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March 21, 1942

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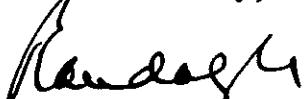
Dear Marriner:

Here is the draft report which I mentioned
yesterday which has been mailed to about 150 leading
bankers. It is our hope that it will facilitate the
kind of program on which you and I are both agreed
and I think we have succeeded in taking out bias for
or against specific methods.

We should be very glad to have your suggestions
before giving it any wider circulation.

I am sending a separate copy to Ronald.

Yours sincerely,



Randolph Burgess
Chairman
Economic Policy Commission

RB:TB
Enc.

TREASURY WAR BORROWING AND THE BANKS

Draft Report by the Economic
Policy Commission of the Ameri-
can Bankers Association and the
Fiscal Policy Committee of the
Reserve City Bankers Association

* * *

March 1942

Confidential

TREASURY WAR BORROWING AND THE BANKS

The banks of the United States are eager to do their full share in financing the war. This is their special area. Their responsibility lies not simply in doing what they are asked by the agencies of government, but in understanding the problem and themselves initiating plans and cooperative efforts for carrying out so vast a project. The 15,000 commercial banks, -- savings banks and 1,200 investment bankers of the country have the capacity and mechanism to meet this responsibility.

The decisions made now as to methods of financing and the energy with which they are pursued will influence the success of the Nation's war effort and will react upon the well being of the people for many years to come.

The two ways of financing war are by taxation and by borrowing. Broadly speaking, the more the taxation and the less the borrowing, the less will be the danger of inflation. A country at war must tax to the maximum extent consistent with the maintenance of morale and incentive. Borrowing must be kept at a minimum.

With this preliminary comment this memorandum will not discuss taxation but is limited to presenting facts and principles as to the Treasury war borrowing program and the place of the banks in that program. No attempt will be made to suggest a specific financing pattern but rather the broad principles which underlie detailed methods.

Amount of Borrowing

In the fiscal year 1941 Treasury public financing totaled 5 1/2 billion dollars. In the fiscal year 1942 the amount will be close to 19 billion dollars, and present estimates place the amount in the fiscal

year 1943 at about 33 1/2 billion dollars. These estimates are shown in the following table, based upon the President's budget message of January 4th:

TABLE I
RECEIPTS - EXPENDITURES - PUBLIC FINANCING
 (In Millions of Dollars)

	<u>Fiscal</u> <u>1941</u> <u>Actual</u>	<u>Fiscal</u> <u>1942</u> <u>Budget</u>	<u>Fiscal</u> <u>1943</u> <u>Budget</u>
<u>Total expenditures</u> (excluding debt retirement)	\$12,711	\$30,576	\$58,928
<u>Total net receipts</u> (excluding social security)	7,607	11,944	23,487*
<u>Budget deficit</u>	5,103	18,632	35,441
Add. govt. corp. - net outlays	1,149	2,220	2,941
Total cash requirements	6,252	20,852	38,382
Less trust funds receipts - net	1,385	2,018	4,764**
Net cash requirements	4,867	18,833	33,618
Change in cash balance	708	- 15	- 3
<u>Total public financing</u>	5,575	18,818	33,615

* Includes proposed \$7 billions increase in taxes.

** Includes proposed \$2 billions increase in social security taxes.

These figures are staggering compared with anything ever done before in this country or in any other country. The largest amount of public financing by the United States in any one year of World War I was the 1919 figure of 13 1/4 billion dollars.

The estimates of expenditure for the fiscal year 1943 call for the devotion of about half of our national productive effort to war, as compared with a maximum of about one quarter in the last year of World War I.

However, other nations have been carrying a burden as great or greater than this in relation to their productive capacity, national income, and financial resources. Germany and England are devoting over 60 per cent of their capacities to war, and Canada approximately 50 per cent. Our

resources of industry, labor and wealth are vastly larger and were not fully employed when the war began, thus greatly easing the shift to a war basis. War has found us also with a sound banking position and enormous gold reserves. While the expenditures and borrowing contemplated are huge, they are within our capacity.

We can finance this vast undertaking, but the choice of methods, -- the way it is done -- will affect directly the efficiency of our war effort, the extent to which that effort disorganizes our economic and social structure, and our capacity to recover prosperity after the war.

Before discussing the borrowing program it should be noted that its size, as estimated above, is dependent on a number of variables. The first is the actual expenditure, and the second, the amount of taxes collected. The table above assumes expenditures and the collection of taxes in accordance with the President's budget message of January 4, 1942. For the avoidance of inflation it is most desirable that at least these amounts of taxes be raised and that the amount of borrowing be kept to a minimum, but for the purpose of this memorandum we start with the amount of borrowing estimated by the President.

