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 Tuesday, November 16, 1948, at 10:30 a.m.

PRESENT: Mr. McCabe, Chairman
Mr. Eccles
Mr. Szymczak
Mr. Draper
Mr. Evans
Mr. Vardaman
Mr. Clayton

Mr. Carpenter, Secretary

Messrs. Spencer, Burgess, Williams, McCoy, Fleming, J. T. Brown, E. E. Brown, Penick, Atwood, Kemper, Woods, and Odlin, members of the Federal Advisory Council from the First, Second, Third, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively.

Mr. Prochnow, Secretary of the Federal Advisory Council

President Brown stated that about a week ago Chairman McCabe called him on the telephone and suggested that at this meeting, instead of following the usual procedure under which the Council would submit a memorandum of matters which it would wish to consider with the Board, there be an informal discussion of the legislative matters that might be contained in the report of the Hoover Commission with respect to the bank supervisory agencies. He said that he discussed the suggestion with other members of the Council and they were glad to proceed at this meeting in that manner.

Before undertaking such a discussion, President Brown made substantially the following statement on behalf of the Council:

> The unexpected outcome of the national elections caused a very profound change in business sentiment. There is no clear-cut pattern or grounds for decision on whether a recession is in prospect at an earlier date than we had previously thought or whether inflationary pressures will continue. However, there is no question that a large number of expansion plans have been shelved at least temporarily. If Congress should enact an excess profits tax or heavier corporation taxes, a tremendous amount of expansion that had been planned would be abandoned. Business people with whom we have talked are more worried about the prospect of tax increases than they are about the repeal of the Taft-Hartley law. They are also worried about price controls and allocation of commodities. If when Congress convenes there is an indication that it is going to move in that direction, expansion will be restricted on a very large scale.
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> Part of the change in the situation with respect to the Government bond market was due to a belief that the present administration is more likely to continue the policy of supporting the Government securities market than a new administration would have been. There is also the feeling, which is more important, that investment opportunities will be less than anticipated because of the deferment or cancellation of plans for expansion and that perhaps a $2\frac{1}{2}$ per cent Government bond is a good thing for insurance companies to hold. The Council feels that under these circumstances it would be unwise, at least until the situation settles and it is possible to see where we are going, to "rock the boat" by changes in short-term rates or in discount rates of the Federal Reserve Banks. Short-term rates should be raised as opportunity offers but, in view of the present delicate situation, the Council feels that the timing should be left to the combined judgment of the Treasury and the Board of Governors. There is a possibility of a recession getting under way much earlier than was anticipated and the Council feels strongly that until the trend becomes clear the best thing to do would be to take no important action.

Among bankers throughout the country the recent increase in reserve requirements of member banks is almost universally disliked. They feel the changes in reserve requirements are not a proper method of dealing with the present problem of inflation, and that they have resulted in transferring Government securities from the member banks to the Federal Reserve Banks and have not been effective in reducing the volume of bank loans. As long as the Federal Reserve Banks buy securities in the market it is not likely that increases in reserve requirements will be effective in restricting loans. While earnings of banks as a whole have not decreased, the earnings of some individual banks have declined and bank earnings are so low that bank stocks are selling below their liquidation value in many instances, making it difficult to get additional capital.

The Federal Advisory Council is not opposed to a reexamination of the whole problem of bank reserves or a study by some group, perhaps a monetary commission, of the proposal that reserves be computed on the basis of the kind of deposit rather than the location of the bank, but it feels that it would be its duty to object to a request by the Federal Reserve System for further authority to increase bank reserves, and the Council is sure that banks generally would feel the same way.

All members of the Council feel that too much emphasis has been placed on the effectiveness of monetary controls and the part monetary expansion has played in the inflationary situation that has existed up to the present time. We feel that inflation is due primarily to large expenditures for capital goods and consumers' durable goods beyond the capacity of the country to supply labor and materials for such goods. We are not unmindful that members of the Board have very courageously taken the position before Congress that expenditures for housing which had been encouraged by Government guarantees were too high. On the other hand, the Government has promised more aid for housing. It might be that the fear of higher taxes and direct controls will reduce expenditures for producers' capital goods. We feel that the recent informal conference with representatives of the insurance companies has been effective in reducing sales of securities by these institutions. We also feel that the Board of Governors should emphasize that monetary policy by itself can have very little effect as long as other things are going on and if price supports are going to be continued on agricultural production and other prices are going to be kept high. In that situation it is inevitable that more bank credit or Government funds are going to be used in one way or another to carry commodities than would be the case if prices were allowed to seek a more normal level.

