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82d Congress }
2d Session } JOINT COMMITTEE PRINT

MONETARY POLICY AND THE MANAGEMENT OF THE PUBLIC DEBT

THEIR ROLE IN ACHIEVING PRICE STABILITY AND HIGH-LEVEL EMPLOYMENT

REPLIES TO QUESTIONS AND OTHER MATERIAL FOR THE USE OF THE SUBCOMMITTEE ON GENERAL CREDIT CONTROL AND DEBT MANAGEMENT

PART 2

JOINT COMMITTEE ON THE ECONOMIC REPORT

Printed for the use of the Joint Committee on the Economic Report

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JOINT COMMITTEE ON THE ECONOMIC REPORT

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- The Secretary of the Treasury.
- The Chairman of the Board of Governors of the Federal Reserve System.
- The Chairman of the Federal Open Market Committee (in collaboration with the Vice Chairman).

CHAPTER IV

REPLIES BY PRESIDENTS OF THE FEDERAL RESERVE BANKS

Introduction

The presidents of the Federal Reserve banks were informed, when the questionnaire printed in the appendix to this chapter was sent to them, that the questions, insofar as they referred to country-wide practices and conditions, might be answered jointly by the presidents if they so preferred—each president, of course, adding such supplement or dissent as he desired. This procedure was followed; each president submitted a set of joint answers to most of the questions to which, when he considered it appropriate, he added his supplemental comments. Some of the presidents also submitted general statements, best presented as a whole. General statements by the presidents follow, and after them the joint answers with the individual comments of the several presidents.

General Statements by Federal Reserve Bank Presidents

Joseph A. Erickson, Boston

We want to assure you of our willingness to cooperate with the subcommittee in any way that will be helpful to its work. The subjects being investigated represent important parts of the Nation's monetary, credit, and debt management problems. We believe it would be worth while for your subcommittee to consider further the question whether it would be desirable sometime in the near future to establish a National Monetary Commission to review all aspects of the financial organization of the country, including all of its lending and investing institutions, both public and private, the controls to which they are subject, and the extent to which all are contributing to the objectives of the Employment Act of 1946.

Allan Sproul, New York

This letter and its attachment are my answers to the questionnaire which you sent me under cover of your letter of October 12, which reached me on October 15. As in the case of a similar questionnaire sent to the presidents of the Federal Reserve banks by a subcommittee of the Joint Committee on the Economic Report in August 1949, and as suggested in the heading of the questionnaire of the present subcommittee, I am using material prepared in behalf of all of the presidents of the Federal Reserve banks to answer most of the questions asked by the subcommittee, and to provide the background for my individual comments.

This method of answering the questionnaire recommends itself both as a means of avoiding unnecessary duplication of effort, and as the

only practical way of meeting the time schedule suggested by your subcommittee. Even by adopting this time-saving method, however, it has been impossible to prepare exhaustive answers to a list of 36 questions and many subquestions, covering a very wide range of economic theory and banking practice. Volumes could be written on these questions without exhausting their possibilities for discussion and debate. The only practical alternative, when limited to 1 month for the preparation of replies, is a series of short, sharp answers which try to hit the target of the inquiry. Obviously this method leaves out much in the way of analysis, and does not permit of necessary qualifications and variations. The answers to the questions, therefore, must be taken only as a summary of views, not as complete and inclusive expressions of opinion.

This observation and caveat leads me to repeat what I said in a letter to Senator Douglas (then chairman of a similar subcommittee) under date of October 14, 1949:

> * * * many of the problems you have raised deserve prolonged study and the seasoning that comes from extended public discussion. I feel that the national interest would best be served if a number of these could be reviewed at length by a special commission, set up to reexamine our entire monetary system in a manner comparable to the investigations of 1909 to 1912, which preceded the original establishment of the Federal Reserve System.

In my opinion, a national monetary commission, made up of men in public life, in private business, and in academic chairs, is the best way to bring these problems under final review and provide the Congress with a comprehensive and seasoned report on which legislative changes might be based.

My general comments, supplementing the attached specific answers to the questionnaire which you addressed to the presidents of the Federal Reserve banks, try to follow three or four main threads which seem to me to run through the whole inquiry.

The first of these threads is the relation of the Federal Reserve System to the Government, or more particularly to the executive branch of the Government. This question was brought sharply to the fore by the public dispute between the Treasury and the Federal Reserve System in late 1950 and early 1951. It is not a new question, however; it was debated and decided in favor of an independent Federal Reserve System at the time the Federal Reserve Act was passed in 1913. It was a troublesome problem immediately after the First World War, and it has been a persistent problem during the past dozen years since the public debt began to occupy so large a place in the whole debt structure of the country. Yet, whenever there have been major amendments to the Federal Reserve Act the Congress has reaffirmed its original judgment on this important point.

I think the wisdom of those who created the Federal Reserve System, in establishing a buffer zone between the System and the executive branch of the Government, has been demonstrated over the years, and never more so than during the regrettable dispute between the Treasury and the Federal Reserve System last fall and winter. The executive branch of the Government, no less than the Federal Reserve System, needs a buffer zone to protect it from the pressures which would converge upon it if it had final authority and responsibility in the technical field of monetary and credit policy. This is not to argue that an independent Federal Reserve System can have policies and a

program which run counter to the national economic policy. That has never been the case, is not now, and never should be. It does argue for specialized competence acting under a general directive from the Congress within the bounds of national economic policy as determined by the Congress.

The core of the problem as it has recently presented itself is the coordination of debt management and credit policy. Debt management and credit policy cannot work separately, but they can work badly or well together. Putting the case from the standpoint of the Federal Reserve System, their coordination requires recognition of the fact that there cannot be a purposeful credit policy unless the Federal Reserve System is able to pursue alternating programs of restraint, neutrality, and ease as the business and credit situation may require, and to act promptly with each change in the general situation. It requires recognition of the fact that such programs must, as they accomplish an increase or contraction in the volume of credit and a tightening or loosening in the availability of credit, affect interest rates not only for private lenders and borrowers, but for Government securities—the terms of Treasury offerings for new money and for refunding issues must be affected. It does not require that the management of the public debt be made unnecessarily burdensome to the Treasury, nor that the cost of servicing the debt, over time, necessarily be increased, but it does require that Government borrowing hold its place in the market instead of being floated on a stream of newly created money. Successful coordination of debt management and credit policy depends on the sensitivity of the money and capital markets, and the possibility of close and continuous contact with all areas of these markets, to make credit policy effective with relatively small changes in credit availability and interest rates. It depends on the great growth that has occurred in the Federal debt, its widespread distribution, and its importance in the portfolios of the increasingly important institutional investor, to make this sensitivity real and this contact with the money and capital markets pervasive. In other words, it uses the facts as they exist to further the purposes of credit policy and to combine it with effective debt management; it does not try to alter the facts.

This does not require nor suggest a subordination of the Treasury to the Federal Reserve System as some have charged or implied. What is needed is to redress the balance in their coordinate spheres. The Treasury is one of the oldest branches of the Federal Government, and the Secretary of the Treasury is one of the highest executive officers of the Government and usually an intimate of the President. It has been natural for succeeding Secretaries to assume, since the relatively recent establishment of the Federal Reserve System, that their responsibility and authority is exclusive in cases where credit policy and debt management overlap. It should be possible, however, to separate the Federal Reserve System from a host of advisers to the Treasury, public and private, so that the Treasury and the System could approach these overlapping problems as equals seeking solutions and, by mutual agreement, finding solutions which best fit the needs of the economy of the country at the time.

Recognizing that there still could be differences of opinion, the situation suggests to some that the Federal Reserve System be brought

within the executive branch of the Government, or that the Chairman of the Board of Governors be made a member of the Cabinet, so that as a last resort conflicts might be resolved by the President. This solution runs counter to the whole idea of a buffer zone between the central banking system and changing executive administrations, and compounds the mistake of burdening the President with too many responsibilities in fields where a tradition of technical competence is necessary. It would lead either to bottlenecks in reaching decisions, or to decisions actually made by staff members having no direct responsibility to the Congress or to the public. Its practical effect would probably be to place the Federal Reserve System under the domination of the Treasury, or to place both the System and the Treasury under the domination of something like the Council of Economic Advisers.

A more hopeful avenue to follow is the suggestion of your predecessor subcommittee (the Douglas committee) that Congress give a general mandate to the Treasury and the Federal Reserve System regarding the objectives of debt management and credit policy in the light of present-day conditions. These instructions, as the Douglas committee said, need not and in fact should not be detailed. They would not challenge the primary responsibility of the Treasury for debt management. They should specify, however, as part of the legislative framework of debt management, that the Treasury have regard for the structure of interest rates appropriate to the economic situation. The implication of such a directive, to me, would be that the Treasury could not, as a matter of right or of superior position, call upon the Federal Reserve System to "make a market for its securities" at rates which the System believed to be out of line with the degree of credit restraint considered necessary by the System. I recognize that there would continue to be differences of opinion about these matters, and I realize that you cannot legislate cooperation between people, but the Congress, as final arbiter, might be able to provide a mandate which would charge debt management as well as monetary management with some responsibility for the objectives specified in the Employment Act of 1946. The country cannot afford to keep money cheap at all times and in all circumstances, if the counterpart of that action is inflation, rising prices, and a progressive deterioration in the purchasing power of the dollar—including the purchasing power of the dollars which the Government itself must spend and the purchasing power of dollars invested by the public in Government securities.

That brings me to what seems to me to be a second main thread of your inquiry, a challenge to bring proof of the effectiveness of moderate changes in the availability of credit (and the consequent changes in interest rates) in counteracting inflation or deflation. Questions in this area cannot be answered categorically by recourse to the record. You are always faced with the problem of the facts and statistics which are not there—the record of what would have happened if no action had been taken in the field of credit policy. The fact is, of course, that at times too much emphasis and at times too little emphasis has been placed on the effectiveness of credit policy in combating inflation and deflation. General economic situations are made up of a whole complex of individual situations, and economic developments are the resultant of a variety of economic forces. All that should be claimed for credit policy is that, combined with other measures working in the same direction, such as fiscal policy, debt management,

and, in extraordinary circumstances, direct controls, it can contribute to anti-inflationary or anti-deflationary forces.

It is quite generally admitted, however, that a severe policy of credit restraint, and the resultant sharp increase in interest rates, can be effective (even by itself) in combating inflation. Such a policy works itself out in terms of a sharp restriction of the money supply, contraction of production, contraction of employment, and contraction of income. This few would now advocate, but it is not necessary to jump from rejecting the strong-arm use of the power of the purse to complete rejection of monetary measures. The tendency of some is, however, to claim or to suggest that there is no point of effectiveness between such drastic use of credit power as is socially unacceptable, and such mild use as is wholly ineffective, and even harmful in the vocabulary of those who talk about "wading through $250 billion of public debt" to get at a segment of the private debt. Such an attitude, which denies that there is any place between the extremes where credit policy could be made effective, seems to me to fly in the face of common sense. And common sense as well as fine-spun theoretical argument has its place in the consideration of this economic problem (which is also a problem in human reactions), if the public and the Congress are to understand what it is all about.

Certainly there are difficult problems to be worked out, in finding the proper sphere of effectiveness of general credit policy under present conditions. But if any are to be asked to bring proof of their theories, it should be those who are trying to discredit general credit controls (or general credit controls which must operate within a framework of orderly conditions in the Government security market), and who would place main reliance on selective credit controls, or who suggest recourses to old laws, directed to other purposes, to bring about rationing of bank credit to individual borrowers. To quote from a recent issue of the London Economist:

> The proper reply to those who deny the effectiveness of (changing credit availability and) interest rates is not, however, to cite instances in which they would be effective; on the contrary, it is to point out that it is precisely because no one can possibly know and catalog the manifold instances, and neatly classify them in degrees of vulnerability, that the sifting function of a variable interest rate cannot be duplicated by a planning mechanism. Such a mechanism, if operated by a physical licensing system of sufficiently great complexity, might conceivably succeed in exerting a sufficient restraint upon total demand; but, if it did succeed, it would be at the cost of intolerable frictions, wastages, and anomalies. A variable interest rate, like any other price mechanism, sifts automatically a virtually infinite number of marginal and near marginal demands, and discriminatingly grades the remainder according to economic "priorities" established naturally in the market place. * * * [Matter in parentheses supplied.]

A third thread of inquiry in the various questionnaires relates to the structure of the Federal Reserve System and the allocation of powers within it. Private participation in the affairs of the Federal Reserve System seems to be called into question, and an attempt seems to be made to trace undue private influence upon the formulation of national credit policy, through the directors and presidents of the Federal Reserve banks. This aspect of the operations of the Federal Reserve System has been discussed in the answers to sections A, B, and C of the questionnaire addressed to me as president of the Federal Reserve Bank of New York. I would emphasize what I believe to be the advantages of the present modest measure of private participation

in the affairs of the Federal Reserve System, and I would enlarge upon the suggestion that the responsibility for all of the major instruments of credit policy be placed in the group now called the Federal Open Market Committee. Here I can do no better than repeat what I said at the hearings of the Douglas committee in December 1949:

This is a question on which men in the System may differ, displaying a bias, perhaps, toward the side they know best. As a Reserve bank president, it is probably natural that I should see advantages in this proposal, while members of the Board of Governors may react against it, as an intrusion upon their authority. On this question, just as on the substantive questions of credit policy, both views deserve a hearing. My own view is that we shall do well to retain, wherever we can, the regional characteristics of the System, both in the matter of decentralized operation and, more important, in the matter of System national policy. No one would deny the need for coordination of general credit policy, but we now have, in the Federal Open Market Committee, the statutory means of achieving this while retaining some regional participation and responsibility. This committee is composed, as you know, of the seven members of the Board of Governors and five of the presidents of the Federal Reserve banks. Here are brought together, under stautory auspices and with statutory responsibilities, men who are devoting their full time to the problems of the Federal Reserve System and who are in touch with governmental policies and private views and opinions, in Washington and throughout the country. It is the best expression which we have of the Federal character of the System, a character which is in tune with our political organization, with the continuously expressed intent of the Congress, and with the desires of our people.

And let me nail right here one or two arguments which have been advanced on the other side. First, there is the argument that the presidents on the Federal Open Market Committee exercise authority without having responsibility. In the first place, as I have stated, membership on the Federal Open Market Committee, and the duties and responsibilities of the committee are now fixed by statute. Every man who accepts a place on that committee derives his authority from the Congress and assumes a responsibility to the Congress and, through it, to the public. These presidents are mostly men who have devoted their lives to the Federal Reserve System—they are career men in the public service. * * * You do not plant honor and integrity in a man by bringing him to Washington and giving him an official position in the Government.

Second, there is the argument by threat; by posing a wholly unacceptable solution as the only alternative to the giving of additional powers to the Federal Open Market Committee. This is the argument that if you are going to give additional powers to the committee, you should abolish the Board of Governors. Such an argument seems to me to miss the whole point of the original suggestion. The essential and unique characteristic of the Federal Open Market Committee is its blend. The Board retains all of its existing duties, but exercises its principal powers through majority membership in the Federal Open Market Committee. The presidents, with their experience gained through carrying out policy in the field, sit as minority members of the committee. All participate in policy-making discussions, and conflicting views are given the test of thorough debate. You are protected from being blown off your course by either the political winds of Washington or the financial winds of Wall Street.

* * * * * * *

This is a case where the whole cannot adequately be replaced by either of its parts. In my view, we have developed through the Federal Open Market Committee a unique contribution to the processes of democratic administration. The System will best meet its responsibilities if this successful pioneering experiment is expanded to embrace all of the major policy determination of the System.

A fourth field of inquiry embraced in most of the questionnaires sent out by your subcommittee, which seems a little apart from the main thread of investigation, is the availability of capital and credit for small business. The implication here is that small business has not had adequate access to capital and credit and that this has led to a concentration of economic power and a lessening of the dynamic character of our economy. The answers to questions 35 and 36 of

the questionnaire prepared in behalf of the presidents of all of the Federal Reserve banks try to separate myth from fact in this area, and suggest that while there may be some difficulty in obtaining capital for small business, it cannot be held that credit has generally been lacking.

It is my own observation that the difficulties of small business, to the extent that they may be distinguished from the difficulties of big business, do not ordinarily arise from a lack of credit. They arise from a lack of management ability, from a lack of distribution and sales skill, from the keeping of inadequate records, from a lack of knowledge of cost accounting, and from a lack of access to the stream of research discoveries and technological developments which are so conspicuous a part of our economic progress. Attempts to supply these lacks, where they can be supplied, through private initiative or public aid, have not gotten very far but, in my opinion, should be pursued further. At the Federal Reserve Bank of New York we are actively pursuing this objective, with gratifying results, in our relations with our small member banks, aiding them in the setting up of commercial and agricultural credit files, in the handling of their check operations, and prospectively with some of their other problems and procedures. It would be a disservice to small business, in my opinion, to try to cure its ills by more liberal injections of credit. The maladies of small business, which obviously suffers from a high birth and death rate, are not due to credit anemia.

I should like to close this letter with a general observation. The purpose of the inquiry launched by your subcommittee is to contribute to our knowledge of economic problems so that we may be better able to make effective the policy of the Congress, with respect to economic stability, which is implicit in the Employment Act of 1946. Under circumstances such as have existed during most of the past 5 or 6 years, and such as still may exist during the next year or two, the pursuit of economic stability has required resistance to inflationary pressures in our economy. The basic elements of an anti-inflation program in a country such as the United States are not unknown. They include:

1. A fiscal policy which demands a balanced cash budget or a surplus, achieved by—

   (*a*) Rigid pruning of Government expenditures, both civil and military, to achieve the results demanded by the domestic and international situation in the most efficient manner;

   (*b*) Taxes which so far as possible retain production incentives and keep consumer spending in line with available supplies of goods and services.

2. A debt management policy which—

   (*a*) Competes for nonbank funds in the market rather than waiting for such funds to accumulate and become available at some predetermined level of interest rates;

   (*b*) Aggressively seeks to channel directly into Government hands a substantial part of the savings which accumulate in a period of full employment, high national income, and relative scarcity of goods.

3. A credit policy or program which places restraint on the availability of bank reserves and thus on the ability of the banking system to expand its loans and investments.

4. In war or semiwar, when there are special military demands on the economy, certain direct controls to channel scarce materials into the defense production effort, and to check a wage-price spiral from developing or continuing. (If the wage-price controls have form but not substance, and a farm price policy requires that increases in wages and industrial prices be matched by rises in farm support prices, you have built-in inflation, not a check rein.)

All of these things must be working in the same direction and toward the same end if there is to be a chance of success in combating inflation in an economy in which the maintenance of a high level of employment and production is desirable and, in fact, necessary. If we don't want to meet the tests of such a program, we don't really want to avoid inflation. Credit measures alone can't do the job. Inflation can come about through the push of costs as well as the pull of demand, even though the end result may be too much money chasing too few goods. An increasing money supply which merely permits the business of the country to be carried on at a higher level of costs may be more a symptom than a cause.

I hope that the answers which I have given to your questionnaire, and the views which I have expressed in this letter, will be of help to your subcommittee in the important study which it has undertaken in behalf of the Joint Committee on the Economic Report.

Alfred H. Williams, Philadelphia

My replies to the questions addressed to the presidents of the Federal Reserve banks by the subcommittee of which you are chairman are attached to this letter. The answers are identical with those prepared under the direction of a special committee of Federal Reserve bank presidents, except as to No. 34 and the concluding paragraphs of Nos. 6, 35, and 36, which relate to the third Federal Reserve district and are attached to the answers of the special committee.

I wish to supplement these answers to your specific questions with judgments on several of the basic issues raised by the range of questions as a whole. I shall limit these observations to four such issues, as follows:

1. The relationship between the Federal Government and the Federal Reserve System as the central banking organization of the country.
2. The internal functioning of the System.
3. The roles of fiscal, debt management, and monetary policies in a competitive enterprise economy, with particular emphasis on the area for which the System has primary responsibility: namely, general and selective instruments of monetary policy.
4. The functions and availability of capital and credit, especially for small business.

1. *The relationship between the Government and the Federal Reserve System.*—The Constitution of the United States, based on the principle of the separation of powers, vests in the Congress the power to coin money and regulate its value. The decision to place the regulation of money in the legislative branch was based on sound principles of government and on extensive experience in many countries with executive control over money.

The Congress, in turn, has created the Federal Reserve System to regulate the amount, availability, and cost of money and credit in ways that will promote the purposes specified by the Congress. In the Federal Reserve System the Congress created a central banking system that is apart from but not above the Government. It provided safeguards to assure that the System would operate in the long-run public interest and not, under the exigencies of the moment, for short-run private or political advantage. The ultimate assurance that the System will operate in the long-run public interest arises from the fact that, as a creature of the Congress, it is responsible to the Congress.

The question of making the System responsible to the President raises the much more basic issue of the separation of legislative powers from executive powers. The President of the United States, unlike the prime minister in parliamentary systems of government, is not responsible to the Congress or the legislative branch of government. The President has a fixed term and does not resign when he is unable to secure a congressional or parliamentary majority. The basic issue, therefore, is not whether the System should be independent in an absolute sense, but whether it should be responsible to the Legislature or Congress on the one hand or the Executive or President on the other. I believe our experience confirms the judgment of those who drafted the Constitution and that the System should continue to be responsible to the Congress.

2. *The internal functioning of the Federal Reserve System.*—The formal structure under which it operates is an important aspect of any organization; but it is only one of several aspects that produce a living institution. Others are traditions and people. In judging the competence of an institution and the desirability of change, it is important to view the institution as a whole and to recognize that a change in one aspect may produce profound changes in other aspects. A change in organization, for example, will affect the traditions and the willingness of people to serve. Given changes in organization produce some effects that are apparent or can be foreseen; but they can—and often do—produce unforeseen effects that are undesirable. That is why change merely for the sake of change or merely for the purpose of creating a logically consistent organization structure seldom proves desirable.

These general principles are relevant to the organization of the Federal Reserve banks. If we had no central banking system and were now confronted with the necessity of establishing Federal Reserve banks, we probably would not organize them precisely as the existing Reserve banks are organized. Actually the Reserve banks have been operating for 37 years. A characteristic that permeates these banks is the tradition that the public interest is paramount. Directors, officers, and employees receive this tradition as they enter the service of a Reserve bank. Over almost four decades they have enriched it through their own service. It is now deeply embedded. A significant feature of this tradition is that the Reserve banks have developed in the direction intended by the Congress when it established them. A change in methods of selecting directors or in organization could impair this tradition significantly. I believe it would be a serious mistake to run that risk in the hope of achieving gains which, even if fully realized, would concern appearance rather than sub-

stance. I do not envision, however, that any adverse consequences would result from placing final responsibility for all instruments of credit control in the Federal Open Market Committee, as is indicated in the answer to question 11. I agree also that the present allocation of authorities has proved workable and satisfactory, and that change in this particular is not urgent.

3. *The role of general and selective monetary and credit policies.*—The future of our dynamic competitive organization may well depend on our ability to achieve economic stability at high levels of employment and production. Since the subcommittee is concerned with debt management and monetary policies, my observations will be directed primarily to these fields. It is imperative to remember, however, that such stability cannot be achieved through these means alone because it is inherently a collective responsibility.

Since we have a money and credit economy, a heavy share of responsibility rests on the major agencies that determine our fiscal, debt management, and monetary policies: the Congress, the Treasury, and the Federal Reserve System.

The Congress has responsibility for expenditures and receipts and consequently also for the cash surplus or deficit of the Federal Government. In a period of inflation, congressional action which produces a surplus contributes to stability and makes easier both the Treasury's problem of managing the debt and the System's task of restricting credit. A deficit, on the other hand, reinforces inflationary developments and aggravates the problems of both the Treasury and the System. The tax and expenditure structures also influence the volume and flow of expenditures and may contribute to stability or aggravate instability.

The Treasury takes up where the Congress leaves off. It has a basic responsibility for managing the public debt and the Government's cash balance. The terms established by the Treasury in financing the debt influence the willingness of investors to buy and to hold the securities and the flow of expenditures throughout the whole economy. Unattractive terms stimulate expenditures and exert upward pressures on prices of goods and services, including those purchased by the Government. The debt management policies of the Treasury, therefore, have important influences on economic stability.

The Federal Reserve System has primary responsibility for monetary policy. It influences the flow of expenditures primarily through the use of instruments which affect the supply, availability, and cost of money. A program of monetary ease—increasing the supply and availability and reducing the cost—tends to encourage expenditures; and a program of monetary restraint tends to discourage spending.

Policies in these three fields should be formulated with reference to developments in the entire economy. Although Government financial operations dwarf those of any other individual or institution, even at currently projected maximum prospective levels, Government expenditures will be less than one quarter of total expenditures for goods and services. We should not, therefore, choose what may appear in the short run to be the easiest way to meet the immediate needs of the Government when that choice will impair the strength of the entire country, including the Government, in the long run.

Monetary policy influences the flow of expenditures primarily through its effects on the amount, availability, and cost of money and

reserves. Unless a central bank controls both the amount of assets eligible as reserves and—in a country such as ours with many independent banks—reserve requirements, it cannot impersonally and effectively control the volume of deposits and money. Impersonal quantitative control, such as can be achieved only through the use of general instruments, is an essential bulwark to the maintenance of free competitive enterprise, which is a basic objective of the Employment Act of 1946.

Open market operations, changes in reserve requirements, and changes in discount rates place upon the market the function of allocating credit among competing uses. Use of these general instruments of monetary policy thus decentralizes this important function. In my judgment, we cannot hope to maintain a strong free competitive enterprise system if we concentrate in the central bank the allocation of credit through a complex system of rationing.

Use of the general instruments will, of course, affect the cost of reserves and money. It is tempting, therefore, to look toward the selective instruments as a means of avoiding this effect. Selective instruments directed toward the use of credit, however, are no substitute for general instruments directed toward the total amount of money. If the total amount of money is allowed to increase relative to the demand at current prices, borrowers will be able to meet rising down payments and shortening maturities. Selective instruments are relatively ineffective unless they are built on the solid foundation of general instruments.

At times, despite appropriate over-all control through general instrument, credit developments in particular sectors may be getting out of hand. Under these circumstances, selective instruments can be helpful in promoting economic stability. That is their limited but important role. They are a supplement to, not a substitute for, open market operations, changes in reserve requirements, and changes in discount rates in a free competitive economy.

4. *The functions and availability of capital and credit, especially for small business.*—A highly dynamic economy is inherently a mixture of individual successes and failures. It is distinguished by a continuous flow of new ideas, new methods, new operations, new institutions. It is difficult and at times impossible to say in advance which will survive. Each survivor tends to make its competitors obsolete. We cannot expect to maintain this dynamic character if we insist that every new idea shall succeed and that every old one shall survive.

Capital and credit are an important aspect of this process. We shall weaken our system if we provide ever-increasing amounts of funds to those who cannot meet the competition of the market place. To do so would reduce first the profitability of the efficient and next the incentive to efficiency itself. The small-business unit generally competes with other small businesses as well as with large businesses. To retain through subsidy or otherwise the competition of the inefficient producer merely because he is small will weaken the efficient competitor, whether large or small.

The hope of profit motivates those who have funds to invest as well as those who desire funds. Owners of funds are under strong incentives to select from among their applicants those most likely to succeed. With the advantage of hindsight, it may be concluded that

mistakes are made. But some mistakes are inevitable. The real question is whether a centralized agency would make fewer and smaller mistakes than are made under our present private decentralized system in which profitability is the primary motivating force for those with funds and for those in need of funds. In my judgment, the probability is that such an agency would make more and larger mistakes.

