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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Statement for the Press

March 24, 1941.

The attached letter by Chairman Eccles is for release in morning newspapers of Tuesday, March 25, 1941.

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Federal Reserve Bank of St. Louis

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

March 21, 1941

Dear Mr. Patman:

From time to time my attention has been called to your frequent public utterances on the floor of the House and over the radio, culminating in your recent radio address as printed in the Congressional Record of March 17, 1941. You have long charged that the Federal Reserve System is under the domination of the private bankers of the country and more recently you have proposed that the government finance its entire expenditures through the issue of new money and without the payment of interest. Since these questions are of increasing importance in these times, I feel that your statements should not remain unanswered lest the public be misled into supposing that the issue by the government of interest-bearing bonds is unnecessary, extravagant and wasteful, as you contend. Your propositions concern matters in which I have an especial interest and for the purposes of the record I am making this personal reply. While I have no reason to believe that the Board would differ with the substance of this letter, it has not been submitted to the other members and therefore does not necessarily represent their views.

Your plan as described in the Congressional Record is for the government to finance its expenditures by issuing new money and avoiding the payment of interest. In this fashion you would have the government meet not only its normal expenditures in excess of receipts but also the enormous defense expenditures now under way and in contemplation and ultimately the entire outstanding Federal debt.

The sovereign power of the Congress to authorize such a program is beyond question. What has to be determined, however, is whether it would be for the good of the country to embark on such a course. To my mind it would be disastrous. Plausible as your proposals may be made to appear, there is no escape from the truth that someone must pay for everything. If the government could save the billion or more a year without causing any corresponding or greater losses to the country, no one could reasonably be opposed to your proposal. I am convinced, however, that the creation of the huge amount of new money contemplated by your plan could only lead to incalculable losses for the country as a whole.

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At the outset I think it necessary to dispose of some of your misconceptions on the subject of the banking system. First of all, the interest received by the commercial banks of the country on their government bond holdings is not an unconscionable tribute, as one might imply from your discussion. The banking system of the country is an indispensable part of our capitalistic economy. Practically all the people make use of some banking service, either directly or indirectly. How would these people be affected by your proposal? If the revenue from government bond holdings should be taken from the banks, they would seek some other source of revenue to replace it or reduce their disbursements. Obviously they could not raise their lending rates, since the huge amount of new money involved in your plan would drive interest rates even below their present low levels. The banks would be obliged to reduce still further the rate of interest paid on their savings accounts although the savers of the country are now receiving an excessively low rate of return. Beyond that, the banks would have to increase materially their service charges of various kinds, principally for checking accounts. These efforts to replace the revenue now derived from interest on government securities would impose a new burden upon the people of the country substantially in the same amount as the interest now received by the banks on their government bond holdings. There is this important difference, however, that the new burden upon savers and other individuals using banking services would fall most heavily upon the more numerous owners of small accounts whereas the burden of taxes collected by the Federal government to pay interest on its bonds falls for the most part upon those with ability to pay.

Nor can it be truthfully said that banks make inordinate profits, and that they could operate on a sound basis with less income. During the ten-year period 1930-1939 the average rate of net earnings on invested capital by member banks was 2 per cent, which is less than a reasonable rate of return. It should be noted that these earnings relate only to banks which survived the great depression. A complete picture would show that during the period 1929-1933 inclusive, 9,755 banks failed and their stockholders in nearly every instance lost their entire investment and in many cases paid assessments up to the par value of their stock. During the five-year period 1935-1939 the average rate of return was 6.1 per cent, but this better showing was due in large part to the fact that during this period banks were realizing recoveries on losses charged off during the depression and profits on the sale of securities in a steadily rising bond market. Obviously, these are non-recurring items, without which the earnings for this recent five-year period would have been substantially lower.

That the banking business is not considered lucrative by the investing public is attested by the fact that during 1940 the average price of common stocks of nineteen New York banks was about 55 per cent of the corresponding prices in 1926, whereas public

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utilities stock prices averaged around 80 per cent and industrials around 100 per cent of the corresponding prices in 1926.

The effect of your proposals upon mutual savings banks, life insurance companies, educational endowments and other institutional investors who hold government bonds would be even worse because these institutions would have great difficulty in making up the loss of revenue. They would be compelled to reduce drastically their disbursements. Savings banks would have to reduce still further the rate of interest paid on their accounts, life insurance companies would have to curtail dividends on outstanding policies and charge higher premiums for future policies, and educational endowments would be forced to decrease their support of schools and colleges.

One of your favorite complaints is that the Federal Reserve Banks are owned by private bankers and that the Board of Governors in Washington as well as the Federal Reserve Banks are operated in the interest of private bankers. These charges will not stand up under examination. The Board of Governors, the members of which are appointed by the President and confirmed by the Senate, is a public body. As to the Federal Reserve Banks, you rest your case upon the slender point that the stock of the Federal Reserve Banks is owned by the member banks. Congress specifically provided for this, as well as for the rate of dividend and Congress can change the nature of the stock and the rate of return at will. This so-called stock ownership, however, is more in the nature of an enforced subscription to the capital of the Federal Reserve Banks than an ownership in the usual sense. The stock cannot be sold, transferred or hypothecated, nor can it be voted in accordance with the par value of the shares held. Thus the smallest member bank has an equal vote with the largest. Member banks have no right to participate in earnings above the statutory dividend, and upon liquidation any funds remaining after retirement of the stock revert to the government. You greatly exaggerate the significance of this so-called stock ownership. At the current dividend rate of six per cent, it involves the payment annually of approximately $8,000,000 to more than 6,000 member banks, and could be done away with altogether without important effects except to put an end to an illusion created by you and others in the minds of some people. At the same time, it is my view that the Federal Reserve System should be unequivocally a public instrumentality but the ownership of the stock of the Federal Reserve Banks is not the determining factor.

