Some Current Features of Bank Liquidity in the United States

by

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Little is to be gained, ordinarily, by applying to the affairs of Europe experience gathered in the United States. In the field of bank liquidity, however, something can perhaps be said for this procedure. While American financial practices have not usually been regarded in Europe as models which to copy, the age-old American institution of legal reserve requirements for banks seems recently to have enjoyed a remarkable vogue in a number of European countries. It may therefore be assumed that the experience of American bankers with this and other aspects of liquidity has something to offer to their European confreres.

In subjecting banks to legal reserve requirements, the United States has made explicit something that elsewhere had remained implicit. The cash/deposit ratios observed by the London banks immediately come to mind. On the Continent, banks more often have preferred to « play by ear », but here too certain norms for the relation between liquid assets, capital, and deposits are known.

Such rules of thumb, of course, are only a very partial solution of the banker's problem. The difficulty is that liquidity needs are only in part of an actuarial character. The monthly, quarterly, and annual rhythm of the banker's cash needs is not hard to discern — a glance at his books will tell him. Proper liquidity dispositions, which vary widely from bank to bank, can easily be made to meet these needs. But for the other kind of need — arising out of cyclical movements, calamities among his customers, and other major and unique events, he cannot rely on statistics.

If he is overcautious and pays the price of excessive liquidity, he may sleep more soundly, but he will not eat well. Yet to underestimate the nonactuarial risks would be fatal for an enterprise whose solidity rests upon its liquidity. That there is a way out of the dilemma confirms the wisdom of the remark that while one may not know what is going to happen one can know what to do about it. There is a rational way of meeting unknown contingencies. All banks, to some extent, do this by a continued reappraisal of the situation. But because this exposes them to considerable fluctuations of optimism and pessimism, many have found it expedient, in addition, to adhere to more or less invariant liquidity rules.

In the United States, bank liquidity has not represented a major problem for many years. During a long period when liquidity became increasingly interesting to academic economists as an apparent determinant of consumer and business behavior, its significance for bankers diminished. Recently, however, the rush of new lending and the drop of many bank-held government securities below par has somewhat changed the situation. It has compelled bankers to recognize that part of their portfolio has lost some of its earlier liquidity. Increasingly one hears of individual banks regarding themselves as « loaned up ». In this situation, interest focuses on three aspects of liquidity: 1) the liquidity position of individual banks; 2) the liquidity of the entire banking system in its relation to monetary policy; and 3) questions arising out of the coincidence of slim capital margins, wider market fluctuations, and low earnings. These three aspects round out the liquidity picture.

I - *Individual Banks*

In generalizing on liquidity problems of individual banks, one may with profit observe the procedure of the geometrist, who often finds it easier to manipulate a line than a point. It is not easy — perhaps not even particularly relevant — to define where we stand today. Much clearer is the direction in which we have been moving. Since the disasters of the early thirties, progress very predominantly has been toward greater liquidity and stability. This is true both as regards potential fluctuations in deposits and other needs for cash, and as regards the liquidity and soundness of assets. Only the deteriorating capital position of banks has run counter to this trend — a matter of a somewhat different order that will require separate comment.

A. *Needs for Funds.*

As regards potential withdrawals of deposits, the changes wrought by the last three decades are of both an institutional and a historical character. The establishment of the Federal Deposit Insurance Corporation, which now insures deposits up to $ 10,000, has greatly reduced one of the less predictable causes of withdrawals — the bank run. Since the FDIC in practice seeks to forestall altogether the need to close weak banks, it lends some measure of protection also to the large depositor. Further assurance against panicky withdrawals has been provided by the broadening of Federal Reserve powers to come to the aid of the banks and the securities market in difficult times.

The total volume of deposits has gained in stability. Instead of being based primarily upon loans, the liquidation of which would cause a general deposit shrinkage, they are now based in good part upon government securities. This part of the deposit structure could shrink only if the securities were sold by the banking system to the public or if the government were to redeem its debt out of taxes. No prophetic gifts are needed to discern the unlikelihood of either event.

