ECONOMICS U$A

PBS PROGRAM #8

THE BANKING SYSTEM: WHY MUST IT BE PROTECTED?

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AND
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AIRSCRIPT

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8.**THE BANKING SYSTEM: IS MY MONEY SAFE?**

PURPOSE:

To help viewers understand the key role of banks in the U.S. economy and how government agencies act to prevent individual bank failures from becoming banking crises.

OBJECTIVES:

1. Banks play a key role in the economy by holding deposits, handling withdrawals, and making loans.
   a) banks only need a small fraction of their deposits in cash to handle withdrawals.
   b) banks are forced by banking regulations to hold a certain percentage of their deposits as reserves.

2. A balance sheet tallies a bank's assets and liabilities.
   a) cash and loans are the primary assets
   b) deposits are the primary liabilities

3. The banking system can expand the amount of money in circulation by making loans.
   a) the amount of the expansion is limited by the reserve ratio.
   b) during depressions deposit contraction takes place.

4. Various government agencies regulate banks and are able to reduce the risk of bank failure.
   a) the Federal Reserve acts as a lender of last resort.
   b) the FDIC insures the deposits of some banks
   c) regulators examine banks' books in order to prevent excessively risky bank practices

KEY ECONOMIC CONCEPTS:

deposits
reserve ratio
liabilities
balance sheets
Federal Reserve System
FDIC
fractional reserves

multiple expansion of bank deposits
lender of last resort
loans
assets
bank runs
deposit insurance
deposit contraction

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TEASER

DAVID SCHOUMACHER: New York, 1907. One of the city's major banks, the Knickerbocker Trust, closes…one man commits suicide…the banking system nearly collapses…What is it about the nature of banking that could lead to such a calamity? In the 1920's the banking system helped spread prosperity. By the 1930's it dragged the nation down…How could a holiday put an end to the deepening crisis? Banking deregulation cost the taxpayers almost a half trillion dollars. Did banks need more regulation…or less? Our nation has a long history of trying to protect the business of banking but we've never eliminated all the risks. The banking system…Why must it be protected? That's the question economic analyst Richard Gill and I will investigate on this edition of Economics U$A…I'm David Schoumacher…

(MUSIC PLAYS --OPENING TITLES)
(THE BANKING SYSTEM: Why Must It Be Protected? Appears on screen)

PART I

DAVID SCHOUMACHER: America's businessmen and women know how dependent they are on a friendly bank for their success of their companies and the growth of their communities, and this country's banking system has provided that success and that growth for more than a century. Although most banks are healthy and long-lived, historically we have had to face the tragedy of bank failures. While we can accept the failures of other businesses with a shrug, the closing of a bank is another matter…as we learn in our story of a bank that is no longer with us…the Knickerbocker Trust. New York at the turn of the century. Financial capital of America. It was money that kept New York moving and growing…money that built its elevated trains and skyscrapers…and

most of the money that built New York came from the banks, of which New York boasted hundreds. From the powerful national firms on Wall Street to the more modest banks like the Knickerbocker Trust, which served the city's neighborhoods and its people…Working class families who kept their savings in the Knickerbocker… storekeepers who dropped off their daily receipts there and borrowed at the Knickerbocker to buy merchandise…wealthy matrons who used their checking accounts to shop Fifth Avenue…captains of industry who invested their corporate profits at the Knickerbocker Trust…and as banks had done for centuries, the Knickerbocker held only a fraction of its depositors' money in reserve and loaned out the rest. Wall Street analyst Henry Kaufman explains how a bank earns money…

HENRY KAUFMAN: "Banks tended to earn money the same way as they do today in a general way…by making loans and by making investments. There was perhaps in those days, in hindsight, a somewhat greater risk taking than has tended to occur within the last forty years or so in the United States or in banking in modern times. It was and had a stronger entrepreneurial drive in those days and at the same time there was inadequate governmental supervision."

