Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

20

Office Correspondence

Date November 12, 1936.

To Chairman Eccles

Subject: Future Trend of Bank Assets.

F n Lauchlin Currie

L.C.

In accordance with your suggestions I have considerably enlarged my previous note on the trend of bank assets in the next few years. I should be grateful for any further comments or criticisms. Do you think it would be a useful thing to send to the Board and, perhaps, Presidents of the Open Market Committee?

I am now engaged on a memorandum on the monetary situation in relation to excess reserves, attempting among other things to work out a criterion of the "adequacy" or "excessiveness" of the money supply.

LC: R & S.
Confidential
Nov.11, 1936.

THE TREND OF BANK ASSETS IN THE NEXT FEW YEARS

Statement of the Problem

Although it is not possible to be very explicit on this subject its importance in various connections justifies a consideration of the evidence bearing on it. Some people feel that in order to meet the demand for commercial loans on the part of their customers that is anticipated with further recovery, banks will dispose of their holdings of Governments and this will exert pressure on the Government bond market. Of even more importance, the rapidity and extent to which banks expand loans may determine in large part the rapidity and extent to which it may prove desirable to take action with regard to excess reserves.

Conclusion

A survey of the previous experience in this and other countries, and a consideration of the effect of more recent developments, suggests that while the probable increase in the demand for unsecured and secured loans may very well be in excess of the amount by which it is thought desirable to let total earning assets and, hence, deposits, expand, it will probably not be greatly in excess. This view rests on the assumption that the recovery movement will continue to be orderly and will not be characterized by rapid advances in commodity prices. Even the anticipated excess in the demand for loans over the amount by which it is thought desirable to permit total earning assets to increase need not entail a liquidation of bank holdings of Government bonds because (a) a substantial portion of bank holdings is in notes and bills and (b) it is to be expected that the Government will retire and refund a portion of the short-term debt.

Considerations Leading Up to the Conclusion

It would appear, in the first place, that there will be little necessity or disposition to liquidate Governments in order to meet the demand for other types of loans so long as member banks possess an abundance of excess reserves. In view of the magnitude of the expansion of circulating deposits plus outside currency that has occurred since 1933, it is questionable whether it may not be thought desirable to prevent further expansion of the volume of money. If such should prove to be the case, action would have to be taken to return to the condition that prevailed up to 1932 of no excess reserves. The question would then arise as to whether and to what extent banks would liquidate their Governments in order to increase other types of earning assets.

In addition to the expansion of other assets that is possible so long as banks possess excess reserves, there is the expansion that will be possible on the basis of reserves released by a shift from demand to time deposits and on the basis of additional capital and surplus. It is apparent, therefore, that considerable expansion of loans is possible before any necessity would arise for a liquidation of Governments.

We may now look at the matter from the banks' point of view. Banks are as a rule anxious to meet any requirements for loans of their customers which they consider safe. The rates are generally higher than on other assets and the goodwill and maintenance of the customer relationship is a factor. On the other hand, banks have always the problem of liquidity to bear in mind. They feel they need a substantial portion of assets they can realize on quickly without loss of principal or of goodwill.

It is of interest to compare the proportion of earning assets of member banks represented by Governments, call loans to brokers in New York, and acceptances and commercial paper, of 18.6 percent in 1929 with 41 percent in 1936. If, on the latter date, Government guaranteed issues are included, the proportion becomes 47 percent. If only Government notes, bills and certificates are included in each case, the proportions were 10 percent in 1929 and 24 percent in 1936. Even allowing for some increase in liquidity requirements resulting from the experience in the depression, it is apparent that, judged by pre-depression standards, banks have a large portion of their earning assets in liquid form and could well afford to increase their customer loans at the expense of liquid earning assets.

