THE BANK AS AN INSTRUMENT OF RE-ADJUSTMENT

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IT is doubtful whether any element in the aftermath of war is more harmful than the abrupt changes in the prices of commodities. The rapid rise of the tidal wave carries many paper profits and is viewed with equanimity. The succeeding decline scatters business wrecks upon the shore, and is not borne with corresponding fortitude. The fall of prices is always irregular. Some goods, and wages in some occupations, are more susceptible than others to changes in demand or supply. Superficially it would appear that the different effects come from different causes. Charges of combination, of profiteering, of all varieties of unfair practice are freely made. There is a breaking down of business ethics, and the rules of the game are frankly abandoned by men who believe their competitors have already violated them. Business becomes a scramble to escape loss or even insolvency by any ready means at hand.

Whatever the cause may be, a general rise of prices is equivalent to a general fall in the purchasing power of money. If it were possible to maintain a uniform value in the dollar or the pound, this would be equivalent to maintaining a stable level of prices even though prices of particular goods would change from time to time. Problems involved in the rise of prices in general, then, are problems of a depreciated currency.

People in the United States have had a varied and instructive experience with depreciated currency. From the Colonial notes of Massachusetts in 1690 to the present, there is a sort of monetary panorama exhibiting all the futile experiments that go with the efforts to run a government without taxes or develope a country without capital. It is not the purpose of this paper to discuss the evils which flowed from these unhappy incidents of American history, for they are generally known. The purpose is to consider some facts peculiar to the depression that prevails to-day in Canada and the United States, together with some remedies which are proposed.

One characteristic of inflation periods of the past was the presence not only of a depreciated currency but of one that was

inconvertible as well. The literature on the subject of inflation movements, therefore, is the literature of inconvertible paper circulation. If the evils of inflation are the evils of inconvertibility merely, the safeguard against recurrence would be in those measures which insure redemption on demand. The corollary to this position would be either that a cheapening of gold itself and rise of gold prices cannot occur, or else that inflation of gold prices cannot be prevented and must be endured.

In glancing at any price chart that shows the curve of greenback prices in the United States from 1860 to 1868, one will be struck by the similarity of the curve showing gold prices from 1913 to 1921. In terms of goods gold was growing cheap during the world war and then became suddenly dear during 1921, and the people have been experiencing all the traditional concomitants of a depreciated currency except the one of inconvertibility. Using the average level of 1913 as a base and calling it 100, we may say that prices rose to their peak in May of 1920 at 272 in the United States and 263 in Canada. By August, 1921, they had dropped to 143 in the States and to 174 in Canada. It is not the rise and fall of prices in themselves that is most significant, but the change in business activity that accompanies the price changes. People bought at a hectic rate on the upward course, but supply only their most urgent needs on the decline. These alternating phases of elation and depression have been as pronounced with gold the medium of exchange as when the *onus* could be placed on inconvertible notes.

That gold was really the money of America is evidenced by the fact that the Federal Reserve against both notes and deposits never fell below 40 per cent during the whole period, and the combined "cash" reserves of Canadian chartered banks was as large at the end of the war as at the beginning. Part of the Canadian reserve was in Dominion notes, but these notes were amply protected by gold through the whole period. If further evidence were needed, it is found in the fact that neither in Canada nor in the United States was there ever a quotable premium on gold.

It is true that there has been for some time a premium on New York Exchange or "gold funds", but a study of Canadian trade statistics will support the view that this premium on exchange does not represent a difference in purchasing power between gold dollars and paper dollars in Canada. It is the result of a foreign trade policy, a matter of expediency rather than of necessity. Canada's trade with the States has resulted in an unfavourable balance because of the embargo on the export of gold. However, Canada's trade over seas resulted in a balance that was favourable and larger.

From the records available it would have been possible for Canadian merchants to sell Sterling bills in New York for more than enough to maintain the parity of dollar exchange without any loss of gold. The embargo on gold export from Canada and from the United States alike must be attributed to an excess of caution justified only by the uncertainties of war. If the premium on exchange had represented a depreciation of Canadian notes in comparison with gold, the level of prices in Canada should have been higher than in the United States by the amount of this premium. As a matter of fact this was not the case. Therefore, we are driven to the conclusion that even a gold currency may not be a sound currency, if soundness implies stability of purchasing power.

Those who seek the cause of the changes in value of gold find it in the increase in the supply of that metal and the expansion and contraction of credit based on gold. The estimated stock of gold in the United States rose from 1870 millions of dollars in 1913 to 3288 millions in 1921. The movement in Canada was in the same direction if not to the same extent. In efforts to appraise the effect of a varying value of gold it must be remembered that the monetary position of gold to-day is very different from that which it held in past periods of inflation. It is no longer gold alone that is significant, but gold together with a vast aura of credit, mainly in the form of bank deposits, the value of which must rise and fall together with the value of gold.