I have made these comments because I want to make clear my own point of view on some of the basic issues that all of us wish to have resolved in the best interest of the entire country. Unfortunately, a basic philosophy is apt to be obscured in answers to a list of particular questions, including some that are necessarily rather detailed. Since my general comments and the answers to specific questions prepared by the System subcommittee are consistent, I have not made minor changes in phraseology.

C. E. Earhart, San Francisco

Generally speaking, the questions in section D call for discussions of the various instruments of monetary policy, with reference to the roles they play, and the effects they create, and their accomplishments and shortcomings in restraining inflation. In any series of questions and answers dealing with a subject which has as many facets as monetary and credit policy, it is virtually inevitable that problems are treated somewhat piecemeal. Limitations upon the effectiveness of a particular credit control measure, and the disadvantages to some persons that result if the measure is effective, may be rather readily apparent.

A restrictive credit policy pursued by the Reserve System may well result in a rise in the interest charge on the public debt; allow Government securities to fall below par, thus bringing losses to sellers of Governments; oblige commercial banks to deny some of their customers credit for ventures which hold promise of success; and even prevent a particular individual, in certain circumstances, from buying a house, an automobile, or a television set. These and similar readily apparent consequences of credit controls are certainly not desirable for their own sake. For instance, taxpayers may well object to the first result, investors to the second, businessmen to the third, and consumers to the last. However, before concluding that the policies which have such apparent effects should not be followed, one should attempt to assess the results if another available course of action, or inaction, were to be chosen instead. Sometimes the cure is worse than the disease, but at other times, the disease is worse than the cure.

We should like to develop this point a little further with respect to the situation which has probably provoked more discussion in the postwar period than any other aspect of credit policy, namely, the pegging of prices (or yields) of Government securities. As long as the Federal Reserve System keeps a firm floor under Government security prices and a ceiling on yields, it appears that Treasury borrowing will be facilitated, refunding of maturing issues will be readily accomplished, the burden of interest payments on public debt will not increase relative to the total debt, and holders of Government securities will consider them as good as cash.

But if it is necessary to peg the Government security market (as opposed to intervention to maintain an orderly market), it is because Government securities have not been made sufficiently attractive to find

buyers in an unsupported market. Preference of investors for other uses of their funds means that the Federal Reserve System must buy the unwanted Governments in whatever amounts are being offered in the market at the pegged prices. The ultimate result is much the same as if the Reserve System had purchased directly from the Treasury these securities that the market refused to accept or retain.

The unwillingness of Congress, both to give the System more than limited authority to buy Government securities directly from the Treasury and to allow the Treasury to issue currency with no reserve whatever in lieu of borrowing, reflects its recognition of the undesirability of insulating Government borrowing from the test of the market, except under temporary, emergency conditions. Yet to peg the Government security market short circuits market influence in essentially the same fashion.

The inflationary dangers of "printing press" money, and of direct sale of securities by the Government to the central bank, have been recognized by Congress and the public alike, but they are not quite so apparent when securities reach the central bank through a supported market. Yet, as long as it is pegging Government security prices and maintaining a fixed pattern of yields, the Federal Reserve System has been aptly described as "an engine of inflation." Pegging the market makes Government securities as good as cash, to be sure, but as inflation progresses and prices rise, cash itself becomes less and less desirable.

The taxpayer might find that the effect of price increases on Government expenditures far outweighs the saving in interest charges; the investor might find that the reduction in purchasing power of his Government bonds is more serious than the capital losses he might possibly have incurred through their sale before maturity in an unsupported market; the businessman might find that rising costs, uncertainty of supplies, and distorted markets have increased his difficulties of profitable operation; and the consumer might find that rising prices have swept a house, an automobile, or a television set well beyond his reach.

If the economy hopes to avoid the effects of inflation but does not wish to bear the effects of restrictive open-market operations, it might rely on an extensive system of direct controls. Price and wage controls, rationing of commodities and credit, controls over industrial materials and end products, would all be needed to dam the pressure upon prices.

The taxpayer then might find other restrictions even more irritating than taxes; the investor might find himself compelled to hold Government securities; the businessman might find that his output was strictly limited, either by raw materials controls or by direct order and that his selling prices were strictly regulated; and the consumer might find himself in one queue after another.

To substitute administrative decision for that of the market throughout the economy is feasible only for periods of serious and temporary emergency when patriotism can insure reasonable compliance. Even if they are effective, direct controls only postpone the resumption of price increases, if nothing is done to check the growth of the money supply.

Unchecked inflation and a network of direct controls over economic activities obviously have their unfavorable aspects, too. Whether or

not any attempt is made to check inflation, regardless of the kinds of anti-inflation measures that might be adopted, and regardless of how much our productive capacity may be expanded, the fact remains that the men and materials being used to provide for our defense and our foreign-aid program cannot contribute to current civilian production, and someone must forego the use of the goods and services they represent. That fact is inescapable and is the reason that the advantages and disadvantages of open-market operations, selective credit regulations, or any other instrument of economic control, can only be evaluated with reference to the advantages and disadvantages of other courses of action.

Replies to Individual Questions

A. OWNERSHIP OF THE FEDERAL RESERVE BANKS AND THEIR RELATIONSHIP TO THE GOVERNMENT

1. Describe the present arrangements with respect to the ownership of the stock of the Federal Reserve banks. What are the implications, advantages, and disadvantages of this ownership as compared with ownership by the Federal Government?

Joint answer

Stock of the Federal Reserve banks is owned by banks which are members of the Federal Reserve System, but their ownership of stock is as much an obligation as a right. Member banks are all the national banks and the qualified State-chartered banks that have been admitted to membership by the Board of Governors of the Federal Reserve System. Each member bank is required to subscribe to stock of the Federal Reserve bank of its district in a sum equal to 6 percent of its paid-up capital stock and surplus. Member banks have been required to pay in only one-half of their subscriptions, the remaining one-half being subject to call by the Board of Governors of the Federal Reserve System.

Ownership of stock does not imply proprietary interest in or the control over policies and operations of the Reserve banks, and thus differs essentially from the case of ordinary commercial or industrial corporations or banks carried on for profit. It implies, rather, private provision of capital for, and membership in, one of a federated system of regional banks which administer and help to formulate monetary and credit policies which will contribute to a sound and stable economy.

Member banks are entitled to a cumulative dividend at a specified rate on the stock they hold. Member banks have no other claim upon the earnings of the Reserve bank. The stock cannot be transferred or hypothecated. Each member bank, regardless of the number of shares it holds, has but one vote, which may be exercised only for the election of directors of a Federal Reserve bank, according to the procedures described in the answer to question 6. Member bank ownership of the stock of the Reserve banks was not intended to place control of the System's policies in the hands of the member banks, and has not, in fact, done so.

The present stock ownership arrangement stimulates among member banks a greater interest in Reserve bank affairs than would exist in the absence of such ownership. It helps to secure effective co-

operation between private business and Government for the attainment of objectives in the interest of the general public, at the same time avoiding both political partisanship and narrow private interest. The Federal Reserve System has achieved much of its effectiveness because of its regional organization and internal freedom from domination by any particular group. In the actual administration of the 12 banks, a unique combination is obtained through the positive contributions of able directors and experienced officers combined with effective supervision by a public body.

Because the Reserve banks have many of the attributes of private management while conducting operations in the public interest, they have been able to combine the advantages of businesslike efficiency with the spirit of public service. Directors are willing to serve because they feel that they are elected or appointed on the basis of ability and reputation to render service within their field of competence; officers who have made a career of central banking have done so both because they are attracted to a public service institution and because they feel that advancement for merit and security from arbitrary political preferment are available in the Federal Reserve banks.

The present stock ownership of the Federal Reserve banks has contributed to a distribution of powers commensurate with the duties to be performed. Some powers have been given to the central agency, the Board of Governors; some to the regional banks; and some to a combination of the two. This distribution of powers assures group judgments, which provide variation in emphasis, and decentralized administration, which encourages initiative.

The advantages just cited are achieved by a type of stock ownership which does not imply control. Transfer of ownership to the Government would deprive the Federal Reserve System of most of these advantages. Government ownership, unlike private ownership, would imply control which would be unnecessarily centralized. Fears of political interference would impair the cooperation with banks and business already achieved and would reduce the willingness of able men to serve the Reserve banks. These consequences of Government ownership would be reflected in a loss of efficiency in operations of the Reserve banks and reduced effectiveness in achieving the ultimate objectives of maintaining business stability and high levels of production and employment.

The only disadvantage of private ownership of the stock, from the viewpoint of the Federal Reserve System, is the occasional misconception to which it gives rise. The principal misconception is that the policies of the System are or may be subject to private domination. That this is a misinterpretation is shown by the statements of fact contained in this and subsequent answers. The method of dealing with this problem is to conduct a continuing program of public information as to the role and functioning of the Federal Reserve System. The same misconception may have led some Members of Congress to suppose that private ownership of the stock of Federal Reserve banks has made the policies of the System subject to undue influence by private interests, and may consequently have been an obstacle to full support of the System, including legislative action as needed, in the efforts to carry out its responsibilities. If that is the case, congressional inquiries such as the present one should help to clarify the situation.

Comment of R. R. Gilbert, Dallas

In connection with this answer, I think it might be pointed out that, although at the time of organization of the Federal Reserve System the organization committees were permitted under certain limited restrictions to allot stock in the Federal Reserve banks to the United States to be paid for at par out of any money in the Treasury not otherwise appropriated, such authority was in the nature of a "last resort" provision.

In fact, the act provides that subscription to stock of the Federal Reserve banks was intended to be limited to national banks and other member banks and that only if such subscriptions did not provide adequate capital could the organization committees turn to other sources for such funds. Even then, however, it was first provided that additional funds, if needed, should be obtained through stock offered to the public, and then, finally, if that secondary source did not provide adequate capital funds, stock was to be allotted to the Treasury as a last resort device.

2. Who, in your opinion, owns the surplus of the Federal Reserve banks?

Joint answer

The surplus of the Federal Reserve banks belongs to the Federal Reserve banks and not to their stockholders or to the United States. The surplus of a Federal Reserve bank protects its depositors and other creditors, and so long as a Federal Reserve bank is a going concern its surplus should continue to perform this normal function. Should a Federal Reserve bank be dissolved or go into liquidation, any surplus remaining after payment of debts, dividends, and par value of its stock becomes the property of the United States.

3. Do you consider the Federal Reserve banks to be part of the United States Government? Part of the private economy? If neither, or partly one and partly the other, discuss their status.

Joint answer

As distinguished from the Board of Governors of the Federal Reserve System, Federal Reserve banks are not independent establishments of the Government. Federal Reserve banks are "instrumentalities" of the Federal Government. As such, they act as agents of the Government in performing Government functions.

There are many kinds of Government instrumentalities. Distinctions may be drawn between such instrumentalities of the Government as (*a*) private independent contractors working on Government contracts; (*b*) national banks, which are wholly privately owned and controlled, and are operated for private profit; (*c*) Federal Reserve banks, all the stock of which is privately owned, a majority of the directors of which are elected by such stockholders, and which are operated (under the general supervision of the Board of Governors of the Federal Reserve System, an independent establishment of the Government) primarily for public and governmental purposes and not at all for private profit; and (*d*) the numerous corporations wholly owned and controlled by the Federal Government and operated entirely for Federal governmental purposes, such as the Reconstruction Finance Corporation.

In our opinion Federal Reserve banks are partially part of the private economy and are part of the functioning of the Government (although not technically a part of the Government). Because they are a part of the functioning of Government the public interest is dominant in their policies. They thus carry out the original intent for which they were formed which was to function somewhere between private enterprise and the Government itself (much closer to the Government than are national banks, but not so close as are "Government agencies"). We believe that it was an essential part of the intent of Congress, in enacting the Federal Reserve Act, that Federal Reserve banks should thus be allied to the Government but not be a part of the Government itself.

Comment of Allan Sproul, New York:

[Mr. Sproul would substitute the following for the last paragraph of the joint answer.]

In my opinion Federal Reserve banks are not part of the United States Government nor are they wholly a part of the private economy. Disregarding the pitfalls of semantics, I would say that in discharging their most important responsibilities—participation in the formulation and execution of monetary and credit policy—the Federal Reserve banks are part of the functioning of Government. In performing their duties as fiscal agent, they are instrumentalities of Government. In the provision of such services as the clearing of checks, they are part of the private economy. In the field of monetary and credit policy, the Government or public interest is dominant and controlling as it should be. In the field of fiscal agency operations, the Federal Reserve banks act as agents of a Government principal. In the field of check clearings, and similar operations, the private economy is served in the public interest.

I share the belief that it was the original intent of those who created the Federal Reserve System, that the Federal Reserve banks should function somewhere between private enterprise and the Government. I believe that it has been the continuing intent of each succeeding Congress that the Federal Reserve banks should be allied to Government but not part of Government. I believe that there has been and is wisdom in this segregation. It has generally protected the Federal Reserve banks from partisan political pressure; it has enabled the Federal Reserve banks to repel the pressure of private interests; and it has provided the country with a central banking system staffed by men who have made central banking a career, and operated the Federal Reserve banks according to standards of efficiency and service which compare favorably with the best in Government undertakings and private enterprise. It is significant that there have been no scandals, no charges of influence peddling, no evidence of favors given and received, in connection with the operations of the Federal Reserve banks.

Comment of R. R. Gilbert, Dallas

As further evidence in support of the position that the Federal Reserve banks are not part of the United States Government, I believe it is significant that the Congress does not appropriate Government funds for use in connection with the System's operations; neither does the System obtain funds from the Government by borrowing. More-

over, funds required by the Board of Governors of the System for its operation are derived from the Federal Reserve banks and not from the Government.

4. State the congressional policy directives applying to the Federal Reserve banks, citing appropriate statutes. In what respects, if any, do you believe that these directives should be altered?

Joint answer

The following are brief references to statutory provisions which in our opinion may be regarded as congressional policy directives applying to the Federal Reserve banks or to the Federal Open Market Committee, upon which are five representatives of Federal Reserve banks.

Paragraph 8 of section 4 of the Federal Reserve Act provides that the board of directors of each Federal Reserve bank—

> shall administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks and may, subject to the provisions of law and the orders of the Board of Governors of the Federal Reserve System, extend to each member bank such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks, the maintenance of sound credit conditions, and the accommodation of commerce, industry, and agriculture.

It further provides that each Federal Reserve bank—

> shall keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions; and, in determining whether to grant or refuse advances, rediscounts, or other credit accommodations, the Federal Reserve bank shall give consideration to such information;

and that (after report and recommendation by the chairman of the Federal Reserve bank to the Board of Governors):

> Whenever, in the judgment of the Board of Governors of the Federal Reserve System, any member bank is making such undue use of bank credit, the Board may, in its discretion, after reasonable notice and an opportunity for a hearing, suspend such bank from the use of the credit facilities of the Federal Reserve System and may terminate such suspension or may renew it from time to time.

Subdivision (b) of section 12A of the Federal Reserve Act provides that no Federal Reserve bank shall engage or decline to engage in open market operations under section 14 of the Federal Reserve Act except in accordance with the direction of and regulations adopted by the Federal Open Market Committee; and subdivision (c) provides that the time, character, and volume of all purchases and sales of paper described in section 14 as eligible for open-market operations shall be governed with the view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country. Section 14 of the Federal Reserve Act has the heading "Open-market operations" and authorizes Federal Reserve banks subject to specified conditions and limitations to purchase and sell cable transfers, bankers' acceptances, bills of exchange, direct and guaranteed obligations of the United States, bonds of the Federal Farm Mortgage Corporation, bonds issued under the provisions of the Home Owners' Loan Act of 1933, obligations of States and other

municipalities, obligations guaranteed by the United States, acceptances of Federal intermediate credit banks and national agricultural credit corporations. In addition, Congress has directed in section 14 (d) that the Federal Reserve banks shall establish discount rates "with a view of accommodating commerce and business."

Although some of the wording of the first part of paragraph 8 of section 4 of the Federal Reserve Act reflects concepts of the functioning of a central bank at the time the Federal Reserve System was created, and might be changed if it were written now, we see no compelling need for revision of any of these directives. They serve the purpose, and occasion no difficulties.

While the Employment Act of 1946 contains no explicit directive to the Federal Reserve banks, the stated objectives of that act guide the consideration of Federal Reserve policy.

Comment of Ray M. Gidney, Cleveland

It is not clear from the question whether congressional policy directives applying to the Federal Reserve banks is intended by your committee to refer only to the extension of credit by the Federal Reserve System as is apparently assumed in the answers submitted to the joint reply. I believe that there should be reference to congressional directives which give rise to major activities of the Reserve banks in terms of numbers of employees and volume of daily transactions, and result in Reserve banks performing services of great value to banking, business, individuals, and the Nation.

The preamble of the Federal Reserve Act states that the purpose is to "furnish an elastic currency" and section 16 gives detailed directions as to the issuance of Federal Reserve notes. Under this directive, the Federal Reserve banks supply the currency of the country and carry on huge daily transactions in doing so.

Section 16 of the Federal Reserve Act provides:

> Every Federal Reserve bank shall receive on deposit at par from member banks or from Federal Reserve banks checks and drafts drawn upon any of its depositors, and when remitted by a Federal Reserve bank, checks and drafts drawn by any depositor in any other Federal Reserve bank or member bank upon funds to the credit of said depositor in said Reserve bank or member bank.

Under this directive and the broader authorization of section 13, the Federal Reserve banks engage in huge operations in collecting and clearing checks, an invaluable service to the people of the country.

Section 15 of the Federal Reserve Act requires the Reserve banks to act as depositaries and fiscal agents of the United States upon the direction of the Secretary of the Treasury. This requirement is the basis for a very large volume of services performed efficiently for the United States Government for which appropriate reimbursement is made to the banks by the Treasury.

Note should also be taken of the purpose stated in the preamble of the act—

> to establish a more effective supervision of banking in the United States—

and the provision of section 21 relative to the power of the Board of Governors of the Federal Reserve System and the Federal Reserve banks to conduct bank examinations of member banks.

Delos C. Johns, St. Louis

[Following are Mr. Johns' comments on the joint answers to questions under section A. Ownership of the Federal Reserve Banks and Their Relationship to the Government.]

My opinion, with respect to the replies to questions 1, 2, 3, and 4, coincides with that expressed in the joint replies prepared under the direction of a special committee of the presidents of the Federal Reserve banks to these questions. I wish to emphasize, however, certain points with respect to these questions. My comment is general and relates mainly to questions 1 and 3.

The primary responsibility of the Federal Reserve System is to influence the supply, cost, and availability of credit with a view to maintaining full employment, stable values, and a rising standard of living. History would seem to indicate that a central banking institution has proved to be the best instrument yet devised for influencing the monetary and credit conditions of a country in the public interest. The reasons, distilled from experience, for separating in some measure Government's participation in the formulation of monetary and credit policy from the political functions of Government are generally understood. High on the list of such reasons are the necessity to keep monetary and credit policies flexible and responsive to continuously changing conditions, even to the point of trying to foresee changes, the necessity to preserve continuity and unity in these policies, and the need to maintain nonpartisan objectivity in their determination. This concept involves considerations which in some respects resemble those underlying the separation of the judicial branch from the political branches of Government.

This is not to argue that the central bank should be so independent of the several branches of Government as to destroy the unity of Government. In a democracy, monetary policy cannot be made in disregard of the opinion of Government elected by the people. In the United States where the monetary authority is responsibile to the legislative branch, such obviously cannot long be the case. What is meant by independence on the part of the central bank is its nonpartisan approach and its freedom to make appropriate decisions as to national monetary and credit policy in the light of broad economic considerations. That independence to make policy is subject to broad veto power on the part of the legislative branch.

The principle of this kind of independence for the central bank apparently was in the minds of the framers of the act when the System was begun almost 40 years ago. The American approach to constitutionalism involves laying down certain broad principles and then attempting to write into law and bring into practice certain specific safeguards for those broad principles. The legal form set up for the central bank and subsequent modifications in the form were designed to safeguard that broad principle of independence. Among such safeguards are provisions for 14-year terms for the Governors, for stock ownership by the member banks, and other like requirements. The regional characteristics of the System and the forms of regional representation have been built into the act. All of these steps and others were merely devices to insure the kind of independence in the central bank that the Congress believed desirable. Insurance that the public interest would be served was provided by

fixing responsibility of the Federal Reserve System to the Congress, but in such a way as to insure at the same time the System's nonpartisan approach. These provisions seem to have served their purposes pretty well and I do not believe they should be changed.

I wish to emphasize the fact that, while the Federal Reserve banks are not Government agencies in the legal or technical sense, they are regional elements in the Federal Reserve System and as such are responsible to the Government through the direct responsibility of the Board of Governors to the Congress. Without question the System in its entirety is a public institution operated in the public interest and responsible to the public.

B. ORGANIZATION OF THE FEDERAL RESERVE BANKS

5. Describe the role of the presidents and the boards of directors of the Federal Reserve banks and of the Board of Governors in the management of the Reserve banks.

Joint answer

The Federal Reserve Act provides that each Federal Reserve bank is to be controlled and supervised by its board of directors. Certain actions of the bank boards, however, are subject to the control vested by law in the Board of Governors of the Federal Reserve System.

The directors of a Reserve bank perform the duties usually appertaining to the office of directors of banking associations and all such duties as are prescribed by statute. The board of directors prescribes the bylaws under which the bank's general business is conducted and its privileges are exercised. It has the responsibility of determining the management policies of the bank. It appoints the officers of the bank, defines their duties, bonds, and in some cases tenure, and, subject to the approval of the Board of Governors, fixes their compensation. The president and first vice president are appointed with the approval of the Board of Governors for terms of 5 years. All appointees by the board of directors are subject to dismissal. By statute any officer or director of the bank may be suspended or removed by the Board of Governors.

The directors have a continuing responsibility for obtaining and maintaining management personnel of the necessary quality to make possible efficient, progressive, and economical operations, careful analysis of information, and expert counsel for the board of directors, the Board of Governors, and the Open Market Committee.

The directors have a special responsibility for maintaining and supervising the internal auditing system of the Reserve bank. They appoint the auditor who conducts an independent and continuous audit of the accounts of the banks. The auditor reports directly to the auditing committee of each bank's board of directors. The directors share with the Board of Governors the responsibility for reviewing annual budgets of the banks.

The chairman of the board of directors presides at all meetings, and in his absence his powers are executed and duties performed by the deputy chairman. The chairman of the board of directors is also designated as Federal Reserve agent and as such has administrative duties in connection with the issuance of Federal Reserve notes. The chairman of the board is appointed by the Board of Governors as

is the deputy chairman. The chairman is the official representative of the Board of Governors at the bank.

The board of directors or its executive committee meets at least fortnightly to review banking and business conditions and to pass upon discounts and advances, discount rates, or any other matters requiring consideration or action.

The directors of a Reserve bank share a broader public responsibility than their counterparts in the ordinary banking association. This responsibility extends beyond the banking field to the broad interests of commerce, industry, agriculture, and the whole economy. In the conduct of the bank's affairs, the directors must administer fairly and impartially without discrimination in favor of or against any member bank or banks. Discount rates, although established in the first instance by the directors, take into account credit policies of the System as a whole, and are subject to review and determination by the Board of Governors.

The Federal Reserve Act requires that each Federal Reserve bank must keep itself informed on the general character and amount of loans and investments of its members with a view to ascertaining whether undue use is being made of bank credit for speculative purposes or other purposes inconsistent with the maintenance of sound credit conditions. The board of directors is required to give consideration to such information in extending or refusing to extend credit, and the chairman of the board must report to the Board of Governors cases of undue use of bank credit with his recommendations. In practice this is usually delegated to the internal management of the bank and is reviewed by the board of directors.

The president is the chief executive officer of the bank and actual manager of the bank as a working mechanism, and he is directly in charge of the bulk of relationships between the bank and its members. In his absence, the first vice president acts in his place. Both officers in their managerial duties are subject to the supervision and control of the board of directors. All executive officers and all employees are directly responsible to the president.

The president has general supervision and direction of policy of the bank in effectuating the regulations of the Board of Governors and the Open Market Committee on major matters of System policy, and over the administration of these policies in the district.

Officers responsible to the president exercise general supervision over discounts, collections, clearings and transfers, examination of State member banks, and, if necessary, other member banks; apply for Federal Reserve notes and provide the security to be pledged against them as may be necessary for the general requirements of the bank; supervise the participation of the bank in the open market account, and manage personnel. They perform fiscal agency functions for the Government; collect, assembl, and analyze pertinent economic information and statistics; and carry out other duties of an administrative and operating sort related to the business and affairs of the bank.

The president communicates with member banks on matters of policy and administration affecting them and is also responsible for developing ways and means of improving services rendered to member banks, the banking community, and through them to the gen-

eral public. He participates in discussions at meetings of the president's conference held to exchange information and to coordinate, to the necessary extent, the internal administration of the banks and the application of policies. The presidents meeting jointly with the Board of Governors help to formulate System policies and methods of implementing them.

The Board of Governors of the Federal Reserve System, as noted above, has important powers concerning the internal administration and operation of the Federal Reserve banks. Some of these powers are direct, some of a supervisory nature, and others of a coordinating character.

Among the more important powers of the Board of Governors concerned with internal administration of the Reserve banks are the following:

Examination of the Reserve banks.

Approval of operating budgets.

Approval of compensation of individual officers and the staff salary classification system.

Appointment of the class C directors, one of whom is designated chairman and Federal Reserve agent.

Approval of appointment of president and first vice president.

Right to remove officers or directors of the banks for cause.

Review and determination of discount rates set by directors.

Definition of paper eligible for rediscount.

Right to require inter-Reserve bank rediscounting.

Permit or require establishment or closing of branches or agencies.

Right to withhold issues of Federal Reserve notes.

Right to impose interest charges on Federal Reserve notes.

Authorization and approval of arrangements made and right of participation in transactions and relationships with foreign central banks and governments.

Setting the terms and conditions under which selective credit control regulations and operating regulations are to be administered.

Requiring Federal Reserve banks to follow certain standard practices in dealing with member banks.

Initiating, in some instances, changes in services offered member banks.

Approval of the appointments of the officer in charge of examinations and of examiners.

The management of the Reserve banks thus is subject to the influence of both the local boards of directors and the central body, the Board of Governors. The method of organization of the Federal Reserve System, in which some powers have been given to a central agency, some to the regional banks, and some to a combination of the two, provides room for initiative and imagination in the formulation and administration of System policies, and contributes toward a better understanding of System policies and problems.

Comment of Ray M. Gidney, Cleveland

I am in agreement with the joint answer but would like to add to the list of duties of directors the following:

1. Appointment of four of seven directors of branches.

2. Election of member and alternate member of the Federal Open Market Committee as specified by law.
3. Appointment of industrial advisory committee to advise the officers and directors on applications for industrial loans under the provisions of section 13b.
4. Appointment of a member of the Federal Advisory Council.
5. Appointment of the chairmen of the boards of directors at the branches.
6. Making of recommendations to the Board of Governors on applications for fiduciary powers of national banks.
7. Making of recommendations to the Board of Governors on applications for voting permits of holding company affiliates.

The agenda of two directors' meetings at this bank are attached with the thought that they may give an idea of the duties, responsibilities, and practices of the directors of the Federal Reserve Bank of Cleveland as they are met with in the course of current operations. (Exhibits A and B.)

