Monthly Review

FEDERAL RESERVE BANK OF ST. LOUIS

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THE FEDERAL RESERVE BANK OF ST. LOUIS

IN THE

DEFENSE PROGRAM

by

Delos C. Johns,
President
Federal Reserve Bank
of St. Louis

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The national defense program is bringing substantial changes to the American economy. Those changes are being reflected in the Eighth Federal Reserve District and in the work of the Federal Reserve Bank of St. Louis.

In this brief article, I wish to discuss three points: The responsibility of the Federal Reserve System and of the St. Louis Reserve Bank, as part of the System, in furthering the defense effort; the task facing the commercial bankers of the district in providing for sound financing needs; and the need for continued strengthening of the district's economy for a probable long-term defense effort.

The major responsibility of the Federal Reserve System in the period ahead is to formulate national monetary policy that will contribute most efficiently to the success of the national defense program. This requires, on the one hand, that the System make sufficient reserves available to the commercial banks so that the essential credit needs of the economy can be met. But it requires, on the other hand, that the supply, cost and availability of bank reserves be regulated to the end that the volume of bank credit be held to the minimum consistent with the essential needs of the economy.

The primary task facing the United States at present is to attain the production goals necessary to meet the requirements of a large scale military defense program plus the essential requirements of the civilian economy. To reach that objective it is vital to hold down inflationary pressures. Inflation raises the cost of the military defense program. It reduces the value of the dollar and makes Government financing more difficult. It creates great distortions in the economy and impairs the efficient functioning of the economic machine. It drives people away from money and into goods, thereby further intensifying inflationary pressures and creating greater economic distortions.

Appropriate monetary policy is essential to the fight against inflation. It cannot do the job alone, but it is an essential element in any anti-inflationary program. As a curb on inflation, monetary policy aims at restraining growth in bank credit which will result in additions to the money supply. It does this through making reserves less available and more costly to the commercial banks. Unless the commercial banks obtain additional reserves they cannot extend additional credit.

It is most important to recognize that when the Federal Reserve System attempts to restrict the supply and availability of bank reserves, such action tends to be expressed in an increase in the cost of money, a rise in interest rates. This increase in money cost is just one result of making reserves harder to obtain; it is not an end in itself but merely one expression of a tighter money policy.

It is also important to recognize that Federal Reserve action to restrict credit (through restricting supply and availability of reserves) cannot be taken if the System is required to support a rigid pattern of rates on Government securities. When the System buys Government securities it adds to bank reserves. The very act of preserving complete stability in Government security rates means that the System has to buy securities at predetermined prices when offered by banks and other holders, thereby forfeiting its ability to use open market operations as a means of making reserves less available. Under conditions now prevailing, flexibility in Government security prices and yields is a necessity if the Federal Reserve is to curb bank credit expansion.

As noted earlier, a restrictive monetary policy does not mean that no credit should be used. The economy cannot function without adequate credit. The crux of the financing problem in a time of inflation is to see that there is adequate credit for essential needs, but that the total supply of credit is held within reasonable bounds. The Federal Reserve System is attempting, in effect, to put an over-all ceiling on bank credit. Under that broad ceiling the individual commercial bank can operate with freedom to extend credit for whatever purposes and on whatever terms it wishes.

Here is where individual banker responsibility comes into the picture. The traditional economic responsibility of the banker is to exercise his best efforts to distribute credit in such a way that the most useful purposes are fulfilled. He attempts to channel available funds into the most essential activities and to withhold funds from less essential purposes. Programs sponsored by the American Bankers Association and other organizations are stressing this most important responsibility.

As part of the Federal Reserve System, the Federal Reserve Bank of St. Louis shares in the major responsibility of the nation's central bank, the formulation of sound and appropriate monetary policies to further the defense program. It is my

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earnest hope that the bankers of the Eighth District will continue to cooperate with the Reserve Bank and with each other in holding down credit for less essential purposes while seeing, at the same time, that the essential credit needs of the district economy are met.

It should be pointed out that the financing of defense production is an obviously desirable and necessary undertaking. So far the volume of defense contracts in this district is not large, and financing requirements therefore have not yet been large. As defense work increases there will be more need for financing. The V-Loan program has been reactivated to provide guarantees on loans to defense contractors who are called upon to perform services or produce material and supplies needed for the defense program. Again the Federal Reserve banks have been designated as the instrumentalities of the guaranteeing agencies of the Government. Eighth District banks are invited to make use of this facility when needed and to discuss defense financing problems with our officers and staff whenever their assistance can be useful.

