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, December 4, 1944, at 10:30 a.m.

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

Mr. Morrill, Secretary
Mr. Carpenter, Assistant Secretary
Mr. Hammond, Assistant Secretary
Mr. Clayton, Assistant to the Chairman
Mr. Thurston, Special Assistant to the Chairman
Mr. Goldenweiser, Director of the Division of Research and Statistics
Mr. Smead, Director of the Division of Bank Operations
Mr. Paulger, Director of the Division of Examinations
Mr. Parry, Director of the Division of Security Loans
Mr. Dreibelbis, General Attorney
Mr. Leonard, Director of the Division of Personnel Administration
Mr. Vest, Assistant General Attorney
Mr. Wyatt, General Counsel

Messrs. Charles E. Spencer, Jr., John C. Traphagen, William F. Kurtz, B. C. Huntington, Robert V. Fleming, Keehn W. Berry, Ralph C. Gifford, Lyman E. Wakefield, A. E. Bradshaw, Ed. H. Winton, and George M. Wallace, members of the Federal Advisory Council representing the First, Second, Third, Fourth, Fifth, Sixth, Eighth, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively

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Mr. Walter S. McLucas, Chairman of the Board of the National Bank of Detroit, was designated by the Federal Reserve Bank of Chicago to attend this meeting in the absence of Mr. Edward E. Brown who was unable to be present.

Mr. Walter Lichtenstein, Secretary of the Federal Advisory Council

Mr. Spencer stated that Mr. Brown was in Mexico and for that reason was unable to attend this meeting.

Mr. Spencer also said that the first item on the agenda for the meeting of the Council was developments in connection with the absorption of exchange and collection charges as an indirect payment of interest in violation of the law and the Board's Regulation Q, Payment of Interest on Deposits. He said the Council discussed the matter yesterday and would like to know whether the Board had any further information with respect to it.

Mr. Ransom stated that the Board received informal word from the clerk of the Senate Banking and Currency Committee last week end that the Committee was planning to hold hearings on the Brown-Maybank bill commencing Thursday of this week; that the proponents of the bill would be heard from first, and that although there was no information available yet as to how long the hearings would be or how many witnesses would be asked to testify it was hoped that before the day was over additional information would be available. Mr. Ransom also said that, while it was his expectation that the bill would not be reported out

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by the Senate committee, if it were found that it was the intention of the committee to have a full hearing, the Board proposed to notify everyone who had indicated a desire to testify in opposition to the bill. He went on to say that it now appeared that Congress would not adjourn until Christmas so that there was time for a hearing before the committee if that should be its decision, and that the length and completeness of the hearing might depend on the willingness of bank representatives and others to come to Washington at this time. Mr. Ransom repeated the comment made at earlier meetings with the Council that in the opinion of the Board the Brown-Maybank bill was in no sense a solution of the problem and would weaken the position of the Federal Reserve System at a time when it should be strengthened, that therefore the bill should be opposed as completely as possible, and that it would be necessary that the Board have the cooperation of the bankers to make it clear to the committee that much more was involved in the bill than the mere question of earnings of small banks. He reviewed briefly the information in the Board's files as to the attitude of bankers' associations and others in opposition to the bill and said that it was assumed that the position of the Federal Advisory Council, which was in opposition to the enactment of the bill, had not changed. There was no general response on the part of the members of the Council, but it appeared from individual remarks that the members present were still opposed to the passage of the bill.

Mr. Spencer stated that another matter discussed by the Council was the decline of the ratio of gold to member bank reserve balances and Federal Reserve notes in circulation, and he asked if the Board had any comment to make on that subject.

Chairman Eccles stated that it was expected that legislation would be requested sometime after the first of the year to reduce the gold reserve required to be maintained by the Federal Reserve Banks against deposits and Federal Reserve notes in circulation. He also said that the legislation had not been drawn but that there was unanimous agreement on the part of the Board and the Federal Reserve Banks that the only effective solution of the problem was legislation, and that the matter had been discussed with Under Secretary of the Treasury Bell who agreed that steps should be taken shortly after the first of the year to get the necessary legislation.

