Date 12-10-47

To Miss Egbert

From T. Hemminger

MESSAGE: Mr. Young said he told the Chairman pretty much what was in this but thought he might like to have it available anyhow.

Youngdahl ?

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Message delivered by ______________

F.R. 468
Rev. 1/47

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 9, 1947

To Chairman Eccles

From Richard Youngdahl

Subject: Testimony of Edward E. Brown Before the Joint Committee on the Economic Report.

Mr. Brown's testimony before the Joint Committee on the Economic Report did little, if anything, to strengthen the position of the banking community in opposition to the special reserve plan. He was received by the Committee with cold courtesy and the members were armed with questions which served to bring out errors, inconsistencies, and irrevelancies in his testimony.

Mr. Brown began his testimony by reading without interruption a prepared statement, a copy of which is attached. He also re-read the memorandum submitted by the Federal Advisory Council to the Board on November 18.

The following were major points in Mr. Brown's prepared statement:

1. The expansion of bank lending has not been a material factor in the rise of price level. The major problem is rather the mass of purchasing power in cash and deposits in the hands of the public.

2. Bank loans which increase production or which increase or influence distribution are anti-inflationary (almost all loans according to Mr. Brown fall in these categories.)

3. The special reserve plan would not have any material effect in reducing inflation. To the extent that it restricted bank credit, it would reduce production and be inflationary.

4. If the special reserve plan became law banks would immediately begin to put their affairs in shape to meet the maximum requirement. Accordingly the Board could not apply just a little of the special-reserve-asset medicine, since the mere existence of the power would in effect administer immediately the full dose. This might easily bring about panic in the securities markets. (If enactment of the plan resulted in loan reduction, production would decline.)

5. The plan is impractical and highly inequitable. This point was made by reference to the 15,000 banks and the varying customers and communities they serve and at various seasons of the year. Further reference was also made to the possibility of banks refusing loans necessary to maintain existing production.

6. The plan would tend towards the socialization of banking and Government control over credit.

a. A substitution of the edicts of a Board in Washington for judgments of the Boards of Directors of the 15,000 banks.

b. Enable the Treasury and the Board to control bank earnings.

c. Restraint of bank lending would lead to demand for enlarged Government lending agencies.

7. The Federal Reserve Board still has powers under existing law to:

a. raise the rediscount rate

b. increase reserve requirements in New York and Chicago

c. tighten up its open market operations

d. use its influence with the Treasury to further reduce war loan accounts.

He warned, however, against too vigorous use of these powers to avoid upsetting public confidence. Special emphasis was given to the "profound psychological effect" of a slight change in the rediscount rate (1/4 to 1/2 per cent). This would cause many businesses to abandon or postpone expansion plans and cause bankers to scrutinize more closely loan requests for capital expansion.

8. He commended the Treasury and the Federal Reserve Board on recent monetary actions and stated that these policies had been more effective than the Chairman of the Board realized.

9. The remedy for the present inflationary situation lies outside the field of monetary policy.

a. More production

b. Strict economy by Government

c. Budget surplus applied to reduction of the debt

d. Thrift and savings by the people to provide funds for plant expansion.

In questioning, Senators Taft, O'Mahoney, and Watkins in particular asked questions which caused Mr. Brown a considerable degree of embarrassment and the Senators appeared to enjoy twisting Mr. Brown's tail. Senator Taft pressed hard on Mr. Brown's point that bank loans are productive and are not inflationary but anti-inflationary. The Senator succeeded in convincing everyone but Mr. Brown that in the short-run creation of money merely adds to an already excessive demand for goods. In the later testimony this point was raised again and again and from time to time it appeared that Mr. Brown was involved in serious contradiction. When his position became untenable, he merely restated his contention that bank loans increased production. At no time in the testimony was the point made that even though a loan did increase production initially the funds thus created would find subsequent inflationary uses which might far outweigh the production increase.

Senator Taft asked if something might be done by regulation to permit only productive-type loans and inquired whether it would be possible to distinguish between productive and non-productive loans should the Board be given such authority. Mr. Brown thought it would not be possible to make this distinction.

In commenting further on his own program for Federal Reserve action in response to questions Mr. Brown defined more closely his suggestion that the System "tighten up" open market policy. To him this means buying short-term Government securities at slightly lower prices than at present and exercising slightly a "tighter policy" without sending the long-term bonds below par. When questioned further, however, it developed that Mr. Brown does not believe that monetary policy can stop the inflation or change the price level. He was pressed further to state that with present powers the System could discourage lending but that this would have no effect on reducing the price level.

