

**BANKS AND THE BANKING SYSTEM**

1 September 1954

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Mr. Edward A. Wayne, First Vice President, Federal Reserve Bank of Richmond, was born in Eau Claire, South Carolina, March 1903. From 1936 to 1940 he was chief examiner for the South Carolina Board of Bank Control; in 1940 he was elected Executive Secretary of the North Carolina Bankers Association; and has been in his present position since May 1953. Mr. Wayne has been for several years a member of the faculty at the Graduate School of Banking at Rutgers University, has taught in the School of Business Administration at the University of Richmond, and was a lecturer in classes sponsored by the American Institute of Banking. In 1950 he was "drafted" by the Board of Governors of the Federal Reserve System as acting chief of the System's Division of Examination, later special adviser to the Board. He is the author of many articles on banking and economics that appeared in numerous financial journals, coauthor of "Municipals," an authoritative study of problems in municipal finance. This is his first lecture at the Industrial College.

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DR. KRESS: General Niblo, Miss Boutell, gentlemen: One of my faculty associate groups suggested that we might find some practical application of these things we are talking about in the "Wall Street Journal," and I am happy to concur in that recommendation. Also I would recommend the "New York Times" as being a little broader in its coverage.

We have had various doctors on this platform. There are various kinds of doctors. There are the M.D.'s described as moderately dumb; the D.D.'s, darn dumb; and the Ph.D.'s, phenominally dumb. Our speaker this morning is not cursed in that respect at all, judging from a careful reading of his biography. But Alfred Marshall, one of the great economists of bygone days, said that there were five qualities that an economist must have--perception, imagination, reason, sympathy, and caution. Our speaker this morning is a banker; I am sure those are the qualities of a banker as well as an economist.

I have not previously had the pleasure of hearing Mr. Wayne, but I have seen the film of which he is the narrator and which you will see this afternoon. You will then have a chance to challenge his views. Mr. Wayne is a great teacher as well as a great banker.

Mr. Wayne, it is a pleasure to welcome you to this platform.

MR. WAYNE: Thank you, Dr. Kress. General Niblo: I am honored to be on the platform. Last year this talk was given by Dr. Watrous H. Irons from Dallas. When I received the invitation, I wrote Dr. Irons and told him that somehow the first team must be involved in something else because the scrubs had been called in. I told him I would do my best to fill in for him and to please give me a lead as to how attentive the group was.

He said he had no difficulty at all, attention was quite keen, but he was not quite sure whether it was the scintillating comments of the speaker or the presence of the Admiral. This morning we will have to rely on the General and I feel fairly safe in that respect.

I am glad to be here to discuss with you the banking system. The banking system in America has grown and changed over the years to meet changing requirements and changing population, to meet the growth of America. It is not a planned system.

I am sure that each of us, if we made a study of banking or economics and were given a clean sheet of paper, would be satisfied in our own minds that we could develop a much better system than we have in America. I am not sure we could, but we all recognize that we don't have a clean sheet of paper. We never start with a completely clean sheet. We start with what we have. We start with the things that have grown up over the years. We start with the traditions of our fathers, the plans which they made.

I have been fascinated in my connection with the Federal Reserve System--which we think of as the key to the banking arch of America, the keystone--to look back in the record of the founding of the system and discover rather clearly that the men who built the system built many things that they were unaware of.

I suppose that is true with military science. I have heard it said that you get into trouble by fighting the last war instead of the next one. That, if true, it seems to me, is not limited to military science. It is true of economics; it is true of banking. In establishing the Federal Reserve System to meet the particular need of America, they designed something to meet an old need; however, they left it sufficiently flexible so that it could be dynamic and grow, to change to meet the needs of the new days. The commercial banks, too, have changed.

Let us go back and take a look at the banking structure in America and see what it is, what makes it tick. One thing you notice about the American banking system is the multiplicity of banks. That is, too, a phenomenon responsive to the American development. We pushed westward rapidly, opening up a continent. We pushed away from financial centers. Financial centers were abroad, as a matter of fact, and we undertook to develop a banking system that met our own needs. We were an individualistic people--still are, I like to think. The expression of that was the growth of a multitude of local banks, unrelated, unassociated with one another, each one operating as though it were the only bank in America, operating without regard for the effect of its operations upon other banking institutions.

As a result of that dog-eat-dog attitude within the banking system, some of the chapters in American banking make lurid reading. Some

make very interesting reading. Some of the comments of our slang expressions arose out of the experiences in the early days.

Take "wildcat banking," for instance--a little over a hundred years ago, banks in my home country--down in the Carolinas--issued a lot of bank notes which, it was hoped, would not be presented too soon. Agents for the banks were appointed and sent into Kentucky to buy whatever they could with the bank notes, but to buy far enough away so that the notes wouldn't be presented very soon. The agents said, "How far away?" They were told, "Go out there where there is nothing left but a few trappers and wildcats." Thus the expression "wildcat banking" was born.

