BANKS AND THE BANKING SYSTEM

3 September 1953

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INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

Dr. Watrous H. Irons, Vice President, Federal Reserve Bank of Dallas, was born in Atlanta, Georgia, on 18 January 1903. He received his education from public schools in Georgia, New York, and Massachusetts and from the University of Georgia. He received his B.A. in 1925 from Pennsylvania State College and his M.A. in 1933 and Ph.D. in 1937 from the University of Pennsylvania. From 1937 through June 1945, he was professor of banking and finance at the University of Texas School of Business Administration. On 1 July 1945 he joined the Federal Reserve Bank of Dallas as director of Research and in April 1946 was made a vice president of the Bank. His publications include "Commercial Credit and Collection Practice," "The International Gold Standard, 1925-1934," and articles in economic and business journals and periodicals.

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DR. KRESS: Admiral Hague, gentlemen: Yesterday Dr. Chandler told us all about money and credit and its theoretical side and practical side, too. Today our speaker will tell us how the Federal Reserve System actually operates and the relationship between the various parts of the System. He is well qualified to do this, having taught economics at the University of Texas for some years, but transferred over to the Federal Reserve Bank of Dallas where, several years ago, he became vice president --which is pretty good for an economist in a practical system.

Dr. Irons was recommended to us by Mr. Anderson, the Secretary of the Navy, who guarantees that he knows more about the organization of the Federal Reserve System than any man in the United States. They served together in that bank when the Secretary was the deputy chairman. Since the Secretary has grabbed him from us for lunch, I think their association was a pleasant one.

It is a great pleasure to introduce to you Dr. W. H. Irons, Vice President, Federal Reserve Bank of Dallas. Dr. Irons.

DR. IRONS: Thank you, sir. It is a pleasure to be here with you this morning to think out loud a little bit and try to give you a picture of what makes our banking system "tick."

I hope that I won't become too elementary on some points. You will pardon me if I do, but I find in talking to bankers in our district that while they know how to run their own banks admirably and profitably, they are sometimes not so familiar with some of the broader principles and relationships of the banking system.

I will try to give you an outline picture, first, of the organization of our banking system and, second, of the operation of banking insofar as the relationship between the Federal Reserve System and the commercial banking system is concerned. It is largely through this relationship that the increase in the money supply arises--from an increase in deposit currency or the demand deposits of commercial banks.

To give you a sort of graphic mental picture of the organization of the banking system, I shall start at the top with the central banking system and move down. At the center of the top of the picture there is the Board of Governors of the Federal Reserve System. This Board legally consists of seven members appointed by the President of United States and confirmed by the Senate for 14-year terms of office.

The salary is now 16,500 dollars. The Board of Governors is the central body of the Federal Reserve System and, in a sense, of the banking system.

There are two other legal bodies at the top of the system, one with mandatory powers and authority and the other purely advisory. The one with mandatory power and authority with respect to credit policy is the Open Market Committee. This committee is a legally constituted body consisting of the seven members of the Board of Governors --at the moment there are only six members on the Board--plus the presidents of five of the Federal Reserve banks. The New York Federal Reserve Bank president is always on the committee and the other four president members are selected on a rotating basis. The Open Market Committee has full power and responsibility with regard to transactions which are known as open-market operations. I will explain later what those transactions consist of and indicate their importance.

The second of these bodies is the Federal Advisory Council and it is, as the name implies, advisory. It has no mandatory authority or power, but can recommend, suggest, and confer with the Board of Governors. The Federal Advisory Council is constituted of 12 members, one from each of the Federal Reserve districts. The members are usually bankers. The purpose of the council is to bring to the central body of the System, the Board of Governors, the views of business, banking, financial, and other types of economic leadership in each of the Reserve districts.

You must remember that the Federal Reserve System is unique in that, although we talk of it as a central banking system, it is not really centralized. It is not like the Bank of England, the Bank of France, the Bank of Canada; it is a regional system of central banks, with each of the regional banks having a considerable degree of autonomy.

Those then are the three legally provided bodies, the Board of Governors being the central body but not with regard to open-market operations. The Open Market Committee has that responsibility. The Federal Advisory Council is merely advisory. Underneath that you have the 12 Federal Reserve banks and their 24 branches. The following cities constitute the Federal Reserve System: Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. Some of them have branches and some of them don't. In our district, we have three branches --Houston, San Antonio, and El Paso. Some districts have four and some have fewer or none.

