

A meeting of the Board of Governors of the Federal Reserve System with the Federal Advisory Council was held in the offices of the Board of Governors in Washington on Monday, May 18, 1942, at 10:30 a.m.

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

Mr. Morrill, Secretary
Mr. Bethea, Assistant Secretary
Mr. Carpenter, Assistant Secretary
Mr. Clayton, Assistant to the Chairman
Mr. Wyatt, General Counsel
Mr. Goldenweiser, Director of the Division
of Research and Statistics
Mr. Smead, Chief of the Division of Bank
Operations
Mr. Parry, Chief of the Division of Security
Loans
Mr. Berntson, Clerk in the Office of the
Secretary

Messrs. Charles E. Spencer, Jr., George L. Harrison, William F. Kurtz, B. G. Huntington, Robert V. Fleming, H. Lane Young, Edward E. Brown, S. E. Ragland, Lyman E. Wakefield, W. Dale Clark, Nathan Adams, and George M. Wallace, members of the Federal Advisory Council representing the respective Federal Reserve Districts

Mr. Walter Lichtenstein, Secretary, Federal Advisory Council

Mr. Brown stated that the Council met in separate session yesterday and that, while it had not adopted any formal recommendations or resolutions for submission to the Board, it had considered a number of matters which it would like to discuss with the Board and on which

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the Council would like to express its views.

Mr. Brown then said that the Council felt very strongly that any plan of compulsory savings as a means of financing the war should be undertaken only as a last resort, and that every effort should first be made to obtain the necessary funds by voluntary subscriptions and through the use of an organized drive to raise funds on that basis. He added that one of the greatest obstacles to the present effort to obtain voluntary subscriptions was the reports from Washington to the effect that compulsory savings would be necessary, which was making wage earners and the small-salaried classes unwilling to purchase, on a voluntary basis, the securities that they otherwise would be willing to take. He said that it was realized that officials in Washington could not commit themselves that compulsory savings would not be necessary, but that if they would withhold comments to the effect that such a step would be necessary the present plan for voluntary subscriptions would have a much greater chance of success.

Mr. McKee inquired whether the Council had any opinion on the question whether the present program was adequate or was the best way to approach the matter, and Mr. Wakefield responded with the statement that the present program, which involved a plan of personal solicitation, was just getting under way.

Mr. Brown commented that the Council felt that additional taxation would be much more desirable than a forced savings plan.

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In response to an inquiry from Mr. Ransom as to the reasons for objecting to a compulsory savings plan, Mr. Brown stated that it was impossible to eliminate the inequalities and hardships that would result from compulsory savings. Mr. Wakefield added that any such plan would, of necessity, have to be placed on the same basis as income tax collections because of the many varied situations in which individuals found themselves, and that it would result in distresses and dislocations of personal affairs as well as enormous expense on the part of the Treasury. Mr. Ransom questioned whether that would be the case, and said that the present voluntary basis had such an element of compulsion in it that in effect it came out at the same point as an involuntary plan.

Mr. Wakefield referred to the proposed \$2,000,000,000 additional social security taxes and to the broader application of rationing, and stated that as the latter was applied the need for forced savings would be eliminated because there would be no other place for the people to put their funds.

Mr. Ransom recognized the difficulties in putting a forced savings plan into effect but felt that that was not an adequate reason for not doing so, and he expressed doubt that a broader application of rationing would remove the need for such a program.

Mr. Fleming stated he thought that with the application of higher taxes it would be necessary to give some recognition, in determining the tax base, to the payment of debts, and that he had a memorandum on that subject which he would turn over to the Board.

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Mr. Brown stated that the point the Council wanted to make was that greater efforts could be made to make the voluntary program successful and that the comments coming from Washington operated as a terrific damper on any efforts to make it effective.

Chairman Eccles said that so far as he knew there had been little, if anything, said in Washington on that point since the decision was reached to adopt the voluntary program, and that the articles which had appeared in the press on that subject were largely inspired by the press and the financial writers.

