# BANKS AND THE BANKING SYSTEM

30 August 1955

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Publication No. L56-9

INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

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 was elected Executive Secretary of the North Carolina Bankers Association; and he has been in this 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 Advisor to the Board. He is the author of many articles on banking and economics that appeared in numerous financial journals, co-author of "Municipals," an authoritative study of problems in municipal finance.

# BANKS AND THE BANKING SYSTEM

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GENERAL CALHOUN: General Hollis, gentlemen: Our speaker this morning is not only a banker of considerable experience but also a very excellent instructor and teacher in the art of banking.

He will talk today on the subject of Banks and the Banking System and will touch on credit instruments and credit transactions as well as on the bank itself.

He has combined a career of practical banking with that of teaching both in the university and in the American Institute of Banking. You have a copy of his biography. He should be well known to you. This is his second lecture at the Industrial College.

It is a great pleasure to introduce Mr. Edward A. Wayne, First Vice President of the Federal Reserve Bank of Richmond. Mr. Wayne.

MR. WAYNE: Gentlemen, I was saying to the General this morning that I was honored with the invitation to be with you last year. I came on that occasion on the recommendation of others. I was surprised to be invited to return this year. I may have traveled last year on the railroad of others, but the General said this morning, "Today you are on your own." That always leaves you just a little bit uncertain. It is better to be able to travel on others' tracks at times than on your own. But I welcome an opportunity to talk to you about banks and the banking system, credit transactions and credit instruments.

Bankers are essentially dealers in debt. In this day and age we have come to recognize that our monetary system is a debt system. There have been times in the history of man--and they may come again--Who knows?--when dealers in debt were certainly not acceptable in all circles of society. We hope that day has passed. The American banking system, though, like all other banking systems, is essentially a system dealing in debt.

The structure of the system itself is unique to many banking systems of the world, just as other facets of the American economy are different from the other nations of the world. Our banking system, the nature, the type of the system, the structure of the system, is responsive to the type of country we have and to the mores of our people.

We have been from the very beginning an individualistic people. We may be in many ways becoming less individualistic as the population grows and as we are thrust closer and closer together in large groups of people, as our States grow, as we become more of a social unit than we were in our early days; and it might be that if our banking system were developed from scratch, from a clean sheet of paper, under the conditions of today, we would have a very different system from the system we have. We never start with a clean sheet of paper. Our institutions are developed to meet a particular need and, as the need changes, our institutions either change with the need or do not and are replaced by other institutions.

As a background we might spend the first few moments running briefly over the development of the American banking system. That, in itself, explains why we have the kind of system we have.

We were 13 isolated Colonies, not only isolated in a very real sense from the rest of the world but in a very large sense isolated from each other. We were agrarian. We were the producers of raw materials. We were not a trading nation, except in the sense that we produced raw materials for export, largely to British markets. Financially, in the early days, our centers were London and other British cities.

The development of the country was financed largely by foreign capital. As a matter of fact, it was not until World War I that we became a creditor nation. Throughout the whole history of this country until 1918 we were a debtor nation. The railroads of this country, as they stretched across the continent, were financed by foreign capital. The development of our industries, textiles particularly, and later others, was based upon foreign capital. With importation of capital from abroad, we were a debtor nation.

One of the things that resulted, was a distrust of concentrations of power--financial, economic, as well as political--and so our American system began with the distrust of concentration of power. It was developed out of a great deal of local pride and very strong sectionalism--some may call it provincialism, perhaps correctly so.

Individualistically, each locality developed its own bank rather than rely on distant institutions. Some of the slang phrases in our vocabulary today are derived from our early experience with banking. I suppose most of you have heard the term used in describing something of little value, saying it was not worth a "continental." That came of course from the fact that we used in the Revolutionary War a form of nonsupported currency known as continentals, which rapidly became worth nothing. To appraise something of no value they said, "It is worth a continental"--worth nothing. The phrase survived to this day, though continentals did not survive. The first bank was organized to assist in financing the Revolutionary War--organized at Philadelphia.

Banks appeared as cities developed--cities with populations large enough to support banking institutions--Philadelphia, Boston, New York, Charleston, Baltimore--places of that kind.

Very early after the independence of this country we experimented with the establishment of a central bank--the form of a central bank--at least a bank with a Federal charter--the Bank of the United States, which has come to be known historically as the First Bank of the United States, because there was subsequently a second one.

The bank was chartered with a twenty-year life limit. It got involved in politics and the charter was not renewed. About the time that charter expired, we became involved in what some people came to know as Mr. Jefferson's War--otherwise historically known as the War of 1812. It became immediately necessary to experiment again with a banking institution, so there was organized the Second Bank of the United States. That bank also became involved in politics, in fact, it became involved with Andrew Jackson. Its charter very definitely expired; and it was a long time before any further momentum gathered behind a central bank.

We then moved into the era which we know in banking as the State banking era. Under our doctrine of States rights, the autonomy of the several States was carried to the nth degree in the financial field. The States insisted that they alone had a right to charter banks. (There is still a feeling in this country in some places that only the States should charter banks.) At least the States issued banking charters. I am not quite sure that what they chartered were banks. Some of them were.