Senator O'Mahoney pointed to shortages of materials and labor (the over-employment which Brown had referred to in previous testimony) and asked if bank credit expansion would not merely make the shortages worse. The witness wavered in his opinion at this point.

Under interrogation Mr. Brown restated that his major suggestion for monetary action, that is, an increase in the rediscount rate, would have only psychological effect. It developed that Mr. Brown was not sure whether the psychological effect would be good or bad. Apparently if the change was small enough it might be good.

Mr. Brown testified that at the present time Government policies with respect to housing credit were inflationary. He recommended that Title VI not be extended when the authorization expires. He stated that houses could be built just so fast and that houses would still be built although loans were not made under Title VI. The effect of curtailment in this area would be to bring about a better balance in the supply and demand for new housing.

Senator Taft expressed sympathy with his desire to cut down mortgage lending and indicated that, unlike Mr. Brown, he thought that loans for other purposes were also inflationary.

Mr. Brown was asked whether he would prefer an increase in reserve requirements to the special reserve plan. He stated that he did not feel that an increase in reserve requirements would be desirable but that he would prefer it to the special reserve plan. He stated further, however, that he believed the differences in requirements among country, reserve city, and central reserve city banks should be narrowed if the Board were given additional powers to increase reserve requirements.

Senator Taft asked if there would be any point in increasing the gold certificate requirements of the Federal Reserve Banks to 35 per cent of deposit liabilities and 40 per cent of Federal Reserve notes. Mr. Brown stated that should this change be made the System would still have excess reserves and that there would be no effect in the present situation.

RY.

Attachment

December 9, 1947

TO BE RELEASED
AFTER TESTIFYING

STATEMENT OF EDWARD E. BROWN, CHAIRMAN OF BOARD
FIRST NATIONAL BANK, CHICAGO, ILLINOIS, AND
PRESIDENT OF THE FEDERAL ADVISORY COUNCIL, BEFORE
THE JOINT COMMITTEE ON THE ECONOMIC REPORT

I am addressing my testimony to the Special Reserve Plan, the so-called Eccles plan. Unless the committee desires me to do so I shall not discuss the restoration of controls over instalment credit.

The Special Reserve Plan as outlined by Governor Eccles, is that all commercial banks, whether or not members of the Federal Reserve System, may be required by the Federal Reserve Board to carry a special reserve up to 25% of their demand deposits, and 10% of their time or savings deposits in United States government bills, certificates of indebtedness, or notes, or cash, cash items, interbank balances, or balances with Federal Reserve Banks. This special reserve would be in addition to cash reserves now required of member banks, or to cash reserves now required of nonmember banks by state law. Within the 25% maximum against demand deposits and the 10% maximum against time deposits, the Federal Reserve Board could set from time to time the percentage of special reserve which all banks should carry.

The Federal Advisory Council, of which I am president, is unanimously opposed to such a plan.

In response to a request of the Federal Reserve Board which read: "The Board is very concerned about the rapid expansion of bank credit. The Board, therefore, desires to have the views of the Council as to the further steps that might be taken to correct this serious situation through monetary or fiscal means," the Council submitted a memorandum on November 18 to the Board. Mr. Eccles filed a copy of it with your committee.

The expansion of bank lending has not been a material factor in the rise of the price level. The Special Reserve Plan proposed by Governor Eccles would not have any material effect in reducing inflation. It might well cause a great deal of difficulty to the economy of the country and bring about a restriction of production and distribution.

We have in this country in addition to currency and bank deposits, large amounts of savings deposits both in commercial banks and in Mutual Savings Banks. We have outstanding over $50 billions of savings bonds and notes which are cashable on demand, and some of which are continually being cashed. We have a large amount of short term debt. We have an even larger amount of long term bonds whose holders can sell them at any time, as they are now supported by the Treasury and Federal Reserve when necessary to keep them above par, and in my opinion they must and will continue to be so supported.

This tremendous aggregate mass of purchasing power in cash, or else convertible into cash in a very few days, exists against a supply of goods which in many cases is short of present demand.

Forcing the banks to carry a special reserve in government bills, certificates, or notes will not affect the ability of people who have money in a bank to take it out and buy goods if they can get them. It will not affect the pressure which the owners of savings accounts, or of government bonds, are in a position to put on the demand for goods, should they decide to cash their savings accounts or bonds.

