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A Book on the Federal Reserve System of the
United States -- By R. Entov
(Translation by Paul Gekker)

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Combining Central and Commercial Banking
Lewis N. Dembitz

2 pages

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A Book on the Federal Reserve System of the United States*

R. Entov

The banking system of the most powerful capitalist country--the United States of America--encompasses at the present time a great number of credit institutions of various types, related to one another by a complex system of relationships. For this reason, any investigation of the structure of finance capital, undertaken from a Marxist position, presupposes a serious analysis of the specific organizational forms of the Federal Reserve System--which reflect the enlargement of the area of control and influence by the financial oligarchy--as well as a thorough criticism of bourgeois theories of credit. The Soviet reader may be helped in accomplishing this task by the existence of a translation into Russian of the book The Federal Reserve System, published by the Board of Governors of the Federal Reserve System.

The editors have shown good judgment in prefacing the translation by an interesting essay by Professor E. Ya. Bregel. The introductory essay provides a short historical account of the organization of the Federal Reserve Banks, and

* The recent publication of a Soviet translation of The Federal Reserve System: Its Purposes and Functions was announced in a short note in the April 1960 issue of Dengi i kredit ("Currency and Credit"), the monthly journal of the State Bank of the USSR.) The translation is the joint work of V. Usoskin and E. Zolotareno, under the editorship of Professor E. Ya. Bregel, and contains an introductory essay by Professor Bregel. The volume was published in 1959 by the State Publishing House for Financial Literature in Moscow. This review of the book, by R. Entov, appeared in the June 1960 issue of Dengi i kredit, and was translated into English by Paul Gekker of the Division of International Finance.

The translation, which is complete except for an introductory sentence in the review identifying the book, is informal and unofficial. Some slight liberties in translation were taken in a few passages in which the Russian seemed cumbersome or unnecessarily involved. The quotations from American sources cited by the reviewer are reproduced in their original (English) form; for convenience, the footnotes have been renumbered consecutively. The reviewer's page references, in parentheses, have been retained unchanged; they refer to the Soviet edition, which appears to be between ten and fifteen pages longer than the Federal Reserve edition, because of the inclusion of Professor Bregel's introduction.

We have not yet received a copy of the Soviet edition of the "Purposes and Functions" volume, and therefore cannot comment as yet on Professor Bregel's introductory essay. The Entov review itself is a curious mixture. It combines Marxist comment and criticism of Western economic institutions and Western economic thought with a selection of statements by American economists--written of course from a totally different point of view--criticizing the Federal Reserve System and its policies. It has not seemed worthwhile to annotate the attached translation of this Soviet piece which, with its somewhat disorganized discussion and its numerous misconceptions, is presented simply as a matter of possible interest.

subjects a number of apologetic statements of bourgeois economists and politicians regarding the activities of the Federal Reserve system to criticism from a Marxist point of view.

The book begins with a description of the functions of the Federal Reserve System. Its principal function, in the opinion of the authors of the volume, is the regulation of the movement of credit and money (page 33). A large portion of the book is, therefore, devoted to a description of the credit policy methods of the Federal Reserve banks (or, as the authors put it, the methods of "credit regulation"), and to their influence on the country's economic development. In the book the forms of credit policy are subdivided into two groups: (1) "general methods of credit regulation," to which belong discount operations of the Federal Reserve Banks, open market operations, and changes in reserve requirements of banks which are members of the Federal Reserve System; and (2) "special credit regulation measures," which include the establishment of margin requirements for stock exchange transactions, restrictions in the fields of consumer and mortgage credit, and others.

The principal emphasis is placed on an examination of "general methods of credit regulation" which, in the view of the authors of the book, constitutes the major weapon of credit policy of the Federal Reserve Banks.

Following an exposition of the basic methods and means for the regulation of credit, and a description of the structure of the Federal Reserve System, the authors proceed to examine the connection between money supply and the organization of the Federal Reserve Banks. In the process an apologetic attempt is made to represent the American system of money supply as an "elastic system" which, presumably, guarantees the automatic adaptation of the volume of money in circulation to the needs of the population.

