# BANKS AND THE BANKING SYSTEM

28 August 1956

## CONTENTS


| | Page |
|---|---|
| INTRODUCTION--Colonel J. C. Lackas, USA, Requirements Branch, ICAF | 1 |
| SPEAKER--Mr. Edward A. Wayne, First Vice President, Federal Reserve Bank of Richmond | 1 |
| GENERAL DISCUSSION | 17 |



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Mr. Edward A. Wayne, First Vice President, Federal Reserve Bank of Richmond, was born in Eau Claire, South Carolina, in 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 1955 he was appointed a visiting lecturer on the faculty of the Graduate School of Business Administration of the University of Virginia. In 1950 he was "drafted" by the Board of Governors of the Federal Reserve System as Acting Chief of the System's Division of Examinations, 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.

# BANKS AND THE BANKING SYSTEM

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COLONEL LACKAS: Gentlemen: Yesterday we considered money and the monetary system. The emphasis was on the formulation of monetary policy, its objective, and its accomplishments.

Today we have proposed to discuss the means by which that monetary policy may be implemented, the instrument by which it may be accomplished; that is, through the banks and the banking system.

We have as our speaker a man preeminently qualified to make this presentation. As his biography indicates, he has had considerable experience in the banking field. In addition to that, he is an extraordinarily good teacher.

It is therefore with a great deal of pleasure that I present to you Mr. Edward A. Wayne, First Vice President of the Federal Reserve Bank of Richmond. Mr. Wayne.

MR. WAYNE: Thank you Colonel. General Hollis, General Calhoun: It is a pleasure for me to be here for my third visit. You are amazingly patient to let me come again.

In discussing banks and the banking system and the implementation of monetary policy, it seems to me desirable for us to realize in the beginning that, while banks perform a number of service functions, bankers are essentially dealers in debt; bankers exchange one form of debt for other forms of debt; in return for debt instruments, which we think of as notes or mortgages or securities, bankers give in exchange another form of debt which we think of as bank deposits.

The difference is a very significant difference. The debt instruments which the banker provides in exchange for the debt instruments which he accepts circulate as money. That fact in and of itself makes it necessary in a modern economic structure to exercise some form of restraint over the banking process. It does not follow that the bankers are always happy about the restraint which is exercised. In fact, it may generally and safely be assumed that they don't like it.

Just as in your thinking about money yesterday and your recognition that by the banking process the banker creates money your first reaction is that somehow it is a bit dishonest, the banker also feels that the exercise of restraint over his actions is also a bit dishonest and not in keeping with the American principle of free enterprise.

We are always a little confused between freedom and license. So are bankers. Not only are bankers dealers in debt, but we should also realize that our monetary system itself is a debt system, with a precious metal, gold, serving as the means of ultimate internal restraint and ultimate external settlement.

That is to say the monetary gold stock held in this country fixes the outside limit of money expansion that is possible in this country. So that is why we say that it serves internally as an ultimate restraint upon the growth of the money supply. Externally we are on a gold bullion standard, and the settlement of net international balances is effected through the transfer of gold--somewhat apart from our subject, but audiences are usually fascinated by the process of that transfer.

Very seldom does the gold itself actually move from one spot to another. Down in the bottom vault of the Federal Reserve Bank of New York, about nine stories imbedded deep in the granite of Manhattan Island, is the gold vault. It is interesting to go into that vault and find it filled to the ceiling, from floor to ceiling, with bars of gold. Those gold bars are separated into sections by what looks at first glance like partitions made of chicken wire. It is merely something to separate these bays of gold. They are closed and locked with seals that are placed on them, and attached to these seals is the designation of ownership. You may look at one particular bay containing so many ounces of fine gold, and the seal on it may say that this gold belongs to the Bank of England. Should the net international balances run against England and it become necessary to settle those balances, and should the Bank of England decide to dispose of some of this gold in the American market to settle those balances, what would actually happen is, the tag on the chicken wire would be changed. Instead of saying, "This gold belongs to the Bank of England," that would be taken off and it would say, "This gold belongs to the Treasury of the United States." The gold would still lie right there in the vault of the Federal Reserve Bank of New York. Of course finally it might move abroad, or it might move in, but at any rate gold serves that purpose of settling net international balances.

The American banking system through which our monetary policy operates is different from other banking systems of the world. That is also true of other facets of our economy. The American banking system reflects, as do these other segments of the American economy, the essentially individualistic character of the American people. Our banking system is not only individualistic; it is even provincial in part.

We might go back quickly and review how it grew and became what it is. During the colonial period of this country you will recall that we were an agrarian people. We were exporters of raw material and importers of finished goods. London and Liverpool were our financial centers. The monetary units circulating in this country were British pounds and subsidiary British monetary units, and the Spanish milled dollar. The westward expansion of this country was financed very largely by an importation of foreign capital. The spread of the railroad across the land was based on the importation of British and French capital. The development of our early industrial units, textiles, for instance, was financed largely by the importation of British capital.

As a matter of fact, we were a debtor nation, a net importer of capital, until 1918, and one of the fundamental effects of World War I, which is still affecting our whole existence as a people, was the change from a debtor nation, a net importer of capital, to a creditor nation, a net exporter of capital, a situation in which we remain to this day.