All the special reserve proposal could do would be to restrict bank credit. The adoption of this proposal might not only restrict an increase in bank credit which would be desirable to enable a further increase in production and distribution, but it might very well have the effect of cutting down existing bank credit which now serves to maintain present production and distribution.

Bank loans which increase production or which increase and facilitate distribution are anti-inflationary. Loans to a farmer to buy fertilizer for his crops or to raise and finish cattle increase production. Loans to a meat packer to buy and process livestock into meat, or to a miller to buy grain and make it into flour, are necessary if the farmer's products are to be efficiently used for food. Similarly, loans to an oil producer to drill oil wells increase production. So does a loan to a steel company to build some item, such as a battery of coke ovens, which are necessary to balance the capacity of the rest of its plant.

The members of the Federal Advisory Council, of which I am president, come from all the twelve Federal Reserve Districts. They know pretty well the type of loans which the banks in their respective districts are making. They believe that the great bulk of the existing loans in the banking system and the great bulk of the loans being made serve to maintain and increase production and distribution. There are very few speculative loans on securities and almost none on commodities. The only considerable segment of bank loans being made which the Advisory Council feel have an inflationary effect on prices, are housing real estate loans guaranteed by the FHA or under the G. I. Bill of Rights. Many banks are making such loans in reliance on the guarantee and without much regard to the value of the property behind the loans. It is difficult, if not impossible, to persuade banks not to make loans guaranteed by the Federal Government. Many of these guaranteed loans are in excess of either the cost of the property mortgaged to secure them, or of its reasonable value. They can only result in loss to the buyer, and to the Government on its guarantees. Meantime, while they may temporarily stimulate the building of housing, they are pushing up the cost of building very rapidly and out of all reason. Governor Eccles has testified before you on this subject. While the Advisory Council fully appreciates the desirability of providing more housing rapidly, it fully concurs in Governor Eccles' recommendation made in his testimony before your committee that "Congress should reconsider in the longer term interest of the country the present policy and program of the Federal Government in the field of housing credit.'"

The proponents of the special reserve plan say that it will not reduce bank loans which serve a productive purpose, or even prevent an increase in bank loans which will result in increased production. They argue that if more bank credit is necessary to carry on or increase production, the Federal Reserve Board will either not require a special reserve, or reduce the percentage of the special reserve required.

The weakness of this argument lies in the fact that any banker who is worth his salt, so arranges his loans and investments that he can without dislocating his bank's business meet in a very short time the maximum reserves that could be required of his bank under the law. If the proposed special reserve plan should become law, the banks of the country would in general immediately begin to put their affairs in such shape that they could meet the maximum 25% special reserve in a few months. This would be the case even if the Federal Reserve Board took no action to impose it or any part of it.

With very little stock exchange loans out and with the paucity of commercial paper the banks could do this only by building up their holdings of short government obligations. To get the money they would either sell their longer-term governments or contract their loans by collecting on old ones, and making fewer new ones, or by a combination of both means. If the banks sold longer bonds no one practically would buy them except the Federal Reserve banks. True, the Federal Reserve banks would sell short-term government obligations to the commercial banks as they bought the longer bonds from them. But the very fact that the Federal Reserve banks were buying the longer bonds in large amounts would almost certainly cause many holders of such bonds outside the banking system to sell out of fear that the Federal Reserve banks would not or could not support them at par. The situation might easily become panicky.

To the extent that banks sought to put themselves in a position to meet possible special reserve requirements by collecting old loans or by restricting new extensions of credit, they would almost certainly reduce the amount of loans which would sustain or increase production. The average banker seeking to reduce or even to hold down his loans, would give preference in renewals or new extensions of ctedit to those of his borrowers whose credit was strongest and whose balances were large, without much regard to the effect of his action on the overall production of needed goods. It would be the little fellow, and the one with small capital, that would have difficulty in getting credit, no matter how much their production would suffer from lack of credit, and no matter how desirable their production might be to help bring the supply of goods into relation with demand.

The Special Reserve Plan is impractical and highly inequitable. Thare are about fifteen thousand banks in this country serving communities and customers with widely different needs, and with varying seasonal demands for credit. A bank in a vegetable growing section of Florida, or Texas, for instance, will have a heavy demand for credit during the winter growing season and large deposits with very little demand for loans during the balance of the year. At other seasons of the year similar situations will occur in banks serving areas in Kansas or the Northwest that are predominantly wheat growing sections, or in banks in the south that serve growers of cotton.

