FEDERAL ADVISORY COUNCIL

May 20, 1940

Under date of April 27, 1940, the Federal Reserve Board, through its Secretary, asked the following

QUESTION

> "The Council has urged upon the Board the 'modification of the policy of extreme easy money'. The Board would like to have the opinion of the Council as to the more important causes of the 'easy money' conditions; as to what actions within the power of the Board of Governors would be desirable and effective in the public interest; and as to the probable consequences of such actions."

ANSWER

I - Causes

In the unanimous opinion of the Council, the more important causes of extreme "easy money" are:

1. The adoption by the Federal Reserve Board of "easy money" as a guiding policy, and its continuous advocacy in annual reports, other publications, at Congressional hearings, in advice to the Executive, and in public addresses and press interviews. The Board should not underestimate the influence it has exercised, or the responsibility it has assumed before the public, the Congress, and other governmental agencies, by repeatedly defining "easy money" as the official monetary objective of the highest responsible monetary authority in the land. The following quotation from its 1939 report to the Congress is one of many which define that objective.

"In recent years it has been the policy of the Government and of the Federal Reserve System to encourage the expansion of credit. This has constituted the so-called policy of monetary ease, which has been directed at keeping banks supplied with an abundant volume of reserves, so as to encourage them to expand their loans and investments. This policy has been one of the factors in the creation of the existing large volume of deposits in the hands of business enterprises and of individual and corporate investors, and has resulted in reducing interest rates to the lowest level in history.****

"Nor is there any immediate reason for considering a reversal of this policy." (Report submitted January 27, 1939)

As far as the Council is aware, the Board still advocates the doctrine of "easy money" and is taking no steps to set up warning signals against the evil effects of the extreme to which it has been carried and of the dangers of its continuance, nor to evolve any long range plans to eliminate some of its causes or to counteract its consequences. The Council believes that this policy has failed after years of trial to bring about its pre-announced objectives--namely the expansion of private borrowing, the stimulation of business and the reduction of unemployment and that the dangers of the extreme to which it has been carried are now so apparent that the Board should publicly advocate its modification.

2. The expansive open market operations of the System beginning toward the end of 1929, continuing for several years, and never reversed in principle. (Note Annual Report of the Board dated June 18, 1937.)

3. The too long delayed reduction of the portfolio of Government bills thereby forcing interest rates on bills to the vanishing point. The repetition of that process in the case of the Government bonds acquired last autumn and retained (except for some relatively small sales) in the face of a market that rose steadily until a few days ago—despite the fact that so great a volume was not needed for the maintenance of the System. As hitherto stated, when repeatedly advising sales, the Council is of the opinion that it was and is unhealthy for the central monetary authority to retain as a fixed policy a large volume of Government obligations.

4. The unprecedented spending program of the Federal Government, which necessitated borrowing and inevitably induced the authorities to exercise their influence in the direction of keeping interest rates at a minimum. Deficit financing and official pressure for "easy money" go hand in hand. Furthermore, to the extent that the Government has borrowed from commercial banks, and dispersed the funds, an increase in the aggregate of deposits has resulted, intensifying the pressure upon interest rates.

5. A series of other policies of the Federal Government tending to increase the <u>supply</u> of funds or the volume of excess reserves, or both, such as:

(a) The increase in the dollar price of gold, thereby encouraging the production of that metal;

(b) The discontinuance of the practice of sterilizing incoming gold;

(c) The policy of purchasing silver far above its world price and issuing silver certificates therefor on the basis of the artificial valuation;

(d) The creation of scores of lending agencies which, avowedly established for emergency purposes, are apparently perpetuating themselves, and are lending taxpayers' funds at progressively lower rates, often in competition with the taxpayer himself;

(e) The Johnson Act and the "cash-and-carry" provisions of the neutrality laws upon the merits of which the Council does not express an opinion but which, in effect, are impelling most of the leading foreign powers to ship us gold or to go without indispensable supplies.