As a part of this isolated colonial experience of ours, being 13 colonies spread along the narrow sea coast, isolated from the rest of the world by the distance of a vast ocean--at least what was at that date a vast ocean--and the slowness of transportation, not only were we isolated from the rest of the world, but we were isolated from each other. The colonies were very largely self-sufficient units, communities that were sufficient unto themselves in their own needs, in large measure distrustful of any concentration of power which imposed restraint upon their own freedom of action.

As we moved west of the mountains, that sense of self-sufficiency became an integral part of our heritage, and our distrust of power concentrations grew with the Nation.

That applies not only to banking but to politics, and explains in large part the system of restraints and balances which we built into our governmental structure. We have deliberately sacrificed a measure

of efficiency in return for a measure of restraint and have felt that the price was cheap. We have done the same thing in economics. We have statutes against monopolistic practices. We distrust bigness; we laud smallness. It used to be that the cry of the American politician was "Pity the poor farmer." It has now become, "Pity the small businessman." Smallness is looked upon as something inherent in and essential to the American system.

That is true of banks, and as a reflection of that heritage of ours, our banking system is different. Instead of five big banks as in England, with thousands of branches blanketing not only the British Isles but the Commonwealth, we have thousands of separately chartered banks spread across this broad land of ours.

During the colonial period, banking houses existed, but banks as we know them appeared as cities developed. We found that our lack of banking houses was a severe handicap during the War for American Independence. The development of banking houses and banks was stimulated by our efforts subsequent thereto to take our place in the family of nations as an independent nation.

The earliest chartered banks in this country were chartered by the several states--first Pennsylvania, followed quickly by New York. Then, in 1792, the Federal Government asserted its right to issue a bank charter, and we had our first pseudo central bank, the Bank of the United States, later known as the First Bank of the United States, because we had a second one. It was chartered for 20 years, and its charter was allowed to expire at the end of 20 years, it having become involved in a conflict with the state chartered banks and in politics.

Shortly after the expiration of the charter of the First Bank of the United States we became involved in our second war with England, and the Second Bank of the United States was chartered, in 1816, also with a 20-year charter. It not only became involved in politics; it became involved with Andrew Jackson, and its charter expired, but definitely, at the end of 20 years, in 1836.

These two Banks of the United States undertook to exercise a unifying influence within the American banking system, but that effort was resented. It generated sharp hostility on the part of the chartered banks, and they supported the move to let them die. So from 1836 until 1863 we were in a period of strictly state-chartered banks.

These banks were essentially banks of issue, rather than banks of deposit. They exchanged the debt instruments which they accepted for bank notes which circulated as money, not as deposits; but these bank notes were allegedly a promise to pay on demand hard money or precious metal, and of course they did not have adequate reserves of precious metal to meet any sustained demand for conversion. So we suffered recurrent conversion problems and panics. Bank notes circulated, as a result, at a severe discount, and anyone, in trying to handle a business transaction, didn't know the real value of the instrument he was accepting.

Then, as now, the majority of those who operated banks were men of integrity, and they undertook to police themselves. The first organized unifying unit of American banking appeared with the establishment of the clearinghouse in New England. The purpose of the clearinghouse was to assure the convertibility of the bank notes of the members of the clearinghouse. That existed only in the centers of population. The banks scattered out in the hinterlands still resisted it.

Then, in the early 1860's, we became involved in an internal altercation known in different sections of the country by different names. You perhaps have gathered by this time that I come from the Deep South. I could not conceal that if I tried, and I have no desire to conceal it. I was brought up to believe that the correct title was the War Between the States. I reached man's estate and learned that it was the War of the Rebellion. I will settle for the Civil War.

During that altercation internally we found ourselves as a people--and here I am speaking of the Union--in need of a circulating medium of nationwide acceptability and, in addition, the Union found a need for a market for its bonds. So the Federal Government again asserted its right to charter banks, national bank charters, and established the national banking system to provide a circulating medium of nationwide acceptibility and to provide a market for U. S. bonds to finance the Civil War.

State banks were expected to disappear and, to speed their demise, a 10 percent tax on note issue was applied, and still applies under the law. One effect was that state banks no longer issued notes, but the state banks did not disappear, because they developed deposit banking. So the two systems grew side by side, and still exist side by side, and

we have one of the "shibboleths" of organized banking in America as a result, known as the dual banking system. Bankers swear by the dual banking system, by which they mean the right of the State to charter and the right of the Federal Government to charter, side by side.

They believe in that duality because it exercises a restraint on Government again an expression of this American heritage of distrust of power concentration.

The two systems grew side by side, and each one tried to out-charter the other, until there developed what was named by one banking authority of another generation "a competition in laxity" in charter. At any rate, we ended World War I with 30-odd thousand banks in the United States, a vast number of them much too small to exist; and so, in the decade of the twenties, and entering into the thirties, a wave of bank suspensions swept across this country, which resulted in some further changes in our banking structure, which I shall mention in a moment.

Coming quickly to the size of the two systems today, there are 4,692 national banks and 9,024 state banks, or a total of 13,716. When I met with this group last year, there were13,772. We have some 56 fewer banks today than we had a year ago, because, responsive to the changes in our social structure and the growth of suburbia, we are seeing a merger movement and a branch development which attempts to meet the changing requirements of the American economy. So that today, these national banks, 4,692 in number, operate 3,365 branches, while the state banks operate 3,558 branches, or a total number of banking offices of 20,639. All of these figures are as of 31 December 1955, and have no doubt changed considerably in the past nine months.