With the prospects of withdrawals as a result of bank runs or over-all deposit shrinkage greatly diminished, main attention centers upon interbank shifts of funds. Immediately after the war it had been thought that there would be considerable regional shifts in the great mass of war-created deposits. Such, however, did not occur on any large scale. The relatively much greater rise in demand deposits as compared with time deposits may have increased the over-all volatility of deposits, but this has been offset, to some extent, by the decline in the rate of turnover as against the twenties. The limitations, *de jure* and *de facto*, upon the international mobility of money have contributed in some small measure to the stability of deposits, particularly those of the New York banks. Since the volatility of deposits varies widely from bank to bank, depending on the nature of the clientele, very sweeping generalizations are not advisable.

A need for liquid funds may arise also through a greater demand for loans. Most banks give loans priority over investments, and must therefore stand ready to liquidate part of their investment portfolio in order to accomodate borrowers. A potential need for funds is created also by the possibility of increases in reserve requirements, so long as the Federal Reserve has fixed these requirements below the legal maxima and accordingly may decide to raise them. Putting together all these potential causes of sudden or gradual demand for liquid funds, one emerges with the impression that for most banks the danger of unexpected drains is smaller than it was in years gone by.

B. *Asset Structure.*

In the liquidity of assets, various and, to some extent, divergent trends are to be noted. Outstanding among them is the rise in the proportion of United States Government securities. From 8.9 per cent of total assets in 1928, it rose to a high of 56.6 per cent in 1945, and at the end of 1950 it still stood at 36.2 per cent. A breakdown by maturity is shown in Table I. Prior to March 1951, when the Federal Reserve ceased to support the market, even longer-term government bonds offered a high degree of liquidity to their holders. Today, part of these holdings could only be sold at a loss. While the aggregate depreciation is negligible in relation to the capital funds of banks, the banks

nevertheless are reluctant to sell because of the impact of realized losses upon current earnings. The mass of government and other high-grade securities therefore looks somewhat less liquid today than it did some time ago. Even so they are a tower of strength in the liquidity position of the banking system.

TABLE I

MATURITY DISTRIBUTION OF BANK-HELD GOVERNMENT DEBT (1)

December 31, 1950

Classification	Per cent distribution
Marketable:	96.7
Maturing within 1 year	20.6
» 1-5 years	53.9
» 5-10 years	12.9
» 10-15 years	4.2
» 15-20 years	0.4
» over 20 years	4.9
Nonmarketable	3.3
Total holdings	100.0

(1) 7,193 reporting commercial banks in the United States.
Note: Figures may not add to totals because of rounding.
Source: U.S. Treasury Department.

From a purely technical point of view, changes in the form in which banks carry their secondary reserves are worth noting. During the twenties, the main media were stock market loans, bankers' acceptances and commercial paper, and, for country banks, correspondent balances. Today, all except correspondent balances have become relatively insignificant. In their place rule short-term Treasuries, chiefly bills and certificates of indebtedness and for New York banks « Federal funds ». The latter represent daily money in the form of balances with the Federal Reserve, which are negotiated in the form of checks. The sellers are banks whose primary reserves (deposits with the Federal Reserve) are above the legal minimum; the buyers those who are deficient in that respect. The sellers thus can earn interest upon their excess reserves whenever there is demand in the market. The rate for « Federal funds » fluctuates much more sharply than other short-term rates but finds its ceiling at the level of the Federal Reserve discount rate. At that level, borrowing from the Federal Reserve becomes preferable.

The liquidity imparted to the banks by the great size of their investment portfolios probably has helped to encourage them to enter new territory with some of their loan policies. The declining trend in traditional commercial loan business no doubt has been another and stronger factor. Thus many banks have branched out into the fields of consumer, real-estate, and term loans. The structure of loan portfolios, as of the end of 1950, is shown in Table II.

TABLE II

STRUCTURE OF BANK LOAN PORTFOLIOS (1)

December 30, 1950

Classification	Per cent distribution
Commercial loans	45.3
Agricultural loans	4.0
Real estate loans	23.2
Consumer loans	13.7
Loans on securities	6.0
All other loans	7.9
Total loans	100.0

(1) Member banks of the Federal Reserve System.
Note: Figures may not add to totals because of rounding.
Source: Member Bank Call Report, December 30, 1950.