Upon inquiry as to the amount of the contemplated reduction of the required reserve, Chairman Eccles stated that, with the use of monetary gold being limited to international payments, a gold reserve against deposits and currency in circulation was largely academic, and that personally he would like to see the requirement eliminated altogether for the reason that its position had adverse effects on the market for Government securities. He said that as long as the requirement was in the law there was always the question whether, when the limitations imposed by the requirement were being approached, the Federal Reserve System would be able to continue to support the market

for Government securities, and that if the limits were removed the System's policy would not be changed thereby, as the System would not buy any more Government securities than were necessary. He also said that the authority to pledge Government securities as collateral for Federal Reserve notes would expire on June 30 of next year, and that that authority should be made permanent.

Mr. Fleming, who had suggested that the Advisory Council consider the matter of the reserve ratio, stated that there did not appear to be any question but that legislation was required and that an effort to meet the problem in any other way would be more disturbing than action in the form of Congressional legislation.

Mr. Spencer then referred to a third topic on the agenda for the Council which suggested that the proposed amendment to section 13b authorizing Federal Reserve Banks to guarantee loans should define the term "loan" to include a loan, discount, advance, or a participation therein, and the term "guarantee" to include a commitment to make such a guarantee.

Mr. Wallace, who had raised the question, stated that in conferences in connection with V-loans the suggestion had been made that it would be well to have these definitions included in the amendment and that the lawyers were pretty well agreed on them.

In response to a request for his comments, Mr. Vest stated that it was his feeling that, while there might be some room for

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differences of opinion, the amendment in its present form would mean the same with or without the definitions, that early drafts of the amendment had contained a provision that would authorize the Board of Governors to define the terms used in the amendment, but that an effort had been made to make the amendment as short and as simple as possible and it was felt that if these terms were defined it would be necessary to define additional terms as well.

Mr. McKee suggested that the proposed definitions be left with the Board for further study and this was agreed to by all of the members of the Council present.

In connection with a discussion of the prospects regarding the passage of the amendment to section 13b, Chairman Eccles said that he did not think that anything more would be done on it at this session of Congress, that if it were taken up at the next session it would have to be reintroduced, and that he doubted that that would be done particularly in view of the passage by the House on December 1 of the bill (S-2004) appropriating additional funds for the Smaller War Plants Corporation. He made the further statement that the amendment to section 13b had failed because of both the opposition of the American Bankers Association to this amendment, and its failure to oppose the Smaller War Plants Corporation bill, and that so far as he was concerned he was not going to do anything further to bring about the passage of the amendment to section 13b. He also said that unless the bankers took steps to oppose the bill which was now before Congress to appropriate one billion

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dollars for the Smaller War Plants Corporation that bill might also be enacted into law.

Mr. Fleming stated that, so far as the Council was concerned, it still favored the amendment to section 13b, that the position of the American Bankers Association was expressed in a resolution adopted in 1943 in opposition to guaranteed loans, that that position could not be changed until the subsequent meeting of the Association, and that when the matter came up the opposition was so strong that it was not possible to change the position of the Association to favor the amendment to section 13b.

Reference was made during the discussion to statements by members of the House of Representatives when the Smaller War Plants bill was under discussion in the House last week, and some of these statements were read by Mr. Clayton. Mr. Morrill said that copies of the House hearings on the bill were being sent to the members of the Council today.

Chairman Eccles stated that, in view of the passage of the Contract Settlement Act of 1944 requiring the Director of Contract Settlement to confer with the Smaller War Plants Corporation and the authority given to the Smaller War Plants Corporation in that Act to purchase surplus properties for resale to small business concerns, it was difficult to see how Congress could refuse to make additional funds available to the Corporation and that in the absence of further developments a further expansion in the activities of the Corporation and an

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extension of its existence as a permanent organization could be expected.