In addition to these, we have the mutual savings banks, 527 in number, with total resources of some 31 billions of dollars; and two relatively new forms of financial institutions are asserting their right to a place in the American financial structure. We have 6,060 savings and loan associations, with total resources approaching 38 billion dollars, and we have 15,000 credit unions with total resources in excess of 2.3 billion dollars.

Banking grew and took form to meet the needs and demands of the American business structure. We had these recurrent conversion panics that I mentioned, the last of which occurred in 1907. You may recall that in 1907 we had a Republican administration. That administration appointed a monetary commission to look into the cure for these recurring conversion panics. That commission recommended the organization of a central bank. Before any action was taken on that recommendation, the administration changed hands, and in 1913 a Democratic administration took office. The Democratic administration picked up the recommendation of the Republican commission, and enacted the Federal Reserve Act, with some changes, of course. But at its inception the Federal Reserve Act was nonpartisan; not bipartisan, but nonpartisan. We like to think that it has remained that way to this date. At least an attempt was made, in establishing our monetary authority, the Federal Reserve System, to make it nonpartisan.

The System--when I use the term "system" I am referring again to the Federal Reserve System; no other word seems to fit it. --The System, which is our "central bank," reflects the sectional characteristics of the United States. Canada, for instance, has one central bank, the Bank of Canada. England has one, the Bank of England. France has one, the Bank of France; and so on across the modern world. But we have 12. And these 12 separate corporations, the 12 Federal Reserve banks, together with a Government agency, the Board of Governors of the Federal Reserve System, located in Washington, which is a coordinating and regulatory body, constitute the System which is the Central Bank of the United States.

These 12 banks have separate charters, have separate stockholders, have separate boards of directors, but are bound together to form one System, through the common purpose, the common statutory authority under which they function, and the unifying acts of the Board of Governors.

All stock in the Federal Reserve banks is owned by the member banks, though the residual interest belongs to the Treasurer of the United States. So that, if you may draw a parallel between private corporations, and it is not too good a parallel, it is as though one man had an idea and the other one had some capital, and the man with the idea said, "Let us join together and form a corporation, and I will put my idea in and take common stock, and you will put your capital in and take preferred stock. You will obtain from the earnings a

fixed return, and I will retain the residual. What the United States put in was the sovereign's right to issue money. What the banks put in was the capital and the reserves against which that money was issued. So banks receive the stock, on which they receive a return of six percent, no more, no less.

If I may mention just as an aside, taking the Federal Reserve Bank of Richmond as an illustration, and I don't recall these figures with complete accuracy, my recollection is that last year we paid about 800,000 dollars in dividends on the stock of the Federal Reserve Bank of Richmond out of 22 million dollars in earnings. We paid to the Treasurer of the United States a tax, 90 percent, on net earnings after the payment of dividends. It is at that point that the commercial banker thinks a tremendous degree of dishonesty has injected itself into the banking system.

All national banks are required to be members, and such state banks as apply and are accepted are members. Of the 13,000-odd banks in the United States, the minority are members of the System, 6,543, with 7,176 nonmembers. But the 6,543 member banks hold 179.4 billion dollars in resources, and the 7,000-odd nonmember banks hold 31 billion dollars in resources. Therefore the member banks represent, roughly, 80-odd percent of the banking resources of the country.

A third very significant part of the structure of our monetary authority is the Federal Open Market Committee. The Federal Open-Market Committee consists of the 7 members of the Board of Governors, who are appointed by the President of the United States, by and with the consent of the Senate, and 5 additional members of a 12-member committee, these 5 members being elected from among the 12 presidents of the 12 Federal Reserve banks; and they are elected by the directors of the Reserve banks.

Here again you have sectional representation, sectional influence, trying to knit together a body which is not entirely located at the center, but represents the experiences and the contacts at the periphery as well as, on the national level, at the center.

Out of the terrific series of bank failures in the thirties there developed a demand for insurance of deposits, and the Federal Deposit Insurance Corporation emerged. In effect it is a mutual insurance

fund, with banks bearing the cost of administration and of liquidation, through payment of a percentage of their deposits. Thirteen thousand two hundred seventeen banks are insured and four hundred ninety-nine are not. The insured banks hold 208 billion dollars in resources, and the uninsured hold only 2 billion dollars.

Thus we have the American banking system, diversified, individualistic, essentially responsive to the community in which each local bank does business, but unified at the national level, to a degree, by the Federal Reserve System, and to a lesser degree by the Federal Deposit Insurance Corporation.

Now, a relatively stable dollar is of paramount importance to all of us, and especially to the monetary authority. A factor of instability, however, arises from the very nature of our banking system. These commercial banks create money every time they make a loan or purchase a security from anyone other than another bank, because the instruments of debt which they issue, bank deposits, circulate as money and are effectively our money supply. Bank credit circulates as freely as currency. In fact, the bank check is the most acceptable means of settlement.

Now, if there were no limit placed on the money-creating ability of the commercial banks, our monetary system would be chaotic; for the value of the dollar is the result of a very delicate equation--the balance between the supply of purchasing power and the means of making that purchasing power effective, on the one hand, (which, in monetary terms we will refer to as the supply and velocity of money), and on the other side the supply of goods and services. Our economy can pour out a certain amount of goods and services. We have, on the other side, to buy and to pay for these goods and services, money.