It would appear, therefore, that the amount of expansion of customer loans to be expected becomes more largely a question of the probable demand for such loans than of reluctance of banks to make loans. In approaching this problem it will be helpful to compare the earning assets of member banks in 1933 with the earning assets in 1929. This is done in the following table:

Member Bank Loans and Investments, June 1929-36.[1/] (In millions of dollars)

	1929	Percent	1936	Percent
Government Obligations				
Bills, Certificates and Notes	1,150	3.28	6,426	19.97
Bonds	3,005	8.58	5,295	16.46
Total	4,155	11.86	11,721	36.43
Guaranteed	-	-	1,951	6.06
Total direct and guaranteed	4,155	11.86	13,672	42.49
Other Securities	5,898	16.83	6,045	18.79
Total Securities	10,053	28.69	19,717	61.28
Loans on Securities				
To brokers in New York	2,025	5.78	1,079	3.35
To others	7,734	22.07	3,130	9.73
Total	9,759	27.85	4,209	13.08
Loans on Real Estate	3,164	9.03	2,340	7.27
Acceptances & commercial paper	447	1.28	557	1.73
All Other Loans	11,618	33.16	5,355	16.64
Total Loans	24,988	71.31	12,461	38.72
Total Loans & Investments	35,041	100.00	32,178	100.00

1/ Exclusive of interbank loans.

This table serves the purpose of bringing out the absolute and percentage changes in the composition of the earning assets of member banks since 1929 and indicates the magnitude of changes the restoration of the 1929 composition would entail. The big changes, of course, have been the increase in Government direct and guaranteed issues and the declines in loans on securities and "All Other Loans". It is interesting, however, to note that Government bonds are only $2.3 billion in excess of 1929, although if guaranteed issues are included the increase is $4.2 billion. The big increase in Governments has been in bills and notes. Non-member insured banks on June 30, 1936, held approximately $500 million of Government bonds and $300 million of guaranteed issues. The figures would be still further increased by the inclusion of non-member non-insured banks.

It is now proposed to examine separately the prospects of expansion in the various types of earning assets. We will then be in a better position to weigh the probabilities of a decline in bank holdings of Governments.

Unsecured Loans

1. Movement of "All Other Loans", 1921-29, 1933-36. From June 1921 to June 1923 the index of production rose from 65 to 106. In the same period national bank loans other than on securities and real estate declined $607 million, and holdings of Government securities increased $370 million.

From June 1923 to June 1929 the index of production rose from 106 to 125. Loans other than on securities and real estate of national banks decreased by $714 million, or 9 percent. Their holdings of Government securities increased $110 million. In the same period the Government debt outstanding decreased by $5,369. In interpreting these facts a plausible explanation appears to be as follows:

New loans were undoubtedly being made in the sharp recovery from 1921 to 1923. The total outstanding declined, however, as a result of the heavy liquidation of loans that had been carried over from the peak of 1920. Moreover, the price level stabilized at a considerably lower level than prevailed in 1919-20, and the requirements for working capital were lower on this account. From 1923 to 1929 unsecured loans continued to decline, although the index of production rose. This behavior appears to be in large part attributable to the lessening economic importance of those individuals and concerns that comprise the bulk of borrowing customers, and in part to the increasing ability to finance expansion in ways other than by bank loans. I may quote what I have said elsewhere on this subject: 1/

> "Upon the basis of an investigation into the accounts of 729 companies, divided into 30 groups, for which comparable balance sheets were available from 1922 to 1928 inclusive, the writer sought to explain the decline in bank loans as due to a recognition of the extent to which loans intensify the dangers

1/ The Supply and Control of Money in the United States, p. 41.

of a drastic decline in net earnings and of insolvency, should gross earnings decline.1/ Although only the larger companies were studied it is highly significant, in view of the apparent trend toward large scale enterprise, that the companies that were growing most rapidly and should on that account require larger loans, actually reduced them to a nominal figure, while companies whose earnings were low or declining were carrying heavy bank loans and in some cases actually increasing them. It appeared that the desire to liquidate loans pervaded all industry, since in those cases where loans were still relatively heavy in 1928 the ability to liquidate was lacking. It was inferred, moreover, from this study that the great bulk of commercial loans were being made to farmers and relatively small business concerns. If economic progress continues to be associated with the increasing importance of the larger corporations having access to the stock and bond markets, there is a strong probability that the commercial loan will continue to decline in the future."