Again carrying out that regional picture, the 12 Federal Reserve banks are sort of unusual corporate creatures. The Reserve banks are not Government agencies. Their employees are not under the Civil Service System. The banks do not receive any appropriations from the

Congress; in fact, they receive no money from the Government. Each bank has its own retirement system, its own employment plans and policies, and its own board of directors. Each bank's directors elect the bank's officers. A Reserve bank is a financial corporation that is a quasi governmental agency in the sense that with respect to credit policy and similar such policies its actions are subject to final approval by the Board of Governors of the System.

In brief at the top of the System is the Board of Governors, a public body appointed by the President and confirmed by the Senate, a governmental agency but an independent governmental agency. Then at the next stage there are the 12 Federal Reserve banks which, we say, are quasi governmental in character. The Reserve banks are owned by the member banks in the respective districts. Each member commercial bank owns stock in its Federal Reserve bank. The Reserve banks pay 6 percent dividends--by law--on that stock to their member bank stockholders. Yet the member banks are a kind of preferred stockholder because they have little to say concerning the operation of the Reserve banks.

The principal power that the member bank stockholders have with regard to Federal Reserve banks is to elect six of the nine directors. Each Federal Reserve bank has nine directors. Three, referred to as class C directors, are the public directors appointed by the Board of Governors; three class A directors are bankers in the district elected by the bank stockholders; and three class B directors are businessmen --nonbankers--elected by the bank stockholders of the district.

Underneath the 12 banks are what are known as the member banks. They include all the national banks, which by law must belong to the Federal Reserve System, and such State banks as meet the requirements for membership in the Federal Reserve System.

There are about 14,000 banks in the United States. Of that 14,000 almost 5,000 are national banks and are members of the Federal Reserve System. The remaining 9,000 are State banks, of which almost 2,000 are members of the Federal Reserve System. So from the point of view of number, roughly half of the commercial banks in the country are members of the Federal Reserve System, but from the point of view of either assets or deposits, about 85 percent of either total assets or deposits of the commercial banking system are held by banks that are members of the Federal Reserve System. In effect, therefore, the Federal Reserve System has a direct influence over approximately 85 percent of the banking resources of the country.

Now that is the organizational picture. If you were drawing an organizational chart, at the top you would place the Board of Governors, followed by the Open Market Committee and the Federal Advisory Council. On a line under the Board of Governors you would show 12 Federal

Reserve banks. Underneath each Federal Reserve bank, you would show the member banks, broken down into national banks and State member banks. For all practical purposes that is the Federal Reserve System.

There is also an indirect influence on the nonmember commercial banks, or the State banks that have not decided to take membership. That is because those banks--which are almost exclusively small country banks--use city banks as their central banks, and the Federal Reserve influences the city banks. So if the Federal Reserve tightens credit, for instance, and the tightening of credit has an impact on the city bank, the city bank will tend to tighten its credit, or restrict its advances and dealings with the country bank that is not a member. So the System can get at about 85 percent of the banking system directly and indirectly, through that 85 percent, at least touch the 15 percent that is outside the membership.

That is one reason, for instance, why I personally would much prefer a voluntary type of membership in the Federal Reserve System for State banks; also it is a reason why, although the question often comes up about forcing all banks into the Federal Reserve System, I cannot get much enthusiasm for it. Perhaps we would tear down something that over the years has come to be tradition and has a certain value. You tear that down. For what? To get a little more fringe control, which I question as being worth the cost.

Turning from the organizational picture, then, to how this banking system operates, I feel that the heart of our banking system, the core of its operation, lies in what bankers refer to as reserves.

I know that people often wonder about the manner of creating money, as though it was something plucked out of thin air and created with a stroke of a pen.

Let us examine graphically and quickly--a commercial bank statement. If you were to look over a financial statement of a commercial bank, what would you find on it? What would it include? On the asset side you would see, first, a certain amount of cash. That cash will vary with the condition and the circumstances of the bank and the banking system as a whole. Perhaps if you had a composite statement, that cash might be from 3 to 4 percent of the total resources.