As long as we can maintain a relative balance between those two, so that one expands about in line with the other, there is no major change in price, which is the meeting place of the two forces. But, if one side of this equation is sharply out of balance with the other, then the meeting point is affected and price changes; and, as price changes, the value of our dollar changes. So that is what we are trying to do; to maintain a balance between the volume and velocity of money and the volume of goods and services, both expanding as our economy expands, neither too fast for the other, neither too slow to sustain the other. It is a nice trick, if you can do it. If banks could

continue to add to the money supply ad infinitum, then your equation obviously would be thrown out of balance constantly, and you would have unbridled inflation.

What is back of our money? That brings us to the key on which the whole monetary system functions. What is back of our money leads us to the fractional reserve principle, to a study of bank reserves. Originally these reserves consisted of hard money, specie, gold and silver in the vaults of the banks. That is no longer true. These reserves now consist of deposits with the central bank, with the Reserve bank.

With your permission I would like to move to this flannel board in the center of the stage and put a little diagram on the board which I think may illustrate my point more effectively.

Try to answer this question: What is behind our money? Our money consists in part of demand deposits, deposits with banks, in part of currency in circulation. In addition to our demand-deposit structure, we have time deposits which, while not always thought of as a part of the money supply, can, under our present processes, be quickly converted into demand deposits by simply going down to the bank and changing them from one account to another. Let's think of them also as part of our money supply.

So, what is back of it? I mentioned the fractional reserve principle. Against these demand deposits, commercial banks are required to keep on deposit with the central bank a fixed percentage of the deposits, depending on their location. Banks in the central Reserve cities are required to keep currently 20 percent of their demand deposits in the form of deposits with the central bank. Banks in Reserve cities, which are some 50-odd financial centers outside of New York and Chicago, are required to keep currently 18 percent of their total demand deposits on deposit with the central bank. All other member banks in the country are required to keep currently 12 percent of their demand deposits in the form of deposits with the central bank. All of them must keep 5 percent of their time deposits on deposit with the central bank. So that, back and behind this part of our money supply there are the deposits in the central bank.

The other part of our circulating medium consists principally of Federal Reserve notes. Just as the commercial banks must keep a percentage of their liabilities, their deposits, in the form of a deposit

with the central bank, so the central bank must keep a percentage of its liabilities in gold. Now, there was a time when this was actually kept in the form of gold bars, but now that is no longer true, and it is kept in the form of gold certificates, which represent our gold stock.

We must hold these certificates which represent the gold, and the gold in turn, this particular gold, is largely in your keeping at Fort Knox. We at one time had the gold, but I understand that now it is sleeping at Fort Knox. We hold certificates against it, and we must keep not less than 25 percent in gold against the liabilities of the central bank. The remaining assets supporting the liabilities of the central bank must be in the form of either Government securities or eligible paper, discounted for the member banks.

Obviously, the key to the expansion or contraction of the money supply lies in the supply of bank reserves. Our monetary gold stock is basic, but here I have reference to the required reserves of the commercial banks held in the form of balances with the central bank--the Federal Reserve System.

These are not liquidity reserves. The central bank provides the necessary liquidity through what we call a flexible currency, but these reserves are essentially a control mechanism. They represent the key to the expansion of our money supply, and it is in this sector that your monetary authorities operate.

Let us switch to another diagram illustrating what happened in a recent period of our history which is fresh in our memory. We can trace here the necessity for central bank operation and the way it works. Let us look quickly at our money supply and see what it consists of. It consists of currency outside banks and of deposits in banks.

In 1939 our money supply totalled 63 billion dollars, of which 57 billion was in the form of bank deposits and 6 billion in the form of currency in circulation. As we came to the end of World War II in 1945, our money supply had grown from 63 billion to 151 billion dollars. Currency in circulation had grown from 6 billion to 26 billion; and bank deposits had grown from 57 billion to 124 billion dollars.

In the immediate postwar years we saw a very rapid price inflation in this country as this purchasing power, or money supply,

built up as a result of war financing, forced its way out into the market place and tried to buy goods that were not then available. This terrific pressure worked itself out in a very sharp price increase, which is the way we see inflation. Inflation itself is imbalance between the supply and the velocity of money and the supply of goods and services. That imbalance had been created during World War II, but the effect of it had been held under restraint because a large part of the war-created purchasing power had not been spent. We undertook to spend it in the immediate postwar years and it worked itself out in a price inflation.

Back to our diagram--as we move on to 1951, we had relatively much slower growth of our money supply, from 151 billion to 172 billion dollars, but again the growth took the form of bank deposits. As of now our money supply totals 213 billion dollars, of which 28 billion is currency in circulation outside of banks and 185 billion represents bank deposits.

Where does it come from? It comes from loans and investments of all banks in the process which I have mentioned by which they create this money. We will see the importance of it in just a moment.

In 1939 the loans and investments of all banks totalled 51 billion dollars; 22 billion in loans, 9 billion in securities other than U. S. Government, and 19 billion in U. S. Government securities. As a part of the financing of World War II, total loans and investments grew, by 1945 to 140 billion dollars. Deposits grew from 57 billion to 124 billion dollars. The growth resulted largely from increases in public debt. Bank holdings of U. S. Government securities grew from 19 billion to 101 billion dollars. Other securities remained static. Loans went up slightly, from 22 to 30 billion dollars.