Exhibit A

Federal Reserve Bank of Cleveland—Meeting of Board of Directors, January 11, 1951, 9:45 A. M.

Order of Business

1. Executive session (directors).
   (*a*) Appointment of officers.[1]
2. Minutes of meetings (summaries in folders).
   (*a*) Board of directors, December 14, 1950.
   (*b*) Executive committee, December 28, 1950.
3. Report of chairman (Mr. Brainard).
   (*a*) Announcements.
4. Resolution—retirement of Mr. A. Z. Baker (Mr. Brainard).[1]
5. Appointments (Mr. Brainard).
   (*a*) Executive committee for 1951.[1]
   (*b*) Standing committees, board of directors, 1951.[1]
   (*c*) Federal Open Market Committee, member and alternate, year beginning March 1, 1951.[1]
   (*d*) Industrial advisory committee, year beginning March 1, 1951.[1]
6. Correspondence from Board of Governors (Mr. Gidney).
7. Annual statement, 1950 (Mr. Gidney).
8. Report of the officers (Mr. Gidney).
9. Retirement plan, change of rate of contribution (Mr. Gidney).[1]
10. Personnel matters (Mr. Morrison).
   (*a*) Salary adjustments effective February 1, 1951.[1]
   (*b*) Salary adjustments made December 1, 1950, December 16, 1950, and January 1, 1951.[1]
   (*c*) Changes in salary-adjustment schedule effective January 1, 1951.[1]
   (*d*) Graduate schools of banking.[1]
   (*e*) Four-month leave of absence—31-year employee.[1]
   (*f*) Leaves of absence.
   (*g*) Report of separation wages paid during 1950.
   (*h*) Report of operations of confidential funds, 1950.
   (*i*) Personnel report for 1950.
11. Report of audit review committee (Mr. Bainer).
12. Statement of investments (Mr. Fletcher).
   (*a*) Loans and discounts.
   (*b*) Regulation V and industrial loans.
13. Cincinnati branch, management agreement, Robert A. Cline, Inc. (Mr. Fulton).[1]
14. Pittsburgh branch, lease of vault space (Mr. Kossin).[1]
15. Preliminary comparison of expenses with budget for 1950 (Mr. Laning).
16. Assessment, Board of Governors' expenses (Mr. Laning).[1]

[1] Presented for action by directors.

17. Fire insurance, renewal of (Mr. Clouse).
18. Report on bank and public-relations activities (Mr. Clouse).
19. Report on open-market operations (Mr. Hostetler).
20. "Price control in 1951" (Mr. Cutler).
21. Discount and interest rates (Mr. Gidney).[1]

EXHIBIT B

FEDERAL RESERVE BANK OF CLEVELAND—MEETING OF BOARD OF DIRECTORS, SEPTEMBER 13, 1951—9:30 A. M.

1. Minutes of meetings (summaries in folders).
   (a) Board of directors, August 9, 1951.[1]
   (b) Executive committee, August 23, 1951; September 6, 1951.[1]
2. Report of chairman (Mr. Brainard).
   (a) Announcements.
3. Correspondence from Board of Governors (Mr. Gidney).
4. Report of the officers (Mr. Gidney).
5. Reports of committees.
   (a) Personnel committee (Mr. Virden).
      (1) Salary adjustments.[1]
      (2) Leaves of absence.
      (3) Employees, obligation reports.
   (b) Budget committee (Mr. Bowlby).
      (1) Expense budget 1952.[1]
   (c) Research committee (Mr. Stilwell).
6. Statement of investments (Mr. Fletcher).
   (a) Loans and discounts.[1]
   (b) Advances and commitments under section 13b of the Federal Reserve Act.[1]
   (c) Foreign loan, Banque Centrale de la Republique de Turquie.[1]
   (d) Regulation V loans.
7. Report on open market operations (Mr. Thompson).[1]
8. Report of Pittsburgh branch chairman (Mr. Burchfield).
9. Report of Cincinnati branch chairman (Mr. Cramer).
10. "Boom, Bust, or Phfft" (Mr. Thompson).
11. Discount and interest rates (Mr. Gidney).[1]
12. Remarks by Governor Powell.
13. Discussion of matters of public interest (directors).
14. Adjournment.[1]

Comment of R. R. Gilbert, Dallas

An additional important responsibility of the boards of directors of the Federal Reserve banks is their selection of a Federal advisory councilman to represent their respective districts.

I believe that greater emphasis also should be given to the responsibility of the boards of directors of the Federal Reserve banks with respect to budgetary control of expenses than is given in the answer to this question. The broad business and professional experience of the directors is a very valuable asset to the System in connection with the directors' study of the banks' budgets and control of expenditures, as well as in many other respects. Budgetary views of the directors are influenced to some extent by many of the same principles of conservative budgeting that are essential for the successful operation of a private business. This tends to minimize waste and to promote efficiency in the Reserve banks. Although final approval of the budgets

[1] Presented for action by the directors.

of the Reserve banks rests with the Board of Governors of the System, it should be emphasized that most careful and conservative consideration has been given by the banks' directors to the budgets before submission to the Board of Governors.

6. State the qualifications required for election as class A and class B directors of the Federal Reserve banks, and the method of electing such directors. Include in your description both qualifications and procedures prescribed by statute and those established by customary usage, distinguishing between them when necessary.

Joint answer

Section 4 of the Federal Reserve Act provides that each Federal Reserve bank shall be conducted under the supervision and control of a board of directors consisting of nine members holding office for 3 years and divided into classes A, B, and C. Class A consists of three members who are chosen by and are representative of the member banks. Class B consists of three members chosen by the member banks who at the time of their election are actively engaged in their district in commerce, agriculture, or some industrial pursuit. Class C consists of three members appointed by the Board of Governors of the Federal Reserve System.

No officer or director of a member bank is eligible to serve as a class A director unless nominated and elected by banks which are members of the same group as the member bank of which he is an officer or director.

No director of class B may be an officer, director, or employee of any bank. No director of class C may be an officer, director, employee, or stockholder of any bank. Thus the majority of each board is made up of persons having no affiliation with banks.

Directors of class C at the time of their appointment must have been residents of the district from which appointed for at least 2 years. One of the class C directors is designated by the Board of Governors as chairman and as Federal Reserve agent, and another class C director is designated as deputy chairman. No Member of Congress may be an officer or a director of a Federal Reserve bank.

The class A and B directors are elected according to a special plan designed to prevent domination of the electoral procedure by any group. The Board of Governors classifies the member banks of the district into three general groups, each of which is designated by number. Each group consists as nearly as may be of banks of similar capitalization, and elects one class A and one class B director. Generally, group 1 contains the largest banks of the district, group 2 the middle-sized banks, and group 3 the smaller banks. Each member bank of the group then electing is permitted to nominate to the chairman of the board of directors of the Federal Reserve bank of the district one candidate for director of class A and one candidate for director of class B. A list of the candidates so nominated is prepared, indicating by whom nominated, and a copy of this list is furnished to each member bank by the chairman within 15 days after completion. Each member bank by a resolution of its board of directors or by amendments to its bylaws authorizes its president, cashier, or some other officer to cast the vote of the member bank in the elections of the class A and class B directors. Whenever two or

more member banks within the same Federal Reserve district are affiliated with the same holding company, participation by such member banks in any such nomination or election is confined to one of such banks, which may be designated by the holding-company affiliate for the purpose.

Within 15 days after receipt of the list of candidates, the duly authorized officer of a member bank of the group then electing certifies to the chairman of the board of directors of the Federal Reserve bank of the district his first, second, and other choices for director of class A and class B, respectively, upon a preferential ballot furnished by the chairman. Each such officer makes a cross opposite the name of the first, second, and other choices for a director of class A and for a director of class B but cannot vote more than one choice for any one candidate.

Any candidate having a majority of all votes cast in the column of first choice is declared elected. If no candidate has a majority of all the votes in the first column, then the votes cast by the electors for each of the candidates in the second column and the votes cast for each of the candidates in the first column are added together. The candidate then having a majority of the electors voting and the highest number of combined votes is declared elected. If no candidate has a majority of electors voting and the highest number of votes when the first and second choices have been added, then the votes cast in the third column for other choices are added together in like manner, and the candidate then having the highest number of votes is declared elected. An immediate report of election is declared.

Vacancies that may occur in the several classes of directors of Federal Reserve banks may be filled in the manner provided for the original selection of such directors. Such directors hold office for the unexpired terms of their predecessors.

On three occasions the Board of Governors has ruled concerning the eligibility of certain persons for election to a Reserve bank board, and the Attorney General has ruled in this connection on one occasion.

On December 23, 1915, the Federal Reserve Board [1] adopted a resolution which read in part:

> It is the opinion of the Federal Reserve Board that persons holding political or public office in the service of the United States, or of any State, Territory, county, district, political subdivision, or municipality thereof, or acting as members of political party committees, cannot, consistently with the spirit and underlying principles of the Federal Reserve Act, serve as directors or officers of Federal Reserve banks.

Under date of July 2, 1925, the Federal Reserve Board advised that it had

> reached the conclusion that a person whose sole occupation is that of officer of an insurance company is not eligible for election as a class B director of a Federal Reserve bank—

and, similarly, the Board ruled on October 18, 1939, that a person whose sole occupation is that of president of a Federal savings and loan association is not eligible for election and service as a class B director.

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[1] Under sec. 203 (a) of the Banking Act of 1935, the Federal Reserve Board is now known as the Board of Governors of the Federal Reserve System.

In a letter dated March 4, 1926, the Attorney General expressed the opinion that mutual savings banks are banks within the meaning of section 4 of the Federal Reserve Act prohibiting directors of class B and class C from being officers, directors, or employees of any bank.

The Board of Governors has also ruled on the procedure of nominating and voting for directors. On October 27, 1920, the Federal Reserve Board declared that it is optional with the member banks whether they shall nominate candidates for class A and class B directors, but under the terms of the law it is mandatory for each member bank to empower some officer to cast its vote in the election of directors.

In some districts it has become the practice for member banks to form committees whose purpose is to suggest nominees. In other districts committees of State bankers' associations may suggest candidates. In still others the stockholding member banks have formed associations, one of whose functions is to suggest nominees. In some districts, including the ninth, no such groups are formed for the purpose of suggesting nominees, and in all districts any bank can make nominations in accordance with the procedures outlined above.

Comment of Joseph A. Erickson, Boston

In the first Federal Reserve district the member banks have formed the stockholders advisory committee, which has been in continuous existence since 1923. This committee, composed of seven members, is elected each year. Two members are elected by the member banks present at the annual convention of the Massachusetts Bankers' Association, and one member each by the member banks present at the annual conventions of the State bankers' associations of the other five New England States.

This committee annually appoints a committee on Reserve directors of seven members each to present to member banks of the group participating in the regular election of class A and class B directors of the bank to be held that year recommendations of one or more names for the directors to be elected. Thus, one committee is appointed for group 1 banks (capital and surplus of more than $1,800,000) in the year in which group 1 banks elect a class A director or class B director, one for group 2 banks (capital and surplus of $400,000 to $1,800,000, both inclusive) in the year in which group 2 banks elect a class A director or class B director, and one for group 3 banks (capital and surplus of less than $400,000) in the year in which group 3 banks elect a class A director or class B director. The membership of each committee on Reserve bank directors is made up of two members from Massachusetts and one from each of the other New England States. Similar recommendations are made by the appropriate group committee whenever special elections are held to fill vacancies occurring in the class A and class B directorships.

Comment of Alfred H. Williams, Philadelphia

In the third Federal Reserve district a nominating advisory committee was created in 1923 to stimulate interest in the election of directors and to recommend qualified persons for nomination. In operation, the committee is divided into three subcommittees, one for each electoral group: Large, medium, and small member banks. Each of the groups of the Pennsylvania Bankers Association having territory in this district, the Delaware Bankers Association, and the New

Jersey Bankers Association appoints one member to each of these subcommittees. Prior to an election, the members of the appropriate subcommittee canvass the member banks for suggestions as to possible candidates. The subcommittee then meets to review the suggestions and to recommend a candidate or candidates to the member banks in its group. As its name implies, the functions of the committee are purely advisory. Actual nominations are made by the member banks.

Comment of Hugh Leach, Richmond

There is no distinction between the qualifications required for election as class A and class B directors prescribed by statute and those established by customary usage in the fifth Federal Reserve district. However, a procedure peculiar to the district is followed in the nomination and election of such directors by the three general groups of member banks prescribed by statute.

The fifth Federal Reserve district is composed of the States of Maryland, Virginia, North Carolina, and South Carolina, all of West Virginia except six counties in the northern panhandle, and the District of Columbia. Since the member banks in the district had to elect six directors prior to the opening of the bank, they arranged to hold a conference in Richmond of representative bankers from these six geographical divisions on May 18, 1914, approximately 6 months before the bank was opened. Representatives of 210 member banks were present at the conference, at which it was decided to appoint a committee of 18 (3 from each of the 6 geographical divisions) to consider the question of nominations and the adoption of some method to insure a satisfactory distribution of representation among the 6 divisions. This committee recommended that one director be elected from each of the six geographical divisions and that the nominees of group 1 banks be a class A director from Maryland and a class B director from Virginia; of group 2 banks, a class A director from North Carolina and a class B director from South Carolina; and of group 3 banks, a class A director from West Virginia and a class B director from the District of Columbia.

The recommendations of the committee were unanimously adopted by the conference and it was ordered that the action of the conference be formally reported to all member banks in the district. The agreement thus arrived at voluntarily by member banks of the district before the Federal Reserve bank was opened has been adhered to continuously from the beginning.

Comment of J. N. Peyton, Minneapolis

In some districts it has become the practice for member banks to form committees whose purpose is to suggest nominees. In other districts committees of State bankers' associations may suggest candidates. In still others the stockholding member banks have formed associations, one of whose functions is to suggest nominees. In some districts, including the Ninth, no such groups are formed for the purpose of suggesting nominees and in all districts any bank can make nominations in accordance with the procedures outlined above.

Comment of C. E. Earhart, San Francisco

In connection with the concluding paragraph of the joint reply there are no formal committees or associations of twelfth district member banks that suggest candidates for director. Any consulta-

tions among banks that occur are informal and are initiated by banks that may be interested in particular individuals as possible nominees.

7. Do you believe that all the directors of the Federal Reserve banks should be chosen as public representatives rather than as representatives of specified groups? If so, how should they be chosen? If representation of specified groups is to be continued, do you believe that labor should be added to the groups represented? If so, how should the labor representatives be chosen?

Joint answer

The class A and class B directors, although not designated or familiarly referred to as public representatives, are in fact such representatives. All classes of Reserve bank directors may be considered and consider themselves to be trustees of the public interest. The directors of the Federal Reserve banks are chosen for their competence to render a service to the Reserve banks and through them to the public.

The unique character of the Federal Reserve System in its operation for the benefit of the whole economy imposes upon directors in each class a special public responsibility which extends beyond the banking field to the broad interests of all economic groups. The public nature of the Reserve System is well illustrated in its functions and services and the absence of the profit motive, but with regard for maximum efficiency, in its operations.

In the case of class A directors who "are chosen by and are representative of" the member banks, their specialized professional experience and advice is helpful in connection with the improvement of technical operations and the overseeing and management of banking functions performed by the Reserve banks. Their professional experience and advice is helpful in judging the impact of broad policy decisions affecting the supply and cost of money and credit. Their knowledge of local conditions provides valuable sources of economic information for guidance in making policy decisions, and their standing in their communities provides local support for the Reserve System and helps to widen public understanding of the functions of the Federal Reserve System and of the purposes of its policy actions.

Class B directors are chosen from those actively engaged in their districts in commerce, agriculture, or some other industrial pursuit. Their point of view reflects that of the commercial bank customer which complements and balances the point of view of the bankers on matters apart from technical phases of operation. Just as the class A directors may be expected to be familiar with the problems of lenders, so the class B directors may be expected to be familiar with the problems of borrowers. The class B directors, like those of class A and class C, are a local source of information about the System and its function.

No group of banks can dominate the Federal Reserve banks' boards of directors. While each member bank has one vote for one class A director and one vote for one class B director, irrespective of its size, the group classification prevents small, medium, or large banks from electing all six of the A and B directors and insures roughly equal representation of banks of differing size.

Class C directors appointed by the Board of Governors are usually men of standing in their communities—public-spirited individuals,

serving because of a sense of community responsibility. (The occupational groups from which the present directors have been drawn are listed in the answer submitted by the Chairman of the Board of Governors to question 9 addressed to him by the subcommittee.)

At all Reserve banks, a broad cross section of the public has always been represented on the boards of directors. The distribution of representation of various groups has differed from district to district but this has reflected the distinctive economic characteristics of the districts. The word "representation" should not be construed to mean that the directors come to meetings as the instructed delegates of a constituency. In fact, the tradition has become established that in acceptance of a directorship the individual puts aside the narrow interest of any one group and serves the public generally.

In discharge of their statutory duties at the Reserve banks, it is essential that the banks' boards continue to include in their composition men experienced in the techniques of banking, both as lenders and as borrowers and aware of the impacts of credit policy upon our economy. The prescription for board composition at the present time is diversified enough to reflect the public interest. It would permit the appointment by the Board of Governors of a labor man if that were desirable on grounds other than occupational classification or group representation alone. Further definition of occupational classifications, or repeal of present occupational designations, would risk destruction of the present balance and might fail to recognize the background against which the Reserve banks operate, causing confusion and misunderstanding which would more than offset any theoretical gains.

The Federal Reserve Act does not call for representation of organized groups as such on the boards of directors; rather, it is based on the concept that those able to serve the Reserve banks because of experience or training will aid in developing a more effective administration of the banks, and thus make the banks more useful instruments to the community and to the Nation. Credit policy is determined and finally made by the System's central bodies—the Federal Open Market Committee and the Board of Governors. It is the decisions of these groups that influence monetary and credit conditions which are of greatest importance to labor, capital, agriculture, and business, rather than the decisions made by the individual Reserve banks' boards of directors. The interests of the public generally are now represented on the banks' boards and we do not favor a change designed to encourage representation of the narrow interest of any particular group.

Comment of C. E. Earhart, San Francisco

The joint replies, as set forth in section I, to questions 5 and 7 do not describe the role of branch directors. Each of the four branches of the Federal Reserve Bank of San Francisco has a board of directors consisting of five members; three branch directors are appointed by the district board of directors at San Francisco and two by the Board of Governors. One of the Board of Governors' appointees is designated by the district board as chairman of the branch board of directors. Chairmanship designations have usually been on an annual rotation basis. While there are no occupational or other requirements governing the appointment of branch directors, it is the practice of

this banks' directors to appoint bankers, and of the Board of Governors to appoint men in other fields who are not officers or directors of commercial banks.

The benefits obtained from this composition of the branch board are essentially the same as those discussed in the answer to question 7 with respect to class A and class C directors of Federal Reserve banks. Through the branch boards, further participation is obtained in System affairs by men of particular competence in the field of banking, and men, other than bankers, who are public-spirited men of standing, all with intimate knowledge of business conditions in their branch zone.

The role of the branch boards in management is to quite an extent advisory. The officers of the bank and the San Francisco directors obtain valued counsel and recommendations of branch boards on various matters affecting the branches and on questions relating to bank and System administration and policy. Thus, additional "grass-roots" experience and advice are made available with respect to the conduct of this bank and the System as a whole, on the one hand, and additional local understanding of the System's purposes and functions is obtained, on the other.

Delos C. Johns, St. Louis

[Mr. Johns submits the following comments on the joint answers to questions under section B. The Organization of the Federal Reserve Banks]

I concur completely in the joint replies of the special committee of the presidents of the Federal Reserve banks to questions 5, 6, and 7.

I might point out that with respect to the eighth Federal Reserve district, nominations for the bank-elected directors follow precisely the provisions of the Federal Reserve Act. There are no formal committees of member banks or of State bankers' associations which exist for the purpose of nominating directors for the St. Louis bank. Nominations are made by informal and ad hoc groups of banks or by individual banks as a desire to see a particular individual serve on the bank board arises.

I might note further that it has become the practice in recent years for St. Louis bank class A and B directors elected by the large banks to serve no more than two terms. This is not an unchanging custom but a matter for joint determination of the individual director and the nominating and electing banks. There is no definite practice with respect to length of service for the class A or B directors elected by the medium-sized and small banks.

I wish to emphasize two points with respect to the boards of directors of the Federal Reserve Bank of St. Louis and its branches. I am sure these comments apply equally to the directors of the other Reserve banks and branches. First, the men who have served and are serving on the St. Louis bank board and the three branch boards have been of unfailing help in providing judgment and counsel to the internal management of the bank and branches, fostering understanding of and good working relations for the Federal Reserve System in the eighth Federal Reserve district, and providing helpful information and opinion as background for the St. Louis bank's participation in the shaping of national monetary policy. There is little question

in my mind that the management of the bank, the strength of the Federal Reserve System in general, and the formulation of monetary policy benefit from their presence.

The second point I wish to emphasize is brought out in the joint reply to question 7. All of the members of the St. Louis bank or branch boards serve as public members. They bring to the St. Louis bank and branches wide experience in public affairs, intimate knowledge of district conditions, and, in the case of the bankers, specific knowledge of technical credit problems. None of the directors serves as the representative of a special group. An industrialist on our board does not consider himself the representative of industrial interests but rather as a director who is in a position to provide counsel with respect to business-management practices and to the general course of business developments. A farmer who serves on our board considers himself as a director with a knowledge of agriculture but not as a specially instructed representative of agriculture. The same is true for the bankers. All of the class A and B directors are just as much public members as are the class C directors.

As I see it, there is no reason why a labor man should not serve on a Federal Reserve bank or branch board. However, he should serve as a public member acquainted with labor problems, practices, and conditions, and not as an instructed representative of organized labor as such.

C. DISTRIBUTION WITHIN THE FEDERAL RESERVE SYSTEM OF AUTHORITY ON CREDIT POLICIES

8. Discuss the extent to which it is possible to maintain regional credit policies differing from national credit policies. Who is responsible for the formulation of such policies and what are the instrumentalities by which they can be maintained?

Joint answer

The Federal Reserve System does not attempt to formulate and maintain regional credit policies which differ from national credit policies. Rather, it attempts to take regional considerations into account in developing national policy and to adapt that policy to local conditions.

It is chiefly through the Federal Open Market Committee on which five presidents of the Federal Reserve banks and the seven members of the Board of Governors serve that national credit policy is formulated and implemented. Thus is provided a body for centralized decision-making on credit policy in which is reflected the thinking of people from all regions of the country. Diverse viewpoints and opinions are brought together and welded into a national policy.

The application and adaptation of national policy to local conditions is achieved in the Federal Reserve System through the presidents and officers of the Federal Reserve banks and their boards of directors. Examples may be found in the administration of loans to member banks, the administration of consumer credit and real estate credit regulations, direct or guaranteed loans to business, and guaranteed loans to defense contractors. Additionally, the voluntary credit restraint program, which was developed largely under the aegis of the Federal Reserve System, illustrates the feasibility of adapting gener-

alized guiding principles to local conditions. In each of the areas mentioned the Federal Reserve banks follow the over-all policy which has been developed with their participation.

When the Federal Reserve System was started, regional differences in credit policy were emphasized. The improvement in facilities for transferring funds and the increasing interdependence of the various districts brought about a gradual lessening of regional differences and the System's experience led to an increasing awareness of the need for a more unified credit policy. The present System organization, which has evolved from experience, provides for the establishment of central banking policy on a national basis. At the same time it provides the means whereby the policy can be adapted or modified to meet the needs of regional conditions. At times there may be local situations which may call for local action to restrain bank financing of speculative or other unhealthy developments through discount policy or bank supervisory policy, which situations can be handled within the framework of general System policies. Similarly, there may be special needs for credit in particular localities which likewise can be met by the regional Reserve banks within the over-all policies of the System. The present organization provides the best assurance that the existence of such needs will be quickly recognized.

The procedures followed in the formulation and administration of Federal Reserve credit policy stand in sharp contrast with any centralized determination of policy in which participation of regional representatives is absent and in which administration also is centralized.

The processes by which policy is determined, implemented, and administered under the Federal Reserve System are a unique embodiment of the political, economic, and social traditions built up in this country.

9. Describe the role played by the boards of directors and the presidents of the Federal Reserve banks in the formulation of national credit policy.

Joint answer

In the determination of national credit policy the directors of the Federal Reserve banks act directly and formally only on discount rates, subject to review and determination by the Board of Governors, and on requests for opinions received from the Board of Governors. In addition, they contribute informally or indirectly in the formulation of the entire range of credit policy. They do so, from time to time, by communicating with the Board of Governors, and by expressing to the presidents of the Reserve banks their impressions and opinions on economic developments and on desirable credit policy in the light of those developments.

The presidents thus have the benefit of the views of the boards of directors which they are able to utilize in developing their own views which they present in the Federal Open Market Committee and in discussions with the Board of Governors. They also have the benefit of economic information and analysis furnished by the research departments of the Reserve banks, as well as the advice of Reserve bank operating officers based on their direct experience in administering credit policies.

It should be noted that the presidents as members of the Open Market Committee do not go to meetings of the Committee with specific instructions from the boards of directors of the Federal Reserve banks, for in that capacity the presidents act as individual members of the committee. They do not reveal to their boards of directors policy actions that are to be considered at forthcoming meetings of the committee, and they do not report to the directors concerning the decisions made by the Committee until those decisions are public information. Thus, although the informed judgments of the directors are obtained concerning the broad characteristics of economic developments and the desirable direction of open market policy, and although the directors are in a position to help broaden the public understanding of policy decisions taken, the directors are not given access to confidential information about open market policy.

It is in meetings of the Open Market Committee that lines of thought from two directions converge to form national credit policy, as far as the Federal Reserve System is concerned. The one flows from banking, business, and the general public in the various regions of the country through the presidents of the Reserve banks. The other flows from the Board of Governors of the Federal Reserve System. Each member of the Committee, with statutory responsibilities for the determination of national credit policies, brings to the deliberations of the Committee the sum total of his knowledge and experience.

The Board of Governors before reaching decisions on important matters usually consults with the presidents of the Reserve banks. These consultations take place either informally, in meetings of the Federal Open Market Committee, or in joint meetings with the Conference of Presidents of the Federal Reserve Banks.

The procedures outlined indicate that the Open Market Committee is supplied with regular and continuing sources of information from all parts of the economy.

Comment of H. G Leedy, Kansas City

While the direct participation of the directors of the Federal Reserve banks in the determination of national credit policy is limited to the establishment of discount rates subject to the approval of the Board of Governors, the indirect contribution of their advice and judgment in the determination of credit policy is of great importance. By reason of their contacts with the various segments of the economy, including banking, and their familiarity with economic developments in their respective districts, they are in a position to make an important contribution to the System's economic knowledge and understanding. This capacity to effectively serve the Federal Reserve System is greatly increased as a result of the fact that these directors come from a wide variety of business, banking, agricultural, professional, and other pursuits, and are outstanding men in their respective fields of endeavor.

From time to time, the Chairman of the Board of Governors requests the views of members of the boards of directors on problems that are under consideration by the Board. Moreover, the presidents of the Reserve banks have the benefit of the views of the boards of directors, including their impressions and opinions on economic developments and on desirable credit policy in the light of those developments, which

the presidents are able to utilize in developing their personal analysis and judgment on matters that come before them in the Federal Open Market Committee and in joint meetings of the presidents' conference with the Board of Governors.