1/ The Decline of the Commercial Loan, Quarterly Journal of Economics, August, 1931, pp. 698-709.

Our past experience appears to have some relevance to recent developments and future prospects. During the recovery from 1933 to 1935, the volume of liquidation and write-offs of old loans of member banks exceeded the volume of new loans made, so that the total declined by $23 million despite an expansion of business activity. In 1935, however, new loans being made began to exceed old loans paid or written off, and the total for reporting member banks increased $693 million from October 1935 to October 1936. The fact that all other loans have begun to expand before full recovery is achieved, which was not true in 1921-23, is perhaps partly attributable to the extremely heavy liquidation that had already occurred in the period 1929-33, and partly to the relatively more favorable recovery of agriculture in the present movement.

The trend noticeable in the Twenties, where it appeared that broadly speaking only those industrial and commercial concerns that could not easily raise money elsewhere borrowed from banks, may be expected to continue. In fact the experience of the depression has served to emphasize anew the dangers associated with short-term indebtedness. From the point of view of this long-term trend, therefore, we would expect the proportion of other loans to total loans and investments to be less in the future than in the Twenties.

2. Bank Loans and the Recovery in Other Countries. The co-existënce of increasing business activity and declining bank loans experienced in this country from 1921 to 1923 and from 1933 to 1935 is not peculiar to this country. As the following table indicates, the same divergent movements took place in the United Kingdom, Canada, and Sweden in recent years, though in the past year an upturn in loans has occurred in the United Kingdom.

In interpreting these figures it should be borne in mind that the decline from 1929 was far less steep in England and Sweden, and hence that the percentage rate of decline and recovery in the United States is much greater. Another factor was the decline and subsequent increase in bank loans in the United States attributable to bank closings and the subsequent taking over in part of loans from closed banks. We should, therefore, expect loans to decline more rapidly in the United States and show a greater degree of recovery.

Bank Loans in United Kingdom, Canada, Sweden and the United States, 1929-36, and Yearly Average Index of Production.

	United Kingdom		Canada		Sweden		United States	
	Loans to customers (millions of £)	Index of Production	Loans & discounts other than on secur. (mill.of Canad.$	Index of Production	Loans & overdrafts (millions of kronor)	Index of Production	All other loans (millions of dollars)	Index of Production
1929. .	996	100.0	1,434	100.0	3,203	100.0	11,618	100.0
1930. .	976	92.3	1,425	84.8	3,409	99.3	10,349	80.7
1931. .	926	83.8	1,263	71.0	3,392	95.4	8,744	68.1
1932. .	856	83.5	1,211	58.1	3,031	90.1	6,892	53.8
1935. .	780	88.2	955	60.3	2,763	126.9	4,834	63.9
1936. .	852	115.1 1/	777	87.6 2/		135.8 2/	5,355	86.6 2/

1/ Second quarter.
2/ June.

3. Other Considerations Bearing on the Future Movement of "All Other Loans".

American industry as a whole appears to have more cash and be in a more liquid position than in 1929. A considerable expansion of activity could, therefore, be financed without entailing the necessity of raising new money. Too much emphasis should not be put on this factor, however, since, for one thing, industry may prefer to remain more liquid than heretofore and, for another, a general condition of liquidity is quite compatible with the existence of a shortage of working capital on the part of small manufacturers, merchants, and farmers, who make up so large a proportion of the borrowers from banks. The requirements of farmers, on the other hand, are likely to be met more largely by agencies other than commercial banks than was true formerly.