By 1951, the structure had changed. The holdings of Government securities dropped from 101 billion to 69 billion dollars, other securities expanded from 9 billion to 15 billion dollars, and loans grew from 20 billion to 63 billion dollars.

That process has continued until currently (as of June, 1956) loans stand at 106 billion dollars; other securities at 21 billion dollars, and the bank holdings of U. S. Government securities at 65 billion dollars.

It does not matter whether these debt instruments are in the form of private debt or public debt, when they are taken into the commercial

banks they add to the money supply of this country in the form of bank deposits.

Thus we see the meaning of the term I used earlier, that banks are dealers in debt. As they exchange their debt for that of others, they create additions to the money supply.

The purpose of the central bank is to exert an influence over that particular phase of the commercial banking system. How is it done? If the earning assets of banks are to increase, thereby increasing the money supply, the banks must have a certain amount of free reserves, and the influence of the central bank is exerted primarily on these free reserves, on the supply, availability, and cost of reserves.

Again I would like to go back to this flannel board. If you will think of this block as representing the available reserves of the banking system, if the central bank, the monetary authority, is to perform its function, it must exercise an influence over the supply and use of these reserves. What we actually are thinking of, however, is not the total reserves held but the free reserves. As we saw on the diagram which was first placed on the board, banks are required to keep a percentage of their liabilities on deposit with the central bank; that is their required reserves. Those reserves are not free reserves.--They cannot drop below the required percentage without facing a rather stiff penalty. The power of the banks to expand depends upon the reserves which they have available above and beyond the required reserves.

The influence of the monetary authority is exerted right here. It is exerted in three ways. I said that currently all member banks located in a central Reserve city have to keep 20 percent of their demand deposits as a reserve with the Reserve bank of which they are a member. That percentage may be changed by the Board of Governors of the Federal Reserve System. It could be increased to as high as 26 percent. It could be lowered to as low as 13 percent.

Let us assume that that instrument is used. A change in the required reserve percentage has two effects. In the first place, you have blocked out a certain part of the reserves which the banking system held. By raising the reserve requirement, you have changed free reserves to required reserves, and in addition to that you have

changed the multiplier. In other words, a 20 percent reserve requirement means that for 20 cents of reserves you can support a dollar of liabilities. So the multiplier is 5 to 1. But on a 25 percent reserve requirement the multiplier becomes 4 to 1.

By lowering the reserve requirements you have the opposite effect. You free a certain amount of reserves which were formerly blocked.

Banks operate for profit. In my book, there is nothing wrong with operating for profit. The profit motive is a spur to action. If they have free reserves they will try to put them to work and, as they put them to work, they make loans. As they seek an opportunity to make loans, they encourage the use of these funds by business and individuals.

By that process, the lowering of reserves, you tend to stimulate the expansion and the use of the money supply. By increasing the reserves you tend to slow down--not contract, but restrict the rate of growth of the money supply. So, by changes in the reserve requirements, the monetary authorities exert influence on the banking system.

Another thing that can be done is change the cost. The System has done that six times in the past eighteen months, changed the cost of obtaining additional reserves. There are two ways in which banks can obtain additional reserves from the central bank. What usually happens is, if reserve requirements are increased, or if the pressure as a result of a loan demand on the outside continually building the deposit structure of banks uses up the free reserves, from either of those two pressures the banks will usually turn first to obtain new reserves by borrowing from the central bank. They will send in their notes, debts secured by U. S. Government obligations or by what is known as eligible paper, or they may rediscount directly eligible paper and we will deposit to their credit the proceeds of that note, just as they deposit to your account the proceeds of a personal note which they have.

The difference is, when the commercial bank discounts your note it adds to the money supply, dollar for dollar. When we discount the note of a member bank, we add to the money supply, dollar for dollar, but we add to the potential at a rate currently of 6 to 1; for what we have supplied are reserve dollars on which they can now build additional deposit dollars.

We can make that source of reserves more costly, by changing the rediscount rate. As the cost of borrowing makes it less profitable, they tend to pay back, or seek to pay back, and in seeking to pay back they will try to convert assets into cash or reserves. They will move into the market and try to sell their Government securities to obtain the reserves which will enable them to pay back the borrowed money. If any member bank in the System has excess reserves and buys these securities from the bank that is short on reserves, then the ownership of the reserves is transferred by the transfer of the securities, and the borrowing bank can use them to repay the Reserve bank. But if there are no free reserves in the banking system, then the Reserve System may move into the market in what is known as open-market operations and buy securities, paying for them with the creation of additional reserves. Or, conversely, the Reserve System may move into the open market and sell, thereby mopping up existing reserves.

So, through these three instruments of monetary policy, the influence of the central bank is exerted upon the reserve structure of the commercial banks, and through that influence, on the economy of the country as a whole.

The Federal Reserve System is not trying now or ever, to force a contraction in the American economy. Rather the System tries to restrain immoderate growth which may lead to boom or bust and, conversely, attempts to stimulate a more rapid rate of growth in a period of lessened economic activity.

Essentially, however, the System is trying to influence the decisions of people; for these pressures upon the availability and the supply and the cost of reserves influence the decisions of the banker, and these decisions of the banker to lend or not to lend at one rate or another exercise an influence upon the decisions of businessmen and individuals across the country to borrow, to spend now, or to defer until tomorrow. So we are trying to affect the decisions of people. That is a very delicate thing to play with; for confidence can rapidly become overconfidence, and just as rapidly overconfidence can change to fear for the future.