All of the relatively new types of loans are at least ostensibly less liquid than the self-liquidating commercial loans. But there are qualifications. Term loans — mainly for periods of five to ten years — are in some instances more nearly a formalization of an existing practice than a radical innovation. In former years it was not unknown for ostensibly short-term loans to be employed for longer-term purposes, so that they had to be renewed periodically. This situation is believed to be less frequent today. Real estate loans, ordinarily the least liquid of all, have acquired a degree of liquidity if they are guaranteed by the Federal Housing Authority and the Veterans Administration. A secondary market has developed for these FHA and VA mortgages, which no doubt has contributed to their popularity among bankers. Finally, the regular amortization to which mortgage and consumer loans as well as some of the others are subject does much to improve the liquidity of such assets.

In line with the foregoing developments, bank examiners are placing increasing emphasis

today upon the inherent soundness of assets, as contrasted with their liquidity. This trend is important mainly from the point of view of solvency of banks — a bank is not likely to be declared insolvent today because basically sound assets in its portfolio have depreciated in market value or have otherwise proved less liquid than expected — but it has significance also for liquidity policy.

The broadening of Federal Reserve powers that took place as a result of depression experience has materially increased the liquidity of the banking system. In the first place, the Federal Reserve is empowered today to lend to banks on the security of any acceptable assets, in contrast to the previous limitation to « eligible assets ». In a crisis, therefore, banks could look for very far-reaching support. On government securities, the Federal Reserve stands ready to lend at par, as a matter of policy, even though the market may be lower.

In the second place, the Federal Reserve's open market powers have been broadened implicitly by allowing that part of its notes and deposits not backed by gold (minimum gold cover is 25 per cent) to be backed by government securities instead of commercial paper. This plus the acquired habit of intervention in the long sector of the market as well as in the short would permit very effective support of government securities. This in turn would indirectly serve to give greater stability to all other classes of bonds and hence to most of the range of bank investments. The fact that international gold movements are more constricted today than formerly, and are regarded as less compelling a factor for central bank policy than in the days of the full gold standard, adds to the Federal Reserve's freedom of action.

As a final factor giving stability to the banks, one must note the general antideflationary orientation of American economic policy. This is a vague concept that carries no actionable guarantee. It is sufficiently pervasive, however, to make one doubt whether conditions such as prevailed in 1932-33 will ever recur.

C. *Other Changes.*

Hand in hand with the changes that can be read in the account books of the banks and in the statute books of the nation, go some general changes in attitudes of bankers. One of the early victims of progress has been the time-honored argument about self-liquidating versus shiftable assets. The lessons, which practical experience has driven home more firmly than any amount of debate could have done, were simple. It had to be recognized that for an individual bank faced with sudden withdrawals, shiftable assets give better protection than self-liquidating loans. Earlier emphasis on the supposed merits of self-liquidating loans was seen to have rested on a confusion between what was good for a single bank and what was believed to be good for the economy. At the same time, of course, belief in the virtue of the underlying « real bills » doctrine as a guide to stable money was found to be fallacious.

But if shiftability was preferable to auto-liquidity for a single bank, from a national viewpoint the whole debate was seen to be pointless. In a depression, when all banks were under pressure, neither would give real liquidity. Assets could not be shifted by all banks together unless the central bank was willing to take them. Loans could not be liquidated *en masse* without freezing the whole economy. Thus, the matter resolved itself into something to be dealt with by the monetary authorities.

A change in the attitude of bankers toward minimum liquidity provisions seems to be another lesson of experience. There was a time during the twenties when the demands of liquidity seemed adequately met, to many banks, with the legal minimum in cash reserves, a moderate volume of till money and secondary reserves, and a small investment portfolio of bonds, some of which were not of top caliber. The great bulk of assets would be in loans. While liquidity requirements, then as now, vary greatly from bank to bank and wide differences in portfolio composition are entirely justified, it may be said that the majority of bankers today set their liquidity sights higher than in the twenties. Many large banks, in particular the money market banks with their high correspondent balances, seem to regard themselves as fairly well « loaned up » when loans approach 50 per cent of total deposits. This heightened conservatism is probably one of the after-

effects of the 1932-33 banking crisis, which is still a living memory for most of today's top executives. Greater caution may also be a reflection of the thinner ratio of capital to deposits, which is bound to squelch enthusiasm for risk-taking.