These early banks were principally banks of issue, rather than banks of deposit. The main profit in operating a bank was to secure the note-issue power and to extend credit in the form of your own obligations. I remind you again that banks are dealers in debt. They merely exchange their own debt for the debt of another.

In the early days, when a merchant, or importer, or farmer came into the bank to borrow money, it was a very simple transaction, in that they accepted his note for so many dollars, for which they made a charge. So they exchanged their debt, which was better known than his debt. It may not have been better supported, but it was better known than his debt, and it would at least circulate as money, whereas his debt would not circulate as money.

Credit instruments on both sides of the banking picture, both the obligation issued by a borrower, whether it be in the form of a note or a bond, and whatever instrument you use, are merely an instrument of debt which is exchanged for another instrument of debt; the difference being that these instruments of debt for which the individual or corporate obligations are exchanged are instruments which circulate today freely and which circulated in the early days, I should say, more or less freely--some much less freely than others.

There is another term in our vocabulary of today which comes from our early banking experience. I refer to the term "wild-catting." That is a banking term which originally was known as "wild-cat banking," and came from the early banks of issue down in my home country. I suppose you have already gathered I am from the South. Somehow people can figure that out. I don't know how. Some of our Southern States are responsible for the term "wild-catting" or "wild-cat banking." Banking charters were secured with the right to issue notes. These banks wanted to get their notes in circulation and didn't want them to come back too fast for payment. They had to be paid in specie--hard money--but there was a limited supply of hard money. We suffered for a long time from the shortage of hard money. (Some people think we are still suffering from it.)

These banks wanted to get the notes in circulation, but didn't want them coming back for payment right away. They appointed agents to circulate them at distant points. The agents went out into the wilds of Kentucky where it was said there was no one but "trappers and wild cats;" so the term "wild-catting" came into our vocabulary.

It was frequently true in those days that notes would come in with a demand for hard money, for gold and silver, and the banks didn't have it. So the notes were traded at a discount. Bank notes would be quoted at all kinds of discounts--some of them at 100 cents on the dollar; a few of them at 98 or 97 cents; some at 95, 90, or 85 cents; some at 60 cents. Merchants at distant places had no way of knowing the value of the debt instrument they were dealing with.

The banks undertook to clear this up among themselves. Most of those engaged in the banking business were men of high moral and ethical principles. These men determined to do something about it. They organized as the integrating influence in American banking the clearing house, which originated in New England. The purpose of the clearing house was to insure that the outstanding bank notes to all members of the clearing house were circulated at 100 cents on the dollar.

In order to join the early clearing house, a bank had to satisfy the clearing house that it was in a position to meet its obligations. The notes would come into one central bank which served as the clearing bank for the clearing house. They would be presented to the issuer with a demand for specie, to be sure it lived up to its obligation. The purpose of the clearing house today is largely to clear checks, which have become the circulating medium, rather than bank notes.

Then there came an incident known in some sections of the country as the "War of Rebellion." In other places it is referred to as the Civil War. The correct term obviously is the War Between the States. In that incident the United States Government found itself in need of financing and a new and very important segment of the banking system of America came into being--the national banking system.

I have already mentioned the experience of the First and Second Banks of the United States. For thirty years the States alone exercised the right to issue banking charters. Then the Federal Government stepped in, asserted its right to issue banking charters, and chartered the national banking system to provide a circulating medium of nationwide acceptability. National banks were permitted to issue notes only to the extent of capital. They were permitted to take the full amount of their capital and buy special-issue United States Government obligations which they in turn pledged with the Treasury of the United States to guarantee the payment of those national bank notes.

Another form of circulating medium appeared during that same period in our history, which again accounts for an additional word in our vocabulary. The Federal Government issued noninterest bearing United States notes which happened to be green in color, and they became known as "green-backs." Some of them have never come in and are shown on the Treasury Department daily statement as outstanding. From them came the term "green-backs" by which slang term we know our currency today.

With the development of the national system, many expected the State banking system to disappear. As I mentioned, our early banks were essentially banks of issue, rather than banks of deposit. In order to, in a sense, protect the national banking currency, an exorbitant tax was imposed on the State banks, which meant the State banks could no longer issue their notes. Out of that development, the banks concentrated on deposits with the result that the principal circulation medium came to be checks rather than bank notes. So, rather than having abolished the State banking system, the two systems have grown side by side through the years.

There developed in the early days of this century what was sometimes referred to as "competition in laxity" in the chartering activity of the national-versus-State systems. A national bank or a State bank would be chartered in some town, whereupon a group of people would go to the other charter authority and get a charter from that one. Thus a town which hardly needed one bank, would suddenly find itself with two banks.

This charter situation reached such scandalous proportions in the early days of the century that, when we moved into the sharp depression following World War I, we had 34,000 banks in this country. Perhaps this was an expression of individualistic community pride, typical of America.

You may be interested in comparing the growth of these two systems. Following the sharp recession of the twenties and the real depression of the thirties, we had a terrific house cleaning in the banking system. Mergers followed liquidations. Today there are 13,840 banks in the United States; or, to be correct, on 31 December 1954, there were 13,840. On 29 June 1955 there were 13,782.