Sources of Funds

The problem of inflation has been summarized as follows by the Secretary of the Treasury: "Our economy today resembles an overloaded steam boiler. The fire under the boiler is being fed by billions of additional purchasing power in the hands of the public. The fire is growing hotter and is generating more steam than the boiler can safely hold. If we are to prevent the boiler from bursting, we must damp down the fires by diverting spending away from those articles or commodities in which there is a shortage, actual or potential."

In the application of this principle to war borrowing, the first rule is that the Treasury should borrow as much as it can from the current income of the people which might otherwise be spent. The great danger of inflation arises from spending power in excess of the amount of goods available to be bought, and when the Treasury taps this spending power through tax collections or through the sale of government securities it reduces the inflationary forces. The sale of defense bonds through payroll deductions does exactly this. The greatest increase in purchasing power in this war effort is arising from swelling industrial payrolls. The more of these funds which can be drawn off in taxes and bond purchases, the less will be the danger of inflation.

A second source of funds is idle money in the hands of individuals and corporations. The use of this money is not as anti-inflationary as the tapping of current income, but it is less positively inflationary than the purchase of bonds by banks. The use of idle money by the Government gives this money greater activity; the purchase of securities by banks tends to create new money. Both of these steps are somewhat inflationary, but the second is more so than the first.

The worst way to finance a war is by the Treasury's borrowing at the central bank, -- the Federal Reserve System. This adds both to bank deposits and to bank reserves and has potentialities for inflationary credit expansion several times the amount of money actually borrowed. Borrowing at central banks was the mechanism of inflation in Germany and France after World War I.

The underlying principle may be summarized by saying that the desirable sources for Treasury borrowing are in order:

First, and best, From the current income of the people which would otherwise be spent;

Second, From idle money in the hands of non-bank holders;

Third, From the commercial banks;

Fourth, and worst, From the Federal Reserve System.

It is in the interest of the banks, the enterprises, the worker, the farmer and everybody else that every possible dollar be borrowed from the first source.

The following table shows the sources of funds for Treasury borrowing in the fiscal year 1941, estimates for fiscal year 1942, and projected for 1943 if the present trends should be continued.

TABLE II

ESTIMATED CHANGES IN HOLDINGS OF
PUBLICLY HELD DIRECT & GTD. DEBT
IF PRESENT TRENDS SHOULD BE
CONTINUED.

(In Millions of Dollars)

	Fiscal	Fiscal	Fiscal
	1941 Actual	1942 Estimated	1943 Projected
Defense savings bonds	\$ 1,409	\$ 6,500	\$ 12,000
Tax anticipation notes	-	\$ 2,500	\$ 1,000
Insurance companies	\$ 600	\$ 1,700	\$ 1,500
Mutual savings banks	\$ 312	\$ 400	\$ 200
Federal Reserve banks	- 266	\$ 570	-
Govt. corps. (FDIC, etc.)	\$ 46	\$ 100	\$ 100
Indiv., corps., trustees, etc.	- 80	\$ 1,700	\$ 3,000
Subtotal	\$ 2,021	\$ 13,470	\$ 17,800
Commercial banks	\$ 3,554	\$ 5,330	\$ 15,800
Total	\$ 5,575	\$ 18,800	\$ 33,600

These various sources of funds will be discussed in more detail later on, but they show in general that defense savings bonds constitute the major channel now open for drawing off the current income of individuals into the Treasury, though purchases by life insurance companies and mutual savings banks do so indirectly, but just as effectively. A substantial part of the defense bond sales, however, represent putting idle money to work rather than savings from income.

A rough inspection of these sources of funds indicates rather clearly that far too small a part of the total, perhaps one third, represents a diversion of current income which could otherwise be spent. Perhaps two thirds represent either the use of idle money or the extension of bank credit. In fact, unless new methods and efforts are introduced into the borrowing program, half the new money in fiscal year 1943 is likely to come from bank credit expansion. While the banks are prepared to lend the Treasury the amounts it needs, not raised elsewhere, it is in the national interest that these amounts should be as small as possible.

An additional point may be made here that may seem theoretical but is of real importance. Any form of additional saving, refraining from spending, is as effective in avoiding inflation as specific saving through defense bond purchases. Such saving tends to offset war spending in its effect on prices. Our program should be broad enough to recognize and encourage varied forms of saving.