DAVID SCHOUMACHER: Charles Barney, the Knickerbocker's president, was one of those entrepreneurs, ambitious for his bank's success. Apparently, for Charles Barney, the chance came along to make a lot of money…this is if he was willing to take some major risks with the bank's money. Barney had connections with a speculator named Charles Morse. Morse and a partner, Frederick Hines, headed a scheme to manipulate the price of copper on Wall Street. Copper was a "hot item" that a number of people were speculating on in those days. There is debate, historically, over the extent of Barney's involvement, but many believe he made the behind-the-scenes arrangements as the Morse-Hines combine began setting up its trap in early 1907…Historian Robert Sobel explains…

ROBERT SOBEL: "Hines came to New York where he met Morse, who was the small time speculator who was behind American Ice Company and a few other companies like that, and their plan was to get four or five banks behind them…and, once they had the

banks' assets, to use it to create a new copper company…<u>United Copper</u>…push the stock up, squeeze the shorts….that is to say, squeeze those people who sold the stock thinking it would go down, and make themselves a bundle. Perfectly legal for that period…"

DAVID SCHOUMACHER: (over the shoulder question) What happened?

ROBERT SOBEL: "The stock market at that time was heading downward because of this "money crunch" I mentioned just briefly before…that is to say, the economy was overheating, many people were frightened that perhaps there would be a "crash". They were taking their gold out of the banks. Most people knew that Knickerbocker was part of this group…and when <u>United Copper</u> started to collapse they put two and two together. Depositors started to appear at the Knickerbocker with those pieces of paper…as I said before, gold certificates written by the Knickerbocker…and said, "Give us our gold…" and the money starts flowing out of the Knickerbocker. Now under normal circumstances…had the Knickerbocker been just a major bank…they would have gone to Morgan or someone else and said, "help us out of this. Otherwise there's going to be a panic."

DAVID SCHOUMACHER: On Sunday, October 20, Charles Barney left his home here on Park Avenue to try to borrow the cash he needed. He went to appeal to the only source that he knew could save him…J.P. Morgan. Morgan had helped banks in trouble before…he was one of the few men with the resources and reputation to do it. But when Barney got to Morgan's headquarters here at his library, Morgan wouldn't even see him. For Barney disaster was now inescapable…The rumors took on a life of their own… Monday…the runs on the Knickerbocker began…Depositors panicked and tried to withdraw their savings…Tuesday, at noon, the Knickerbocker's cash was gone and the panic spread to other banks until 246 banks across the country closed…their customers - out of luck. J.P. Morgan, realizing the entire system was threatened, not to mention his holdings, finally stepped in to end the panic of 1907. Under his leadership, a large reserve fund was put together. Then, facing appeals from banks and trust companies and brokerage firms, Morgan met with a group of New York City bankers in his library. Together they often worked through the night. In fact, it's said that at one point Morgan

locked them in while they argued over which firms to save and which to let die. Morgan played solitaire at his desk…until they made their decision. Morgan had saved the day…as a grateful nation acknowledged…but the costs of the 1907 panic were high, as it affected banks and businesses and personal lives…including that of disgraced, distraught, Charles Barney…who killed himself. Ironically, the Knickerbocker Trust was not a bad bank. It was to re-open five months later, and the people who frantically lined up along here got most of their money back…As for the nation's bankers, they had to face two important realities. Could they allow the power to save the banking system to remain in the hands of J.P. Morgan?…What would they do if a J.P. Morgan wasn't there? The bankers turned to the federal government for help. They accepted the need for a central bank. The other important reality was that, despite all its inherent instability, neither the bankers nor businessmen wanted to give up fractional-reserve banking. Economic analyst Richard Gill explains why…

(MUSIC PLAYS - COMMENT & ANALYSIS I)
(ECONOMICS U$A LOGO appears on screen)

RICHARD GILL: The reason why bankers wouldn't want to give up a fractional reserve system is pretty obvious. It's because they make money by lending out their depositors' money. Is this somehow sinful? Hardly. Banks are commercial enterprises. If they didn't make money on their loans, they'd have to charge us hefty fees to hold our deposits for us. Most of us, I suspect, would regard this as even more sinful. The Knickerbocker case, naturally, was a bit alarming but the fact is that, most of the time, fractional reserve banking works well. In its simplest form, a commercial bank's balance sheet might look like this. We have two columns here: assets and liabilities. Roughly speaking, "assets" are what the bank owns and "liabilities" are what the bank owes. In this stripped down case, the bank's assets consist of cash--money we have deposited in the bank…and its loans to businesses. This bank owns a claim of $80 million against the industrial firms, who have borrowed money from the bank and will pay interest back to the bank. Against these assets, we have what the bank owes to its depositors -- what we call demand deposits since they are, in principle, payable whenever we write a check on