We have seen right before our eyes another rather significant change in the American banking system. We are seeing a merger movement, which again is responsive to a change in the structure of our economy. It is a reflection of the social integration into urban communities. It is the growth of urban America, transplanting agrarianism or taking its place. We have seen the growth of suburban America, which is terrific today. The suburban areas are essentially bedrooms for the cities. People work in town and sleep in the suburbs.

The suburban housewife doesn't have to shop in the city now, and the community bank finds itself handicapped in serving her. Don't think for a moment that the American housewife is not still spending more money than the American husband. I don't mean that in a derogatory way. That's her assignment. She lives up to it admirably. She has learned to use banks.

The American banking system is changing to meet the need of American industry by establishing suburban branches of banks in the central cities. The city grows out to the suburbs, and what was a separate community becomes a suburb of the city. Then there's a merger. It is a quick way, and there's less conflict. If a downtown bank tries to move into some suburban community, the small bank out there is going to cry to high heaven that it is being defeated by the large institution with which it can't compete; that it is unfair competition.

To the cry "you must protect the farmer" is gradually being added "you must protect small business." The suburban bank, being small, can raise the small-business cry, while the downtown bank, being big business, is handicapped in that contest. The community bank knows the people but needs larger resources. The downtown bank needs him; so they are complementary to each other, rather than in conflict. So we see the mergers that have been going on.

As I said, there are 13,782 banks. I will have to go back to the December figures to break them down. I don't have a later breakdown. On 31 December 1954, there were 13,840 banks, of which 4,789 were national banks and 9,051 were State banks. Those banks were operating 6,108 branches, which is expressive of the branching trend I mentioned.

In addition to that, in certain sections of the country we find mutual savings banks, of which there are 527. They don't have paid-in capital. They are theoretically and technically owned by depositors. The depositors don't receive interest; they receive dividends. The depositors will tell you it is interest, but it is dividends. These banks are concentrated in the Middle Atlantic and New England States. Part of them are in Baltimore, scattered, and part of them in Ohio. Then you have to jump to the Pacific Northwest to find some more.

I don't know what happened. Probably some New Englander moved to the Pacific Northwest, saw a good thing, and started it. He didn't stop in between. The country in between didn't appeal to him. So there are no mutual savings banks in the intervening section.

Our banking system developed and grew to meet our needs. We had recessions; we had depressions; we had money panics. It became perfectly obvious that we had to have an integrating influence. Strong support for this idea developed after the great money panic of 1907. A Monetary Commission set up by the Congress came up with a recommendation for a central bank.

You will recall that in 1907 we had a Republican Administration. In 1912 the Democrats were elected. The report of the Monetary Commission was made to a Democratic-controlled Congress in a Republic Administration. It was not acted upon. When the Democratic Administration took over in 1913 it picked up the idea and enacted the Federal Reserve Act. Because of a fortunate twist of circumstances, the central bank in this country at its inception was bipartisan, or at least it was nonpartisan. We like to think it has remained that way.

In its essential characteristics it was recommended by a Republican appointed commission and approved by a Democratic Congress. Its paternity is generally credited to Democratic President Wilson.

The Federal Reserve System in broad outlines reflects the sectionalism of the country. We have a unique organization--a central bank which is decentralized. Central banks in other countries are one bank. The Bank of Canada is the Bank of Canada at Ottawa. The Bank of England is the Bank of England at London.

The Federal Reserve System, which is the central bank of the United States, is made up of 12 banks, separate corporations, separate boards of directors, separate stockholders. The unifying board is the Board of Governors of the Federal Reserve System at Washington. There are seven members on the Board of Governors, appointed by the President of the United States, by and with the consent of the Senate.

...ks of the several districts own all the stock in the ... All national banks are required to be members of ...e State banks which wish to join, and which qualify, ...ere is a total of 6,660 member banks in the system; 4,789 ...banks, and 1,871 are State banks. That is there are 6,660 ...anks out of a total of 13,840 banks.

...member banks control 85 percent of the total resources of the com- ...cial banking system in the United States. They own the stock of ...e 12 Federal Reserve banks. They elect six of the nine directors at each of the Reserve banks. The remaining three directors are ap- pointed by the Board of Governors here in Washington. Those nine directors elect the president and the first vice president of the banks, subject to the approval of the Board of Governors in Washington. They elect all the other officers of the Reserve banks without being subject to the approval of the Board of Governors in Washington. The manage- ment of each of the Reserve banks lies with the elected officers. They in turn, subject to the approval of the directors, employ the staff.

Then we have the Federal Open Market Committee, which is one of the most potent institutions, and it is composed of the seven members of the Board of Governors and five of the 12 Reserve bank presidents, who in turn are elected by the directors of all of the 12 banks, they being divided into units. New York is a district unto itself, and the directors of the Federal Reserve bank elect the president of the Federal Reserve Bank of New York to the Open Market Committee. The Boston District, the Philadelphia District, and the Richmond District are by law a unit unto themselves, and one of those three bank presidents is elected to the Federal Open Market Committee by the directors of the three banks. By a strange coincidence, they all vote for the same one this year, and next year they all vote for another one, and the year after they all vote for the third one, and the next year after that they all vote for the first one again.

