September 2, 1947.

TO Chairman Eccles

FROM Mr. Thurston

Attached is one of those drafts for the talk to the Bank Supervisors. I have sounded out all the staff members I could find and this is in large part Ralph Young's suggestion, which seemed to me to be meritorious because it is, on the whole, a new approach that should be particularly interesting to Bank Supervisors. I also think it would fulfill your specifications for a dignified, informative discussion on an intelligent plane. Like every draft I have ever seen, it could be tightened up. It avoids any controversy over the banking structure. I have given copies to Ralph, Morrill and Leonard.

If all goes well, I shall take the boat to Virginia Beach tonight, and subject to the well-known referendum and recall, hope and pray to linger there with the sand crabs for the rest of the month. I have reservations back on the boat on October 1, which is also notable in history because it is my birthday. I shall be 35!!

I hope Larry arrived safely and that you enjoyed the sun or whatever it is they have in that Valley. It has been persistently hot and humid here. You are fortunate to have been away. It is also very quiet now that the Britishers have gotten out of town, to say nothing of the President. Spike has taken off. Matt is, of course, acting in your stead and has kept us posted on his many meetings. Incidentally, the Illinois Bankers Association has adopted a resolution and forwarded same to the White House urging Matt's reappointment. When here, Jake seems very quiescent, and Ernest hasn't stepped out of character.

I am leaving my address and as soon as I discover it, will advise Miss Benton as to what the telephone number is in case the previous tenants didn't have the gadget removed.

Attachment

D R A F T

President Leggett, members and guests of the National Association of Supervisors of State Banks:

I appreciate the opportunity to participate in the proceedings of this, the forty-fifth annual meeting of this Association.

More than ever today, public servants, both Federal and State, who are primarily concerned with the nation's banking system, are bound together by common problems and responsibilities. In the chaotic world of today, still groping for the answers to the overriding problems of economic security and enduring peace, it is of some comfort to know that our banking system is stronger than ever before. It seems paradoxical that much of this strength is a heritage of war finance which generated the inflationary dangers that still beset us.

The postwar inflation, with its severe distortions in the structure of prices, wages and profits, is basically due, of course, to the enormous wartime increase in our money supply and to the accompanying and, in many categories, continuing shortages of civilian goods. We have heard much about the dollar shortage. That is a complete misnomer. What the world is still facing is a shortage of food, clothing, machinery, coal and other goods as well as labor. Currency inflations afflict most of mankind today. We have had, fortunately, less of it than many countries but, unfortunately, more of it than would have been the case had we managed our war financing and price control programs more wisely.

The premature abandonment of such wartime controls as allocations of raw materials, building permits, rationing, price and wage restrictions, as well as the excess profits tax, lost much of the ground that was gained during the war in combating inflation. We must now take the consequences of having permitted the normal forces of free enterprise to operate unrestricted in an abnormal time when effective demand far exceeded available supply. The longer we postpone the inevitable readjustment by further general price and wage increases, by further rapid expansion of private debt and failure to reduce public spending, the more serious the ultimate reaction is certain to be and the longer it will take to reach a stable condition of employment and production.

What is actually implied in the gratifying strength of the banking system today is that it is in a better position than ever before in history to withstand the impact of economic reaction. Thus, it is in a better position than ever before to contribute to ultimate and sustained recovery. The major elements of banking strength today are:

1. Deposits of approximately 118 billion dollars are in the fourteen thousand commercial banks of the country, or more than three times the prewar level and nearly four times the 1920 total, when the country had about twice as many commercial banks.

2. Commercial bank capital is about two-fifths greater than its prewar level and is now greater than at any time in the past.

3. The riskless assets of commercial banks -- cash and Government securities -- are currently equal to nearly three-quarters of total assets. Prior to the war, this was about three-fifths; following World War I, it was less than one-fourth. While bank capital since before the war has not grown as rapidly as total assets, capital accounts have been kept in strong relationship with holdings of risk assets. In the aggregate, the present capital of all commercial banks is equal to just under one-quarter of their total risk assets. This is nearly half again more capital in relation to holdings of risk assets than the commercial banking system maintained during the twenties and early thirties.