them…that is to say, "on demand". And what "fractional reserve banking" means is not that our assets exceed our liabilities…as you see, they balance here at $100 million…but that the bank's demand deposit liabilities exceed the bank's cash reserves. The "fraction" here is one-fifth. Now what the Knickerbocker case shows is that there is an inherent vulnerability in this kind of banking. If this bank's $80,000,000 in loans turns out to be bad loans, it can get into serious financial trouble. Even if the loans are O.K., the bank can get into bad trouble if people believe it is in trouble. If everybody wants their cash "on demand", obviously our bank is not going to be able to satisfy them. "Believing makes it so!" But this same principle also explains why the system usually works just fine. By believing our money is safe in the bank, it becomes so. Most of us never even think to ask our banks to show us their balance sheets. Not knowing, we have no need to know. Most of the time.

PART II

DAVID SCHOUMACHER: Twenty-five years after the panic of 1907, the country was torn and nearly overturned by the "Great Depression". Not only did banks fail by the thousands, but many felt the banking system contributed to its collapse. How could this happen…and could anything prevent it from getting worse? The Federal Reserve, Washington D.C…The central bank in a sense was a kind of institutionalized J.P. Morgan. It was intended as a lender of "last resort"…loaning money to banks such as the Knickerbocker Trust which were basically sound but temporarily in need of "shoring up". All of the nationally chartered banks were automatically members of the Federal Reserve system and many of the state banks joined as well. Did the Federal Reserve work? Well, through the 1920's, there were few complaints. In fact, the presence of the Federal Reserve in part reflected and in part reinforced the optimistic view of the times. The banking system supported the boom of the 20's. In fact, it increased the amount of money in circulation during those years. How did the banking system create money? Well, by making loans. As a loan was granted, credit was created and more money flowed through the banks. It had a multiplying effect. Workers earned their wages and the wages went into a bank, where it could be loaned out to other people to buy cars…and more money flowed through the banks. Auto company profits could then be

invested in steel mills, and so it would go… more and more money flowing through the banks. Would we grow forever?…Henry Kaufman explains why most Americans in the 20's acted as if we would…

HENRY KAUFMAN: "When you get into an economic expansion, the commercial banking system or a financial institutional structure can aggravate problems by becoming too liberal in its loans…allowing a liberalization in credit standards. Now that immediately drives the economy very sharply, but within time adds to problems.

DAVID SCHOUMACHER: Banks gave liberal loans to investors…Investors in turn speculated widely on the stock market…Wall Street boomed…until "Black Thursday". October 24, 1929, the inevitable happened…The market fell! The "crash" pushed the country into the "Great Depression". Americans felt the pain of an economy grinding down…the money in circulation virtually drying up. Workers lost their jobs and took their savings out of the banks. Loans weren't made to industry…they were called in. Many losses couldn't be covered. People weren't looking to buy new homes or cars or furniture…They were lucky to hold on to what they had. The economy hurt the banks…the banks hurt the economy. Historian Eugene White explains…

EUGENE WHITE: "The problems with the banks began to feed the fires of the Depression and it worked through a multiple credit contraction…that is that once a bank began to cease to make a lot of loans…when it began to increase its reserves…not make new loans to new customers…an increasing number of businesses began to fail, and other businesses couldn't pay back their loans. That meant that many banks found that their loans were weaker and they contracted even further…so it was a real slow unwinding of the system of financial intermediation."

DAVID SCHOUMACHER: (over the shoulder question): What was the Federal Reserve doing at this time?

EUGENE WHITE: "What the Fed was supposed to do was to engage in a counter-cyclical policy to counteract the trends in the economy, but instead, it at the

beginning…began to play a very neutral role. It just let the banking system slide very slowly into chaos."

DAVID SCHOUMACHER: Once again panic took hold. In 1930, about a thousand banks failed. In 1931, more than two thousand…In 1932, the American people looked to new leadership to lift the country out of its economic crisis.

FRANKLIN ROOSEVELT: "I propose to show that this leadership misunderstood the forces that were involved in the economic life of the country…It encouraged speculation and overproduction through its false economic policy."