Mr. Burgess has some figures which show that expenditures for consumer durable goods have increased about $3\frac{1}{2}$ times since 1938 or 1939. Whether the level of these expenditures will be checked we do not know but we think the fear of what might happen because of the outcome of the election may very seriously reduce the rate of expenditure for producers' capital goods.

Mr. Burgess distributed copies of the tabulation referred to by Mr. Brown which showed that expenditures for consumer durable goods had increased since 1938 from an annual rate of $7.4 billion to $30.4 billion, that expenditures for producers' goods had increased from $5.4 billion to $22 billion, and that the expenditures of States and municipalities for public works had increased from $3.4 billion to $4.2 billion in the same period. He said that if there were added to these expenditures substantial expenditures for munitions and foreign aid, etc., the total would be beyond the capacity of this country to produce and some way would have to be found to select the things that should be produced.

In the ensuing discussion, Mr. Eccles stated that the situation was one in which we were trying to do too much too fast, which might result in the country using up the surplus that would be needed to cushion a recession and that production of these desirable goods and services should be spread out over a period of years.

Mr. Burgess stated that there should be some group which could undertake a study to determine what the situation was and suggest the principles upon which decisions could be made as to the projects that should be postponed and those that should be carried out.

There ensued a discussion of the reasons for the decline in sales of Government securities by insurance companies and whether a policy of allocating basic materials would be effective.

Chairman McCabe inquired whether the Board was to understand from the Council's statement that it felt that deflationary forces from now on might be greater than the forces of inflation.

President Brown responded that the members of the Council did not know but felt that there was a possibility that the restriction of capital expenditures might be so great as to cause a recession and that the top of the inflation might be past. Some members of the Council felt, he said, that a large number of people were cancelling major projects (including the railroads which feared a contraction of freight car loadings and were not ordering the freight cars that they had expected to buy), but that such a readjustment might be a desirable thing taking the economy as a whole.

There was further discussion of the change in the situation since the national elections, and President Brown stated that the future trend would depend to a very considerable extent on the program of the administration and the attitude of Congress toward the various proposals that might be advanced. At least, he said, there would be a breathing spell of three or four months before expansion plans of business would be resumed at anything like the rate that had been contemplated before the election. That did not mean, he said, that utilities would not continue to supply services by expanding their facilities but that such projects as the construction of department stores, freight cars, etc., would slow down.

During the discussion there appeared to be agreement that an adjustment such as outlined by President Brown would be a desirable thing if it did not go too far.

Mr. Eccles stated that the volume of expenditures for producers' and consumers' durable goods was in excess of the savings of the country and therefore it did not make much difference whether the additional funds were raised in the form of equity securities or bonds, that the difficulty was that the country was trying to fill the backlog of demand more rapidly than there were labor and materials to supply the demand, that the volume of money already in existence was more than sufficient to meet the requirements of this demand, but that while the Government had followed a policy of reducing the supply of funds by retiring Government debt and by other actions, the banks had nullified that policy by increasing loans and thereby adding to the already excessive money supply. Although a large part of the responsibility for inflation was outside the credit field and not with the bankers, he said, they must take part of the responsibility for having followed such a policy. He added that if the System had been free, as it was after the first World War, to adopt restrictive credit policies so that it would not have been possible for banks and insurance companies to provide credit, the inflation would not have developed to the extent that it had.

Mr. Fleming stated that that was not the whole story and that to tell it all it would be necessary to start with the reasons for the policies that had been followed, including the fear of eight million unemployed and the demand of labor for increased wages, all of which resulted in higher prices and the need for additional credit to do business at the higher price level.

In the discussion of these points, Mr. Eccles referred to the suggestion of the Council that increases in reserve requirements were not a proper instrument of credit policy in an inflationary situation. He stated that when the last increase was approved the System was faced with the alternative of increasing reserve requirements or changing its policy of supporting the Government securities market, that a majority of the Council at its last meeting favored continuation of the support policy, and that if that were done the Board had no choice but to increase reserve requirements to sterilize the reserves created by the purchase by the Federal Reserve Banks of securities from nonbank holders. Otherwise, he said, these reserves would have been added to the reserves being created by gold imports and would have been a further inducement for banks to expand their loans and investments. He made the further statement that anything that could be done to reduce prices and bring about some recession and thereby prevent a fourth round of wage increases would be a desirable step.