Chicago and Cleveland are in a unit to themselves. Presidents of the two banks are elected by the directors--one year from the Federal Reserve bank at Chicago, and the next year from the Federal Reserve bank at Cleveland--and so on.

One member of Congress has said that the Open Market Com- mittee is the most powerful economic body in the United States--more powerful than Congress. Then he backed up a little bit. These 12 men who comprise the Open Market Committee bring to bear on the monetary problems of this country their experience and their daily intimate contact in these regions all over the United States, with the majority of two lodged in the central body here in Washington.

The group, when they meet, seldom vote as 7 to 5. If they do, it is purely by conviction. Each individual member brings to the deliberations his whole background and understanding.

There was one further significant development of the banking system. Out of the thirties' terrific loss of banking institutions, there came the cry for deposit insurance, and there was developed the Federal Deposit Insurance Corporation, which guarantees deposits up to 10,000 dollars. It is, in effect, a mutual insurance fund, with the banks bearing the costs of both operations and liquidations if such become necessary.

The American banking system includes State banks and national banks; banks which are members of the Federal Reserve System, and banks which are not; also insured and noninsured banks. However, there are very few banks now without deposit insurance. It is an individualistic system scattered across the broad land, responsible to the local communities all over the land; yet it is integrated at the national level by the Federal Reserve System and, to a lesser degree, by the Federal Deposit Insurance Corporation.

Of overriding importance to the monetary authorities of the central bank is the maintenance of a relatively stable dollar. One of the great factors, one of the great problems, which introduces instability into the monetary system is the basic fact that banks are dealers in debt. By the very process of their function they create additional money. A bank deposit circulates just as readily for all practical purposes or more readily than currency. Most of the business transactions of the country have been effectuated by bank checks. The bank check has become the circulating medium of this country.

The commercial bank, by making loans, creates deposits against which checks are drawn. If there were no limit placed upon it, there would be chaos in our whole monetary system; because the value of the dollar is the result of a very delicate equation. We think of it as supply and demand. It applies in the monetary field just as it applies elsewhere. If banks could add to the supply of money ad infinitum, that equation would be constantly thrown off balance.

What is back of our money? We have introduced by law in our country a Fractional Reserve Principle. Originally, in order to put a brake on this ability of the banks to enlarge the money supply ad infinitum, each bank was required to hold a certain percentage of its outstanding liabilities in hard money. When the Federal Reserve banks were established, the member banks were required to keep a certain percentage of their liabilities, their deposits, in the form of credit with the central banks.

I want to move to this felt board. I hope you will be able to hear me. I want to try to build what I would like to call an inverted pyramid of credit--what is back of your money. Your money, all over, largely bank deposits, consists of demand deposits and time deposits, in somewhat that ratio (indicating). Now, member banks are required to hold on deposit in the central bank their reserves of 20 percent, if they are in a central-Reserve city (New York or Chicago); 18 percent if they are in a Reserve city, of which there are some 50 in the country at large (Boston, Washington, Baltimore, Richmond, St. Louis, San Francisco, Los Angeles, Dallas, and so on); 12 percent in any other part of the country, against demand deposits; and 5 percent against time deposits, regardless of where they are located.

So you see this is a restraining influence. If a bank in a central-reserve city lends a million dollars, it will take the note, the credit instrument, of the borrower and credit the account of the borrower. Immediately it has to have 200 thousand dollars in free reserves, or 18 percent or 12 percent, depending on where it is. When the deposit is drawn out, the responsibility for maintaining that reserve passes to the bank to which the deposit is transferred. The banking system as a whole can't make a million-dollar loan unless it has 200 thousand dollars in free reserves to support it.

Now the Federal Reserve in turn is required to keep reserves against its liabilities. You see? The support of all these deposits, your principal circulating medium, is the member banks' reserves in the central bank. Your principal circulating currency is Federal Reserve notes. So the Federal Reserve bank has two principal outstanding liabilities--bank reserves and Federal Reserve notes.

The Federal Reserve System is required to keep 25 percent reserve in gold against its outstanding liabilities. Thus you have this inverted pyramid. You have the monetary gold stock of the country, which in turn becomes the limiting factor on the amount of liabilities which the central bank can create, and the available liabilities of the central bank, which are the required reserves of the commercial banking system, become the ultimate restraining factor on the money-creating capacity or power of the commercial banks.

Now, for the balance of these outstanding liabilities of the central bank, we must hold not less than 25 percent in gold. As a matter of fact, we hold currently about 47 percent in gold. The balance must be in other Government securities or eligible paper. There is so little eligible paper around, I won't talk about it. One purpose of the system is to monetize the eligible paper, issuing currency against the actual commercial paper which the banks themselves create, which in turn they can exchange and discount.