DAVID SCHOUMACHER: The incumbent president, Herbert Hoover, was to be routed at the polls by Franklin Delano Roosevelt.

FRANKLIN ROOSEVELT: "This great nation will endure as it has endured. First of all, let me assert my firm belief that the only thing we have to fear is fear itself."

DAVID SCHOUMACHER: In his inaugural address, Roosevelt pledged to establish strong banking safeguards.

FRANKLIN ROOSEVELT: "There must be a strict supervision of all banking and credit and investments. There must be an end to speculation with other people's money!"

DAVID SCHOUMACHER: Responding to the urgent need, one of Roosevelt's first presidential acts was to declare a national bank holiday. Merritt Sherman, who was with the Federal Reserve at the time, tells us why Roosevelt took this course of action…

MERRITT SHERMAN: "What Roosevelt was trying to do was to create a period in which the whole banking system…individual banks…could be reviewed by bank examiners…by experts who had a great deal of information about banks…and enable them, through the procedure of licensing banks, to re-open to carry out the promise made by the President, that any bank that was re-opened would be able to stay opened."

DAVID SCHOUMACHER: In his fireside chat, FDR announced to the people that the re-opened banks were safe.

FRANKLIN ROOSEVELT: "Let me make it clear that the banks will take care of all needs, and it is my belief that hoarding, during the past week, has become an exceedingly unfashionable pastime."

DAVID SCHOUMACHER: And Roosevelt did more. Legislation following the bank holiday extended the powers of the Federal Reserve…forced banks to meet tougher regulatory standards…and created the Federal Deposit Insurance Corporation to guarantee each customer's account up to $10,000.

LITTLE BOY: "Give me my sixty cents."

CASHIER: "How do I know you got sixty cents?"

LITTLE BOY: "Here's my bank book…"

CASHIER: "All right, that's fine."

LITTLE BOY: "Five…ten…fifteen…twenty…twenty-five…thirty…thirty-five…forty…. forty-five…. fifty…fifty-five…sixty. That's o.k."

DAVID SCHOUMACHER: Americans showed their faith in the re-opened banks and the crisis passed. The "bank holiday" was a watershed in the Depression and is remembered as one of the most popular political moves by any President. The action was unprecedented, but, Richard Gill…Was a "bank holiday" really necessary? What had happened to the money supply?

(MUSIC PLAYS - COMMENT & ANALYSIS II)
(ECONOMICS U$A LOGO appears on screen)

RICHARD GILL: Well, the money supply shrank drastically between 1929 and 1933, but you have to understand that by "money supply" we mean not just coins and currency, but also our checking accounts in the banks. In fact, since we make most of our major purchases by checks rather than cash, these banks deposits are by far the most important part of our money supply. And a point not all of us may be aware of is that commercial

banks can actually "create" these deposits--actually create "money"! This really does seem a bit much, but in fact, it's a simple consequence of our old friend, fractional reserve banking. Let's follow through a million dollar new deposit of cash in the banking system. Let's suppose there is a rich widow who, frightened by the panic of 1907, has been keeping her $1 million in cash under her mattress…hopefully not in one dollar bills -- and now, in the "roaring 20's", she deposits this million in the bank. The bank has $1 million more in cash and she has a $1 million demand deposit in her name. Now we get to the fractional part of it. The bank lends out, say, $800,000 of this to businessmen, and now the businessmen withdraw this money so that our bank now looks like this. But what do the businessmen do with this money? They pay it out to workers, landowners, and so on, who deposit it in <u>their</u> bank. So now we have a <u>second</u> bank that has a new cash deposit. Its balance sheet looks like this. But now the second bank…on the familiar fractional reserve principle…lends out most of its new cash…say, $640,000. Its balance sheet now looks like this. But hold on a second. Look what's happened. There are now $800,000 more demand deposits in the economy…$800,000 more <u>money</u> in the economy. We have the original $1 million in the first bank <u>plus</u> $800,000 in the second bank. And you ain't seen nothin' yet. Because this $640,000 that the second bank lends out now becomes a cash deposit in a third bank, and so on and so on. We have had, by the time we are finished, a multiple expansion of money throughout the economy. Or a multiple <u>contraction</u> of money, because this same process can also work in reverse. Not only can, but <u>did</u> during the Great Depression No wonder Roosevelt called for a bank holiday! No wonder our money supply collapsed so completely!