The agents did exactly that. They went into Kentucky, Tennessee, and the Middle West, wherever they could buy something of value with banks notes; they bought it and brought it back to the East. The means of transportation were very primitive and slow. The bank notes were a pretty long time getting back for payment. There were terrific discounts and at times men suffered great losses. Traders couldn't even guess what the value of the medium of exchange was with which they were dealing.

The banks themselves attempted to cure the situation and established clearing house associations. The areas covered were scattered throughout the country and the associations demanded 100 percent of value. So American banking began the process of integration.

Then along came something that has been referred to as the Civil War and in some places as the War of Rebellion. Where I come from it is called the War Between the States. Out of that military trial of our Nation was born the national banking system. Up to that time, after the experience with two federally chartered banks--the First Bank of the United States, which got involved in politics, resulting in a refusal to renew its 20-year charter; and the Second Bank of the United States which not only got involved in politics but got involved with Andrew Jackson, and its charter definitely expired--we relied upon the banks with state charters.

Everybody believed that the establishment of the national banking system meant the death of the state banking systems, but they were wrong. The two systems have grown side by side until today we have just under 14,000 banks, of which 4,856--these are the only statistics I have so don't worry--are national banks and 9,125 are state banks, a total of 13,981, with perhaps 4,000 branches.

Now in addition to that total of commercial banks, there are 528 mutual savings banks concentrated in the Northeast, in Baltimore, and, strangely enough, in the Pacific Northwest. How that idea jumped clear across the country will be an interesting study if somebody will make it one of these days. But the mutual savings idea is primarily a New England idea. Such banks are very well established in New England and New York, with a sort of island of them in Baltimore, some very scattered ones, and then they jump all the way to the Pacific Northwest. They serve a particular need.

These parallel banking systems began to grow, and chartering became what one great American of another generation called "competition in laxity," everyone trying to see how many he could charter in competition with the other. When we came to the economic crisis of the thirties, we had about 30,000 banks in the United States. This led to a terrific weeding out process which came in the great depression. Subsequently and as a result of that experience, there developed new features of American banking which I will come to in a moment because I have skipped over one that I want to talk about.

As this tremendous spread of individual banks took place, the American people began to recognize that they needed some kind of unifying influence, and, as is frequently the case, they looked abroad. They looked at the English experience with the Bank of England; they looked at the experience of other countries and decided that, after all, we needed a central bank.

But again strong local pride was felt in the halls of Congress, so that in the establishing finally of a central bank in the United States--what we know as the Federal Reserve System--much of this strong local pride found expression in the nature of the institution which was established.

So we have as a keystone of our banking structure our Federal Reserve System, an institution (or group of institutions) which is partly public in nature but private in ownership. All of the stock of the Federal Reserve banks is owned by the member banks, but the United States itself has the residual interest in the event of dissolution.

You have a central bank with 12 more or less independent banks and one unifying board in Washington. Each of the 12 banks is operated by 9 directors, of which 6 are elected by the member banks and 3 are

appointed by the Board of Governors here in Washington. The Board of Governors in turn is appointed by the President of the United States, by and with the consent of the Senate. The directors of the 12 banks elect the officers. The officers "manage" the banks. The banks perform service functions as well as policy functions.

With that thought, let us move forward now to the depression of the thirties. In the great depression of the thirties, with the bank failures which resulted, there arose a strong undercurrent of demand for protection against bank failures. I have heard the failures of American banks during the depression referred to as the American method for the redistribution of wealth. I don't know whether that is a correct statement.

In a sense, transfer of property took place. Loans had been made and plants had been built. While many loans couldn't be repaid, the plants were still there. The productive capacity financed by these unpaid loans was still in existence even though many depositors suffered severe losses. Americans didn't like this system of "redistribution of wealth" so a new movement began to develop insurance of deposits and to restore and strengthen confidence in American banking. This resulted in the establishment of the Federal Deposit Insurance Corporation.

That is a quick rundown of the institutional structure of the American banking system. We have the national banks, which are chartered by the Federal Government; we have the state banks, which are chartered by the 48 States; we have mutual savings banks, which are chartered by the States in which they are domiciled. We have a strong sense of States rights pervading the banking system, so much so that the Federally chartered banks only have the branching powers, accorded to the state banks of the State in which they are domiciled.

Someone has suggested that we have, not one banking system, but 49; with the Federal Reserve System and the Federal Deposit Insurance Corporation superimposed upon all of them. Actually we have a rather effective banking system, fairly well adjusted to America's needs and preserving a healthy amount of freedom.

There are 6,753 members of the Federal Reserve System, out of 13,981 commercial banks. All national banks are required to be members. State banks may join if they apply and meet certain requirements. But those 6,753 member banks hold 85 percent of the banking resources of the country. This banking structure has grown very rapidly in resources in the last decade.