Then there would be an item, "Balances with other Banks." Now commercial banks keep certain balances on deposit with other banks just as you and I keep deposits with commercial banks for the purpose of transacting our business. And down below there would appear "Reserves in Federal Reserve Bank." Members of the Federal Reserve System are required to keep--and this is the key to the problem--reserves with the Federal Reserve bank of their district.

There are three classes of banks for reserve purposes. There are what we call "country" banks which include most of the banks; those country banks at the moment are required to keep on deposit collected funds with the Federal Reserve bank of their respective districts an amount equal to 13 percent of the country bank's demand deposits and an amount equal to 6 percent of the country bank's time deposits.

The second class of banks includes banks located in a city such as Dallas, Houston, or any large city other than New York and Chicago; such a bank is required to keep 19 percent of its demand deposits with its Reserve bank. If it is located in New York City or Chicago, it is required to keep 22 percent of its demand deposits with its Reserve bank. So on the asset side of the commercial bank statement there will appear in this item "Reserves with Federal Reserve Bank" an amount that is at least equal to 13, 19, or 22 percent of the commercial bank's demand deposits, plus at least 6 percent of that bank's time deposits. The significance of this is that if the bank's deposits increase, there will be additional reserves required.

Further, on the asset side of its statement the commercial bank will show loans. What happens when the commercial bank makes a loan of $25,000? Suppose that commercial bank is located in the city of Dallas. In 99 cases out of 100, the banker credits the borrower's deposit account. So, in the process of making the loan, loans increase $25,000 and deposits go up $25,000. But, if deposits have gone up $25,000, the banker--if located in Dallas--must have 19 percent of that increase to put aside in reserve funds. If those reserves are not available to him, he cannot make the loan because in making the loan, he creates the deposit which requires an increase in reserve funds.

However, when anyone borrows from a bank, it is rare that the borrower does so for the purpose of allowing the money to lie idle in the bank. It is drawn out quickly. So the individual bank cannot make a loan and create a deposit unless it is in a position, not only to meet the reserve requirement, but really in a position to lose by withdrawal an amount of funds about equal to the created deposit. There is no multiplication in this credit process for the individual bank, but for the banking system as a whole, there is.

Let us assume that an individual bank obtains $1,000 in funds. Receiving $1,000 on deposit, it has to set up a reserve--let me use 20 percent--of $200. That leaves excess reserves or unused funds amounting to $800. The bank then is in a position to make a loan of $800, or the amount it could lose by a withdrawal of the $800 that it has. In making an $800 loan the bank has created a derivative or secondary deposit of $800.

Now that is what that one bank could do. It received a $1,000 deposit and put $200 aside as reserve; that left it with $800. It made a loan for $800 and that created a deposit of $800. It didn't "pluck something" out of thin air. It had "something" to start with.

Someone borrowed $800; he had to pay some bills so he immediately drew checks on bank A, and that $800--let us just take the extreme example--was drawn out of bank A as those checks were collected by banks B, C, and D. Those three banks, we will say received the $800 through the checks. They have to set up a 20 percent reserve or $160. That leaves banks, B, C, and D, with $640 excess funds. Those three banks now could make $640 worth of loans and create $640 worth of derivative deposits.

The people who borrowed the $640 draw checks on it and send them around the country, and they get into banks E, F, and G. Those banks set one-fifth aside for reserves and have four-fifths left. That is the process as it moves from bank to bank. On the basis of a 20 percent reserve requirement, the banking system as a whole can expand a dollar reserve of funds deposited with it five times. The individual banks can only expand about once, but the system as a whole can expand about five times. Reversely, of course, if there is a withdrawal of reserves and the banking system as a whole loses a dollar of reserve, there is the extreme possibility that it might involve a five-time contraction. If a $5 bank deposit has been built on the basis of a dollar of reserve and the dollar of reserves is withdrawn, deposits will tend to shrink.

Now, I would like to mention the importance of the money supply which we hear much talk about. Money supply, as I think of it, would include demand deposits of banks, exclusive of interbank deposits and a few other items, plus currency in actual circulation, outside Federal Reserve banks and the Treasury. I believe at the end of June, the demand deposit figure was somewhere in the neighborhood of 99 billion dollars and the currency outstanding was about 28 billion dollars, with the money supply somewhere in the neighborhood of 127 billion dollars. The more volatile part of that total is the deposits, not the currency.

