March 19, 1946

Honorable Frederick C. Smith
House of Representatives
Washington, D.C.

Dear Mr. Smith:

Your letter of March 7 raises a number of interesting questions about war financing. The 17 billion dollar figure to which you refer is the total outstanding amount of 3-month Treasury bills. Of this amount, the Federal Reserve Banks hold about 13 billion dollars, commercial banks about 2 billion and other investors 2 billion. Commercial banks and other investors obtain bills directly from the Treasury by bidding for new issues. The 13 billion dollars of Federal Reserve holdings represents net purchases at the 3/8 per cent fixed buying rate, principally from Commercial banks needing reserve funds.

Holdings of Government securities by Commercial banks increased since the beginning of the defense program in June 1940 by 73 billion dollars to a total of 90 billion at the end of December 1945. This increase reflected purchases of Government securities by banks in the market and subscriptions for securities offered by the Treasury. From June 1940 to the first large-scale war financing drive in December 1942, the Treasury made periodic offerings of securities to the market and banks as well as other investors were permitted to subscribe. In each of the first two war loans, banks were permitted to subscribe for 5 billion dollars of securities. Beginning with the Third War Loan banks were excluded from the drives, but were permitted to subscribe outside the drives for relatively small amounts of securities under a formula based on time deposits. During the drives, however, banks purchased large amounts of Government securities in the market at times when non-bank investors were selling previously acquired issues in order to raise funds with which to increase their subscription in the drives. Hence, the bulk of the increase in commercial bank holdings has been through purchases in the market rather than on subscription to the Treasury.

In addition to Government securities purchased by banks on subscription or in the market, banks made loans to dealers and others for purchasing or carrying of Government securities. Such loans increased to a peak during the drives and declined following the drives. Such loans by reporting member banks during the Victory Loan amounted to 4.4 billion dollars. These loans have subsequently declined to 3.5 billion dollars on March 6.

During World War I, as I stated before the House Banking and Currency Committee, banks made relatively much larger loans to individuals and businesses for purchase of Government securities. A breakdown of loans during that period is not available. On December 31, 1919, the first date for which detailed figures are available, member banks had outstanding 4.3 billion dollars of loans on securities. Total loans of all banks, which included loans on Government securities as well as other loans increased by 13 billion dollars during the war to 30.8 billion on June 30, 1920. As indicated in your letter, member bank holdings of Government securities increased to 5.1 billion dollars on June 30, 1919 and subsequently declined somewhat. All bank holdings of Government securities reached a peak of 5.8 billion dollars on June 30, 1919. In contrast, during World War II banks purchased on subscription or in the market substantial amounts of Government securities and, while loans were large, they were relatively much smaller in proportion to size of the financing job than in the previous war.

From the standpoint of expansion of credit, there is no essential difference whether the expansion is in the form of loans or holdings of Government securities--in either case bank deposits increase. There is a difference, however, in the types of securities that the Government issues and in the rates of interest paid by the Government. Securities sold on subscription directly to banks were largely low-rate short-term bills and certificates, while loans were generally made against the long-term higher-yielding issues. To the extent that bank credit is used to finance the Government, therefore, it is better to offer the securities directly to the banks rather than channel them through individuals and businesses to the banks. You will recall also that with the large amount of loans on securities outstanding at the close of the previous war, serious consequences resulted when individuals and businesses sought to sell their securities in a sharply declining market.

I do not wish to imply that there is objection to loans on securities when such loans are made in anticipation of income and are repaid over a reasonable time out of income. There are no figures available showing what per cent of Government securities purchased by private individuals with borrowings from banks was paid for by the purchasers through earnings or accumulated funds or through sale of the securities. A far too large per centage, I feel, was purchased by bank borrowings for speculative purposes and sold at a profit in the market following the drives.

Sincerely yours,

M. S. Eccles,
Chairman.

DMK/lf