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Special Report to the Congress

by the

Board of Governors of the Federal Reserve System, the Presidents of the Federal Reserve Banks, and the Federal Advisory Council

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Federal Reserve Bank of St. Louis

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(Submitted to the President of the Senate and the Speaker of the House of Representatives, December 31, 1940)

FOR the first time since the creation of the Federal Reserve System, the Board of Governors, the Presidents of the twelve Federal Reserve Banks, and the members of the Federal Advisory Council representing the twelve Federal Reserve Districts present a joint report to the Congress.

This step is taken in order to draw attention to the need of proper preparedness in our monetary organization at a time when the country is engaged in a great defense program that requires the coordinated effort of the entire Nation. Defense is not exclusively a military undertaking, but involves economic and financial effectiveness as well. The volume of physical production is now greater than ever before and under the stimulus of the defense program is certain to rise to still higher levels. Vast expenditures of the military program and their financing create additional problems in the monetary field which make it necessary to review our existing monetary machinery and to place ourselves in a position to take measures, when necessary, to forestall the development of inflationary tendencies attributable to defects in the machinery of credit control. These tendencies, if unchecked, would produce a rise of prices, would retard the national effort for defense and greatly increase its cost, and would aggravate the situation which may result when the needs of defense, now a stimulus, later absorb less of our economic productivity. While inflation cannot be controlled by monetary measures alone, the present extraordinary situation demands that adequate means be provided to combat the dangers of overexpansion of bank credit due to monetary causes.

The volume of demand deposits and currency is fifty per cent greater than in any other period in our history. Excess reserves are huge and are increasing. They provide a base for more than doubling the existing supply of bank credit. Since the early part of 1934 fourteen billion dollars of gold, the principal cause of excess reserves, has flowed into the country, and the stream of incoming gold is continuing. The necessarily large defense program of the Government will have still further expansive effects. Government securities have become the chief asset of the banking system, and purchases by banks have created additional deposits. Because of the excess reserves, interest rates have fallen to unprecedentedly low levels. Some of them are well below the reasonable requirements of an easy money policy, and are raising serious, long-term problems for the future well-being of our charitable and educational institutions, for the holders of insurance policies and savings bank accounts, and for the national economy as a whole.

The Federal Reserve System finds itself in the position of being unable effectively to discharge all of its responsibilities. While the Congress has not deprived the System of responsibilities or of powers, but in fact has granted it new powers, nevertheless, due to extraordinary world conditions, its authority is now inadequate to cope with the present and potential excess reserve problem. The Federal Reserve System, therefore, submits for the consideration of the Congress the following five-point program:

1. Congress should provide means for absorbing a large part of existing excess reserves, which amount to seven billion dollars, as well as such additions to these reserves as may occur. Specifically, it is recommended that Congress—

(a) Increase the statutory reserve requirements for demand deposits in banks in central reserve cities to 26%; for demand deposits in banks in reserve cities to 20%; for demand deposits in country banks to 14%; and for time deposits in all banks to 6%.

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(b) Empower the Federal Open Market Committee to make further increases of reserve requirements sufficient to absorb excess reserves, subject to the limitation that reserve requirements shall not be increased to more than double the respective percentages specified in paragraph (a).
(The power to change reserve requirements, now vested in the Board of Governors, and the control of open market operations, now vested in the Federal Open Market Committee, should be placed in the same body.)

(c) Authorize the Federal Open Market Committee to change reserve requirements for central reserve city banks, or for reserve city banks, or for country banks, or for any combination of these three classes.

(d) Make reserve requirements applicable to all banks receiving demand deposits regardless of whether or not they are members of the Federal Reserve System.

(e) Exempt reserves required under paragraphs (a), (b) and (d) from the assessments of the Federal Deposit Insurance Corporation.

2. Various sources of potential increases in excess reserves should be removed. These include: the power to issue three billions of greenbacks; further monetization of foreign silver; the power to issue silver certificates against the seigniorage, now amounting to one and a half billion dollars on previous purchases of silver. In view of the completely changed international situation during the past year, the power further to devalue the dollar in terms of gold is no longer necessary or desirable and should be permitted to lapse. If it should be necessary to use the stabilization fund in any manner which would affect excess reserves of banks of this country, it would be advisable if it were done only after consultation with the Federal Open Market Committee, whose responsibility it would be to fix reserve requirements.

3. Without interfering with any assistance that this Government may wish to extend to friendly nations, means should be found to prevent further growth in excess reserves and in deposits arising from future gold acquisitions. Such acquisitions should be insulated from the credit system and, once insulated, it would be advisable if they were not restored to the credit system except after consultation with the Federal Open Market Committee.