6. The series of policies of the Federal Government tending to decrease the demand for funds on the part of business enterprise. The Council has no wish to appear to enter into the field of political controversy, and therefore contents itself with stating, purely objectively, that it is its belief that the concept of more and more state interventionism, expounded by many Government officials as a universal remedy, and the growing practice of it, have exercised and are exercising a depressant effect upon new capital demand in many fields, with the result that even at the prevailing low money rates, relatively little new industrial borrowing for other than refunding purposes has taken place.

(7) The developments abroad that have led to the repatriation of American capital and have caused huge shipments of gold to this country by foreigners,—both operations that have vastly contributed to our excess reserves, thereby affecting the interest rate structure. The Council believes that we should continue to accept incoming gold, but notes that no steps are being taken to attempt to offset this influence upon our credit structure.

The Council has mentioned this important cause last, not because it does not recognize its dominant influence, but because it feels that this cause should not be permitted to overshadow the many other important causes, enumerated above, or to create any misconception that "easy money" has been thrust upon the responsible monetary authorities against their wills.

II - Action to Be Taken

In the opinion of the Council, there is no more important public service which the Board and its members can perform than to use their influence in every direction possible to bring an end to the period of extreme "easy money". Among the steps to that end that might be taken are:

1. Let the Board publicly announce that in the light of events, it is modifying its former policy of extreme "easy money" and will exercise its powers, particularly those of counsel and persuasion, to reverse the trend. This does not mean credit stringency or high interest rates,

but means only a recognition of the fact that extremely "easy money" is reducing the purchasing power of millions of American citizens, and is creating hardship without compensating advantage in stimulating business or reducing unemployment.

2. Reduce the Government portfolio at the earliest opportunity and adhere consistently to the policy of purchasing Governments only to offset manifestly disorderly or panicky markets and to dispose of such purchases as soon as circumstances permit.

3. Exert the Board's influence with the Treasury, directly and through the Open Market Committee, against the choice of methods of Government financing which would tend to make money rates still lower or to increase excess reserves by the use, for example, of silver seigniorage "profits" or similar "funds" to avoid the debt limit. Indeed there should be public opposition to all such devices that can but create more excess reserves and more extreme low rates.

4. Exert its influence upon the Treasury toward the establishment of a policy in offering Government securities which would encourage their purchase as far as possible by investors—such as individuals, life insurance companies, trusts, etc.—rather than by the commercial banking system.

5. Accept the role customarily exercised by the central monetary authority of "keeper of the Government's financial conscience", and in that capacity actively and openly insist upon the elimination of the several menaces to the financial structure, many of which, among

other things, would still further increase excess reserves, such as the power to issue greenbacks, further to devalue the dollar, etc.

6. Consider plans, on a long range basis, which may at the proper time be recommended for the purpose of coping with the gold and silver problems, such as the question of reestablishing a full gold standard with the resumption of specie payment, readopting sterilization (any such sterilized gold to be released only with the approval of the Open Market Committee), reconsidering the silver program, alteration of the legal reserve requirements, and use of existing legal powers in these respects. With reference to the adoption of any of the foregoing measures the Council recognizes that the prevalence of war conditions may make the matter of timing one of extreme importance.

7. If the Board is unprepared to take any or all of the foregoing steps, we urge that it enter upon the study of the probable long range consequences of the extreme "easy money" policy, which the Council recommended to the Board in February of last year, when it expressed the belief that the probable fundamental consequences of this policy had not been fully appreciated. The Board then replied, in effect, that it considered that such a special independent study was not required. The Council cannot share this view. Last June it detailed what, in its judgment, had been some of the evil consequences of extreme "easy money", and expressed the opinion that present tendencies contained grave threats for the future. It is unnecessary to repeat this lengthy resolution here. No answer has been received by the Council, and the Council is

still unaware as to how far, if at all, the Board shares its views. Such a study is clearly within the power of the Board and the Council believes that it is highly desirable in the public interest.

