

SHOULD BANKS BE PERMITTED TO BORROW SHORT AND LEND LONG?

(Published in the *The COMMERCIAL and FINANCIAL
CHRONICLE*, July 20, 1967)

Yes! Says Dr. Walter Salant, Senior Staff Economist,
The Brookings Institution, Washington, D. C.

No! Says Mr. Robert de Fremery, President, Onox, Inc.,
San Francisco, Calif.

Whether or not banks jeopardize their existence because of the prevailing practice of lending on a long-term basis funds borrowed short term is the subject of a debate between Brookings Institution's top economist, who defends banks' intermediation methods, and San Franciscan manufacturer and writer on monetary economics, who claims that the failure to match borrowing and lending maturities is as unnecessary as it is dangerous. The debate stems from an Oct. 20, 1966 article by Robert de Fremery in the CHRONICLE which was republished by THE BUSINESS DIGEST (published monthly at 681 Market Street, San Francisco, Calif.) and which, in turn, led to an exchange of views between Mr. de Fremery and Dr. Salant in the April and May 1967 issues of THE BUSINESS DIGEST. The debate is reprinted here with the kind permission of all parties concerned.

BY DR. SALANT

As I understand it, your basic thesis is that the practice of borrowing short and lending long inevitably leads to instability because it causes the public sooner or later to lose confidence in bank deposits and ask for currency, which the banks, being illiquid, cannot supply. That result you regard as inherent in this method of bank operation.

I agree that some members of the public will always be wanting to convert bank deposits into currency. But others will always be depositing currency. The question is whether the net demand for conversion of deposits into currencies is unstable because of the banking practice which you criticize. I see no reason to think that it is.

I agree that other economic forces (which you do not discuss and apparently do not regard as central) may lead to general increases in the demand for currency and that when such increases do occur, a fractional-reserve banking system is more vulnerable to collapse in the absence of intelligent central bank action than a hundred per cent reserve system would be. Apart from economic factors, other than the bank practice of borrowing short and lending long, I see no great problem.

Like Insurance Companies

The situation of banks seems to me akin to that of insurance companies. They invest the proceeds of premiums in long-term assets despite the possibility that the insured may die. The foundation of their safety is that the proportion of people dying is rather stable, therefore predictable. Admittedly, the proportion of bank depositors who wish to convert deposits into currency is less stable.

But it is essential to my view that any tendency for this instability to reach crisis proportions arises primarily from factors originating outside the structure of the banking system itself, although these factors are reflected in expansion and contraction of bank deposits.

(I recognize that the analogy with insurance companies breaks down insofar as expansion of bank deposits increases the danger of bank failure and therefore the withdrawals, whereas expansion of insurance does not increase the proportion of insured people who die. My response is that deposit expansion itself does not increase the relative demand for currency much, if at all.)

If general economic policy is properly conducted, the loss of confidence to which you refer is not, in my view, inevitable.

Positive Argument

Now for the positive argument in favor of borrowing short and lending long. It rests on the importance of the economic function performed by financial intermediaries. This is more than a brokerage function. The argument for it has been developed only in the past six or seven years. (I have in mind the work of Messrs. Gurley and Shaw; e.g., their book *Money in a Theory of Finance*, published by the Brookings Institution in 1960.) ...

The essential point is that even though the amount of current saving and the amount of capital expenditures that other people wish to undertake in the same period may be equal, the assets which the savers wish to acquire may not be of the same kind that those who wish to make capital expenditures want to issue.

Savers, for example, may want highly liquid assets whereas would-be borrowers may want to issue only less liquid obligations.

Banks and other financial institutions supply liquid assets to the savers and take the less liquid securities of the would-be borrowers ... Performance of this function makes possible and also permits a given amount of saving to be transformed into investment with less use of economic resources.

You might agree that this should be done but say it should not be done by banks, whose liabilities are used as money. To this I can only ask why not? The stock of money is a portion of the total stock of financial assets and increases in it are one of the forms which current saving takes.

Central Bank Vital

If policy is so mismanaged as to permit large economic fluctuations of the kind that have led to widespread desire to convert deposits into currency, the remedy is to meet those crisis requirements through action by the central bank, the lender of last resort.

Since the Federal Reserve System has been in operation, we have had such a crisis only in 1932-33. That crisis would not have developed if the economic contraction had not advanced so far as it did.

I do think our understanding of economic policy is now good enough to make such an extreme situation no longer a major problem. But if it did arise, it could be handled through provision of reserves by the central bank.

Let me point out that immense shifts from deposits to currency now occur as a seasonal matter. They cause no

trouble because central banks are quite prepared to deal with them by supplying reserves, regarding such operations as a routine technical matter. If avoidable crisis demands for currency are not actually avoided, they can be dealt with in the same way.

BY MR. DE FREMERY

Although we disagree as to the underlying cause of a general increase in the demand for currency, at least we agree a "fractional-reserve banking system is more vulnerable to collapse in the absence of intelligent central bank action." I would even question whether intelligent bank action could prevent a collapse. Time will tell.