The authors of the book regard credit policy as playing an extremely significant role "in the attainment of economic stability." (page 198). In the book, therefore, every possible prescription for the "surmounting" of cyclical fluctuations with the help of Federal Reserve policy is subjected to detailed examination.

It should be noted that The Federal Reserve System may be favorably compared with a great number of similar works of bourgeois economic literature in providing a more precise and briefer description of the technical aspects of the operations of the Federal Reserve Banks and of the presumed consequences of these operations.

In addition, in acquainting the Soviet reader with the technical operations of the Federal Reserve Banks, the translation serves the further purpose of attracting a wider circle of economists to undertake the criticism of contemporary bourgeois theories of credit. The presentation in the book of an apologetic appraisal of the functions and activities of the American banks of issue expresses not only the official viewpoint of the management of the Federal Reserve System but also reflects those deep-seated preconceptions which manifest themselves in bourgeois economic literature.

In the course of the entire book the authors develop one variant of the theory of "managed capitalism"--the concept of "credit regulation." The basic support for this concept comes to this: that the Federal Reserve Banks, in exercising their policy, control the volume and direction of bank credit and the quantity of money in circulation and, thereby exert a guiding influence on the development of the capitalist economy. The book describes in detail the "ways in which a general tightening or easing of credit, with accompanying changes in interest rates, may"--so write the authors of the book--"function to help maintain economic stability." (page 160.) Thus, for example, the expansion of credit--in the view of Federal Reserve officials--should increase cash holdings of individuals which they can use for further expenditures. In addition, an expansion of credit brings about beneficial indirect effects, stimulating purchases of securities, strengthening the "propensity to spend money," and so forth. (See pp. 133-134, 154-155, and others.) Consequently, by means of an expansion of credit--according to bourgeois economists--one can eliminate, or at least moderate, the extremely vexing problem of disposing of commodities under contemporary capitalist conditions. This type of policy, therefore, is resorted to "in a period of economic recession." (page 152.)

The theory of "credit regulation" is based on two premises: (1) Federal Reserve policy brings about basic changes in the market for loan capital; and (2) changes in the market for loans play the guiding role in the development of the capitalist economy. Neither one of these premises has any justification.

Federal Reserve policy cannot be the determining factor in the development of the market for loan funds. When the authors of the book state that the money market "reflects Federal Reserve credit and monetary policy" (page 103), they are simply putting the cart before the horse. The physical basis for the accumulation and utilization of bank credit is the movement of productive capital, and changes in the market for loanable funds actually reflect, above all, changes in the movement of real capital. The reduction in the level of interest rates and the increasing supply of funds experienced in a period following a crisis of overproduction is explained primarily by the contraction and paralysis of productive capital, and not by the application of a policy of "expanding credit" by the Reserve Banks.

Thus, for example, in the 1929-33 crisis the volume of commercial loans of Federal Reserve member banks was reduced from \$12 billion on October 4, 1929, to \$4.8 billion on June 30, 1933--that is, declined by 2.5 times.^{1/} As a result of the economic crisis of 1948-1949, total commercial loans of American banks declined by about \$2 billion.^{2/}

^{1/} Banking and Monetary Statistics, Washington, 1943, page 75. Translator's note: A "decline by 2.5 times" is customary Russian usage.

^{2/} Statistical Abstract of the United States, 1952, page 388.

The sharp increase in the relative surplus of loanable funds during crisis periods also manifests itself in a reduction of discount rates of the Federal Reserve Banks. In this way, actually, it is not that the "credit market" reflects Federal Reserve policy but that the credit policy of the Federal Reserve Banks reflects conditions on the market for loanable funds.

Naturally, this does not exclude the operation of an active reverse influence of credit policy on money markets. The limits to the possibility of exercising that influence, however, are determined by movements of real capital.

Let us, for example, examine the role which is played by the influence of the Federal Reserve Banks on the increase in member bank reserves. The authors of the book repeatedly assert that the increase in member bank reserves effected by means of changes in reserve requirements or open market operations leads to the multiple expansion of credit and the creation of new deposits (see pp. 49-54, 56, 63-64, 71, etc.). "Bank reserves have a multiplying capacity" say the authors (page 73). It is not difficult (sic) to detect the connection between the principle of the "credit multiplier" and the Keynesian theory of the income multiplier.