It seems to the Council that the Board should make the difficult effort of projecting itself five to ten years into the future and reach conjectures, assuming a continuation of the present extreme "easy money" conditions, as to the then probable economic results. For example:

1. What will be the condition of the commercial banks?

2. What will have happened to the mutual savings banks and to the principal and interest of the millions who have entrusted their hard-earned savings to the care of such institutions?

3. What will have happened to the cost of life insurance and the return therefrom, and to the income received, or to be received, by the beneficiaries of the sixty million persons who are paying for life insurance or annuities?

4. What will be the aggregate debt burden of Federal and local governments?

5. What will be the position of the operations, and staff of our great private and semi-public hospital, educational, religious, and charitable institutions throughout the land, dependent in large measure upon income from the generous endowments that private enterprise has contributed in the past?

6. What will have happened to the purchasing power of the army of the hard-working and thrifty who have set something aside for

their old age or a rainy day?

7. What will be the effect on additional unemployment, arising out of the inability of persons whose incomes from investments are reduced, to continue their usual purchases of goods and services? Is not this whole class being subjected to a veiled form of taxation if the rates of interest are artificially forced, say one per cent, below what would otherwise be operative?

8. What are the probable advantages to offset the imperilment of our commercial banks, our savings banks, our assurance funds, our endowment funds, and the hardship to those who live on their savings, to widows and children of those deceased?

This enumeration of questions is merely illustrative of many more.

III - Consequences

The Council believes that in the long run the consequences of action in the direction of a reversal of the policy of extreme "easy money" would be beneficial to our economy and would help toward a partial restoration of confidence in the future of private enterprise, which is the condition precedent to sustained recovery and which represents the only alternative to state socialism or worse. The Council believes that the Board might take a leaf from the book of British experience since the beginning of the depression. While believing in, and practicing, a policy of "easy money", the British authorities were careful to avoid the pitfall of extreme "easy money", because they recognized that "easy money" is a destructive influence if pushed too far. Thus, for example, the authorities collaborated with the market in preventing the ninety day bill rate from falling below one half of one per cent. What relation this sounder administration of the policy of "easy money" had to the British recovery, which was much more rapid and complete than here, is a matter of opinion, but its objective of protecting the banking system, and investment generally, is manifest. The Council maintains no argument for high interest rates, as such. Indeed, in an atmosphere of confidence and given sound underlying conditions, low interest rates often have a beneficial effect upon business and the economy generally. But abnormally low interest rates, due in part to the persistent efforts of Government interventionism, create uncertainty and have a depressing effect upon the economic structure. They are certainly not a natural accompaniment of a situation where enormous Government deficits are piling up and more are frankly predicted, where taxes are steadily mounting, accumulated wealth steadily being consumed, and business confidence fundamentally lacking.

In expressing the view that the consequences of a change of trend would be of a beneficial character, the Council recognizes that existing complexities of the economic and political situation are such that confident prediction as to the consequences of any single remedial step is hardly warranted. The failure of prices to respond, except fleetingly, to the change in the gold content of the dollar, the breakdown of the "pump priming" experiment, the failure of the policy of stimulating spending by taxing undistributed earnings, the failure of the "easy money" policy as a stimulant to new private borrowing, are all illustrations of the dangers of definite prediction in a world where the normal operations of economic laws are frustrated by one artificial device after another. It cannot be expected, therefore, that damage done by a single policy will be instantly remedied by a modification of that policy alone, but the Council does believe that a change in the policy is necessary before a sound economic structure can be restored, and that in the long run the Board will have rendered great service to the country by modifying publicly, definitely, and actively its previous policy, by taking all steps within its power to correct the situation, including therein the potent ones of advice, warning, and popular education, and to oppose all measures of our Government, the natural consequences of which are to maintain extreme "easy money", or to drive rates still lower.