But the important thing is: Why use a system that is vulnerable to collapse? I was puzzled by your defense based on an analogy with insurance companies. You say, "Deposit expansion does not increase the relative demand for currency much, if at all." Yet we have had panics periodically for the last 200 years. You reply by saying, "If general economic policy is properly conducted, the loss of confidence ... is not inevitable."

May I ask: What do you consider to be proper economic policy in the present situation in which all newly mined gold is going into private hoards because of the extent to which gold has been short-sold by the world's central bankers and their respective banking systems?

Vulnerability the Issue

I don't feel you answered any of the reasons I gave for believing a confidence crisis is inevitable under such a

system. You say the practice of borrowing short to lend long gives us a "system more vulnerable to collapse." Doesn't the extent of the vulnerability depend upon the extent of deposit expansion?

Shouldn't we expect business and financial interests to become less and less confident in the strength of a banking system that is getting more and more vulnerable?

Shouldn't economists recognize that the public *does* react this way even though you may think it unintelligent for them to do so?

Money Is Still Money

In your positive argument in favor of borrowing short and lending long, you say, "The stock of money is a portion of the total stock of financial assets." True. But money is still money, and other financial assets are not money.

Money has a very important function to perform as a standard of value. The process of borrowing short to lend long upsets the stability of the standard of value. You partially recognize this when you concede the vulnerability of the system.

Fed Helpless In Crisis

Your faith in the ability of central bankers to deal with confidence crises doesn't inspire me. The Fed must still maintain a 25% gold reserve behind its notes. Although it can exceed these limits, it can do so only by paying a tax which would rise quite steeply if reserve deficiencies penetrated below 20%. This tax must be added to reserve Bank discount rates.

In other words, even if banks were able to rediscount

all their assets, the price would be prohibitive. Actually, banks can't rediscount all their assets. See George W. Mitchell's article in *The Commercial and Financial Chronicle*, December 30, 1965. He has suggested a change in the law to make this possible. But, as the law now stands, we definitely can have a loss of confidence merely from fear of another liquidity crisis.

The tragedy is that when another crisis occurs, persons with your faith will blame it again on "mismanagement." Even today the Federal Reserve Board is badly split on policy measures. Each individual thinks he can manage the monetary system—but they disagree among themselves as to what constitutes sound management. Wouldn't it be wise—in view of all the disagreement—to convert to a less vulnerable system that requires no "management" as such?

Sound Lending Needed

Real capital formation is desirable and is facilitated by financial intermediaries. But the practice of borrowing short to lend long is not a sound method of intermediation. You ask, "Why not?" Because it gives us what you admit is a vulnerable system. The likelihood of a loss of confidence increases the more vulnerable the system becomes.

As I see it, the only reason (and I do not consider it a valid reason) for allowing banks to borrow short to lend long is that it makes possible an expansion of "the supply of money." But that is not a proper function of the banking system.

I distinguish sharply between the government's legitimate function of providing our country with an adequate supply of money and the banks' legitimate function of

acting as financial intermediaries. Because we have allowed banks to interfere with the government's function, the government has been forced to interfere with the banks in a multitude of ways.

I do not believe it possible for banks to resist an eventual government control of all banking unless they put their house in order by having what George S. Moore called "a back-to-back relation" between loans and CD's. George W. Mitchell calls it "meshing the maturity profile of assets and liabilities."

Well, so much for that. I am concerned about the future of our country. If my reasons for thinking the present system unsound are invalid, please tell me where I've gone astray.

REBUTTAL BY DR. SALANT

Let me try to identify basic points which may underlie the differences in our views.

One is that so long as the demand of asset-holders for liquid financial assets exceeds the amount of such assets which borrowers are willing to have outstanding as liabilities against themselves, and their demand for long-term assets is less than such borrowers want to issue at existing short and long-term interest rates, there are bound to be intermediaries which—in the absence of restrictions on arbitrage between the short and long-term markets—will create the short-term assets which the savers want, and purchase the longer-term liabilities which the borrowers want to issue.

The only way you could stop this would be to require

that the time pattern of intermediaries' liabilities and assets be the same. If this requirement were imposed, the rates of interest in long-term and short-term markets could differ greatly.

If the differential were great, incidentally, such regulation would be hard to enforce, but the main point is that such a barrier would inhibit some uses of current saving that are more socially desirable (as judged by the market) than some of the uses that would be promoted. Avoidance of this misallocation is the benefit that we get for the risk you regard as great and I regard as slight.

Restrict Banks Only?

Perhaps your response to this is that you have no desire to prevent all intermediaries from borrowing short and lending long; you merely want to stop banks from doing so, while allowing non-bank intermediaries to continue the practice.

If this is your answer, then I think the difference between us probably rests, at bottom, on your view that "money is still money, and other financial assets are not money." You apparently feel that, because of this distinction, what is permissible for non-banks should not be permitted for banks.

In my view, the distinction between money and non-money financial assets is not so sharp as your statement implies. It does not really matter very much whether the liabilities issued by those who lend long and borrow short are money or close substitutes for money. The "monyness" of a financial asset is a matter of degree.

I realize that this view may be hard to accept; the belief

that the distinction between money-creation and intermediation is sharp dies hard, even among professional economists—it is in fact having a certain revival—but I think it is mistaken.

