A meeting of the Board of Governors of the Federal Reserve System with members of the executive committee of the Federal Advisory Council was held in the offices of the Board of Governors in Washington on Thursday, April 9, 1942, at 10:40 a.m.

PRESENT: Mr. Ransom, Vice Chairman
Mr. McKee
Mr. Draper
Mr. Evans

Mr. Morrill, Secretary
Mr. Carpenter, Assistant Secretary

Messrs. Edward E. Brown, George L. Harrison, W. F. Kurtz, R. V. Fleming, and S. E. Ragland, members of the executive committee of the Federal Advisory Council

Mr. Walter Lichtenstein, Secretary of the Federal Advisory Council

Mr. Brown referred to the recent Treasury offering of certificates of indebtedness and said that the response to the measures adopted by the Treasury of indiscriminate use of telegrams and solicitation to urge subscription to the issue must have been rather disappointing.

Mr. Draper stated that it had not been the recommendation of the executive committee of the Federal Open Market Committee that the issue be handled in that manner, and that the decision appeared to have been made at the Treasury prior to the last meeting of representatives of the Treasury with members of the executive committee of the Federal Open Market Committee at which the terms of the issue were discussed.

Mr. McKee said that the suggestion of an issue of certificates of indebtedness was made about six weeks ago at the Treasury as a substitute for the suggestion of the representatives of the Federal Reserve System that more short-term paper be put into the market along with investment paper to meet the needs of investors.

Mr. Brown expressed the opinion that it was a mistake to send telegrams indiscriminately to corporations and through personal solicitation to ask for subscriptions from corporations that did not have funds to invest and in some cases were borrowing money for their own business purposes and, therefore, were not in a position to subscribe. He added that the total subscriptions from Chicago were very small, and he felt many corporations were not willing to subscribe for the reason that the return after taxes would have been so small that they were not interested in the return as against the advantage of having the money available for use in the event of necessity. He made the further comment that the issue had demonstrated that with the tax bill pending there was no considerable amount of short-term corporate money for investment at 1/2 per cent.

Mr. Ransom said that it had been the feeling of the members of the Federal Open Market Committee that there was a considerable amount of short-term funds that might flow into a short-term security, and that, if a test were made and the funds did not come in, it would be a reasonable demonstration of the fact that they did not exist. He went on to say that he did not know whether the recent certificate was the best method of testing whether these funds were available, but that it was true that to the extent the necessity for resort to the banks could be reduced by such issues the better the situation would be.

Mr. Harrison suggested that it was not possible to have a satisfactory test as long as corporations did not know what their tax bill would be over the next year.

Mr. Kurtz stated that, while it might have been true that corporations had surplus funds sometime ago, as was suggested by a study made at the Federal Reserve Bank of Philadelphia, inquiries that he had made recently indicated that because of the many uncertainties in the picture corporations desired to hold their cash. He also said that Government payments were slowing up, which required more working capital in the hands of corporations with Government contracts.

Mr. Ransom said he took it for granted that the Federal Reserve System would do everything in its power that might be necessary to assist in financing the war, that of necessity the banks would be relied upon for a substantial part of the financing, but that he would like to be sure that everything possible had been done to bring about the investment in Government securities of as many nonbank funds as possible before a decision was reached on the question whether the Board of Governors should reduce reserve requirements.

Mr. McKee questioned whether the uncertainty injected into the picture by the pending tax bill was a factor in the attitude of corporate investors toward the recent issue of certificates for the reason that the certificates would mature before the new taxes became due.

Mr. Harrison suggested that the tax question was a factor because corporations would take into account the net income from the securities after possible taxes and take the position that, if they should have to pay most of the income back in the form of taxes, the net return would not be sufficient to justify tying their funds up for six months in a period of uncertainty when it might be necessary to have funds available. He also said that he doubted whether new funds available for investment in long-term governments in the next year or so would go much beyond $2,000,000,000 as a maximum, and that it was not possible for a company to say in response to a telegram from the Treasury what the company's interest would be in a short-term certificate of indebtedness because it would not know the answer until it knew what the opportunities were going to be for long-term investment. Therefore, he felt that the test of market demand should be made first in the form of long-term securities to ascertain how many long-term funds were available, and that when that was ascertained short-term securities could be offered which could be taken by the banks.