Just as in the case of the multiplier in Keynesian theory, however, the principle of the "credit multiplier" is based on a number of premises which ignore concrete conditions in the development of the capitalist economy. The increase in reserves of Federal Reserve member banks simply indicates the legal limits to an expansion of lending operations; this legal possibility, however, by no means always coincides with the operation of the natural economic development of capitalist society, which leads to the inflation of the superstructure of credit. The authors of the book observe that "the increase in reserve requirements has been taken at times when the total of excess reserves reached was so large that the effect on the total demand for Reserve Bank credit was small." (page 74.) At the same time they are compelled to acknowledge the extremely limited possibilities of "regulating" credit by influencing the level of member bank reserves.

The conceptual operation of the "credit multiplier" is incompatible with the prolonged existence of large amounts of excess reserves; it presupposes the automatic utilization of excess reserves for an expansion of credit. Thus, despite repeated increases in reserve requirements of Federal Reserve member banks, the existence by 1940 of unutilized reserves amounting to \$7 billion (page 193) provides conclusive evidence of the ineffectiveness of the principle of "multiple expansion of credit."

The mechanism of "multiple contraction" of credit is also seen to be worthless. The authors of the book assume that the retirement of a given amount of reserves "may result in a multiple reduction of loans and investments" (pages 53-54). In reality, however, a given reduction of reserves in a period of cyclical improvement by no means signifies succeeding multiple contractions of credit. An increase in reserve requirements of Federal Reserve banks in the postwar period was usually accompanied by the mobilization of resources by commercial banks through the device of selling government securities. Moreover, since the funds gained by the commercial banks from the sale of government securities were used as reserves it proved

sufficient for the banks to reduce their holdings of Treasury bills only by an amount equal to the increase in reserve requirements. In this way, if a significant demand for loan funds existed on the part of large-scale capitalist concerns, the Federal Reserve member banks, despite the increase in reserve requirements, were able to expand credit by a more significant reduction in their ample portfolios of government securities.

The failure of the attempt to promote an expansion of the economy by a policy of expanding credit gave rise to serious doubts regarding the very real possibilities of "credit regulation" of the cycle. Thus the well-known American economist J. Williams wrote: "But as the great depression deepened, despite the fact that the easy money policy was carried to lengths unprecedented in this or any other country, the conviction grew that whatever might have been the defects of central bank policy, the main trouble lay in the inadequacy of this method, by itself, to control investment and the level of output and employment.^{3/} And shortly before the publication of the first edition of the book under review the Board of Governors of the Federal Reserve System, in its Annual Report for 1937, was obliged to recognize the inadequacy of Federal Reserve Bank policy for the stabilization of the capitalist economy.

Bourgeois economists, and among them representatives of the Federal Reserve System, were therefore obliged to find a new basis for the role of restrictive Federal Reserve policy during the recovery period.^{4/} This point of view is also reflected in the book under review. "The ability to combat a recession with credit and monetary action," write the authors, "depends in large part on the extent to which restrictive measures were taken in the preceding boom. . ." (page 136). The restriction of credit and the use of interest rate increases are represented in the book as some sort of magical device which "deters inventory accumulation of a speculative character" (page 144), "counteracts unsound business booms" (page 161), and so forth; and these must, in the authors' opinion, avert succeeding cyclical declines in production.

The increased strain on the loan market and the rise in interest rates which took place during the 1950's served broadly to confirm the fact that, if Federal Reserve credit policy is incapable of leading to an expansion of credit, it can at any rate bring about an effective contraction of credit.^{5/}

In reality, however, the increase in interest rates in the 1950's accompanied a sharp expansion in the demand for credit on the part of entrepreneurs, in connection with output increases under relatively favorable

^{3/} John H. Williams, "The Implications of Fiscal Policy for Monetary Policy and the Banking System," in Readings in Fiscal Policy, London, 1955, page 185. (This reference is to the British edition of the American Economic Association Readings series, Vol. VII.)