Fractional reserve banking is a response to the difference in the demand for long and short-term assets as between holders and issuers of financial assets. Any attempt to prevent the banks from bridging that difference would only result in its being bridged by some other existing or newly developed institutions.

Faith In Fed

You say we have had panics periodically for the last 200 years. As I pointed out in my earlier letter, we have had only one banking panic in the 50 years since we have had a lender of last resort, and that did not occur until a late stage of an economy-shattering depression.

You ask what I consider proper economic policy in the present situation in which all newly-mined gold is going into private hoards. That question introduces problems of international liquidity which I consider unrelated to fractional reserve banking in the domestic sphere. I think the present international monetary system has some serious defects but shall not go into them here; they are not related to domestic fractional reserve banking.

I certainly agree that the 25% gold reserve requirement behind Federal Reserve notes makes no sense. It immobilizes our gold holdings for the only purpose they can usefully serve. It should be abolished. Every competent economist I know is of the same opinion on this point. But the presence of this requirement is not an indictment of

fractional reserve banking.

If it is a fact that business and financial interests really are becoming less and less confident in the strength of the banking system, I should agree that economists ought to recognize it. But I do not think that the banking system is becoming more and more vulnerable, and I do not think business and financial interests think it is.

Summarizes Position

My fundamental points are:

1. that borrowing short and lending long is a basic aspect of intermediation
2. that there is no special reason why banks should not be among the intermediaries performing this function, both because the distinction between their liabilities and those of other intermediaries is not a sharp one and because, with a lender of last resort, there is no reason, short of gross mismanagement to expect the difficulties you fear.

REBUTTAL BY MR. DE FREMERY

You are correct in saying: "The only way you could stop this (borrowing short to lend long) would be to require that the time pattern of intermediaries' liabilities and assets be the same." One Governor of the Federal Reserve Board calls this "meshing the maturity profile of assets and liabilities" (private correspondence). I asked this Governor if he favored banks doing this and he replied: "Every step in that direction has a stabilizing effect on the economy whenever the economy is confronted with real or fancied distur-

bances affecting people's desire for liquidity." (letter, 5-18-66)

There is no doubt this could cause rates of interest in long-term and short-term markets to differ greatly. But that would not make it difficult to enforce such a regulation.

Easy To Enforce

When the public fully understands that the practice of borrowing short to lend long causes a debasement of our standard of value, few persons will engage in such an action—either as borrowers, lenders, or intermediaries. It would be only the criminal element in society that would need to be watched—just as we watch for counterfeiters today.

Money Still Money

The holders of CDs issued by the now defunct San Francisco National Bank would certainly disagree with your belief "it does not really matter very much whether the liabilities issued by those who lend long and borrow short are money or close substitutes for money."

The public justifiably makes a sharp distinction between legal tender and bank deposits they may not be able to get the next day. Bank panics would not occur otherwise.

No Faith in Fed

My last letter explained why I could not share your faith in the ability of the Federal Reserve to prevent a severe confidence crisis. Your reply does not reassure me. You say the only banking panic we have had since the Fed's existence was due to "an economy-shattering depression." But

I gave reasons ... why that depression was brought on by the expectation of trouble with the banks. There was no reply to this.

Naturally the protective measures taken by those who saw the crisis coming started the economy downhill. But the blame should fall squarely on the weak banking system—not on those who were trying to protect themselves from that weak system.

You divorce problems of international liquidity from fractional reserve banking. Seems to me that one grew out of the other ... As pointed out by James Callaghan, Chancellor of the Exchequer: "Most of England's balance of payments troubles are due to too much borrowing short and lending long ... the classic road to bankruptcy."

Negotiable CDs Solve Problem

The "gap" between savers who want liquidity and borrowers who want funds for a stated period of time would cease to exist if we would simply give banks more freedom to use negotiable CDs of varying maturities to fit the needs of borrowers. Banks could then lend for stated periods of time without putting themselves in a vulnerable position; and savers would have their desired liquidity in the form of negotiable CDs. This is what George S. Moore, President, First National City Bank, sees so clearly (although he apparently does not wish to extend his line of reasoning to include all bank lending.)

Gold Hoarding Significant

You say, "There is no reason, short of gross mismanagement, to expect the difficulties you fear." But my point

is that the system is so unsound it is impossible for central bankers to prevent a breakdown. That is why so much gold has been going into private hoards the last few years. You do not wish to relate these things. But sooner or later we're going to have to admit the cause and effect relationship between inflationary practices and the hoarding of gold.

Have you had a chance to read Stephen V. O. Clarke, *Central Bank Cooperation 1924-31*, recently published by the Federal Reserve Bank of New York? After reading it you may still feel that the system is manageable. But it had the opposite effect on me.

Summarizes Position

My fundamental points are:

1. the practice of borrowing short to lend long need not be a basic aspect of intermediation
2. the economy—both domestic and world—would be far more stable without that type of intermediation
3. that type of intermediation has such disastrous consequences on both domestic and world economic affairs that we are being forced to accept more and more government intervention in market processes—a distinct threat to our freedom.