Reaching Current Income - Defense Bonds

The first step in reaching current income is to promote vigorously the sale of defense bonds and stamps. There is, of course, ground for debate whether their terms are the best possible for drawing into the Treasury current income which would otherwise be spent. The important facts, however, are, first, that these bonds have demonstrated real effectiveness and, second, that they have back of them an educational campaign of several years' duration so that we fortunately come into the war period with a program already well under way. No substitute plan could be inaugurated and put into active operation without many months' loss of time. So regardless of theories, the wise course is to use with our utmost vigor this instrument which we have. The results achieved in December, January and February make it clear that

the potentialities for the sale of these bonds are only beginning to be tapped, and vigorous sales efforts will bring results. The banks have had a large share in the success of this program thus far and have the contacts and machinery to carry it much further.

It should again be noted that only part of the purchases of defense bonds have been made out of current income. It may be assumed that purchases of F and G bonds represent largely the employment of idle balances rather than of new income, but on the other hand, that a substantial part of the purchases of E bonds are out of current income. Sales divided between the three types are shown in the following table.

SALES OF DEFENSE SAVINGS BONDS, BY MONTHS

(000 omitted)

	<u>Series E</u>	<u>Series F & G</u>	<u>Total</u>
May, 1941	\$100,581	\$249,237	\$349,818
June	102,517	212,010	314,527
July	145,274	196,857	342,131
August	117,603	148,003	265,606
September	105,241	127,086	232,327
October	122,916	147,798	270,714
November	109,475	124,013	233,488
December	341,085	187,514	528,599
January, 1942	667,411	393,136	1,060,547
February	<u>298,000</u>	<u>305,200</u>	<u>703,200</u>
Total	2,210,103	2,090,854	4,300,957

It is encouraging that the volume of sales of E bonds is steadily rising as payroll deduction plans are getting under way more vigorously, and as individuals respond to actual war. It is still true, however, that the amounts of current income absorbed by these bonds are small compared with the additional income created by defense activities, largely in the form of industrial payrolls, and available for consumer spending. The active promotion of purchases of these bonds out of current income is a first duty of bankers and others interested in avoiding inflation.

For the foregoing reason sales efforts up to now have been largely concentrated on the E bonds and properly so. While purchases of Series F and G have been substantial for trust funds and large accounts, there has been no vigorous selling campaign for these series. Such a program could now be undertaken without confusion or interference with E bond sales, and the banks are in much the best position to do it. It should bring forth substantial subscriptions, not so much out of current income, but out of idle balances, and reduce by that much the amount of borrowing from banks.

One feature of the defense bonds which has caused some concern to many people is the fact that holders of these bonds may present them to the Treasury for redemption. This constitutes in effect a floating debt or demand liability for the Treasury which might conceivably prove embarrassing. Our experience with this type of obligation is limited. The bonds have been carefully designed, however, to discourage redemption, and a large portion is evidently being bought with the intention of holding to maturity. The total amount of this liability does not yet seem to justify serious concern, or offer a serious obstacle to pressing the program vigorously. It is one of the questions which should be reviewed from time to time as the amount outstanding increases, and as experience accumulates.

Other Ways of Reaching Savings Funds of Individuals

The most obvious sources of savings funds of individuals aside from those reached by defense savings bonds are the insurance companies and savings banks. Insurance companies provide an indirect means for gathering up savings from current income and making them available for the Government. Under present conditions few other means of employing their funds are available to insurance companies. Private building, aside from defense plant and defense housing, has practically ceased, and there is relatively little

financing in the market except for refundings. Insurance companies look forward to some borrowing by policy holders to pay taxes, but are likely to have in the coming year something between 1 billion and 1 1/2 billion dollars available for the purchase of government securities. Insurance companies are among the few willing buyers of bonds of long maturity. They are more interested in the rate and will take the longest bonds offered.

As noted earlier, the savings banks have been sizable buyers of government securities, but it seems unlikely that they can be counted upon for much this year. The savings banks as a whole have not been gaining deposits, partly because their customers have been buying defense bonds. There is no advantage in depositors withdrawing money from savings banks to buy defense bonds if the savings banks themselves find it necessary as a result to sell some of their own holdings. A recent tendency in this direction further emphasizes the desirability of directing the campaign for the sale of defense bonds primarily to the absorption of current income.

The objective is to gather up the savings of the people out of current income through every available channel. In the long run it would impair the program if the defense bond drive were so narrow as to damage such savings agencies as savings banks, building and loan associations and insurance companies. To avoid this the publicity program should be a coordinated effort reorganizing the place of these collecting agencies as the medium through which large amounts of savings will reach the Government.

