system of democratic capitalism is that it is an efficient system. Historically it stands out as the most efficient system yet devised by man. Free men and free markets have stood the most severe test of all - the test of time. A dynamic economic system such as ours has resulted over time in higher living standards and in the greatest economic good for the greatest number. Free choice has resulted in having more to choose from.

The central bank of this nation, as it should, fits into the general philosophic pattern of individual freedom and into our free and dynamic economic system because its powers are so exercised as to permit the maximum degree of freedom of action on the part of borrowers and lenders. In a report, made early in 1950, of the Douglas Subcommittee on Monetary, Credit and Fiscal Policies, the Subcommittee noted that

monetary, credit and fiscal policies are more consistent with the maintenance of our democratic system and with the fostering and promoting of free competitive enterprise than other methods aimed at economic stabilization.

The following are the Subcommittee's words: "These instruments do not involve the Government in detailed control of the particulars of the economy; they do not require the Government to intervene in individual transactions between buyer and seller, in dealings between employer and employee, and in the determination of the prices and production of particular commodities. These millions of intricate decisions are left to the operation of the market mechanism while general monetary, credit, and fiscal policies work toward stabilization by influencing the total supply and cost of money and the total amount of money income at the disposal of the private sectors of the economy. There is every difference between the effects of general over-all monetary, credit, and fiscal policies which indirectly influence the economy toward stabilization and the effects of an elaborate system of direct controls."

Now I come to the final point. As citizens, all of you are concerned with the maintenance of our system of democratic capitalism and the broad principle of maximum individual freedom. As citizens, you are concerned with economic stability through means consonant with our American system. As bankers, you are interested in the preservation of a sound system of American banking and in helping to reach sound decisions on our great money questions.

All too often in the past it has seemed to me that the banking fraternity has not spoken out clearly and decisively with respect to the great and important money questions. All too often it has appeared to me that banking in general has taken a position of passiveness.

Now I believe is the time for bankers as well as all other citizens to look with suspicious eye upon attempts to restrict the area of individual freedom. On issues of monetary policy, banking opinion particularly should be based on full and complete understanding of the issues and on recognition of the joint roles played by commercial banking system and the central banking system of this nation. Having full understanding and recognition, banking should then speak out clearly and forcefully as to its own interests and the broad interests of the nation.

Meetings like this are characteristic phenomena of our kind of society. There are countries where they couldn't happen. In those countries the concept of individual freedom is outlawed and banished. If I have provoked your thoughts today I hope they have been turned in the direction of solving our money problems, which are the special care of bankers, by utilizing and, if need be, improving the means we have already adopted for sharing the responsibilities which spring from the unique character and powers of our private banking system - means which preserve in the American way the maximum of individual freedom.

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