THE BANKS AND GOVERNMENT BONDS

A SUGGESTED SOLUTION FOR A MENACING SITUATION

Memorandum in reference to United States Government bonds now owned by the Federal Reserve System and its member banks and suggestions concerning a refunding and change in form thereof which would appear to be in the interest of the Treasury, the Federal Reserve System, the member banks, the Federal Deposit Insurance Corporation and the public generally whose money is deposited in the member banks.

May 7th, 1940 *

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As of December 31st, last, the Federal Reserve System itself and all member banks held, respectively, 2.5 and 11.2 billions of direct obligations of the United States Government. In addition thereto, member banks held 3.1 billions of bonds and notes guaranteed by the United States Government, 2.7 billions of the obligations of states and their political subdivisions and 3.0 billions of other securities.

Those vast aggregates totaling 22.5 billions have, when considered as a whole, been acquired within the banking system at extremely high market levels and at excessively low yields.

(Inasmuch as many individual banks may have purchased certain of their securities prior to the advent of extreme easy money, this statement may be challenged by those banks and should be verified by a factual study of actual reports on file of examination of all member banks by the National Bank and Federal Reserve Examiners).

The net working capital of all member banks (i.e., gross capital less capital permanently tied up in bank premises, furniture and fixtures and other non-convertible items) is approximately 4.4 billions. (This total includes a substantial amount of preferred stock owned by the Government and not as yet redeemed).

The United States Government, in public estimation, substantially guarantees the safety of deposits in member banks through its Federal Deposit Insurance Corporation.

* (Since this memorandum was prepared statistics have become available as of June 30, 1940, and should be inserted. The substitution of later figures would but magnify the problem.

In 1920 when the total Government debt was less than 25 billions of dollars, Fourth 4-1/4% Liberty Loan bonds sold in the middle 80's, approximating a 6% yield to maturity and in the same year the Government offered one year certificates at 6% interest. The net yield of Federal obligations has recently ranged between less than 0% for the shortest maturities and 2½% for the longest maturities. The return on the latter has fallen to this level from 4½% in 1932 in the face of the fact that the national debt has substantially doubled since that date.

An advance in the yield on a 10 to 15 year bond selling on a 2½% basis to even a 4% basis would cause its market value to decrease approximately 15%. A 15% decrease in the investment account of all member banks would wipe out approximately two-thirds of their net capital. This net capital must also absorb all losses arising from some 14 billions of loans.

In particular reference to the Government securities now owned by member banks, during the past several years the carrying value of these bonds has in effect been steadily written up through the process of selling one issue for profit and buying another at the same market level and often of substantially the same maturity. Early issues of higher coupon rates have been paid off and issues of progressively lower coupon rates have taken their places. Thus the present carrying values will approximate the existing extremely high market values.

It has been conclusively demonstrated that the market for Government securities promptly disappears whenever any general selling movement occurs except insofar as the Federal Reserve System is willing to support a declining market and by so doing further increase the System investment in Government securities which is already in excess of 20% of the reserve deposits of its member banks.

THE EXISTING HOLDINGS OF 11.2 BILLIONS OF DIRECT UNITED STATES GOVERNMENT SECURITIES CONSTITUTE 23% OF THE AGGREGATE DEPOSITS OF ALL MEMBER BANKS.

In view of the dangers inherent in the situation above outlined, I would recommend for the serious consideration of the Federal authorities that -

1. The Treasury issue and sell at par to the Federal Reserve System account and to all member banks, indebtedness of the United States Government in the form of consols of no maturity in the aggregate amount of 13.7 billions, all for the purpose of refunding the System account of 2.5 billions and the member banks' account of 11.2 billions, i.e., their present holdings of direct United States Government securities. In payment for consols at par the Treasury to accept from the System account and from member banks cash and/or their present holdings of direct United States Government securities at the average daily opening market value of each issue so tendered for a reasonable period immediately preceding the conversion, or from the offering date on issues sold within that period. The said consols to be subject to call at par by the Treasury proportionately from all holders and until called to bear a rate of interest substantially equal to the present yield of the System portfolio, i.e., 1-3/4%. The ownership of consols to be restricted to the Federal Reserve System and its member banks.