There was a discussion of how this could be brought about and Mr. J. T. Brown raised the question of the inflationary effects of the lending policies of the Government through the banks for cooperatives and the Commodity Credit Corporation.

Mr. Odlin expressed the view that the increase in reserve requirements had not been effective in restricting the expansion of bank credit and Mr. Burgess stated that such increases would not have that effect as long as the policy of supporting the Government security market was continued which enabled banks and insurance companies to get additional funds by selling securities to the Federal Reserve Banks. He added that the existing large volume of production would require a certain amount of credit which the banks were under necessity to supply because of their customer relationships and that after the insurance companies had made a loan for a construction project and had obtained the funds by selling Government securities to the Federal Reserve Banks there was not much that could be done to deny the bank credit that might be needed in connection with the project.

Mr. Szymczak asked the question what could be done assuming that the policy of supporting the Government security market was continued.

Mr. Burgess expressed the view that there was a substantial volume of public works being undertaken by the Government and various States and municipalities and that the Board should urge that such projects be deferred until the backlog of other demands had been more fully met. He added that the public was getting the opinion that the banks were the chief sources of inflationary credit expansion, that this made for bad public relations, and that the problem should be attacked nearer the source of the credit.

Mr. Fleming referred to the monthly letter of the National City Bank for November in which it was stated that during the first eight months of 1948 insurance companies had sold $1.9 billion of Government securities and that their loans and investments had increased by the net amount of $2,535,000,000, while weekly reporting member banks in the period January 1 to October 20, 1948, had decreased their loans and investments by $2,519,000,000 as compared with an increase of $575 million in about the same period in 1947.

In a further discussion, Mr. Eccles expressed the view that the insurance companies and savings banks were even more responsible than the banks for adding to inflationary pressures and that some solution for the insurance company problem should be found.

Chairman McCabe stated that it was a healthy situation when the Board as a regulatory body and the members of the Federal Advisory Council, as representatives of the banks which were regulated by the Board, could sit around the table and have an entirely free discussion of their problems as was done at meetings of the Board and the Federal Advisory Council. He contrasted that situation with the one existing in the case of the Federal Trade Commission and business and the Interstate Commerce Commission and the railroads, where a procedure of more formal hearings was followed without the advantage of free informal discussion. While it would not be possible, he said, to reconcile all the differences of opinion, there could be a general support by the banks of the Federal Reserve System and unity in fighting to preserve the opportunity for free discussion which was provided through the present organization of the Federal Reserve System.

Mr. Fleming stated that if there was a belief in the chartered banking system with some degree of autonomy in the banks, it should be remembered that only a few years ago the statement was made by men in public life that the banks were not doing their job and that bills were introduced for the establishment of a loaning agency in the Department of Commerce. He added that there had also been a question whether the banks could do the job of reconversion after the war, that the banks fully met that test, but that if the banking system continued to be made the target for the charge that they could not meet the needs of their customers there was going to be increased pressure for the entry of the Government into the credit field, which would mean the end of the private banking system.

Chairman McCabe did not concur with the opinion indicated by some members of the Council that the bankers were "in the dog house". On the contrary, he felt that they were in better repute than ever before and he said that public statements that he had made had emphasized the part that the banks had played in the war and postwar period. So far as he knew that was the view of the Board. That did not mean, he said, that the differences between the Board and the Council could be reconciled entirely because he did not think that would be possible.

Mr. Odlin inquired whether the Board planned to ask Congress at the next session for further powers over bank reserves, and Chairman McCabe stated that the Board had not reached a decision on that point.

President Brown then stated that the Federal Advisory Council at its separate meeting had given a great deal of attention to the question of changes in the Federal bank supervisory agencies that might be recommended by the Hoover Commission, that some of the members of the Council had seen the study on the Federal Reserve Board prepared by Mr. Bach for the Commission, but that it was expected that the report submitted would be different from the Bach report. He also said that, while there were differences of opinion among the members of the Council on some points, there was general agreement on the points under the following five headings:

1. The Council believes in the maintenance of the dual banking system, that the checks and balances that this System provides have been constructive in the past, and that it is desirable that they be maintained. While the Bach report indicates that the dual banking system is illogical, it is politically useless to try to abolish it.