The directors of the Federal Reserve banks also perform an important function in contributing to public understanding of Federal Reserve policies in their districts and throughout the country. It is of considerable importance that bankers, businessmen, and others should be informed regarding the problems to which Federal Reserve actions relate and the reasons for the policies adopted. Over the years, this should lead to a better appreciation of the role of appropriate central bank policies. In order for directors of Federal Reserve banks to perform their various functions as successfully as they have in the past, it is essential that capable and outstanding men be attracted to these functions and continue to serve as directors of the Reserve banks.

The presidents of the Federal Reserve banks have a part either specifically or indirectly in the formulation of virtually the entire range of credit policy. The specific role is that of serving on the Federal Open Market Committee, in which capacity they not only have a part in the determination of open market operations, but also participate in the consideration of the use of the other instruments of credit policy, which need to be coordinated with open market operations. As members of the Open Market Committee, the presidents go to meetings of the committee without specific instructions from the boards of directors of the Federal Reserve banks, for in that capacity the presidents act as individual members of the committee. Although the informed judgment of the directors is obtained concerning the broad characteristics of economic developments and desirable direction of national credit policy, and although the directors are in a position to help broaden the public understanding of policy decisions taken, the directors are not given access to confidential information about open market policy.

In addition to the participation in the formulation of national credit policy through the Federal Open Market Committee, the presidents also contribute indirectly in the formulation of that policy in many other ways. Matters of credit policy pending before the Board of Governors are discussed in joint meetings of the presidents' conference with the Board of Governors. Moreover, at other times, the Board requests the views of the presidents with respect to pending decisions and enlists the aid of the presidents in assembling pertinent economic information in their districts with respect to problems under consideration. Furthermore, the presidents on their own initiative pass on to the Board of Governors their views on credit policy matters and pertinent information that reaches them through the Reserve banks' research departments and operating officers and in a multitude of informal ways.

Comment of R. R. Gilbert, Dallas

The answer to this question points out that the boards of directors of the Federal Reserve banks contribute informally and indirectly in the formulation of national credit policy by communicating with the Board of Governors and by expressing to the presidents of the Reserve banks their impressions and opinions on economic developments and

desirable credit policy in the light of those developments. In addition, it should be stated that the boards of directors of the Federal Reserve banks also communicate their impressions and opinions on such economic matters and related credit policy questions to the Federal Advisory Council members of their respective districts. The Federal Advisory Council members, thus, are in a better position to discuss such questions and problems at their council meetings and to perform their legal responsibility under the act at their periodic meetings with the Board of Governors of the Federal Reserve System.

10. Trace the historical development of open-market operations covering both their significance as instruments of monetary and credit policy, and the nature and composition of the bodies which have successively had control over them.

Joint answer

The present role and administration of open-market operations as an instrument of Federal Reserve policy have been the result of a process of gradual development. This development has taken place in accordance with the changing credit situation and the increasing recognition of the importance and use of open-market operations as an instrument of central bank policy. The administration of these operations as an instrument of Nation-wide credit policy under the control of a single body developed as the money and capital markets became increasingly national in scope and the Nation-wide effects of open-market operations were more fully comprehended. During the life of the Federal Reserve System, their use has been adapted to the changing character of the credit requirements of the economy.

To a considerable degree, the changes in the use of open-market operations and in the control over them have taken place without special legislation, and some of the legislative actions taken have given legal status to changes in policy and organization already in effect. These changes, along with the legislative changes, have been the result of the test of experience which has revealed both the strength and the weakness of past decisions. The developments that have taken place have been influenced by the problems that have arisen and the situations with which the System has been confronted.

In contrast with present understanding, which recognizes open-market operations as the most important single instrument of credit control, the discount rate was considered the most important instrument in the early years of the Federal Reserve System with open-market operations not regarded as a major instrument of policy. The use of open-market operations was viewed as essentially a local matter. Although the Federal Reserve Act empowered the Federal Reserve banks to buy and sell specified types of credit instruments in the open market, it was originally expected that these transactions would be carried out primarily to enable the Federal Reserve banks to acquire sufficient earnings on occasions when rediscounting by member banks was small. The fact that open-market operations could be an effective instrument of credit control was learned only gradually.

In 1921 and 1922, the individual Federal Reserve banks on their own initiative and in order to build up their earnings began to buy Government securities in the New York market. Since these investment operations tended to disturb the market and to affect the re-

serve position of the member banks, it became evident that some degree of coordination was required. In April 1922, therefore, the Conference of Governors of Federal Reserve Banks (the predecessor of the Conference of Presidents of Federal Reserve Banks) appointed a Committee on Centralized Execution of Purchases and Sales of Government Securities, consisting of the Governors of the Boston, New York, Philadelphia, and Chicago banks, to buy and sell securities at the request of the Reserve banks and thereby to coordinate these operations. In October 1922, the committee also began to make recommendations, purely on an advisory basis, as to policy.

The experiences of 1922 also led to a recognition of the importance of open market operations as an instrument for making the discount rate effective in general credit policy and of the need for coordination of open market policy and discount rate policy to make credit control effective. In view of this need, the Federal Reserve Board discontinued the committee in April 1923, and supplanted it with an Open Market Investment Committee, whose membership was identical with that of the preceding Committee except for the addition of the Governor of the Federal Reserve Bank of Cleveland. At that time, it was agreed that the Federal Reserve banks would not carry out open market operations on a significant scale without the approval of the Board, and that all such operations would be governed "with primary regard to the accommodation of commerce and business" and to their effect "on the general credit situation." The individual Reserve banks retained the power to determine whether they would participate in open market operations, however. In 1930, this committee gave way without special legislation, as in the earlier instances, to the Open Market Policy Conference consisting of the Governors of all 12 Federal Reserve banks. An executive committee of five Governors was established to act under authorization of the full committee. Again, the decisions of the committee were subject to the approval of the Federal Reserve Board, which also was authorized to call meetings of the committee and to participate in its discussions.

The Banking Act of 1933 gave legislative status to the Committee and changed its name to the Federal Open Market Committee. The Federal Reserve banks were forbidden to engage in any open market operations except in accordance with regulations of the Federal Reserve Board, but neither the Committee nor the Board was empowered to require any Reserve bank to engage in such operations. However, any Reserve bank not participating was required to state its objections in writing. In keeping with regulations already in effect, the law provided that open market operations should be conducted—

with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

Finally, the Banking Act of 1935, as amended in 1942, placed full authority for open market operations in the hands of a reconstituted Federal Open Market Committee, consisting of the seven members of the Board of Governors, a representative (in practice the president) of the New York bank, and representatives (in practice the presidents) of four other Reserve banks chosen in rotation annually. The control over open market operations has remained in the hands of this body since that time. The Committee meets whenever required, but at least four times a year, and sets general policy. It ap-

points an executive committee (three members of the Board and two presidents of Reserve banks) which meets frequently and implements the broad policy laid down by the full committee.

Thus the authority for open market operations has been placed in the hands of a single body to act for the Federal Reserve System as a unit. This body has been given authority to determine policy and to engage in open market operations in accordance with that policy, and the individual Reserve banks are prohibited from engaging in open market operations except in accordance with the Open Market Committee's direction and regulations. These provisions are based upon a recognition of the fact that open market operations are of Nation-wide rather than local significance. While the organizational arrangement is in keeping with that recognition, it also recognizes the advantages of the combined views of the members of the Board of Governors and of the presidents of the Federal Reserve banks.

During the course of their evolution, Federal Reserve open market operations have been undertaken with a number of different objectives. Originally, as already noted, open market purchases were made primarily as investments and as a means of obtaining earnings for meeting expenses and dividends. In the earlier years of the System's history, the importance of open market operations as an instrument of national credit policy was not recognized. For a decade beginning with 1923, open market operations were undertaken predominantly as a means of influencing the volume of bank reserves and bank credit. During the 1920's, these operations were used as an important part of System policy directed to promoting credit restraint at times of apparently excessive business and speculative activity, and credit ease at times of business depression. A common view was that open market operations should be used primarily to make the discount rate effective. In the early 1930's, open market operations were conducted with a view to establishing easier credit conditions in an effort to encourage bank credit expansion and economic recovery. This program led to the virtual elimination of member bank indebtedness without the credit expansion hoped for, and in 1932 and 1933, operations were conducted for the express purpose of building up excess reserves. As the large increase in the monetary gold stock contributed to an increasingly larger volume of excess reserves, the System did not again undertake open market operations for the purpose of changing the total volume of member bank reserves until the United States entered World War II, and the size of the Government security portfolios of the Federal Reserve banks showed little change from 1934 to 1941.

With the growing importance of the public debt, increasing attention has been directed, in deciding upon open market operations, to conditions in the market for Government securities. In the spring of 1937, for the first time, the Federal Reserve banks purchased long-term Government bonds specifically to limit their decline in price and to maintain "orderly conditions" in the bond market. These purchases were undertaken in connection with the liquidation of Government securities by a limited number of banks, particularly in New York City, which were adjusting to increases in the level of member bank reserve requirements, and were not undertaken for the purpose of affecting the total volume of member bank reserves. Purchases in order to maintain orderly conditions in the market were again under-

taken at the time of the outbreak of war in Europe in September 1939, the invasion of Norway, Denmark, and the Low Countries in the spring of 1940, and the entry of the United States into the war in December 1941, with offsetting sales during the intervening periods. The purpose of these operations was not the maintenance of any particular level of prices or yields on Government securities but was limited to the maintenance of orderly conditions in the market.

In May 1942, however, this objective was carried further by the initiation of a policy, in agreement with the Treasury, of maintaining a fixed pattern of interest rates on Treasury obligations, whereby a virtual price floor was placed under the entire structure of the public debt. The objective of maintaining stability in the Government securities market was to assure the ready financing of the war, to keep down the cost of Treasury borrowing during the war, and to remove the incentive for investors to delay purchases of Government securities in anticipation of higher yields. The System also had another basic objective during the war, namely, the restriction of credit expansion within the limits permitted by the attainment of the first objective. However, the process of maintaining stability in the market transferred the initiative in open market operations from the Federal Reserve System to the market and make it impossible for such operations to be used as an effective credit control device.

The objective of maintaining stability in the Government securities market was continued into the postwar period, but the System also necessarily continued to carry the responsibility for an effective credit policy. So long as the System maintained a fixed pattern of rates in the Government securities market, however, it was not in a position to exercise effective control over the volume of reserve funds available to the banking system. In view of the strong inflationary pressures that prevailed during much of the postwar period, the conflict between these two objectives became especially acute, and the System undertook to restrict the extension of credit through open market operations by endeavoring through sales and redemptions to offset purchases in the segment of the market under pressure. Following some earlier modifications beginning in 1947 in the policy of maintaining fixed prices in the Government securities market, that policy was finally revised under the Treasury-Federal Reserve accord of March 1951, so that the System withdrew its intervention in the Government securities market except to the extent necessary to maintain orderly conditions.

11. What is the rationale of the present assignment of authority over open market operations to a body other than the Board of Governors? Why should the allocation of responsibility for open market policy differ from the allocations with respect to discount rates and reserve requirements? Do you consider these differences desirable? Why, or why not?

Joint answer

The Federal Open Market Committee brings together, with statutory responsibilities for the exercise of the most important instrument of credit policy—the direction of open market operations—men of diversified background who are devoting their full time to the problems of the Federal Reserve System and who are in touch not only

with Government views in Washington but also with private views and opinions throughout the country. The assignment of the authority over open market operations to the Committee has been an evolutionary development.

The Federal Open Market Committee in its present form has worked well for a number of years. It provides a method for conducting policy deliberations that is uniquely in tune with our political and economic institutions. It is a body in which Government is directly represented through the Presidential appointees to the Board of Governors, and regional interests and the lessons of experience "in the field" are represented by the Reserve bank presidents. It is an organization in which responsibility for the determination of reserve requirements and approval of discount rates might properly be lodged.

The fact that the Federal Open Market Committee directs open market operations, the Board of Governors fixes reserve requirements, and the Reserve banks establish discount rates subject to review and determination of the Board of Governors, has not in practice constituted any serious difficulty. Changes in reserve requirements and in discount rates are considered in relation to open market policy. Since actions with respect to all instruments of credit control are discussed by the Open Market Committee and since open market operations generally are recognized as the most important single instrument of Federal Reserve policy, it may be expected that other policy actions of the Board of Governors, or of the Reserve banks, with the concurrence of the Board of Governors, will not run counter to those of the Open Market Committee.

If any past actions taken with respect to reserve requirements or discount rates appear to have been inconsistent with the direction of open market operations in the same period, it should be recognized that such apparent inconsistencies are not necessarily attributable to faults in the organizational structure of the Federal Reserve System. This point is elaborated in the answer to the next question.

Although the present allocation of responsibility over the various instruments of credit control has proved workable and satisfactory, greater assurance of coordination in the use of those instruments in the future could be achieved by placing the fixing of reserve requirements and the approving of discount rates in the hands of the Federal Open Market Committee.

12. Can open-market policy, discount policy, and reserve requirement policy pursue different general objectives or should these various instruments always be directed to a common policy? When differences of viewpoint among different policy-determining groups must be compromised in order to adopt a common policy, what are the factors of strength and weakness in the position of each of the parties to the compromise—i. e., the Board of Governors, the Federal Reserve bank president members of the Federal Open Market Committee, and the boards of directors of the Federal Reserve banks?

Joint answer

Open-market policy, discount policy, and reserve-requirement policy should be directed to a common objective. The public interest

would usually be better served if all instruments of monetary control were coordinated to facilitate greater availability of credit or to restrain monetary expansion, as the general condition of the economy demands.

If the various instruments of credit policy are directed toward different objectives, the over-all effectiveness of credit policy is likely to be impaired. For example, if open-market operations are directed toward the maintenance of stable prices and interest rates for Government securities, the effectiveness of other actions, such as increases in Reserve bank discount rates or increases in member bank reserve requirements designed to restrain credit expansion, is likely to be greatly reduced. Under such circumstances, higher discount rates would have only a psychological influence, if any, since there would be little need for borrowing by member banks. Higher reserve requirements could easily be met by member banks through sales in the market of Government securities which the Federal Reserve System would have to buy in order to maintain the stability of the market, and the higher reserve requirements would thus have little effect in deterring credit expansion.

It is true that at times during recent years, the Federal Reserve System has employed the tools of monetary policy in a manner which may have appeared inconsistent. For example, during the year beginning in November 1947, the System considered it necessary, in the light of circumstances prevailing at that time, to maintain a stable and orderly market for Government bonds even though the inflationary tendencies of the early postwar years were still apparent. As a result, the System offset widespread selling of Government bonds by banks and nonbank investors with purchases of bonds in amounts sufficient to keep market prices slightly above par. At the same time, the Board of Governors on several occasions during 1948 (acting in part under the temporarily enlarged authority granted it by the special session of Congress in August of that year) increased the percentage reserve requirements of member banks. With the aid of Treasury surpluses, it was possible largely to offset the effect on bank reserves of the large-scale purchases of bonds through Treasury redemption of maturing securities held by the System and through market sales of short-term securities by the System, but other factors, such as gold inflows, provided the banks with additional reserves. The increases in reserve requirements may have helped to immobilize some of the additional reserves, but they also led to further bank sales of Treasury securities which the Federal Reserve System had to absorb if the stability of the market was to be maintained. On the whole, the actions taken during this period did not result in such large additions to the lending power of the banks as has been commonly assumed, but neither did they constitute a fully effective program of restraining credit expansion as a means of combating inflationary tendencies.

To the extent that such actions by the Federal Reserve System appear to be inconsistent—in that one action tended to facilitate monetary expansion, while others were directed toward restraint of monetary expansion—it should be recognized that the apparent inconsistency was attributable to special circumstances prevailing at that time. Large amounts of the war-expanded public debt were loosely

held by investors who had become unaccustomed to the fluctuations in interest rates and security prices that had been considered normal in earlier years and tended to become alarmed over the possibility of substantial declines in the value of their securities when heavy demands for capital and credit began to be reflected in an upward drift in interest rates. Furthermore, many institutional investors who preferred greater diversification of their investments, and saw the prospect of obtaining higher yields from other types of investments, sold Government bonds in substantial amounts. There was danger of the development of panicky conditions in which acute weakness in the security markets might have had serious repercussions in the general business situation. Consequently, while the Federal Reserve System never abandoned its objective of restraining inflationary pressures to the extent possible through credit action, it felt obliged to engage in open market operations which would prevent serious disturbances and would thus work toward a situation in which more normal use of the instruments of credit policy might be possible in the future.

Actions taken under such circumstances, therefore, in no sense suggest any abandonment of belief in the desirability of coordination of all the instruments of credit policy toward a common objective.

The second part of this question might seem to suggest that lack of logical coordination in open market policy, discount policy, and reserve requirement policy, or a lack of common direction in the use of the various instruments of credit control, might be attributable to differences of viewpoint among "policy determining groups" within the Federal Reserve System. These groups are named in the question, i. e., the Board of Governors, the Reserve bank president members of the Federal Open Market Committee, and the boards of directors of the Reserve banks.

While the general credit powers are lodged with different bodies within the System, that arrangement does not prevent a coordinated use of those credit instruments. Inasmuch as they should be used so as to complement each other, it is important that a forum be provided for the careful consideration of their coordinated use. This is provided by the Federal Open Market Committee, in which both the members of the Board of Governors and the presidents of the Reserve banks are represented. The directors of the Reserve banks do not have a direct role in policy formulation in the Open Market Committee, but they do have an indirect part in the process of judging the economic situation and appraising the factors influencing credit policy. It must clearly be stated that in the Open Market Committee, where open market policy is determined, members of the committee have not banded into groups. They have come into the meetings of the committee as individuals, each with his opinion concerning the actions which might most appropriately and effectively be taken. They have come uninstructed and free to express their opinions, and each has exerted an influence proportionate to his persuasiveness and his ability to marshal facts supporting his opinions. Hence the factors of strength or weakness in the position of each party—each individual—depends on the strength or weakness of his position when pitted against or compared with the strength or weakness of the position taken by others. Past experience indicates that when there is division of opinion within the Federal Open Market Committee,

the division is likely to be between individual members of the committee, regardless of whether they are members of the Board of Governors or Reserve bank presidents, rather than between the Board members as a group and the presidents as a group.

Comment of C. S. Young, Chicago

In addition, it should be noted that oftentimes technical and temporary considerations require apparently conflicting operations on the part of monetary authorities. The impact of some restrictive actions must be cushioned and spread over time in order to avoid transient market disruptions. Thus, the imposition of higher reserve requirements may be accompanied by a modest amount of Federal Reserve purchases of Government securities during the few days immediately preceding the effective date of the new requirements. Such action, while providing fewer new bank reserves than are immobilized by the new requirement, alleviates strain on the banking system and pressure in the Government securities market which would otherwise develop as banks in tight reserve positions attempt to acquire necessary additional reserves. In succeeding days, as the new reserve positions of banks become more stabilized, some of the temporary reserves supplied by Federal Reserve purchases of Government securities can be absorbed by subsequent sales by the System. Within the framework of one common policy, such partially compensatory operations are frequently required in order that the degrees of credit ease or stringency introduced on any given day do not exceed the capacity of the financial markets to absorb them.

Comment of J. N. Peyton, Minneapolis

[Mr. Peyton would substitute the following for the first part of the System answer.]

Open-market policy, discount policy, and reserve requirement policy should not pursue different general objectives; they should rather be directed to a common policy. Coordination in the use of the instruments of credit control is certainly desirable. The structural arrangement of the Federal Reserve System does not prevent such coordination from being achieved. On occasion, there may appear to be a lack of coordination in the use of the various instruments of credit control even though they are directed toward a common policy, or the pursuit of a coordinated use of the instruments may be difficult because of considerations other than monetary policy.

The public interest would more likely be better served if all instruments of monetary control would be coordinated to effect over-all monetary expansion or monetary contraction, as the general condition of the economy demands. Such coordination of the uses of the various instruments of monetary control—each complementing the others—would provide the most effective implementation of general credit policy.

It may be pointed out that in past years the Federal Reserve System at times has employed the tools of monetary policy in a manner which may have appeared inconsistent—for example, the open-market operations have at times effected monetary expansion while at the same time changes in reserve requirements have been used in an attempt to effect monetary contraction, or that the one instrument has been used in an attempt to offset the effects of the other. This was clearly the

case in 1948 when the Federal Reserve, in accord with the Treasury, deemed it an overriding objective that a stable and orderly market for Government bonds should be maintained. In pursuit of this objective the System met widespread selling of bonds by banks and nonbank investors with purchases in an amount sufficient to keep the market prices of those bonds slightly above par. Recognizing that such purchases created commercial bank reserves, to the extent that they were not offset by System sales and redemptions, it was decided by the Board of Governors that reserve requirements should be raised in order to immobilize at least a part of the reserve so created.

If such actions by the Federal Reserve should be deemed inconsistent—that the one action worked in the direction of monetary expansion while the other worked toward monetary contraction or toward offsetting expansion—it also should be recognized that the inconsistency was assignable to debt-management considerations rather than to monetary-policy considerations. The pegging of Government bond prices overrode appropriate monetary-policy considerations in that such action forbade interest rates to perform freely an economic function. As Chairman McCabe observed in his report to the Subcommittee on Monetary, Credit, and Fiscal Policies in 1949:

> * * * To keep down the rate of interest by making credit freely available at a time when capital demands exceed current savings has an inflationary result. Conversely, to increase rates of interest and thereby discourage borrowing at a time when business activity is low, is conducive to further contraction. Monetary policies should be flexibly adapted to the changing needs of the economy. However, in view of the large outstanding debt and its widespread distribution, the Federal Reserve faces the dilemma of endeavoring to follow flexible monetary policies without detracting from the willingness of investors to be firm holders of Government securities.

Delos C. Johns, St. Louis

[Mr. Johns offers the following comments on the joint answers to questions under section C. Distribution Within the Federal Reserve System of Authority on Credit Policies.]

The joint replies of the special committee of the presidents of the Federal Reserve banks to questions 8 through 12 are generally satisfactory to me. The comment which follows represents no substantive difference with those replies. It relates to the section as a whole and is not tied specifically to the individual questions.

One of the great strengths of the Federal Reserve System is found in its regional characteristics. As is noted in my reply to question 35, the eighth Federal Reserve district is a definite regional entity with regional conditions and problems which differ in degree and in kind from those of other regions. In a nation as extensive as the United States such differences may be expected. They reflect differences in the amount and kind of basic resources, in population, and in the type and extent of resource utilization.

It is important to recognize that these regional variations exist and important to take them into consideration in the formulation of national policies. This should not be taken to mean that national policies should reflect merely narrow and selfish sectional interests; rather it means that national policies should reflect realistic recognition of the facts of regional differences so as to make those policies serve most fully the purposes for which they are designed and hence the true national interest. This principle, of course, underlies the federal form

of government we have chosen. Policies are formulated in the broad national interest but they are formulated with the benefit of regional representation and opinion. This approach implicitly recognizes that, while national aggregates and national averages have meaning, policies based solely on such aggregates and averages without consideration for the regional deviations from them may well be at best inadequate, at worst harmful.

System policies are forged with due consideration for regional deviations from national averages. This helps prevent adoption of unsound or unworkable national policies and helps promote adoption of policies that are sound and workable. The fact that there are 12 Reserve districts and the fact that each bank and branch has directors drawn from the particular district provides for full recognition of the characteristics of the district. Each Reserve bank president is in a position to judge possible alternatives of national monetary policy with due regard to the particular characteristics of his region. This makes for adoption of national monetary policy that squares realistically with actual conditions in the regions rather than with a statistical average of all regions, which average may or may not be meaningful.

At the same time the Federal Reserve banks and branches are in a position to make the policy chosen best fit the characteristics of the various regions, as indicated in the joint reply to question 8. Thus, proper flexibility is assured and the adopted policy serves its purpose. No Reserve bank acting by itself can or would contravene the real purpose of the national monetary policy, but it can provide for special regional circumstances.

The desirability of the regional characteristics of the Federal Reserve System thus seems clear. Much of the System's strength stems from this factor. And the official record of the decisions and votes of the Open-Market Committee demonstrates the fact that the regional characteristics do not result in or reflect selfish sectionalism. Such divisions as have occurred on open-market policy have not been commonly between the five bank representatives and the seven board representatives as two distinct groups but between shifting groups, each of which may contain both presidents and board members. The differences reflect the individual committee members' analyses, interpretations, and viewpoints. In actual practice, even on matters of reserve-requirement policy, for which statutory authority rests solely in the Board of Governors, and on discount policy, there is consultation between the presidents and the board, demonstrating full recognition of the principle of considering regional factors of difference and also demonstrating the fact that regional representation is a source of strength.

In this connection I wish to emphasize strongly a point upon which there seems to be considerable misunderstanding. The presidents of the Federal Reserve banks naturally are in close contact with the commercial bankers in their districts. This fact is interpreted by some people as meaning that the presidents reflect commercial-banking opinion and apparently that such opinion necessarily is at odds with

the public interest. In my opinion, the Reserve bank presidents' views are not unduly influenced by the commercial bankers he works with daily. Rather, these intimate contacts provide him with a "feel" for conditions as they exist in his district and enable him to make a greater contribution to System policy consideration. Also, I do not believe that commercial-banking opinion is necessarily at odds with the public interest. I believe that it may well be as patriotic and as publicly oriented as any other opinion. Furthermore, the very fact that the presidents are in regular contact with commercial bankers gives them better insight into the practical administrative problems of monetary-policy implementation. Lack of such contact would seem more likely to result in unrealistic approaches to policy formulation rather than to more objectivity. The System has taken great pride in the fact that it does not employ the "ivory tower" technique in formulating policy, but that it seeks to obtain as much evidence and informed opinion as possible before taking action.

Finally, I wish to note specifically my concurrence in the joint reply to question 12, which points out that open-market policy, discount policy, and reserve-requirement policy actually have not pursued different objectives, although superficial examination of the record might lead to the belief that such had been the case at various times. Consequently, the fact that open-market-policy power is lodged in the Open Market Committee, while reserve-requirement-policy power rests with the Board of Governors, and discount-policy power with both banks and Board, has not in practice led to action in one field deliberately offsetting action in another. I have already noted that the Board ordinarily seeks the advice of the Reserve bank presidents and staffs prior to taking action with respect to reserve requirements. Discount-rate changes are initiated at the Reserve banks, but require approval by the Board. Action in both fields ordinarily is discussed and considered at Open Market Committee meetings, and policies in practice are coordinated.

It might seem more logical to lodge all three policy powers with the Open Market Committee, but there would seem to be no compelling reason to do so on the basis of the record. However, in keeping with the broad principle of constitutionalism, referred to in the discussion of section A of the subcommittee questionnaire, if there is to be full assurance for all time of proper recognition of regional differences and of coordination of open-market, discount, and reserve-requirement policies, the discount and reserve-requirement powers might well be placed in the Open Market Committee. This step would follow the general American approach in safeguarding a principle with specific legislative action.

In summary, my opinion with respect to the points raised in the questions forming section C of the questionnaire agrees generally with that expressed in the joint replies. My supplementary comment has attempted to stress the strengths resulting from the regional characteristics of the System and to emphasize the fact that the distribution of powers within the System reflects that regional strength and has worked well in practice.

D. GENERAL CREDIT AND MONETARY POLICIES

13. Analyze the effects of the rising yield upon short-term Governments between August 1950 and March 1951 from the standpoint of (*a*) effect upon the volume of bank loans, (*b*) effect upon the level of private interest rates and the differential between those rates and the yield on Governments, (*c*) effect upon the market prices and the volume of sales of long-term Governments, (*d*) effect upon the policy of the Federal Reserve System to support the long-term Governments.