Tax anticipation notes for individuals have not produced any substantial amount of money. There must be large amounts of funds held by individuals for the payment of taxes which might be reached by some modification of the program. It might, for example, be wise to raise the limit on the A Series



of notes from \$1,200 to \$10,000 or to remove the limit altogether or perhaps accept other issues of Governments in payment of taxes. Since taxpayers will return to the Government a substantial part of interest received, the net interest paid even at 2 per cent would not be large after deduction of taxes. The present plan furnishes little incentive for the individual taxpayer, and there are large amounts of funds available which should be reached.

In recent years there has been a remarkable increase in bank deposits which will continue. To the extent that these deposits can be made available for the purchase of government securities the amounts which banks themselves must buy directly are reduced. While withdrawals from these deposits may compel adjustments of position for the bank concerned, the funds later reenter the banking system so there is no net loss of deposits.

The banker who has been constantly engaged in trying to build up his deposits naturally hesitates to suggest to a depositor the use of that deposit to buy government bonds, especially if large amounts are involved. It is cold comfort to know that the deposit will return to some bank when the Government spends the money.

To leap this hurdle the banker will need a somewhat new point of view -- which indeed the new situation justifies. The banker's problem in the coming months will be not to keep his deposits up -- but to restrain overexpansion. It may be noted also that if the banks generally follow a practice of selling government bonds to their depositors their relative deposit position will be little changed. Such a policy is to the long time interest of the banks and the whole country.

From the point of view of the Treasury it would be highly desirable to spread out the Treasury debt over a longer number of years by finding investors who are willing to take longer maturities. The principal diffi-

culty is perhaps that few investors outside the insurance companies have been so eager for rate of return as to venture the greater risk of depreciation involved in longer-term obligations, at very low yields after taxes. Various modified sorts of bonds to reach this investment market and various sorts of special sales campaigns such as have been successful in other countries have been suggested. This is a subject which requires special examination.

A further substantial source of funds of individuals that remains untapped is hoarded currency. The present amount of money in circulation is $11\frac{1}{2}$ billion dollars, as compared with around $4\frac{1}{2}$ billion dollars at the peak of the 1929 prosperity. A part of this is accounted for by higher wage rates and larger incomes of lower income groups not accustomed to having bank accounts. A substantial amount represents hoarding. It should be possible to devise some appeal which would bring forth some of these funds for the use of the Government. This again is a special problem requiring individual analysis.

In this whole program of reaching current savings and idle investment funds it should again be emphasized that the banks and investment bankers of the country constitute the agencies best qualified to aid the Treasury in the distribution of its obligations.

Reaching Corporation Funds

In the past year the Treasury tried successfully an experiment in reaching the current income of corporations, in the form of tax anticipation notes. These performed the valuable service of bringing over $2\frac{1}{2}$ billion dollars into the Treasury perhaps a year earlier than its normal payment in taxes. This is of course an anticipation of future receipts rather than a new source of funds, and any further increase depends on future increases in corporate income and its taxation.

In addition to tax reserves corporations hold substantial amounts of cash, part of which might be reached in some way. While doing so is not as useful as tapping current income otherwise expendable, funds from this source at least reduce the amount to be borrowed from banks.

There are differences of opinion as to the amount of corporation cash which might be tapped. Industries doing defense work will need most of their cash and some will have to borrow. On the other hand, in non-defense industries inventories will be liquidated and depreciation reserves cannot be fully employed in plant improvements because of priorities. Without dogmatism as to amounts available, they are at least substantial and should be reached. In Canada corporations are heavy buyers of War Loan Bonds partly as temporary underwriters and partly to hold.

Most corporations consider it necessary that securities which they purchase should be liquid and not subject to substantial fluctuation in price, since corporations generally are not in the investment business. This means that they are ordinarily interested in obligations with maturities up to two years, though some corporations might go longer than that if they can always realize on the securities promptly.

The Treasury has not recently been offering any securities, aside from tax anticipation notes, of this sort that are attractive to corporations. Treasury bills have been sold at such a low yield basis that after taxes they are only worth while for someone who has a special requirement for them. But whenever the Treasury bill rate has gone above 1/4 per cent, corporations have begun to buy. An immediate logical step in reaching corporations would be to supply the market with enough bills and other short maturities so that this market will no longer be starved and corporations can fill their needs. The banks also need a broader market of short-term securities to facilitate adjustments of position between banks.