In connection with a further reference to the question whether the uncertainties in the tax situation had any effect on the attitude toward the certificate issue, Mr. Brown stated that he had talked to the treasurers of certain large corporations and that they felt they needed to hold their cash to meet possible demands that might be made upon them in connection with war production, that the loss of the small amount of net income that they might get from a 1/2 per cent security would be a cheap price to pay for having the cash available, and that if they were going to invest in anything it should be higher interest rate securities.

Mr. Ransom inquired what the members of the Council thought would be the effect of lowering reserve requirements in a situation where the threat of inflation was already strong, and Mr. Brown responded with the statement that in his opinion inflation of bank deposits would not result in an inflation of prices and that a greater danger from inflated bank deposits lay in the tendency of banks to over-invest in long-term securities in relation to their capital assets, which might result in insolvency for the banks if the Government should be unable to maintain prices of long-term securities. He agreed with the statement made by Mr. Ransom that large increases in excess reserves would result in a decline in interest rates to a point where it might endanger the whole economic structure, but expressed disagreement with the statement which he said had recently been made at a meeting of the board of directors of the Federal Reserve Bank of Chicago by a representative of the Treasury that, if the bill rate went up to 3/8 per cent, it might affect the price of intermediate bonds and perhaps long-term securities so that it would not be possible for the Treasury to finance at 2-1/2 per cent. Some of the members of the Council indicated that they did not agree that an increase in the short-term rate would have that effect, and Mr. Harrison stated that it was not out of proportion to have a long-term rate five times as large as the short-term rate and that in England, where the banks were recognized as being necessary to the war effort, it had been made possible for them to live by the issuance of short-term securities carrying a rate of 1 or 1-1/8 per cent. He did not think such an arrangement would be politically possible in this country but that it was not reasonable to say that a 1/2 per cent short-term rate would make it impossible to maintain a 2-1/2 per cent rate on long-term securities.

Mr. Fleming commented that in the long run it was going to be necessary to rely on the banks for a substantial part of the war financing and that, while the banks should of course pay taxes on earnings from loans, there should be a recognition in the tax program of the free services that the banks are called upon to render in the sale of defense bonds, the handling of blocked accounts of foreigners, and in other connections. He also said that he felt it was important that the Government, after having done a very constructive job in building bank capital in the depression, do not at this time adopt a taxation program which would work in the opposite direction and result in banks being in such a position at the end of the war that they could not stand the shocks that might come during the post-war period.

In response to a suggestion from Mr. Ransom that the banks should conserve their capital by curtailing dividends, Mr. Fleming said that he did not think dividend payments were heavy.

Mr. Ransom inquired how a preferential treatment of banks in the tax program could be justified, and Mr. Fleming said that it should be considered in view of the circumstances to which he had referred and that it had been discussed with the Treasury in connection with the pending tax bill.

Mr. McKee suggested that the problem should be met by the Treasury reimbursing the banks for out-of-pocket expenses incurred by them in connection with the services which they were now rendering to the Government without charge.

Mr. Brown inquired what the situation was with respect to the long-term program of Treasury financing that had been suggested to the Treasury by the Federal Reserve System, and stated that the members of the Council had the impression that not much headway had been made in the direction of a long-term program and that the Treasury was continuing to operate on a day-to-day basis.

Mr. Ransom stated that he felt that, since the members of the Federal Open Market Committee first began studying the matter, considerable progress had been made toward the adoption of a program but that it had not been as rapid as he would have liked, and that the difficulty had been a tendency to argue over details instead of agreeing on a set of general principles and leaving to the technicians the details of rates and maturities in harmony with the agreed principles. He felt that the necessities of the situation would force the Treasury to adopt some kind of a program which the Federal Reserve System and the banks would have to support, and that when a program was adopted the results would be much more satisfactory.

Mr. McKee stated that it was felt that the Treasury was well along the way toward the adoption of a program recently when a banker entered the picture and urged on the Treasury the continuation of open-market issues rather than the issuance of nonmarket tap securities suggested in the program proposed by the Federal Reserve System, with the result that up to the present time the Treasury had been unwilling to adopt a program.

