

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 13, 1936.

Chairman Eccles.

Subject: _____

From Mr. Thurston.

Attached are the questions provoked by your Cincinnati speech and brief answers which Dr. Currie has suggested. It seems to me that you ought to go over these before we attempt to mimeograph them.

Attachment.

BOARD OF GOVERNORS
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Office Correspondence

Date May 12, 1936, Mr. ThurstonSubject: Answers to Questions Sub-From Mr. CurrieMr. Eccles*L.C.*

GPO 16-852

I am enclosing a revised set of answers to the questions submitted to Chairman Eccles. In one or two places, lines in the answers were not indented but since you expect to have them mimeographed I did not have them done over.

8-23-1934

ANSWERS TO QUESTIONS SUBMITTED TO CHAIRMAN ECCLES AFTER HIS CINCINNATI ADDRESS

Federal Reserve System

1. Will political groups ever stand for restriction of credit during periods of prosperity?

It is not generally appreciated that there has never been a numerically significant "cheap money" party in this country except in periods of falling prices and depression. The Reserve Administration pursued a restrictive policy in 1925 and again in 1928-1929, and did not meet any significant opposition from any political group. It is not anticipated that the Reserve Administration will encounter any widespread political objections if it should decide that a restriction of credit is necessary.

2. What can the Federal Reserve System do to put to work the heavy cash reserves on hand throughout the country today?

The Federal Reserve System can exert an influence toward the continuance of low interest rates and thus encourage borrowing. It may also encourage long-term borrowing and lending operations by creating assurance that it will work for economic stability and the avoidance of booms and depressions.

3. Please state your reaction to the utterances of Father Coughlin with respect to the privately-owned Federal Reserve banks. Is the Federal Reserve bank a private institution?

Father Coughlin's attacks are based on a misconception of the organization of the Federal Reserve System. The Board of Governors is the dominant agency in determining the monetary policy of the System and its members are appointed by the President by and with the advice and consent of the Senate. Even the presidents of the reserve banks, five of whom serve on the Open Market Committee, are appointed subject to the approval of the Board of Governors. Although the stock of the various Federal Reserve banks is owned by member banks, the determination of policy is in no sense in private hands.

4. Did you read the recent article in Time regarding the present members of the Federal Reserve, in which it was stated that a large group of opinion feels that you are all that stands between this country and disaster? Have you any comment on this?

The really difficult problem is not only to avoid disastrous inflations but to keep the fluctuations of business activity within tolerable limits. To achieve this objective it will be necessary

to coordinate both monetary policy and the taxing and spending policies of the Federal Government.

5. How does the Federal Reserve Bank plan to control "loans by others" in order to avoid such inflationary movements as the one experienced up to 1929?

Under the Banking Act of 1935, banks are prohibited from making loans to brokers on account of others. Under the Securities Exchange Act of 1934 brokers are prohibited from borrowing except from member banks or from non-member banks complying with Federal Reserve regulations.

6. Do you believe that the Federal Reserve System will develop into a central banking system?

In essence the Federal Reserve System is a central banking system now insofar as provision has been made for the concentration of authority and responsibility for national monetary policies. For other purposes the continuance of the regional system of Federal Reserve banks is desirable in such a large and economically diversified country as ours.

7. Can it be said that the Banking Act of 1935, and the "new banking philosophy" has shifted the emphasis from the quality of credit to the quantity of credit?

The Federal Reserve Administration, particularly in the Federal Reserve banks, is still actively concerned with the quality of bank credit. The Banking Act of 1935 gave the Board of Governors increased authority in determining national monetary policies, and to this extent it may possibly be said that increased emphasis has been placed on the control of the volume of credit (deposits).

8. During 1928 and 1929 apparently the will of the people and the will of Congress prevented the Federal Reserve Board from trying to check the speculative trend. With the high excess bank reserves, with the eagerness of the government officials to have larger incomes to tax, do you believe the "will of the people and of Congress" can be resisted by the Reserve Board to curb a speculative boom?

