

TO Mr. Morrill

FROM Gov. Eccles

REMARKS:

Would you have a chance to look over this,
mark it and prepare a friendly reply to
Reno Odlin?

GOVERNOR ECCLES' OFFICE

THE PUGET SOUND NATIONAL BANK

ESTABLISHED 1890

TACOMA 1, WASHINGTON

RENO ODLIN
PRESIDENT

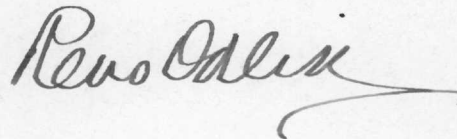
September 1, 1949

Dear Marriner:

The other night I had to fill an engagement at the Pacific Coast Banking School at the University of Washington. My talk had to do with the fiscal and monetary questions of the day and I'm sending a copy forward to you for your information, and would welcome any criticisms you may have.

With best regards,

Sincerely yours,

A handwritten signature in dark ink, reading "Reno Odlin". The signature is written in a cursive style with a long, sweeping underline that extends to the right.

RO:H
Enc.

Hon. Marriner S. Eccles
Member, Board of Governors
Federal Reserve System
Washington, D. C.

AN ADDRESS TO THE PACIFIC COAST BANKING SCHOOL.
DELIVERED BY RENO OPLIN, PRESIDENT, THE PUGET SOUND NATIONAL BANK
OF TACOMA, AT GUGGENHEIM HALL, UNIVERSITY OF WASHINGTON, MONDAY,
AUGUST 22, 1949.

About two months ago, to be exact on June 24, my associate on the Federal Advisory Council, Dr. W. Randolph Burgess of New York, delivered a lecture to the student body of the Graduate School of Banking of New Brunswick. The lecture was titled "The Future of The Federal Reserve System". It is available in pamphlet form from the American Bankers Association. I suggest that you who are interested in a very clear and learned study of the Federal Reserve System send for a copy of the pamphlet.

Dr. Burgess, whose intimate knowledge of the Federal Reserve System and whose rank as an authority is well known to you, discusses in his lecture the critical questions of the relation of the System to the Treasury, the balance of power within the System, and the trend toward control of banking by the System. As his conclusion he warns of the drift toward concentration of power in Washington through unjustifiable additions of controls and power of regulation in the Federal Reserve.

He believes that the traditional powers of the Federal Reserve System to influence the cost and volume of credit are sufficiently powerful instruments for moderating business fluctuations and provide an adequate degree of monetary management.

And he warns that everyone should recognize that the Reserve System is only one of many influences on business fluctuations. He says:

"The final result reflects many causes: the wisdom or unwisdom of business men in accumulating inventories, in starting new ventures, in keeping production costs and selling prices down; the soundness of labor union policies; the international situation; the thousands of ways government stimulates or retards activity; the spending or saving habits of the individual; etc. The Reserve System is no substitute for sound policies in all these areas, nor can it wholly offset unsound policies. In the long run, the economic trend reflects the stresses and the strains from all these fields."

I commend this lecture to your attention.

I thought it proper to devote my attention tonight first to the so-called new phase of central bank policy which was inaugurated on June 28 when the Open Market Committee issued the following statement:

"The Federal Open Market Committee, after consultation with the Treasury, announced today (June 28) that with a view to increasing the supply of funds available in the

market to meet the needs of commerce, business, and agriculture it will be the policy of the Committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve Banks with primary regard to the general business and credit situation. The policy of maintaining orderly conditions in the Government security market and the confidence of investors in Government bonds will be continued. Under present conditions the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased.

There has been elaborate interpretation of this announcement and speculation as to its meaning.

For example, the July 27 issue of the Guaranty Survey of the Guaranty Trust Company of New York has this to say:

"The committee's statement indicated that its primary endeavor henceforth would be to increase the supply of funds available to meet the needs of business, rather than continue to maintain a relatively fixed pattern of interest rates on Government obligations through the sale of such securities, a policy which had the effect of withdrawing funds from the money market. The exact nature of the new policy, especially in its longer-term aspects, has been a subject of considerable discussion in financial circles since the statement was issued. For the immediate future, the change seems to point clearly in the direction of 'easier' money. The main question is whether this supposedly expansionary influence will be followed by correspondingly greater credit restraint when the economic balance swings again toward the inflationary side.