4. The general quality of commercial bank risk assets is probably higher at present than at any time in the past three decades. The amount of commercial

bank real estate assets has declined by half since 1929 and is about the level of 1920. This comparison would be even more striking were figures for real estate assets for earlier years available on the same basis as those for recent years.

5. Total loans of all commercial banks, while close to the all-time peak reached in 1929, have elements of strength not present in the twenties. For example, the proportion of outstanding loan balances representing credits with amortization planned in advance currently runs between two-fifths and one-half of total loans. It is doubtful whether this proportion ever ran much over 1/20 ~~five per cent~~ during the twenties. Again, a substantial proportion of commercial bank loans at present -- mainly real estate loans -- are guaranteed in whole or in part by agencies of the Federal Government. This method of limiting the loan risk of individual banks and of the banking system as a whole has only been applied on a broad scale for certain classes of loans since the middle thirties.

6. Another factor of strength in the present loan portfolio of most commercial banks results from regulation of consumer instalment credit and of margin requirements on security loans through the war and transition period. Although Regulation W expires on November 1, it has tended to make for more uniform and conservative standards in these categories of loans. With regard to security loans, it may be recalled that they comprised almost a third of total bank loans in 1929; their current volume is under ten per cent of total loans, and a substantial volume of present security loans is collateraled by Government securities, which are without credit risk and practically without market risk.

7. The credit standing of the typical bank borrower is generally higher than in the past. This is a result of the rapid expansion of individual incomes and business earnings that has occurred since prewar years and of the large holdings of liquid assets which individuals and businesses have accumulated over this period.

8. The average quality of commercial bank investments in corporate and municipal issues is probably also higher than in the past. The rising incomes of ~~issuers~~ their borrowers over the war and postwar periods have improved the quality of many of their obligations and provided a favorable market situation for weeding out undesirable bank investments. Since methods of war finance kept down the volume of new private security offerings and since these issues have enjoyed an especially active market with nonbank investors during the transition, there has been little recent expansion in bank holdings of corporate securities.

9. The 1938 bank examination agreement, to which both Federal and State bank supervisory agencies subscribed, by abandoning the "slow" classification for bank assets, and by establishing and substituting numerical classifications based upon relative credit risk or intrinsic worth instead of upon capricious current market values, serves to protect banks from abnormal or speculative fluctuations in market prices.

10. The Banking Act of 1935 liberalized member bank borrowing privileges (under Regulation A of the Board of Governors) so that member banks are in a better position than ever before to maintain necessary liquidity without sacrifice of sound assets.

11. Last, but not least, the insurance of bank deposits has served to reestablish and sustain public confidence and to remove the hazard of panicky runs on banks.

Although abnormally low interest rates have prevailed since prewar years, the rapid growth in volume of bank assets and the improvement in general quality of these assets, has permitted bank earnings in recent years to attain record levels. The rate of net profits on invested capital of insured commercial banks in 1945 was higher than ever before. While average net profits of commercial banks have fallen somewhat, the current average rate, as nearly as can be estimated now, will compare favorably with bank profit rates in most previous peacetime years.

There is reason for gratification in the present strength of the nation's banking position, for in the past banking weaknesses have often contributed to and intensified economic reversal and depression. In other sectors of the economy there are definitely unhealthy developments. Banking supervisors are properly concerned about these conditions. They include the extremely high prices of farm products and farm land, the sharply inflated state of construction costs and urban real estate, the uncertain inflation in business inventories, the abnormal foreign demand for American products and the difficulties of obtaining dollars with which to pay for them, the continuing rise in the cost of living, and the increasing use of savings by lower-income classes to maintain consumption standards. If the universally accepted national objective of sustained high levels of production and employment without inflation is to be realized, radical correction of these unbalanced developments must take place, even though it is probable that correction will involve temporary economic recession.

Fortunately, it is possible to anticipate such a corrective process without any serious deterioration in the existing strong banking situation. Indeed, it is difficult to imagine any near-term business recession so severe that the banking mechanism would be disrupted enough in its operations to intensify economic depression.