The prevalent desire to limit loans to a moderate proportion of total assets seems to mean that bankers today, on the whole, regard government security holdings as an organic part of their portfolio. They are not just something foisted upon them by the government and to be got rid of altogether as soon as enough loans can be made. In dealings with customers, the desire to carry a substantial government portfolio may at times involve delicate decisions. As a matter of principle, the banks try to accomodate borrowing customers; moreover, for many years banks had less loans than they wanted, and customers came to take for granted that a sound proposition would be well received. A negative reply, « sorry, we're loaned up », has been something unusual, and is perhaps more likely to disturb customer relations today than it was 25 years ago.

The permanent acceptance of government securities into bank portfolios has also changed the hopes and fears that influence a banker's decisions. A quarter century ago, the choice was predominantly between more loans and more liquidity. The penalty for reaching out after too much profit could be of a serious character. Today, the choice is more complicated — it lies between more liquidity, more loans, and more and longer-term bonds. Serious liquidity problems as a result of unexpected cash needs are not likely as long as there is a bond portfolio, even if secondary reserves have been drawn down. The penalty for overreaching is that bonds may have to be sold at a loss.

The risk of having to pay this penalty does not become too pressing, of course, so long as a bank is willing to resort to the Federal Reserve. Ordinarily, the banks' traditional policy allows them to do this only for brief periods. Today, however, the alternative to borrowing may well be to have to sell at a small loss. Moreover, it happens that, under the recent excess profit tax, borrowing from the Federal Reserve works out more profitably than selling assets. It will be interesting to observe whether this long-standing dislike of remaining in debt to the Federal Reserve will be affected in any way by these factors.

II. - *Liquidity and Monetary Policy*

For monetary policy, bank liquidity has a significance quite distinct from the role it plays for the individual bank. For monetary policy, it is the focus of attack. Through the variation of reserve funds and through a subtle technique of manipulating the market for the banks' secondary reserve instruments and longer-term security holdings, the monetary authorities influence the banks' willingness and ability to lend.

A. *Recent Open Market Developments.*

In recent monetary action, and particularly since the Treasury-Federal Reserve accord of last March, market variations have been in the foreground. Since March the market for all maturities has been allowed to fluctuate freely, and most of them have dropped slightly below par. The results of this rather mild move have been striking: the willingness of banks to lend has been noticeably curtailed. In the field of long-term credit, which is dominated by life insurance companies and other institutional investors, the effect has perhaps been even greater: long-term money has become definitely tight and residential building in particular has been noticeably restrained.

This sharp reaction of lenders to a change in their liquidity engineered by the monetary authorities lends strong support to a school of thought that has been gaining ground recently. This view holds that under present conditions quite small changes in interest rates and in the price of securities are sufficient to bring about substantial changes in the credit situation (1). Given the dominant role in the market of professional portfolio managers and the enormous volume of public and private debt that is being held and arbitraged, the sensitivity of

(1) Cf. Robert V. Rosa, *Interest Rates and the Central Bank*, in « Money, Trade, and Economic Growth », Essays in Honor of John H. Williams, Macmillan, New York, 1951.

the market has increased far beyond prewar times. A slight increase in uncertainty about future prices may cause substantial postponement of new commitments. A decline in the market below cost prices « pins in » investors who could sell only at a loss and makes these assets temporarily useless as secondary reserves out of which new loans or investments could be made.

This new view relates more intimately than ever monetary policy and bank liquidity. It does not rely on the widely questioned effectiveness of interest rates in persuading entrepreneurs to borrow, and savers to save, more or less than before. It addresses itself directly to the lender. What is affected by interest rates is not primarily the flow of saving and investment, but the handling of a pool of loanable funds by the professionals in charge of it. In case of rising rates, as recently, the effect envisaged is essentially one of postponement. The postponement may of course lead to changes in the underlying situation that produce more permanent changes in the flow of saving and investment. The temporary nature of the initial effect is also to be seen in the way in which it runs counter to normal static relationships: a rise in interest rates is expected to bring about initially a greater, instead of a lesser, demand for liquidity. A lesser demand is what would have to be assumed if the conditions applying to Keynesian liquidity preference reasoning prevailed. In a dynamic situation they do not, because the action of the monetary authorities increases uncertainty and so the demand for liquidity.