I suppose I should say we don't hold gold. We hold gold certificates. An act of Congress back in 1934 required that all gold be delivered to the Treasury. So we had to turn in our gold to the Treasury. The Treasury took it and put it underground. While the Army walks around the posts, the gold sleeps down under the ground. Nevertheless, that gold is now the restraining factor on this inverted pyramid of credit.

Obviously your key to the whole thing is right in here--bank reserves. That is what they have to hold now. It is the control and the influence that the central bank can exercise over this key to the expansive powers of the commercial banking system which is the restraining influence in our whole monetary system today.

Let us take a quick look at our money supply and see what happens to it, where it comes from, and what we do to it. To trace it historically, back in 1939, before the outbreak of World War II, our money supply was 63 billion dollars, consisting of 6 billion dollars in currency outstanding outside of banks and 57 billion dollars in bank deposits.

During World War II our money supply grew from 63 billion to 151 billion dollars--26 billion in currency in circulation outside of banks. As people were uprooted from their accustomed places and moved to distant cities, the demand for currency increased. It stayed that way. It has not come back in. Some of it never will come back. There is a lot of U. S. currency abroad. We still get every now and then some of the old big bills. I suppose most of you have seen them. I think I have one of them here. (Holds one up.) They are not in general circulation. They look pretty large. We still have some of them coming in, looking like that one. Some of these also are in circulation abroad, that went out during World War I.

After the war many people thought the money supply would contract. Did it? It has risen from 1945 to 1953 from 151 billion dollars to 192 billion dollars. Then it moved up to 207 billion dollars. That is not the total resources of the banking system. That is money supply, deposits and currency, outside of banks.

Let us see where it came from. It was created by the banking system in the process of making loans and investments for all purposes. In 1939 the banks had total earning assets of 51 billion dollars, of which 22 billion dollars was in loans; 9 billion dollars was in other securities; and 19 billion dollars was in U. S. Government securities. As would be expected, during the war, bank holdings of U. S. Government securities grew enormously. As the banking system picked up the difference between the needs of the Treasury on the outgo side and taxes on the income side, plus the sales of securities to individuals, the gap was picked up by the banking system. As the commercial banks lent money to the Treasury by buying Treasury securities, they paid for it by crediting the Treasury's general account. The Treasury used the general account to meet military payrolls and civilian payrolls and to purchase materiel. It stayed in circulation. It will stay in circulation until the date the instrument which created it is extinguished.

Now, after the war, many people thought, you see, that there would be a change. There was a change, but it wasn't the way they were looking for it. In 1953 we had a great growth in bank holdings of private debts from 30 billion to 77 billion dollars. We had an increase in corporate and municipal securities from 9 billion dollars to 18 billion dollars. We had a drop in the bank-held portion of the Federal debt from 101 billion to 72 billion dollars.

So we see that banks are dealers in debt. As they exchange their debt for the debt of others, they create additions to the money supply. Obviously, if no influence is exerted on that money-creating power, our monetary equation will be most unstable. The purpose of the central bank is to exercise an influence over that particular phase of the commercial banking system. How is it done?

Well, I pointed out that the key to the power of the commercial banks to increase our money supply lay in reserves. Under our fractional reserve principle, banks are required to hold a certain amount of reserves. Therefore, the influence of the central bank is exercised on the reserves. Actually we are not talking about all reserves. We are talking about the reserves that are available in excess of the required reserves. Since the banks have to keep a certain amount of reserves, all they hold are not free reserves. They are already committed to the outstanding liabilities.

If the earning assets of banks are to increase, thereby increasing the money supply, they must have a certain amount of free reserves. So the influence of the central bank is exerted primarily on these free reserves--on the supply, availability, and cost of reserves. There are three ways in which that influence is exerted.

Banks may borrow reserves from the central bank. These reserves of the banking system, aside from the monetary gold stock, have actually all been created by the central bank itself, which in turn is a dealer in debt, just exactly like the commercial banks are; but the debt they create is the reserves of the commercial banks against which they then create the principal circulating medium of the country. Banks can obtain these reserves by borrowing from the central bank. So we can exert an influence by raising or lowering the discount rate, by making it more costly to borrow.

Banks are operated for profit. There is nothing immoral in profit, in my book. I have a pretty strong feeling that the day is a long way off, if it ever arrives, when men collectively will produce for the sheer joy of producing and consume just what they need and nothing else. I don't think that is going to come. I think men need a spur. They, like a horse, operate better with spur. The spur in our banking system has been profit. There is nothing wrong with profit. Banks are operating for profit. They are going to try to make a profit. If you exert pressure on that profit-making ability it influences their action. If you raise the discount rate, you raise the rate which they in turn will charge to their borrowers, which may make it less profitable for a businessman to borrow, and he may postpone his decision to expand his activities. If you lower it, it works the other way. There is another very great effect. A change in the discount rate affects the market price of securities which brings us to open market operations, our most sensitive, our most potent instrument.

If we in the Federal Reserve System move into the market and buy United States Government obligations, we pay for them by crediting the reserve account of some member bank, creating more reserves, thus affecting the supply. If we sell, no matter who buys, payment will be effected by a charge against the reserve account of some member bank. This extinguishes a portion of the supply outstanding and tends to restrict--not contract--the economy.