Before concluding this discussion it seems appropriate to offer some comment on the problem of continued economic development in this district during the national emergency. The Federal Reserve Bank of St. Louis has been working for several years in the field of economic development for the Eighth District. For the most part that work has involved study of district problems and encouragement of programs aimed at their solution. The Bank has worked, primarily in cooperation with other interested groups and organizations in this field, to point out the benefits of sound industrial development, better and fuller utilization of the district's resources, a balanced agriculture—in short, to point out the need for higher district income and various means to attain that goal. Among the many organizations and groups with which the Bank has worked are state bankers associations, state universities, state development organizations, both public and private, chambers of commerce and various Federal agencies. It is sincerely hoped that we will continue to enjoy opportunities to cooperate with these bodies and to take part in these development programs.

In connection with this subject I want to point out three facts. First, the needs of the defense program make it mandatory that resource development for a particular region must at this time be geared to the national interest and not exclusively to regional interest. In other words, regional development programs must be shaped in the light of national needs, and their impact on the national economy must be considered more carefully than would be the case in "normal" peacetime situations.

Second, the requirements of the defense program seem likely to run over an extended period of time. The key to successful maintenance of a strong defense economy is proper management and allocation of resources over the long term. It is vital to choose among various short-run policy alternatives those that will not impair long-run efficiencies in the district. Of course, if we must engage in full-scale war it may become necessary to subordinate long-run efficiencies to the hard business of survival. On the other hand, if we are to continue the present type of mobilization program, a most important factor is ability to sustain it and at the same time keep the economy strong and healthy not only during the emergency period but also thereafter. As just one illustration of this point, it is essential to maintain and enhance soil productivity in so far as possible for the long pull, despite the temptation offered by high farm prices at any given time to exploit the soil and mortgage its future productivity.

Finally, sound development programs that will strengthen the district economy for a long-term defense effort and result in greater output from the district are worthy financing projects for banks. In providing such financing, individual district bankers have the responsibility for (1) determining the soundness of particular projects, (2) judging their desirability in view of the general inflationary situation and selecting those projects that will add most to the strength and productivity of the economy, and (3) curtailing other less essential credit demands. By exercising their traditional responsibility wisely Eighth District bankers can make major contributions to both district development and the national fight against inflation.

We have ahead of us, in this nation and in this district, many perplexing problems that at times seem almost imponderable. If the people of the nation and the Eighth District work as conscientiously as they have in the past, if bankers of the nation and this district continue to discharge their responsibilities as wisely and unselfishly as they have in the past, these problems can be moved toward solution. My abiding faith in the sound sense, initiative, industry and courage of our people gives me confidence to say that these problems can and will be solved with benefit not only to ourselves but to all mankind. The Federal Reserve Bank of St. Louis stands ready and eager to do its full share and more in that effort.

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MEMBER BANK EARNINGS

Bank earnings reached a new high in 1950. The increase came as a result of growth in total assets and fuller investment of those assets plus a shift toward earning assets with higher rates of return. Salary and wage expenses were up in 1950. Other expenses were slightly lower. Charge-offs and reserves were less than in 1949. Greater net earnings meant higher tax payments. However, net profits after taxes were larger than ever before. Dividends were larger and capital accounts were increased.

Earnings of Eighth District member banks reached a new high in 1950.

Bankers will remember 1950 as a very good year. Gross earnings of Eighth District member banks were $123 million, almost $10 million above 1949 and the highest on record.[1] Even with rising expenses and taxes and substantial charge-offs and transfers to valuation reserves, net profits were up $2.7 million from 1949, reaching $30.6 million, which equaled the previous record posted in 1946.

Eighth District member banks had $73 million in operating expenses and paid $13.5 million in taxes in 1950. The increase in expenses from 1949 was $4.5 million and in taxes was $3.5 million. Charge-offs on loans and securities and transfers to valuation reserves for bad debt losses were $5.5 million in 1950.