"On its face, the committee's statement leaves room for the inference that such restraint will be attempted—in other words, that the wartime policy of maintaining rigid stability in the Government bond market will be relaxed in favor of a policy aimed at greater stability in commodity prices and business in general. If this is the case, and if the experiment proves successful, a significant step toward healthier economic conditions will have been taken.

"The wording of the statement has been criticized in some quarters as ambiguous. Certainly different implications can be read into different parts, and the committee has left itself (as it probably intended to do) considerable latitude in the choice of specific courses of action under varying conditions. Read as a whole, however, the announcement must in fairness be interpreted as indicating at least

a temporary and perhaps a permanent shift of emphasis toward greater flexibility and a broader objective of central-bank policy".

In analysing the significance of this new statement of policy, it would perhaps be advisable to review the monetary circumstances of the last few years and to bear in mind the developments in that field since, say 1935.

In 1935 the banking system of the United States began piling up excess reserves to an extent never dreamed of before. These reserves in considerable part developed from a flow of capital and gold from Europe into this country on a tremendous scale. The gold, it will be recalled, was valued at \$35.00 an ounce in comparison with the former long-standing rate of \$20.67 an ounce. Reserves mounted steadily and simultaneously short-term money rates drifted steadily downward until at one stage there was actually a minus yield on United States Treasury bills. Even the demands of the Federal government for deficit financing did not result in contraction of excess reserves or in firming of interest rates. In 1936-37 bank reserve requirements were increased and the problem of excess reserves became the principal concern of the banking system and of the monetary authorities. There was a brief slump in 1938, and reserve requirements were reduced somewhat from the 1937 level.

In November, 1941, bank reserve requirements were substantially raised to attack the inflation problem, and this action cut excess reserves substantially, but still left them at a figure near four billion.

We then entered the war and in the light of probable financing requirements of the Government, rates began to stiffen. There developed at this point the so-called "pattern" of interest rates which prevailed throughout the whole war period— $3/8$ per cent on Treasury bills, $2\frac{1}{2}$ per cent on the long-term bonds, and a curve in between the two reflecting the yields for intermediate maturities. In other words, an arbitrary "pattern" was adopted, and the classical relationship between excess reserves and money rates disappeared.

That war-time "pattern" of rates was slowly modified after the war had ended. But in the process of maintaining the rate "pattern" the reserve banks had increased their holdings of government securities from around two billion dollars at the start to some 24 billion dollars at the end of the war; and on this reserve base the banking system absorbed a tremendous amount of government securities.

In July, 1947, the repurchase option on Treasury bills, which had the effect of making them almost the equivalent of cash, was terminated by the Federal and the rate on bills rose sharply and continued to rise to around $1\frac{1}{8}$ per cent. The rate on certificates rose in a parallel "pattern". Late in 1947 the longer-term government securities began to show the effect of increasing demand for credit and were bought by the Federal Reserve in considerable amounts in order to maintain the long-term $2\frac{1}{2}$ per cent rate.

On December 24, 1947, the Open Market Committee reduced its buying prices for bonds, and yields on some maturities rose very sharply; but to support this policy the Reserve System was obliged to buy large quantities of bonds. The

holdings of bonds rose from one billion in late 1947 to over 11 billion in the latter part of 1948. Short-term holdings declined in somewhat the same amount so that the total holdings of the System did not increase materially.

During this era it was argued rather strongly in many quarters that the Reserve System should turn loose the pegs and permit its holdings of governments to decline in order to eliminate excess reserves, stop the expansion of bank credit and thereby brake the inflationary trend. This, however, would have involved the abandonment of the support of the government bond market, which the Federal Reserve was not willing to do. There were strong arguments on both sides of that particular question; many people believed the cost in inflationary price rises was greater than the value of maintenance of the pegs and that they should, therefore, be dropped; others feared that a withdrawal of the supports would have a disastrous effect and that the supposed cure would be worse than the disease. Every thinking person recognized that the Federal Reserve authorities were faced with a very difficult dilemma and that either course of action—abandonment or support of the bond price level—carried with it very serious risks and potentialities.

Around the latter part of 1948, however, the question seemed to solve itself to some extent. Bank loans turned downward and the expansion of bank credit became a contraction. The problem of restraining inflation disappeared and became rather a problem of cushioning a deflation.