Distribution of Maturities

Another principle to be considered in determining a borrowing program should perhaps be stated at this point, and that relates to the distribution of maturities of the public debt. By June, 1943, the national debt is likely to be well over \$100,000,000,000. It is desirable that the maturities of this debt should be spread out over a sufficient number of years so that the Treasury would not have to refund too large an amount in any one year, particularly during the period when large amounts of new money have to be raised. The following table shows the distribution of the present Treasury debt in terms of maturities, (Page 14).

It must be recognized that there is here a conflict in interest. All lenders would like to avoid the risk of fluctuations in the market values of holdings, a protection they ordinarily obtain by holding short maturities. On the other hand, both from the point of view of the Treasury and the effect on the money market, security markets, and the whole economy, it is undesirable for the Treasury to face too large maturities in nearby years. It is the old problem of a floating debt which proved so disastrous to France after World War I. This conflict of interest between what most borrowers want and the Treasury's position is always one of the puzzling problems for Treasury financing.

Fortunately, the Treasury for some years has been following a policy of selling long term bonds whenever possible with the recognition that it was desirable to leave the nearby years reasonably available for financing in an emergency. This policy leaves the Treasury much more free at this time to meet the needs of investors than would otherwise be true, though it is still desirable to spread out new financing as much as possible without sacrificing other objectives, and especially the objective of putting the debt into the hands of investors rather than banks.

MATURITY SCHEDULE

United States Direct and Guaranteed, Marketable and
 Non-marketable Securities Outstanding as of December 31, 1941
 (Exclusive of "Special Issues" sold
 to various Federal Trust Funds)

(In Millions of Dollars)

<u>Year</u>	<u>Classified by year in which issues are first callable *</u>	<u>5-Year Average</u>	<u>Classified by year in which issues mature</u>	<u>5-Year Average</u>
1942	\$5,123)		\$3,908)	
1943	6,336)		4,481)	
1944	6,798)	\$5,201	3,410)	\$3,631
1945	4,575)		4,008)	
1946	3,175)		2,350)	
1947	1,879)		3,884)	
1948	3,849)		1,975)	
1949	3,084)	3,603	2,460)	3,042
1950	2,185)		2,686)	
1951	7,017)		4,206)	
1952	1,043)		3,233)	
1953	816)		2,995)	
1954	707)	1,526	3,713)	2,629
1955	2,632)		2,034)	
1956	2,431)		1,170)	
1957))	
1958	919)		1,449)	
1959)	491	982)	1,018
1960	1,485)		2,611)	
1961	50)		50)	
1962)	
1963			919)	
1964			95)	500
1965			1,485)	
1966)	
1967	2,666			
1968				
1969				
1970				
1971				
1972	—		<u>2,666</u>	
Total	\$56,770		\$56,770	

* Fixed maturity issues are classified by year in which due. Those non-marketable issues that are redeemable at any time at option of owner are classified by years in which due.

Source: Daily Treasury Statement - Dec. 31, 1941.

General Place of Commercial Banks

In this whole program the banks have a large function as distributors of securities to investors. Banks are willingly doing millions of dollars' worth of work in connection with the Defense Bond campaign for which they receive no reimbursement. This is in conformity with the practice established for many years in this country by which the banks have performed for the Treasury a substantial number of free services in connection with the Treasury financing operations.

The banks have also acted in a sense (though not technically) as underwriters of government security issues. Their subscriptions have insured the success of every issue and they have later distributed over a period a considerable number of the securities so purchased to investors and institutions. There has usually been some profit on this undertaking which may be balanced against the services performed.

Banks' Own Purchases

In the fiscal year ended June 30, 1941, holdings of government securities by commercial banks were increased by 3 1/2 billion dollars. In the current fiscal year this increase is likely to be over 5 billion dollars, and in the fiscal year 1943 it may be three times that amount if amounts of purchases by other buyers continue at about the present rate, a development which every effort should be made to avoid.

The following table is designed to show the effect of any such large additional purchases on the general condition of the banks. The data used are for member banks only, for which current reports are available, and the table assumes for illustrative purposes that recent trends continue as in Table II; that bank loans will remain practically stable in 1943 and bank deposits will increase along with holdings of government securities, except to the extent that deposits are withdrawn in currency. The estimated figures are as follows: (Page 16).