The total resources of the banking system of the United States as of 31 December 1953 were 219 billion dollars; total deposits, 201 billion dollars. The difference represents largely capital liabilities and a little borrowed money. The deposits are divided into commercial deposits--176 billion dollars held by commercial banks; 24 billion dollars, by mutual savings banks.

The value of the American dollar, its purchasing power, is of tremendous importance to you and to me as citizens. It is important to all of us, not only as individuals but in our official capacity. It is tremendously important to us collectively, for instance, in the purchase of requirements for the military services. What you get for your dollars is the value of the dollar. We have had to learn over the years the economic principle, which has been in the textbooks a long time but most of us are just beginning to learn it, that the value of money is an equation--a sort of uneasy balance between the amount of money on hand and the goods and services available for purchase.

Now the banking system by its very process of operation actually creates money, and that creative process can be a very disturbing factor. Let us take a look at it. What is behind your money? There were many people who felt that money consisted only of currency and coin. We have learned that bank deposits are money, even more effective than actual currency and coin because most of the business transactions of the country are effectuated--that is, settlement is made--through bank checks. So our money actually consists not only of money in circulation, but of deposits.

Take a look at what is back of it. We have demand deposits and we have time deposits. Together they make up this deposit structure which is the principal part of our money supply--deposits rather than currency.

Back of the demand deposits we have the assets of the banking system, a portion of which is required reserves. These reserves vary with the nature and location of the bank. A bank in a central reserve city would be required to carry 20 percent of its demand deposits on deposit with the Federal Reserve System. New York and Chicago, the money centers of the country, are the only central reserve cities.

The banks in reserve cities--Washington, Cleveland, St. Louis, Richmond, and so on--would keep 18 percent; all other Federal Reserve member banks keep 12 percent with us; and all member banks keep 5 percent against their time deposits.

The reserve requirements of banks which are not members of the Federal Reserve System are determined by the laws of the chartering State and usually consist of vault cash plus deposits in other banks.

These required reserves of member banks--deposits which these banks keep in the Federal Reserve banks: 20 percent, 18 percent, 12 percent of demand deposits, and 5 percent of time deposits--plus notes in circulation constitute the principal liabilities of the Federal Reserve banks.

Against those two items, member bank reserves and notes in circulation, we in turn must keep a minimum reserve of 25 percent in gold certificates. The gold certificates are nothing more than warehouse receipts for gold bars at Fort Knox. This gets complicated. The title to this gold rests in the United States of America. The Treasury issues certificates to us and we must hold these to meet our gold reserve requirements; for the difference between the gold certificates and the total outstanding liabilities, we must hold other assets--mainly Government securities.

So back of currency in circulation there must be at least 25 percent in gold; the balance must be in either Government securities or so-called eligible paper. There is so little of that today I won't even mention it.

Back of deposits there must be these percentage reserves on deposit with the central banks; against those reserves, the central bank must in turn keep 25 percent in gold. So the key to the ability of the banking system of the United States to expand and the influence which might force a contraction is in the final analysis, gold. Only in a multiple of four of the gold which we hold, monetary gold stock, can we multiply the reserves; in turn, the banking system can multiply deposits only as a multiple of bank reserves. Therefore, if society, or the Government, or society through the Government can affect the supply, availability, and cost of reserves, the ability of the banks to expand the money supply can be influenced.

The process is not a simple one, nor can the results of any action be forecast accurately. We have no buttons to push. Reserves can be restricted and the effect is likely to be quickly apparent. But sometimes reserves are made available in volume and little, or nothing significant, happens. In the final analysis you are dealing with people and one cannot know what they will do.

Perhaps we can understand this better if we use the historical analysis method.

Our money supply consists of currency outstanding, time and demand deposits in banks. In 1939 our money supply aggregated 63 billion dollars--6 billion of currency in circulation outside banks and 57 billion of deposits in banks. That was the money supply of the United States in 1939--1939 has been selected for obvious reasons. It is the last year of an old world that is dead. With World War II we emerged into a new world. I don't know whether it is a better world, but it is a new one--of that I am quite certain.

By 1945 our money supply had grown to 151 billion dollars. It is rather natural that during war years--when people were torn loose from their moorings, due either to transfer in military service or to industrial workers moving to strange places--demand for currency grew. People had more currency. Some of it went in the ground; it is still there. Some of it went abroad; it is still there. A terrific expansion took place during the war years. Currency in circulation went from 6 billion to 26 billion dollars, but bank deposits went from 57 billion to 124 billion dollars.

Many people thought at the close of World War II that this money supply would begin to contract, that the banking system would draw back to the dollar figures which it represented before the war. It couldn't be. During those years, we became quite disturbed over the feeling of banks that the growth which had taken place during the war would go away. And their whole policy was being geared to that concept of their system. In our own district--the Fifth Federal Reserve District, which includes Maryland, Virginia, the District of Columbia, West Virginia, and North and South Carolina--we went around, sat down quietly with bank officers all over the district and said, "That cannot be; here is why it cannot be. You must gear your approach to these postwar years in terms of an entirely different concept. We are not going back." They were a little skeptical, but time has shown we were right.