Chairman Eccles then stated that a special committee appointed by the President, consisting of Vice President Wallace, Director of the Budget Smith, Secretary of Agriculture Wickard, Secretary of the Treasury Morgenthau, Price Administrator Henderson, and himself, had had a large staff at work studying the whole question of inflation, that it had been estimated that by September the war expenditure would reach \$150,000,000 a day and by the end of the year \$200,000,000 a day, that the availability of consumers' goods would continue to decline rapidly due to the lack of raw materials, labor, and facilities during a period of a rapid increase in the supply of funds available for the purchase of such goods, and that the excess of such funds over the anticipated supply of consumer goods would be between \$10,000,000,000 and \$15,000,000,000 after allowance had been made for increased taxation, contraction of debt of all kinds, an increase of \$2,000,000,000 in social security payments, and savings of about \$10,000,000,000 a year. He also stated that Mr. Henderson was of the opinion that it would be impossible to

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control prices or effectively ration commodities if the inflationary gap were not closed, that the German and British Governments had found it necessary to resort to forced savings, and that it was the feeling of the special committee, after giving several weeks to the study of the problem, that the adoption of a forced savings program in the United States was inevitable. The Chairman made the further comment that any effective anti-inflation program would have to cover all phases of the problem, including wages and agricultural prices, and that it would have to be placed on an involuntary basis as had been done in the drafting of manpower for the armed services. The special committee felt very strongly, Chairman Eccles said, that a program should be adopted in which income tax exemptions would be reduced and a withholding tax applied in an amount of at least 10 per cent, and that in addition there should be compulsory saving of at least another 10 per cent of income. This program was believed to be essential to finance the requirements of the Government, and it had been suggested in recognition of the fact that it would not be possible to obtain a program which contemplated a 20 per cent tax on income. The Chairman added that even with this program it might be necessary to increase the amount of taxes and forced savings and apply some form of sales tax.

Mr. Wakefield stated that he did not believe there was any disagreement on the part of the Council with what Chairman Eccles had said but that the discussion of the Council yesterday was in the light of a plan which had been instituted on a voluntary basis, and that that policy should not be reversed until the voluntary program had been tried.

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Chairman Eccles stated that he was in full agreement with that position, that at the moment he would not consider any other course, and that everything possible should be done to make the voluntary program a success.

Mr. Kurtz suggested that, if the program were to be placed on an involuntary basis as was the case with the selective service, there should be recognition of the fact that an individual might have financial and economic disabilities which would exempt him from the financial obligations of the program in the same manner as physical disabilities would exempt him from the draft. He also expressed the opinion that, if a heavy sales tax were applied to sales of other than subsistence items, it would be an extremely helpful step in the solution of the problem.

At this point, Mr. Goldenweiser withdrew from the meeting.

Following a discussion of the effectiveness of a sales tax, Mr. Harrison inquired whether any thought had been given to an expenditure tax instead of an income tax. In connection with a discussion of this point, Mr. Ransom outlined a suggestion which had been made in Britain and amplified in this country under which each individual would be permitted to purchase without tax a stated amount, say 25 shillings, of stamps each week which could be used for such purchases as he might desire, but requiring, if he desired to spend additional amounts, that he pay a progressively greater amount for each additional 25 shillings.

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Mr. Adams stated that the present plan for the distribution of Government securities, under which the Series E bonds were handled by the Treasury and the distribution of other issues was handled by the committees being set up in the Federal Reserve districts, was not an effective way to handle the job, and that it would be his suggestion that the distribution of all Government securities be placed in the hands of the Federal Reserve System.

Mr. McKee stated that he had made some informal investigations in various parts of the country in which pay rolls resulting from war expenditures were heaviest, that it was his conclusion that individuals in those areas were not purchasing Government securities to the extent that they should, and that some means would have to be found to bring about more effective participation. He felt, however, that before an involuntary program was adopted every effort should be made to make the voluntary program a success.