Nothing prevented the Federal Reserve Board from trying to check the speculative trend in 1928-29 and it utilized every instrument it possessed. Its powers then, however, were inadequate.

Very few people want a speculative boom - the aftermath is too painful. What most people want is widely diffused prosperity and the avoidance of both booms and depressions. Little hindrance to the exercise of policy directed to this end is anticipated from popular opposition.

Banking

9. If a considerable commercial credit expansion should be generated in the near future, what effect might be produced on the government bond market? Of course, a considerable business expansion can be financed without resort to bank loans, and banks are able to expand loans to a considerable extent without shifting their bond-holdings to others — is it not, nevertheless, true that a commercial credit expansion will weaken the government bond market?

A complete answer to this question would entail a forecast of the future trend of interest rates. Authorities are divided on this point, some holding that a further expansion of business activity will result in higher long-term interest rates. Others hold that the problem is going to be to find outlets for our large and increasing annual volume of saving. The latter group believes that we have shifted to a permanently lower long-term interest basis. All, however, are agreed that "inflation" would entail higher interest rates, since it is characterized by an insatiable demand for loans. The danger of inflation appears remote.

10. Would not a better financial situation exist if a greater percentage of long-term government bonds were held by private investors, at good yields to those investors, and a smaller percentage held by "commercial" banks?

As of March 4, 1956, member banks held some \$5.8 billion of Government bonds maturing in more than five years. Whether this is dangerous depends on the price paid for them and the future trend of interest rates. Judging from business recoveries in the past, there should be no occasion for banks to dispose of their Government bonds. The Federal Reserve System and the Federal Deposit Insurance Corporation are determined to prevent such a period of forced liquidation as occurred from 1931 to 1933.

11. Will you explain how the excess reserves of the banks are going to be used or dissipated; if by loans to borrowers, either public or private, the money simply returns to the banks and increases deposits. So what? and how?

Excess reserves can be absorbed by an expansion of deposits, which in turn increases reserve requirements. Government borrowing from banks, therefore, tends to decrease rather than increase excess reserves. Expansion of deposits of a magnitude sufficient to absorb present excess reserves, however, would be highly injurious. Reserve requirements can be raised by the Board of Governors, thus extinguishing much, if not all, of the excess reserves; or they can be taken away from banks if the reserve banks sell securities, which are paid for by checks debited to member bank reserves. Excess reserves may also be decreased in other ways.

12. Is there not a considerable bank credit expansion under way at the present time? Is not this credit expansion evidenced by an increase in bank holdings of government bonds on the one hand, and an increase in bank deposits on the other hand? Is there any essential difference between this sort of bank credit expansion and that which might take place through an expansion of bank loans and discounts?

From June 30, 1935 to March 4, 1936 member banks' holdings of Government and Government-guaranteed securities increased \$5½ billion. Other loans and investments showed practically no change. Non-Government adjusted demand deposits increased \$7 billion. So far as demand deposits are concerned the contraction of 1929-35 has been more than made good. The main difference between an expansion of commercial loans and an expansion of holdings of Government bonds is that the former is usually a reflection of very prosperous times, while the latter is in the present circumstances a reflection of a continued need for Government borrowing to finance relief and recovery.

15. American bank vaults are said to have a plethora of government bonds "voluntarily" purchased by the banks. How much of a drop in market listing of government bonds can there be before a number of these banks will "go under"?

Of the \$10½ billion of Government bonds held by member banks, nearly \$7 billion mature in less than five years. Some of the longer-term bonds were bought at prices considerably under those now prevailing. When it is considered that the capital, surplus and undivided profits of member banks is now nearly \$5 billion, it becomes obvious that very heavy depreciation would have to be sustained in the banks' holdings of all bonds before their capital would be wiped out. Finally, it may be pointed out that many authorities believe that long-term interest rates have moved permanently lower. Even in 1929, the average yield on long-term Government bonds was 5.6%.