Presently, the money supply, instead of being 151 billion dollars as it was at the end of World War II, is 199 billion dollars. Currency in circulation has changed very little, from 26 to 27 billion dollars--fluctuates within that billion range. But bank deposits have gone from 124 billion to 173 billion dollars. Why? Where did it come from? It came from the loans and investments of all banks, the creative process of the banking system itself.

The bankers of the country saw clearly that during the war years their purchase of Government securities was paid for by crediting the account of the Treasurer of the United States. They saw the rise and the direct relationships, one with the other. Let us take a look at how it actually followed.

Back in 1939 loans and investments of all American banks were 50 billion dollars--19 billion in United States Government securities, 9 billion in other securities, and 22 billion in loans. During the war years, from 1939 to 1945, the banking portfolio of Government securities rose from 19 billion dollars to 101 billion dollars; other securities were unchanged, while loans rose from 22 to 30 billion dollars. The terrific expansion of the money supply during the war years resulted from the purchase of Government securities by banks, and the credit for the purchase to the account of the Treasurer of the United States.

You can see that when the Treasury spends the money, it merely changes hands. It doesn't disappear and it will not disappear unless and until the instrument which created it is itself extinguished and taken out of the banking system.

That is well understood with respect to public borrowing. But, where did the postwar increase come from? Since the war, the loans and investments of our banks have grown from 140 to 173 billion dollars; holdings of Government securities declined from 101 billion to 73 billion dollars, other securities rose from 9 billion to 20 billion, and loans went up from 30 billion to 81 billion dollars. So it doesn't matter whether the debt is public or private, the process of the banking system itself actually creates the money supply.

Obviously, there has to be some kind of an influence on the part of society to either restrain or encourage, whichever may be in the public interest--that kind of process. So the Federal Reserve System is charged, as the principal monetary authority of the country, with trying to influence the activities of the banking system in that respect. And the way we do it is, as I mentioned and pointed out in the early diagram, in the influence which we have over bank reserves.

There are three principal ways in which the banking system is influenced by the Federal Reserve System. We think of those as the three principal tools of monetary policy. You will recall in the earlier diagram that banks were required to keep certain reserves, certain of their resources on deposit with the Federal Reserve System on a

percentage basis. The Federal Reserve Board in Washington is empowered to change those requirements up or down within certain fixed limits.

They may, for instance, lower reserve requirements in central reserve cities to--if they saw fit to do so--13 percent, or if occasion demanded, they might increase those reserve requirements from 20 percent to as high as 26 percent. So there is a range from 13 to 26 percent, and they may vary the reserve requirements within that margin.

The effect of a system like that is pretty obvious. In the first place if reserve requirements are raised, then such free reserves as the banking system may have become required reserves and immediately tighten. The second thing it does is change the multiplier. Whereas on a dollar reserve at 20 percent a bank can support a five-dollar deposit; if it is at 26 percent, it can only support a four-dollar deposit, or your multiplier is contracted. If you lower requirements, the multiplier is expanded. That is one potent instrument of monetary policy in the banking system.

It has been referred to as a "blunt axe" because it hits all banks alike; the interesting thing about America is that America isn't all alike. The needs of California may vary sharply from the needs of Maine. They are not only far apart geographically, they are separated almost as widely by tradition. They are separated almost as widely by their philosophies. It is a great diverse country and when you use a tool like that, it strikes home.

There is another tool that can be used. We can change the discount rate, the cost to banks to obtain reserves. Banks can obtain reserves by borrowing from us.

We have been talking about bank reserves --(placed cards on board). Let that represent reserves, if you will. Actually, we are not talking about total reserves; we are talking about the amount available above the required reserves because part of the total reserves which they hold are not free for use. They have to be kept at the central banks. If we change the required reserves--let us assume this is total required reserves--only this part above the required reserves line is free to be used by the banking system.

Let me run through just a moment how that actually works. Let us assume Riggs National Bank has a million dollars in free reserves.

Bankers don't like reserves lying around because they are getting no earnings on them. So Riggs wants to put that million dollars of free reserves to work and seeks somebody who will want a loan of a million dollars.

Let us assume that bank loans a million dollars to the Chrysler Corporation and its principal account is in Detroit. With the million dollars in free reserves, Riggs loaned a million dollars to Chrysler Corporation out in Detroit. Now Riggs doesn't have a million dollars in free reserves. The bank in Detroit has a million dollars on deposit and it has a million dollars in reserves. But, since the bank got a million dollars in deposits, it has to keep 200,000 dollars in reserves against it, so the banker has 800,000 dollars in free reserves which burns his hands. So he looks around for somebody to lend 800,000 dollars to. You can always find somebody in Los Angeles who wants to borrow 800,000 dollars. So he loans 800,000 dollars to the Gray Development Studios. The proceeds are transferred to a Los Angeles bank and it now has 800,000 dollars on deposit and 800,000 dollars in reserve. That Los Angeles banker must keep 160,000 dollars against the 800,000 dollar deposit, but he has 640,000 dollars burning his pockets, and he looks around to see where he can loan 640,000 dollars. When the whole process has been carried down to the final point, you have 5 million dollars in new money, new deposits; the banking system has created 5 million dollars in new money (and earning assets!) against a million dollars of free reserves. Simple, isn't it.