The money supply in a sense represents demand for goods. It is a potential demand for goods, at any rate, and it should be kept reasonably well balanced with the available supply of goods. When the money supply and the available supply of goods and services become badly out of line one way or another, you have inflationary or deflationary trends --too much money seeking too few goods or too little money seeking too many goods. The former is what happened during the World War II period. Of course, during that period we were creating--due largely to deficit financing on the part of the Government--additional money supplies and limiting the supply of goods available for consumers inasmuch as a large part of our production was being diverted into military utilization. During the war years we had all sorts of direct controls to keep the pressures under restraint.

As soon as the war ended, at the end of 1945, as you will recall, there was a great clamor to remove all kinds of controls; that was

done, and it turned loose, free of controls, this big money supply and potential money supply on a production system that had not yet shifted from military production entirely into civilian production. Consequently, there were strong inflationary pressures.

During the postwar period other policies were inflationary in their contribution and tended further to increase the money supply. During the past year and a half the money supply increased slightly but not appreciably. It has been kept pretty well in line and we have found that prices and other relationships have been kept fairly well stabilized.

The volatile factor has been the deposit currency fluctuations.

Now let us turn back to the Federal Reserve System. I think it can probably be correctly said that the basic reason for a central bank is to exercise an influence or control over the volume, availability, and cost of bank reserves. We do a lot of other things in the Federal Reserve System such as to assist in the collection of checks or the clearance of checks, thus we serve as a sort of clearing house; issue currency by means of Federal Reserve notes; with 75 or 80 percent of the currency outstanding in the form of Federal Reserve notes; act as fiscal agent for the Treasury and certain other governmental bodies, such as Commodity Credit Corporation. But, at the heart of central banking there is the problem of influencing and controlling the volume, availability, and the cost of reserves to the banking system. It is that function that I would like to talk about during the remainder of my time.

The Federal Reserve System has several legally authorized means by which it may influence bank reserves. First, there is the process which we refer to as Open Market Operations. That simply means the buying or selling of Government securities by the System. Buying and selling of Government securities in the open market are under the direction of the Open Market Committee.

The agent for the Open Market Committee and acting for the 12 Federal Reserve Banks is the New York Federal Reserve Bank. That bank, being located in the Nation's central money market, is the agent that carries out the actual purchasing or selling and handling of open-market account transactions. Then the 12 banks participate in the total on a pro rata basis--at the moment based on each bank's share of the total assets in the system.

The second means of influencing bank reserves is through the discount window, as we call it. The member banks may for certain purposes and under certain conditions borrow from their Federal Reserve banks. Just as an individual or a business may borrow from a commercial bank, a member bank may borrow from us. We do not do business with the public

or with business firms. We only do business with member banks, except for our Treasury relations as fiscal agent.

The third is the authority of the system to change member bank reserve requirements within certain limits. You will remember in discussing our member commercial bank statement I pointed out that there were three groups--the country banks, the reserve city banks, and the central reserve city banks. The basic legal reserve requirement for country banks is 7 percent; 10 percent for reserve city banks; and 13 percent for central reserve city banks. The 1935 amendment to the act gave the Board of Governors authority to raise the reserve requirement by not more than 100 percent for each class of bank, so now reserve requirements may be set by the Board of Governors for country banks at from 7 to 14 percent on demand deposits and from 3 to 6 percent on time deposits; for reserve city banks from 10 to 20 percent on demand deposits and from 3 to 6 percent on time deposits; and for central reserve city banks from 13 to 26 percent on demand deposits and from 3 to 6 percent on time deposits.

The authority to change reserve requirements influences reserves. It either frees some funds, making them available for lending, or it absorbs some funds which might otherwise have been available for lending; or it may force banks to liquidate some loans or investments to get the funds to meet higher reserve requirements.

It is sometimes alleged that the System uses a sort of "open-mouth policy," where now and then judiciously placed statements appear in the press that no one takes credit for but are nevertheless there. I have my doubts as to how much good that does. Maybe once in a while it might do some good but if what is hinted doesn't happen and it is hinted again and again, it becomes a sort of "crying wolf" and not very effective.