While there was a great increase in the absolute cash reserves of the banks during the war, there was a greater increase in the bank deposits. These deposits mounted step by step with the flotation of the great war loans. Examination will show that the Federal Reserve in the United States and the great chartered banks of Canada were the instrumentalities by which the loans were floated, and that the deposits expanded because of the loans. The manner of proceeding in the States was about as follows:—The Treasury would determine upon the sale of a new loan. The bonds or certificates would be divided among the Federal Reserve banks. Each of these banks would invite subscriptions from the banks operating in its district. Through these the bonds would finally reach the people who, having no spare cash with which to buy, nevertheless bought. Sometimes the buyer of the bond borrowed from the bank for the required amount. At other times he borrowed later in order to replace his working capital, depleted by the purchase of the bond. In either case the result was a credit to government account or private account expanding the deposit liability of the bank by something near the price of the bond.

In Canada the bonds were not sold to the banks, but the changes in their deposit account indicate that to a large degree, indirectly if not directly, they extended the credit by which the purchase was accomplished. Moreover, their liabilities for government deposits and their holdings of government funds grew side by side so that the net result in Canada was not different from that in the United States. This expansion of deposits was an expansion of the nominal purchasing power of the people, with no corresponding addition to the supply of goods to be purchased. The inevitable result was a rise in the prices of goods already in existence as well as a rise in the money cost of producing more. By this lifting of the price level the proceeds of the loan itself had a lower purchasing power for the government. Each succeeding loan was for this reason less effective than the last. The process of inflation therefore was cumulative, and if the war had continued long enough the policy of conducting it by loans would have defeated itself.

Such was the manner in which the bubble was blown. Its maintenance depended not only on a high rate of production, consumption and exchange, but on a rate continually accelerating. The end of the war did not bring immediate collapse because there was a great void in the world's stock of goods that must be partially filled, and for more than a year the merry course went on. Then came the end of inflation with bankruptcy, strikes and unemployment. Of these the end is not yet.

After each experience with inconvertible currency in the past, proposals for reform have looked in two directions. The purpose of one group of reformers has been to enact measures adapted to prevent inflation and insure convertibility. The purpose of the other group has been to retain a measure of the high level of prices, adopting a course that will prevent or relieve the depression that follows the boom. The "greenback movement" in the seventies was the most striking of these. The issue of many notes was said to have caused high prices. Then why not issue more notes later and stop the decline of prices? Or why not alternately expand and contract the note issues in such a manner as to insure stability in the price level and continued activity in business?

In these historic debates the conservative has had one great advantage. He always had something concrete to propose. He urged a return to metallic circulation and he could show that such a monetary system had many advantages to commend it. In the present case the conservative is baffled by the fact that the metallic circulation itself no longer insures a stable level of prices and wages. The logical course for the conservative now will be to propose some

sort of change in the gold standard itself, in the hope that a "dollar" may be made a unit of fixed purchasing power rather than a unit of fixed weight of gold. In this effort he will be able to show that the gold standard to-day is a very different thing from what it was when all European countries rested their currencies upon it. In those days any change in the value of gold from events occurring at one point was imparted to and distributed over millions of pounds, marks, crowns, francs, lire, roubles and yen. To-day the dollar must bear the full impact of every change except in so far as the currencies of the smaller neutral countries share it. One may pump water into a small lake or draw water from it with no appreciable effect on its level, so long as the lake has an outlet to the sea. But with the outlet cut off the level is easily changed. To-day the outlet for the flow of gold is closed. Its level of purchasing power will no longer be dependable. General prices are likely to respond to influences of many kinds and of relatively small importance in themselves.

But proposals to modify the gold standard are not proposals to return to some former practice. They are revolutionary proposals and, however meritorious, can succeed only after a long campaign of education. No reform in this direction will promise relief from the depression now existing, and it is doubtful whether anything effective can be done before another great wave of inflation has begun to rise on the broad basis of America's present gold supply. In this state of affairs there is apt to be encouragement for the other type of reform, the one directed to the maintenance of prosperity by an expansion of credit and the restoration of higher prices now and stable prices later. Already there have been serious attempts to bring this about by appropriate manipulation of the banking system or a modification of banking policy. Specifically, writers in the United States have charged the Federal Reserve Board with a deliberate purpose to contract credit and depress business. Others have demanded changes in the rates of discount; others again have asked for special extension of loans to farmers, who suffer most promptly and acutely when credit collapses.

Efforts to operate on the price level through the medium of the banks involve considerations of two sorts; one is the character of the banking mechanism by which a national policy could be carried out, and the other is the prospect of success for any measures with any banking mechanism we know.