Mr. Ransom emphasized that the failure of the System and the Treasury to agree on a program was not because of bad relations, because he thought they were really very good, but because of differences of opinion as to what should be done.

Mr. Harrison inquired whether the members of the Council were to assume from what had been said that the plan suggested by the System had been discarded, and Mr. Ransom replied that such was not the case, and that the representatives of the System felt that some plan along the line suggested should be adopted for the purpose of ascertaining what funds could be obtained through the use of nonmarket issues. The members of the Board present concurred in Mr. Ransom's statement that the suggested plan had not been discarded by the Treasury.

Mr. Harrison stated that the reason for his inquiry was that, if non-negotiable tap issues were to be offered, someone should look into the question whether they would be legal investments for corporate investors, that there was a real question whether his company could buy them, that so far as his company was concerned it did not make much difference whether the securities were negotiable or not for the reason that it purchased them to hold to maturity, but that he did not want to have to look forward to a time when there would be no long-term issues available which would be legal investments for insurance companies. He also said that, so far as his own company was concerned, he was willing not only to spend all its available funds but to borrow money for the purchase of Government securities, but in order to do that it would be necessary to know what the program was to be, and that the longer a program was delayed the more difficult the problem would become because of the investment of available funds.

In a further discussion, it was stated that it was questionable whether the tap issues contemplated by the program suggested to the Treasury would be legal investments for trust funds. In that connection, Mr. Kurtz stated that the Series G bonds were a good instrument for trust investment, and he suggested that the limit on these be increased to $100,000.

Mr. Harrison expressed the opinion that it would be a mistake to finance the war on a basis which would result at the end of the war in from 50 to 75 per cent of the Government debt being payable on demand, that if rates increased after the war the demand obligations would be offered for redemption at a time when it would be difficult for the Government to refund, and that a situation might be created which would force the Government to resort to greenbacks as a means of paying off the debt.

Mr. Ransom suggested that the most important job before the country was to win the war, that if the job could be done along orthodox lines and inflation could be avoided that, of course, was desirable, but that we should be most concerned about winning the war. In that situation, he said, we should decide what the alternatives were and what would be the effects if the Board of Governors should lower reserve requirements.

Mr. Harrison stated that he would not lower requirements at this time, that he would try first to get as many long-term nonbank funds as possible invested in Government securities, and that only when it became necessary to rely on the banks for a preponderant part of the financing would he give consideration to the necessity for a change in reserve requirements. Mr. Ransom concurred in this statement and said that, if reserve requirements were lowered, it probably would be necessary to resort to selective methods of control which would raise difficult problems.

Mr. Harrison said that he did not agree with a statement made by Chairman Eccles at an earlier meeting that, if the Federal Reserve System were to support the market, long-term Government securities would be in fact demand obligations. It was his opinion, Mr. Harrison said, that if the Government did not want the banks to purchase long-term securities it had sufficient influence over the banks that they would not buy them. Messrs. Brown and Fleming did not agree with this statement, but Mr. Ransom said he was in agreement with it and felt that, if the Government had a comprehensive financing program, the banks' supervisory authorities could say that short-term securities would be made available for bank investment and they should not purchase long-term securities, and that if that were done the banks would respond.

In a further discussion of the pending tax bill, members of the Council reiterated the opinion that the Treasury tax proposals were very dangerous to the maintenance of bank capital. In response to an inquiry from Mr. Ransom whether that view was being presented to the Treasury, it was stated that it had been and that it would also be presented to Congress.

In answer to a question from Mr. McKee as to whether the members of the Council had any comments to make with respect to the Series

E war bonds, Mr. Brown stated that the cost of issuing and redeeming these securities in the small denominations in which they were issued was out of all proportion to the amount of funds raised, and that 95 per cent of the expense of issue and redemption would be eliminated if provision were made only to inscribe the bonds with the name of the purchaser, taking whatever chances of oversubscription or loss that might be involved in the elimination of the elaborate records required in the present procedure.