Now let me go into these methods a bit and see how they work. Let us take open market first. How do we in the Federal Reserve System get reserves into the market? Just how is that done?

Suppose we consider an open-market operation in which we are the purchaser. We would, through the New York Federal Reserve Bank, purchase Government bonds from someone. Say an insurance company decides it wants to sell 10 million dollars' worth of Government bonds. It offers those Government bonds to a bond dealer in the New York market. The bond dealer offers the bonds in the market and we in the Federal Reserve System buy them. The New York Federal Reserve Bank acting for the Open Market Committee purchases the 10 million dollars' worth of bonds.

Now, what happens? What do we use with which to purchase? Lots of folks--and unfortuantely too many commercial bankers--think we use their deposits, but we do not. We couldn't if we wanted to.

The cashier of the New York Federal Reserve Bank writes a check on his bank, a cashier's check, for 10 million dollars, and purchases the bonds, and pays the 10 million dollars to the dealer. The dealer--let us skip the intermediate steps--passes the 10 million dollars on to the XYZ insurance company. We have bonds in the New York Federal Reserve Bank and the XYZ insurance company has a check for 10 million dollars on the New York Federal Reserve Bank. The insurance company banks with the First National Bank, so it deposits the 10-million-dollar check in the First National Bank. The First National Bank thus obtains one of those deposits we were talking of previously. It credits the deposit account of the XYZ insurance company. The First National Bank, however, goes about collecting the check and presents it to the Federal Reserve bank for payment.

The check can be paid in one or the other of two ways and the First National Bank can make its choice. It can present the check and say, "Give us reserve credit in our reserve account," and we would be glad to do that. Or it could say, "We don't want deposit credit, we want money. Give us 10 million dollars." We would be glad to do that, too, because we issue money. In most cases we would credit the reserve account with one of the member banks with 10 million dollars. If the bank is a Reserve city bank, only 19 percent is required against the 10-million-dollar deposit it put on its books. So, that bank would have over 8 million dollars of free reserves ready for expansion.

Where did we get the money to buy these 10 million dollars' worth of bonds? We created it through our power to issue notes or create deposits. Now what limits the extent to which we can do it? We, too, have to keep a reserve. We have to keep a reserve in gold certificates against our deposits and notes equal to 25 percent of the deposits and/or notes. The other 75 percent can be in the form of Government bonds or certain types of commercial paper. So we could take 75 percent of the bonds we bought with our cashier's check and set them aside as 75 percent reserve against this deposit we created or the notes we issued and hold 25 percent in gold reserve against the remainder.

Our ability to buy Government securities in the market is limited by whether or not we have free gold certificates to provide a 25-percent reserve against what we purchase. At present we have about 22 billion dollars of gold certificates of which the sum of about 11 billion dollars is tied up and the amount of about 11 billion dollars is unused. So if that 11 billion dollars, roughly, should represent 25 percent, it would mean that we could buy if necessary some 40 billion dollars' worth of Government bonds. That would mean an awful lot of credit expansion because, as you remember, each dollar of reserve credit might support as much as five dollars of commercial bank credit.

Whenever the Federal Reserve System, through its Open Market Committee, buys or sells Government securities, it puts an amount of reserves

in the market equal to the purchase or it takes an amount out of the market equal to the sale. That is an economic fact of life, and unfortunately these economic facts of life sometimes come into bitter conflict with questions of expediency or other factors. That was one of the very difficult problems faced in connection with the support of prices of Government securities by the Federal Reserve System until March of 1951.

On one angle, you say you are buying securities of the Government in order to maintain the price at par, which we were, but the damaging economic effect of that was that--regardless of why we bought the Government securities--whenever we bought them, we put reserves in the market and we couldn't help it. So during a period when we ought not to have been inflating by buying securities, we were creating reserves, and making it possible for the banking system to expand its credit; that was economically wrong. Since March 1951 policies have been changed and we haven't been supporting the price of Government securities.

Inconsistent or not, bankers sometimes say that they think that "interest rates ought to be higher. The interest rate is one kind of price that hasn't gone up. The price of everything else has gone up but not the price of money. We ought to have higher interest rates." But in the next breath some of them say, "You ought to do something to keep the price of Government bonds from going down."