The banks can be made to do two things which have a bearing on business expansion or decline. They can raise and lower the discount rate; they can direct capital into certain channels and

withhold it from others. The efficacy of such changes as these differs widely in different systems. In a close-knit, homogeneous country like England, with established business traditions, where the reserve of the country has long been kept as a matter of course in a single institution, a change in the discount rate is reflected quickly in the outside market, and commerce and industry respond to a greater or less degree. British banks face toward London and take their cue from the Bank of England.

In Canada and the United States the situation is very different. American custom leans toward local independence. Of the thirty thousand banks in the United States only a third are members of the Federal Reserve, and these members are not in any sense under its control; neither are they dependent on it in normal times. A change in the discount rate in the reserve bank is of no immediate concern to a country banker, unless perchance he expects to borrow or to re-discount his paper. For the most part the American banker banks on his own resources, and for the most part those resources are sufficient for his community except in a crisis or when credit is unduly expanded. To understand the true relation of the banks to the Federal Reserve it is recalled that these banks were established self-contained units before the central institution was founded. They had their own capital, and plenty of it for the communities which they served. Each bank had its own cash reserve and through long experience had adjusted reserves to liabilities with a deep-seated aversion to any dependence on outside help. Each bank was conducted by its own board of directors. The Federal Reserve was not intended to destroy this independent responsibility. Its purpose was to smooth the path of exchange between the banks and serve as a sort of store of credit to be drawn upon in time of need. It was established, not in the interest of the banks, but in the interest of the public. It is not adapted to the task of lifting a dead level of depression but to serve as a buffer in any sudden collapse of credit, which is apt to be a greater catastrophe for the customers of banks than for bankers themselves.

The banking system of Canada, in some respects, is more like that of the United States since the Federal Reserve was established than it was before. The eighteen great chartered banks are analogous to the twelve reserve banks, and the branches distributed over Canada are analogous to the member banks in the United States. There are important differences in detail. Authority is differently located, and independence of action in the local banking unit is wanting. The parent bank determines the policy which its numerous branches must carry out. The rate of discount and the selection

of paper at distant points can be brought into accord with this policy. There is more opportunity to fix control in the hands of experts where boards of control are few and their power and responsibility are great. There is a strong probability that any of the great institutions with its many branches will be guided by a wider vision and a truer foresight. On the other hand, the separate organization, ownership and competition of the parent banks renders a true national policy, such as might proceed from Parliament in distinction from the Canadian Bankers Association, less likely to develope than in the United States. The Canadian habit of leaving the banking business to bankers makes for safety and conservation, and works against efforts to manufacture prosperity through a manipulation of credit.

The political relations of banks in the United States expose them to attack in any period of depression and general discontent. From very early times banking has been looked upon as a sort of public service subject to public regulation. The legislative rules of practice have gone into greater and greater detail as the years have passed. Private banks have been abolished, or subjected to restrictions that have caused them almost to disappear in most of the states. The state banking laws differ widely, but in most cases they are alike in evincing popular distrust of the business. They grow more explicit in limiting and directing operations, not only for the protection of depositors, but also for the advancement of the dominant business interest of the communities served. Banks in the far west are encouraged to buy bonds of irrigation districts. Those of the middle states are permitted to invest in farm mortgages to a liberal extent. These legislative rules are established with but little regard to the question whether either irrigation bonds or farm mortgage loans are consistent with sound commercial banking. With this legal background it is not strange that men advocate legislation that would cause an extension of loans to interests in which there may be the greatest need but least fluidity and security. The theory of public control finds its most emphatic expression in a demand for Government ownership of the banks. This view has prevailed in North Dakota. As a doctrine it is not confined to the Non Partisan League, and is certain to be extended if the business depression should drag along. Under the flag of democracy the advocates of this change are seeking to establish an institution modelled after the Bank of Russia under the Czar.

The very weakness of the Reserve Board when control is considered may contribute to its power from the point of view of influence. Its members have nothing to gain by an expansion of

banking operations, and nothing to lose but their reputations. Protected in their positions, they are singularly free from political forces on the one hand and from the subtle influence of special business interests on the other. From the outset the appointed members of the Board have conducted themselves with dignity, and their admonitions as well as their regulations have received commendation from men of informed judgment. Although appointed to represent the people rather than the banks, the Board would undoubtedly prove more conservative in the face of popular attack than would the House of Representatives at Washington, or the State Assemblies.

There yet remains the question whether it would be possible with an organization imperialistic in character and paternalistic in purpose to manipulate the volume of bank credit in such a manner as would change the price level in a direction desired or prevent change from a scale already satisfactory.