ESTIMATED POSITION OF
ALL MEMBER BANKS IN THE UNITED STATES,
ASSUMING CONTINUANCE OF PRESENT TRENDS*
 (In Billions of Dollars)

	<u>June 30</u> <u>1941</u>	<u>Dec. 31</u> <u>1941</u>	<u>June 30</u> <u>1942</u>	<u>June 30</u> <u>1943</u>
ASSETS:				
Actual Reserves	\$13.0	\$12.4	\$12.1	\$10.0
Required Reserves	7.8	9.4	10.1	8.0 **
Excess Reserves	5.2	3.0	2.0	2.0
Loans	16.7	18.0	18.8	18.8
Governments	18.1	19.5	22.6	36.0
Other Investments	<u>5.8</u>	<u>6.0</u>	<u>6.0</u>	<u>6.0</u>
Total Loans & Investments	40.6	43.5	47.4	60.8

LIABILITIES:

Deposits	58.5	59.6	63.0	74.3
Capital Funds	5.8	5.9	6.0	6.2

CAPITAL FUNDS RATIOS:

To Deposits	9.9%	9.9%	9.5%	8.3%
To Loans & Investments	14.3%	13.6%	12.6%	10.2%

* Assumes also an estimated increase of \$800,000,000 in Federal Reserve holdings of government securities between December 31, 1941 and June 30, 1942.

** Reserve requirements of \$12.4 billions under existing rates reduced by 35 per cent to maintain an excess reserve of about \$2 billion. This will be commented on later.

It has been assumed in this table as a working hypothesis that the Federal Reserve System would replenish bank reserves by open market operations or by reducing reserve requirements when the excess is reduced to about 2 billion dollars, a status which is likely to be reached before the middle of 1942. This assumption will be discussed later.

An Inflationary Trend. A first observation from these facts is that they indicate a highly inflationary tendency. They show an increase of about 25 per cent in bank deposits and an even larger percentage increase in total loans and investments from December 31, 1941 to June 30, 1943, a period of 18 months, and the war may well last years beyond that time. With such a huge addition to purchasing power at a time of great activity, the maintenance of stable prices would be most difficult. It would certainly call for very detailed and unwelcome economic controls. Even if inflationary effects were resisted in the war period, post-war stability would be endangered.

The conclusion is that ways must be found to finance the war more largely from taxes and bond sales to the people.

Capital Position and Government Holdings. It will be seen that under conditions assumed in the foregoing table the ratios of bank capital to deposits and to loans and investments would be considerably reduced. There does not seem to be any reasonable way by which capital could be increased as rapidly as government security holdings, since the banks must be expected to pay their share of the added tax bill. The table, therefore, assumes that bank capital will only increase at slightly more than the rate of the last two or three years, namely, about 200 million dollars a year. This will be discussed later.

A good many bankers have been concerned about the recent continuing reduction in their capital ratios, and supervisory authorities have also

been giving the question attention. As the banks are called on to carry through their considerable responsibility in the huge war program they must be so strong that no doubt about their position will arise in the public mind.

Since the increase in the assets of the banks is likely to be wholly in cash and in government securities, their ultimate soundness is not seriously impaired by even the changes contemplated above. The principal immediate question aside from inflationary dangers is with respect to fluctuations in market value of the securities which might cause concern on the part of depositors or others or, if these securities had to be liquidated, might raise question of a potential loss.

It is difficult now to anticipate circumstances under which such liquidation would be necessary. The Federal Reserve System is ready to discount notes secured by governments at their par value and it may safely be assumed that this practice will continue during the war period. Moreover, the Treasury and the Reserve System have ample power to keep the banks supplied with cash so that there need be no occasion in the banking system as a whole for liquidation of securities.

However, it is clear that if a major part of the estimated increase in government securities were in long bonds and the market were to fluctuate five to ten points the capital of the banks would at least on paper be impaired. Such a situation might be expected to cause concern among some depositors and bank officers and directors. Again it may be said that the Treasury and the Reserve System would be active in attempting to avoid such a decline in the market. But conditions change rapidly; unforeseen post-war conditions will succeed the war; and it seems doubtful whether the Treasury and the central bank can underwrite fully against such fluctuations.

One proposal to safeguard this situation is that the securities offered the banks should be wholly of very short maturities of perhaps one to five years and hence subject to only modest fluctuations even with a considerable change in the market. The difficulty with this proposal is that under it the Treasury would have a huge floating debt which has to be renewed embarrassingly often, at the same time that large additional issues for new money are being floated.

A more realistic suggestion would be the sale to the banks of maturities ranging from one year to about ten years. This would have the effect of spreading out Treasury maturities and would give the banks well distributed portfolios with a fair yield and some market outside the banks. With obligations up to ten years and an average maturity of five years or less the banks would not be exposed to serious fluctuations in values.