But suppose the Federal Reserve System intervened--what then? If it is felt that the banking system should not expand, the Board might raise the reserve requirements. In that way the million dollars in free reserves becomes required reserves. In our hypothetical case Riggs had a million dollars in free reserves, so it would not be affected except it could not have made that loan. But, assume a banker in, say, Dallas didn't have any free reserves at all but his reserve requirements went up at the same time. What does he do? He borrows it. He sends his note to the Federal Reserve Bank of Dallas, which credits his reserve account. He now has a million dollars in reserves to meet his needs when we raised his requirement.

(Some of the bankers think this is a little bit crooked. They think we raise their requirements, loan them the money, and charge them for it. We won't go into that side of it.)

At the moment our discount rate is 1.5 percent. Our Dallas banker borrowed that million dollars; he got the reserves all right, but it cost him 1.5 percent.

Suppose the situation is such that the monetary authorities feel they really want to tighten it down a bit more. We could raise the discount rate from 1.5 to some higher figure.

Now it is costing him even more than he counted on, so he is subject to additional pressure. He tries to get out of debt. There are two pressures at work: One is the economic pressure of cost and the second, a very potent one, is tradition. Traditionally, an American banker does not like to be in debt. You can rely on that traditional attitude--he is going to repay quickly. But how?

His search for means of repayment begins immediately. Perhaps he calls a loan he has out or it is coming up for renewal and he notifies the borrower that he has to pay off the loan. The borrower begins to look around for some other bank to take over the loan and if he finds another one that wasn't caught short by this raise in requirement and still has some free reserves, he borrows money there and pays off the Dallas bank, and the Dallas bank pays us. But if there are no free reserves anywhere, our multiple expansion process must go into reverse and contracts the deposit totals until they reach a figure which the available reserves will support.

In practice, our Dallas banker would seek to replenish his reserves by selling securities rather than calling loans. He would call the dealer in New York and say, "Sell a million dollars worth of securities." If the Federal is in the market buying, reserves would go up by the fact that we bought the securities. We pay for them by crediting some member bank's account. No matter from whom we buy, payment is in the form of a credit to bank reserves. Conversely, when we sell, bank reserves are reduced because payment to us will be in the form of a charge to some member bank's reserve account.

Those are the three influences: Buying and selling securities on the open market because that process creates or destroys reserves; the cost factor--that is raising or lowering discount rates which affects the cost of banks' borrowings; and changing the multiplier--raising or lowering reserve requirements. Those three things, used, I hope, with some degree of intelligence and adroitness by the monetary authorities are designed to influence the banking system.

The most sensitive and the most potent of the three tools and the one which most directly influences the banking system is what we call "open market operations," simply the buying and selling of securities-- United States Government notes, bills, and bonds, mostly bills, on the open market.

The reason open-market operations is the most potent is because it is sensitive and affects directly the banks that are most responsive to the change which you want to bring about at that particular moment.

Let me go back a little. You change reserve requirements, it affects all banks but in different ways, depending on their reserve position at the time. You change the discount rate, it affects those that are borrowing. Ordinarily most banks are not borrowing and have no desire to borrow. Its only effect upon them is psychological.

But when you buy on the open market, the funds released naturally flow immediately to the person who wants them because he was the seller. He wouldn't have been in the market selling if he hadn't wanted the money. On the other hand, when you sell, you can only sell when somebody wants to buy, and the individual or banking institution in there trying to buy had decided not to utilize those reserves in other ways and is seeking to employ them in the market. It is very sensitive because it reaches directly the point of need one way or another.

It also can be used quietly. The other two are publicized from the housetops, but this one you don't have to tell anybody what you are doing. Wait and let them find out; you would be surprised how long it takes for some of them to find it out, too. At any rate, you use it, and it is quite effective.

But there are inhibiting factors. One is the effect which it has upon the price in the market. The System buys and sells on the market without primary regard to price. Our actions are designed to influence the banking system by providing reserves or extinguishing reserves. In any free market in the world of any kind, a selling pressure will depress prices and a buying pressure will move prices up. It is just an axiom of the market place.