While the banking situation is characterized by unprecedented strength, nevertheless, this very strength is itself a danger to the economy for the longer run unless it is kept within constructive channels. The abnormal demand, price and other conditions that prevail in some sectors of the economy reflect inflationary pressures arising from war and postwar expansion of bank credit and hence of the money supply. Price developments in recent months clearly indicate that these inflationary pressures have not spent their force. Even if a period of corrective recession should set in at an early stage, however, the economy's unparalleled liquidity could lead to an inflationary revival after an interval of readjustment. In fact, because of the country's present vast stock of liquid resources and the almost unlimited capacity of the banking system to expand further the money supply, we are confronted with the danger of recurrent inflationary periods as a long-run prospect.

The banking system's virtually unlimited capacity to expand credit and to swell further the supply of money is due to the nature of the huge public debt created to finance the war. Stability of the value of this debt and stability of its cost to the Government are of crucial importance to the maintenance of general financial stability. The Federal Reserve System, as a result of its central banking functions, has the responsibility for maintaining an orderly and stable market for public debt. Commercial banks, with their large holdings of Government securities, can sell Government securities whenever more attractive opportunities for the use of funds appear. The Reserve System, in the absence of other buyers, must of necessity purchase such securities. The funds expended by the System to buy these securities, which are newly created for the purpose, are added to reserve balances of commercial banks. On the basis of such new reserve funds, the commercial banks as a whole can expand bank credit by from six to ten times the amount of the additional reserves.

Whether the commercial banking system functions over the long-run in a way that will result in recurrent rapid expansion of credit and thus contribute to successive periods of inflationary pressures depends on a number of important factors. Foremost among them is the availability of assets suitable for holding by commercial banks. The possible sources, quality and volume of such assets will need continuing, serious study by the bank supervisory authorities.

There exists currently outside the commercial banking system about 18 billion dollars of eligible Government securities. Very large additional amounts will become eligible in 1952 and thereafter. As time passes, some of these securities will be absorbed in commercial bank portfolios, but it may be possible through debt management policies to limit somewhat the further substantial expansion in total holdings by banks of Government issues. Domestic and international circumstances from time to time may require additions to the public debt; we do not yet know how large a financial commitment our Government will be willing ~~required~~ to make for purposes of effectuating the Marshall plan for European recovery in the interest of world peace. As far as possible, however, any additions to the public debt should be financed outside the commercial banking system. As budget conditions permit, reductions in public debt are desirable, but we should recognize that a large reduction in this total debt can only be accomplished gradually over a relatively long period.

If we assume that public opinion will oppose, and that fiscal policies will limit, further growth in public debt, the question then arises as to whether long-run expansion in private debt will provide a sufficient volume of assets for additional, and during some periods, rapid expansion of bank credit. Various considerations point to an affirmative answer.

Private debt formation was arrested by the financial collapse of the early thirties. Since then, there have been important changes in the composition of that debt, but only nominal growth. At present, private debt is equal to only three-fourths of the nation's current annual product. Throughout the twenties, it was substantially greater than the total output. Historically speaking, therefore, the level of total private indebtedness is low and the margin for its potential expansion is large.

Special factors that may encourage expansion of private debt could be discussed at length, but time permits only a brief review of the more important ones. If further expansion in public debt is held in check, simple growth of the economy will generate pressure for expansion of private debt. Expansion of public debt has largely taken the place of expansion in private debt since the thirties, and has, in fact, been an immediate substitute for growth in private debt.

Another important factor will be that the national objective of sustained high levels of output and employment requires much additional modernization and expansion of commercial, manufacturing, and public utility facilities. At current levels of output, existing facilities in these activities are heavily taxed. The costs of additional facilities needed will be substantially higher than prewar costs and the dollar volume of financing necessary will also be much larger.

Again, postwar inflation has recently reduced the liquidity which business concerns accumulated over the war period. While business enterprises are still highly liquid, in relation to the dollar volume of current transactions, business liquidity is no longer as excessive as superficial indications might suggest because of high levels of operating costs and because of high costs of fixed facilities. This condition is likely to remain as a legacy of war and postwar monetary inflation.