^{4/} "The new view," states the American economist H. Wallich, "is that the best way to fight recessions is to prevent the preceding boom." United States Monetary Policy: Its Contribution to Prosperity Without Inflation. The American Assembly, Columbia University, December 1958, page 109.

^{5/} See, for example, United States Monetary Policy, page 116.

business conditions, with the modernization of fixed capital, with a significant volume of housing construction, and so forth. In individual years Federal Reserve credit policy played a certain part in the restriction of the market for loan credit, but its influence in this respect was hardly decisive.

Moreover, the opportunities for pursuing an effective restrictionary policy turned out to be significantly limited, a result which is explained by objective processes taking place in the market for loan capital.

In the opinion of the authors of the book, Federal Reserve policy in the boom period must be directed toward "restraining the rate of investment." But investment is most frequently financed by long-term credit; the principal lenders in the "long-term credit market" under current conditions are--as is noted in the book--credit institutions which are not part of the Federal Reserve System and, consequently, are in general not subject to control by the Federal Reserve by means of the method of required reserves. The role in the loan markets played by credit institutions not belonging to the Federal Reserve System--insurance companies, savings and loan associations, public and private pension funds, etc.--has risen sharply since the crisis of 1929-33. "In recent decades the flow of savings to nonbank lenders, particularly insurance companies, has increased rapidly," write the authors (page 142). Since the Second World War the increase in assets of nonbank institutions has exceeded by no less than three times the growth in commercial bank assets. Control over these colossal new money capital resources is directly in the hands of the strongest magnates of American finance capital, who have no use for the Federal Reserve System.

Even with respect to the Federal Reserve itself, the possibilities of pursuing restrictive policies toward the member banks have been significantly reduced. The authors write: "Since the early 1930's perhaps the most important change in the nation's financial structure has been the great growth in the debt of the Federal Government resulting from financing economic recovery and the Second World War." (page 67). In the book, however, this development toward a parasitical degeneration of the American banking system, and toward the use of a significant share of loan capital for the financing of the armaments race, is obscured in every conceivable way.

The concentration of a great mass of government securities in the American banking system sharply restricts the organization of credit management within the Federal Reserve System. As the authors recognize, the policy of preventing the inflation of bank portfolios of government securities by purchase of these securities, which was pursued uninterruptedly until 1951, was "incompatible with effective Federal Reserve regulation of the volume of bank reserves." (page 130)

Even since 1951, however, the growing instability of the entire system of government credit does not permit the Federal Reserve to depart for any protracted period from a policy of maintaining the prices of government securities. The use of Federal Reserve funds for the financing of government orders, at high profits for the monopolies, leaves its imprint on the nature

of open market operations, actually depriving them of that "flexibility" which the authors of the book praise so highly. (See, for example, page 66.) In order to maintain the prices of government securities the Federal Reserve Banks are obliged from time to time to purchase significant amounts of these obligations, thereby bringing about increases in the reserves of Federal Reserve member banks. At the same time, the reserve banks refrain from selling long and intermediate-term government securities on the open market because such sales could lead to a sharp depreciation in the values of government paper. In sum, it turns out that the Federal Reserve portfolio of government securities over a period of 7 years--from the end of 1951 to the end of 1958--rose from \$23.8 to \$26.3 billion.^{6/}

Finally, even if Federal Reserve Bank policy had been adequate to bring about a corresponding restriction of credit, it would be naive to suppose that this would have prevented the operation of powerful forces which lead to crises of overproduction in the capitalist economic system. The authors, apparently aware of this to some extent, are forced to conclude their exposition of the problem of "credit regulation" with the observation that "when savings are very large, as they ordinarily are in this country, sustained expansion of productive capital in substantial volume is possible without an excessive and unstabilizing growth of credit and money." (page 161) But this admission actually renders the entire preceding theoretical formulation of the prevention of crises by restraining "unhealthy expansion" quite valueless.

On almost every page of the book there is repeated, with minor variations, one and the same expression to the effect that Federal Reserve credit policy is directed toward the "maintenance of economic stability," "the surmounting of economic instability," etc. But the actual development of the capitalist economic system disproves these bourgeois theories of the crisis-free development of capitalism. Crisis-like declines in production have occurred with greater frequency in the postwar period. The economic crisis of 1957-58 provided new and graphic testimony to the bankruptcy of the theory of the "avoidance of economic instability" with the help of Federal Reserve credit policy. In spite of isolated restrictive measures adopted by the Federal Reserve banks, the 1950's witnessed a rapid inflation of the superstructure of credit which called forth an expansion of output and contributed, in its turn, to a strengthening of mounting overproduction.