So if we move into the market to sell, we depress prices and when you depress prices, you increase yield; when you increase yield, you increase the cost to the businessman to borrow and to utilize credit in

expansion--this is a deterrent to him because some operate with very high break-even points and very close margins. Thus it has an effect far beyond the price factor. With the growth of the Federal debt, we can't overlook the fact that any violent gyrations in the market have a terrific psychological effect upon a great number of people. This great Federal debt of ours is held by banks, by insurance companies, by corporations, by endowment funds, by trusts, and by individuals, and their whole psychological approach to the future is affected by what they believe is going to happen, not by what is going to happen because nobody knows, but by what they believe is going to happen.

When we move into the market and sell regardless of its effect on price, we must take into account these long-range effects and we can't go quite that far.

That is the banking system of America. It is made up of a vast number of banks scattered across the face of the land. It has grown like Topsy. It renders a service. Its only reason for existence is the service which it renders.

One of the early texts that I studied in banking--I don't remember much else of what was in the text, but this I remember--said: "The wants which banks supply are simple in kind and sure to arise early in the development of any commercial or industrial people where there is mutual confidence among men." I think that is an almost verbatim quote from the text that I really haven't looked at in 30 years.

Let me spell out what those wants are. One of those wants is a simple, expeditious, economical process for transferring values between people, for transferring the value which your work has created to somebody else in exchange for the value which his work has created. Another want which banks supply is an economical, expeditious, and reliable means of transferring values between places, from one place to another. And the third, a simple and reliable process for transferring values in time. Those are the wants which banks supply, a medium of payment between people; a medium of payment between places; and a transfer of values in time.

You and I as individual citizens attempt to save. We practice thrift, acquire something, in terms of life insurance if nothing else, in terms of savings accounts, in terms of what have you against tomorrow. We try to take the value created by our labor today and store it so that we or somebody else can enjoy tomorrow. That is what I mean by transferring values in time.

When we come to this question of transferring values in time we reach a point where society becomes tremendously involved. That is just another way of saying "maintaining the value of the dollar," because if the value of the dollar fluctuates greatly, these values do not last in time. So we try through these different processes to establish some kind of stability, not a static, dead economic world, but a dynamic world where expansion of ideas and processes is possible by at least some measure of preservation of these values in time. Those are the wants which banks supply.

I have tried to give a quick rundown. If you have any questions I will be glad to answer them.

CAPTAIN MOTT: Gentlemen, I am sure with such an opening presentation here so far, there are probably numerous questions in your minds to ask. Mr. Wayne is ready for your questions.

QUESTION: You mentioned 25 percent gold reserves which is held. I have a lot of confusion in my mind as to whether that gold is against currency or bank credit?

MR. WAYNE: Both. The 25 percent requirement is a minimum requirement. As a matter of fact, our actual gold reserve is 42 percent at the moment, but against the liabilities of the Federal Reserve bank, either in notes or deposits, we must hold not less than 25 percent in gold.

Deposits, of course, are interchangeable. A bank may withdraw its deposit in currency. All it would get would be another liability of the central bank. The note is a liability the same as a deposit, but we still have to hold the 25 percent minimum in gold against either a deposit or currency.

QUESTION: Mr. Wayne, I would like to hear some comments as to what is the purpose and reason for the United States commitment to pay a fixed price for gold in the market. How does it affect that first diagram?

MR. WAYNE: The payment of a fixed price for gold maintains at least one constant factor in an involved equation. Political questions are involved, foreign as well as domestic. The fixed-dollar price of gold is useful in settling international balances. In dollar terms of

course you realize and so do others, as the purchasing power of the dollar changes, the real value of gold changes. If you change the dollar price of gold--as we have done once in this century--you change the value relationships in this equation all the way down the line. It takes some time for it to permeate, but it nevertheless will.

The principal reason for changing it would be to reflect a change in the value of the dollar relative to other currencies. Then you get into the question of how often you are going to change the dollar price of gold and frequent changes impede trade.

Another point in passing--reference to a 52-cent dollar simply means that in terms of 1939 prices, you can buy 52 cents worth of goods; in terms of 1945 prices, 83 cents worth; in terms of 1835 prices, the dollar is probably worth about 10 cents.

QUESTION: Will you give your opinion as to the possibilities of going to the pound dollar and its effect on Britain if that were done?

MR. WAYNE: I assume the question refers to establishing free convertibility between the pound and the dollar. I don't believe I could give a competent answer to that because I am not close to the field of international finance, but a "horseback" opinion is that it would be determined very largely by the enormous sterling balances blocked in Britain. The desire on the part of many of these countries to convert frozen pound balances to the American dollar would impose a severe strain on British gold reserves. Convertibility would certainly tend to draw the dollar area and the sterling area closer together in an economic bloc. It would tend to free the exchange of goods and services between the two and enlarge the area of multilateral trade.

It is highly desirable, but the problem in accomplishing it--to transfer balances built up in Britain during the war when expenditures were made in sterling area countries by the United Kingdom and paid for by blocked balances of pounds in London--is that when you draw them out you have to transfer either goods or gold, and Britain may not have enough of either.