Interest Rates and the Market. The foregoing shows the need for financing the war on a fairly steady level of interest rates. Any serious fluctuations in rates would cause concern and interfere with the maintenance of a broad and active market, which is desirable as a means for effecting adjustments between individual banks and other institutions and taking care of the flow of funds through the market incident to the enormous transactions of the war period. The Treasury moreover would be greatly handicapped in its financing program if succeeding issues of bonds appeared at sharply rising interest rates. Investors would be tempted to wait for better rates. Such a tendency is natural in view of the fact that the present interest rates are the lowest in the history of this or any other country.

The experience of England and Canada, however, has shown that it has been possible to finance their war effort at fairly steady rates. For this purpose the fundamental necessity is the general understanding on the

part of the market, the banks, and the Government that rates will be maintained at a fairly steady level within a moderate range of fluctuations. To attempt to peg a rate firmly would defeat the purpose for it would take away freedom of trading in the market, which is essential both to confidence and to the usefulness of the market for adjustments between investors and institutions.

This general statement of principle does not mean that there should be no moderate change in rate level. If, for example, it is found that real investors can be induced into the market at slightly higher rates for short money or for very long money, there seems no inherent reason why those rates should not be allowed to adjust themselves to the more desirable level without fear of a general market collapse.

For the maintenance of a broad and dependable market for government securities, the prime necessity is cooperative understanding between the Treasury and the Reserve System on the one hand and the banks on the other.

Reserve Position. Closely related to the question of the maintenance of steady interest rates is the reserve position of the banks. For a number of years the banks have held huge amounts of excess reserves and this excess has been largely responsible for a continuous decline in interest rates. It has made Treasury financing very easy, for as rates fell, bank earnings fell also, and the banks were under pressure to use excess funds to buy more government securities.

Now this situation needs to be reexamined for it is necessary that securities be distributed widely among investors and the banks take only what cannot be sold to others. The banks ought to have less inducement to invest; others should have more. This object would probably be achieved more easily if excess reserves declined somewhat. But they should

not be allowed to decrease enough to place pressure on the market at a time when it is facing large additional amounts of financing.

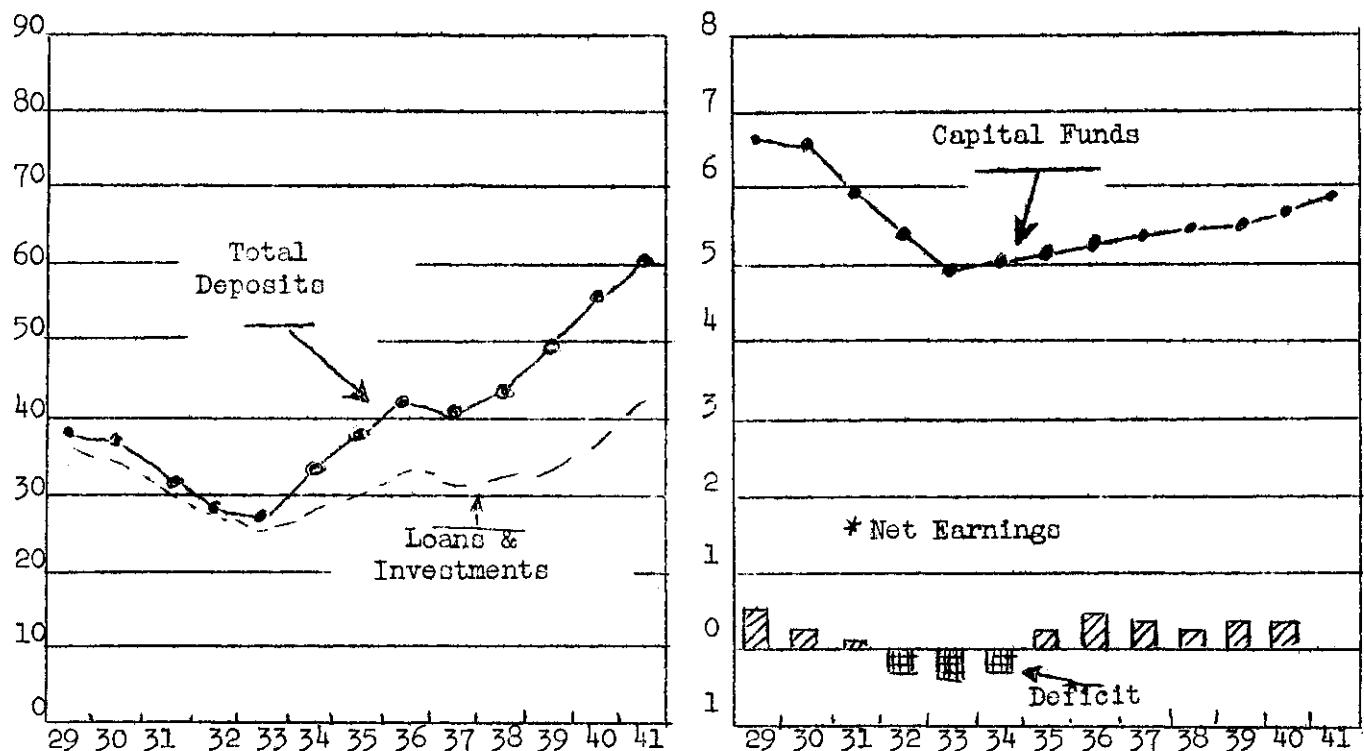
The current increase in deposits together with currency withdrawals will normally lead to some decrease in excess reserves. In the table on page 16 it has been assumed as a working hypothesis that the Treasury and the Reserve System might consider 2 billion dollars as a point where they might maintain excess reserves by open market operations or decreases in reserve requirements. That level should be adequate to maintain interest rates at about their present level especially if we assume, first, some redistribution of reserves as between banks, resulting from a larger supply of short term securities in the market, and second, mutual cooperation with respect to the market between the Treasury and the Reserve System, and the banks.