The present-day structure of the Federal Reserve Banks is portrayed by the authors as having developed into a most effective arrangement for the regulation of credit. Under the influence of the 1957-58 crisis, however, a number of American officials found themselves obliged to modify the official tone of optimism--which is quite characteristic of the book--regarding the capabilities of the Federal Reserve System. The report to the American Congress rendered in 1958 on the activities of the Federal Reserve System noted: "The recent boom followed by the sharpest recession in the postwar period has emphasized once more the necessity of a fundamental reexamination of our financial system with a view to increasing the effectiveness of monetary policy in a stabilization program."^{7/}

^{6/} Federal Reserve Bulletin, March 1959, page 292.

^{7/} Federal Reserve Policy and Economic Stability, United States Senate, 85th Congress, 2d Session, Committee on Banking and Currency, page 75.

In recent years the leaders of the Federal Reserve System have been forced to acknowledge, with increasing frequency, the bankruptcy of the theory of "credit regulation." The Chairman of the Board of Governors of the Federal Reserve System, W. Martin, said in his official statement before a Congressional committee: "It is my conviction . . . that it is not money and credit policy that controls the matter."^{8/} R. Young, Director of the Division of Research and Statistics of the Federal Reserve System--who headed the group of authors of the book The Federal Reserve System--was obliged to recognize, in his 1958 article, that monetary policy "is not omnipotent" in the "attainment of greater economic stability."^{9/}

To be sure, the contradictions of Federal Reserve credit policy do not signify that this policy is entirely meaningless. Undoubtedly, the restrictive credit policy pursued by the Federal Reserve System definitely influences the money market and contributes, within certain limits, to higher interest rates and increased profits for the banks themselves. V.I. Lenin showed that "conscious control by the banks constitutes the despoilment of the public by a handful of completely organized monopolies."^{10/} Actually, therefore, the credit policy of the Federal Reserve System, in guaranteeing the incomes of the money magnates, does not serve the "public welfare," as the authors of the book assure us, but the interests of monopolistic capital.

In such circumstances, when the banks act as active participants in the financing of government expenditures, the ceaseless repetition in the book of assertions that the aim of the Federal Reserve System is to serve the "public welfare," and that this aim "is approached through action directed toward regularizing the flow of credit and money, and fostering a stable dollar" (page 198) appears clearly unfounded.

Government expenditures, financed by loans of the Federal Reserve System, do not serve the "welfare" of society, but benefit the contemptible little group of monopolists who are enriching themselves at the public treasury. The major share of government loans is spent for military purposes which are related to the unproductive squandering of material, human, and financial resources.

In addition, the distribution of government securities throughout the banking system leads to the further inflation of the volume of deposit

^{8/} Investigation of the Financial Condition of the United States. Hearings before the Committee on Finance. United States Senate, 85th Congress, 1st Session, Part 3, page 1302. What Chairman Martin's statement appears to say when torn from context, as in the present instance, is quite different from what it was probably intended to say. The Chairman had just been asked, in effect, whether he would not agree that continued economic growth would be worth the price of creeping inflation. Part of his reply was the suggestion that the continuity of economic growth is determined more by real forces than by monetary influences; and the statement quoted formed part of that line of thought.

^{9/} See United States Monetary Policy, page 42.

^{10/} V. I. Lenin, Soch. (Works), Vol. 22, page 206.

money and the strengthening of inflationary processes. From 1938 to 1958, for example, the volume of Federal Reserve notes in circulation rose by 2.9 times while deposits in American banks increased at a rate 2.2 times faster than the volume of retail sales at constant prices.^{11/}

At the present time, when the dollar has depreciated by two times^{12/} in relation to the prewar level, it is hardly possible to talk seriously of the "elastic" system of money in circulation in the United States, and of the successful "maintenance of stability of the dollar." The whole system of credit relationships heightens the depreciation of the dollar and violates the ordinary process of the "well-regulated flow of credit" of which the authors write.