We have learned that money will not manage itself. If left alone, it is a hard taskmaster; but there is a vast difference between managed money and a managed economy. There are inhibiting factors in the action of the monetary managers of the Federal Reserve System. I will mention quickly three. First, the size of the Federal debt itself. Second the fact that though the economy as a whole may be enjoying what appears to be a boom, there will be sectors of the economy which are not enjoying this upsurge of economic activity. The monetary

managers must recognize, and do, that in their attempt to restrain the boom in certain sectors of the economy they may adversely affect other sectors of the economy. The third inhibiting factor is the American objection to restraint, which exists all across the country in the minds and hearts of almost all of us.

These intangibles of human reaction must give us pause, for no one knows what the reaction of Americans will be en masse. While Americans are essentially individualistic, in recent decades trends toward a more socially integrated society have been apparent. Sudden changes in the thinking of people spread across the land very much more rapidly than in other days. Back in 1951 we experienced in a period of 90 days a change of rate of savings in the country from 3 percent of personal income after taxes to 9 percent of personal income after taxes on an average across the country. We may be all individualistic, but we decided to be all individualistic in the same direction at the same time--within 90 days. Why, nobody knows. We can just as quickly turn the other way. Why, nobody will know. But that change in the rate of savings, together with certain monetary policies which took effect in 1951, led us into a period of price stability. It is the longest we have ever known in our history; something like 5 years of a relatively stable price level on the average. It has begun to move up a little bit in recent months. Where we are headed, I do not know. That remains to be seen.

In a text which I studied a good many years ago, a text which today is out of date, there is one sentence which stays with me. I quote: "The wants which banks supply are simple in kind and sure to rise early in the development of any commerce of industrial people where there is mutual confidence among men."

Now, banking must be responsive to the changing needs of the economy, but it can exist only where there is mutual confidence among men. If these wants which banks supply are in fact simple, we should be able to reduce them to simple terms. I think we can. There are three.

First, banks provide a mechanism and a means by which we transfer values between people, a mechanism by which the value of your service is transferred to the grocer to provide food, to the merchant to provide clothing, to provide shelter--a transfer of values between people. The banking mechanism and money satisfy that want.

Second, banks provide a mechanism for the transfer of values between places, a process which enables a distributor in Baltimore to obtain from a manufacturer in Detroit and sell to a retailer in Washington, who places in the hands of a consumer in Arlington some commodity. These four separated places can have the values transferred between them with such ease that they hardly realize the mechanism exists. Banking enables people to transfer values between people and to transfer values between places.

Third, banks provide a mechanism for the transfer of values in time. There we come to the crux of the responsibility of the monetary authority. Our economy is built upon faith in the future. If we do not believe that our medium of exchange will preserve something of today's value tomorrow and next year and in the next generation, we cannot build an enduring structure. Therefore, the monetary authorities strive for a stable dollar, though not a static economy.

Thank you.

COLONEL LACKAS: Mr. Wayne is now prepared to answer your questions.

MR. WAYNE: That's a broad statement.

QUESTION: I would like to know, for example, why just recently you changed the interest rate to discourage loans. What controls or restraints do you have over member banks to keep them out, to restrain them from selling Government securities that they might have so that they can increase their reserves, which in turn would do the very same thing you didn't want them to do by changing the interest rate?

MR. WAYNE: The question, as I understand it, is: What restraint or restriction exists to prevent member banks, in a period when the monetary authorities are attempting to exercise an influence of restraint, from moving into the market and selling their Government securities, thereby obtaining the reserves which would enable them to go ahead and do what we had undertaken to restrain them from doing?

Well, there are two simple answers to it; or there is one very simple answer to it, and there is one that is a little bit more involved. Both of them apply. The first, the rather simple answer, is the

deterrent of the profit motive. In a period of restraint, as the price, in terms of interest, rises, the price, in terms of the market value of securities, falls. So that a bank which may hold a block of U. S. Government 2-1/2 percents of 1967-72 may go into the market and sell those securities and thereby obtain reserves, provided there are any reserves available for them to obtain; but to sell them the bank will have to take an 8-point loss on the dollar, because the market price, I think, is down to around 92, if I remember my market quotation correctly.

But the real restraint is this: If the bank goes into the market to sell the securities, seeking reserves, it has to get those reserves from someone who has reserves. If there are no free reserves available in the banking system as a whole, the only place it can obtain the reserves is to sell them to the System itself, to the Federal Reserve System itself. If the Federal Reserve System is not buying then the banker is in a desperate situation, and the only thing he can do is stop lending, or restrict his lending.

As a matter of fact, as of right now, the banking system is in debt. As of today, the banking system is in debt to the central bank by approximately 400 million dollars more than the free reserves held by the banking system. Now, the same banks are not in debt that hold the free reserves, but there is a net negative reserve situation in the banking system as a whole; so that there are few buyers for the securities, if a banker undertook to convert those, and therefore he would find it very difficult to obtain reserves.

We do not exercise any influence directly on the individual bank. We merely influence the total availability and supply, and the bank operates on a price factor within the market which rises out of our action. We do not restrict the individual banker. He may, at a price, undertake to obtain reserves, but that price tends to restrain him.

QUESTION: Mr. Wayne, would you discuss the relationship or interrelationship among the various Government agencies concerned with the economy--the Federal Reserve Board, the Treasury Department, the Council of Economic Advisers, and even the President's personal economic adviser, Dr. Harvey? How do all those people gear in together?

