Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 6, 1937.

To Chairman Eccles

Subject: Comments on "Monetary Situation Summarized"

From Lauchlin Currie
LBC

This is an excellent discussion of some factors in the present monetary situation. As you have already read it, I shall not attempt to summarize it but shall limit my comments to the marginal queries and to some factors which are susceptible of different interpretations than those presented.

Influence No. I.

"The supply of money has ceased to expand". It is true that there has been a contraction of nearly $1 billion this year in the total of adjusted demand deposits and United States Government deposits. The significance of this, however, is severely limited by the consideration that the total supply of money is over $5 billion in excess of 1929 while the national income is considerably under that year. The implication of the statement, "However, it may be noted that since bank expansion ceased at the year end business has continued at a level virtually unchanged and now gives signs of declining", appears unwarranted, as the downturn has not been associated with tighter money, which is the channel through which bank restriction would affect business activity.

Influence No. II.

The point is made that the increase in total loans relative to deposits this year is a danger signal. Business has leveled off with the development just as it has in the past.

I should not be inclined to attribute any significance to this development at this time. What significance it had in the past is probably attributable to the concomitant rise in interest rates. Since deposits increased greatly from 1933-36 with little rise in loans, it is hardly to be expected that deposits should increase proportionately with loans in the next few years. Loans can expand considerably without any tightening of interest rates and, hence, there is no reason why a rise in the ratio of loans to deposits should presage a downturn in business activity.

The second point, that reserves do not have the mobility that existed in the preceding period of recovery and prosperity, is, I think, valid. It does not follow that "the availability of the monetary resources of the country to business is limited". After all, banks now have a large volume of excess reserves while in the Twenties they had continually to borrow a portion of their reserves from the Federal Reserve banks.

Influence No. IV

With doubled reserve requirements "a gain of deposits now requires twice as much reserves as it did in the 20's, consequently a loss of reserves by any given bank in clearing removes the basis for twice the volume of deposits which a similar loss did in earlier years. Hence, a bank must be operated with greater caution.....". The writer is confused on this point. It is true that, because of doubled reserve requirements a bank can utilize a smaller portion of a new accession of deposits and reserves in making loans and investments. On the other hand, when a bank loses a deposit and a corresponding amount of reserve, it is under the obligation of liquidating a smaller volume of loans and investments than previously.

The system as a whole can expand less on the basis of a given amount of excess reserves than formerly. The significant point here, however, is that banks now possess $1 billion of excess reserves, whereas in the Twenties they had no excess reserves but, on the contrary, were continuously borrowing over $½ billion. In other words, the change in the position relative to excess reserves and reserve requirements combined, in comparison with the Twenties, should be cited as an influence for expansion rather than restriction.

Influence No. V.

It is very questionable whether business activity was checked by a scarcity of funds available for durable goods expenditure. New plant and equipment expenditures in the first nine months were considerably in excess of 1936 and may have approximated the 1928 level. Cash holdings carried over from previous years were large; depreciation accounts furnish a large volume of funds for plant and equipment expenditures; and corporations which cannot or do not wish to go to the new issue market can retain 40 percent of their earnings by paying an average tax of 13 percent on this amount. Banks were in a position to make more loans to industrial borrowers.

Influence No. VI - The diminished "potency" of money.

1. Increased margin requirements. Lower demands for call money, and the low rate on short-term Governments should result in corporations and individuals carrying larger cash balances in relation to the volume of their business than formerly.

2. Minimum Balances. This, likewise, is a valid point but is probably not of great significance quantitatively.

3. Credit Creation. Although the points made in this section are valid in themselves, they are in large part offset by things that are not mentioned, namely, a higher volume of money than in the Twenties, and a large volume of excess reserves.

4. The Flow of Capital is restricted by

(a) the tax on undistributed earnings. Insofar as distributed earnings are syphoned, through Government taxes, to people selling goods or performing services for the Government, the monetary circulation is not diminished; insofar as they are spent by dividend receivers the same is true; and insofar as the savings of dividend receivers are returned, via the capital market, to industry, there is no diminution. The question boils down as to whether the stimulating factor of a probable greater demand for consumer goods resulting from the operation of the tax is offset by the likelihood that some of the investors' savings may not return to industry.

(b) Capital gains tax. The writer does not show how this diminishes the total monetary circulation.

(c) "Increased income taxes and surtaxes tend to divert some income, which would otherwise go to capital investment, into consumption. To no small extent, this diminishes the formation of capital." This ignores the stimulus to the formation of capital afforded by increasing consumer demands. Did capital formation increase in 1936 and 1937 because of increased availability of capital funds or because of a growth in the demands for the products of industry?