QUESTION: You spoke of the undesirability of wielding the so-called blunt axe. Has it been done?

MR. WAYNE: The blunt axe approach is extremely useful at certain times when you want a quick and nationwide effect. It has been done more or less frequently.

Specifically, in the early months of 1953, in our projections of the needs of the banking system, we had to make some guesses--I don't know how reliable they are, but we had to make them--as to what the reserve requirement needs were going to be. We took a look at the gold flow. Gold was flowing out of the country. When gold goes out, dollar reserve goes out. We thought it might continue for a while and it did. We thought that the return flow of currency would help--you see at Christmas time currency goes out of banks, currency in circulation rises in December and falls in January. As it falls it adds to bank reserves, because when it comes back into the bank for redeposit on account it becomes a reserve. So we made all these guesstimates, took a look at what the Treasury needs would be, and decided not to supply reserves to the market. The market got rather tight. Of course some market analysts insisted there was a connection between the change of Administration and that policy, but I won't go into that one.

At any rate in the early months of 1953, we didn't supply reserves to the market, the Treasury offered a long-term issue, and things began to happen in the money market. There developed such a tense situation, with a pretty sensitive market, that people began to believe that a tight-money policy was going to be pursued to a point where there would be a real contraction.

We began feeding reserves into the market by buying bills. The first move was in--don't hold me to an exact date; I have forgotten--the last week in April; we bought about 80 million dollars in bills which provided 80 million dollars in additional reserves, an exact reversal of a tight-money policy.

We moved into an easier policy, but the market was still tight. We waited a while then bought 100 million dollars' worth of bills. It was still real tight, so we waited a week and went in again and bought another 100 million dollars' worth. We actually purchased between 4 and 5 hundred million dollars in bills, creating that much additional reserves, and the market still acted like it didn't believe we were doing it. Then reserve requirements were reduced across the board. The sum of 1.2 billion dollars in reserves was freed.

We could have continued to supply reserves by working in the market, but it was felt desirable to explain to everybody that we were not pursuing tight money willy-nilly. So we changed the reserve requirements and everybody was hit at one time; everybody said, "They mean what they were trying to say quietly for the last two months."

QUESTION: What is the reserve requirement percentage today?

MR. WAYNE: The current figures are 20, 18, and 12 percent of demand deposits--5 percent of time deposits.

QUESTION: You have reduced it?

MR. WAYNE: Yes, they have been reduced. Up until a little over two years ago reserve requirements in central reserve cities was 24 percent; reserve cities, 20 percent--they have been as high as 21.5 or 22 percent; and in banks outside central reserve and reserve cities, it was 14 and is now 12 percent.

QUESTION: Has there been any attempt on the part of the Federal Reserve to limit the size of particular banking institutions? I was thinking about the operation of the Bank of America on the Pacific Coast which extends from California to Washington?

MR. WAYNE: It sure does. It is a big one. The only attempt on the part of the Federal Reserve System which might be interpreted as designed to limit the size of an institution dealt not with its size per se but was on the question of monopoly and whether or not the relative size of the institution in terms of total credit and banking structure of the area which it serves is such as to create a credit monopoly. There would be a reluctance on the part of the Federal Reserve System to see that develop.

Your question may perhaps be prompted by the suit which the Federal Reserve System fought with the Transamerica Corporation over a long number of years and finally won and then lost, concerning the Bank of America.

The basis of that suit was fundamentally monopoly, but it does not deal directly with the size of the institution at all. It deals rather with the monopolistic control of the credit of an area through a holding company device in which there would be preserved the appearance of competition but it wouldn't be real because this one holding company would control enough credit to have monopolized the area.

The only interest of the Federal Reserve System is the question of monopoly. Its only power is very vague and uncertain and involves primarily the use of the holding company device.

QUESTION: You have explained the banking system. My question concerns the fringe area, such as FHA and RFC. Are those truly banking concerns and, if not, would you comment on just how they operate through the banking system?

MR. WAYNE: The Reconstruction Finance Corporation--recently buried and replaced now by a new organization, the Small Business Administration--was in a real sense a banking institution in that it made loans directly. The source of its funds was the Treasury of the United States. The sources of Treasury funds were either by taxation or borrowing. The borrowing itself would create credit in the banking system. So the Reconstruction Finance Corporation was a banking organization insofar as creating credit is concerned; not on the supplying of this basic transfer of values directly but through the Treasury.

The FHA, and there are two agencies that use the same initials--one is Federal Housing Administration and the other is the Farmers Home Administration; both operate on the same basis as they are insuring or guaranteeing institutions.

Many of the loans for which there is a strong demand in terms of housing may run for a period of time beyond what was traditionally believed the appropriate range for the investment of bank funds. I mentioned that those who founded the Federal Reserve System built they knew not what. They dealt with self-liquidating paper. The general belief was that commercial banks should only make loans which, by the very process itself, would be liquidated within a short period of time. That concept carried over not only in banks and with bankers but in life insurance companies, trust funds, and the like. For generation after generation they wouldn't make those loans.