The authors are unable to deny that "during the war the amount of currency in circulation increased greatly." But in attempting to present this growth as a reflection of the "elasticity" of the U.S. monetary system they assure the reader that the factors which determined the increase of cash were the growth in payrolls, increased incomes of various groups among the population, etc. The apologetic orientation is quite clearly evident in similar assertions of the theory of the "elasticity" of the contemporary currency system.

The realities of the situation attest to the fact that it is not the growth of wage payments to the workers that brings about an expansion of currency in circulation, but that the inflationary swelling of the mass of paper money in circulation brings with it a lowering of the real incomes of working groups. The increase in wages, which the working class obtains in the course of a tenacious struggle, is not really the cause of inflation but an attempt to counteract, to some extent, the inflation brought about by the fall in real wages. The rising cost of living in capitalist countries represents, under contemporary conditions, one form of the pauperization of the workers through the unbelievable enrichment of a handful of representatives of monopolistic capital.

^{11/} Calculated from data in Statistical Abstract of the United States, 1940, page 244; ibid, 1949, page 431; ibid, 1959, pp. 440, 445; Monthly Bulletin of Statistics, November 1951, pp. 92, 143; ibid, November 1959, pp. 92, 157.

^{12/} Translator's note: As indicated above, this mode of expression is customary Russian usage.

August 2, 1960.

Combining Central and Commercial Banking

Lewis N. Dembitz

In an article on Central Banking in Libya, in The Bankers' Magazine (London) for June 1960, A. G. Chandavarkar says that "Libyan experience underlines the desirability and feasibility of combining central and commercial banking in an economy without indigenous banks." (page 498). I would like to disagree with this idea.

A main function of commercial banks, especially in an underdeveloped economy, is to promote economic development in an active way, seeking out investment opportunities and encouraging entrepreneurs to exploit all opportunities that give promise of being profitable to them. A main function of the central banking authorities, on the other hand, is to influence the rate of investment with a view to producing a rate of national economic growth that will be sustainable; this means that monetary policy should be designed so as to encourage at some times a rate of investment that will be higher, but at other times lower, than the rate that would have resulted from the activities of other elements in the economy without the influence of the central bank.

Among the various functions and activities of the central bank, the imposition of monetary restraint (as distinguished from the promoting and directing of economic expansion) should normally occupy only a minority of the authorities' attention, or for only a minority of the time. The imposing of restraint, however, represents the more difficult and exacting function of a central bank. It is the function that really justifies and demands the central bank's existence. Unless the central bank is able and willing to impose restraint when needed, the country would probably be better off without any central bank, especially since the other functions of the bank could be performed just about as well by other kinds of agencies.

Now, can this function of restraint be performed equally well by an organization that combines central banking and commercial banking functions? I think not.

Especially in a young and growing country, the commercial banking functions will be of much the greater interest to the Directors of any combined institution. These functions will seem to be the dynamic and constructive part of the bank's activities. They will provide by far the greater scope for developing the reputations of individual managers and directors for prowess and business ability and for contributing to national progress, as well as developing their influence in the business community and contacts that may lead to opportunities for personal profit (without any implication of dishonesty or impropriety in this).

But, if such a commercial banking business is to be really successful in playing its role in national development, its management and direction must have an enthusiasm for the promotion and expansion of investment; they need to be promotion-minded. Regardless of their general competence and judgment and ability, men whose careers are devoted to this

kind of promotional effort, and whose reputations depend on its success, cannot be expected to see the need of restraint at times when the "boom" has progressed too far.

The combining of the central banking and commercial banking functions in Libya, as described in Mr. Chandavarkar's article, while apparently successful to date, is not really a case in point. This is because, with the Libyan requirement of a 100 per cent currency reserve, the National Bank's functions do not include the regulating of the money supply which is such an essential function of full central banking. If Libya should at some time want to depart from its requirement of a 100 per cent reserve behind its currency, so that its National Bank would engage in full-scale central banking, then a separation between the commercial banking and central banking functions would seem very desirable.