14. If, as you have said, the quantity of money multiplied by the velocity determines the volume of business, then we should have been justified in assuming that Germany at the height of its inflation was doing its maximum of production and of business. Do you think that this belief coincides with the facts?

I intended to say that the quantity of money multiplied by the velocity "measures" the volume of business. Movements of the volume of business transactions and the volume of physical production would only correspond under conditions of stable prices and slack in the productive system. When all the slack has been taken up, as in the German inflation, production cannot increase with an increase in the financial volume of business (sales, etc.) and prices rise. At the present time in this country an increase in the demand for goods in general would be matched by an increase in the supply.

Interest Rates

15. I understand that almost half of the government debt is represented by short-term securities that will mature in the next five years. Therefore, the government has a big stake to justify its efforts to keep interest rates very low. But while the government may be able to do this temporarily to its advantage, what about the effects on private industry?

Of the \$31 billion of Government interest-bearing debt outstanding on March 1, 1936, approximately half matures in less than five years. While the Secretary of the Treasury is naturally desirous of securing low rates of interest on Government bonds he must place the interests of the economy at large above all other considerations. Moreover, the Board of Governors would not hesitate to take action which would have among its consequences higher yields on Government bonds if in its judgment economic developments called for such action.

16. Do you believe that the present low rate of interest is an accurate indicator of over-capitalization in the United States?

I do not believe that the present low rate of interest is an accurate indicator of over-capitalization. It is a reflection of a great volume of funds seeking investment, with public bodies being the only important borrowers. With continued recovery savings will increase and public borrowings will fall off as private borrowings expand. Low interest rates should, therefore, persist for a considerable time.

17. You make the statement that the interest rates on the public debt have gone down. Wasn't that just natural or are we to believe that this is an accomplishment of the present administration? Didn't this occur in spite of the New Deal?

The Administration contributed directly toward lower rates of interest in various ways. In the first place, it aided in checking liquidation and deflation. By revaluing gold it made possible the great inflow of gold which has increased the excess reserves of member banks. Thirdly, by bringing about an expansion of deposits through its borrowings and an increase in the national income through its relief and recovery expenditures, it has made possible the increase of savings and the present great volume of funds seeking investment.

Government debt

18. Does anyone else in the administration believe in balancing the budget?

Every responsible person in the Administration, from the President down, believes that the budget should be balanced with the continuance of recovery, and further, as recovery proceeds, that substantial annual debt retirement should be effected. The principle of making the Government a compensatory agency requires that public debt should move in a direction counter to private debt, not that the public debt should always increase.

19. Cincinnati's share of the carrying charges on the national debt is about \$8,000,000 a year - which is greater than the operating costs of the entire city government. What do you mean that a thirty billion dollar national debt is not excessive?

My statement was based on the fact that the interest charges of the national debt amount only to a little over 1 percent of our present national income, and to less than 1 percent of our national income in 1929. This can hardly be called excessive, especially when it is considered that interest on the national debt is not paid to foreigners, but to our own citizens.

20/ You believe in a balanced budget, and you say we are approaching that goal because tax receipts are increasing rapidly. Published figures from the government in the past few days show that the deficit is increasing over a year ago notwithstanding the larger tax receipts. In other words, spending is growing more rapidly than tax receipts.

In the calendar year 1932 federal revenues amounted to \$1,880,000,000. In the calendar year 1935 they amounted to \$5,857,000,000. Moreover, the current revenue figures have been adversely affected by the loss of the processing taxes. New taxes to take their place have not as yet been enacted, though this is expected to occur shortly. Despite the loss of processing taxes the deficit for the present fiscal year to April 27th is over \$100 million less than the deficit for the corresponding period in the fiscal year 1935. With the bonus out of the way and new taxes enacted, the favorable trend of revenues relative to expenditures will be accelerated.

21. Does the thirty billion dollars mentioned by you as the total national debt include the various bonds guaranteed by the government?

Guaranteed bonds amounted to \$4,630,000,000 as of February 28, 1936. They were not included because they are secured by corresponding loans to individuals and institutions.