Frequently you have what appears to be economic problems and you run into social problems. There was a very great shortage of housing in America and there were tremendous demands for credit on "easy terms."

On one side you have an unsatisfied demand for housing; on the other side you have men seeking work. If adequate credit can be made available, both "wants" may be satisfied. Spreading the risk by means of Government insurance made such obligations attractive to lenders. Thus the demand became an effective demand. There is no end to the wants of man; the problem is to make the demands effective. You would make the demand for housing effective by putting it in terms of payments

buyers could make. The insuring agencies do not extend credit and they are not banking institutions at all.

QUESTION: I am confused as to who it is that is making these decisions. Who is making these decisions? Where can I take my vote if I don't like it?

MR. WAYNE: You have no doubt read various statements about the independent Federal Reserve System. We have been asked to define what we mean by independent, independent of whom? Primarily it is independent of the executive but responsive to the legislative branches of the Federal Government.

Mr. Humphrey's decisions, as the Secretary of the Treasury, deal with what we speak of as fiscal policy. Fiscal policy involves anything in the area of taxing, spending, and debt management.

Taxing is fixed by the Congress; spending, too, is fixed by the Congress; and in between the two there comes debt management arising from the necessity of covering the spread between taxing and spending. The nature of the resulting debt and the terms of Treasury financing have a great many effects upon our economy. Whether the debt is held by firm investors or allowed to enter the banking system and build up the money supply, has a direct effect on the monetary situation.

When I say "we" that is an editorial expression. I have very little to do with policy decisions of the Federal Reserve System. I am charged with running a bank. The Federal Reserve System is made up of three parts. There is the Board of Governors in Washington, composed of seven men appointed by the President of the United States, by and with the consent of the Senate. The members of the Board are appointed for terms of 14 years and cannot be removed from office except for misfeasance in office. The terms are so arranged that one term runs out every other year so that there is a slow, gradual change in the composition of the Board of Governors of the Federal Reserve System.

The Board of Governors, these seven men, in their own province decide to raise reserve requirements or to lower reserve requirements. That and many other decisions are solely within the province of the Board.

I mentioned the 12 Reserve banks, each having 9 directors. These 9 directors initiate changes in the discount rates. If these 9 men at

Richmond decide that the discount rate should be raised, they will take action to that effect, but they can't raise it without the approval of these 7 men in Washington. On the other hand, if the Board in Washington says it ought to be raised and the 9 directors say, "We are not going to raise it," it is not quite clear how to overcome that impediment. It hasn't happened.

Open-market operations are controlled by another organization of 12 men, 7 of whom are the 7 members of the Board of Governors. The other 5 are elected by the 12 boards (of 9 directors each) of the Reserve banks and must come from among the 12 presidents of the 12 Reserve banks or the 12 first vice presidents. From that group of 24 men, the other 5 are selected. I think you will be interested in how it actually works out in practice.

The president or first vice president of the Federal Reserve Bank of New York is--not by law but by agreement--always on this 12-man open-market committee, because New York is the money market and the men there are closest in touch with it. The other 11 districts are divided into 4 groups. Cleveland and Chicago are together, and each year that membership in the open-market committee alternates between the president of the Federal Reserve Bank of Cleveland and the president of the Federal Reserve Bank of Chicago. The remaining 9 districts are divided into three groups of three each. Boston, Philadelphia, and Richmond are by agreement in one group. So one year the directors of the Richmond bank vote for the election of the president of the Boston bank; the next year, they all vote for the president of the Philadelphia bank; the next year they all vote for the President of the Richmond bank; and so it moves among the three banks.

Thus you have in effect a group of men in close touch with the 12 districts all over the country sending 5 as a minority of a board of 12, with the 7 here in Washington appointed by the Executive with the consent of the Senate, who make the decisions in regard to open-market operations. You have an attempt to combine public and private interests, national and district levels, into a coordinated, cooperative, and, we hope, effective group.

Now do you follow who "we" are? That is what is meant by an independent Federal Reserve System. It was deliberately designed that way by the founders who believed that if the central bank with its power to create reserves was made completely responsive to the Executive, then the perfectly natural desire of the Treasury to borrow at

the lowest possible rate would result in what happened here during the war years; it will inevitably happen during war years, namely, that voluntarily the central bank will abdicate its complete independence in terms of the national need. But the reason for not making it completely answerable to the Executive is because it places too much power in one individual.

The Bank of France is a good example of the tie-in where the Minister of Finance and the president of the Bank of France is one individual. It is very difficult for him to separate himself.

CAPTAIN MOTT: Mr. Wayne, I regret the time has run out. There are still questions but we can't possibly allow any more of them. On behalf of the Commandant, the faculty, and the student body, thank you very much. I am sure we know more about this subject of money than we did prior to this lecture.

(12 Oct 1954--250)S/sgb