Joint answer

The analysis of any segment of the historical record of credit control must proceed from an explanation of the mechanism and the essential principles of that control. For that reason, a reading of the reply to this question might best follow a reading of the replies to all other questions in section D on general credit and monetary policies. The present question deals only with certain effects of a program of general credit restraint, without embracing all aspects of that program. While each of these selected aspects is important, it will also prove desirable to summarize briefly the background of other developments and the over-all effects of general credit restraint during the period from August 1950 to March 1951, to which this question directs attention.

During a period of emergency affecting the national security, credit policy must consider the immediate interests of national defense as well as its primary responsibility for a monetary policy which will contribute to economic stability. For this reason, although the Federal Reserve System was prepared to implement a credit program designed to combat reviving inflationary pressures prior to the Korean outbreak, the System withheld action on such a program and aimed its policy along the lines of credit neutrality when the Secretary of the Treasury asked the System to stand aside until the President had presented a special message to Congress on the defense needs growing out of the Korean hostilities, and until the Secretary himself had determined the probable magnitude of early needs for additional financing. By the middle of August 1950 both of the conditions set forth by the Secretary had been clarified, and the civilian sector of the economy was in the throes of a substantial boom, while defense expenditures were scheduled at a rate which would not in itself contribute directly to inflationary pressure for some time to come. The President had called for tax increases and restriction of credit to combat the inflationary tendencies in the private sector of the economy. In that setting, on August 18, the Board of Governors approved an increase in the discount rate of the Federal Reserve Bank of New York, and the Board and the Federal Open Market Committee announced that they were—

> prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market.

Unfortunately, on the same date, the Secretary of the Treasury announced that $13.5 billion of Treasury securities called or maturing on September 15 and October 1 would be refunded through a short-term offering identical in form and rate with similar offerings of

June 1 and July 1 that had been announced before the Korean outbreak and the intensification of inflationary pressures which followed.

The Federal Reserve System then chose the only course which afforded an opportunity for compromise between a Treasury decision that required an abundant supply of funds in the market and an over-all governmental policy (cf. the President's message of July 19) calling for credit restraint. The System made no attempt to peg the entire short-term market in line with the terms of the Treasury's offerings; but it stood ready to purchase any of the outstanding securities scheduled to mature on September 15 or October 1 at the higher prices (lower yields) consistent with the Treasury's terms. The System, in turn, sold other securities from its own portfolio at the relatively lower prices (higher yields) consistent with market demand. The results over the ensuing 7-week period were System purchases of roughly $8 billion, offsetting sales (or redemptions) of roughly $7 billion, and a net rise of $1 billion in Federal Reserve credit. The inflationary repercussions of this unfortunate lack of coordination continued throughout the autumn and early winter. On November 22, the Treasury made an advance announcement of the terms for its refunding operations of December 15, 1950, and January 1, 1951, and the System was obliged to stabilize a wide segment of market prices until after January 1. Thus, in effect, a large part of the System's effort to restrain credit over the 29-week period from the announcement of August 18, 1950, through the announcement of Treasury-System accord on March 4, 1951, was consumed in offsetting the Federal Reserve credit released during the 13 weeks within this period that Treasury refunding issues (other than bills) were before the market. Despite these handicaps, however, the over-all growth of the money supply (demand deposits and currency) during this period amounted to only slightly more than 1 percent. Continuing gold outflows throughout the period were a principal source of restraining pressure on bank reserves; and an increase of member bank required reserve percentages during January helped to reinforce the System's efforts to exercise a restraining influence through open market operations during the relatively free interlude.

(*a*) *The effect upon the volume of bank loans.*—The effects of rising yields on short-term Governments during this period were largely counteracted by the System's purchases in support of Treasury refunding operations, and therefore did not prevent an unduly large loan expansion. But the amount and the inflationary character of this expansion might have been considerably greater if two positive results had not been achieved. First, rising yields enabled the Federal Reserve System, in effect, to sell such a large volume of short-term securities to the market that member banks were left with barely two-thirds of a billion dollars of added reserves to use as a base for credit expansion (after allowing for the effect of the increase in the ratios of required reserves) over the 29-week period as a whole. Second, because the member bank reserve base was thus limited, much of the loan expansion which occurred in the banks was financed through bank sale of short-term Government securities to nonbank investors (mainly business corporations)—and thus represented a shift of bank assets without an expansion of the total credit and money supply. The total loans of all commercial banks (for which estimated data are available

only as of the end of each month, without breakdown as to type of loan) rose $7.6 billion in the 7 months from August through February, inclusive; their holdings of Government securities declined $6.2 billion. For the same 7 months, total loans of the weekly reporting member banks rose $5.9 billion; their business loans rose $4.8 billion; and their holdings of Government securities declined $4.9 billion. Some of these Government securities sold by the banks found their way to the Federal Reserve banks, thus adding to reserves; but because short-term rates were attractive to the market the combined Federal Reserve acquisitions from all sources were well below the amounts unloaded by the banks.

(*b*) *Effect upon the level of private interest rates and the differential between those rates and the yield on Governments.*—When Federal Reserve credit is scarce, interest rates on all classes of credit tend to rise. The resulting increase in yields on short-term Governments may often precede increases in other yields, but such increases are interrelated results of the general reduction of credit availability; one increase is not necessarily the cause of the other. Over the 7-month period, the issue rates on new Treasury bills (3 months) rose from 1.173 on August 17 to 1.406 on March 1, or not quite one-quarter of 1 percent. The rise in Federal Reserve discount rates by one-fourth of 1 percent on August 18 was matched almost immediately by all of the open-market private money rates. In general, short-term Government interest rates rose more slowly, and not so far, as the private short-term rates over the 7-month period. Longer-term rates fluctuated moderately around a very slight rising yield trend. There was little change in the differentials between Government bonds and other longer-term issues. The causes and significance of these changing differentials are discussed further under question 17.

(*c*) *Effect upon the market prices and the volume of sales of long-term Governments.*—To some extent, rising short-term rates contributed to expectations of somewhat higher long-term yields (i. e., lower market prices), and may have encouraged some anticipatory sales of Government bonds during these 7 months. But the major factor in the bond sales was the steady unloading by insurance companies, savings banks, and other investors in order to obtain funds for other commitments promising higher rates. They had been undertaking larger commitments than could be met out of newly arising savings or the repayment of past loans or investments. They did so because long-term Government securities themselves were being kept at an arbitrarily high price (low yield), in the face of mounting inflationary pressures, and because they expected that support would continue to make Government bonds virtually the equivalent of cash on demand—available whenever the commitments came in to be met. The fact that yields on most types of longer-term private securities or other outlets for funds did not rise appreciably under these inflationary circumstances reflected the fact that easy access to freshly created credit (through sales of Government securities to the System in a supported market), kept the supply of long-term funds closely abreast of the demand.

The rise of short-term rates did exert a counterinfluence, however. Some of the sellers of long-term Government bonds, while continuing their regular unloading programs, were persuaded by the growing prospects of rate uncertainty to return some of the proceeds to the

short-term market. In addition, the rise in rates also attracted large investment in short-term Government securities by other nonbank investors. Thus, by meeting this demand through further sales of short-term Governments, in the relatively attractive short-term market, the Federal Reserve was able to offset to some extent the inflationary effects of its support of the long-term bond market.

(d) *Effect upon the policy of the Federal Reserve System to support the long-term Governments.*—The System's policy of support, which was focused upon the two longest-term bank-restricted bonds, made it impossible for the System to achieve any sustained measure of effective control over the credit supply through sales of Government bonds. At times, within the anchor prices set for the longest-term bonds, the System could make some sales, as it had done to offset the credit released in supporting the Treasury's June and July refinancing. But the volume of such potential sales was limited at all events, and had been largely exhausted by August 18. Nonetheless, the System continued supporting the long Governments throughout this period, hoping to be able to more than offset the effects of such support by sales of short-term securities at the more attractive yields demanded by the market. By January and February of 1951, however, System purchases of the long-term bonds began to accelerate under selling pressure. A final break was made away from arbitrary support following the Treasury-System "accord" of March 4, 1951. The gradual rise of short-term yields had not made possible enough sales out of the System's short-term portfolio to offset the purchases of bonds entailed by the support technique during a period of mounting inflationary stress. The purposes of bond support through the long "digestion" period following the great growth of long-term debt in World War II had already been largely served; and, as events proved, the transition to unsupported long-term markets below par no longer presented insurmountable problems. Since March and April of 1951 credit restraint has been reflected in the prices and yields of all classes of Government securities, as well as throughout the long-term securities market.

Comment of R. R. Gilbert, Dallas

The answer to this question refers to the approval by the Board of Governors on August 18 of an increase in the discount rate of the Federal Reserve Bank of New York. It should be added that the Board of Governors approved increases in the discount rates of the other Federal Reserve banks, with such increases becoming effective between August 21 and August 25. By the 25th of August the discount rate at all Federal Reserve banks was 1¾ percent.

14. Describe the mechanism by which a general tightening or easing of credit, and the changes in interest rates which may result, is expected to counteract inflation or deflation. Discuss the impact on borrowers and lenders in both the short-term and long-term credit markets and on spending and savings. Indicate the effect on each of the broad categories of spending entering into gross national product. What are the (actual or potential) capital losses or gains that would be brought about by changes in interest rates? To what extent is the effectiveness of a program of credit restraint affected by or dependent upon expectations with

respect to subsequent changes in interest rates? Distinguish in your discussion between small changes in rates and large changes in rates.

Joint answer

The reply to this question will serve as an introduction to the replies to other questions in section D on general credit and monetary policies. Those other replies develop in further detail the broad principles which are outlined here largely in terms of an inflationary situation that necessitates a general tightening of credit. Centering this reply on inflationary conditions should lend orderliness to the presentation, and will also high-light the fact that credit policies are most influential in curbing inflationary distortions before the economy reaches a stage of crisis (and the subsequent collapse into depression). Credit controls help to counteract inflation mainly by limiting those volatile additions to aggregate demand that are financed with borrowed funds. They do not, of course, remove other causes of cyclical disturbance, but credit-financed demand frequently accentuates disturbances set off by other causes. Consequently, effective credit controls must be an important part of any program aimed at limiting cyclical swings and preserving a sustained high level of employment and production. They cannot, however, be relied upon to offset or conceal all other causes of cyclical disturbances.

In an inflationary situation, no source of bank reserves should be permitted to serve as a basis for an over-all expansion of credit or the money supply in excess of the economy's physical capabilities at current prices. The volume of Federal Reserve credit must be restricted to prevent an increase in bank reserves sufficient to support excessive expansion of credit. Broadly speaking, that volume is largely controlled by changes in the Federal Reserve System's holdings of Government securities. Variations in Reserve bank discount rates and discount policy also exert some influence, but their significance derives largely from the reinforcement they supply to the System's open-market operations in Government securities. Increases in the ratio of required bank reserves may, for banks which are members of the Federal Reserve System, help to immobilize Federal Reserve credit already outstanding, but that will be the case only so long as banks cannot readily meet the higher requirements by selling additional Government securities to the Federal Reserve banks. Thus, so far as anti-inflationary control over the volume and usability of Federal Reserve credit is concerned, the key to effective action is the System's open-market account.

The dependence of general credit control upon the System's ability to operate in the Government security market is dictated by the debt (i. e., the credit) structure of the economy. Because the Government debt is now equal to one-half the total debt of the economy, and because the wide distribution of the holding of that debt has been successfully encouraged by developing a well-organized market for Government securities (for which few, if any, parallels exist in other countries), it is inevitable that general credit control must be exerted through the Government security market.

Characteristically, under inflationary conditions, private demands for credit increase beyond the supply of loanable funds arising from current savings and the repayment of other debt. Lending institu-

tions confronted by this large demand for funds attempt to liquidate some of their other assets in order to satisfy this demand. Their usual recourse is sales of those assets which represent the closest substitutes for cash—that is, Government securities. If sales are made to others who have currently accumulated savings, or have funds arising from debt repayment, the net effect is merely a transference of existing loanable funds without necessarily adding to inflationary pressures, although there may be an increase in the velocity of use of funds. But, if the sales of Government securities are financed by an expansion of bank credit, or especially by an expansion of Federal Reserve credit, they will in most circumstances produce an excessive volume of credit and intensify the upward pressure upon prices that results when aggregate demand exceeds (at current prices) the physical volume of goods and services that the economy can produce. Under some inflationary conditions, notably when the Treasury incurs a cash deficit, it is not sufficient to check an expansion of private credit; a part of the current flow of savings must actually be diverted away from private demands to the Government, so that there will be no expansion in total credit, Government and private. (See question No. 16.) Other conditions requiring some direction of the use of currently investable funds, within the framework of general credit restraint, are described under questions 21 through 25.

Certainly the essence of credit control, as a check upon inflation in existing circumstances, is use of the Federal Reserve open-market account to prevent "monetization" of the large outstanding public debt. That must necessarily mean, at times, strict limitations on the volume of System purchases and consequent reductions in the market prices of Government securities. It does not mean that the credit of the Government itself is impaired in any way. It does mean that holders who attempt to dispose of Government securities in a manner that will produce an excess supply of new credit, instead of holding to maturity when full repayment is assured, must expect to find their way impeded under inflationary conditions. For the small individual saver, or for others who cannot be expected to take account of changing market prices, nonmarketable savings bonds are available in suitable amounts at yields fixed arbitrarily above the yield levels that usually prevail in the market. The impact of changing market prices is felt by the banking institutions which provide the major proportion of the Nation's over-all credit supply and by the large and informed institutional investors.

Credit control during an inflation is not, however, aimed specifically at lowering the prices of Government securities, nor at raising interest rates. The entire complex of the forces of market supply and demand will determine what happens to prices and yields when the Federal Reserve refuses to buy, or aggressively sells. But unless all Government securities are immobilized in the portfolios of all classes of lenders by compulsion, and additional supplies of cash resources do not become available to the banks from other sources, the pressure of an excessive demand for credit upon a limited supply will unavoidably force some reduction in prices on Government and other securities, and a corresponding rise in interest rates. Generally speaking, interest rates on shorter-term Government securities will have to rise far enough to assure nonbank purchases of these securities in whatever

volume the Treasury has put into the market. For longer-term securities, a rise of yields means larger capital losses in the event of sale than a similar rise in shorter-term securities, and the attention of some holders will necessarily be focused upon the magnitude of those potential losses. In general, if the over-all credit volume is to be effectively limited to economic requirements, market yields on longer-term securities will rise until potential capital losses become large enough to discourage most sellers, or alternatively, until the lowered market prices attract other buyers in sufficient volume to absorb all sales that continue to be offered.

Because of the wide participation in the Government security market, and because important groups of institutional lenders have a preference for relatively riskless assets and have income requirements of an actuarial type that change relatively slowly, rather small changes in yields (or capital gains or losses) will usually bring about a balance in the market. As a general rule, short-term rates will fluctuate more frequently, and over a wider range, than long-term rates. However, no clear-cut assurance can be given as to the magnitude of the changes in interest rates which occur as a result of restraint upon credit expansion. This depends upon the demand for credit as well as the reduction in the supply of credit available to meet it. The choice is not between very small and very large changes in rates; there may be an almost infinite number of gradations of change as credit restraint is imposed. Recent experience indicates that effective credit restraint can be accomplished without causing more than relatively small changes, in existing circumstances, but any commitment to that effect by the Federal Reserve System would remove the element of uncertainty over rate movements that frequently serves as a useful substitute for further restraining action.

This uncertainty over rate changes is one aspect of expectations that plays an important role in reinforcing the specific action taken to restrain credit. Of course, if a general rise in rates is expected to continue for a long period, some borrowers may try to avoid higher borrowing costs later by borrowing more now; but lenders tend, under these same circumstances, to become unwilling to lend except for relatively short periods; and all classes of investors become increasingly interested in short-term Government securities as a temporary resting place for their investable funds. By feeding this demand for short-term securities, the Federal open-market account can actually strengthen its hold on bank reserve positions. Government borrowing plans must also be adjusted to the investor responses growing out of these expectations of rising rates, as will be further described below.

The principal impact of credit tightening upon borrowers comes through the limitations imposed on the availability of funds. As lenders reject applications, borrowers are compelled to postpone or scale down their plans. To be sure, some borrowers, particularly those intending long-term capital investment, may take themselves out of the market if rates rise above a point consistent with their projections of costs and probable income, or if they think they may be able to obtain the funds at lower cost (and perhaps carry out their expenditure programs more economically) at a later time. Rising short-term rates, in an atmosphere of uncertainty over the pros-

pects for particular businesses, may also deter borrowing for inventory expansion or for carrying additional trade receivables. These are important effects; they occur on a significant scale; but by far the most important influence upon borrowers is the difficulty of obtaining funds from lenders who feel they have become "loaned up."

There is an apparent, but not an actual, loophole in attempts to restrain lenders who hold short-term Government securities. It would seem that they could obtain additional loanable funds merely by allowing their holdings to run off at maturity, accepting cash instead of the new issue. For any individual lender that is indeed possible from time to time, but there are few lending institutions that have such regular, frequent, and ample maturities that they can obtain by that means all the additional funds they could use. Moreover, it is not possible for all lenders unless the Federal Reserve System purchases enough of the refunding issues to supply the Treasury with the cash to pay off the holders of maturing issues. It is the Treasury's inherent responsibility for combating inflation that it offer securities which are acceptable to the prevailing market.

Another apparent difficulty concerns the implications of investor expectations for Treasury financing operations, when interest rates rise as a result of restricted credit availability. In the face of rising rates, investors may shrink away from any given Treasury offering, and await the better yields to be expected shortly. In that event, it has been suggested, the Treasury might be forced to turn directly or indirectly to the Federal Reserve banks, and thereby actually cause the total volume of money and credit to expand. Paradoxically, it would seem, rising market rates of interest would, in that event, have caused a greater release of new credit than might have occurred if bank money had been used to support prices (peg yields) in order to attract a greater response by other investors to the Treasury's offering. There is no doubt that this is a difficult problem. It cannot be resolved by a simple formula. But when it is met squarely by the Treasury and the Federal Reserve acting together, it can be reduced to a matter of skillful timing and studied selection of the terms for Treasury issues. (See questions 13, 16, and 17.) Slight errors, or miscalculations, sometimes occur. But on balance, although continuously pegged markets might on some occasions assure greater direct response to an individual Treasury offering, the cumulative effect over time would necessarily be a complete loss of control over credit availability since pegged markets can be maintained only by more or less continuous support by the Federal Reserve System, which means the extension of Federal Reserve credit at the option of "the market."

The effects of credit restraint upon savings and spending are clear as to the direction of influence, discernible as to the relative magnitude of their influence, but altogether unmeasurable in terms of statistical aggregates because they act by preventing what might have been. So far as savings are concerned, those of individuals are certainly stimulated (over what they might otherwise have been) by any appreciable rise in the return on savings media that accompanies a general tightening of credit, but the over-all magnitude of this response is not likely to be large. By far the greater impulse to individual saving results from a steadying of general prices, for which credit restraint must always divide responsibility with other measures. Business savings tend to rise over what they might otherwise have been, in the aggre-

gate, as credit restraint reduces access to borrowed funds, and provides an incentive to rely more heavily on retained earnings as a source of funds. A dampening of excessive consumer demand affects business inventory policy and other business expenditures. Both directly and indirectly this rise of business saving serves as a significant anti-inflationary factor.

With respect to "the broad categories of spending entering into gross national product," credit restraint exerts a wide range of direct and indirect influences. Consumption expenditures are affected directly when general credit restrictions check the growth of credit for the purchase of durable consumer goods; further price increases for such goods become less likely; and, while output is likely to remain at the peaks permitted by available materials in a period of heavy overall demand, consumers devote less of their current (or future) income to such purchases. The real income of consumers is protected or enlarged by preventing a swollen money supply from inflating the entire price structure. When there is general credit restraint, the dollar volume of gross private domestic investment expenditures, like that for consumer durables, will not be expanded by duplicating grants of credit to competing investors, which cause them to bid up prices for the inventories, equipment, plant, residential housing, or other construction that the economy is capable of producing. The ricocheting effects of these price increases upon other costs, money wages, and the general level of prices may thus also be avoided.

And it must be remembered that general credit controls are not punitive; they are not imposed to cut the aggregate volume of available credit below the aggregate volume of goods and services that the economy is physically able to produce for the civilian economy at prevailing prices. They do tend to prevent excessive demands for the same goods, financed by borrowed money. They leave the allocation of the limited credit supply to the operation of the price mechanism and the combined wisdom of the specialized lending institutions of the economy which are best able to allocate credit among its most economic uses—so long as the total volume of loanable funds which they have to allocate is not so easily expansible as to remove the necessity for selection among borrowers.

The other "broad categories" of spending are net foreign investment and Government purchases of goods and services. For both of these the effects of credit restraint are indirect—the results of holding prices lower than they would otherwise have been if money and credit had continued to expand freely. In the case of the Government, however, these indirect effects may be very substantial because credit restraint directly limits excessive demand for the wide range of investment goods which utilize the same types of materials that are embodied in a large proportion of the goods purchased by the Government. There is no direct effect upon Government expenditures, since these are determined by Congress and, in effect, have priority over all other demands for goods and services; but the price tags on Government purchases are held down.

As indicated at the outset, the reply to this question has been prepared in terms of inflationary conditions. That approach seemed appropriate both because the exposition of these broad principles could be undertaken more systematically by tracing all of them

through a single set of conditions, and also because credit control is relatively more effective as a check upon inflationary tendencies than as a stimulant during deflation. However, because changes in credit availability may exert a very early effect upon most of the categories of investment, it is also possible for a well-timed program of credit ease to play a significant part in resisting a downturn during its early stages, particularly if that downturn has resulted from a gradual wearing out of expansionary forces rather than the precipitate curtailment associated with an economic crisis. The measures undertaken to check such a "sagging deflation" will be essentially the same in character, although perhaps not in magnitude, as those undertaken to stimulate recovery from severe depression. Consequently, a summary of those measures may provide a useful conclusion to this review of the contracyclical effects of general credit control.

The stimulus toward recovery would, under most deflationary circumstances, be exerted initially by Federal Reserve System purchases of Government securities, or a lowering of required reserves, with a consequent increase in excess reserves available for credit expansion. Credit availability will be increased; interest rates may be expected to decline. Having an opportunity for capital gains on longer-term securities, and with the prospect of lower yields on shorter-term money market instruments, lenders will attempt to enlarge their longer-term investments, particularly if they fear that yield levels may decline still further. The flotation of new securities, particularly fixed-interest obligations, will be encouraged. Longer-term investment projects that had been postponed during the period of limited credit availability, and higher interest rates, may be revived. Lenders and underwriting organizations will aggressively seek out new investment opportunities. Industrial concerns may take advantage of the easy credit conditions to borrow for the financing of receivables (credit extensions to distributors), using this means to build up their own sales outlets and indirectly to assist those outlets themselves, particularly smaller concerns or concerns of marginal creditworthiness. Retailers will be able to borrow readily in order to make credit sales to consumers. As the interest costs of carrying inventory lessen, some concerns may carry more diversified stocks to attract additional business. The construction of residential housing will be especially encouraged, because the segment of carrying costs represented by interest charges (which is normally a large proportion of the total) will have been materially lowered. Similarly, the production and sale of consumers' durable goods may be aided. Treasury borrowing costs will probably decline.

In these ways, and through a variety of associated psychological influences, a turn toward credit ease may help to check or offset undesirable deflationary tendencies. Although the "spur" effect of credit ease may be less pronounced than the "bit" effect of credit restraint, both have a necessary place in fulfilling the Nation's economic objectives—sustained high level production and employment, steady growth, and rising living standards.

Comment of Hugh Leach, Richmond

As indicated in the joint answer, open-market operations can be the most flexible and effective instrument of general credit control for use

in tightening or easing bank credit. However, it should not be overlooked that the other quantitative credit-control instruments—reserve requirements and discount rates—are an integral part of System policy. Even though changes in reserve requirements are admittedly a clumsy tool to be used sparingly and the effect of discount rate changes is now largely psychological, these instruments can be of considerable value under certain circumstances.

It is true, of course, that an increase in requirements at a time when member banks have few loans and heavy investments in Government securities selling above cost will have little restraining effect on most banks beyond reducing potential expansion on a given amount of excess reserves, because they can sell securities (at a profit) to the Federal Reserve System. However, the situation would be quite different if the volume of outstanding loans was so large that many member banks would find it difficult or impossible to adjust their reserve positions to additional requirements by offsetting sales of Government securities. Under such conditions an increase in reserve requirements would undoubtedly be restrictive. The restrictive effect would be increased at times when banks could sell Government securities only at a loss.

Granting the current effect of discount rate changes as largely "psychological," it has been clearly demonstrated in the postwar period that discount rate increases do have an immediate effect (apart from open-market operations) on the credit climate and short-term money rates.

Comment of C. E. Earhart, San Francisco

If taken as a statement of general principle, we agree entirely with the following sentence taken from the joint reply to question 14:

> In an inflationary situation, no source of bank reserves should be permitted to serve as a basis for an over-all expansion of credit or the money supply in excess of the economy's physical capabilities at current prices (second paragraph, first sentence).

This should not be taken to mean that the Reserve System believes that it can be free to restrain credit to this extent under all inflationary conditions, as might be inferred if this statement were read out of context. Reference to two statements in the joint replies to other questions clearly illustrates this point:

> During a period of emergency affecting the national security, credit policy must consider the immediate interests of national defense as well as its primary responsibility for a monetary policy which will contribute to economic stability (question 13).

> Financing a major war involves two conflicting objectives—adequate financial support of the war program and avoidance of inflationary effects. * * * Deficit financing on a large scale would be a serious obstacle to a strongly restrictive monetary policy, as the Federal Reserve System would have to avoid interference with, and even assist in, Treasury financing of the deficit (question 16).

15. How rapidly and to what extent would you expect the volume of bank loans to respond to measures of general credit control under present conditions?

Joint answer

It is never possible to measure quantitatively the effects on the volume of bank credit of general credit control actions. To so measure the effects would require definite knowledge of what would have

happened had no action been taken, and that must necessarily remain a matter of informed opinion rather than knowledge. Nevertheless, we would expect some response in bank extensions of credit to restrictive measures of general credit control almost immediately, with increasing effects over a period of time.

For example, the change of open market policy by the Federal Reserve System in the spring of 1951 and the fall in prices of Government securities which ensued were reflected almost immediately in a reduced availability of funds for mortgages other than those for which commitments had been made previously. The market for corporation and "municipal" securities also was affected, so that the flotation of new issues became more difficult.

Furthermore, we are informed that the action by the Federal Reserve System had the effect of making many banks feel "loaned up," thus leading them to adopt a more restrictive policy with respect to new extensions of credit. The fact that market prices of Government securities fell below par contributed to the "loaned-up" feeling, as banks (and other lending institutions) were reluctant to take actual losses by selling such securities as a means of obtaining additional cash resources. We are informed that this situation has contributed materially to the success of the voluntary credit restraint program.

In the case of use of measures of general credit control to make credit more freely available, the response may involve some time lag, especially if the action is taken in a period of pronounced business recession. In such circumstances, potential borrowers may be more intent upon reducing their liabilities than upon obtaining additional funds for the purpose of extending their activities. Nevertheless, there is reason to believe that tendencies toward credit liquidation are likely to be relieved by the easier credit conditions brought about by a change of general credit policy, except perhaps under conditions of extreme depression. And when the immediate cause of more moderate business recession (such as an overextended inventory position) has been corrected, easy credit conditions facilitate the financing of a resumption of activities. Here again, however, it is impossible to measure the effects of the credit action in quantitative terms.