We can't do both because if we buy bonds at par or any other price we inevitably put reserves in the banking system, money becomes easy and readily available; when the supply of money becomes easy and very available, the price for it goes down and we get lower interest rates.

We come now to the rediscount device which is a pretty simple process. We don't take the initiative in this matter. We fix the discount rate at which we will make loans to member banks. Then it is up to the member bank to borrow from us if it needs to. The only time we take the initiative is in those few cases where we turn down a loan. Discounting is not a right a member bank has; it is a privilege. It may rediscount with us; sometimes we turn down loans or we call loans after one renewal because we expect the member bank to operate on its own capital most of the time. Banks should only come to us for occasional, unanticipated needs, or certain seasonal needs; it ought not to be operating on our capital.

We have had to watch the discount process very closely, of course, during the past couple of years because of the excess-profits tax angle under which banks can get credit on their excess-profits tax on borrowed money. We do try to limit rediscount to appropriate uses--the proper use of bank credit. Each case is in reality an individual case. In most cases, it is a short-term type of adjustment credit which runs sometimes from 2 or 3 days up to 15 days. Some banks that

are subject to sudden shifts of funds may come in and borrow a few million dollars today and the day after tomorrow pay it off when the funds shift around. Some borrow for seasonal purposes, for the movement of crops, and so forth. But the initiative rests with the bank. We can't make them borrow. We can however fix the discount rate at whatever level seems most desirable.

Finally, with respect to the changing reserve requirements, I think enough probably has been said. The Board of Governors can change reserve requirements as previously noted.

Recently, to put the banks in a position to assist the Treasury in raising about 6 billion dollars the Federal Reserve System reduced the reserve requirements by one percentage point for reserve city and country banks and two points in the central Reserve city banks. The reduction was sufficient to release 1 billion, 160 million dollars of reserves. That 1 billion, 160 million in reserves was released shortly before the Treasury came into the market. Multiply 1 billion, 160 million by about 5, which is about the multiplier, and you come up with approximately 6 billion. The Treasury was seeking about 6 billion and got it. Subsequently, those reserve funds will be shifted around, but reserves were made available to help the Treasury get the funds it had to have.

I think I have talked long enough. I will subject myself to any questions you care to ask.

QUESTION: Would you care to comment about the manner of the relationship between the Federal Reserve and the Treasury? For instance, you mentioned where the Treasury needed 6 billion dollars. Suppose there was some difference of opinion between the Federal Reserve and the Treasury? Is there much difference of opinion in that respect?

DR. IRONS: With regard to the Federal Reserve and the Treasury, the present relationship is excellent. I don't believe that either one can ignore the other. They cannot be independent to that extent. But there is a difference between a continued subservience in the direction of monetary and credit policy as determined and reflected by economic developments and the direction of monetary and credit policy simply for a fiscal or Government security purpose.

Now when I said a moment ago that the Treasury needed money and the System helped to make it available, you must view the whole picture, and it is a very complicated picture. We do have a Government debt of 272.5 billion dollars. Maybe we shouldn't have it. Maybe we ought to have fought the last war on more taxes and less borrowing, and that sort of thing, but we didn't. The debt is here. We must live with it.

I think we also recognize that in a credit system such as ours, and, of course, our economy is truly a credit economy, the basis of

the credit structure is Government credit; if Government credit isn't good, what is? That doesn't mean that the central bank must subvert everything to this problem, but it means we must aid in as sound a way as possible. It doesn't mean that we have to support the price of Government securities continually as we were doing prior to March 1951, which I think was wrong; but it is another thing to make reserves available from time to time to the banking system to aid the Treasury in its financing problem.

I think at present the Federal Reserve System and the Treasury are seeing eye to eye and are in complete agreement. We did make reserves available partly to assist the Treasury in the market.

I think one would have to say that the Federal Reserve System and the Treasury--the one dominated by fiscal policy and its relationship and its effects upon the economy, and the other dominated by the monetary and credit situation--have to work together to get the job done, and I think it can be done; I think it has been done for the past couple of years. I don't know whether that is an answer to your question or not, sir, but if you want to carry it further, I will try to answer it.

QUESTION: What happens or who is the final authority if they continue to disagree?