2. Concurrently with (1) above the legal reserve requirements of all member banks to be increased by an average of 23%, which increased reserves shall be held in United States Government consols. The said increase averaging 23% shall be proportioned in the same manner and to the same relative degree as cash reserves are now proportioned between Central Reserve City banks, Reserve City banks, and country banks, and between demand and time deposits as follows:

	DEMAND DEPOSITS			TIME DEPOSITS	AVERAGE
	Central Res. City Banks	Res.City Banks	Country Banks	All Banks	All Banks
Required cash reserve.......	22-3/4%	17½%	12%	5%	13%
Required consol reserve.......	40 %	31 %	21%	9%	23%
Total...........	62-3/4%	48½%	33%	14%	36%

3. The System account to purchase from each member bank daily at par all consols held in excess of reserves required to be so held and to sell daily at par consols to each member bank sufficient to fill reserves required to be so held. Since consols would be held in safe-keeping by Federal Reserve banks, ownership could be transferred from one member bank to another by book entry.

4. The Treasury to redeem consols at par when total outstanding exceeds 2.5 billion (System account) plus the required reserves of all member banks to be held in consols (i.e., in case of a shrinkage in the total of all deposits in member banks).

5. The Treasury may __at its option__ sell additional consols at par to the System when total outstanding is less than 2.5 billions (System account) plus the above required reserves of all member banks to be held in consols (i.e., in case of an increase in the total of all deposits in member banks.) In case the Treasury failed to avail itself of said option the reserves of member banks required to be held in consols shall be automatically proportionately so reduced.

> Under a National emergency and possibly in any event for flexibility, it is possible that the Secretary of the Treasury and the Board of Governors of the Federal Reserve System, acting jointly, should have some discretion, but in any event within definite fixed limits, to increase the consol reserves above 23% (being the % of member bank deposits now invested in the direct obligations of Government.) On the one hand, the Treasury has full authority to redeem consols. It is obvious that if the Treasury and the Board of Governors, acting jointly, had the authority to increase the average consol reserve above the existing 23% average to an average of 26%, it would give the Government a further call upon the deposits of the public in member banks of approximately 1 billion dollars.

6. At such time as the Treasury is retiring the national debt and at its option calls proportionately from all holders all or any part of its then outstanding consols, reducing the total of 2.5 billions (System account) plus the above required reserves of all member banks to be held in consols, to a lesser total, the reserves of member banks required to be held in consols shall first and to that extent be automatically proportionately so reduced and thereafter applied to reduce the System account.

7. The aggregate of consols held within the System in its own and member bank accounts shall not exceed a total which is not covered, as are all other member bank reserves, by 35% in gold or lawful money.

8. Total gold or lawful money required to be held in vaults of System or subject to its sole order would then be as follows:

40% to cover circulation of 4.9 billions	± 2.
35% to cover member banks' cash reserves	± 4.
35% to cover member banks' consol reserve	± 4.
Total gold or lawful money required by System	± 10.
Total gold now held by Federal Reserve System	± 16.

9. Member banks desiring to do so would be permitted to hold any other United States Government securities but at free market risk in addition to their required reserves in consols.

This procedure should be desirable from the Treasury viewpoint because it will -

1. Effect a permanent refunding of 32% of the total Federal debt without increasing the total thereof outstanding except as offset by subsequent saving in interest.

2. Reduce present cost of interest to the Treasury on 11.2 billions of direct debt owned by member banks.

(This statement should be verified from reports of Examiners. It is believed that the average coupon rate of member bank holdings exceeds that of the System account).

3. Stabilize the market for all Government issues by removing the constant threat of bank selling of bonds held against demand deposit liabilities. Other holders of balance of public debt such as life insurance companies, corporations, trusts, savings and other individuals are generally investors of term funds not subject to mass withdrawal and therefore more stable holders. Balance of public debt so held as more permanent investment reduced to ± 28.5 billions.