That is something we have learned over the years. We are not trying to contract the American economy. Even when we move as we do today in restrictive fashion, it is not to contract the American economy; it is to restrain a too exuberant growth of the American economy. It is a very delicate thing to try to do, because that line between exuberance and normal growth is poorly defined; and, even if well defined, is often somewhat difficult to identify. Besides, you are dealing with the reactions of people. You don't know just how they are going to react. You don't know at just what point their confidence may disappear and turn to a feeling of fear, which you don't want to introduce.

The third way you can affect reserves is, you can change the required amount. I said central reserve city banks had to keep 20 percent. The Board in Washington can raise that to 26 percent or lower it to 13 percent. Now, if we raise the reserve requirements, you see, we absorb a part of the free reserves. They are no longer free. They are required. In order to replenish reserves, banks have to turn somewhere. The first resort is usually to the discount window at the Reserve bank.

Having raised the reserve requirements, inducing an increase in bank borrowing, you raise the discount rate. That puts further pressure on banks to restrict their loans. Banks are prone to get out of debt to the central bank as quickly as they can. They don't like to be in debt. It is a tradition you can count on. We are sometimes accused of encouraging the tradition. I will neither affirm nor deny that. It is a tradition. It is there.

They will borrow to meet the immediate need. Then they will begin to look at the market to see whether or not they can dispose of some U. S. Government obligations, to replenish their reserves that way. Now, if there are free reserves elsewhere in the banking system, they can be moved to the point of impact by the bank that needs the reserves selling securities to the bank that has free reserves. If there are no free reserves the System may have to step in and buy, which we can do. We can supply reserves through operation in the open market.

Generally, what we would actually do is, if reserve requirements were raised, we would probably move into the market immediately and buy securities approximately equal to the raise in reserve requirements, so that, instead of making that terrific impact all across the country, we would supply the reserves, then move back into the market, gradually exerting pressure by selling, thus spreading the impact of an increase in required reserves over a period of time.

A year ago reserve requirements were lowered. The System sold securities to absorb the major portion of these new, free reserves, then reversed its market actions and let the reserves seep into the economy gradually.

When the System's security holdings rise, member banks' borrowing declines, and vice versa.

Those are the transactions by which the central bank undertakes to exert its influence over the expansion of the money supply, over the reserves of the banks of the country.

Money will not manage itself. We have found that if left alone it is a hard task master; but there is a vast difference between a managed money and a managed economy. In this country we have managed money, though not managed economy. There are inhibiting factors to the action of the managers. To begin with, there is the very size of the Federal debt. The wide distribution of the Federal debt must also be considered, plus the unpredictable psychological reaction to violent gyrations in the market for the Federal debt.

All of those are inhibiting factors on complete freedom of action of the monetary authorities, and we recognize them. There are further inhibiting factors in the intangibles of human reaction. No one knows what the reaction of Americans will be en masse.

I started our little talk by saying Americans are essentially individualistic. But, in recent days, we have become much more closely integrated, and trends sweep very rapidly across the country. In the first quarter of 1951 Americans were spending 97 cents out of every dollar after taxes and saving three cents. In the second quarter of 1951 Americans were spending 92 cents out of every dollar after taxes and saving eight cents. In the second quarter of 1951 Americans were spending 92 cents out of every dollar after taxes and saving eight cents. Why? I don't know. They did, though. All across the country, in all sections, they decided to start saving a little money, and 5 percent of the spendable income of the American people was switched from spending to saving; and at a time when we had strong inflationary pressures. That would be in itself enough to take the wind out of the sails of a sharp inflation. At the same time the monetary authorities and the Treasury reached a momentous agreement which enabled the Federal Reserve to take positive, effective action. The two things working together have given us the nearest thing to a stable price level in the history of this country.

In conclusion I want to quote from a banking text which I studied a great many years ago. I remember only some of it.

> "The wants which banks supply are simple in kind, but sure to arise early in the development of any commercial or industrial people where there is mutual confidence among men."

Banking must be responsive to the changing needs of the economy and can exist only when there is mutual confidence among men. The wants which banks supply are simple. What are they?

First, there is the transfer of values between people; so that the value of your labor may be transferred to another individual in payment for his labor. Banking facilitates the transfer of values between people.

Second, banking facilitates the transfer of values between places, so that men who do not even know each may transact business in common terms; so that a manufacturer in Detroit may ship his product to a dealer in New Orleans; in turn, he may sell it to a distributor in Mississippi; and he may sell it to a consumer in Tennessee to Mississippi to New Orleans to Detroit in common terms, transferring value between places.

Perhaps banking's most important use is to facilitate the transfer of values in time; so that the fruits of your labor and mine today may be transferred to our own needs in later years, a different period of time, or to other people, our children or even our children's children, and, most important of all, to our wives, who are likely to survive us--they have a way of doing that.