All this explains why the proponents of the new view do not claim more than moderate effectiveness for action along their lines. Continued success depends upon the authorities' ability to influence the professional investors' desire for liquidity. If the investors should succeed in reducing this influence, *e. g.* remaining more liquid at all times, some of the effect would be lost. Furthermore, the emphatic confirmation that recent experience has given to the new approach requires further tests. It is not unlikely that the preceding long period of relative stability of longer-term bonds, and the apparently very great shock of seeing the sanctity of par violated for the first time in many years, added something unique to the recent development. On the other hand, the question raised by some whether small rate movements could be effective at all seems to have been effectively answered.

To implement the new strategy, open market operations are the best device. They permit a maximum of flexibility and allow the monetary authorities to influence long-term bonds and their holders directly, if the authorities are so inclined. Their impact upon reserves and deposits does not strike bankers as unfamiliar, because it is in no way different from other gains and losses of funds.

B. *Reserve Proposals.*

Freedom of open market operations is a new achievement, however, after almost a decade of commitment to supporting the government market in varying degree. Prior to this achievement, much of the discussion was about changes in reserve requirements as a leading instrument of monetary control. Circumstances may well arise that would again limit the freedom of open market policy. This makes it useful to survey the role that reserve requirements of various kinds might play.

The rigid mechanics of the American reserve mechanism probably are not found in any Continental banking system. They undoubtedly were not fully envisaged by the founders of the Federal Reserve System who created them. It was only during the early thirties that the monetary authorities finally ceased to think of required reserves as something primarily designed to keep banks liquid and began to regard them mainly as the basis of credit control (2). To appreciate these mechanics, one must remember that for American banks, Federal Reserve credit is by far the main source of reserve funds. Owing to the negligible role of currency in circulation, the banks have little prospect of increasing their reserves and deposits from this source, and because of the low level of international operations, international flows of funds usually (with some notable exceptions) also do not affect the banking system very much. To the extent that the Federal Reserve can control the volume of its credit and has been able to avoid the emergence of large excess reserves in the banking system, it therefore has a very firm hold on bank reserves. The fixing of a legal minimum ratio of reserves to deposits thus enables the Federal Reserve, by limiting reserves, to limit the expansion of deposits.

(2) Cf. E. A. Goldenweiser, *American Monetary Policy*, McGraw Hill, New York, 1951, Ch. VII.

The essence of most schemes for variation of reserve requirements is to alter the volume of money and credit that can be created with a given volume of reserves. Here again, the peculiarities of the American money mechanism are important. It is perhaps not out of order to go over this familiar ground so as to recall to the memory of those readers who are accustomed to think in different financial terms the main features of the American mechanism of deposit expansion. Because of the relative unimportance of the cash circulation it can be taken for granted in normal times that if a bank lends out funds, these will be immediately redeposited in the same or another bank. The employment of funds does not reduce the sum total of funds in the hands of the banking system. It merely leads to an increase in the volume of deposits and hence of required reserves. A fraction of the funds held in excess of required reserves must therefore be incorporated in the latter, and only the remainder can again be lent out. Elementary algebra shows that the maximum increase in deposits that can result from successive rounds of lending and depositing is equal to the reciprocal of the reserve ratio. At that point deposits have risen to a level where all funds of the banking system are required as legal reserves, and no further loans can be made. It is this mechanism, based on the fact that leakages into circulation or abroad are normally unlikely, that enables American monetary authorities to estimate with such relative assurance the extra volume of deposits that can arise from a given increase in reserves.

The simplest of the new reserve proposals is that for an extension of existing powers. At present, the Federal Reserve is authorized to double the minimum reserves required by law to be held against demand and time deposits of different categories of banks. (The ratios now in force, going as high as 24 per cent for demand deposits of central reserve city banks, are close to the permissible maxima). Power to raise requirements well over present levels might be useful if the banks should in some manner accumulate a large volume of excess reserves, as they did during the thirties. These excess reserves could then be cut down and the banks be brought into closer touch with Federal Reserve policy.