4. The financing of both the ordinary requirements of Government and the extraordinary needs of the defense program should be accomplished by drawing upon the existing large volume of deposits rather than by creating additional deposits through bank purchases of Government securities. We are in accord with the view that the general debt limit should be raised; that the special limitations on defense financing should be removed; and that the Treasury should be authorized to issue any type of securities (including fully taxable securities) which would be especially suitable for investors other than commercial banks. This is clearly desirable for monetary as well as fiscal reasons.

5. As the national income increases a larger and larger portion of the defense expenses should be met by tax revenues rather than by borrowing. Whatever the point may be at which the budget should be balanced, there cannot be any question that whenever the country approaches a condition of full utilization of its economic capacity, with appropriate consideration of both employment and production, the budget should be balanced. This will be essential if monetary responsibility is to be discharged effectively.

In making these five recommendations, the Federal Reserve System has addressed itself primarily to the monetary aspects of the situation. These monetary measures are necessary, but there are protective steps, equally or more important, that should be taken in other fields, such as prevention of industrial and labor bottlenecks, and pursuance of a tax policy appropriate to the defense program and to our monetary and fiscal needs.

It is vital to the success of these measures that there be unity of policy and full coordination of action by the various Governmental bodies. A monetary system divided against itself cannot stand securely. In the period that lies ahead a secure monetary system is essential to the success of the defense program and constitutes an indispensable bulwark of the Nation.

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PRESS EXCERPTS OF CRITICAL COMMENTS
ABOUT DECEMBER 1940 JOINT STATEMENT

January 3, 1941

President Roosevelt was described in authoritative quarters yesterday as contemplating "no fight" against the request of Chairman Eccles and other central banking authorities that his power to devalue the dollar be scrapped at this time. High Administration sources indicated that the five-point program outlined by the Board of Governors, the presidents of the twelve Reserve banks and the Federal Advisory Council would be given consideration and study by the Administration. Stephen T. Early, secretary to Mr. Roosevelt, said at a White House press conference that there would be "no fight" over the proposals so far as the Administration was concerned. (Trib., p. 1)

It is only proper that Mr. Eccles should take the lead in lining up Federal Reserve opinion behind a monetary program at this time. The statement will be to most people unexceptionable, a very able document. It is deserving of the support of Secretary Morgenthau, and one hopes that the Secretary will not hesitate to sacrifice the monetary powers which his department now possesses so that there can be centralization of monetary control in the Administration. (Trib., p. 23.)

Government security prices broke sharply yesterday following the request by Chairman Eccles for added powers to use as an inflation check, but the volume of selling was relatively light. Bankers and bond men agreed that the volume of liquidation would have been substantially greater had the market judged that the Eccles' program would be enacted. Commercial bankers generally expressed favor for the proposal, declaring that in the absence of checks the defense boom might well create an inflation. Among investment bankers, on the other hand, opinion was less uniform. Many of the investment bankers feared that the program, by curtailing the rise of bond prices and perhaps causing a decline, would stop the present movement for refunding outstanding bonds. (J. of C., p.7.)

In view of the Administration's previous monetary policies the special report of the Federal Reserve System might fairly be described as a bombshell. But it is a bombshell that explodes to excellent purpose, that will destroy an unhealthy situation; and it is accompanied by a full set of plans for reconstruction. To some persons Chairman Eccles and others who have been set down as "inflationists" may now appear to be reversing themselves; but they may reply that their action is perfectly consistent with their policy of urging "inflation" to correct a previous "deflationary situation" and urging what might in other circumstances be "deflationary measures" merely to correct what now threatens to become an "inflationary situation." (Ed., Times, p. 18.)

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In the report which he has just presented to Congress, Chairman Eccles has made a very genuine and very important contribution to the national defense program. It is no exaggeration to say that the position of the Reserve Board, with respect to monetary control at the present, can be likened to that in which the New York Fire Department would find itself if it were compelled to fight tenement and office-building fires with ordinary garden hose and kitchen stepladders. The most important of Mr. Eccles's proposals is that the Reserve Board be given the authority to increase legal reserve requirements to the point where the volume of excess reserves would be brought within actual control of the authorities through open-market operations, but the others are equally sound and desirable. (Ed., Trib., p. 18.)

In an article praising the proposal of Marriner S. Eccles for reducing excess reserves, the National City Bank of New York says in its current monthly letter that such a move would be beneficial in three principal ways, as follows: it would relieve the pressure upon interest rates, it would enable the Treasury to place a larger proportion of its securities with the public and it would tend to moderate the expansion of bank credit. (Trib., p. 25.)