22. What is the justification for the "embalming" of the national debt in the commercial banks of the country? In other words, do we now have a commercial banking system?

Had the banks not purchased Government bonds they could not have reported net earnings, and the deflation of deposits that took place from 1929 to 1935 could not have been made up. There is plenty of money available for commercial borrowers when they need it. The more important function of the banks is to supply the circulating medium of the country in the form of deposits subject to check. If this cannot be supplied by the making of commercial loans it must be supplied in other ways.

23. If, as you say, the increase in debt is so insignificant why do so many persons high in the administration advocate higher taxes?

The increase in the national debt is small compared with our national debt-paying ability. I was, in this connection, speaking of the burden of the debt. There are other considerations, however, such as the relation of a further increase of the debt to bank deposits, which suggest that the budget should be balanced as soon as the recovery movement becomes firmly established and independent of further Government assistance.

Inflation

24. What is your definition of inflation? How far can we go before we have inflation of a kind to be feared?

I define inflation in general as a condition arising when the demand for goods is outstripping the production of goods. This would occur after the slack in our productive organization had been taken up. Under this definition we would have to have full recovery before we could have inflation. A danger point would begin to rise when we approached relatively full employment.

25. What would be the result if the government printed money and paid the W. P. A. workers with it instead of selling bonds to banks and using the proceeds to pay the workers, the object being to save the government cost of interest?

If paper money were printed and issued it would flow back to the banks and would increase excess reserves to nearly a corresponding degree. This would give rise to grave problems of credit control in the future. When the Government borrows from banks, deposits and hence reserve requirements increase and excess reserves are diminished. The interest cost is a minor item and is barely sufficient to compensate the banks for the costs of handling the additional deposits.

26. If prices should begin to rise sharply, what should be done to control them?

If the cause of a sharp rise is speculative inventory buying, such as occurred in the spring of 1933, it will quickly burn itself out. If the cause is a continuing excess of demand for goods over the production of goods, the reserve administration can raise reserve requirements and sell securities. These actions force interest rates higher, discourage long-term borrowing and construction. This, in turn, leads to a decline in incomes and buying. The Government can aid in this process by impounding cash or by increasing taxes.

27. Why will not Father Coughlin's plan of having the government issue its own money do to a large measure what you have suggested?

See answer to question 25.

28. Are we going to have currency inflation? If you think not, how are we going to pay the debts which the federal government, the states, municipalities and their sub-divisions have piled up in the last six years?

I do not think we are going to have currency inflation. The debts of public bodies will be serviced and in part retired by taxes paid out of future incomes, increased as a result of continued recovery.

29. Do you consider that we now have inflation in the U. S.? If so, when in your opinion did it begin to manifest itself and do you feel that inflation will develop further? Giving consideration to inflation, how should investment funds be handled- that is, what sort of investments should be considered?

See answer to question 24. Since I consider inflation to be a remote possibility it would follow that investment funds should be handled as always by compromising between yield and safety of principal, depending on the circumstances of the investor.

Government spending

30. Do you believe we can cast aside all fundamental economic laws and legislate ourselves a sound business recovery by issuing bonds and spending the money at a faster rate than tax income? How long can we continue this procedure?

Since when is it a "fundamental economic law" that public expenditures should contract when private expenditures contract and thus intensify the process of deflation? The "law" that the buying power of the community must be sustained if production and

employment are to be sustained is surely more fundamental than the "law" that the Federal Government must never borrow, regardless of circumstances. The Government should contribute to the increase in the national buying power until such time as the increase in business disbursements of all kinds makes this unnecessary. There are now signs that private capital expenditures are getting under way.

51. We all agree that proper governmental relief is necessary. But did we not make a satisfactory recovery from the 1893 depression without great governmental borrowing and spending?