So we have a transfer of values between people, betweeen places, and in time. Our whole banking system is set up to facilitate these things. The first two we can quite readily recognize, the transfer between people and places; but we have come to recognize that the importance of transferring values in time is perhaps the greatest of all. It is faith in the future upon which our economy must be built; and, if we do not believe our medium of exchange will preserve something of this value tomorrow, next year, and ten years from now, we cannot build an enduring structure.

Therefore we strive for a stable dollar--not a static economy.

Thank you very much.

MR. NIKLASON: Mr. Wayne, are you ready?

MR. WAYNE: I am at your mercy.

QUESTION: Sir, I come from one of the two states that the other 46 joined after a twenty-year absence, and we feel that personal debt is something to be avoided at all cost. With the increase in loans to 92 billion dollars and the statement by a previous speaker that we never want to get rid of the national debt, is there some limit to our debt before that becomes an unstable economy?

MR. WAYNE: Obviously there would be, and there is, some limit at which the structure of debt would be crushing. To fix a hard and fast ratio or relationship would be extremely difficult, if not impossible. I am aware that the section of the country from which you came has been in the habit of accumulating the dollar and lending it to other sections of the country at a slight charge. They have begun in recent days to borrow a bit of it themselves, though not quite as heavily as others.

The bearable limit of debt, public or private, is determined by the weight of debt service charges on the earning capacity of the economy as a whole, in the case of public debt, and on that of the debtor, in the case of private debt.

In the private debt area--that 92 billion dollars you mentioned--we often overlook the constant shifting of debtors while the total shows little change. One firm borrows while another repays, and the same is true with individuals. There is a constant turnover in those who owe the money, though the volume stays high. As incomes rise with a rising gross national product, debt also may and probably will rise and, in fact, may be easier to support.

I gather your previous speaker suggested that retirement of the national debt would result in contraction of the money supply, inducing deflation. If that is what he said he was correct. We have to support the monetary system, our money, constantly by monetizing debt. One segment of debt may contract while another segment is rising without reducing our money supply, but not otherwise. If there is contraction, unemployment rises. As unemployment rises, personal income falls off. There you get your cycle. That's the way it goes.

QUESTION: I can appreciate the significance of transferring value from place to place and from person to person; but isn't money losing some of its value in transferring the value from one time to such a future time as our children's children? Wouldn't that inflationary tendency that we have experienced lead to the loss of purchasing power?

MR. WAYNE: Yes, sir. We have had a gradual erosion of the value of the dollar. At times it has not been so gradual. It has been pretty violent. Over a long period of time money has shown a tendency to depreciate, and with a rather consistent record for gradual depreciation in value.

If you had a strictly metallic coinage, metallic money, and there was rapid growth in the supply of the precious metals, even hard money could lose value. Seventeenth century Spain is an example. When you introduce managed money, you let your money supply grow with the growth of the economy. Sometimes it grows more rapidly than the economy can support at stable values.

Some people hold that a dynamic economy requires a gradual rise in the price level, a price level which ought to rise slowly, but nevertheless continuously, perhaps at 1-1/2 or 2 percent annually. It is that rise in the price level they say which exerts the continual pulling influence, drawing in additional capital, supporting capital accretions.

The people who hold that a gradually rising price level is necessary to promote a dynamic economy discount the resulting deflation of the dollar.

When I was 16 years old an insurance salesman got hold of me and sold me not only an insurance policy but an insurance plan. He convinced me that the wife I did not have, but whom he assumed I would eventually acquire, could live like a princess on a sure income of 200 dollars a month. I was making 30 dollars a month, and I agreed with him. He showed me how I could build an estate of 200 dollars a month by taking an insurance policy each year. He convinced me that my income was going to increase, and I could increase my life insurance each year with a 20-pay policy, paid up in 20 years. By the time I was still a relatively young man I was going to have an estate built up which would assure my wife of 200 dollars a month as long as she might live.

I now have the wife and the estate his plan promised but I think she will be in a heck of a fix if she attempts to maintain the standard of living to which she has unfortunately become accustomed on 200 dollars a month.

QUESTION: Mr. Wayne, you have two contrasting systems of fiscal management in the Federal Government and the Commonwealth of Virginia. The Federal Government debt some people think is an excess of spending. The Commonwealth of Virginia has the pay-as-you-go plan. It only proves that the Commonwealth of Virginia still has many fiscal headaches, because of which, at the present time, it is debating the collecting of taxes in advance.

MR. WAYNE: The fiscal policy of the Commonwealth of Virginia has been basically on what we call the pay-as-you-go plan. The Commonwealth has no outstanding general obligations, no general debt.

You are correct in saying that does not eliminate fiscal headaches from the State government, the government of the Commonwealth of Virginia. Another fiscal philosophy proposes acquiring assets by creating public debt. According to that point of view, the acquisition of that asset adds to the power of society to pay for the asset.

Let us contrast Virginia with the State of North Carolina, rather than contrast a State with the Federal Government, because there is some difference--a heck of a big difference. Let us take two States; let us take them side by side.

North Carolina has not been at all reluctant to go into debt. North Carolina was one of the early States to build a highway system. Virginia, instead of going into debt to build a highway system, has insisted on the pay-as-you-go plan. Today Virginia as a whole probably has as good a highway system as North Carolina, maybe in some spots better; but North Carolina has a vast textile industry which spreads over the State. North Carolina built its highway system back in the early twenties, and there are those who believe that the growth of North Carolina's industry is directly related to the development of its highway system.