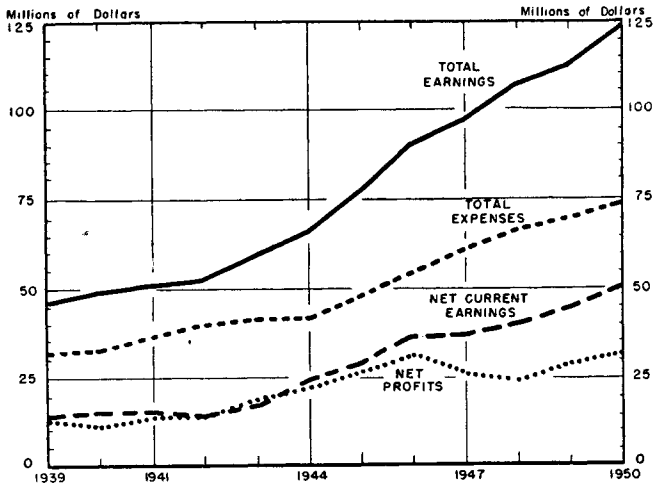
The increase came as a result of growth in total assets and fuller investment of those assets . . .

Total assets of district member banks rose to $5.1 billion in 1950, up almost $90 million from 1949. In addition the larger asset volume was more fully invested in earning assets than in 1949. In 1950 the banks had 75.8 per cent of their total assets producing income, either through investments in United States Government securities or other securities or through loans. The comparable ratio for 1949 was 74.1 per cent.

. . . plus a shift toward earning assets with higher rates of return.

During the war years banks invested heavily in Government securities. Total assets rose, the amount of their Government security holdings rose, and the proportion of assets in Governments in-

SELECTED EARNINGS REPORT ITEMS
EIGHTH DISTRICT MEMBER BANKS
1939 - 1950



creased. By 1946, Government securities represented more than half (54.3 per cent) of total assets. In 1947 a shift from Governments to loans and other securities became evident. By 1949, total assets were well below the war peak and Government security holdings had dropped to 42.1 per cent of total assets. In 1950, total assets were larger than in 1949 (in fact were higher than in any previous post-war year) but the share of such assets in Government securities dropped further to 41.6 per cent.

The shift during the past year was primarily into loans. Loan volume increased substantially (to a new all time high) and the ratio of loans to total assets rose from 24.9 per cent in 1949 to 26.9 per cent in 1950.

Loans earn a higher rate of return than do Government securities. In both 1949 and 1950 the average rate of return on loans was 5.5 per cent and on Governments 1.8 per cent. Thus a shift from Government securities to loans would automatically increase gross income. Add to that an absolute rise in total assets and a more fully invested position and an even larger increase in earnings results. In 1950 district member banks earned 2.69 per cent on total assets; in 1949 the figure was 2.54 per cent.

As a result of the shift in the composition of bank assets, income from Government securities, which had represented 31 cents of each income dollar in 1949, represented only 29.4 cents in 1950. Income from loans represented 53.4 cents of each income dollar in 1950, compared to 51.4 cents in 1949.

Salary and wage expenses were up in 1950.

The cost of operating a bank was higher in 1950 than in 1949. When all expenses were added together they represented 60.5 cents of each income

[1] Figures and percentages used throughout this article are taken from the annual study of operating ratios made by this Bank. In computing the aggregates and the ratios, the asset and liability items used represent averages of figures from the call reports of December 31, 1949, June 30, 1950, and October 4, 1950. Earning and expense items are those reported for the calendar year 1950. Ratios are arithmetic averages of individual ratios of 494 member banks grouped in eight deposit-size classes. Ratios computed in this way differ in some instances from the ratios computed from aggregate dollar amounts. Copies of the operating ratio report may be obtained from the Research Department of the Federal Reserve Bank of St. Louis.

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dollar in 1950, slightly more than the 60.4 cents of 1949.

The entire increase was reflected in payments for salaries and wages. In 1949, 29.2 cents of each dollar of income went for salaries and wages; in 1950, these purposes took 30.2 cents.

Other expenses were slightly lower.

Other bank expense items were slightly lower in 1950 than in 1949. One important bank expense item is interest paid on time and savings deposits. This expense did not contribute to higher bank operating costs in 1950 for this cost was reduced from 7.6 cents of dollar income in 1949 to 7.3 cents in 1950. Remaining expenses consisted of fees paid to directors, interest and discount on borrowed money, taxes other than income taxes and depreciation. These expenses also were below 1949, consuming only 23 cents of each income dollar in 1950. The previous year they had taken 23.6 cents.