DR. IRONS: Well, I would say that the only answer to that, so far as the Federal Reserve System is concerned, is the Congress. The Congress is the final body to which the Federal Reserve System is responsible. Congress passed the Federal Reserve Act which established certain powers and charged the Federal Reserve System with certain responsibilities. If those responsibilities and powers are to be changed, it is the right and the duty of Congress to do it. The Federal Reserve System is not responsible to the executive branch, to the President, or to any other part of the Government. It is responsible to the Congress. Congress alone has the right to alter the Federal Reserve Act.

QUESTION: Dr. Irons, should the Federal Reserve decide to sell Government securities and your prospective customers do not want to buy those, what means do you have to coerce prospective customers into becoming customers?

DR. IRONS: We do not have any means, and we would not coerce. However, in a market such as the Government security market there is always a buyer at a price. We could offer Government securities to dealers with whom we deal at the market price and there would be a buyer at the price. So it wouldn't be a matter of coercion. There will be a buyer for the Government securities at a price.

Of course, most of our operations--although we own some long-term bonds--are done in Treasury bills which are 91-day bills. We own

several billion dollars' worth of Treasury bills and they are on a weekly basis, 13 issues, each issue matures in 91 days. That means each week an issue comes due. We own some of each of those issues. It would be just as effective if we just let those for a particular week just run off--fail to replace them. That would be the equivalent of a sale because somebody else would have to buy them out of the market. In operating with Treasury bills, we can get the same effect by letting the bills run off at maturity.

QUESTION: Dr. Irons, recognizing the stabilizing influence of the Federal Reserve System on the economy of the country in the commercial banking field, what is your opinion of the Federal Reserve System, in order to assist the economy of the country, getting into the investment banking business?

DR. IRONS: Personally, I would prefer not to do it. I don't think that the Federal Reserve System ought to engage in investment banking because the funds for investment banking ought to come from genuine savings and not out of the banking system. Our operations are those of a central bank and are in the working capital area.

Now there have been proposals--most of them pointed at aiding small business--made on the basis that there is a void of that kind of financing. If a large corporation wants to raise 50 or 100 million dollars, there is an investment banking system through which it can raise the money; moreover, if the commercial banking system needs to expand, it has the Federal Reserve System. However, if a fellow gets a bright idea and wants to get into business or a small businessman wants to raise 50,000, 100,000, or a million dollars, it is said to be difficult or impossible for him to do so.

Personally I would rather see such action through some other kind of system than the central bank. We don't belong in that field. Whether a Government agency or private agency of some sort is needed may be another question. I don't think the Federal Reserve System ought to be in the investment banking field.

QUESTION: This is pretty much a hypothetical question, Dr. Irons. I would like to ask your opinion as to the effect on the banking system if Russia or some other country were able to dump several billion dollars of counterfeit money into our system?

DR. IRONS: Well, it would, of course, play havoc until we caught up with it, assuming it could effectively get into the banking system. I don't think it would pose a really significant problem however, although it might have dangerous potentialities.

QUESTION: I am a little disturbed at the way you made 6 billion dollars available to the Treasury. It brings up several questions:

(1) What effect would it have on the consumers' price index, lowering the reserve required? (2) You were operating at just about the legal limit in reserves at that time. I think you were up quite high; (3) Did you immediately increase the reserve requirements of the banks after the Treasury met its requirement?

DR. IRONS: Well, let me take those in reverse order if I may. First, did we immediately increase the reserve requirements of the banks after the Treasury met its requirement? We did not. The reason we did not was that such action would have been very restrictive. Moreover, we knew that between about the second or third week in August and the week after Christmas we would have to put perhaps 2.5 billion dollars in the market in reserves. Year after year the currency circulation begins to increase in the third or fourth week in August and between that time and the day after Christmas, there will be somewhere around a billion-dollar increase in money. Every dollar of pocket money that goes into circulation takes one dollar of reserves out because that is where the banks get that money. So with no expansion, but just to meet that seasonal increase in currency circulation reserves were needed. Then, too, there is a seasonal increase in loans, moving agricultural commodities, seasonal activity, that is normally very substantial. Finally, we have been losing gold steadily to foreign countries, although not in great amounts. So in July we knew that between that time and the end of December the system would probably have to put--to use round figures--2.5 billion dollars in the market. Not for expansion; just to meet the seasonal requirement.