16. Compare the applicability of general credit and monetary measures and the resultant increases in interest rates as a means of restraining inflation (*a*) when the Treasury is not expected to be a large borrower in the foreseeable future, (*b*) when a large volume of Treasury refunding operations will have to be effected in the foreseeable future, (*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future, (*d*) under conditions of total war.

Joint answer

A basic objective of economic policy in this country is assumed to be the maintenance of high levels of production and employment, free from the disruptive influences of either serious inflation or serious deflation. In view of this objective, we believe that in an inflationary period both general credit and monetary policies and public-debt management policies should be directed toward restraining inflationary pressures, whether or not the Treasury is expected to have to carry out large borrowing or refunding operations in the foreseeable future.

While not all inflationary pressures are directly attributable to monetary expansion, nor can be dealt with completely by monetary action, we believe that, in most circumstances, action to check monetary expansion is an essential part of an anti-inflationary program. In a free market, a restricted supply of credit in the face of heavy demand for credit will unavoidably be reflected in somewhat higher interest rates.

In our opinion the Treasury's borrowing operations can and should be adjusted to the requirements of over-all economic policy. Public-debt operations may supplement and reinforce monetary action and may even reduce the need for strong measures in the monetary and credit field, or they may interfere with, and hamper the effectiveness of monetary action if they are not appropriate to the existing economic situation. For example, the Treasury surpluses of the early postwar years and their use to retire securities held by the Federal Reserve banks not only helped to offset the effects on the income stream of credit expansion, but helped to offset the expansionary effect on the banking system of gold inflows and to exert recurrent pressure on bank reserves and thus to restrain credit expansion.

(*a*) A situation in which the Treasury is not expected to be a large borrower in the foreseeable future implies that Treasury receipts are expected at least to equal Government expenditures, and also implies such a distribution of maturities in the public debt that frequent refunding operations are not necessary. The presumption would be that, at least so far as the amount of Treasury receipts and disbursements is concerned, Treasury operations were not contributing to inflationary pressures and were imposing no obstacles to the execution of monetary measures designed to combat inflationary tendencies.

(*b*) The prospect of a large volume of Treasury refunding operations would in no way relieve the need for action to combat inflation. But depending upon how well the refunding operations were adjusted to current market conditions, that is, adjusted to meet competitive demands for credit and capital, they might facilitate an appropriate monetary and credit policy or might interfere seriously with such a policy.

In an inflationary situation there are likely to be heavy demands for capital and credit to finance industrial-plant expansion and improvement, commercial and residential construction, and, quite possibly, State and local government projects, and to finance increased business inventories and receivables and increased consumer spending. If the Treasury offers securities in its refunding operations that are competitively attractive, interest rates and risk considered, the exchange of new securities for the maturing issues can be accomplished without any permanent addition to commercial bank or central bank credit. On the other hand, if Treasury operations are not competitively attractive, heavy recourse, directly or indirectly, to central bank credit is likely to be necessary to prevent their failure. The result will be additions to bank reserves and the creation of a basis for multiple expansion of bank credit and the money supply, which is likely to accentuate the inflationary pressures and the depreciation of the purchasing power or real value of the currency.

If, as a result of restrictive monetary policies and heavy demands for credit and capital, interest rates tend to rise, the Treasury may

have to pay higher interest rates on the new securities it offers than on maturing securities of comparable maturity, and the demand for securities of various terms to maturity may be affected. Usually a rise in interest rates tends to create uncertainty as to the future course of rates and to increase the relative demand for securities of short maturity. Since short-term rates generally have been considerably lower than long-term rates for many years, the increased demand for short maturities might enable the Treasury to do its refunding without increasing materially the total interest cost on the public debt by taking advantage of this demand. However, interest cost should be a secondary consideration in refunding operations during an inflationary period; and both the interest rate and the length of maturity should be selected with the primary objective of placing the refunding issues as largely as possible with nonbank investors to avoid contributing to monetary expansion.

Even with the best of financing methods, however, some degree of interference with an effective monetary policy is likely for the period during which the refunding operations are carried out. A considerable amount of shifting of holdings of securities from one investor to another always occurs in refunding operations, Government or private. Fairly stable market conditions ordinarily are necessary during the period of the refunding operation to facilitate the redistribution. In the case of a large Treasury refunding operation, which frequently runs into billions of dollars, maintenance of stable market conditions during the refunding period may require the injection of Federal Reserve credit into the market, temporarily at least. The result is that additional reserve funds are made available to the banking system, on the basis of which credit can be extended. The more frequent the refunding operations, therefore, the greater the disruptive effect on an anti-inflationary monetary and credit policy. Consequently, well-spaced maturities in the public debt are highly desirable if the management of the public debt and monetary policy are to work together in combating inflation.

(*c*) When the Treasury is expected to be a large net borrower, there is even greater need for measures to restrain expansion of private credit, if inflationary tendencies are to be held in check. Such a situation implies that an increased share of over-all production of goods and services is to be diverted to governmental purposes, and that there is no corresponding reduction of private spendable income through taxes. If Treasury borrowing operations are such as to encourage increased savings by the public and to attract such savings to the financing of Government expenditures, the inflationary effects of the Government deficit financing will be mitigated, and the need for strong measures to restrict private credit will be reduced. On the other hand, if not enough is done in debt management operations to divert income from the private sector to the financing of Government expenditures, strongly restrictive measures to restrain expansion of private credit, or even to force contraction in such credit, are likely to be necessary if the inflationary tendencies are not to be allowed to develop unchecked.

In the case of large net borrowing by the Treasury, it is even more important that the financing of the Government be done in ways that will stimulate and attract savings and so minimize the inflationary

effects of Government spending, even though higher interest cost on the public debt is involved. Avoidance of such cost is likely to result in generally higher costs for the goods and services acquired by the Government, as the result of an accentuation of inflationary tendencies. It has been suggested that this dilemma might be resolved by direct limitations on private demands for credit, coupled with compulsory allocation of Treasury securities to institutions and individuals. If inflationary tendencies are permitted to develop unchecked, the cost to the Government is likely to be many times the interest cost of making Government securities more attractive to investors, and there will be other costs in the form of injury to groups who are unable to protect themselves against the inflation. Compulsory allocation of securities would almost certainly encounter strong public resistance in circumstances short of all-out war, and, if applied, would have a deleterious effect on the credit of the Government and on the voluntary demand for Government securities.

In addition to general restraints on credit expansion, the need for supplemental use of selective credit controls, such as restrictions on consumer credit, is likely to be intensified in periods of heavy Treasury borrowing in order to reduce the demand for goods in the production of which there is much use of materials and manpower needed for governmental purposes, such as the greatly expanded national defense program now in progress. Measures designed to direct credit and capital into the financing of the more essential activities and away from nonessential uses, such as the current voluntary credit restraint and "V loan" programs, are also helpful in these circumstances.

(*d*) Experience has demonstrated that under conditions of total war, when the existence of the Nation and all the freedoms of its people are threatened, there must be not only economic sacrifice, but also the sacrifice "for the duration" of some of the normal economic freedoms of a democracy. To some extent there can be reliance upon appeals to patriotism, but there is likely to be the necessity also of increased recourse to compulsion in order to assure the disciplines and the equality of sacrifice that are necessary for the winning of war and for survival. Less reliance than in peacetime can be placed upon the normal functioning of the market, whether for goods or for money. Under such conditions, restrictive monetary measures are needed to deter tendencies in the private economy which conflict with the war effort, but the major roles in combating inflation must be played by fiscal and debt management policies designed to keep to a minimum monetary expansion arising out of the financing of the war. In addition, these policies must be supplemented by direct controls, such as allocations of materials, inventory controls, price and wage controls, and the rationing of consumers' goods.

Financing a major war involves two conflicting objectives—adequate financial support of the war program and avoidance of inflationary effects. A major share of the income of the public has no counterpart in the production of peacetime goods and services, and must be drained off through taxes or immobilized through savings that are not returned to the private income stream if inflationary pressures are to be kept within bounds and direct controls are to have a reasonable chance of effective application. The choice is between making the sacrifices necessary to channel a sufficient amount

of current income into the Treasury, through taxes or savings, to meet its requirements, or enduring the hardships imposed by price inflation (open or concealed) when a major part of Treasury financing is done through the banking system.

Determination of the extent to which Government expenditures are to be met by taxation is the responsibility of Congress, and its action will greatly influence the feasibility of restraining inflationary monetary expansion. Deficit financing on a large scale would be a serious obstacle to a strongly restrictive monetary policy, as the Federal Reserve System would have to avoid interference with, and even assist in, Treasury financing of the deficits. To the extent that deficits should prove unavoidable, every effort should be made to finance them through the investment of savings. But if the Treasury were unable, with the best of financing methods, to raise enough funds without recourse to bank credit, the central banking system would have to provide the necessary reserves to enable the banks to do their part in financing the war. In any case, a coordinated debt management and monetary policy designed to keep monetary expansion at a minimum would be essential, not only to minimize the inflationary pressures during the war, but also to avoid creating the monetary basis for serious inflation after the war when the restraints of wartime patriotic impulses no longer are effective. The alternative might be to keep the economy in a strait-jacket of direct controls for an indefinite period, in the effort to keep dormant inflation from becoming active inflation.

Comment of Allan Sproul, New York

[Mr. Sproul would eliminate the last sentence of the joint answer, stating that the alternative there presented is not really possible, practical, or desirable, given our form of society and Government.]

Comment of Ray M. Gidney, Cleveland

I am in substantial agreement with the joint reply. However, I should like to comment on the sentence containing the following:

> Compulsory allocation of securities would almost certainly encounter strong public resistance in circumstances short of all-out war, and, if applied, would have a deleterious effect on the credit of the Government and on the voluntary demand for Government securities.

I believe that compulsory allocation of securities would be undesirable and would encounter strong public resistance even during an all-out war. During World War II, there were occasional rumors that the Government intended to take action of this kind perhaps by levying on savings accounts. Frequent denials were made of any such intention but, even so, each new rumor caused heavy withdrawals from banks and apparent increases in currency hoarding. I do not favor including compulsory allocation of securities as a possible method of financing Government needs.

I should like also to comment on the paragraph stating:

> In addition to general restraints on credit expansion, the need for supplemental use of selective credit controls, such as restrictions on consumer credit, is likely to be intensified in periods of heavy Treasury borrowing in order to reduce the demand for goods in the production of which there is much use of materials and manpower needed for governmental purposes, such as the greatly expanded national defense program now in progress.

I do not share the confidence in the use of selective credit controls implied by this paragraph and shall make further reference to the matter in discussing other questions.

The closing sentences of the joint answer state:

> a coordinated debt management and monetary policy designed to keep monetary expansion at a minimum would be essential, not only to minimize the inflationary pressures during the war, but also to avoid creating the monetary basis for serious inflation after the war when the restraints of wartime patriotic impulses no longer are effective—

and—

> the alternative might be to keep the economy in a strait-jacket of direct controls for an indefinite period, in the effort to keep dormant inflation from becoming active inflation.

I agree with these statements to the extent that they imply that under the conditions indicated, the absence of sound, coordinated, anti-inflationary fiscal public debt and general monetary policies might result in ruinous inflation unless the American economy and people were put into an effective strait-jacket of controls and regimentation. However, I do not believe that a "strait-jacket of direct controls" could be maintained. It would interfere with the economic forces which, in the normal course, would be moving to bring about a replenishment of the deficiencies remaining as a result of wartime conditions, and would break down from weariness, cynicism, public resistance, and spreading lack of integrity in application. I have not shared the frequently expressed view that it was a mistake to remove direct controls after World War II. I believe that the freedom given to economic forces at that time was a principal reason why the country so quickly increased production of goods that in a relatively short time we moved from a condition of undersupply to one of balance or in some lines of oversupply. It is essential that our powerful economic machine have freedom to function.

17. To what extent is the demand for United States Government and other high-grade, fixed-interest-bearing securities by nonbank investors influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

Joint answer

Nonbank investors are a very mixed group, including savings banks, insurance companies, business corporations, and individuals. Their composite demand for Government securities, or for other high-grade, fixed-interest-bearing securities, represents a wide variety of influences, many of which are subject to continuous change. While it is necessary in the implementation of credit policy and debt management to observe these changing influences very closely, one lesson of that observation has been that few timeless generalizations can be made concerning the reactions of nonbank investors. It is only possible to describe certain patterns of behavior that recur from time to time. Consequently, the three sets of influences indicated in the wording of this question, (*a*), (*b*), and (*c*), may best be discussed together, in order to indicate some of their interactions upon one another and some of the changes in their relative significance.

Under any circumstances, however, changes in interest rates, the current level of rates, and expectations with respect to market factors that may bring about changes in rates, all play important parts in determining the distribution of nonbank holdings among Government securities, privately issued securities, and such other outlets for funds as business loans, mortgages, or direct investments in businesses, as well as in influencing the distribution between shorter- or longer-term obligations. As a longer run matter, many nonbank investors, particularly those which are financial institutions, attempt to work within some bench marks of diversification that are consistent with the nature of their liabilities. Such bench marks are apparently adjustable, however, when fundamental or prolonged changes occur in interest rates or in the composition of outstanding Government and private indebtedness.

Because United States Government securities are free from credit risk, market forces develop differentials between the yields on Governments and those on other classes of marketable securities. The fact that this spread generally tends to widen as credit becomes tighter indicates that over-all demand, in which the demand of nonbank investors is a substantial part, often moves toward Government securities, on balance, when interest rates rise. Part of the explanation lies, no doubt, in the fact that many thrift institutions (such as life insurance companies) must give very high priority to safety of the principal amount of their investments, and will consequently tend to hold as many Government securities as they can consistently with their income requirements. These income requirements, so far as they relate to dividends on thrift accounts or actuarial yields on insurance policies, do not change frequently. Consequently, a rise in interest yields at a time of inflationary developments may soon dry up much of the potential selling of Government securities by these institutions, and encourage some to resume purchases. Meanwhile, as the obverse of this reaction in the Government security market, the market for other types of loans or securities will have been narrowed, and somewhat greater price reductions (yield increases) will occur as supply and demand are brought into balance in the non-Government market. For comparable reasons, the yield differential between Government securities and others tends to narrow under deflationary conditions as credit is eased and rates decline.

Expectations have an important bearing on nonbank investor demand, sometimes adding to, and sometimes simplifying, the Treasury's financing problems. They also serve as an important bridge between the shorter-term and longer-term markets; and occasionally the uncertainty created by rising short-term rates, for example, creates market responses in the longer-term segment of the market that serve the interests of credit policy effectively without actually producing any material change in long-term prices or yields. Moreover, expectations differ in kind, varying from a predominantly speculative character under some circumstances to a predominantly investment character in others, with the result that both credit policy and debt management must be sensitively attuned to the nature of prevailing expectations, as well as to their intensity.

To illustrate, if large blocks of longer-term Government securities should be lightly held, as was clearly the case through the first 2 or 3 years after the completion of the Treasury's enormous wartime financ-

ing, any vigorous attempt by the Federal Reserve to back away from such securities when they were offered for sale would lead to expectations of a severe decline in the market and might cause a great volume of panic selling. To avoid chaotic repercussions throughout the securities markets, and to avert a paralysis of the orderly capital financing that is needed to sustain economic activity at high levels, the System might be forced to step in to make substantial purchases. It would then have to rely upon offsetting sales of very short-term securities to those who were nervous about long-term security prices (or upon Treasury redemption of System-held securities if the Government should then be enjoying a cash surplus) in order to reabsorb the Federal Reserve credit created by its purchases of longer-term securities. But if the holders of longer-term securities should be predominantly investors concerned mainly with the long-term yields from sustained holding (as was the case in the spring of 1951), the Federal Reserve can readily absorb any lightly held fringe of longer-term securities by carefully calculated scale-down purchases, can offset the Federal Reserve credit thus created by sales of shorter-term securities at rising yields, and can then let the market bottom out on its own. The results of these differing forms of restraining action will follow the general patterns outlined in the reply to question 14.

The important point to recognize is that the approach to credit restraint must be conditioned by the state of prevailing expectations, and often primarily the expectations of nonbank investors. Another aspect of nonbank-investor psychology that gave strength to credit restraint in recent months was the growing realization among many of the larger investors that they must themselves accept an attitude of responsibility toward the market. Holding large blocks of longer-term Governments, many of them were individually capable of producing sharp price declines if they should attempt to unload heavily in an abrupt manner. Recognizing that, some were persuaded by the expectation of capital losses (as a result of sales at prices which would be lower than those currently quoted in the market) to continue their holdings of Governments and to limit their commitments for new credits to the volume of their own currently arising inflow of new savings or debt repayments. Others spaced or reduced their offerings and were thus able to obtain funds through the market from other investors without sharp repercussions on prices. The net effect was to permit the System to hold the volume of Federal Reserve credit, and in turn the aggregate volume of money and credit, within bounds that were consistent with the prevailing level of prices.

From the Treasury's viewpoint, the rising interest rates associated with credit restraint raised the problem (also alluded to under question 14) of investor reluctance to accept a given Treasury financing offering. In the investor's view, delay may mean a better return a few weeks later. But a Government securities market that is on its own will actually reflect the balanced effect of such expectations in its current pricing. When credit demands are heavy and investors understand that Federal Reserve credit will not be supplied (through the Government securities market) to support financing of a total demand in excess of the economy's physical capacity valued at current prices, the market itself will find the prices (and yields) that are consistent both with the available credit supply and the Treasury's projected

financing needs. And under those circumstances, although admittedly a high degree of skill in debt management and some measures of technical—but temporary—market stabilization will be required, the Treasury can successfully place its offerings provided they are tailored to the market. The market mechanism, and credit restraint as well, would only break down if the setting were reversed, and new credit were pumped out to tailor the market to the terms chosen for a given Treasury offering.

Another characteristic investor reaction to rising rates may be a general shift in preferences to shorter-term issues. That, too, will be reflected in market prices and yields, and is likely to mean that Treasury financing, as well as any needed System sales in the interest of general credit restraint, may often be concentrated largely in the shorter-term sector of the market during periods of credit tightening. The shorter-term sector has also been increasingly strengthened in recent years by a growing interest of business concerns in Government securities as a suitable lodgment for funds (including their tax acruals) not immediately required in the conduct of their businesses. It is significant that this interest developed on an important scale after short-term rates had risen markedly above the arbitrarily low levels at which they had been pegged during and immediately following World War II.

As stressed at the beginning of the reply to this question, there is no single or set pattern of nonbank investor demand for Government securities and for other types of loans or investments. General business conditions as well as the condition of each individual investor will exert a changing over-all influence upon such demand. But the brief résumé given here should serve to illustrate the manner in which credit controls, which produce changes in interest rates, and in expectations concerning investment opportunities (including possible further changes in interest rates), also exert a strong influence upon the investment decisions of nonbank investors. The relative importance of actual rates, or expectations, or other factors, will vary considerably. All of these aspects must be kept under close observation, and continuously tested through the price mechanism of the Government security market, the money market, and the capital market, if credit policy and debt management are to be effective in meeting their common objectives.

18. What is the reason for the relatively slight use by commercial banks of the Federal Reserve discount and borrowing privilege? Do you believe that greater reliance should be placed on this privilege as a means of obtaining Federal Reserve credit? Under what conditions, if any, would you expect to see a greater use made of the discount privilege?

Joint answer

The limited use by commercial banks of the privilege of borrowing from the Federal Reserve banks in recent years is primarily attributable to the ability of the banks to obtain adequate amounts of reserve funds from other sources, but is partly attributable to the rather general reluctance of bank managements to rely upon borrowed funds at least for more than very short periods. Continued indebtedness has long been considered by most banks as an indication of an over-

extended position, and the reluctance of bank managements to show indebtedness in their statements of condition was accentuated by the serious banking difficulties of the early 1930's. In their efforts to avoid borrowing, the banks usually tend to extend credit less freely when they are in debt to the Reserve banks.

During the depression of the 1930's, the Federal Reserve System took action through open market operations to provide the banks with ample reserve funds to enable them to repay any indebtedness and to accumulate fairly sizable amounts of excess reserves so that they would be in a position readily to supply their customers' needs for credit. From 1934 to 1940, inclusive, the heavy inflow of gold from abroad resulted in the accumulation of a huge volume of excess bank reserves which became widely distributed throughout the country, and as a result there was so little occasion for the banks to borrow that they became unaccustomed to that method of obtaining reserve funds. Furthermore, after the serious banking troubles of the early 1930's, many banks feared to have it become known that they were borrowing lest their customers interpret their indebtedness as a sign of weakness.

After the United States entered World War II, the heavy public demand for currency, some outflow of gold, and the large increase in the banks' reserve requirements that accompanied the growth in their deposits quickly depleted the banks' excess reserves. Measures were then taken to ease the pressure on bank reserves; moderate reductions were made in the percentage of reserve requirements of central reserve city banks whose reserves were under the heaviest pressure, and Government deposits in the banks were exempted from reserve requirements. Nevertheless, the banks needed large amounts of additional reserves and, despite the fact that the Federal Reserve banks established the unprecedentedly low rate of ½ percent on advances to member banks secured by Government obligations maturing in 1 year or less, their reluctance to borrow limited the extent to which they took advantage of this extremely cheap sources of reserves, and the banks obtained most of the reserve funds they needed by selling short-term Government securities. The banks obtained reserves in part by sales of Treasury bills to the Reserve banks at the fixed rate of ⅜ percent which was maintained from 1942 to 1947, and in part by sales in the market of other Treasury securities, which the Federal Reserve System was forced to buy in order to maintain the structure of interest rates adopted by the Treasury in 1942 for the period of the war financing.

After the war, the gold inflow was resumed and continued virtually without interruption until the fall of 1949, reaching a total for the postwar period of approximately $5 billion. In addition, there was a moderate return flow of currency to the banks after 1946, which also added to the supply of reserve funds available to the banks. The main problem of the Federal Reserve System during most of this period was to prevent a plethora of reserve funds from leading to a further inflationary growth in bank credit and the money supply, following the very large increase during the war. Total Government securities held by the Federal Reserve banks were reduced by more than $6 billion in this period from the beginning of 1946 to the autumn of 1949, which had the effect of absorbing a like amount of reserve funds. In the process of reducing its holdings by redemptions

and sales, the Federal Reserve System succeeded, with the aid of Treasury surpluses, in keeping the reserves of the commercial banking system under recurrent moderate pressure, but the tradition against borrowing weakened only gradually. A practice that came into more common use in that period was interbank borrowing of reserves, or Federal funds, which are traded at rates at least slightly lower than the Federal Reserve discount rate.

During the recession of 1949, the Reserve System took action to ease the reserve position of member banks somewhat and to make it unnecessary for the banks to borrow any considerable amount. This policy gave way to a firmer credit policy as business recovered and signs of inflationary tendencies reappeared. But as long as the System maintained fixed prices of Government securities, the commercial banks could obtain most of the reserve funds they needed as the basis for credit expansion (or to offset gold outflows) by selling Government securities indirectly to the Reserve banks through the market. The only way in which the System could have forced the banks to obtain the reserve funds by borrowing would have been to have refrained from buying the Government securities offered for sale by banks and other investors in the market, regardless of the effects on Government security prices and interest rates.

With the accentuation of inflationary pressures that followed the outbreak of war in Korea and the development of a greatly expanded national defense program, the Federal Reserve System endeavored to restrict its extensions of Federal Reserve credit through open-market operations in order to curb the growth in bank credit, and in March 1951, by agreement with the Treasury, withdrew its intervention in the Government security market except to the extent necessary to maintain orderly market conditions. While borrowing by member banks has become somewhat more frequent, most banks continue to show reluctance to borrow for more than a few days at a time, if at all, and continue to resort to sales of Government securities to meet other than their temporary needs for reserve funds. But when the Reserve banks are not buying securities freely and market prices are not assured, the banks tend to extend credit less freely and with greater discretion.

From this brief review of past experience, it may be concluded that whether or not greater reliance should be placed upon member bank borrowing from the Federal Reserve banks as a means of obtaining Federal Reserve credit depends upon the general economic situation. In times of recession in business, employment, and prices, it would be undesirable to require banks to borrow in order to obtain Federal Reserve credit, as the banks' aversion to borrowing would discourage them from extending readily the credit needed by their customers. Lending by the Reserve banks at low interest rates in such periods might reduce somewhat, but would not fully overcome, this tendency. On the other hand, in boom periods, when credit expansion needs to be discouraged to restrain inflationary pressures, forcing banks to borrow to obtain Federal Reserve credit works in the right direction. When banks borrow from the Reserve banks, they realize that they are dependent upon Federal Reserve credit for part of their loanable funds, whereas if they sell Government securities in the market and the securities are absorbed by the Federal Reserve System, there is not the same realization, if any, of dependence upon Federal Reserve credit, and, consequently, less restraining effect. Furthermore, sales

of securities provide permanent additions to loanable funds, while funds obtained by borrowing are usually regarded as repayable at an early date. The restraining influence of borrowing will be enhanced if discount rates are high enough to reduce the profitability of using borrowed funds for the extension of credit. The lower the discount rate, the less the effectiveness of such a policy.

We would expect greater use to be made of the discount privilege only if the commercial banks have difficulty in obtaining the reserve funds they need by other means. Such a situation would be most likely to prevail if a "neutral" open-market policy were being followed by the Federal Reserve System and demands for credit and currency were increasing, with no offsetting elements in the situation, or if a strongly restrictive credit policy involving net sales of securities were followed by the Federal Reserve System.

19. Do you believe that there is any conflict between measures to restrain excess demand by credit control and the need for expanding the economy to meet the requirements of a continuing readiness to resist aggression and a continuing high standard of living? If so, how can the effects of this conflict be mitigated?

Joint answer

There is no real conflict between the use of credit controls to restrain excess demand and an expanding physical volume of production. The reference to "excess demand" in this question presumes a situation in which the demands for goods and services at current prices are beyond the current ability of the economy to supply them. Expansion of the productive capacity of the country to meet the combined requirements of a large national defense program and a continuing high standard of living in such circumstances is likely to require the diversion of materials and manpower from the production of end products to the creation of additional productive facilities. Consequently, during the process of expanding capacity, there is likely to be an intensification of shortages of end products. For example, if more steel and copper are used for the building and equipment of new plants, less will remain for the production of such things as automobiles, household appliances, and homes.

The measures needed to deal with such a situation include fiscal policies designed to reduce the disposable income of the public, monetary policies designed to discourage credit expansion that would enlarge effective demand, and other measures designed to direct the use of resources from less essential to more essential purposes. Competitive efforts to expand in all directions at the same time would accentuate inflationary pressures and would be definitely undesirable. Hence, credit restraints are an essential element in an appropriate economic policy under the conditions stated, as they can play a useful role in dampening competitive demands for scarce resources, and in that way exert a restraining influence on inflationary pressures. There would be no thought, however, of applying credit controls to a degree that would prevent maintenance of the highest standards of living practicable in the circumstances. Any reduction of living standards would be the result of diversion of physical resources to defense purposes, not the results of credit controls to restrain excess demand.