This very sketchy background will perhaps serve to set the new policy pronouncement in the right scenery and clarify its meaning. The Federal Reserve is no longer withdrawing funds from the money market to restrain inflation; it has turned to an affirmative policy of providing funds to increase the availability of credit.

It seems proper to comment that the Open Market Committee probably did not mean to suggest that there was a credit shortage. There is certainly no such thing at the moment. Commercial bank loans have gone down substantially during the past seven months not because of lack of availability of credit but because of a let-down in the demand for credit. There have been in the history of the country many shortages of credit, but that is a situation which most certainly does not present itself today.

We have had exceptionally "easy money" conditions in this country for many years past. The addition of funds into the money market today can hardly be expected to have much effect other than psychological. Bank loans will expand when the demand for loans increases and lower rates will have little to do with that expansion. A more favorable economic climate and more favorable prospects for business are the pre-requisites to an increase in demand for credit. Sensible and equitable changes in tax policies are the most important steps that should be taken.

But from the standpoint of the Treasury, easier rates present a considerable advantage from the fiscal angle. The Treasury is facing very substantial refunding problems, and the fiscal policy of the administration is apparently

based upon the deliberate creation of a budget deficit. As a matter of fact the President recently stated that it would be "economic folly" to try for a balanced budget under these conditions.

The long range effects of the easy credit pronouncement are a little harder to prophesy. The wording has been interpreted as announcing a greater flexibility of Federal Reserve policy. One wonders whether this is to be a two-way flexibility and whether political considerations will permit the reversal of the easy money policy when circumstances indicate the wisdom of that course. Probably the Open Market Committee deliberately left a degree of ambiguity in the statement. It would perhaps be unfair to expect them to be more precise than they were.

As a matter of fact the announcement of June 28 is really improperly called a "new" policy. In the pre-war era the Federal Reserve open market policies were presumed to be established with "primary regard to the general business and credit situation."

Section 12 A of the Federal Reserve Act contains this language relative to open market operations:

"The time, character, and volume of all purchases and sales shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

This is the language of the Federal Reserve Act since 1933 at which time statutory recognition was given to the "Federal Open Market Committee".

In its August, 1949 letter, the National City Bank of New York says the following:

"The objective of 'maintaining orderly conditions in the government security market', restated with secondary emphasis in the new policy statement, has no foundation in statute, though the Reserve System has always been attentive to the problems of Treasury financing and in the two world wars made assistance to the vast loan drives its prepossessing concern. The 'orderly markets' language was first used publicly in the spring of 1937 when reserve requirement increases, invoked to cut down excess reserves, threw the bond market into turmoil. The Federal Reserve entered the market and, with \$200 million purchases of long-term governments, restored order. They again intervened in the market to soften the impact of the outbreak of the war in Europe in September, 1939, and the blow of Pearl Harbor in December, 1941.

"The wisdom of these emergency open market operations, in the circumstances, was never seriously questioned. But the easing of an unexpected shock is quite a different sort of thing than the detailed control of prices and trading which has been in effect since the 'pattern of rates' technique was adopted in 1942.

The experience of the postwar period has taught--not only here but in England, Sweden and elsewhere--that when a central banking system devotes itself to controlling government security prices it reduces its power to control credit. The two things are incompatible."

The same authority points out that the primary purpose of the Federal Reserve System was to provide an elastic currency for this country, and to provide a system under when the reserves of the banking structure would be mobilized and made available to serve the purpose implied in the word "reserves".

So the "new" policy is really a restatement of the original purposes and intentions of the Federal Reserve Act. It seems to me the significance is that conditions have changed to an extent that the wartime deviation from these original purposes can now be corrected and the System can revert to its original objectives.

In view of the frequent requests for more powers and controls by the Board of Governors of the Federal Reserve System, which requests many of us have felt unnecessary and unwise, it seems pertinent to add a few comments by people identified with the System in its earlier days.

The other day I read the proceedings of the American Bankers Association convention of 1915, the year following the inception of the Federal Reserve System--which convention by coincidence was held here in Seattle.