Coming to the principal issues involved in your proposal to issue a constant stream of new money to finance the government, the reasons why this would be contrary to the public interest may be summarized as follows: (1) borrowing by the government at interest, particularly the borrowing of money actually saved by consumers, rather than issuance of currency, is a necessary safeguard

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against inflation, particularly at this time, and (2) borrowing by the government at interest is an essential part of the capitalist economy in which we live.

There are times when the money supply should be increased and times when it should not be. It is one of the tasks of the Federal Reserve System to see that the money supply is adjusted to current requirements of the economic situation. The System has powers to supply almost unlimited increases, but its powers to prevent harmful increases or to bring about needed decreases are now wholly inadequate.

The prevailing situation, which is likely to continue during the next few years, does not call for increases in the available supply of money. The amount of adjusted demand deposits and currency, which together constitute the supply of money owned by the public, already exceeds $42 billions or more than double the amount that existed in 1933 and some $15 billions more than was on hand at the peak of the boom period of the twenties. A large part of these deposits represents idle funds being held on demand for future investment. In addition, commercial banks of the country have over $6 billions of reserve funds in excess of their requirements and available as a basis for a multiple expansion of loans and investments and therefore of deposits. In fact, existing deposits, if utilized at the rate of turnover that prevailed in the twenties, could support a tremendous boom without creation of an additional dollar of new money.

With prospects for improved business under the stimulus of the defense program, it is probable that individuals and institutional investors will find greater demands for their now idle lendable funds, and that these funds will be put to more active use. In the first place, idle funds will be lent to the government for its defense expenditures, and this will unavoidably put them into active circulation. Then, as business improves, idle funds will be put to use by large and small business units raising new capital. Even beyond this, as prosperity grows, individuals themselves will put into circulation part of their accumulated cash savings by buying goods and services of one kind and another, the purchase of which they postponed in the past when they accumulated those cash savings. It is possible that this expansion of the use of existing funds may go so far that, added on to the present rate of turnover of money and goods and services, it may exceed the productive capacity of our economic system. Such a condition is one of monetary inflation, characterized by attempts to buy things that cannot be bought, that is, by the bidding up of prices of goods, of equities, and of other property--in other words by the usual phenomena of general inflation.

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One way of helping to avoid this development is for the government to finance its expenditures by taxation and by borrowing existing funds. It is better that borrowing be done from the current savings of the public and from past savings now held as deposits of individuals, business corporations, insurance companies, and other fiduciary institutions, rather than from the idle reserve funds of the banking system. Borrowing from the latter results in a further increase in the supply of bank deposits. It amounts to financing with new money which would be dangerous if the supply of deposits were already actively in use and with production already nearing capacity levels. Yet your proposal would court this danger by bringing about an even greater increase in bank deposits. In order to carry out the growing defense program it may at some stage become desirable that borrowing be entirely from current savings—which will, however, need to be larger than now--so that for every dollar the government spends the consuming public will have spent a dollar less. It may also be necessary to absorb a part of the banks' additional lending power by increasing their reserve requirements, as was indicated by the Special Report which the Federal Reserve System submitted to Congress on December 31, 1940. Your proposal, on the contrary, would increase many-fold the excess reserves of member banks, through the issuance of new money by the Federal Reserve Banks for government expenditures, and would add enormously to the banks' lending power.

Your plan is inconsistent with the nature of our capitalistic democracy. As our economic system works, a large part of the public saves a part of its income which is invested in homes or in plant, equipment, and the like, which supply current goods and services to others. Or they lend to the government to meet its expenses in excess of tax receipts. Interest is the most common form of compensation that these individuals obtain for the use of their money. These savings are often not invested directly but are entrusted to insurance companies, banks, and other institutions, which do the lending. These institutions receive interest and in turn either pay interest or provide services to savers, as well as meet their operating costs.

Interest on debt—a large part of which is public debt—constitutes income of private individuals, of educational and charitable trusts, of insurance companies, and of banks. A certain part of it pays for the costs of the process of investment. Discontinuance of interest on the public debt, therefore, must be thought of not merely as so much "saved" the government or the taxpayer, but also as so much income cut off from savers, trusts, institutions, and individuals that require the safest type of investment.

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If there were some virtue in your ideas for government financing, other countries might be expected to follow them. But the fact is that not even the dictator nations and none of the other powers have abandoned the payment of interest on government issues. For all of the boasted efficacy of German financial management, the Nazi Government has adhered to strict orthodoxy in paying interest rates, considerably higher than those prevailing in the United States, on its obligations and has sought with much success so far to avoid creating new money. Instead, by heavy and widely distributed taxation, the Nazi Government has sought to finance its vast expenditures so far as possible out of existing funds and to avoid monetary inflation, possibly because the memory of the demoralization of the mark after the first World War is still so fresh in German memory.

Financing government by issuing currency would have a double-barreled effect upon the interest income of the public. It would reduce the amount of interest received by savers, and it would increase the amount of money available for investment. As use for these funds was sought, interest rates on all types of debt would decline, until the bare costs of investment could not be met. In such circumstances funds intended for investment would either remain uninvested or would out of necessity be used for the speculative purchase of existing consumption goods, physical property or equities of various kinds. This would intensify the inflation already generated by capacity production for the defense program if financed by new money. Such conditions would completely demoralize our economic system as now constituted. It would mean the end of capitalism and require the substitution of some other system in its place.

Very truly yours,

(signed) M. S. Eccles

M. S. Eccles
Chairman

Honorable Wright Patman
House of Representatives
Washington, D. C.

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