Still another factor that favors expansion of private debt is that both wartime and postwar price inflation, with their effects of sustaining high earnings for business, have sharply expanded the equity accounts of business concerns.

The capacity of business enterprise to qualify for and obtain debt financing has been greatly increased by these developments.

Because of the dominant place of our huge public debt in the economy and because of the role of interest cost on this debt in the Federal budget, it is probable that the level of interest rates will remain low indefinitely. Low interest costs on debt, together with the income tax advantages of debt as compared with equity financing, will probably give impetus to long-term growth in business debt. An optimistic climate of business opinion regarding the tremendous future potentialities of the economy would increase the weight that business men place on the cost and other advantages of debt as compared with equity financing, and perhaps accentuate growth in business debt.

A further important factor in the possible future expansion of private debt will be a high level of demand for consumers' durable goods and houses which is to be expected for an extended period. War and postwar shortages in supply of durable goods and houses account in part for their present large market, but the size of the market is also the result of current high levels of employment and incomes. Continuing high levels of employment and incomes could sustain a large demand for these items, especially if credit facilities are widely available at low costs to aid in their financing. There are no areas of private finance in which credit facilities are more adequate than those of durable goods and housing. In both of these fields, too, commercial banks are currently, and seem disposed to remain, among the most active lenders.

Lastly, the area of farm debt needs to be taken into account. Because of the abnormal prosperity that farmers have enjoyed, the current level of farm debt is below that of prewar years. In addition, farm operators as a group have accumulated large holdings of liquid assets. Unless forced to incur debt by drastic downward readjustment of farm prices, as in the early twenties, present operators will not soon be in heavy need of debt financing. But farm ownership is constantly turning over, and new owners often have occasion to supplement their resources with debt. Consequently, long-term expansion of farm debt is likely to take place, but the rate of expansion will probably be less rapid than for other areas of private debt.

The conclusion to be drawn is that the immediate problem confronting bank supervision is the routine one of assuring that banking arrangements are kept in good order in accordance with established practice, regulation and statute. In view of the prevailing strength of the banking situation, even termination of the present inflationary boom and an interlude of deflation and business readjustment, would not greatly change the immediate supervisory problem. The supervisory problem may be changed, however, by revival of long-run growth in private debt, with recurrent periods of accelerated expansion in this debt. The sharp expansion of private bank credit since mid-1946 may mark the beginning of a new era of private debt growth.

At the present time, no direct authority exists to restrain commercial bank participation in a too rapid or excessive expansion of private debt. If this participation is to be limited at all under existing banking legislation, it must be accomplished through the insistence of bank supervision that each individual bank maintain rigorously high credit standards in every extension of private debt, that bank standards of soundness with regard to particular categories of bank assets be consistent with standards as formally defined by the supervisory authorities, and that the credit standards as between banks be consistent for various types of paper. Such insistence would represent an important extension of bank supervisory responsibilities. But its purpose and justification would be to prevent a dissipation of present banking strength by unsound expansion of bank credit for private debt financing and to forestall future banking troubles.

To carry out the suggested responsibilities, it will be essential that all banking authorities, Federal and State, cooperate in the study of banking and economic trends and in the development of uniform supervisory standards appropriate to the changing conditions of banking. The cooperative formulation of proper standards in advance of the need, and their application to supervisory practice when formulated, is the challenge presented to the supervisory authorities by the danger inherent in the existing unprecedented strength of the banking situation. The foundations for this cooperation are already firmly laid. I am confident, and I am sure that others present share this confidence, that a cooperative supervisory program along these lines would constructively serve the national interest in the maintenance of a sound banking system.

9/2/47

September 22, 1947

To: Chairman Eccles

From: Ralph A. Young

Attached is a redraft of your speech before the National Association of Bank Supervisors Wednesday morning. The general tenor of the original draft was changed to meet comments and suggestions of other members of the staff. Mr. Leonard's comments on the most recent draft are attached for your information.

Attachment

President Leggett, members, and guests of the National Association of Supervisors of State Banks:

I appreciate the opportunity to participate in the proceedings of this, the forty-fifth annual meeting of this Association.