What effect does it have on prices? It hasn't had any effect on prices because it hasn't affected appreciably the money supply as yet.

QUESTION: Yes, sir, it is clear. But these discounts that the banks work on, you have a certain time lag, and I think as I see it, in order to make your controls effective, you have to predict trends?

DR. IRONS: Really that is what we were doing in this case, too. You see in July we were looking ahead and asking ourselves, between now and the end of the year how much reserves will we have to put in the market to meet the usual fourth quarter seasonal demand. So we went back to the figures and saw that year after year the currency circulation goes up about a billion dollars and we try to estimate how much we think loans will increase and figure additional reserves for that purpose. Then we try to guess how much gold will move out. Finally, we may reach the 2.5 billion-dollar figure that I indicated. We are really doing what you say, looking ahead, trying to judge what requirements would be for the last half of this year.

QUESTION: Dr. Irons, do the deposits of the Federal Government in commercial banks affect the system any differently than the normal private deposits in commercial banks?

DR. IRONS: Well, not particularly. As they are spent, they, of course, get into the system. This is the process. The Treasury issued tax anticipated bills. The banks bought them. The banks credited the account called "Treasury Tax and Loan Account." The Treasury has a deposit with commercial banks. As long as that money lies in the bank in the Treasury's account, it is not any different from your money or my money lying there in the bank to your or my account. It is just money in the bank.

Now when the Treasury starts to spend, it draws the money out. It may draw the money out of the commercial bank and deposit it with a Federal Reserve bank. There is still no effect. It hasn't got out to the public as yet. Then when it is put in the Federal Reserve bank, the Treasury begins to draw checks against it. Those checks go to John Doe, Joe Doakes, government employees, and others. Then when folks get the money, it is spent. That is the procedure. I would say they are not essentially different from other types of deposits.

The Treasury deposit, as created through the banking system, may have an inflationary impact because it is new money that was not there before. When the Treasury borrows from the banking system, it creates new money and that has an inflationary impact. How inflationary it is and whether it stays that way or not depends on whether the bank in turn disposes of the bills it bought from the Treasury to nonbanking investors. If the bank can dispose of the bills to nonbanking investors, then it cancels out the inflationary potential. That is what is being done in this last instance. It is not always what has been done though.

QUESTION: Dr. Irons, this question is not too pertinent to the discussion of the operation of the Federal Reserve System. However, I think it is related to the expansion or contraction of credit that you have discussed considerably. What is your opinion as a fiscal expert on the desirability or the practicability of eliminating the national debt? The assumption is that we can eliminate it. Do you have an opinion at what point we should attempt to stabilize it?

DR. IRONS: I can give you my own opinion on that. First, I think it is fantastic to think it could be eliminated. It is not going to be paid off in the sense that it is going to be eliminated. As Government bonds become due the Treasury will pay them--partly in cash and partly by refunding, but the debt won't be eliminated. I think we should certainly make every effort to reduce the national debt within limits consistent with a sound economy, and I think there will be a gradual reduction but don't think it is going to be any great amount.

Look at the problem practically. We know how tough it is to balance the Government budget. Let us suppose we had a very favorable situation--something happened and we really were lucky, and we not only balanced the budget but for every year for the next 10 years we had a

3 billion dollar surplus, which is far better than I think we are going to do. Ten times 3 would be 30 billion dollars surplus to apply against 272 billion dollars of debt, still leaving a debt of 242 billion dollars. Also the elimination of the debt may tend in its initial impact to have deflationary consequences because the Treasury might take money out of the system and retire the debt, and there might be deflationary implications through that. No, I think we will have to learn to live with it; maybe somewhat lower. Certainly if we don't have war, I would expect it to move down gradually, but I just can't conceive of a situation developing in this country where we would have less than 225 billion dollars of national debt.

COLONEL BARTLETT: Dr. Irons, we are always glad to find that our lecturer has had real practical experience. We are even more thankful when he turns out to be a really gifted speaker such as yourself. But when we receive a talk which is a well-balanced blending of theory and practice, as yours has been this morning, we feel very fortunate indeed. I hope we may count on you in the future as a regular member of our visiting lecturer team.

On behalf of the Commandant and the students, thank you very much for an enlightening and stimulating talk and discussion.

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