It is reasonable to assume that the future character of the recovery movement will have an important influence on the demand for commercial loans. If the movement is steady and orderly in character and is not accompanied by any marked rise in prices, working capital requirements will be less than they would be if the movement assumes the proportions of a boom and rapid increases in prices occur. This reasoning receives some confirmation from a contrast of the 1917-20 experience, which was a commodity and general business boom, with that of 1923-29. Loans of national banks other than on securities increased $3.8 billion, or 59 percent, in the earlier period as contrasted with a decrease of $714, or 9 percent in the period 1925-29 in such loans.

To this point most of the considerations mentioned appear to suggest that on balance a moderate expansion only of "All Other Loans" is to be anticipated if the recovery movement continues orderly and rapid price advances are avoided. There are two considerations, however, which point in the opposite direction. One is an increase in "All Other Loans" of reporting member banks in the past year. If the same amount of expansion took place in the next four years this would mean an increase of $2.8 billion. If, however, the same rate of increase occurs, the expansion would be $4.5 billion. It would be very helpful if more were known of the nature of the increase that has occurred. It may in part represent the taking over of existing loans by member banks, in part an expansion in installment selling, and in part loans for capital purposes which are expected to be refunded. The trend in the next six months in comparison with the trend in the previous year should afford some clue as to the permanence and strength of the recent movement.

A factor which is now present but which was lacking in the Twenties is a tax on undistributed earnings. While it is not expected to induce the larger companies having access to the stock and bond markets to borrow from banks, it may very well have this effect on the intermediate-sized corporations which have no access to the capital markets and which may experience some difficulty in getting some two or three hundred shareholders to take up rights to subscribe for new stock. In such cases there is an added inducement to distribute earnings in dividends and finance working capital requirements by means of bank loans.

Eespite the increase that has occurred in the past year and the uncertain effect of the new tax on undistributed earnings, previous experience in this and other countries would appear to suggest that "All Other Loans" will not regain the proportion of total loans and investments they represented in 1929 and that it is doubtful if they will regain the absolute level then prevailing. In other words, assuming the absence of rapid price advances, it seems more likely that "All Other Loans" will expand some $3 or $4 billion, rather than by the $6 billion necessary to restore the 1929 level.

Security Loans.

The only comparable series of loans on securities covering the post-war decade is that for national banks. This type of loan increased from $2.7 billion in 1921 to $5.5 billion in 1929, or by $2.8 billion. In 1921 they comprised 17 percent of national bank loans and investments, in 1923 eighteen percent and in 1929 twenty-five and a half percent.

It appears improbable that security loans will increase as rapidly in the next few years. For one thing, many people of this generation have had a disastrous experience with margin trading and the caution thus engendered may be expected to last for some time. Of more importance, however, is the requirement for higher margins than prevailed in the Twenties. It is perhaps not unreasonable to expect that any tendency toward a rapid increase in security loans will be checked by higher margin requirements. On the other hand, there may be more of a tendency for commercial loans to be backed by collateral.

Loans on Real Estate.

Although the increase in residential building has not as yet been reflected in any increase in bank loans, this is probably owing to the continuance of liquidation of old loans. It is to be anticipated, however, that loans on real estate will experience considerable rise in the next few years. Various factors should contribute to this end. In the first place, there are the new provisions of the Banking Act of 1935, and the new opportunities to assure against loss afforded by the Federal Housing Administration. The latter are of particular importance in the case of thinly-margined mortgages. Secondly, the probable continuance of low yields on securities, acceptances, commercial paper and call loans, and the present strong liquid position of banks will combine to enhance the attractiveness of real estate loans. Thirdly, there appears to be a strong likelihood of a very heavy volume of building construction in the next few years.

While, therefore, it is to be expected that the bulk of mortgage lending will continue to be handled by agencies other than commercial banks, there is a possibility that loans on real estate by commercial banks may double in the next few years. With reference to our main problem, however, it may be pointed out that this would mean an increase of only two billions.

Acceptances and Commercial Paper.

It appears unlikely that the growth on these types of loans will be of quantitative significance. Even if the total of acceptances rises to the level of the late Twenties, this would mean a net expansion of only some $700 million.