In connection with a comment by Mr. Ransom that the financing requirements of the Government could not be met by reliance on voluntary subscriptions, Mr. Brown stated that, if the limit on the Series F and G bonds were raised to $100,000 and an organized effort made to encourage subscriptions, the funds raised by these issues could be increased very materially.

Mr. Kurtz pointed out that there appeared to be no unanimity among the members of the executive committee of the Federal Advisory Council as to the financing program which should be adopted, and he suggested that they were under obligation to develop a program which could be submitted for consideration.

Mr. Harrison said that the members of the Council had never seen the program suggested to the Treasury by the Federal Reserve System. Mr. Ransom stated that inquiry would be made to ascertain whether there would be any possible objection to furnishing copies of the program to the Council with a view to discussing it at the time of the next meeting of the Council on May 18, 1942.

Mr. Ragland concurred in the opinion that had been generally expressed during the discussion that it would be necessary to resort to the banks in financing the war, and stated that he did not see how that could be done if at the same time the banks were "bled white" through the maintenance of low interest rates and application of high taxes. He said that the banks would be willing to forego profits if necessary but that the capital of the banks must be kept sound, which would not be possible if short-term rates were kept at the present low point and the tax burden were greatly increased.

Mr. Ransom stated that the problem was to keep all costs down, and that he did not believe it would be possible to make out a case for special treatment of the banks. In a discussion of this point, members of the Council stated that they were not asking for special treatment but that the problem of keeping the banks sound would have to be recognized.

Mr. McKee renewed his suggestion that the banks should be reimbursed by the Treasury for the services which they are performing for the Government without charge.

Mr. Brown inquired as to the status of the proposal to have the Federal Reserve Banks act as fiscal agents for the War and Navy Departments and the Maritime Commission in the making and guaranteeing of loans for war production purposes. At Mr. Draper's request, a statement was read which reviewed briefly the attention that had been given to this matter by the Board and representatives of the services since Executive Order No. 9112 was signed on March 26. The memorandum also stated that the regulations to be issued by the Board and the instructions to be given by the services to the Federal Reserve Banks were in final form, subject to minor changes, and would be sent to the Banks not later than the end of this week when the Federal Reserve Banks would be in a position actively to enlist the support of the private banking system in the program. The statement made the further comment that, inasmuch as the documents involved had not yet been cleared finally with the armed services, it was not possible at this time to discuss the details of the program but that they would be available sometime next week.

Mr. Ransom pointed out that the operations of the Federal Reserve System under the Executive Order would be decentralized and handled through the Federal Reserve Banks, and that all information with respect to the program would be issued by them. He also suggested that it was extremely important that the Banks participate in the program to the fullest extent possible as it was the intention of the armed services to get as much of the financing as possible done through the private banking system rather than through the use of Government funds, and that it was for that reason that the suggestion had been made that the Federal Reserve Banks, located throughout the country, act as fiscal agents for the services.

Mr. Brown stated that many manufacturers of war materials felt that they should be financed exclusively by advance payments by the Government, and he inquired whether the proposed program would mean that this type of financing would be discontinued.

Mr. McKee said that in the future advance payments would be made only on the basis of an interest charge, whereupon Mr. Brown stated that contractors felt that they were in a better bargaining position if they had an advance from the Government than they would be in the case of a loan with a Government guarantee, and that, therefore, the question was not whether the banks would be willing to make loans but rather whether contractors would put pressure on the services to continue to finance by means of advance payments.

In connection with a discussion of interest rates and guarantee fees to be charged under the program, Mr. Draper stated that, even in the case of a 100 per cent guarantee, the amount received by the lending bank would be more, on the average, than the cost of servicing the loan, and that if the rates prescribed by the Board should be found to be unsatisfactory they could be changed.

Mr. Fleming inquired whether there was any plan to have this matter presented at the meeting of the Executive Council of the American Bankers Association at French Lick on April 19-22, and Mr. Ransom stated

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that Mr. Cravens, who had been employed by the Board on a temporary basis in connection with the program, very likely would attend the meeting.

Thereupon the meeting adjourned.

Chester Morrill
Secretary.

Approved:

Ronald Ransom
Vice Chairman.