In 1893 we were much more of a rural and agricultural country than we are today and in that year we produced the largest wheat and cotton crops in our history, which, because of crop failures abroad, we sold at good prices to Europe. The recent depression was unique in its severity and worldwide character. Not only is agriculture less important economically than formerly, but our difficulties were intensified by agricultural depression. Never before had we had such an excess of productive capacity in every field relative to current demand. The demand for goods had to be increased until a part of this excess was absorbed before we could have a more "normal" recovery movement characterized by increasing private expenditures on plant and buildings.

52. If the "priming the pump theory" is correct why does the Federal Government have to continue the process, despite a thirty percent increase in the various business indices? Isn't the answer to this question the fact that the benefits of government spending stop as soon as the money is spent and are not recurring as is the case of private spending?

The Government had to continue the process because industry would not expand until more of its excess capacity was utilized and people would not build houses until rents rose in relation to costs. With regard to the second question, a business man does not distinguish between a demand for his products arising from Government spending and one arising from the spending of other business men. He makes goods in both cases to meet the demand. The more the President of General Motors has inveighed against the recovery program, the more cars he has sold. The additional money spent for wages and materials is available for spending, regardless of its original source.

53. If spending creates wealth, as you suggest, why shouldn't we all advocate that the government spend 20 or even 50 billion dollars a year? Or why shouldn't we all stop working in order to spend more rapidly? After all, does not your argument support the Townsend Plan?

An increase of public spending so far as it leads to an increased demand for goods, which in turn leads to greater production of goods, makes the community better off. Too much spending would lead not to greater production of goods but to a rapid rise of prices. There are, moreover, other aspects to be considered, such as the relation of Government financing to the expansion of bank deposits. Because a certain amount of food is beneficial it does not follow that a person should eat all of the time. The Townsend Plan entails a high transference of income from the younger to the older people in the community. There is nothing in my argument that supports this plan.

54. Is it not naive to conclude that because there has been recovery it has necessarily been caused by government spending? How about recovery in other countries and in this country after other depressions?

On the contrary, it is naive to assume that the recent depression differed in no essential degree from previous depressions in this country, or from the depression in other countries. In the Nineteenth Century the bulk of the people were on the land and were more self-sufficing. Industry was composed of smaller units and was more flexible. In 1921 and 1922 there was a great volume of residential construction. From 1931 on, our condition more nearly resembled a breakdown than a depression. In 1932-1933 there was practically no private building or construction of any kind. Excess capacity prevailed in every industry except brewing and distilling, in which building actually took place. Much of our agriculture had ceased to be self-sufficing and had, in addition, lost foreign markets. A large part of our population was in cities and was completely dependent upon industry for its income. In the absence of Government spending it is difficult to see what would have given the impetus to increased business disbursements, or what types of businesses would have expanded plant and equipment on a large scale.

55. Is the business recovery of this country due to government spending a "false recovery" and not due to natural economic laws? Will such a period of recovery extend over a period longer than the federal expenditures?

I would not call the recovery a "false" one merely because the initial increase in demand for goods arose from Government spending rather than private plant and equipment expenditures. Just as soon as part of the excess productive capacity has been

taken up through the demand generated by Government spending, industry will begin to make larger expenditures for maintenance and extensions, and this type of expenditure is self-generating. The Government contribution can then be reduced and the recovery will assume more of the characteristics of a "normal" recovery.

Taxation

56. In upholding your concept of the government as a "compensatory agency", would you have maintained taxes at a high level during the period 1920-1930 and used the proceeds of those high taxes to reduce the national debt still further than it was actually reduced? Do you think that the policy of reducing taxes during that period was a mistake?

My answer is yes to both questions, with the qualification that I would shorten the period to 1922-1929. When recovery is achieved I think we should retain taxes and reduce the national debt substantially.

57. You state that revenue has been increased without an increase in taxation. Don't you consider the excise taxes as taxation which without a doubt has been responsible to some extent for an increase in revenue—not direct but through higher incomes to the farmer?

Excise taxes generally are paid by the poor, and represent money that would otherwise have been spent. Thus, the raising and spending of excise taxes represents more of a transfer of buying power than an actual increase.