In considering this phase of the problem it must be remembered that the banks and their expanded liabilities were not the cause but merely the agency, by which prices were raised during the war. The cause was in the great war loans which were transmuted into deposits, a nominal purchasing power directed towards goods, while there was no corresponding increase in the supply of goods. There can be no great expansion of deposits without great loans, and the initiative for any campaign of borrowing must come from borrowers and not from lenders. But the hope for a stable price level sustained by banking policy depends on the power of the banks to inflate credit on the initiative of those in control of the system rather than on that of their borrowing customers.

A rising bank rate undoubtedly acts as a brake on business activity, tends to diminish loans and causes a fall in deposit liabilities. In normal times a falling bank rate has the opposite effect. Men who are on the margin of doubt as to whether an extension of business will be justified or not, may decide to expand at the prospect of abundant loans at lower cost. However, in a period of severe depression a reduction of rate may not have any such effect. Bank rates are not the only factor, nor are they by any means the most important. If one may be permitted a paradox, the psychological imponderables weigh far more than bank rates. Men are not so much concerned over present costs as they are concerned over the future attitude of customers. The anticipation of gain, which buoyed the market on the rise, has turned to an apprehension of loss through inability to sell to-morrow. Instead of buying largely in the prospect of higher prices, they now buy sparingly in the fear

of reduced sales, and their need for accommodation is proportionally less.

The re-discount rates are lower to-day than they were a year ago, but, as matters stand, many country banks in the United States would not re-discount paper even if the rate should fall to two per cent. Any examination of banking history will show that rates of discount are lowest when business is most depressed, and it is in just such times that banks are most put to it to find safe and profitable loans. No doubt the erroneous belief that banks withhold accommodation to depress the market comes from the fact that they are so often obliged to refuse loans because of the shrinkage in security that the borrower has to offer.

In summary then, the banking system of the United States at its top is well adapted to the initiation of a far-sighted and sound national policy with respect to credit, but the difficulties of carrying out such a policy are almost insurmountable because of the independence of local banks. On the other hand the Canadian system, under the control of bankers from top to bottom, is less likely to be actuated by a policy conceived in the interest of the public at large, while the organization and system of control in Canada is much better adapted to the execution of such measures as may be undertaken.

Efforts to maintain continuous prosperity by manipulating bank loans, and through bank loans the magnitude and character of the deposit circulation, have little prospect of success. The procedure which probably will give best results after the necessary period of investigation and education will be a reconstruction of the gold standard which has been so seriously undermined by the *debacle* in Europe.

A CANADIAN COMMENT.

SIR EDMUND WALKER

I HAVE been accorded the privilege of reading Professor Wildman's paper before its publication. It is an admirable statement of causes and of conditions in connection with the present financial problems of the United States and Canada. The author sets forth more clearly than most writers the effect on prices of what we term "inflation." The effect of gold itself is governed mainly by the extent to which currency and credits may be enlarged with gold as a reserve. In both the United States and Canada about 95 per cent of all commercial transactions are settled by cheques, while the balance is settled mainly by paper currency, the volume of clearing house transactions and of bank deposits. In times of peace these three forms of credit should be

controlled by the amount of gold held in reserve as a guarantee of the maintenance of a gold standard. In times of war enormous quantities of paper currency, treasury bills, and government bonds are created, which are mere evidences of money spent with no saleable commodity resulting, and it would be safe to say that the main cause of high prices is more often fiat money, and the funded shapes which fiat money is forced in part to assume, than any other form of money or credits. In times of peace large expenditures by governments of money obtained by the sale of securities in a foreign country may produce the same effect on prices.

The public does not always realize that a properly secured bank note, subject to actual daily redemption, and issued to enable the ordinary purposes of production and sale to be carried on , is the only form of paper money that is not likely to affect prices, while all fiat money issued to represent a debt for some transaction long past is economically unsound.

Professor Wildman writes as if in the main the "facts peculiar to the depression" were alike in both countries, but we in Canada are naturally anxious to point out our claims to superiority where they exist. In financing our war loans we managed to find ultimate investors without loading our banks with vast amounts of long-dated bonds; and our banks, which as a rule take entire care of a customer's banking requirements, are likely to be more patient and considerate in difficult moments than a bank in the United States which finds itself one of many banks interested in the same debtor.

The statement that the individual banker of the United States before the creation of the Federal Reserve System had for the most part resources sufficient for his community, is quite the reverse of what has usually been urged as the main reason for creating the Federal Reserve System. Indeed, it was created in order to give to the United States the superior qualities in this and other respects of the Canadian banking system, but without the branches, to the creation of which the individual banker objected for reasons quite apart from national welfare.

Professor Wildman's remarks upon the interference by Government in the natural functions of banks are most timely, and offer food for thought to Canadians as well as to the people of the United States. The *Review* is to be complimented on the publication of an important addition to the post-war discussions of finance.