2. The Council realizes the problem of maintaining the independence of the Board of Governors and at the same time providing for cooperation with the administration, but some independence of action and thought on the part of the Board is imperative. The Council realizes that the original concept in which the Board would act as the "supreme court of finance" and have the independence of the Supreme Court has not worked, and that as a long-run proposition the Board has had to go along with the administration in power. The Council believes, however, that some independence of thought and action is necessary, that the Board should not be subservient to the administration or the Treasury, and that while in the last analysis the Board would go along with the Treasury there should be independence enough so that it would not be in effect a bureau of the Treasury. The Council thinks that the suggestions in the Bach report for changes in the membership of the Board and provision for an Under Secretary of the Treasury for Banking as a member of the Board would be undesirable because it would reduce the importance and independence of the Board and its ability to stand out against the Treasury.

3. The Council does not favor the Economic Policy Council proposed in the Bach report for the reason that it would reduce the importance of the Board. Furthermore, it is not necessary. The Administration, through the Bureau of the Budget or otherwise, should bring about the necessary coordination through informal procedures without having the Economic Policy Council. The Federal Advisory Council favors higher salaries for the members of the Board as well as for cabinet members and others.

4. The Council believes that the maintenance of a large degree of independence in the individual Federal Reserve Banks is desirable as a means of rallying support of the Federal Reserve System. It also believes that the present system of electing directors, which is heavily weighted in favor of the smaller banks, should be maintained. The Council thinks that the Presidents should continue to be elected by the boards of directors rather than as proposed in the Bach report. Participation of the Presidents in the Open Market Committee should be continued in order to continue the representation of the banks in that body. If the Presidents were appointed in the manner suggested in the Bach report there would be less likelihood of their being willing to speak out against the Board as they do at the present time, which would weaken the support of the System.

5. The Council would be opposed to the suggestion in the Bach report that the function of examination and supervision of all insured banks be placed under the Board of Governors because:

(a) Bank examination should be objective and confined to the determination of the solvency of the banks and whether their lending policies are sound and they are observing the law. This function should not be used to carry out monetary policies.

(b) The most intelligent criticism of the Board and its policies should come from the banks. That criticism would tend to be stifled if examination and supervision were given to the body responsible for formulating monetary policies. Banks which were critical of the Board might fear retaliation through the examining department of that body, which would be detrimental to the System. There have been instances in the past in which it was felt that the office of the Comptroller of the Currency used the examination procedure as an instrument of retaliation.

Chairman McCabe stated that the Bach report had not been submitted to the Board as such, although some members of the Board had been asked to submit their individual views regarding it.

President Brown stated that no member of the Council had been asked to comment on the report.

Chairman McCabe also made it clear that the Board had reached no decisions regarding any of the questions raised in the Bach report or in the discussion at this meeting.

There was an informal discussion of the comments of the Council during which it was agreed that the views expressed during the discussion would be regarded as those of the individuals who participated.

After a recess for luncheon, the discussion was resumed at 2:30 p.m.

President Brown emphasized the view of the Council that the Board of Governors should be the body for the formulation of monetary policy and that the banks should be free to criticize the System without fear of retaliation through the medium of examination and supervision. He also said that the Council felt there was merit in the suggestion that a member of the Board serve with the Comptroller of the Currency and the Chairman of the Federal Deposit Insurance Corporation as a director of the Corporation.

President Brown stated that ordinarily the next meeting of the Federal Advisory Council would be held on February 13-15, 1949, but that there was some question whether it might be desirable for the Council to meet sometime in January after the President's budget message and his message on the State of the Union had been sent to the Congress.

Chairman McCabe suggested that the Council plan to meet at the usual time with the understanding that, if occasion required, an earlier meeting could be held.

Mr. Burgess stated that if the Board was going to make suggestions to the Congress the Council would like to have an opportunity to discuss the recommendations before they were submitted.

Chairman McCabe stated that he would take that matter up with the Board.

Mr. Eccles suggested that the Council appoint a committee to prepare and submit to the Board such recommendations in connection with legislation as the Council might wish to make.

Mr. Odlin suggested that President Brown be authorized by the Council to appoint a committee for that purpose, and President Brown stated that he would ask the executive committee to meet and consider the matter.

Chairman McCabe stated that the Board would welcome any suggestions that the Council might wish to make. In this connection it was pointed out that the President's letter asking for material for the State of the Union message and the Economic Report and for the legislative program requested submission of material by the 29th of November with supplemental listings for the legislative program not later than December 15.

11/16/48



It was agreed by the members of the Council that the next regular meeting of the Council would be held on February 13-15, 1949.

Thereupon the meeting adjourned.

Secretary.

Approved:

Thomas B. McCabe

Chairman.