4. Natural investment level of premier security of world could be better maintained when freed from threat of mass selling from banks.

5. Protect the deposits of the public and particularly the Federal Deposit Insurance Corporation guarantee.

This procedure should be desirable from the Central Bank or System viewpoint because it will -

1. Increase purely monetary and credit controls.

2. Increase reserve requirements substantially without adversely affecting cash loan or other investment position of member banks <u>as a whole</u>.

(Note that the increased requirements of smaller and country banks are much less than of large banks in Reserve cities. See table on Page 4.)

3. Will not decrease existing System revenue.

4. Remove member bank speculation in Government bonds - switching, gambling on conversion rights, etc.

5. Remove necessity of supporting markets on totals of 42 billions of United States Government securities to protect 11.2 + 2.5 or 13.7 billions held within the Federal Reserve System.

6. Further justify present gold acquisition policy by requiring that gold be held by Federal Reserve System to secure all reserves of member banks.

7. Best promote interests of agriculture and industry and every other objective of the Federal Reserve System by centering attention on ways and means protecting the member banks and hence the money of the public on deposit therein.

This procedure should be desirable from the individual member bank viewpoint because it will -

1. Eliminate the danger of capital impairment due to market fluctuation of existing Government securities which are at times "frozen" and unsalable.

2. Eliminate the possibility of market manipulation by large holders at expense of small holders.

3. Assure moderate earnings on reasonable proportion of required reserves.

4. Divert banking attention to banking needs of public and away from speculative interest in Government bond markets.

This procedure should be desirable from the public viewpoint because it will -

1. Better protect the money of the American people in member banks, restoring the principle of diversification of risk in all forms of loans and investments which are subject to market fluctuation and risk, when made with depositors' money largely subject to demand.

2. Increase the courage and confidence of bank management and, free of the threat of capital impairment, encourage freer lending.

3. Avoid further dangerous and destructive extremes of easy money and tend to arrest the diminishing returns on capital.

Condition of All Member Banks
In Billions of Dollars
12/30/39

Loans	14.		
State and Municipal Bonds	2.7	19.7	
Other Securities	3.0		22.8
U.S.Gov't Securities - Direct	11.2		
U.S.Gov't Securities - Guaranteed	3.1	3.1	
Federal Reserve Cash - Required	6.4	11.6	
Excess	5.2		
Vault	.8		19.7 Cash
Other Banks	5.5	8.1	
In process of collection	1.8		
Miscellaneous assets (Bank premises, bank furniture and fixtures, etc.)	1.1		
	54.8		

Capital Surplus & Undivided Profits	5.5	
Demand Deposits	28.2	
Demand Interbank	8.5	37.4
Demand Foreign	.8	
Time Deposits	11.7	11.8
Time Interbank	.1	
		49.2
	54.8	

U.S.Gov'ts.(direct) of 11.2 are 23% of member bank deposits;
" " " in System account are 2.5 additional yielding avg. of 1.72%

Federal Reserve notes in circulation are 4.9 40%=2.0
Member Bank deposits with Federal are 11.6 35%=4.0
Gold & lawful money now required by System 6.0

Gold now held by System 16.0

Excess Reserves 5.2 Correspondents' balances excessive by 1.8
Loans & other investments of 22.8 could rise 30% before banks would have to rediscount.

19.7 cash + 11.2 Direct Gov'ts.= 30.9 of Cash & Direct Gov'ts. or 63% of total member bank deposits.

Capital Ratio

Would not be between capital & deposits but between net capital & money at risk.

1. Net capital = gross capital of 5.5 less misc. bank premises, etc., of 1.1, or 4.4
2. Loans 14. + State & Munic.Bds. 2.7 + other bonds 3.0 + U.S.guaranteed's 3.1 = 22.8 = loans & investments placed at risk by member bank management (excluding U. S. Direct)

4.4: 22.8 as 1: 5.2