ANALYSIS OF EFFECTS OF FLOTATION OF LARGE POPULAR

GOVERNMENT BOND ISSUE ON BANKING AND ECONOMIC STRUCTURE

By M. S. Eccles -- March 31, 1933

It has been indicated that the Government intends to float a great popular bond issue in the near future, accompanied by a grand patriotic campaign, such as was used during the period of the war. In my opinion this would have very serious consequences on our banking and economic structure and would be a grave mistake.

The special research report of the National Industrial Conference Board as of January 30th, covering the position of the banks of the country exclusive of mutual savings banks, shows that approximately 60% of bank deposits are held by banks in 63 of the reserve cities, amounting to 5% of the banks in number, and that 40% of the deposits are in the remaining banks, representing 95% of the banks in number. Fictitious figures used in banking reports conceal a depreciation of assets in the banks making up the 95%, averaging about 14% even by estimates which are reasonably favorable to the banks. This depreciation has, according to such figures, wiped out all of the reserves, all of the undivided profits, all of the surplus and 84% of the capital of these banks in the average. Since the Bank Holiday, these banks, with the exception of a small percentage, have been allowed to reopen on an unrestricted basis due to a liberal classification on the part of the Treasury Department as well as the various state banking departments, and the President has given the American public assurance that they can have absolute confidence in these banks. From a practical standpoint, this no doubt was absolutely necessary in order to prevent complete paralysis of our entire economic life. These banks are largely in the debtor sections of the country, in the smaller cities and throughout the agricultural areas. With but few exceptions, their assets are almost 100% frozen and many of them have already pledged their best assets with the Reconstruction Finance Corporation, the Federal Reserve Banks and the large banks in the reserve cities. The surplus funds and excess reserves of the country are held entirely by the banks in the 63 reserve cities holding 60% of the deposits, the creditor sections. The deposits of the smaller banks have shrunk to a point where but few of them are able to operate profitably so as to build up reserves to meet losses.

Postal Savings have increased to an astonishing amount, particularly in the territories of the smaller banks where these funds are most needed; in other words, the Government has received the use of these funds at the expense of the local communities. Due to the assurance given to depositors by the President of the safety of the banks licensed to open confidence is somewhat improved since the Bank Holiday, and yet it has not been sufficient to bring money out of Postal Savings into the banks, or to bring out hoarded currency in important amounts except in the larger cities.

Due to no improvement in the unemployment or general price structure, the optimism of two weeks ago has now entirely subsided and people are beginning to gradually lose confidence and are becoming restless again. A grand patriotic campaign by the Government to float a large bond issue to be popularly subscribed would simply raise havoc with thousands of banks, because many of the depositors, who would like to get their money out but can not do so on account of hoarding restrictions, would immediately take advantage of the excuse to withdraw their funds to put into government bonds which would likely bear an interest rate as large as, and in many cases in excess of what the banks are able to pay them on their deposits. The effect of this would be the drawing out of hundreds of millions of dollars from the great debtor or agriculture sections of the country, which are already so short of funds, and the concentration of these funds in the Federal Reserve Banks and banks of the larger cities having surplus government securities with which to secure these funds. It would be absolutely impossible for many of the country banks to meet such withdrawal of funds, and, therefore, many of them would ultimately be forced to close. The closing of any material number of banks which have reopened would completely destroy confidence not only in the entire banking structure but in the President and the administration, and would again precipitate another financial crisis.

It may be argued that all banks now should be able to meet deposit withdrawals for the purchase of government bonds or otherwise by borrowing from the Federal Reserve Banks on their slow assets, where they have no other kind. This is objected to on the ground that increased borrowings to take care of withdrawal deposits, which go entirely out of the banks' territory and into the larger cities or creditor sections, can only result in a further maldistribution of deposits and in decreasing the size and increasing the losses of the smaller banks. There may be some necessity and justification for them to borrow from the Federal Reserve Banks to take care of the minimum requirements of the community which are necessary to sustain it, but to borrow, pledging their best assets with a margin as required by the Federal Reserve Banks of from 50% to 100%, in order to meet withdrawals made to purchase government bonds is not justified and is in no degree being fair to those depositors who still retain any of their money in the banks.

A popular bond issue floated by the Government would create no new money and would only result in the withdrawing of billions of the already greatly shrunken bank deposits, causing a further great contraction in bank credit when this credit should be available for normal business purposes.

I fully recognize the need of the Government raising large sums of money with which to carry out its necessary reconstruction program. From three billion to five billion dollars, and more if necessary, must be gotten out very soon in some manner to the points of consumption if the economic pump is going to be primed and a permanent improvement started, otherwise deflation with decreasing purchasing power and increasing unemployment will continue, bringing about complete bankruptcy and collapse. The Government should adopt a method of financing which will be inflationary in character unless it desires to exclude the only thing which could be effective in improving the general economic situation.

If the Federal Reserve Banks, under the new Banking Act, can loan to any and all banks on government securities as well as on all other sound assets without being required to support this credit by gold, then why can not and should not the Treasury Department sell direct to the Federal Reserve Banks such bonds and notes as may be necessary to raise the funds required? This method would be equivalent to creating an amount of new money or credit equal to the Government's securities purchased by the Federal Reserve Banks from the Treasury, and would tend to bring about the necessary controlled inflation as these funds were put out by the Government to the points of consumption. As business improved and prices rose, deposits would increase in all banks and at that time the Federal Reserve Banks could sell in the open market the government securities held by them as such securities could be absorbed without seriously disturbing the banking structure. This action by the Federal Reserve Banks would assist in controlling the amount of inflation desired. The purchase by the Federal Reserve Banks of all government securities until conditions improve would tend to support the market for the large amount of government bonds now outstanding.

It may be argued that one of the purposes for making a popular patriotic drive is to bring money out of hoarding into government bonds. This was tried, without success, through the Baby Bond issue offered to the public during the anti-hoarding campaign about a year ago, when conditions were not nearly so bad as they are now. Hoarding would soon cease to be a problem if the Government would cheapen the value of money through a financial operation as above suggested, which would substantially raise the price structure and thus relieve the burden of debts and reduce the number of unemployed.