Segment 3 <u>The Threat to the Banking System</u>

DAVID SCHOUMACHER: For almost fifty years after the Great Depression, the banking system worked--and worked well Federal laws guaranteed deposits and kept banks and S&Ls out of high-risk ventures. Then in the seventies and eighties, the government gave S&Ls the green light to offer higher interest and get into high-payoff real estate deals. High-rolling S&L executives gambled on real estate and lavished depositors' money on imported marble and crystal. They lost…big…And the taxpayers got the bill--almost a half-trillion dollars. The commercial banks had troubles too. They

lost money on loans to third world countries and on high-risk junk bond offerings…and they looked to Washington for help. How could the government keep what happened to the S&Ls from happening to the nation's banks? Did the banks need to be restricted more closely, to make sure that they weren't taking big risks with taxpayer-guaranteed deposits? Or should banks be able to expand -- across state lines, or into the securities or insurance businesses -- so that they could earn higher profits and not have to take risks with depositors' money? The debate reopened issues first argued in the "thirties", issues passed down – literally -- from father to son. President George Bush sent Congress a bill that would allow banks to provide a variety of financial services, echoing the position his father, Senator Prescott Bush, had taken forty years before. But Congressman John Dingell Jr., chairman of the powerful House Energy and Commerce Committee, asked whether giving banks more freedom wasn't asking for economic trouble, the same concern his father, Congressman John Dingell Sr. had voiced over fifty years before.

REP. JOHN DINGELL JR.: Well, my old Daddy always taught me that there's no great educational value in the second kick of the mule. And I tired to learn from my mistakes as well as from the mistakes of others. What the banks proposed to do is immediately take all these new powers, rush out, and get into a lot of businesses.

DAVID SCHOUMACHER: Wouldn't the Bush banking bill open the door for banks to speculate in new business with federall-insured deposits, just as the S&Ls had done?

JAMES CHESSEN: We're not talking about taking insured deposits from banks and going into the securities business. We're going into the insurance business. And what you do is you build these walls, in some sense, that say no insured deposits can hop over from the bank to fund any kind of risk-taking, any kind of activities in these other areas.

DAVID SCHOUMACHER: Wouldn't banks know best about how the banking industry should be reformed?

REP. JOHN DINGELL JR.: They've had these huge successes in terms of bringing themselves to their knees. They now want to tell the Congress how the banking industry should be restructured. And they want to bring their expertise into areas like insurance,

real estate, securities, so that they can probably bring about a very successful collapse in those areas.

JAMES CHESSEN: The basic economics is there's a business judgment here. And not all business judgments are right or correct…and the market will penalize those that are wrong. And what we're saying is, the market will evaluate these institutions -- they're the best judge, not the government -- as to what things should be offered to customers.

DAVID SCHOUMACHER: The battle over banking laws wound up on the floor of the House of Representatives, and when the votes were counted, the President's bill lost, and the legislative walls that restricted banks to banking, still stood. There may have been only one thing that George Bush and John Dingell -- like Prescott Bush and John Dingell Sr. before them -- agreed on: however it was done, the banking system pumps the life's blood of the economy and had to be protected -- whatever the cost. How do economists view banking regulation? We asked economic analyst Richard Gill.

RICHARD GILL: How do economists view banking regulation? With ambivalence. It can be and has been argued that it was deregulation and lack of adequate supervision that threw the S&Ls and later the commercial banks into disarray. Or, it can be and has been argued that the real problem has been government intervention -- raising the level of deposit insurance to $100,000 and thus encouraging high-risk loans and investments. In the final analysis, the real issue isn't so much regulation versus deregulation as it is how to protect depositors without giving a green light to the reckless and imprudent.

DAVID SCHOUMACHER: Everybody agrees that a sound economy requires a safe and reliable banking system, and that it's the government's job to guarantee that safety and reliability. That's why the government stepped in to support the banks after the panic of 1907, and why the banking safety net was reinforced in the great depression. And it's why we've paid hundreds of billions of dollars to stand behind the government's guarantee of deposits in bankrupt S&Ls. It's also why, although they disagree on political philosophy, the policy makers in the White House and Congress, and at the regulatory agencies, don't argue whether to protect the system, but how. For Economics U$A, I'm David Schoumacher.