More than ever today, public servants, both Federal and State, who are primarily concerned with the nation's banking system, are bound together by common problems and responsibilities. In the chaotic world of today, still groping for the answers to the overriding problems of economic security and enduring peace, it is of some comfort to know that our banking system is stronger than ever before. It seems paradoxical that much of this strength is a heritage of war finance which generated serious inflationary dangers that still beset us and which will continue to present problems of adjustment for the banking system for a long time.

The postwar inflation, with its severe distortions in the structure of prices, wages, and profits, is basically due, of course, to the enormous wartime increase in our money supply. We have heard much about the dollar shortage. Every bank supervisor knows that this expression "dollar shortage" is a complete misnomer. There is a superabundance of dollars in this country. This superabundance of dollars has been so great that notwithstanding the largest volume of output of civilian goods that this country has ever had, there continue to be serious shortages of civilian goods. What the world is still facing is a shortage of food, clothing, machinery, coal, and other goods as well as labor.

Monetary inflation afflicts most of mankind today. We have had, fortunately, less of it than many countries, but, unfortunately, more of it than would have been the case had we managed our war financing and price control programs more wisely during both the war and the postwar transition periods.

The premature abandonment of such wartime controls as allocation of raw materials, building permits, rationing, price and wage restrictions, as well as the repeal of the excess profits tax, lost much of the ground that was held with such difficulty during the war in the fight against inflation. We must now take the consequences of having placed our reliance upon the release of all of these controls to bring about necessary readjustments in an abnormal time when effective consumer demand far exceeded the available supply of goods. The longer inevitable readjustment is postponed by further general price and wage increases, by further rapid expansion of private debt, and by failure to adjust the Government budget, the more serious the ultimate reaction is certain to be and the longer it will take to reach a stable condition of employment and production.

At the outset of my comments I said that our banking system was stronger than ever before in peacetime. This is true in many ways, including the quality and character of assets, the liquidity position of the banks, and their capital position in relation to risk assets. What is actually implied by this strength is that the banks are in a better situation than ever before to withstand the impact of economic reaction. Thus, the banking system is in a better position than ever before to contribute to the ultimate attainment of sustained high levels of employment and output under our free enterprise system. Unfortunately, the banking system is also in a better position to augment the already strong inflationary forces through continued expansion in bank credit.

Current inflationary developments in various sectors of the economy are definitely unhealthy. Banking supervisors are properly concerned about these conditions. They include the extremely high prices of farm products and farm land, the sharply inflated state of construction costs and urban real estate, the uncertain inflation in business inventories, the abnormal foreign demand for American products and the difficulties of obtaining dollars with which to pay for them, the continuing rise in the cost of living, and the increasing use of savings by lower-income classes to maintain consumption standards. If the universally accepted national objective of sustained high levels of production and employment without inflation is to be realized, radical correction of these unbalanced developments must take place.

The strength of our banking system makes it possible to anticipate such a corrective process without any serious deterioration in banking conditions. Indeed, it is difficult to imagine any business recession so severe that the banking mechanism would be disrupted enough in its operations to intensify economic depression.

The abnormal demand, price, and other conditions prevailing in some sectors of the economy, to which I just referred, reflect inflationary pressures arising from war and postwar expansion of bank credit and hence of the money supply. Price developments in recent months clearly indicate that these inflationary pressures have not spent their force. Even if a period of corrective recession should set in at an early stage, the economy's unparalleled liquidity could lead to an inflationary revival after an interval of readjustment. In fact, because of the country's present vast stock of liquid resources and the almost unlimited capacity of the banking system to expand further the money supply, we are confronted with the danger of recurrent inflationary periods as a long-run prospect. In other words, the very strength of the banking system is a danger to the economy for the longer run unless it is kept within constructive channels.

Today the banking system possesses virtually unlimited capacity to expand credit on its own initiative and to swell further the nation's supply of money. This situation is largely due to our huge public debt created to finance the war. Commercial banks currently hold about 70 billion dollars of Government securities, compared with 16 billions in 1940. This increase has been accomplished without any decrease in the other assets of banks, and Government securities currently comprise nearly one-half of commercial bank assets. A stable value of public debt is obviously of vital importance to the maintenance of sound banking conditions. It is also a vital matter to Government, for the cost of carrying this debt is about 5 billion dollars a year, or nearly one-seventh of total Federal expenditures.