MR. WAYNE: There is very close relationship between the Board of Governors of the Federal Reserve System and the Secretary of the

Treasury. There is an exchange daily at the staff level and discussions between the senior staff people of the Board of Governors and the senior staff people of the Treasury. There are many contacts--I would not say daily--there are times when they are daily, but contact would not necessarily be daily at all times--between the Chairman of the Board at policy level and the Treasury, either the Under Secretary of the Treasury or the Secretary of the Treasury, as the case may be. It so happens that in the present organization of the Treasury Department the Under Secretary of the Treasury, Mr. Burgess, is spending full time on the debt management and the fiscal management problem. So that a great deal of contact between the Federal Reserve System and the Treasury centers there at the policy level between the Chairman of the Board and Dr. Burgess.

The Treasury advises the Reserve System with respect to its advance needs and indicates what it contemplates doing in connection with debt management. The Federal Reserve System in turn keeps the Treasury Department constantly advised of the System's current appraisal of the monetary and credit situation and the monetary steps which seem to be indicated under the circumstances as the System sees them. The Treasury does not, and has not since March of 1951 undertaken to exert any direct influence on the operations of the Reserve System. In turn, the Reserve System has not undertaken to exercise any direct influence upon the problems of the Treasury. The two have recognized their independent areas of responsibility, and act accordingly. They are kept advised mutually as to what is being done, but each proceeds on its own responsibility.

As between the Reserve System and the Council of Economic Advisers, my own personal knowledge of that relationship is much more vague than with respect to the relationship between the Reserve System and the Treasury. Again, however, those contacts are maintained, largely through the Chairman of the Board and certain senior staff members of the Board of Governors, who maintain a close relationship with the senior staff people on the Council of Economic Advisers, and then between the members of the Council and the members of the Board.

The Chairman of the Federal Reserve Board is the representative of the System, for instance, and sits in meetings of the National Security Council, and represents the Reserve System in the discussions at top governmental level concerning our international relationships. It is through the Chairman at the top policy level that those contacts

are maintained, and it is through the senior staff people or other members of the Board that contacts are maintained on the working levels with the various departments.

QUESTION: You seem to be, shall we say, slightly bitter about this 6 percent legal limit on the profits of the Federal Reserve bank. I wonder if you would give us a little comment on both sides of that, both as to why or why not that should be raised.

MR. WAYNE: I am not bitter about it. I merely said that the commercial banks, as they look at the rather large earnings of the central bank, feel that they are entitled to a larger percentage of the earnings of that system.

The arguments on the side of a larger participation on the part of the commercial banks in the earnings of the central bank rest primarily upon the concept of the Reserve banks as private corporations, and the commercial banks as the stock owners of that corporation; plus the fact that the commercial banks carry reserve deposits with the central bank, and many of them are persuaded that it is through the investments of these deposits that the earnings of the reserve banks are obtained.

In a measure that is true, but only to a degree; for the central bank actually creates those deposits through the process that we have discussed here; either by the making of loans or by the purchasing of securities it creates the reserves, which are then the property of the commercial banks.

This leads us in part around to the other side of the argument, against an enlarged participation of the commercial banks, an argument which has been used, and no doubt will be used again, to support eliminating all participation of the commercial banks. Essentially the earnings of the central bank stem from its power, its authorization as a bank of issue, to issue money, plus the requirement in the law for the maintenance of reserves in the form of liabilities of the central bank. That power to issue money is essentially the right of the sovereign, the right of the Government, whatever the government may be. If we were not a bank of issue, if we did not hold the required reserves of the member banks, and if it were not against Federal law, Federal statute, to demand that we convert our liabilities into the ultimate reserve, which is gold, then the profits of the

Reserve System would be severely restricted. So that, since those earnings result from the performance of a function which is essentially in the interest of society through Government, the earnings should properly go to Government as representative of society.

An argument at a somewhat different level, but of considerable significance to the effective operation of the central bank is this: If the central bank were faced with the spur of making earnings, the profit spur, if it were operated for private advantage, which it is not, then it would be under pressure at times to take actions to protect its profit earning capacity, whereas it perhaps should be taking actions in which it would deliberately lose money, in order to stimulate economic activity on the other side. But, if the central bank were under the profit spur and the necessity of making earnings to pay out those earnings in the form of either dividends to the stockholders or interest on the deposits held by the commercial banks, then the central bank would find itself inevitably competing with the commercial banks and the private side of our structure after those profits. If I may use a slight slang term--they ain't seen no competition yet until they try to compete with a bank of issue.

They really don't want it, but they think they do.

QUESTION: Mr. Wayne, what fundamental difference exists within the Reserve System now as opposed to what existed in the thirties during all the bank crashes? Is the safeguard now strictly that of insurance or is there some other fundamental change? What protection do the State banks have against crashes, and so forth?

MR. WAYNE: Two questions--the first question--have there been any fundamental changes in the System since the early thirties? The answer is yes. There was a fundamental change in the basic law under which the Federal Reserve System operates, brought about by the Banking Act of 1935. Prior to the Banking Act of 1935, we could only pledge--the Reserve System could only pledge--against these outstanding liabilities of the Reserve System, gold and eligible paper, and the authority to pledge Government securities back of it was severely restricted, almost nonexistent. In addition, the Reserve System could make advances to member banks only against so-called eligible paper.