Other Securities.

Member banks hold slightly more other securities than they did in 1929 and the proportion of earning assets represented by other securities has increased from 17 percent to 19 percent. It seems probable, therefore, that banks will be somewhat reluctant to increase their holdings by any substantial amount unless they have excess reserves which they can utilize in no other manner. The more stringent definition of investment securities may also be a factor.

Government Securities

Total holdings of Government securities, direct and guaranteed, increased from 12 percent of member bank loans and investments in 1929 to $42\frac{1}{2}$ percent on June 30, 1936. Long-term Governments, direct and guaranteed, showed a much less rapid increase. They amounted to $22\frac{1}{2}$ percent of member bank earning assets on June 30, 1936, as compared with $8\frac{1}{2}$ percent in 1929. In view of the magnitude of the increase, the prospects of little additional increase in the Federal debt, and the signs of an upturn in the demand for bank loans, it is likely that member bank holdings of Government securities are now at or near their peak. If they do not increase further, the proportion they represent of member bank loans and investments will decline as other earning assets increase.

Whether bank holdings of Governments will experience an absolute decline and if so, by what amount, appears to depend more largely on the rapidity of debt retirement by the Government and the policy with regard to funding short-term issues than on the pressure to liquidate arising from the expansion in the demand for other types of loans. This conclusion is based on (a) the probable moderate expansion in the demand for other types of loans, (b) the possibility of increasing total earning assets and (c) the scarcity of other types of liquid earning assets. While the probable increase in the demand for unsecured and secured loans may be in excess of the amount by which it is thought desirable to permit total earning assets and, hence, deposits to expand, it will probably not be greatly in excess. In the meantime it is to be expected that a portion of bank holdings of short-term Governments will be retired and refunded, so that the total bank holdings of all Governments will decline. In other words, there appears little likelihood that banks will be under the necessity of liquidating their holdings of Government bonds in order to satisfy local requirements for loans.

If the expansion in the demand for loans is less than anticipated, if substantial debt retirements by the Federal Government are not effected and if a substantial part of the short-term debt is not converted into long-term issues, it is quite possible that banks will retain the bulk of their present holdings of Governments. This may even prove to be the case if some 20 or 30 percent of the notes are retired or converted into long-term issues. All insured banks now hold only 46 percent of the total of notes outstanding and even including the Federal Reserve Banks they hold less than 60 percent. The liquid character of such notes may lead banks to increase the proportion of the total outstanding they now hold. A table showing the proportions of the total of various classes of Government direct and guaranteed issues held by the member banks, insured banks, and Federal Reserve banks is appended.

Another factor that has a bearing on this subject is the possible liquidation of a substantial amount of notes and bills held by the Federal Reserve banks. Member banks may be expected to absorb a portion of such notes and bills and this would tend to keep up their total holdings of Governments.

Still another factor of uncertain effect would be a rise in long-term interest yields and a fall in bond prices. This might induce a certain amount of liquidation of bonds by banks. It is interesting to note, however, that banks maintained their holdings of Governments in 1928-29 despite the rise in interest rates and the active demand for loans that prevailed at that time.

The preceding discussion serves, among other things, to indicate the important bearing of refunding operations on monetary policy. If, for example, it is found that the conversion of notes and bills into long-term issues leads to a substantial decline in the total holdings of Government securities of banks, such operations would serve to offset an expansion of loans which would otherwise result in an expansion of total deposits. On the other hand, in so far as banks decline to convert short into long-term issues, the rate of interest at which the short-term debt can be converted into long-term debt will be higher than it otherwise would be. Individuals and agencies other than banks must be induced to increase their total holdings of Governments and this will absorb financial deposits otherwise available for investment elsewhere.

A table showing the holdings of Government securities, other securities, and loans of commercial banks in England, Canada and Sweden, is also appended. This table indicates that to date there has been no reduction in the commercial bank holdings of Government securities in these countries.