In the circumstances stated, it may be useful, as indicated in the reply to question 16, to supplement general credit controls with other credit measures, such as consumer credit regulation and a voluntary credit restraint program designed to channel credit and capital into the financing of the more essential activities. If needed, Government guaranties may also be used as an additional means of assuring the financing of essential activities as in the case in the "V loan" procedure with respect to the financing of defense contracts. The objective of such programs would be to supplement other controls in directing limited resources into the most essential uses.

20. What do you believe to be the role of bank examination and supervision in furthering the objectives of the Employment Act?[2]

Joint answer

The role of a bank examiner is essentially that of a fact finder. He determines whether or not the operations of the bank under examination conform appropriately to statutes and regulations, and reports any violations noted to his superior, the supervisor. In addition, the examiner is charged with evaluating the assets of the bank in an effort to inform the supervisor whether the institution is solvent, whether its credit and investment policies are such as to endanger its solvency and destroy its ability to serve the banking needs of the community.

The appraisal of the condition of a bank is made in the light of local current and prospective economic conditions and the quality of the management. The nature and degree of exposure to possible loss in the loan, investment, and other operations of the bank are carefully appraised in order that risks deemed disproportionate to the moderate protection to creditors afforded by the capital funds may be reduced and the bank enabled to serve the reasonable needs of the community without undue jeopardy to its depositors and other creditors. The examiner is also charged with the duty of reporting on the competence of the management. Thus the examiner is concerned solely with the condition of each individual bank rather than with the condition of the banking system as a whole.

The supervisor, whether appointed under authority of the Federal or State statute, is the official or institution charged with the administration and enforcement of the banking laws and regulations and with the initiation and carrying out of efforts to obtain correction of unfavorable trends as revealed by findings of the examiner. The objective of bank supervision is threefold:

1. To see that the public is provided with adequate banking services;
2. To enforce the banking laws of the legislative body under which his office operates; and
3. To maintain solvent and effective banking institutions.

Ready access to deposit and checking account facilities and to a reliable source of credit is essential to the effective functioning of free enterprise. To the extent that bank supervision achieves its objectives it contributes to those "conditions under which there will be

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[2] The objectives of the Employment Act as set forth in sec. 1021 thereof are: "Creating and maintaining, in a manner calculated to foster and promote free enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power."

afforded useful employment opportunities" and the other collateral objectives of the Employment Act. Otherwise, the role of bank examination and supervision in furthering the objectives of the Employment Act is indirect and difficult to trace.

In past periods of business recession the examiner and his superior, the supervisor, have been accused of augmenting deflationary tendencies by bringing additional pressure for liquidation. His influence in this direction tends to increase because the uneasiness of bankers over prospects renders them more willing to conform to the supervisor's criticisms, just as in prosperous times bankers frequently discount the supervisor's cautions. The supervisor and his field representative, the examiner, are concerned with the soundness of the bank assets in those periods when inflationary pressures are predominant just as they are when deflationary pressures are predominant. One of the important problems of examination and supervision is the establishment and maintenance of standards of appraisal of assets which will not reflect unduly the swings of the weather vane of business sentiment.

Comment of Ray M. Gidney, Cleveland

In the statements of the objectives of bank supervision, the joint reply has as No. 1, "to see that the public is provided with adequate banking services." I do not understand that the supervisory authorities have considered that they have a responsibility to promote the organization of banks. It has usually been assumed that free enterprise in banking would bring about organization of enough banks to meet the reasonable needs of the public. I take the joint reply to mean that the supervisory authorities, particularly those who have the right to give or withhold bank charters, should have among their objects the adjustment of the number of banks and banking offices, to provide for both successful operation and good service to the public.

Comment of Hugh Leach, Richmond

The first of the three objectives of bank supervision given on page 703 of the joint answer—"To see that the public is provided with adequate banking services"—is interpreted as meaning that supervisory authorities give considerable weight to adequacy and availability of banking services when considering applications for permission to open new banks or to establish additional branches of existing banks. This should not be considered as implying that supervisory authorities do or should look upon themselves as "prime movers" in the organization of new banks or branches.

21. What do you consider to be the role of selective regulation of consumer credit in restraining inflation under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16? What attention should be given by the controlling authority to inventories and price and employment changes in the particular industries affected by the regulation? Discuss the operation of regulation W since its revival in the fall of 1950.

Joint answer

The various selective credit regulations are a supplementary type of control instrument which should be used as needed as an adjunct

to general credit and monetary measures to enable the System to achieve most effective control over the volume and use of credit. Selective credit controls are not substitutes for general credit and monetary measures, nor do they in any degree minimize the importance of achieving effective use of general controls. In an inflationary situation, the ability to apply restraints upon particular types of credit may be of considerable significance in an over-all anti-inflation program, but such selective credit regulations are of necessity limited to a few areas. They cannot do the job that must be done through restraints upon the creation of additional bank reserves plus an adequate fiscal policy.

When general credit and monetary measures bring about a balanced credit situation from the standpoint both of the economy as a whole and of the various sectors of the economy in which particular types of credit are important, the need for selective instruments of control is either reduced, or possibly eliminated. In the past, despite the use of general credit and monetary measures, unsound credit developments have occurred in different sectors of the credit economy, and it is probable that they will occur in the future. Under such circumstances, the central bank, if it has authority to use selective controls, may be in a position to operate in certain sectors that for one reason or another are not being effectively restricted through the use of the general types of control. In addition, the use of selective controls enables the central bank to supplement general controls in influencing to some extent changes in the velocity of money, for they offer the possibility of more specialized control over the use of funds in some of the particular sectors of the market in which wide variations in velocity may be most likely to occur. It would appear that if the central bank should be prevented, for one reason or another, from using general credit and monetary controls for the purpose of restraining the availability and cost of bank reserves, there would be an even greater need for the use of selective instruments of control as supplementary devices. Unfortunately, however, it is not practicable to apply selective credit controls except in limited areas, and without an appropriate general credit policy, the effectiveness of any selective measure would be greatly impaired.

Questions 21 through 25 refer to the role of various selective and supplementary credit control instruments under differing conditions of Treasury fiscal requirements. Inasmuch as the same principles are involved in each of the cases raised in these various questions, a general statement may be useful at this point.

In general, certain basic tests might be relied upon to determine the need for and the particular type of selective credit control that would be most effective under the circumstances. First, how effective are general credit and monetary measures in bringing about a balanced credit situation in the economy? Second, how strategic and important to the stability of the general economy are those expansive developments which might occur in a particular sector? Third, how extensive is the use of credit in that sector of the economy, and how widely does its volume fluctuate? Fourth, is it administratively feasible to exercise effective selective credit control in the particular sector of the economy in which expansive excesses appear to be developing?

In line with these tests, the role of selective regulation of consumer credit in restraining inflation at a time when the Treasury is not in

the market as a borrower would be less important than under the other alternative conditions indicated in the question. Even in this circumstance, however, conditions might exist or develop—wholly foreign to Treasury financing requirements—which might make the application of selective regulation of consumer credit desirable. In other words, determination of the role and need for selective control of consumer credit or any other selective credit-control device must be measured in terms of and in relation to all influencing conditions in the market and not merely with regard to Treasury financing requirements.

If the Treasury were forced to enter the market as a large borrower, the role of consumer credit regulation might become more important, the degree of importance depending upon the extent to which Treasury debt management policies were coordinated with general credit and monetary measures to limit to a minimum the development of inflationary forces. Even under this circumstance, however, all other factors influencing the consumer credit market would need to be taken into consideration; the judgment should not be based merely upon Treasury financing.

Under conditions of total war, the role of selective regulation of consumer credit would be influenced largely by the severity and effectiveness of noncredit direct controls. The problem of preventing an expansion in the volume of consumer credit and an excessive demand for consumer durable goods would be reduced in proportion to the severity and effectiveness of direct controls covering consumer durable items. If consumer durable goods were effectively and severely rationed, it is questionable whether the threat of an expansion of consumer credit for the purchase of such goods would be very serious, although such credit restrictions might help to relieve the strain upon direct controls. In other words, the greatest need for the application of selective control over consumer credit will tend to occur when the desired goods are available to consumers without direct restriction other than that which is naturally imposed by a short supply of such goods.

Inasmuch as inventories of consumer goods, prices of consumer goods, and employment in the consumer goods industries reflect developments and conditions in those industries, these factors should be given consideration in connection with the administration of consumer credit regulation. All other relevant factors, however, also must be given careful consideration, and in the final analysis the ultimate test of the effectiveness and appropriateness of the regulation's terms must be measured by their impact on credit conditions. Administration of consumer credit regulation during a period of general inflation has as its objective the limiting of the availability of consumer credit in a manner that is most consistent with the over-all credit policy. Therefore, inventories, prices, and employment cannot be considered as the only test of the soundness of the regulation—or possibly even the most important test—but merely one set of conditions which, along with others, is carefully studied to appraise the effectiveness of this particular type of credit control.

In a free-enterprise system, "rationing" of goods and services is accomplished through the price system. On the surface, it may appear that regulation W is more restrictive against those with lower incomes than against those with higher incomes. However, such a

view rests on the assumption that all demands can be satisfied without price increases. But, with increased defense demand, some things will have to be foregone by someone. Without higher taxes and restraints upon credit expansion, those with lower incomes and smaller savings would be the first to be priced out of the market. In addition, price increases would further lessen the purchasing power of their savings bonds, their bank accounts, and their life insurance. It is the man with small savings who is least able to protect his savings against the ravages of inflation, and who most needs the additional protection against credit-inflated prices that a selective regulation of consumer credit affords.

Although it is never possible to single out one instrument of credit control from many others and measure its effectiveness without regard to the possible effects of other credit controls in operation, it would appear to be more than mere coincidence that the increase in the volume of consumer credit outstanding began to level off with the application of regulation W and actually declined during the first 7 months of 1951. This same pattern prevailed with respect to installment credit and would seem to indicate that regulation W has played a valuable part in the effort to control the total volume of credit and, particularly, to limit excesses in the consumer credit sector of the economy. In addition, the majority of reports received from those who have been affected by the regulation appears to indicate that the application of this form of credit control has had a notable restraining influence upon demand in this particular consumer goods sector of the economy.

Comment of Ray M. Gidney, Cleveland

I agree substantially with the comment in the joint reply that—

> selective credit regulations are a supplementary type of control instrument which should be used as needed as an adjunct to general credit and monetary measures to enable the System to achieve most effective control over the volume and use of credit. * * * Selective credit controls are not substitutes for general credit and monetary measures, nor do they in any degree minimize the importance of achieving effective use of general controls.

However, I do not consider these controls to be as useful or effective as supplementary devices as the joint reply infers. It is too easy in practice to turn to selective controls as alternatives or supplements to inadequate general policies. In such cases either they are ineffective or they may have to be applied so severely as to penalize unduly certain types of credit and of economic activity. To the extent that they may be effective, their impact is felt directly by such a large number of persons as to subject the administrative authorities and the Congress to pressures sufficient to compel modification. Recent legislation affecting regulations W and X is illustrative of this point. In addition, the difficulties of administration, particularly of regulation W, are so great as to lead me to doubt the efficiency of this device except when accompanied by effective general credit policy and by controls directly affecting production and distribution of articles affected by the selective credit controls. In such a situation the need of selective credit controls becomes much less apparent.

22. What do you consider to be the role of selective regulation of real-estate credit in restraining inflation under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16? Discuss the operation of selective regulation of real-estate credit during the past year.

Joint answer

Certain unique characteristics of the real-estate market are especially significant. First, because of the durability of houses and other structures, the number of buildings in existence at any time is much larger relative to new construction than is true of consumer durable goods, even automobiles; thus credit restrictions in this field should not be limited to construction. Second, price control and rationing are not administratively applicable to houses or other structures (except for rentals), and consequently prices of houses and other structures are likely to rise sharply in an inflationary period and the demand for real-estate credit may be maintained even when there are direct restrictions of other sorts upon new construction.

Real-estate credit restrictions need not run counter to national policy calling for aid to low-income groups through public housing or aid to veterans through financing made possible by Government guaranties. The extension of Government aid by whatever measures in the field of housing clearly is a matter of congressional decision. It should be recognized, however, that to expand the demand for housing at a time when the construction industry is operating virtually at capacity (or up to the limits of available supplies of materials after meeting the needs for war and defense) will result only in higher prices, not more houses. These price increases in turn intensify the housing problems of the very groups the Government is seeking to aid.

The position of the Treasury is not the sole determinant of the usefulness of selective regulation of real-estate credit in restraining inflation. Under the assumption that the Treasury will not be a borrower in the market in the foreseeable future, selective regulation of real-estate credit would be relatively less important than when the Treasury should be actively in the market for credit. A balanced Treasury position, such as might be expected under this assumption, would tend to remove one strong potential inflationary force. To determine, however, whether real-estate credit regulation of a selective type would be necessary would require thorough analysis of all factors influencing the market. In the event of inflationary developments, general credit and monetary measures should be more effective if the Treasury has no occasion to enter the market, and consequently a relatively firm money-market condition might be maintained, thus tending to prevent diversion of excessive amounts of credit into real estate.

If the Treasury were to be a substantial borrower in the market and if its debt-management policies were of such a nature as to lead to an increase in the money supply and to inflationary pressures, the need for selective regulation of real-estate credit would become increasingly important; but without an effective general restraint upon credit, the anti-inflationary effect of such a selective regulation could not be great.

Under conditions of total war, selective regulation of real-estate credit should be a valuable aid in restraining inflation in the real-estate market. During total war it might be assumed that construction of new properties would be limited and that housing shortages would

begin to appear. Moreover, if war damage should result to properties in this country, the pressure for housing and nonresidential accommodations would increase very markedly, thus imparting an inflationary bias in that sector of the economy. In fact, it is virtually certain that direct controls of a noncredit nature, in addition to selective regulation of real estate credit, would become necessary under conditions of total war.

Selective regulation of real-estate credit has not been in effect long enough to permit a reliable judgment concerning its effectiveness. Moreover, during the period a number of extraneous but closely related developments have affected real-estate trends. For instance, during the first several months of the regulation the exemption of prior commitments resulted in a large number of units being outside of the coverage of the regulation. Also, the very large amount of commitments outstanding by lenders tended to restrain the full effectiveness of the regulation. In recent months, however, there have been indications, according to reports received from builders and lenders, that the regulation is taking hold more effectively. Even in this respect, however, the extent to which the increase in effectiveness is due to the tighter conditions which have been brought about in the money market through general credit and monetary measures, or to the regulation itself, may be subject to question. It is probable, however, that the limitations that the regulation places upon real-estate credit have been important in reducing the effective demand for both residential and nonresidential properties and have been a contributing factor in reducing the amount of building construction from the very high 1950 level.

During the past year no particularly difficult problems have developed in connection with the administration of the regulation. In fact, registrants, including builders, lenders, and contractors, have shown a high degree of compliance and cooperation.

On the whole, this type of selective regulation seems to meet the principles indicated in question 21 that should be considered in determining the applicability of selective instruments of control. In brief, the selective control of real-estate credit was delayed in its impact because of the large number of commitments outstanding at the time of its introduction in October 1950. After March 1951, general credit controls probably were a greater factor than the selective control in curbing the flow of new credit into purchases of real estate. But the selective control has undoubtedly helped to direct the impact of restraint upon the new construction sector of the residential real-estate market, where credit has more often been freely granted. A more reliable appraisal of the role of regulation X, however, probably cannot be made until more experience under the operation of the regulation has been obtained.

Comment of Ray M. Gidney, Cleveland

I believe that control of real-estate credit as provided for under the Defense Production Act of 1950 has been somewhat helpful in reducing the activity in residential construction growth and consistent with the aim of reducing the use of materials used in building more closely to the quantities available in the circumstances for that purpose. However, I believe also that in the fourth Federal Reserve

district the accomplishment in reducing housing construction was due more to the tightening of the money market and the greater difficulty in obtaining mortgage financing after the change in the open-market policy of the Federal Reserve System than it was to the real-estate credit controls.

23. What do you consider to be the role of selective regulation of stock-market credit in restraining inflation under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16?

Joint answer

The selective regulation of stock-market credit through the authority to regulate margin requirements on loans for the purpose of purchasing securities registered on a National Securities Exchange has proved to be an administratively feasible and valuable selective instrument of central bank credit control. Throughout the past several years of strong inflationary forces in the general money market and in other sectors of the economy, and excessive use of credit in the securities markets has been prevented, and, consequently, inflationary developments in that particular area of the economy have been kept to a minimum.

The role of selective regulation of stock-market credit in restraining inflation would be less important when the Treasury is not faced with the necessity of obtaining new money from the banking system or engaging in large refunding operations. Again, all other factors, however, which might have a bearing upon the money supply would need to be considered fully.

If the Treasury were in the market as a substantial borrower for new-money purposes, the role of selective regulation of stock-market credit would take on added importance. Under such circumstances, inflationary pressures would tend to be aggravated and, unless offset by wholly effective general credit and monetary measures, would lead to additional inflation and to the development of an inflation psychology. Whenever an inflation-mindedness develops, public interest in equities as an inflation hedge increases. As more people attempted to protect themselves against a declining value of the dollar—real or anticipated—speculative purchases of equities would be likely to be stimulated, and the role of stock-market credit regulation would become more important. Regulation of stock-market credit, by affecting the demand for stock-market credit rather than the total supply of credit available, would not tend to raise interest rates. Thus it would tend to facilitate rather than hinder Government financing.

Price controls and rationing are not applicable to the securities markets. Therefore the possibility of a substantial credit expansion in that area is increased by total war or preparation for war, which limits the supplies of consumption goods and services. Purchasing power may well be diverted to the stock market if the fear of rising prices increases the demand for stocks as a hedge against inflation.

A total war would lead to an increase in the money supply relative to available goods and services; inflationary pressures would be strong even under most effective credit, monetary, and fiscal policies; and anticipation of a further decline in the dollar would tend to divert credit into equity securities. In general, the principles outlined in

question 21 apply with equal force to the selective regulation of stock-market credit.

24. What selective regulations, other than those over consumer credit, real-estate credit, and stock-market credit do you consider to be feasible? What would be their applicability under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16?

Joint answer

The feasibility of selective regulations other than those applicable to consumer credit, real-estate credit, and stock-market credit should be judged on the basis of the four tests outlined in question 21. These are as follows:

1. The effectiveness of general credit and monetary measures in bringing about a balanced credit situation in the economy.
2. The strategic position and the importance to the stability of the general economy of expansive developments which might occur in a particular sector.
3. Extensiveness of the use of credit in that sector of the economy and the extent of its fluctuation in volume.
4. Administrative feasibility in exercising effective selective credit control in the particular sector of the economy in which expansive excesses appear to be developing.

Inasmuch as selective regulations are supplementary to general credit and monetary measures, no additional selective regulations should be undertaken unless it is evident that general credit and monetary measures need the additional reinforcement provided by such regulations in order to achieve reasonable economic and credit stability. Every effort should be made to achieve this satisfactory degree of stability through the general measures, for, otherwise, a multiplicity of direct controls over credit will introduce into the financial and economic system an undersirably large amount of governmental or official intervention, with all of the inflexibilities and inequities that would be inherent in such a development.

In the area of real-estate credit control, the extension of regulation X to existing properties, that is, to houses and other structures begun before August 3, 1950, would be administratively feasible. From the standpoint of the anti-inflationary objectives of real-estate credit control, it is essential to include old structures as well as new. A very substantial share of the credit in this area is, in fact, extended in connection with transactions involving such properties. The only basis for distinction between new and old properties rests upon the objective of facilitating the diversion of materials to the defense program.

Short of conditions of total war, no additional selective regulations are needed, for it should be possible, assuming that there is an adequate fiscal program and a reasonable coordination of Treasury debt management policy with general credit control objectives, to secure a satisfactory degree of economic and credit stability through general credit and monetary measures plus the supplementary selective devices which already have been legislated. Even under conditions of total war, except for extending real-estate credit regulation to include existing structures, there is some question as to whether additional selective regulations would be needed or whether the regulation of consumer

credit, real-estate credit, and stock-market credit, together with a strengthening of the voluntary credit-restraint program, would not prove adequate.

Conceivably, selective regulation of credit might be applied to the commodity markets, to inventory and other business loans, and to agricultural loans. In terms of the first principle stated above, none of these selective devices should be considered favorably unless distortions develop in these areas which cannot be reached effectively through general means of control. In that event, it would become necessary to consider the feasibility and necessity of these different types of selective control in terms of the remaining three principles that have been previously stated.

Credit is not used extensively in futures trading in the organized commodity markets; and, therefore, on the second principle of the determination of the propriety of selective control, extension of selective regulation to commodity trading would not be justified. Moreover, inasmuch as the Commodity Exchange Commission already has rather extensive authority over speculative commodity trading, this would appear to be a matter for the Department of Agriculture's consideration, rather than the central bank.

Selective regulation of inventory and business loans, as well as agricultural loans, would pose such difficult administrative problems that it would probably not be effective if inaugurated on a formalized basis, with responsibility for the determination of proper loans resting with a governmental agency or with the central bank. These problems are further discussed in the replies to questions 32 and 33, below.

An approach to the same objective that would be sought through selective regulation of these types of credit is being obtained under the more flexible voluntary credit-restraint program, which establishes certain patterns of lending on a recommended basis and permits the individual lender to carry out his operations in compliance with that pattern.

We conclude that selective regulations other than those over consumer, real-estate, and stock-market credit are neither feasible nor desirable.

Comment of Ray M. Gidney, Cleveland

On this question the suggestion is made that—

> in the area of real-estate credit control the extension of regulation X to existing properties * * * would be administratively feasible

and—

> from the standpoint of the anti-inflationary objectives of real-estate credit control, it is as essential to include old structures as well as new.

I agree that inclusion of existing properties probably would be administratively feasible though productive of restraints and frictions disproportionate to the benefits to be derived from such inclusion. I do not believe that their inclusion is essential at this time. We are informed that in the fourth Federal Reserve district lenders are generally conforming to the terms of regulation X on existing properties because of their own interests and also as a part of the voluntary credit-restraint program.

Note on reply of J. N. Peyton, Minneapolis

[Mr. Peyton's reply omits the paragraph referring to futures trading in the organized commodity markets.]

25. Explain and evaluate the voluntary credit-restraint program which has been developed during the past year. What are the precautions taken to insure fair treatment of competing firms? What do you consider to be the role of voluntary credit restraint under each of the assumptions with respect to the magnitude of Government borrowing stated in question 16?

Joint answer

Acting under section 708 of the Defense Production Act of 1950, the President authorized the Board of Governors of the Federal Reserve System to encourage financing institutions to enter into voluntary agreements and programs to restrain credit where such restraint will further the objectives of the act. The program and principles for voluntary credit restraint were worked out by representatives of the American Bankers Association, the Life Insurance Association of America, and the Investment Bankers Association of America, in consultation with the Board of Governors, and have as their major objective—

loan screening by all financing institutions in the United States to eliminate loans which are not necessary to financing the defense program and are not essential to the needs of agriculture, industry, and commerce.

Although financing institutions are urged to coöperate in carrying out the voluntary credit-restraint program, participation is entirely voluntary; no financing institution is required to consult with any voluntary credit-restraint committee; the identity of the applicant for the loan need not be disclosed; and final decision with respect to making or refusing a loan remains with the particular financing institution.

A national committee of 12 members was appointed by the Board of Governors for the purpose of considering the functioning of the program and advising the Board of Governors with respect thereto. Due regard was given in the appointment of the committee to a fair representation for small, medium, and large financing institutions and for different geographical areas. Regional commercial banking, insurance, investment banking, and savings and loan committees were appointed by the national committee to be available for consultation with individual financing institutions and to assist them in determining the application of the program with respect to specific loans. An official of a Federal Reserve bank is a member of each regional committee.

The original statement of principles of the program and the six subsequent bulletins which have been issued identify the types of loans that are considered as being consistent with the objectives of the program and the types of loans which should not be made under present circumstances. In general, the criterion under the program for sound lending in a period of inflationary danger is: Will the loan commensurately increase or maintain production, processing, and distribution of essential goods and services?

Types of loans that are considered as proper under the program include—

(*a*) Loans for defense production, direct or indirect, including fuel, power, and transportation.

(*b*) Loans for the production, processing, and orderly distribution of agricultural and other staple products, including export

and import as well as domestic products, and of goods and services supplying the essential day-to-day needs of the country.

(*c*) Loans to augment working capital where higher wages and prices of materials make such loans necessary to sustain essential production, processing, or distribution.

(*d*) Loans to security dealers in the normal conduct of their business or to them or others incidental to the flotation and distribution of securities where the money is being raised for any of the foregoing purposes.

(*e*) Loans on securities covered by regulation T or U and all loans on securities for purchasing or carrying unlisted securities if the amount of the credit is no more than that permitted by regulation T or U.

(*f*) Loans required for the rehabilitation of disaster areas.

Types of loans that are considered to be inconsistent with the principles of the program include—

(*a*) Loans to acquire or retire corporate equities in the hands of the public, including loans for the acquisition of existing companies or plants where no over-all increase in production would result.

(*b*) Loans for speculative investments or purchases. The first test of speculation is whether the purchase is for any purpose other than use or distribution in the normal course of the borrower's business. The second test is whether the amounts involved are disproportionate to the borrower's normal business operations. This would include speculative expansion of real-estate holdings or plant facilities, as well as speculative accumulations of inventories in expectation of resale instead of use.

(*c*) Loans on existing (non-regulation X) residential (1 to 4 units) properties which would cause the total amount of credit outstanding to exceed the limit imposed by regulation X on new construction, or a limit of 66⅔ percent of the fair value of the property, whichever is the greater.

(*d*) Loans on multiunit residential property, commercial property, and agricultural property which would cause the total amount of credit outstanding to exceed 66⅔ percent of the fair value of the property.

(*e*) Long-term business-capital expenditure financing for such purposes as the construction of facilities to improve the competitive position of a producer of nonessential goods; expansion and modernization of concerns in distribution or services not defense-supporting; and expansion and modernization of manufacturers of consumer goods not related to the defense effort.

(*f*) State and local government borrowing for the replacement of existing facilities that can continue to perform their function during the emergency period; soldiers' bonus payments, and recreational and other types of facilities not recommended by the Defense Production Administration; acquisition of sites or rights-of-way not immediately needed; and purchase of privately owned utilities by municipalities where borrowing is required to replace equity capital.

It is very difficult, if not impossible, to appraise statistically the effect of a single instrument of credit control, such as the voluntary

credit-restraint program, because of the multiplicity of factors and the cross-currents which influence the demand for bank credit and its availability. Moreover, there is no statistical way of ascertaining what the amount of outstanding bank credit would have been during any given period if particular credit-control instruments had not been in effect.

It is true, however, that the contraseasonal increase in commercial and industrial loans of the weekly reporting member banks came to an end at mid-March and coincided with the beginning of the voluntary credit-restraint program; and that the increase in bank loans during the third quarter of this year was much less than in the same period in 1950.

Full credit for these developments obviously cannot be fairly attributed to the voluntary credit-restraint program; but, on the other hand, neither should the program be discounted. The voluntary credit-restraint program has made a worth-while contribution to credit restraint, to the reduction of speculative loans, and to the channeling of bank credit into defense, defense-supporting, and essential civilian uses.

Perhaps one of the most valuable contributions of the voluntary credit-restraint program has been the fact that it has created a consciousness in the minds of lenders and, in fact, many borrowers of the importance of eliminating speculative loans and restraining nonessential borrowing. The program has received very wide support from private lenders over the country. These lenders undoubtedly are screening their loan applications much more carefully and selectively than they did prior to the inauguration of the program. Moreover, the wide publicity given the program in the press, on the radio, and in financial journals has had an important educative and sobering effect upon many borrowers, tending to induce them to limit their loan applications to essential requirements. Many individual oral reports bearing out these accomplishments of the program have been received by Reserve System officials.