58. Will not the increased taxation brought about by increased government spending adversely affect the ability of the United States to compete in world markets?

The trend is toward increased taxes on incomes rather than on goods. Taxes on incomes would not affect our ability to compete in the world's markets.

Others

59. A corporation, like a person, must have a fund for a rainy day. What principle can be used to decide when a fund passes from proper reserve to parsimonious pinching? If we force corporations to distribute all of their earned income during the year in which it is made to avoid excessive taxation what will happen when the next depression comes along and there is no corporate surplus to fall back upon? Will it mean wholesale bankruptcy?

The analogy of the assets of the individual to the bookkeeping surplus of the corporation is not a close one. The analogy of the net worth of the individual to the net worth of the corporation is closer, though even it leaves something to be desired. So long as an individual's assets in relation to his liabilities are satisfactory and his borrowing capacity is good, he does not need to hold cash for a rainy day. Neither does a corporation. Non-financial corporations' holdings of cash and tax exempts declined by only \$2 billion from 1929 to 1955, while their other investments increased by nearly \$5 billion. The decline of \$15 billion in their surplus account did not represent an entrenchment upon a "fund", but merely represented charge-offs and write-downs and depreciation allowances not covered by earnings. Such charges might have been made against capital built up by new stock issues as well as against surplus built up from retained earnings. In either case, the net book worth of the stockholders would decline.

40. Private borrowing will not become very prevalent until vicious legislation in Congress is abated. If it is important that reemployment be effected by putting idle deposits to work, then why does not the administration renew the "breathing spell?"

Did private borrowing decline from 1929 to 1955 because of vicious legislation?

41. Business generally showed a vast improvement in 1955 over the previous year. Larger profits were the rule. Yet just as many people, if not more, are out of work right now. How do you account for this??

Unemployment does not diminish correspondingly with the increase in production for three reasons: (1) The number of people of working age is steadily increasing. (2) There are more people seeking work because of exhaustion of savings, unemployment of the normal breadwinner, etc. (3) People who were "employed", but only working one or two days a week now enjoy a fuller work week. "Employment", in the sense of total man hours worked, has undoubtedly increased much more than "unemployment", in the sense of people totally out of work, has diminished. There is, of course, also continued unemployment arising from excessive lengthening of hours in some trades and technological unemployment due to the introduction of labor-saving machinery.

42. If "government intervention was absolutely necessary" how do you explain the fact that the bottom of the stock market occurred in June, 1932 and business had shown substantial improvement up to November, 1932?

I would not undertake to explain the stock market recovery in 1932. The improvement of business from July to October, 1932, could hardly be called substantial. The index of production rose from 58 to 67. The index of construction arose from 27 to 29. The index of factory employment arose from 58 to 61. Considering the absence of any increase in building or new capital issues, I should characterize the slight upturn in 1932 as being attributable to increased inventories and therefore temporary in nature.

45. Are your views on government competition in private business held by any other members of the Administration?

It is my understanding that the President does not believe in competition with private industry as a general principle but only in cases where he feels there is monopoly that cannot be restrained otherwise, or that private industry cannot or will not undertake something that should be done.

44. Do you consider "bigness" in corporations to be an evil in itself?

I would distinguish between "bigness" that is economically desirable and attributable to efficiency and the nature of the business, and bigness which is not due to efficiency but rather to unrestrained and unregulated monopoly practices. The latter type, I think, is an evil.

45. If our system - "economic" - was so bad, how did we get so far in such a short space of time? How did we manage to evolve the highest standard of living in the world? How will our children and our grandchildren fare as the result of present government borrowing?

I was at pains in my address to point out that the disastrous forces I was discussing are not necessary elements of capitalism and that they only developed in the 20's. It is to be hoped that the Federal debt incurred recently will be paid off before our children or grandchildren replace us. If not, some of the children and grandchildren will pay interest on the Government bonds held by other children and grandchildren. Insofar as taxes are levied to pay interest on and reduce the public debt the community will receive back as interest and principal what it pays in taxes.