There were other factors, of course. Power and labor were available but they were also available in Virginia. It is a fact that North Carolina has the textile industry as a significant part of its tax base. (South Carolina, which follows the same fiscal course, is having a similar experience.) Because of its dependence on truck transport, North Carolina today is the center of the largest over-the-road transport company in the United States. The policy appears to have paid off in North Carolina.

Both States had headaches. They still have. They are both on the low-income side in terms of personal income. Both have terrific headaches with their educational and school problems--but let's not go into that. So far as their fiscal problems are concerned, it is pretty difficult to say that Virginia is free of headaches and North Carolina is not. I don't think you can build a case there.

QUESTION: One of our previous speakers stated that war and prosperity go hand in hand. In that connection, probably I should ask him this question.

MR. WAYNE: I think so.

STUDENT: But he said that conversely, in order to have prosperity we must have periods of conflict.

MR. WAYNE: War has contributed to prosperity, depending on how you define prosperity. Wars have resulted in terrific speed-ups in the growth of capital. In that society Government has speeded up the development of industrial plants and social assets, such as highways, etc., in order to meet war needs. It has added to the spending stream and, to the extent that makes for prosperity, it has created prosperity.

On the other hand, it may be that such prosperity is a false prosperity, bringing with it, of course, fiscal problems which, if not forcefully and boldly handled, may result in fiscal collapse, destroying our apparent prosperity. Is it proper to measure prosperity solely in terms of material things, and disregard the human suffering inseparably bound up with war?

Whether or not we could have prosperity without a series of conflicts would depend on whether or not we could provide the stimuli aside from a period of conflict.

I think unquestionably the record shows that wars have speeded up economic growth, but on the other hand war is the great destroyer. We have prosperity in this country, but they don't have a great deal of prosperity, or they have a different kind of prosperity, in some of those countries that were overrun by the ravages of war. I don't know whether they would agree that they have prosperity at all.

I would hesitate to answer the question, other than to say that war appears to speed up economic expansion, if it does not entirely destroy it. I would add this, that there is no way to pass over to another generation the task of paying for a war.

May I show you one other diagram, which you may have seen? If you haven't seen it, you will see it one day. First, "One man's expense is another's income." Let me illustrate. Let us assume that this factory is representative of all industry, and this machine operator represents the labor and other costs of the factory. What is income to the worker is expense to the factory. In turn, the worker buys a suit of clothes for himself or a dress for his wife. What is income to the merchant is expense to the worker. The merchant replenishes inventory and pays his clerks--what is expense to the merchant is income to the manufacturer. When you hear economists talking about the spending stream, that is what they are talking about.

There's another factor which enters into it. Let that represent the Government. The Government provides the impetus for the economic development during wartime. Where does the Government get its income? The Government draws it out of the income stream. It can draw it out at every point, and does, as you know. On the other hand, the Government pours it back into the spending stream as it buys personal services, as it buys goods, as it buys materiel. But what the Government does is exchange what is in the stream for something else that is coming into the stream. That is all it does. It doesn't add anything material to the stream itself. It merely diverts the stream.

If it is pouring into the stream more than it is taking out, it is adding a pressure on the stream, which tends to increase prices.

When prices increase, and the demand for materiel remains strong, there is the pull to employ more workers and get more goods out. If the economy has idle resources it can respond to that pressure. If it does not have idle resources it will have higher prices, that is the only way out.

Let me complete the circle. There is another factor which is the bank. As you save, you draw off; as you repay a loan, you draw off; as you borrow, you add to; as you withdraw previous savings, you add to. There is where monetary policy operates. Government needs to add impetus to this stream. So we say we have prosperity. You have a very strong force accelerating the spending stream, and what happened may be only a transfer of some of the goods.

How are you going to pay for war, except from this income stream? A manufacturer produces an airplane for the military. It is paid for by the Government, but the money which the Government paid went to pay this fellow who worked for you. Now, you see this circle is a complete circle; so what money he received for his labor he in turn spent to buy the products of his labor.

But the airplane has been destroyed and was not available even if someone wanted it. When you take 30, 40, or 50 percent of the productive capacity of an economy, as you do in war, and destroy it in the oceans and over the continents of the world, that labor is not productive; it is gone. But it is going to be paid for. How? Either by taxing the income stream an equivalent amount or by borrowing so as to defer civilian spending. But then when the civilian defers demand, or saves, and the war is over, with patriotic motive to save gone, he pours it back in again. He is working at the same time, so when he is spending his savings, he is also spending his current earnings; so he is pouring in double what he is drawing, trying to get out of the economy double what he is putting in in labor. All he gets, or can get, is a doubling of prices.

There is no place else to go. We pay for wars through the price level as well as with taxes.

MR. NIKLASON: The time is up, Mr. Wayne. Thank you very much for a very fine and interesting explanation of the operation of our money and the banking system.

MR. WAYNE: Thank You.



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