Charge-offs and reserves were less than in 1949.

Banks are permitted under Federal tax law to set up reserves within certain limits tax free for bad debt losses on loans. Under the accounting method used, transfers to valuation reserves on loans are included with charge-offs and transfers from the account are included with recoveries. District member banks charged off 4.1 cents of each dollar in 1950. About 2.5 cents of this represented transfers to valuation reserves. The dollar amount transferred to this account in 1950 was $3.3 million —a drop from the $4 million of 1949. The table shows net transfers to valuation reserves by deposit-size groups for the years 1950 and 1949.

ADDITIONS TO VALUATION RESERVES ON LOANS EIGHTH DISTRICT MEMBER BANKS, 1949-50

(Thousands of Dollars)

Banks with Average Deposits[1]	1949	1950
$1,000,000 or Less	$ 10.0	$ 4.7
$1,000,000 to $2,000,000	112.7	111.0
$2,000,000 to $3,000,000	95.9	107.8
$3,000,000 to $5,000,000	228.8	218.8
$5,000,000 to $10,000,000	353.3	293.3
$10,000,000 to $25,000,000	428.2	355.6
$25,000,000 to $50,000,000	298.1	449.4
$50,000,000 and Over	2,523.5	1,786.4
All District Member Banks	$4,050.5	$3,327.0

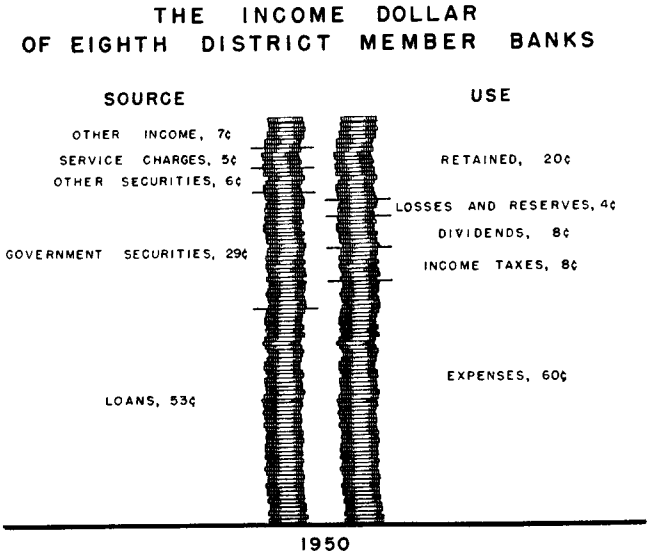
[1] Deposits were averaged from three call reports made on December 31, 1949, June 30, 1950, and October 4, 1950.

Greater net earnings meant higher tax payments.

Income taxes paid by district member banks in 1950 were the highest of record. In dollar amount they totaled $13.5 million, $3.5 million more than in 1949. Of the income dollar income taxes took 8 cents whereas in 1949 they took 7.4 cents.

However, net profits after taxes were larger than ever before.

After all expenses were paid, transfers to valuation reserves completed and income taxes remitted,



member banks still had more net profits than in 1949. As noted, net profits totaled $30.6 million, $2.7 million above the $27.9 million in 1949. Although more dollars were retained as net profits, the proportion of the income dollar retained was smaller, 27.4 cents as compared with 27.6 cents in 1949. In other words, that part of the income dollar remaining as net profit in 1950 was smaller than in 1949 but because of the greater number of dollars involved total net profits were larger.

Dividends were larger . . .

District member banks paid an average dividend of 3 per cent on total capital accounts, the same as paid in 1949. The dollar total of dividends was larger than in previous years as capital accounts had been increased. Stockholders received 7.8 cents of each dollar of earnings in 1950 compared to 7.6 cents in 1949.

. . . and capital accounts were increased.

District member banks used net profits roughly as follows: a little over one-fourth went for dividends—and about threefourths was retained to increase capital structures. After capital accounts were increased they equaled 7.1 per cent of total assets in 1950. The year before they were 6.7 per cent of total assets. District banks increased capital accounts at a faster rate than deposits. Capital accounts rose from 7.2 per cent of total deposits in 1949 to 7.8 per cent in 1950.

E. Francis De Vos

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