The Federal Reserve System, in its capacity as central bank, has the power to increase or decrease the supply of bank reserves. As its part in meeting the war emergency, the System provided the reserves that made it possible for the commercial banks to expand their assets so greatly in aiding to finance the war.

The Federal Reserve System is also directly concerned with and responsible for maintaining an orderly and stable market for public debt. Because of the constant turnover of securities among banks and others, daily transactions of the Federal Reserve in the market run into the hundreds of millions of dollars and on single days may exceed a billion dollars. The significance of this crucial function for the liquidity of each individual bank, for the soundness of the banking system as a whole, and for the debt management operations of the Treasury is fully recognized and appreciated, I am sure, by every bank supervisor.

As a result of its responsibilities for maintaining orderly conditions in the Government securities market, the Reserve System in the present situation is confronted by a very critical problem. Commercial banks can freely sell Government securities in the market, not only to meet losses of funds through clearings, but whenever it seems desirable to rearrange portfolio maturities, or whenever more attractive opportunities for the use of funds appear. The Reserve System, in the absence of other buyers, is obliged to purchase the securities which the banks sell.

We cannot tell at the time whether these offerings are simply temporary adjustments of reserve positions by individual banks which may later be offset by demands of other banks, or whether they represent new credit expansion. The funds expended by the Reserve Banks to buy these securities, in any event, create new reserves that are added to the reserve balances of commercial banks.

On the basis of such new reserve funds, the commercial banks as a system can expand bank credit by from six to ten times the amount of additional reserves. This is the primary reason why I referred to the almost unlimited capacity of the banks further to expand our money supply. This is also the basic reason why I stated that we are confronted with the danger of recurrent inflationary periods as a long-run prospect.

This process of credit expansion is widely misunderstood by the public. Even bankers misunderstand it because the process results from what appear to the individual banker as normal transactions. For example, a decision by one bank to shift from short-term Government to long-term issues or from Governments into private credits is, from its own standpoint, legitimate, proper, and sound, and the sale of Government securities to meet a loss of funds is considered justifiable, even though it may be the result of a previous increase in loans. But if the Reserve System adds to its holdings as a result of the decision or the circumstance, new bank reserves become distributed through the banking system and provide the basis for credit expansion by many banks.

For all banks together, experience shows, this expansion can reach six to ten times any addition to reserves. Thus, one bank by shifting its Government security portfolio or expanding other assets and then selling Governments can cause the creation of reserves which many banks obtain and use to expand credits without any initiative on their own part.

The potential for increases in bank reserves under existing conditions is even greater than I have indicated. Individuals and businesses hold about 80 billion dollars of Government securities which they can sell or redeem. If the public sells or redeems Government securities on balance, the Reserve Banks again must be purchasers of

Government securities, and commercial bank reserves are increased by the amount of such purchases.

To be sure, there are other sources of bank reserves that do not involve purchases by the Reserve Banks of Government securities. I refer, of course, to a reduction of currency in circulation or an inflow of gold. We do not know at what point the public may choose to release its wartime savings in currency. Already, however, our world creditor position is resulting through the import of gold in significant additions to bank reserves.

During the past year, retirement by the Treasury of bank-held Government securities tended to keep banks under reserve pressure and to restrain bank credit expansion. In recent months, however, additions to reserves from gold imports have worked to offset the effects of debt retirement and to permit further expansion of bank credit. This current monetary expansion, even though its pace has been moderate in comparison with war years, has undoubtedly strengthened prevailing inflationary pressures.

Let us consider further the danger that the banking system, because of its present exceptional strength, may function over the long run to foster recurrent monetary inflation.

Whether this danger will be realized is a matter of profound concern to the bank supervisory authorities. Ovbiously, the danger will depend upon an ample availability of assets suitable for bank holding as well as upon the availability of bank reserves. The possible sources, quality, and volume of such assets will need continuing, serious study.

The desire to maintain a high level of earnings, if new assets are readily obtainable, may tempt many banks to seek out the more risky, higher-yield credits.