However, it is clearly impossible to be dogmatic as to the most desirable amount of excess reserves. That must be worked out from experience, having in mind, however, the desirability of selling the maximum amount of government securities to investors rather than banks.

Bank Capital and Earnings. The recent history of the banks with respect to their capital and earnings is shown in the following diagram (page 22) for member banks.

These data may be summarized by saying that in the period from 1929 through 1933 the banks absorbed very large losses so that their capital funds were reduced by about 1,750 million dollars, or 26 per cent. Since that time they have restored out of earnings and recoveries about half of this loss, but their capital funds, even including about 300 million dollars of R. F. C. contributed funds, are still 12 per cent less than in 1929 and their loans and investments 17 per cent larger. Their earnings in this recent period have not been sufficient to build their capital as rapidly as

DEPOSITS, LOANS & INVESTMENTS
 CAPITAL FUNDS AND EARNINGS
 OF ALL MEMBER BANKS
 (Billions of dollars)



*Net earnings are before taxes

their assets and liabilities have increased. Neither their earnings nor their earning prospects have been good enough to enable them to sell additional capital stock to the market. The typical bank has been paying dividends equal to only about 3 per cent of its capital funds. So this emergency finds the banks with clean assets but with reduced capital. As indicated above, this capital is probably sufficient for the need, but in order to maintain unquestioned public confidence in the face of great increases in assets and liabilities some further steady increase in capital seems desirable. With the increase in security holdings, increased earnings are normally to be expected, and it is suggested that enough of these earnings remain in the banks after taxation to allow a moderate but steady increase in capital funds. Similarly it would seem a wise policy for the banks themselves to strengthen their positions by a thoroughly conservative policy as to building up reserves and as to the payment of dividends. This is not a long-term solution but adequate for the present emergency.

Summary

1. The present budget program calls for public financing of \$18,800,000,000 in fiscal 1942 and \$33,600,000,000 in fiscal 1943.
2. The way this huge sum is raised will influence our whole economic and social structure.
3. To avoid inflation the greatest part of this sum should be borrowed from the current income of people who would otherwise spend it, - and next best from funds now idle.
4. Banks and bankers are offered the opportunity of assisting the Treasury in the sale of Defense Savings Bonds and other government securities to investors, of acting in effect as underwriters of government issues, and providing themselves what additional funds may be required, all with the support of the Federal Reserve System as the lender of last resort.

5. To avoid disturbed markets and uncertainties a fairly steady level of interest rates is desirable, and it can be maintained with the co-operative effort of the banks, the Treasury, and the Reserve System.
6. The sale of government securities to investors rather than banks might be encouraged if excess bank reserves were allowed to decrease as deposits expand, to perhaps 2 billion dollars and maintained there instead of at the present $3\frac{1}{2}$ billion. The smaller amount should be adequate to maintain reasonable stability of money rates at low levels.
7. During this period banks cannot expect to maintain as high capital ratios as in the past nor is this necessary as their expansion of assets will be in cash and government securities. Banks should be allowed to earn enough, however, to increase their capital at a moderate rate so that the increase in their deposits will be protected by an adequate capital cushion.

March 19, 1942