In an address by Mr. F. A. Dalano, Vice Governor of the Federal Reserve Board, I found the following:

"These central banks were not created to transact business with the public but primarily, as their name implies, for the purpose of holding the reserve deposits of their owning banks. Among the important services which they may render to their member banks the most important is the right to rediscount their paper and issue bank notes against it. Manifestly, then, the first great result of creating twelve banks has been to bind together all the national banks of the country into twelve strong regiments, thereby creating an effective solidarity.

"Reference has been made to the fact that under the old system in effect for fifty years, there had been developed a system of depositing reserves of smaller banks with other and larger banks. This had led not only to serious duplication of reserves which rapidly evaporated in times of stress but in addition to this, the results of active competition for deposits led to many vicious practices, such as paying high rates of interest or granting special facilities or favors. Banks kept reciprocal balances with each other and by a system which might be likened to the time honored plan of 'you tickle me, I tickle you', they got ahead, at least on paper. However, these methods were not conducive either to safe banking or to low and stable interest rates for the public.

Hence it was that one of the objects of this new law was to make banking less hazardous, make profits surer, but to accomplish it in such a way that the investor, the manufacturer, the merchant, each and all, could count on banking facilities in good times and bad and also a fair stability of interest rates.

"The new plan seeks to put the reserves where you can count on them. The reserves in the (central) reserve bank of the district are used expansively as the basis of note issues, so that instead of these reserves being unavailable in time of need they are at once available to the fullest extent. The operation, simple enough to most of you, consists in allowing member banks to bring around their commercial paper and provided it complies with the not onerous provisions of the law and rules of the Federal Reserve Board, you are given a credit on the books of the bank or, at your option, Federal Reserve notes for the full amount."

Mr. Delano added:

"The rediscounting of commercial paper of member banks by the Reserve Bank is the chief function of these banks....."

In the proceedings of the convention of the following year, 1916, Governor Harding of the Federal Reserve Board, in his address, said this:

"The Federal Reserve Board is not a legislative body; its functions are administrative. Occasionally it has quasi-judicial functions to perform, but in the main its duties are administrative.

"Section 16 shrinks into insignificance as compared with the underlying principles of the Federal Reserve Act, the utilizing of the cash resources of this country, the care of the gold, the ultimate monetary redemption, the only international money.

"That, gentlemen, is the highest province of the Federal Reserve Bank, which is to regulate and stabilize our currency, so that those of you who hold any form of paper money, issued through governmental agency, may be sure of your redeemer--and that you can get the gold when the need for it arrives."

At that same meeting in the address of Paul M. Warburg, Vice Governor of the Federal Reserve Board, I found the following:

"I believe it is safe to say that, in general, those laws have proved the best which put into legal form existing usages

already recognized by actual experience as sound both in principle and practice.

"In 1910 I published a tentative plan entitled, "A United Reserve Bank of the United States". Later on Senator Aldrich called the system that he proposed, "A National Reserve Association"; and, finally the Owen-Glass committees devised the "Federal Reserve System", which was enacted into law. The word "reserve" has been embodied in all these varying names, and this is significant because the adoption of the principle of co-operative reserves is the characteristic feature of each of these plans.

"Reserve is, as the name implies, what one holds back. It generally means an extra supply of something kept idle for the purpose of being immediately available to take care of an increased demand in excess of normal requirements."

It would seem from these excerpts that the primary purposes of the Reserve System were clearly and completely understood. And at this point I again commend to you Dr. Burgess' discussion of the proper scope of Federal Reserve operations.

There are many of us who feel that even the additional powers requested so frequently by the Board of Governors could at best serve no great purpose in the absence of a sound overall fiscal policy in this country. I believe it was Mr. Allan Sproul, president of the New York Federal Reserve Bank, who said to the Senate Banking and Currency Committee, "We cannot do everything wrong everywhere else and then expect to cure things by bank controls."

Monetary management occupies a field of tremendous importance and yet it would seem that the best monetary management would be a very poor substitute for sound fiscal management.

The survival of our way of life and most certainly the continuance of our ability to help out in the survival of representative governments abroad hinges on the solvency of this country and the soundness of its fiscal policy. Recently Senator Byrd said:

"Without American solvency our constitutional freedoms would disappear at home and there would be no deterrent to Communism abroad. Under existing circumstances it is no exaggeration to say there is literally nothing on earth more important than the preservation of the fiscal integrity of the Federal government of the United States and the financial stability of our free enterprise system."