Mr. Brown then stated that it was the feeling of the Council that no new forms of redeemable bonds should be issued by the Treasury, and that, while it was believed desirable to raise the present investment limit on Series F and G bonds to \$100,000, there was danger in expanding this form of security because of the possibility of increased pressure for redemption. The Council was also of the opinion, he said, that with the possibility of selling \$10,000,000,000 to \$12,000,000,000 of Series E, F, and G bonds there would be sufficient redeemable bonds

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going into the hands of the public to secure the necessary funds from that source, and that by issuing different maturities of non-redeemable bonds corporate funds could be reached as well as with redeemable securities.

Chairman Eccles pointed out that the Federal Reserve System had taken the position that a short-term tap issue redeemable after six months upon 60 days' notice would be a desirable part of the financing program as a means of attracting short-term corporate funds, and that this matter had been discussed with members of the Council on previous occasions. He said that, if these funds were left with banks and invested by them, the effect would be an inflationary increase in bank deposits, whereas if the funds were used directly by corporations for the purchase of Government securities there would be no increase in bank deposits and the need for recourse to the banks would be diminished, and that in order to reduce to a minimum the extent to which bank investment would have to be resorted to for financing the war needs it would be necessary to attract all possible funds from other sources.

In explanation of his earlier statement, Mr. Brown said that what the Council had in mind was that the average corporation would prefer to invest its funds in marketable securities with definite maturities, and that more funds could be attracted in this manner than could be attracted by the type of short-term issue that had been

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proposed to the Treasury by the Federal Reserve System.

Mr. McKee stated that he could not see how any harm could result from having such a short-term issue available as a means of effecting the investment of such amounts of corporate funds as could be attracted by such an issue.

Chairman Eccles discussed briefly the terms of the short-term tap issue which had been proposed to the Treasury and the reasons why it had been suggested as a part of a program to tap all sources of existing funds other than bank funds. He referred to the fact that the System had been under pressure to reduce reserve requirements and that the program which had been recommended was for the purpose of avoiding that action as long as possible.

Mr. Fleming expressed the opinion that, with the dislocation that was bound to take place in bank deposits and as the Government-security holdings of banks became larger and larger, there would be increased pressure for the protection of those portfolios.

Chairman Eccles responded that such protection already existed in the form of an announced policy on the part of the System to make advances to member and nonmember banks on the security of Government obligations at par, the policy of the System of supporting the Government security market, and the policy of the Federal Reserve Banks standing ready to purchase all bills offered them at a rate of $3/8$ per cent which enabled member banks to adjust their reserve positions

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quickly and in such a manner as to make the most effective use of the existing volume of reserves.

Chairman Eccles then outlined briefly the organizations which were being set up in each Federal Reserve district for the purpose of distributing Government securities other than Series E war savings bonds, and stated that the existence of a short-term tap issue would give the committees something they could use to attract the funds of corporations for which they had no immediate use. He said he felt such an issue would reduce the amount of open market securities that banks would be called upon to take, and that, if the volume of bank financing of Government needs assumed large proportions, it would be necessary to reduce reserve requirements, which would result in large excess reserves and a very low short-term rate. He added that it was hoped it would be possible to hold open market financing to not to exceed \$1,000,000,000 a month and to raise an additional \$1,000,000,000 through tap issues, and that if that were possible it was likely that a change in reserve requirements could be avoided for a considerable period of time.

Chairman Eccles also stated that the Presidents of the Federal Reserve Banks were calling attention of banks throughout the country with excess reserves to the availability of Treasury bills, and some of the members of the Advisory Council stated that the smaller banks had not been interested in bills in the past and that it would be necessary to do a considerable amount of educational work to bring the

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matter effectively to their attention.

On the question of member bank reserves, Mr. Brown stated that the Council was in complete agreement with what it understood to be the Board's position, that for the present at least the problem of bank reserves should be treated as a single problem for the country as a whole, that the volume of excess reserves was sufficient for the time-being, and that no effort should be made to force balances into the New York market or action taken looking toward an over-all reduction in reserves. He said that, while the Council realized it might be necessary to reduce reserve requirements fairly soon, it was felt that existing reserves could be mobilized through the use of the bill market, and that it was necessary that the Treasury obtain its funds from the sections of the country where the Government was spending money. He added that the Council was opposed to the discontinuance of New York and Chicago as central reserve cities for the reason that the correspondent bank balances and corporate accounts in banks in those cities were more liable to fluctuations than deposits in other parts of the country.

