§ 6

Summary

A complicated material machine, such as a locomotive, an automobile, an airplane or an ocean steamship is never the invention entirely of a single mind but is the result of a long series of inventions and discoveries going back, in some cases, before the dawn of history. The institution of commercial banking is a great, immaterial machine, the product of the thinking and experience of many minds, and having its origin centuries ago. Through its aid the funds of persons who, temporarily but for indeterminate periods, do not desire to use their funds, are placed at the disposal of borrowers, to the mutual advantage of borrowers and ultimate lenders. Through its aid we carry on the major part—in the United States not less than ninety per cent—of business without the transfer of money, becoming successively creditors of the borrowers from the banks. We become creditors of the borrowers from the banks, by accepting,

for goods and services, checks on the banks and so becoming depositors of the banks; and, as depositors, we are dependent, for the value of our claims, upon repayment to the banks, by borrowers, of the sums borrowed.

The checking accounts or claims on banks thus passed from person to person by check, act on prices as does money. They are a money substitute. They constitute a large part of the media of exchange. But bank deposits cannot too much exceed cash reserves. The ratio of bank reserves to bank deposits may be somewhat elastic and depends, in the United States, on the policy of the Board of Governors of the Federal Reserve System (and the Federal Open Market Committee). Checking accounts and cash in tills or pockets tend to maintain a rough proportion to each other because certain things are more conveniently paid for by check and other things are conveniently, and by custom, paid for with money. This fact, as well as the necessity of a cash reserve for banks, tends to relate the volume of bank deposits to the volume of money. Bank notes, like bank deposits, are obligations of the banks and, ultimately, of the debtors of the banks. But they are frequently specially safeguarded by law and, in the United States, are made redeemable by the Federal government in the case of failed banks. Rising and falling prices are to be explained by reference to the relations between money and credit media of exchange on the one hand and the volume of trade on the other. The notion that rising prices are due to, or that they can be caused by, demands for higher wages on the part of wage earners is, except for some minor and, indeed, very dubious qualifications, utterly preposterous, despite the extent to which this notion has been accepted.

In concluding this chapter it may be helpful to emphasize the very great influence which can be exercised over the general price level by the twelve Federal Reserve banks, acting under the direction of the Board and of the Federal Open Market Committee. They can force credit restriction upon member (and other) banks even though these banks and their customers owe the Federal Reserve banks

nothing. For by selling, in the open market, securities held in their vaults, they receive for these securities checks on various banks. These checks are then charged against such banks, forcing settlement from non-members and, in the case of member banks, diminishing their credit balances (which count as their reserves) in the various Federal Reserve banks. Thus, especially if rediscount rates are simultaneously kept high, both member and non-member banks must restrict credit and prices tend downward.

The effect on deposits may be both direct and indirect. The bank deposits of those individuals and firms who purchase these securities of the Federal Reserve banks are, of course, reduced *directly*. The total volume of checking accounts available for the purchase of goods is less than before. But, further than this, the reduction of the reserves of member and non-member banks, consequent on the charging of their customers' checks given for the securities, against them, reduces the lending power of these banks. Thus it tends towards credit restriction and so reduces the volume of checking accounts *indirectly*. This indirect effect is realized, too, if the securities sold by the Federal Reserve banks are purchased by member and non-member banks, since such purchase reduces their reserves.

On the other hand, by purchasing eligible securities in the open market, the Federal Reserve banks can put more money and checking accounts into circulation. They can do this *directly*, since individuals and firms from whom the securities are purchased, now have more money or larger checking accounts or both. But, in addition, such action increases the reserves and lending power of member (and non-member) banks, thereby making possible, *indirectly*, a further expansion of bank credit. Through their open market operations, therefore, the Federal Reserve banks can certainly set in motion forces tending to make the price level rise.