AMOUNT AND PROPORTIONS OF VARIOUS CLASSES OF THE PUBLIC DEBT HELD BY VARIOUS CLASSES OF BANKS, 1934-1936.

	June 30 1934	June 30 1935	June 30 1936
Total direct outstanding	26,480	27,645	32,989
Member banks	9,137	9,871	11,721
Percent	34.5	35.7	35.5
Insured banks	9,708	10,470	12,515
Percent	36.7	37.9	37.9
Federal Reserve banks	2,432	2,432	2,430
Percent	9.2	8.8	7.4
Bonds	16,510	14,936	18,628
Member banks	4,838	4,458	5,295
Percent	29.3	29.8	28.4
Insured banks	5,210	4,889	5,817
Percent	31.6	32.7	31.2
Federal Reserve banks	468	317	316
Percent	2.8	2.1	1.7
Notes	6,932	10,501	11,861
Member banks	2,871	4,313	5,160
Percent	41.4	41.1	43.5
Insured banks	3,047	4,476	5,428
Percent	44.0	42.6	45.8
Federal Reserve banks	605	1,511	1,494
Percent	8.7	14.4	12.6
Certificates	1,635	156	146
Member banks	637	-	-
Percent	39.0	-	-
Insured banks	656	-	-
Percent	40.1	-	-
Federal Reserve banks	265	-	-
Percent	16.2	-	-
Bills	1,404	2,053	2,354
Member banks	791	1,099	1,266
Percent	56.3	53.5	53.8
Insured banks	794	1,105	1,270
Percent	56.6	53.8	54.0
Fed.Reserve bks.bills & certificates 1934	477	604	620
Percent	34.0	29.4	26.3
Fully guaranteed outstanding	681	4,123	4,718
Member banks	276	1,558	1,950
Percent	40.5	37.8	41.3
Insured banks	298	1,882	2,257
Percent	43.8	45.6	47.8

COMMERCIAL BANKS' EARNING ASSETS, CANADA, SWEDEN, UNITED KINGDOM, [illegible], 1929, 1933-35.

Canada

(Money figures in millions of Canadian dollars)

Year June 30	Dominion & Provincial Government Securities		Other Securities		Other loans & discounts		Other earning assets		Total	
	Amount	% to Total	Amount	% to Total	Amount	% to Total	Amount	% to Total	Amount	% to Total
1929	352	13	173	6	1,434	51	861	31	2,820	100
1933	639	28	222	10	1,057	46	383	17	2,301	100
1934	654	29	183	8	1,018	45	398	18	2,253	100
1935	839	36	179	8	954	41	336	15	2,308	100

Sweden

(Money figures in millions of kronor)

Year Dec. 31	Total Securities		Loans outstanding & overdrafts		Other earning assets		Total	
	Amount	% to Total	Amount	% to Total	Amount	% to Total	Amount	% to Total
1929	395	9	3,203	69	1,047	23	4,645	100
1933	462	10	2,803	63	1,166	26	4,431	100
1934	640	14	2,750	61	1,117	25	4,507	100
1935	648	14	2,763	61	1,140	25	4,551	100

United Kingdom

(Money figures in millions of £)

Year June 30	Govt. Secur.& Treas.Notes 1/		Other Securities		Loans to customers 2/		Other earning assets		Total	
	Amount	% to Total	Amount	% to Total	Amount	% to Total	Amount	% to Total	Amount	% to Total
1929	313	19	38	2	996	61	278	17	1,625	100
1933	707	40	35	2	779	44	255	14	1,776	100
1934	625	37	46	3	761	45	245	15	1,677	100
1935	727	41	53	3	779	44	231	13	1,790	100

1/ Includes British Government bonds and Treasury bills, estimated for the 10 London clearing banks, on the basis of data from the banks making such reports. The estimates for '33 & '34 are less reliable than '35, tho all estimates tentative

2/ Advances & items in transit.