Chairman Eccles referred to the proposal that had been made for an amendment to the law which would authorize the Board of Governors to change reserve requirements in central reserve cities or reserve cities, and expressed the opinion that it would be desirable to have this authority for the reason that it might be found necessary to change reserve requirements in central reserve cities without

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taking similar action with respect to reserve city banks.

In the ensuing discussion, Mr. McKee suggested that the amendment might be placed in such form as would insure the maintenance of somewhat higher reserve requirements in New York and Chicago in recognition of the central reserve characteristics of those cities and still permit more elasticity in action by the Board with respect to changes in requirements.

There was a discussion of the alternatives that might be available to the Board of Governors in the absence of the suggested amendment and the reasons why the law was written in its present form. Mr. Harrison referred to the special report which was submitted to Congress by the Board of Governors, the Presidents of the Reserve Banks, and the Federal Advisory Council on December 31, 1940, and to the recommendation contained therein that the authority over reserve requirements be placed in the Federal Open Market Committee and the Committee authorized to change reserve requirements for central reserve city banks or reserve city banks or for country banks, or for any combination of these three classes. He expressed the opinion that, while from an economic and financial standpoint it would be well to amend the law so as to permit a change in reserve requirements of any one of the three classes of banks, it would remove much of the fear of improper use of that power if it were placed in the hands of the Federal Open Market Committee.

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Mr. McKee stated that in his opinion a more important amendment would be one to which he had previously referred in discussions with members of the Council which would amend section 19 of the Federal Reserve Act to eliminate the provision that no bank shall make new loans or pay dividends while its reserves are deficient, that in view of the decision reached in the case of Michelsen et al. v. Penney et al., 41 F. Supp. 603, the directors of banks were fearful of making loans when their reserves were near legal requirements, and that in this situation the recent amendment to the Board's Regulation D to permit the computation of reserves on a weekly basis had been of little help in the situation.

Mr. Brown stated that it was the feeling of banks throughout the country that the Penney case would be reversed in the higher courts, and Chairman Eccles said that the amendment referred to by Mr. McKee was among the amendments that had been proposed by the Board, that the Board did not want to suggest the amendment as separate legislation, but that, if there were to be legislation to permit a change in reserve requirements of central reserve city banks, this point should be covered.

Comments made by members of the Council at this point indicated that they would favor such an amendment, and Mr. Brown stated that the matter would be considered further in the separate session of the Council this afternoon.

Mr. Brown then said that, while Amendment No. 4 to Regulation W had been in effect only a short time and it was not yet possible to

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determine what the effect of the amended regulation would be, it was felt that the inclusion in the regulation of nonpurpose loans up to \$1,500 was not justified by the results that would be obtained, and that in the smaller banks particularly it would result in a disturbance in public relations. He also said that it was the feeling of the Council that considerable pressure had been brought by the personal loan companies to have such loans included in the regulation in the fear that otherwise they would suffer loss of business. He added that the Council would prefer to discuss the entire matter at the time of its next meeting with the Board when there will have been an opportunity to observe the operation of the amended regulation.

Mr. Ransom stated that the reference in the President's anti-inflation program to the desirability of the payment of personal debt was without limit or qualification as to amount, that the problem facing the Board was whether it should regulate all consumer loans regardless of amount, that the alternative was to limit the application of Regulation W to such loans up to \$1,500 and leave other similar debts in larger amounts to be handled in a much more flexible manner which would permit banks and the supervisory authorities to undertake to carry out the purpose of the President's program, and that it would have been entirely inconsistent to undertake to apply the regulation to all kinds of consumer debt and not include similar loans made by banks. He made the further statement that he would like to correct

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any impression that might exist that the form of the amendment was in any sense the result of pressure on the Board from any outside source, and that, if on the basis of experience it was found that any provision of the regulation was not practicable or worked undue hardship, it was hoped that the banks and others would bring the matter promptly to the attention of the Board.