Mr. Spencer stated that the Council had discussed the question submitted by the Board whether the short-term Government debt should be refunded and if so on what basis, and felt that as long as the war drives and the Government's need for additional funds continued not much could be accomplished in the way of refunding securities in longer-term obligations, particularly since the great majority of corporations other than insurance companies were interested only in short-term securities and could not be expected to buy long-term bonds.

Chairman Eccles stated that the question was not directed to the war period but rather to the period following the war when the need for additional funds would be much smaller. He said that there appeared to be an erroneous impression as to the need of refunding the short-term debt and that in the circumstances the contrary course was indicated.

Mr. Fleming suggested that corporations were interested in short-term securities with the idea that they could be disposed of after the war and the funds made available for reconversion purposes, and that it would be undesirable to extend the maturity on these issues for the reason that it was probable that they would have to be purchased by the banks.

Mr. McKee raised a question as to the desirability of increasing

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the issues with three or four year maturities and reducing the number of issues in the very short field so as to provide greater flexibility in that area of the market to meet any situation that might arise.

Chairman Eccles said that he would be opposed to increasing the volume of the three or four year maturities at this time because of the increased interest cost, that in view of the present earning position of the banks there was no reason why they should receive 1-1/4 or 1-1/2 per cent on short-term paper, and that if any change were made it should be to replace outstanding certificates with a 3/4 per cent obligation.

Mr. McKee said that he did not disagree with Chairman Eccles' position but that he had in mind the possibility of some difficulty in connection with the sale by present holders of securities following the war when it might be desirable to be in a position to issue a large amount of short-term Government obligations.

Chairman Eccles questioned whether there would be a widespread liquidation of Government securities by corporations in connection with reconversion and production for the postwar period, and stated that in any event the situation was so completely controlled that there would be no material difficulty from that source.

Mr. Wakefield said that it appeared to him that the question was one of the welfare of the Government and what the banking system would require after the war. He thought that the banks should hold

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very large amounts of short-term issues both from the standpoint of the liquidity of their position and the cost of servicing the public debt, and that, therefore, it would be entirely undesirable to take the short-term debt out of the picture now or at any time in the future but that it should be increased for the reasons which he had stated. He felt that we should not be alarmed at the outstanding short-term debt but should accept it and cultivate it as the most desirable way of financing the war.

At this point Chairman Eccles read an excerpt from a memorandum which he had sent to the Treasury in September of this year, which, among other things, referred to the refunding of short-term Government obligations. The excerpt read as follows:

> "Traditionally, it has been considered good policy whenever conditions permit to refund short-term into long-term debt and to reserve short-term instruments for emergency use. The main purpose of such a policy has been to distribute maturities and to avoid the possibility of having to meet large and unwieldly maturities at a time when conditions were unfavorable. This may be the proper policy to follow in refinancing private debt, since private debtors have no control over and no responsibility for market conditions. In the management of the Government debt, however, the monetary and fiscal authorities can largely control the terms and conditions of refinancing, and they have responsibility for the adoption of policies that will be in the general public interest.
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> "To follow the traditional policy of refunding the short-term Government debt into long-term debt as rapidly as possible would lead to a number of undesirable consequences, particularly in view of the size and distribution of the present debt. Such a policy, by lengthening the

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"average maturity of the Government debt, would result in an increased interest cost and in less flexibility to the Treasury in managing the debt. The consequent increase in commercial bank holdings of longer-term securities would further increase commercial bank earnings, which are already large. This would make the Treasury and the banking system more vulnerable to political attack on the grounds that banks were making unreasonable profits from the public debt. In addition, an increase in the outstanding amount of long-term securities is inherently not in the best public interest if interest rates subsequently change; if interest rates rise the investor will be receiving less than the current rate of interest and will suffer a loss on any securities that he may sell, while if interest rates decline the Treasury will be paying more interest than is necessary at the current rate. Since the average maturity of bank holdings of Government securities would be lengthened, the depreciation of the value of bank holdings would be larger if interest rates should rise. Because of this, the Federal Reserve might be hesitant to pursue a policy of credit restraint, even if such a course should appear to be desirable on general economic grounds."