At present the banks have no substantial excess reserves. Thus changes in reserve requirements now would be much inferior as a policy instrument to open market operations. Their indiscriminate « meat axe » character would cause them to affect banks very unequally, depending on the volume of excess or secondary reserves of each bank. In any case, they could be really effective only if the Federal Reserve were free at the time to let the prices of government securities decline by « backing away » from securities offered for sale to the System. If support of the market were a requisite, the banks on the whole would simply sell part of their government portfolio to the Federal Reserve and so get the needed reserves. There would be no tightening of the market except insofar as the banks might regard their liquidity position diminished by the loss of governments.

Something might be said for a gradual rise in reserve requirements in the very long run. The technique of pyramiding a given volume of Federal Reserve credit into deposits equal to a multiple thereof is what gives the banking system much of its present elasticity. The lower the reserve ratio, the greater multiple that deposits can reach. It may well be that, with the growth of the economy, the greater danger of imbalance and the greater penalties for it, and the tendency toward more centralized guidance in economic affairs, a limitation of this elasticity may be needed. Such a secular increase in reserve requirements would have to take place, however, without great pressure on the banks, and with due consideration for their already insufficient earnings.

A secular rise in reserve requirements does not by any means imply a move toward the

« 100 per cent reserve plan » sponsored by various distinguished economists in this country. The sponsors claim that if the banks were required to carry 100 per cent reserves, they could never increase the money supply through new loans except by rediscounting with the central bank (3). This, the argument goes on, would put the power over money where it belongs, with the government, and would permit more effective control of business fluctuations. To this, the critics of the proposal reply that the control over the money supply promised would not be materially greater than what already exists, and that even complete control over the money supply would not mean anything like effective control over the business cycle. In addition, the plan would probably produce a distortion of the banking system not at all intended by its proponents. At the present time, the plan is outside the field of practical politics.

More ambitious than the plan for moderate increases in primary reserve requirements is one for so-called « ceiling reserves »(4). It would impose higher requirements upon the increase in each bank's deposits over the level existing when the measure goes into effect. Compared with an increase in primary reserve requirements, this would have the advantage of being much more equitable as among banks, but even so it would present considerable problems in operation.

Another variety is the « loan reserve plan », which would call for additional reserves to be carried against loans, or against any other form of asset the expansion of which the monetary authorities wanted to restrain (5). This procedure permits some degree of qualitative control and would allow the curtailment, for instance, of business credit without restricting purchases of government securities. Both the loan-reserve and the ceiling-reserve plan involve a final dilemma — how to eliminate the requirements once the emergency is over. Neither type of requirement is one under which the banking system could conveniently operate in the long run. Yet their relaxation would release a flood of funds, and the central bank would have to cope with these funds in some manner.

Still another proposal — one familiar to many European bankers — is that for « secondary reserve requirements », *i.e.*, additional reserves in the form of government securities. Its purpose is twofold: 1) to limit the ability of the banks to obtain reserves from the Federal Reserve by selling to it their government securities, and 2) to limit the amount of public debt that would be exposed to market fluctuations if the Federal Reserve should permit or originate such fluctuations. Against its merits in either respect a number of liabilities must be weighed. Complex in detail, the liabilities have as their common denominators unequal impact upon banks, doubts as to effectiveness, questionable influence upon public credit, and distortion of institutional arrangements.

It goes without saying that views as to merits and demerits under American conditions, where secondary reserve requirements would be employed as minor adjuncts to a long tradition of primary reserves, cannot be transplanted to the European scene. Are generalizations nevertheless possible? The observer is bound to be struck with the multiplicity of schemes that have turned up. Ingenuity and imagination evidently have here a fertile field, and bankers may look for further surprises. But the observer is bound to be struck also with the multiplicity of situations that the money market has presented. Each proposal, aimed at a specific momentary problem, has rapidly tended to become unneeded or inadequate. The unwisdom of embodying too much current thinking in permanent laws, of which Dr. Goldenweiser warns in his *American Monetary Policy*, strongly impresses itself upon the observer (6).

III. - *Capital and Related Problems*

The general story of developments in the field of bank liquidity has been told. There can be no doubt that much has happened to strengthen the banking and monetary mechanism. Where do we now stand? The skeptic's view might be that we are excellently prepared to cope with the last crisis, and that the problems of the future are still likely to catch us unprepared. A more sanguine appraisal would seek to justify the hope that the monetary mechanism has finally been perfected to the point where no internal defects are likely to cause a breakdown and where our sole remaining danger is lest we run it off the road.