You will recall that when the System was established in 1913 it rested very largely upon the then current Real Bills Doctrine, which

held that as business expanded business paper would expand, and, if you could provide for the monetization of that business paper through the central bank and that business paper only--that is, paper which financed a step in the process of production and was paid for when the goods or services reached the point of consumption--then, as business expanded and business paper expanded, the money supply would expand accordingly and, as the process was completed and the business paper was then retired, it would be retired by a retirement of the money supply which had been issued at the time of the monetizing. You had a mechanical process which would expand as business expanded and would contract as business contracted. It's a beautiful theory. It just doesn't work. But the authority of the Reserve System to make advances was limited to that kind of paper until the 1930's.

Since the 1930's the Reserve System has the authority to extend to member banks credit against any acceptable asset which the bank has. So there has been that basic change.

A second basic change has come about, in that we like to think of the Reserve System as dynamic and not static, and as growing and not staying fixed; and the understandings and experiences of the Reserve System itself have grown as a result of the experiences in the thirties. By experience, the techniques have been refined. By experience, the understanding has been enlarged, so that the monetary authority, the Reserve System, understands itself and its limitations better than it did in the 1930's. That is a second fundamental change.

Then, third, prior to the banking act of the early thirties, the Reserve System had always to stand ready to meet demand for its ultimate reserve, which was gold. It no longer has to protect itself against that demand for its ultimate reserve, so that it can expand with greater freedom. It may be that we have permitted it to expand with too great freedom.

On the second question, as to the protection of the state banks, there is no difference in the sort of charter affecting the strength of a bank. A state bank can be just as strong as a national bank, and a national bank can be just as strong as a state bank. Conversely, one can be just as weak as the other. There is no virtue in the charter which the bank has.

The member banks have access to the discount facilities of the central bank. Nonmember banks do not have direct access to them,

but the nonmember banks have effective access to them through maintaining correspondence relationships with the member banks. So that, while the central bank does not make, ordinarily, loans to nonmember banks, they do obtain their needed credit through the member corresponding bank which in turn may obtain it directly from the Reserve bank.

However, in our open-market operations, where we buy and sell Government securities, and where, within the last week, we have taken what may appear to be contrary action, by increasing the discount rate from 2-3/4 percent to 3 percent, which increases the cost of reserves, we supplied about 80 million dollars in new reserves in the open market by going in and buying securities. What we did was increase the cost and increase the availability, which appears to be working at contrary purposes, though that is not true. We see ahead in the months the need for reserves because of the normal fall expansion of credit to finance the movement of crops. We have to have additional reserves in the months ahead. We know from past experience that, beginning with the first week in October, and running through the 23d day of December, money in circulation, currency outside the banking system, will rise one billion dollars. It always does. We have to buy Santa Claus with something. Currency in circulation outside the banks will rise a billion dollars. We will have to provide reserves to the banking system to meet that rise in currency or else you will have a sharp contraction in the lending power of banks at the very time when, almost regardless of cost, the movements of crops must be financed. We raised the cost of it to suggest that certain capital projects be deferred. That has happened. We also increase the availability to facilitate the movement of crops and to meet the expansion in the currency demand.

Now, state banks, member or nonmember, have just as much access to the market as any other, so they obtain their reserves, largely, that way.

QUESTION: Mr. Wayne, would you discuss the effectiveness of these three controls under conditions of strong inflation, and then under conditions of strong deflation?

MR. WAYNE: In a period of powerful inflationary factors, and the Reserve System believes that we are currently facing some strong inflationary factors, one effect is that none of them, or all three together, will not necessarily prevent an inflationary movement. They

may exercise a restraint on it. In a rise of the discount rate, the result has been to raise the prime rate--that is the rate which borrowers have to pay to commercial banks to obtain funds. Its effect carries through into the longterm market, so that the rate which a corporation would have to pay for obtaining the money to float a 20-year bond would become greater.

As one result, a corporation which might be seeking 100 million dollars in capital or in long-term funds in the capital market, and, let us say, had in mind floating a 100 million dollar bond issue running over a period of 30 years, in order to float that issue now would have to commit itself for 30 years to pay annually 4-1/2 to 4-3/4 or even 5 percent because of the current tight money situation. It is one thing to commit yourself to pay 4, 4-1/2, 4-3/4, or 5 percent for 30 years and it is another thing to commit yourself to pay it for 90 days. The corporation seeking to make that expansion might decide that it would be better to defer it until next year. If several corporations at the margin made that decision, the current pressure for capital funds would be lessened.

On the other side, in a down movement in the economy, if it is a gentle movement, and if you are smart enough to see it at its early stages, you can begin to move quickly in the opposite direction; so that the decisions which were made at the margin to defer will now again be made at the margin to come in and sustain. So you tend to level the demand out.

On the other hand, if the down movement gets sharply under way, monetary action has been spoken of as leaning against a string. You sort of push against the string, and you know what effect that has. If it is taut, then some effect is felt, but the minute the string is allowed to slacken, there has to be an awful lot of push before it is felt.

There is some feeling that the monetary authority is more effective on the restraining side than it is on the sustaining side.

COLONEL LACKAS: I see our time has elapsed. Mr. Wayne, on behalf of the College, I would like to express our appreciation for a most interesting and stimulating discussion. Thank you.

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