He also referred to a speech delivered by Secretary Morgenthau at Los Angeles on October 14, 1944, in which Mr. Morgenthau stated that he saw no need for a wholesale postwar refunding of the public debt into long-term bonds since it would cost the taxpayer more in interest and would shift whatever risk was inherent in fluctuating interest rates from the Government, which was able to bear it, to individuals, institutions, and corporations.

Chairman Eccles said that the point he wanted to make was that from a banking standpoint it was highly desirable that the proportion of outstanding Government debt in the form of bills and certificates should continue, and that if there were some way by which bank holdings

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of Government securities could be confined to bills and certificates that would be a desirable thing to do, but that the banks already held substantial amounts of long-term bonds and there was a tendency to shift additional amounts from short to long maturities.

Mr. Wallace said he thought of short-term as anything within one year. He did not think it would be wise to refund these issues into longer-term securities as it would increase the cost to the Government and it would be difficult to do it in any event as the public was short-term minded and would continue to be. He referred to the fact that the short-term debt in England constituted 1/2 of the total debt as compared to 1/3 in this country.

Chairman Eccles referred to the strong demand for 2 per cent bonds and stated that during the period since the Fifth War Loan Drive, in spite of the increased reserve requirements of member banks, they had increased their holdings of 2 per cent bonds on balance and had sold approximately three billion dollars of bills and certificates.

Mr. Berry suggested that there was a fundamental difference between our approach and the approach in England where the rate paid the banks was based on a return that would meet the overhead requirements of all banks. In this country, he said, we have set up a program that provides securities to meet the overhead requirements of large banks but not of the small banks, which situation could be corrected by increasing the supply of maturities in the three-year area that would

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be available to the banks.

Chairman Eccles stated that it appeared that both the large and the small banks were taken care of now in that, while the larger banks had larger earnings than the smaller ones, generally speaking all banks had adequate earnings.

Mr. Berry thought that that was because of their having purchased long-term securities, and Chairman Eccles' response was that that could not be prevented. He added that, if two or three years ago the present situation could have been foreseen, it would have been wise to prohibit the banks from taking any securities with maturities longer than were necessary to yield a return of 1-1/4 or 1-1/2 per cent.

Mr. Wakefield said that in the group of banks with which he was connected only five had excess profits, that these banks had experienced a very large increase in deposits, and that the policy of the management with respect to them was to have them hold only short-term maturities in order to meet possible deposit losses. He also felt that after the present war loan drive there would be a much smaller demand for the 2 per cent bonds.

Mr. Spencer commented that there was no point in investing in 2 per cent bonds if a substantial portion of the return would be taken as excess profit taxes.

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Mr. McKee suggested that, while it was desirable not to increase the interest cost to the Government, the failure to meet the demand for intermediate issues of securities forced the banks to invest in longer maturities which pushed these issues to a premium. He also pointed out that the amount of bonds held in the System open market account was not sufficient to supply any substantial market demand on balance and that if the pressure on these issues continued they might advance to a point where the interest rate structure would be changed.

Chairman Eccles expressed the opinion that the present rate on Treasury bills was too low in relation to the 7/8 per cent rate on certificates, which caused the certificates to sell at a premium immediately upon issue and the rate on the longer-term securities to be pulled down. He said this could be corrected only by issuing additional long-term obligations which would increase the cost to the Government.

Referring particularly to the question of bank earnings, Chairman Eccles stated that he felt that banks should use their increased earnings to increase bank employees' salaries as soon as possible, to pay a larger rate on savings deposits, and to reduce service charges.