In the last analysis, the two views may not be too different. That we have sublimated, to the high level of monetary policy, some of the humble problems of keeping the mechanism in order seems obvious. No less obvious, however, is that at the new level a good many difficulties are being experienced that are in part, at least, the consequences of some of the things that have contributed to improving the mechanism. The inflationary pressures that have plagued us are related, to some extent, to the creation of the assets that contribute to the banks' liquidity and solvency and that help to keep total deposits stable. More broadly, the inflationary pressures are caused, in part at least, by the general antidepression orientation of our economic policies, of which the laws and policies contributing to the solidity of the banking mechanism are a part. We are already paying for what we have got.

The pessimistic view suggests that in addition to the bills already being rendered, there may be others to come, or that new and unrelated troubles will have to be faced. If so, not many are clearly foreshadowed at this time. Nationalization of banks is not an issue at present. Labor trouble has so far been blissfully absent. Already upon us, however, is the dilemma created by low capital accounts, low profits on this capital, and low appraisal of bank stocks by the markets.

Although commercial banking capital in the United States has grown 64 per cent since 1928, it has not kept step with the rise of deposits. The capital/deposit ratio, for which 10 per cent was the traditional minimum, now stands at about 7½. The importance of this ratio, no doubt, has diminished with the rise in relatively riskless government security holdings. Its place is being taken by a ratio of capital to risk assets, the latter defined as total assets excluding cash and governments. But this ratio, which bank examiners now would like to see above 17 per cent, averages something very close to that figure and is being squeezed by the growth in loans.

Net earnings of member banks after taxes, which might have risen to impressive heights thanks to war financing if the war had gone on much longer, have leveled off at about 700 million dollars after taxes, against 504 million in 1928 and 347 million in 1939. In 1950 they averaged 8 per cent on capital funds, which compares with a return on net worth of 13.3 per cent for a representative sample of leading industrial enterprises. Dividends paid out by banks averaged 45 per cent of earnings. In the light of these earnings and dividends, the market appraises bank stock at an average of about 20 per cent below their book value.

The paradoxical fact is that the banks do not have as much capital as they ought to in order to conduct their business, and that even on this inadequate capital their business does not yield an adequate profit. To be adequate, the profits should be such to produce a market valuation at or above book value. It is only then that banks could sell new stock without giving away some of the old stockholders' equity to the new. Even under such conditions the sale of new stock would be a rather heroic act and a great immediate sacrifice on the part of the stockholders, because an increase in the capital of a bank, unlike that of an industrial corporation, does not make anything like a proportionate contribution to earnings.

If things were left to develop along laissez-faire lines, a reasonable rate of earnings probably would tend to prevail in the long run despite these peculiarities, although it might take longer for the rate to find its proper level than in other industries. For many years, however, the banks have lived in a world of cheap money. Their earning assets have gone up greatly, thanks in part to the official easy money policy, but the average return on them has declined. As the staunchest defenders of private enterprise, they find their profits governed implicitly by official decisions. It is not clear that they would be better off if some of these decisions, relating to debt management

(3) A purely formal version of this proposal is in effect in Argentina.

(4) Provisions for ceiling reserves are in effect in various Latin American countries.

(5) A modified version of this is embodied in the central banking law of the Dominican Republic.

(6) *Op. cit.*, p. 70.

and interest rates, were made explicitly with a view to their repercussions on bank earnings. The banks would then be very much in the position of public utilities whose earnings are subject to public regulation. But neither is it clear what alternative solutions the banks can count on.

The consequences of insufficient earnings and slim capital ratios likewise reach far. Significant for the present discussion is the compulsion to limit risks that flows from a low capitalization. To protect their solvency, banks must restrain their lending and gravitate toward governments. It is here that the themes of liquidity and solvency, distinct but basically related, come together. In the past, problems of liquidity and solvency usually have gone hand in hand. This does not seem to be the case now. Today, the desire to protect their solvency is pushing the banks in the direction of increasing liquidity because the more nearly risk-free assets that they seek — mostly government securities — also happen to be the more liquid ones. A lower degree of liquidity would probably still be quite adequate if it could be made to rest on a broader capital base.