January 9, 1941

Opposition to certain phases of the Federal Reserve Board's recent proposals to forestall the threat of inflation through increase of its monetary and fiscal authority was voiced yesterday by Jesse H. Jones. He indicated a belief that the board's plan for statutory doubling of bank reserve requirements would decrease unwisely the lending power of banks. "I haven't seen any indication toward inflation and I don't see why we should expect any such tendency," he said. "I'm trying to get the banks to lend more. I want to see as much bank credit available as possible." (Times, p. 33.)

January 10, 1941

Secretary Morgenthau blamed proposals for the control of credit advanced by Chairman Eccles for the decline which the government bond market experienced on January 2, the first market trading session of 1941. Secretary Morgenthau declined to state what specific point in the Reserve Board statement contributed to the decline in government bonds. "It was that their proposal had that effect," he said. (Trib., p. 20.)

Prices of long-term Government bonds showed marked gains yesterday following the statement of Secretary Morgenthau indicating opposition to the proposal of Chairman Eccles for tightening the credit structure. The gains were based mainly upon the withdrawal of bonds previously offered for sale rather than new buying. The fact that Government bonds fell sharply following the Eccles proposals and advanced when opposition was indicated for bankers clinched the point that high bond prices are based upon the huge volume of excess reserves held by the banks. It was said that this point, taken as a matter of course by bankers and in the market, had been disputed in Washington and in academic quarters. (J. of C., p. 6.)

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As seen in banking quarters, the difference in point of view between Secretary Morgenthau and Chairman Eccles places the Administration in a delicate position. The inference drawn was that the President has not yet committed himself to either side and that his opinion may still be unformed. Commercial bankers are strong supporters of the position taken by the Reserve authorities. (J. of C., p. 6.)

It may be true, as Secretary Jones says, that there is so far no sign of price-inflation, but price-inflation or no inflation, neither central nor commercial bank vaults are the proper home for government obligations in large and increasing quantities when those obligations result from deficit financing. When this sort of financing is pushed to the end, we have the situation exemplified in the experience of the Reichsbank and of the Bank of France during and after the last war - namely, currency inflation. The matter of "excess reserves" is subordinate to the question where the government obligations which we are to issue are to find lodgment. To lodge those with actual owners of capital and their representatives should be the first aim of Treasury financing. (Ed., W. St.,J., p. 4.)

January 13, 1941

According to Representative Fred L. Crawford "the people of this country have a right to expect of and demand from the Board of Governors sound monetary, banking and credit policies. This because the people speaking through the Congress have enacted and keep in force the central banking laws. If a central banking system is no longer desired by the people of this country, then let them ask for a repeal of the Reserve banking system laws and the enactment of new laws to control the money and credit activities and facilities. So long as present laws are in operation, the Board of Governors is duty bound to insist upon sound procedure. That is what it has been doing now for many months and the Congress has largely ignored the pleas of the Board." (Amer.Bkr., p. 1.)

A majority of the bankers will agree with Marriner S. Eccles that the time has come when the central banking system of the country needs new powers to cope with problems arising from the multi-billion defense program. However, Mr. Eccles finds himself in the same position as the shepherd boy in Aesop's fable, who shouted for help because of a wolf when there was no wolf, and when the wolf appeared no one believed him and no one came to his rescue. It is doubtful if the Federal Reserve System will obtain many of the reforms which it is asking for. Irrespective of the sentiment of the bankers, sound economists and Congressional leaders on Capitol Hill, the Reserve Board's proposals may be sidetracked. (N. P. Gregory, Trib., 1/12, #2, p. 11.)

While it is realized that Mr. Morgenthau was acting in character as Secretary of the Treasury in wanting a boundless supply of funds to tap, all hope has not yet been lost that he will yet see that the carrying out of the Federal Reserve's program is not inconsistent with a ready market for Treasury issues and that the saving in interest which low coupons on

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Treasury issues make possible can be trivial in comparison with the losses which the nation may suffer if the large pool of excess reserves is to continue its inducement to inflation. (W. A. Lyon, Trib., 1/12, #2, p. 11.)

The spokesmen for the Federal Reserve System have selected an inopportune time for advocating transference of responsibility in monetary management from the Administration to the banking world. The need of the hour is centralization of authority. In the circumstances, it would seem wiser for Congress to defer until a more normal and quieter time the long term question of recodifying the banking laws, and determining whether the Federal Reserve System or the Treasury should have the ultimate power in the financial field. (M. S. Rukeyser, Journal-Amer., 1/11, p.1.)

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