In a further discussion it was suggested that the demand for 2 per cent bonds might be aggravated by the thought on the part of the banks that these issues might not continue to be eligible for bank purchase.

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Mr. Wakefield felt that the Government security holdings of banks would increase, that, therefore, deposits would continue to increase, and that if that were true interest rates could not be expected to increase. He thought that these deposits might be highly volatile and therefore could not be invested in long-term securities, and that this would intensify the demand for short-term securities.

Mr. Berry thought that the pressure on the 2 per cent bonds would be reduced if there were an increase in the supply of maturities in the three year area.

Chairman Eccles stated that it appeared that approximately 50 per cent of war and other Government costs this year would be financed out of taxes and that it might be found desirable to issue a 3/4 per cent certificate, to extend the maturity of the 2 per cent bonds to 12 to 15 years, and to issue 10-year maturities at a 1-1/2 per cent rate, which would be more nearly in line with the present short-term rate.

In connection with the question asked by the Board whether a larger portion of bank earnings should be retained for additions to capital and surplus, Mr. Spencer stated that it was the feeling of the Council that the capital structure of the banking system was not adequate in relation to what it used to be, and he inquired whether the Board had any views on that point.

Chairman Eccles stated that he disagreed completely with the

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position of the Comptroller of the Currency and the Federal Deposit Insurance Corporation on the adequacy of bank capital. He felt that in order to arrive at a ratio that would have any meaning there should be subtracted from a bank's deposits its cash and Government securities, which are without risk, and that the remaining deposits should be compared with the total capital funds of the bank after subtracting therefrom banking house, furniture and fixtures, and other real estate. On that basis, he said, the ratio for all banks in this country is about 37 per cent, which is higher than at any previous time. At the same time the banks have reduced or eliminated questionable assets and their risk assets are superior in quality to those previously held. In this situation he did not think that any case could be made for conserving bank earnings for the purpose of increasing capital accounts in relation to total deposits unless our faith in Government securities was to be questioned.

Mr. Spencer commented that Chairman Eccles' statement might be interpreted as a suggestion that the banks should pay higher dividends, to which he responded that he thought they should.

Mr. McKee said that in the future the banks with the largest capital would attract the greatest volume of deposits and that the banks "were not in the hands of the supervisors but of their depositors". Therefore, he felt that if a bank could set up a statement to show what its capital was in relation to its risk assets it would be able

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to attract a considerable amount of corporate deposits and would avoid the unnecessary movement of funds to New York, Chicago, and other large centers. He felt that it was necessary that the banks educate their customers as to the capital funds that were available to protect deposits and that this could be done if the banks would set up a condition statement which would show the bank's liquidity in much the same way as the position of a customer was shown when he borrowed from a bank. While he agreed with Chairman Eccles' statement with respect to capital ratios, he felt that it would be desirable in the future for the Federal Deposit Insurance Corporation assessment to be based on risk assets rather than total deposits, with an allowance deduction for capital funds.

The concluding statement of the discussion was made by Chairman Eccles, who said that no matter how the situation with respect to bank earnings was viewed it was fraught with a great deal of difficulty and that the banks were largely out of the banking business in the real sense and were agents of the Government in selling securities and performing other Government functions. He did not see how there could be much of an increase in borrowing from banks in the future but on the other hand there might well be some reduction. He felt that since the banks had a franchise from the Government to create money in the form of checks the banking system was vulnerable to the trend throughout the world to socialize the banking system.

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Mr. Traphagen asked if it would be possible to have a copy of the memorandum which Chairman Eccles said he had sent to the Treasury and from which he had read an excerpt. Chairman Eccles responded that the memorandum covered a number of other matters which he would not be at liberty to make available but that he had covered all of the comments in the memorandum with respect to refunding the Government debt.

Thereupon the meeting adjourned.

Chester Morrill
Secretary.

Approved: M S Eccles
Chairman.

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