One feasible source of additional bank assets is the amount of eligible Government securities held by the public. There exists currently outside the banking system about 18 billion dollars of such securities and large additional amounts will become eligible in 1952 and thereafter. As time passes, some of these securities will be absorbed in commercial bank portfolios. Through debt management policies followed by the Treasury it may be possible to limit somewhat the amount of securities available for banks and hence further expansion in total holdings by banks of Government issues. It is for this reason that the Federal Open Market Committee has an active interest in the refunding policies followed by the Treasury. This interest is recognized by the Secretary of the Treasury and there is maintained a continuous and close liaison between the Federal Reserve and the Treasury on these matters.

Then there is the possibility that further growth in the public debt will occur. Domestic and international circumstances from time to time may require additions to the public debt; we do not yet know how large a financial commitment our Government will be required to make for purposes of making effective the Marshall plan for European recovery in the interest of world peace. I am sure we all agree that, as far as possible, any additions to the public debt should be financed outside the commercial banking system. In fact, even with a balanced or surplus budget, debt management should aim at absorbing as much as possible of the savings of the public and using the proceeds to reduce bank holdings of Government securities. As budget conditions permit, reductions in public debt are desirable, but we should recognize that a large reduction in this total debt can only be accomplished gradually over a relatively long period.

Public opinion today is emphatically against further substantial growth in national public debt. We may assume therefore that fiscal policy will respond to this sentiment by limiting such growth in the future. The question then arises as to whether long-term expansion in private and local government debt will provide eligible bank assets in a volume that will support an expansion of bank credit, and during some periods contribute to a rapid expansion of such debt. Various considerations, in my judgment, point to an affirmative answer.

Private debt formation was arrested by the financial collapse of the early thirties. Since then, there have been important changes in the composition of that debt, but only nominal growth. At present, private debt is equal to only three-fourths of the nation's current annual product. Throughout the twenties, it was substantially greater than the total output. Historically speaking, therefore, the level of total private indebtedness is low and the margin for its potential expansion is very large.

A number of special factors may encourage expansion of private debt, but time permits mention of only a few of them. In the business area, these include further growth in the economy, the need for modernization and enlargement of our commercial, manufacturing, and industrial facilities to keep pace with the economic growth, higher postwar cost price levels, and the need to maintain a business liquidity consistent with high levels of output. The large capacity of business enterprises, after many years of profitable operation, to qualify for and obtain financing, the low level of interest rates that are likely to prevail in the face of our large national savings, and the income tax advantages of debt as compared with equity financing, will also give an impetus to long-term growth in business debt.

A further important factor in future private debt expansion will be credit extension to finance consumer purchases of durable goods and houses. War and postwar shortages in supply of these goods account for their present large market, but its size is also the result of current high levels of employment and incomes. A continuing high level of employment and incomes will sustain a growing demand for these goods and for credit to finance their purchase.

Farm debt is another area in which growth may be expected. But because of the abnormal prosperity and liquidity that farmers currently enjoy, farm debt will likely expand more slowly than other types of private debt.

Lastly, we need to consider the prospects for growth in State and local government debt. This area of debt is almost certain to expand. Large outlays are required to rehabilitate local facilities, to improve schools and highways, to make available airports and otherwise to care for our enlarged population. Compensation to veterans for military service will be a special source of bond issues. Still other financing will become essential to provide the public services required by our growing population and advancing level of community life.

My review of factors that will influence the availability of bank assets over the longer run future leads to two conclusions. First, the banking system within a foreseeable future will not be confronted with a scarcity of desirable assets. Second, the supply of eligible assets in all probability will continue to be large enough recurrently to encourage rapid, inflationary expansion of bank credit.

In view of the likelihood that growth in private and local government debt will constitute a major source of bank assets in the future, the capital position of banks needs careful review. If commercial banks are to serve their local communities constructively in supplying legitimate credit demands they should tolerate no deterioration in their capital positions. Retention of earnings cannot be relied upon to supply entirely the additions to capital accounts that will be needed to support a healthy credit system in an expanding private economy. Sales of new capital stock to private investors will also be essential.