There ensued a discussion of the provisions of the regulation with respect to insurance policy loans, and Mr. Brown stated that this was a matter the Council might wish to discuss at the time of its next meeting with the Board.

Mr. Brown stated that an important matter which had arisen in connection with loans and guarantees by the armed services and the Maritime Commission under the provisions of Executive Order No. 9112 and the Board's Regulation V was the question of the authority of banks to make loans and commitments in amounts in excess of the limitations imposed by section 5200 of the Revised Statutes on the amount which a national bank might lend to any one borrower. He said the Council was familiar with the letter received by the Board from the office of the Comptroller of the Currency on this subject, but that he had discussed the matter with a number of bank attorneys, all of whom felt that notwithstanding the Comptroller's letter national banks would not be protected if the loans made by them and guaranteed by the armed services exceeded the legal limit.

Messrs. Eccles and McKee stated that Mr. Wyatt had received

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a letter from Representative Sumner, written at the request of the House Banking and Currency Committee, asking that Mr. Wyatt draft an amendment to the Murray Bill which would exempt from the limitations of section 5200 loans made by national banks to the extent that the loans were guaranteed by the Federal Government, and that a letter enclosing alternative drafts of such an amendment had been prepared for Mr. Wyatt's signature which would go forward today.

Mr. McKee inquired whether it might be desirable to have representatives of the War and Navy Departments and the Maritime Commission attend a meeting of the Board and the Council this afternoon for the purpose of discussing some of the problems that had arisen in connection with operations under Executive Order No. 9112. It was agreed, however, that these matters should first be discussed by the Board with the Council, following which a determination could be reached whether it would be helpful to have a discussion with representatives of the services.

Thereupon, the meeting recessed and reconvened at 2:45 p.m. with the same attendance as at the morning session except that Messrs. Goldenweiser and Fleming were not present and Mr. Vest, Assistant General Counsel, and Mr. Cravens, Administrator for the War Loans Committee, were in attendance.

Mr. Brown stated that it had come to the attention of the Council that the War and Navy Departments were now deleting the

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counter-claim clause in Government contracts for war materials before they would recognize an assignment of claims arising under the contract, and that it was felt that if this practice were persisted in it would act as a major deterrent to the financing of the war effort.

Chairman Eccles suggested that the Council present the matter to the Board formally with the request that it take it up with the armed services, and Mr. Brown stated that the Council would be glad to do so.

Chairman Eccles referred to the discussion at the morning session with respect to the position taken by the System in connection with the use of registered securities in the war financing program and to the indication during the discussion that the Council as such had not given consideration to that matter. He said that, as one member of the Board, he would like very much to have the Council give some thought to that phase of the problem as it was felt that it had a very important bearing on the whole financing program.

Mr. Brown inquired whether it was still proposed to issue the long-term tap issue which was mentioned in the program submitted to the Treasury on January 28, 1942, and Chairman Eccles replied that the immediate need for such a security had been met by the $2\frac{1}{2}$ per cent tap issue recently offered. Mr. Brown stated that, in accordance with Chairman Eccles' request, the Council would be glad to consider the desirability of a short-term tap issue and advise the Board of its position in the matter.

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Mr. Brown then stated that in the opinion of the members of the Council the principal obstacle to the effective participation of banks in war financing under Executive Order No. 9112 and the Board's Regulation V was the reluctance of prime and subcontractors to place themselves in a position where, if the war should terminate and the contracts were partially finished, the contractors would find themselves in the position of having large amounts of partially finished material, large expenditures for plant conversion, commitments to buy, obligations in many cases many times their net worth or capitalization only part of which might be guaranteed by the Government, so that even if the guaranteed portions were taken up by the Government contractors would still be in a position where they would not be able to reconvert their plants to peace-time operations for a considerable period of time.