We are being told today that our budget cannot be balanced even at the fantastic level of some 40 billions per year. Political platforms of all political parties are built on promises and assurances to the people that government will continue and increase the out-pouring of contributions and grants for every imaginable purpose. The President has announced a policy of deficit financing to permit the continuance and expansion of this welfare state of ours. In 1948 over one-fourth of the national income went to federal, state and local government, double the amount that went in that direction in 1929.

In the course of his recent financial study Senator Byrd concluded:

"I am convinced that in the coming year we shall extend our fiscal and economical stability to extremes where it may be unable to withstanding additional pressures which are unavoidable in fiscal year 1951. When our fiscal and economic stability weakens, there is certain to be a demoralizing domestic crisis which probably would be disastrous to our private enterprise system and, therefore, to our form of government."

It would seem that it is high time for us to quit worrying about relatively unimportant proposals and concentrate upon the all important problem of national fiscal policy. It, therefore, seems to me that the additional controls requested by the Board of Governors are relatively trivial in importance and that the attention of the highest authorities in government should be directed to the real problem. When an emergency operation is urgently necessary, the doctor doesn't waste too much time smoothing down a broken finger nail on the patient.

Feeling as I do that the tax and fiscal questions are the important ones, I note with pleasure and pride that the Chairman of the Board of Governors of the Federal Reserve System has within the past few days expressed himself clearly and convincingly in answering a question posed to him by Chairman Maybank of the Senate Banking Committee. Chairman Thomas B. McCabe was asked to express his views as to what should be done to improve the status of equity financing, on which our whole economic structure rests.

Mr. McCabe suggested that the attention of the committee and of the Congress be directed toward changes in the tax structure, with particular consideration of lowered surtax rates in the upper brackets, more liberal carry-back tax provisions for corporations, elimination of "double taxation" of corporate income, more rapid depreciation allowances, and some changes in the capital gains tax provisions.

He also suggested the possible removal of tax exemption from presently exempted state and local securities, consideration for insurance companies to take a place in equity financing to some extent, and several other ideas.

He said among other things:

"To realize our potential sustained expansion, we need to be concerned with assuring a steady and adequate flow of savings into equity ownership."

It seems to me that such a statement coming from the Chairman of the Federal Reserve Board is one of the most important and encouraging pronouncements in recent years. Some months ago I had occasion to compliment former Chairman Marriner Eccles upon the courageous and forthright manner in which he opposed many of the unsound proposals presented to the special session of the Congress last year. I think his position in respect to the proposed housing legislation, for one example, was one of the most constructive contributions the Federal Reserve or its people could have made. It is a pleasure now to note the contribution which Chairman McCabe has made toward better understanding and clearer thinking in respect to our national economy.

The Federal Reserve System is a creature of the Congress of the United States. It was created by the Congress and is required to report to the Congress. It seems to me that it can best serve the people of the United States by stating clearly and unequivocally that its own monetary policies can at best do very little to create the right economic climate unless accompanied by a sound taxation and debt management and budget policy, which in the final analysis rests with the Congress and thus with the people of the United States.

September 9, 1949.

Mr. Reno Odlin, President,
The Puget Sound National Bank,
Tacoma 1, Washington.

Dear Reno:

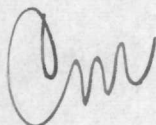
Thank you very much for letting me have a copy of your address to the Pacific Coast Banking School at the University of Washington on Monday, August 22, 1949. There is much that I can agree with in your talk, especially your complimentary reference to me in the next to the last paragraph. There are other things that you would naturally know that I would not entirely agree with but I won't undertake to burden you with any detailed discussion because I am sure that you have been "fed up" with my views at numerous sessions of the Federal Advisory Council. However, it so happens that Larry Clayton made an address before a Virginia Bankers Conference at Charlottesville on September 8 in which he also discussed the recent lecture by Randy Burgess at the Graduate School of Banking at Rutgers to which you referred, and I am taking the liberty of sending you a copy of Larry's speech because I think it might help you in getting a somewhat different slant than that indicated in your talk.

Looking forward to seeing you from time to time, and again expressing my appreciation of the opportunity of reading your speech, I am,

Very truly yours,

M. S. Eccles.

Enclosure



CM:am