It is pertinent to note that many banks still retain capital supplied as an emergency measure by the Reconstruction Finance Corporation 12 to 14 years ago. This Government capital has no permanent place in our system of private ownership of banks and should be replaced as promptly as possible by capital provided by private sources. The Federal Reserve System, as you know, is actively encouraging the early retirement of Reconstruction Finance Corporation capital in member banks, wherever such retirement is consistent with the public interest.

One further general observation is in order. Because of the present strength of the banking situation, the problem now confronting bank supervision is primarily one of assuring that banking arrangements are kept in good order in accordance with established practice, regulation, and statute. Even termination of the current inflationary boom and an interlude of deflation and business readjustment is not likely to alter the basic character of the immediate supervisory problem. The supervisory problem may be changed, however, by long-run growth of private debt, with periodic accelerated expansion in this debt. The sharp increase in private credit since mid-1946 may mark the beginning of a new era of private debt growth.

At the present time, the risks of restraining an excessive expansion of bank credit for private purposes by traditional central banking methods are grave indeed. Foremost among them is the risk of upsetting the Government securities market with possible serious repercussions upon the economy's entire financial mechanism and upon the Government's financing program. The gravity of this risk necessarily encourages the search for other methods. There is no simple solution to this problem. Partly, the solution will be in the field of bank supervision. The bank supervisory authorities have an unescapable responsibility to prevent a dissipation of present banking strength by excessive and unsound expansion of bank credit for private debt financing and to forestall future banking troubles.

The future tasks of bank supervision promise to become much more difficult and complex than they appear at the present time. How bank supervision should adapt its policies and practices to meet the challenge of its prospective increase in responsibilities is a question of direct concern to your Association. We shall be interested in your thinking and your suggestions with regard to this highly important question. You may be assured of the full cooperation of the Federal Reserve System in finding an answer to it. I am personally confident, and I am sure that others present share this confidence, that bank supervision will continue to serve the national interest by doing its part to maintain a sound private banking system.

MR. YOUNG:

The September 18 draft of the speech for the Chairman is, I believe, better for the specific purpose than the first draft.

It is still solid meat all the way, however.

It would not go far, I believe, in "selling System."

The keynote of the talk is "Warning of Dangers Ahead."

The concluding message is that the Supervisors must undertake new but vague responsibilities to prevent individual banks from "doing what comes naturally" with regard to credits which taken individually are O. K. Is this the final note on which the Chairman wishes to end his talk?

a number of modifications [illegible]e been [illegible]de.

Because of some of the long and involved sentences and long words, the speech would be difficult to read and even more difficult to follow. If this basic draft is to be used, I strongly urge that in the next revision a real effort be made to have short paragraphs, short sentences, short words, and simple construction.

Suggestions for this have been incorporated

In the attached copy of the draft I have indicated a possible number of breakdowns to shorter paragraphs. I realize that such short paragraphs may not be the best literary construction, but short paragraphs make for easier reading and easier following.

Suggestion withdrawn by Mr. Leonard

I would like to see incorporated, as a good will gesture, a statement as to the Board's position regarding conversion of national banks to State banks (I believe that the Board is on record regarding this). This is a point in which the State Supervisors are much interested.

You say that Governor Clayton suggested that the presiding officer, in his introduction, might refer to Chairman Eccles' banking experience. True. But I think it would be more effective if the Chairman should make that statement himself.

As a matter of fact, isn't it well in public speaking (and this is a public speech), for the speaker to ease into his subject at first, giving the audience a moment or so to get accustomed to his voice and manner of speaking?

There is a time limit involved. The Chairman is scheduled to go on the program at 11:15. Of course, there may be some delay in this. However, the group is invited to the White House in the afternoon, and is to assemble there promptly at two o'clock. The Chairman's is the last speech of the morning, and the group will have to get luncheon and go from the Mayflower to the White House. Undoubtedly they will want to be there a little bit before two. The audience may be somewhat nervous towards the end if the speech takes too long, and I think it would be well if the Chairman bear this in mind and possibly make some reference to it in his talk.

I have made a few marginal notes on the draft which I am returning.

R. F. Leonard
9-22-47

Attachment