During a discussion of this and other related points, Mr. Brown stated that the Council felt that there had been some indication on the part of the Board that banks had not cooperated in the financing of war contracts as effectively as they could have done. It was made clear that there was no such feeling on the part of the members of the Board.

Mr. Goldenweiser entered the meeting at this point.

Mr. Cravens discussed the provisions of sections 5 and 6 of a revised uniform form of guarantee agreement which had been designed to remove some of the difficulties in the event of cancellation of a contract.

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He said that the present draft of agreement had now been agreed upon by the War and Navy Departments, the Maritime Commission, and the War Production Board, and incorporated practically every suggestion that had been received for the protection of the financing institutions and would make financing operations infinitely easier than had been the case under the first draft of the agreement.

Chairman Eccles stated that it was felt that practically everything had been done that could be done for the protection of the banks in making loans to finance the war effort, and that it was his personal view that the banks would be much better off if they made these loans on this basis than they would be if the Government were made to feel that it would have to do the financing of war contracts itself.

Mr. Brown stated that the point the Council wished to make was that the arrangement would not work unless contractors, whether they were prime or subcontractors, were willing to finance their operations under the arrangement, and that as long as they felt there was any possibility of having the financing done by advances from the Government rather than by loans they would hold out for that type of financing. He said that until that problem was solved the banks would not have much opportunity to do much of the financing.

Chairman Eccles questioned whether it would be possible to get completely away from advances as a means of financing war orders and stated that, although it was hoped that the granting of loans

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and guarantees under Executive Order No. 9112 would work toward a reduction in the number of advances, and the services would endeavor to limit advances wherever possible, they would not refuse to make an advance if they could not keep production going in any other way.

Following a discussion of individual cases referred to by members of the Council of applications for loans, Chairman Eccles stated that the Board was not critical of the effort of the banks in this field, that the whole idea had been to decentralize the program as much as possible and utilize the banking facilities of the country, and that it was hoped by this procedure to save the Government a considerable amount of money and assist the banks throughout the country by affording them an opportunity to make war loans. He also expressed the opinion that in cases where applications were made by individuals or concerns without experience, capital, or integrity they should be turned down no matter what the terms of the proposed loan might be.

Mr. Cravens stated that the sections of the War and Navy Departments and the Maritime Commission having responsibility for operations under Executive Order No. 9112 were new and in the stage of organization, but that they had shown a most cooperative attitude and had been entirely willing in all cases to reconsider any conditions that had been applied whenever it was shown that such conditions were not practicable and should be adjusted.

Mr. Brown inquired as to the reason for the policy requiring

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that a subcontractor borrow to finance his requirements when the prime contractor, who had obtained an advance from the Government but was in a position to borrow without obtaining a guarantee, was willing to advance funds to the subcontractor. Mr. Cravens stated that he had heard of no instance in which there had been objection to such advances by the prime contractor but that, since the services were under obligation to see that advances by the Government were used for proper purposes, they might object to advances to the subcontractor in cases where there was some inherent weakness in the corporation itself.

Following a discussion of the volume of loans that had been made since the adoption of the Executive Order and Regulation V, Mr. Brown stated that there were certain applications for loans in connection with which the moral and financial risk was such that the banks should not make the loans, and Messrs. Eccles and McKee stated that cases of this kind should go to the Reconstruction Finance Corporation.

In response to an inquiry, Mr. Cravens stated that the services had made one or two direct 100 per cent loans in cases in which there was no basis for bank participation but that these were being discouraged as much as possible.

The discussion was concluded by a statement by Chairman Eccles in which he expressed the opinion that it was important that the banks participate in making war loans under the provisions of the Executive

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Order and the Board's regulation and that they give their best efforts in an attempt to make the program succeed. Mr. Brown replied that the banks were anxious to have it succeed and were doing all they could in that direction.

There was unanimous agreement that it would not be necessary at this time to have a meeting of the Board and the Council with representatives of the services.

Thereupon the meeting adjourned.

Chester Morrie

Secretary.

Approved:

W. S. ...

Chairman.