Even in the larger centers different banks cater to different classes of customers. One bank may have its customers chiefly in the metal trades, another among contractors and builders and their suppliers, and still another in the needle trades. Each bank will have varying seasonal demands for loans. One bank may draw its deposits almost exclusively from nonborrowers. Another may get most of its deposits from active businesses, most of which will want loans from time to time.

No percentage as high as 25% in a "special reserve" on top of required existing reserves could be applied to all banks without penalizing different sections of the country and different banks in the same section. It would force many banks to refuse loans necessary to maintain existing production. As the Federal Advisory Council said in its memorandum to the Board of Governors, the very banks which have served the business in their communities most aggressively and helpfully would be hardest hit.

The proposed plan would tend towards the socialization of banking and government control over credit in various ways. As the Advisory Council in its memorandum says it would substitute the edicts of a Board in Washington for the judgments of the Board of Directors of the 15,000 banks throughout the country as to the employment of a substantial part of the funds of their banks. It would put into the hands of the Treasury and the Federal Reserve Board the power to control bank earnings even to the point of rendering banking unprofitable. The Treasury could, if the plan ever became law, practically fix any rate of interest it saw fit on the special types of government securities the banks would be required to keep in their special reserve. Even if the rate was as low as one-eighth the banks would have no option but to buy such securities, or hold cash. While the rate on certificates or notes that would be eligible for the special reserve is now one and an eighth per cent, there would be no assurance that a future Secretary of the Treasury might not greatly reduce the rate. With a rate of, say, one-eighth of one per cent on their securities in a special reserve of

25%, and with present maximum cash reserves, banks could not in my opinion earn anything. The possibility that such a condition might ensue would make it very difficult to get investors to put their capital into bank stocks. Banks need increased capital and it is hard enough for banks to get it today, with most bank stocks selling under their liquidating value.

The restriction on the granting of necessary desirable credit which the adoption of the Special Reserve Plan would force on the banks, would lead to a demand that either existing government agencies under present or enlarged powers, such as the RFC, or new government agencies created for that purpose, supply such credit. I doubt if the demand could successfully be resisted. If granted, it would mean that much credit to industry now given by banks would be given by government agencies instead. This would be a long step towards the socialization of credit.

The Federal Advisory Council disagrees with the Chairman of the Board of Governors when he says that the Federal Reserve is without powers to do anything under the existing law. The Board can raise the rediscount rate, it can increase reserve requirements in the two Central Reserve Cities, New York and Chicago, it can tighten up its open market operations, it can use its influence with the Treasury to still further reduce the War Loan accounts which the Treasury still carries. I am not advocating that it use all these present powers to the limit, or that it use them all at once. To do so might easily upset public confidence. Businessmen, bankers and the investing public are today all apprehensive about the future and justly so. They fear a possible early recession and they do not know how severe it might be. In my opinion even a slight change in the rediscount rate, say, a quarter, or a half of one per cent, would have a profound psychological effect, and would cause many businesses to abandon or postpone present plans for expansion and get their affairs in better order. It would also cause bankers to look more closely at requests for loans for capital expansion. Any rise in the reserve required in the two Central Reserve Cities would have a similar psychological effect.

The Treasury and the Federal Reserve Board are to be commended for what they have already done. By doing away with the preferential discount rate, by the unpegging of bills, by slightly raising the certificate rate, by using excess cash balances and budgetary surpluses to reduce bank held debt, and by transferring part of the government debt from banks to private investors they have greatly improved the credit situation. They have brought the long term 2½% governments down close to par, a highly desirable result. Parenthetically and personally I believe that the national interest requires that the long term 2½'s be supported if necessary, and not allowed to go under par, for a good many years to come. The beneficial effect on the attitude of bankers and businessmen of these policies of the Board and the Treasury has been greater than I think Mr. Eccles realizes. The Advisory Council believes that the powers which the Treasury and the Federal Reserve Board still have even though they may be largely psychological make the adoption of any such plan as the Special Reserve Plan with all its dangers unnecessary.

The remedy for the present inflationary situation lies outside the field of monetary policy. It is more production, strict economy by government, national, state, and local, a budgetary surplus which will be applied to the reduction of the debt, and thrift and savings by the people of this country which will provide for the capital plant expansion the country needs and make possible the gradual transfer of a large part of the national debt out of the banking system and into the hands of investors.