Another advantage of the program has been that it has provided private lenders with a sort of standard or yardstick by which they may measure the acceptability of loan applications during a period of national defense such as now prevails. In other words, acceptability of a loan is not now being considered by most lenders merely on the basis of its soundness from the standpoint of the individual bank but, instead, is being considered on the basis of financial soundness plus its appropriateness and possible effect in terms of the national economic situation.

Finally, the absence of detailed, burdensome rules and regulations has enabled the program to operate with a degree of flexibility and with a lack of inequity and injustice to individual borrowers that would not be possible under a type of direct Government loan rationing. It has been possible under the program for private lenders to meet the bank-credit requirements of the defense program as it has developed and the essential requirements of the civilian economy and, at the same time, refuse to extend credit for nonessential or speculative purposes.

The problem of assuring fair treatment to competing firms under the voluntary credit-restraint program has been met by the national

and regional committees through their agreement upon a uniform set of principles and their policy of acting upon all applications referred to them on the single basis of whether the purpose of the particular credit conforms fully to the principles of the voluntary credit-restraint program. The question of competition as between prospective borrowers is of no significance to the voluntary credit-restraint committees; in fact, the lending institution is requested not to disclose the name of the prospective borrower, except in the case of municipalities. On the other hand, fair and equitable treatment to every borrower in terms of the principles of the program is a "must" that the committees have consciously sought to achieve. For instance, an application submitted to a regional committee for approval of a loan to restore a depleted inventory to a level normal for the particular business would be considered as falling within the classification of a proper loan, assuming that the type of business was not inconsistent with the objectives of the defense program. On the other hand, an application submitted for the purpose of building inventories above normal levels and involving speculative inventory aspects would be considered as a type of loan not appropriate under the program.

The voluntary credit-restraint program is another of the types of credit control that should be considered as supplementary to the basic general credit and monetary measures. The prefatory general comment to question 21 is applicable with respect to the voluntary credit-restraint program.

If the Treasury is not to be a large borrower in the market in the foreseeable future and if other forces influencing the market are not such as to bring about an over-all inflationary situation, it might be assumed that general credit and monetary measures were satisfactorily effective, and the importance of the voluntary credit-restraint program as a restrictive measure would be relatively small. Under such conditions it could be assumed that banks were extending credit in such a manner as not to induce inflationary or speculative developments.

If Treasury financing operations were of an inflationary character, and if general credit and monetary measures were exerting an effective restraint upon the over-all availability of credit, the importance of a voluntary credit-restraint program would be increased because it would provide guidance to banks for the allocation of that limited credit supply in the national interest. The applicability and the role of the voluntary credit-restraint program cannot be tied exclusively to Treasury financing operations but should be related to the full set of inflationary forces influencing the market and their strength. Moreover, in view of the wholly voluntary character of this program, a reasonably effective general credit and monetary policy probably is necessary to assure its successful operation.

The applicability and the role of the voluntary credit-restraint program and the organization that has been set up to administer that program might become very important under conditions of total war. If under these conditions it was decided that credit rationing was necessary, as a supplement to the general credit and monetary measures, it could be administered much more efficiently, with less inflexibility and less inequity, through existing groups such as the national and regional voluntary credit-restraint committees than through a

centralized governmental body, assuming that the authority granted to the committees—appropriately supervised—and the governmental agency was the same. In other words, if additional authority were given to the voluntary credit-restraint committees in the event of total war, these committees, with such modifications and additions as might prove necessary, should be able to serve effectively in directing the degree of credit rationing that might feasibly be imposed on the banking system.

Comment of Ray M. Gidney, Cleveland

I am in general agreement with the joint reply. I believe that the voluntary credit-restraint program has made a really significant contribution to economic stability. The program is collateral to other anti-inflationary actions and depends on voluntary and enthusiastic support of lenders. This suggests certain limitations on its use. Lenders must be satisfied that genuine efforts by monetary, fiscal, and debt-management authorities in particular, and all agencies of Government generally, are being made to mitigate inflationary forces as much as possible and to cope with them where they exist. Relying as the program does, in large part, on enthusiasm and patriotic appeal, it cannot be long sustained in the face of policies which do not support the efforts of the participants.

26. Discuss the use of moral suasion as a tool of credit control. How has this been used in the cases of member banks and of savings institutions, including life-insurance companies?

Joint answer

There are different concepts of the meaning of the term "moral suasion." In the broad sense it encompasses the everyday activities of Reserve System officials as they meet with bankers and others whose operations are important to the immediate credit needs of business and industry and to the money market and hence have an influence on monetary and credit policy, or vice versa. Across-the-desk conversations between System official representatives and bankers take place constantly, both within commerical banks and within Reserve System offices, and Reserve System official representatives are constantly being asked to make speeches. A considerable proportion of these across-the-desk conversations and of the speeches deals with the reasons behind monetary policy. The relationship of everyday business and banking operations to the economy as a whole, the effect of the operations of large investors such as banks and insurance companies on the Government securities market, and the necessity to consider the effect of business, banking, and monetary policy on the public welfare are never lost sight of in Federal Reserve activities. When banks borrow from their Reserve bank, channels are always open for an exchange of ideas as to the influence of additional reserves on the economy under conditions that prevail at the time. More or less formalized conferences between System personnel and bankers, businessmen, and others are employed to a considerable extent in the efforts of the System to understand what those affected by monetary policy are thinking and doing, and to afford an opportunity for an interchange of ideas as to underlying situations and the need for and possible effect of a given monetary policy. These activities are all

part of the everyday functions of the Federal Reserve System. They are directed at the development of a more general understanding and do not constitute an attempt to force acceptance of System thinking in any sense of the word, as a narrower concept of moral suasion might imply.

Moral suasion, in this broad sense, is a valuable adjunct of the instruments of credit control. Its purpose is to give bankers, other lenders, large users of credit, and the business community generally a better understanding of the economy as a whole and the relation of their activities to its functioning. In this way it aims to make the objectives of monetary policy better understood and more acceptable to those whose activities it affects, and hence makes monetary policy more effective.

These activities of the System have another important aspect. They give Federal Reserve officials information on the current business situation and the reaction of bankers, businessmen, and others to it and to monetary policy as well. This is an aid to the System in developing better policy.

Moral suasion may also mean the pressure exerted upon member banks or other financial institutions by the central bank (or conceivably by the Government) through appeals to reason and consideration of the common good, as an alternative prior to consideration of more positive action.

Late in 1947 and continuing on into 1948 when inflationary pressures in the economy were very strong and the central banking authorities had indicated the possibility of more restrictive credit controls, the American Bankers Association urged its membership to scrutinize applications for credit very carefully, to the effect that its use would be restricted to that which would stimulate immediate production and would avoid increasing the pressure on consumption except in areas of large supply. In particular, banks were urged not to contribute to rising prices, fictitious values, or other inflationary developments. While this program was not officially participated in by the Board of Governors, it was supported as a highly desirable undertaking. At the same time, moreover, spokesmen for the Board indicated some skepticism regarding the full effectiveness of the program and continued to discuss the possibility of more positive restrictive measures.

Another example of the use of moral suasion is the voluntary credit-restraint program, inasmuch as it has developed, to some extent, an impression among lenders that if the voluntary program is not reasonably satisfactory in its results, some type of more positive and less desirable (i. e., to the lenders) means of restriction may be imposed by the central bank or Government. In fact, a member of the Board of Governors recently (October 10, 1951) stated that—

> the program is, in essence, nothing but enlistment of the collective horse sense of all kinds of lenders to sort out the kinds of credit which should have priority under today's conditions and in that way avoid governmental regimentation of credit which, at best, must be a clumsy affair.

A mild degree of moral suasion probably was exercised in the fall of 1950 when Board and Reserve bank officials on several occasions indicated that reserve requirements of member banks probably would be increased unless the rapid expansion of bank credit was checked

and indicated to insurance companies that their practice of large-scale selling of Government securities was not in the best interest of a sound economy. Also, on different occasions during the past few years, there have been references to unorthodox or particularly restrictive reserve proposals as a possible consequence of continued monetization of Government securities by banking and nonbanking investors, which might be considered as a form of moral suasion. Neither of these efforts, however, met with any appreciable degree of success.

On the whole, the use of moral suasion (in this narrower and sterner sense) as a tool of credit control has been relatively infrequent, and, in general, it has not proved to be a particularly effective credit-control instrument. It has the disadvantage of swaying the conscientious and licensing the uncooperative, thus impairing competitive relationships. For reasons indicated in the reply to question 25, the voluntary credit-restraint program, while having made some contributions to credit restraint, has not been fully tested; a more severe test of its independent effectiveness might be made if inflationary forces should strengthen and if additional reserves should be made available to the banking system in substantial amounts through open-market operations or otherwise.

Note on reply of J. N. Peyton, Minneapolis

[Mr. Peyton's reply omits the fourth and seventh paragraphs of the joint answer.]

27. What is the function of bank reserves? What are present reserve requirements with respect to banks?

Joint answer

The principal reason for requiring banks to hold reserves against their deposits is to enable the central bank to exercise an effective influence over the volume of such deposits and thereby over the supply of money. The volume of deposits is limited by the amount of reserves available to banks and by reserve requirements—or the relationship between reserves and deposits. Unless a central bank controls reserves, it cannot impersonally and effectively control the volume of deposits.

From the point of view of the individual commercial bank, in turn, the primary function of its reserve is to meet its requirement to hold reserves. An individual bank may also use its reserve in performing routine banking operations, such as meeting adverse clearing balances and customers' requirements for currency. If, however, such uses reduce the bank's actual reserve below its requirement, a penalty is involved and the reserve must be restored.

We understand that the present reserve requirements for member banks, and for nonmember banks subject to different State requirements have been summarized in the reply submitted by the Chairman of the Board of Governors to a similar question from the subcommittee.

Comment of Ray M. Gidney, Cleveland

While I agree that probably a principal reason for requiring member banks to hold against their deposit liabilities reserves in the form of balances with the Federal Reserve banks is to enable the Federal Reserve System to exercise effective control over the volume of bank

deposits, I believe that the joint reply does not give adequate consideration to various other points of view governing reserves.

Member banks naturally are concerned with the necessity of maintaining reserves sufficient to meet minimum requirements. From the viewpoint of the individual bank, reserves both primary and secondary are also extremely important for liquidity purposes. By tradition and experience and because of supervisory practice, the banker is reluctant to borrow or even to get into a position where he thinks he is too dependent on the central bank. The practice has developed of actually maintaining reserves in excess of minimum requirements in order to have a little more room to move in, and of maintaining in addition substantial amounts of secondary reserves. Inasmuch as most, if not all, supervisors and the thousands of individual bankers are vitally concerned with the liquidity function of reserves and have it in mind constantly, it is an important real function and affects banking and public policy. This is true even though, from the viewpoint of the central bank, liquidity is provided less by primary reserves than by the credit granting powers of the central bank.

Comment of C. S. Young, Chicago

Under the management policies of some banks, reserves perform the additional function of providing partial assurance of the safety and liquidity of deposits in case of abnormal drains. This "liquidity" or "solvency" role of reserves is most important for nonmember banks, which do not have direct access to Federal Reserve bank credit in time of stress. Only that portion of reserve assets over and above requirements specified by State banking authorities can be freely utilized by the individual bank for such a purpose. In many cases, however, the formal or informal reserve requirements set by State banking authorities are considered to be established primarily as a safety measure.

Comment of C. E. Earhart, San Francisco

In our opinion, another function of bank reserves, from the point of view of the individual commercial bank and its depositors and other creditors, is to provide a limited but definite amount of protection to its creditors in the event of liquidation of the bank. The bank's required reserve should not be drawn upon, except temporarily, while the bank is a going concern, but it remains an asset of the bank available to the bank's creditors in case of need.

28. Should nonmember banks be required to maintain the same reserves as member banks? Why, or why not?

Joint answer

Although it is recognized that this is a highly controversial question, there are strong reasons for requiring nonmember banks to maintain the same reserves as member banks. If a national monetary policy is to be established, and to be effective, its burdens should be applied to all banks and not solely to those that are members of the Federal Reserve System. Since deposits in nonmember banks are part of the total money supply in exactly the same way as deposits in member banks, nonmember banks should be required to maintain the same reserves as member banks.

Establishment of this requirement would be in keeping with our constitutional development. Article I, section 8, of the Constitution provides that the Congress shall have power to coin money and regulate the value thereof. In 1865, when bank notes represented a major part of our money supply, the Congress exercised this power by imposing a 10-percent tax on notes issued by State banks. In 1913, the Congress created the Federal Reserve System as its agent to regulate the supply, availability, and cost of money. Today, the Congress through the Federal Reserve System has ultimate control over that part of the money supply created by the Federal Reserve banks and the member banks, but it does not have the same direct control over that part of the money supply created by nonmember banks. This defect in the mechanism of control over the Nation's money supply impairs the discharge by the Congress of its Constitutional responsibility and needs correction. Furthermore, to subject only member bank reserves to Federal Reserve System requirements imposes an inequitable burden on those banks relative to nonmember banks.

Establishment of this requirement would not, as it is sometimes contended, be a move to undermine the dual banking system. On the contrary, adequate control over the total supply of money in the national interest is indispensable to the continued maintenance of the dual system. The essence of that system in this country lies in the recognized authority of the State and Federal Governments to (*a*) charter banking organizations and (*b*) supervise those banks of their respective creation toward the end of assuring sound, safe banking institutions. These vital aspects of the dual banking system would not be threatened if nonmember banks were subjected to the reserve requirements of the Federal Reserve System.

Comments of Ray M. Gidney, Cleveland

I do not believe that it is in keeping with our American ideals of fair play to permit any competitive group to have special advantages in a matter so vital to the national welfare as the creation of money (bank deposits). Accordingly, as a matter of principle, I believe that nonmember banks should be required to maintain substantially the same amount of reserves as member banks, entirely independent of questions of membership, chartering power and examination authority. However, nonmember banks do not now have to carry such reserves and there is question as to the necessity for changing the present set-up at this time. So long as the major part of bank deposits, about 85 percent are subject to Federal Reserve requirements and so long as the Federal Reserve System is able to operate freely in the open market and pursue general credit policies consistent with the Employment Act of 1946, I believe that the present privileged position of nonmember banks is not likely to interfere seriously with achievement of those policy objectives. To the extent that Federal Reserve open-market policy is made subservient to other policies with different objectives, the use of other control devices may appear to be more urgent. These devices might include the so-called selective credit controls and the changing of reserve requirements. Under such circumstances, the ability of a large group of banks to avoid and perhaps to nullify national credit policy as expressed in changes in reserve requirements could become serious. It is significant that Congress

in authorizing the use of selective credit controls has made them applicable not only to member banks but also to all lenders, including others than banks.

Comment of C. S. Young, Chicago

At the very least, some mechanism should be established requiring nonmember banks to conform to the increases and decreases in reserve requirements established for member banks. As a possible remedy, division of powers over the reserve requirements of nonmember banks could logically be introduced. As I noted in my answer to question 27, an important purpose of most of the reserve requirements with which nonmember banks now comply is the provision of partial protection against cash shortages in case of abnormal drains. State banking authorities would retain unimpaired power to set reserve requirements for nonmember banks at whatever levels are felt desirable in the interests of bank solvency and liquidity. Over and above this provision, however, the Federal Reserve System could be given the authority to add (and later remove) supplemental reserve requirements for nonmember banks in line with similar changes required of member banks. Without some such power to influence changes in the 15 percent of the aggregate national money supply provided by nonmember banks, the System will remain unable fully to comply with its congressionally charged responsibilities to restrict or encourage bank credit expansion in accord with national economic trends.

Comment of C. E. Earhart, San Francisco

We are in agreement with the position expressed in the last paragraph of the joint reply to this question that to require nonmember banks to maintain the same reserves as member banks would not undermine the dual banking system, because it would not threaten the recognized authority of both the State and Federal Governments to charter and supervise banks. However, to say that adequate control over the money supply in the national interest is indispensable to the maintenance of the dual system (second sentence of that paragraph) describes a factor applicable only indirectly to nonmember banks, in the sense that their existence, along with that of member banks, is dependent upon the continued functioning of the economy. In other words, adequate control over the total supply of money in the national interest is of primary importance to economic stability, rather than to the dual banking system as such.

Without the same reserve requirements applicable to member and nonmember banks, there is not the same control over that part of the money supply created by nonmember banks as over that created by member banks. Also, the problem of equity as between member and nonmember banks is a most important consideration. To have reserve requirements the same for all banks would be the most desirable situation from the standpoint of effective credit policy, as the joint reply indicates. In the light of the history of legislative developments related to the American banking structure, however, it would be more feasible, in our opinion, to relate but not necessarily equate member and nonmember bank reserve requirements.

This could be accomplished if nonmember banks were required to carry the same additional reserve over State requirements as member

banks must carry over their statutory minimum requirements (except that provision could be made to limit the total reserve required of any nonmember bank to no more than that required of a member bank). In other words, were reserve requirements for country member banks (for whom the legal minimum requirement on demand deposits is 7 percent) to be set at, say, 16 percent, a comparable nonmember bank subject to no more than a 7-percent reserve requirement would be required to carry on deposit with the Federal Reserve System a reserve of 9 percent in addition to its reserve, in whatever form, required by State law. Should country member bank reserve requirements later be reduced to, say, 12 percent, the additional requirement for nonmember banks should be lowered correspondingly from 9 to 5 percent. Only if member bank reserve requirements were reduced to their legal minimum would the additional requirement for nonmember banks be suspended.

In terms solely of a logical monetary and credit mechanism this proposal is admittedly not so satisfactory as that calling for identical reserve requirements for member and nonmember banks or for membership of all insured banks. However, it would strengthen considerably the control of the monetary authorities over the volume of bank reserves and lessen appreciably the inequities with respect to reserve requirements that now accompany membership in the Reserve System. At the same time, this proposal would not strip the States of power over reserve requirements; it would maintain differences in minimum reserve requirements as they now exist between State and Federal levels and among the States, and as they might be changed in the future for nonmember banks by State authorities and for member banks by Congress. But when it became necessary, in the national interest, to impose additional reserve requirements, the differences between member and nonmember banks would not be aggravated.

Nonmember banks hold a relatively small part of the total deposits of the banking system at present. Existing inequities between member and nonmember banks, although real and working against the growth of membership, do not appear to be severe enough to cause widespread withdrawals from Reserve System membership. Therefore, we would not be inclined to press for legislation at this time. The situation should be resolved, however, should it become necessary to provide the Board of Governors with authority to raise member bank reserve requirements above existing statutory limits. A further increase in reserve requirements of member banks alone would place them in such an inequitable position that they might not feel able to retain their membership in the Reserve System. Withdrawal from the System by any significant number of member banks would indeed mean that control over the money supply would be seriously impaired. It would be vital to correct, but preferable to prevent, such a condition.

29. Discuss the advantages and disadvantages of basing reserve requirements on types of deposits irrespective of the geographical location of banks.

Joint answer

To an individual bank its reserve is a nonearning asset. The extent to which it is required to hold such assets is a measure of its contribution to an effective national monetary policy. The structure

of reserve requirements should be designed to distribute such contributions equitably among banks. In addition, the structure should be logically defensible, administratively simple, and adapted to the American system of banking. It should be recognized that no structure is perfect and that any new structure may disclose in operation difficulties that are not foreseen.

The present structure, based on geographical location of banks, is a carry-over from the national banking legislation in effect when the Federal Reserve System was established. Higher requirements were originally imposed for banks in Reserve and central Reserve cities because, as their names imply, a substantial portion of the legal reserves of national banks consisted of deposits in such banks. Perhaps the leading advantage of the present structure is that it has the virtue of familiarity; banks have operated under it for a long time and have adjusted themselves to its requirements.

Mere geographic location does not, however, determine the character of a bank's business. For example, many so-called country banks hold a substantial amount of interbank deposits and carry on a banking business similar to that done by some banks located in Reserve cities or central Reserve cities. On the other hand, there are Reserve city and central Reserve city banks which hold no substantial amount of interbank deposits but simply provide banking services for businesses and individuals in their localities. As a result, the present system of reserves frequently involves indefensible inequities and raises very difficult administrative problems.

Inasmuch as the purpose of reserve requirements is to enable the central bank to control the volume of bank credit, it can be contended with some basis that a single reserve requirement subject to variation within reasonable limits without differentiation as to bank or type of deposit might be effective in enabling the central bank to discharge its responsibility. However, a change from the present system of reserves to a system involving a single reserve requirement would be too disruptive, as large excess reserves would be created in central Reserve city banks, while huge deficiencies would appear at country banks. In addition, to a considerable extent, interbank deposits have some of the characteristics of bank reserves. While many fine shadings regarding different types of deposits might be made, from an administrative point of view it is desirable to classify deposits for reserve purposes as interbank deposits, other demand deposits, and time deposits. Such a deposit classification is readily understandable in the banking system, has the value of traditional acceptance, would provide the basis for an equitable system of reserves, and, assuming appropriate discretionary authority to the central bank, would enable effective control over the limits within which expansion of the volume of bank credit could occur.

A system of uniform reserve requirements based upon the three major classes of deposits and involving the specific features outlined below would reduce inequities existing under the present reserve structure, would facilitate administrative control, and would conform to sound economic principles with respect to the control of deposits in a dual system of private banking such as exists in this country.

1. Abolish central Reserve city and Reserve city designations of banks.

2. Establish reserve requirements uniform for all banks accepting deposits on the basis of type of deposits classified as interbank, other demand, and time deposits. Initial reserve requirements should be established at differential levels that would permit the transition to the new system to be made with a minimum unfavorable impact on individual banks and which would result in an aggregate volume of required reserves of a magnitude appropriate to the circumstances at the time of change. The transition might be facilitated if it were undertaken at a time when economic developments called for a reduction in total reserve requirements.

3. Banks should be allowed to consider vault cash as required reserves. Since the purpose of required reserves is to influence the volume of bank credit, it is a matter of indifference to the central bank whether banks hold reserves in the form of central bank currency or reserve deposits with the central bank.

4. Banks should be allowed to consider as reserve that part of their balances due from other banks which those latter banks are required to hold as reserves against such balances. This provision would recognize the correspondent bank relationship as an established part of our banking system but would relate correspondent balances to reserves in such a way that a shift of funds by banks into or out of "due from banks" would not affect the total volume of the banking system's excess reserves.

To assure effective control over the volume of deposits it would be necessary under this structure, as under any other, to authorize the Federal Reserve System to change specific requirements within reasonably broad statutory limits.

Comment of Ray M. Gidney, Cleveland

I believe that the joint reply overrates the advantages and ignores the disadvantages of basing reserve requirements on types of deposits irrespective of the geographical location of banks. In my 30 years of experience with the Federal Reserve Banks of New York and Cleveland I have not been impressed with the administrative difficulties of the present system, nor have I heard many complaints of inequities except with regard to the inability of banks to count their vault cash as reserve.

Differentation by type of deposit is difficult to attain administratively. Only two types—time and demand—are now in use and the proposal in the joint reply would add a third by separating interbank from other demand deposits. The change would alter the impact of requirements on individual banks and might disrupt some long-established practices and competitive relationships. A clear understanding of the implications of the plan requires a further description of the reserve ratios which would apply if the plan were adopted and I believe that they would involve changes which would be considered by many to be too drastic to warrant serious consideration.

I believe that it would be helpful to have the subject of reserves reviewed by a group widely representative of banking and finance.

Comment of J. N. Peyton, Minneapolis

[Mr. Peyton would substitute the following for the paragraph in the joint answer immediately preceding the numbered points:]

To serve merely as a base for discussion, and without recommendation for its immediate adoption, a system of uniform reserve requirements is presented. This plan would base required reserve balances upon the three major classes of deposits and would, it has been argued, reduce inequities existing under the present reserve structure, facilitate administrative control, and conform to sound economic principles with respect to the control of deposits in a dual system of private banking such as exists in this country.

Comment of R. R. Gilbert, Dallas

The answer to this question indicates several favorable features of the plan of basing reserve requirements on types of deposits, irrespective of the geographical location of banks, but it does not point out certain important disadvantages of the plan. While the plan would correct certain of the undesirable features of the existing type of reserve structure, it has, in my opinion, certain important disadvantages and raises some difficult problems. Therefore, while I believe that this plan, along with other approaches to the reserve problem, should continue to receive study, I am not willing to give my approval at this time to the plan as developed in the answer to this question.

Comment of C. E. Earhart, San Francisco

The joint reply states, with respect to the proposal that reserve requirements be based upon types of deposit without regard to bank location, that the transition from the present method—

> might be facilitated if it were undertaken at a time when economic developments called for a reduction in total reserve requirements.

We agree and, in fact, would be more explicit; in our opinion, the proposal outline should not be adopted under present circumstances, and consideration of such a step should be postponed until a period of definite credit ease develops.

30. Discuss the advantages and disadvantages of requiring additional reserves which might be held in whole or in part in the form of Government securities. Illustrate with a specific plan or plans.

Joint answer

Central bank control over reserves and therefore over the money supply stems from: (1) a limited supply of bank assets which can be counted as reserves, and (2) the ability of the central bank to control the creation and the extinction of reserves through its loans and investments. Without the first condition, member banks would not need to go to the Federal Reserve banks for reserves to support an expansion of credit and deposits, and without the second the Federal Reserve System would not have control over the volume of reserves it created. The policy of maintaining fixed prices of Government securities, for example, seriously impaired control over the amount of reserves created because the volume of Government securities purchased by the System was determined by the market rather than by the Federal Reserve.

The supplementary reserve plan which would require banks to hold additional reserves in whole or in part in the form of Government securities has been suggested as a means of retaining control over reserves while the System was also supporting the Government security market at predetermined interest rates during an inflationary period. For purposes of illustration, let us assume that banks are required to hold a supplementary reserve in Government securities equal to 25 percent of their demand deposits in addition to a primary reserve requirement of 15 percent. The higher reserve requirement would reduce the ratio of a deposit expansion based on non-Government assets from about 6 to 1 down to 2½ to 1. It would not, however, reduce the ratio of deposits to primary reserves if expansion were based on bank acquisition of Government securities. By immobilizing a large block of the banks' existing holdings of Government securities, the supplementary reserve might make some banks more reluctant to sell Governments as a means of obtaining reserves for expanding loans and other investments. There might be an effect in the opposite direction, though, as banks would be encouraged, in effect, to purchase additional Government securities as the means of expanding their earning assets. Any support by such action that the banks would give to the Government security market by purchases from nonbank investors would result in further expansion in the money and credit supply.

For the banking system as a whole, a supplementary reserve requirement might impose little additional restraint. In the first place, the additional amount of required reserves would be more than offset by the increase in bank assets eligible as reserves. Government security holdings of member banks, for example, at the end of August 1951 were about 55 percent of their total demand deposits. Secondly, the supplemental reserve requirement would have little effect on the ability of member banks to get reserves to support expansion as long as the Federal Reserve banks supplied additional reserves. Most member banks would still have free Governments which they could sell and, if not, they could liquidate other securities or could borrow from the Federal Reserve banks on the basis of any sound asset if the Reserve System took no other action to restrict the availability of reserves.

The supplemental reserve plan has the serious disadvantage of not reducing the availability of reserves. Reducing the amount of deposits which could be created on the basis of $1 of new reserves would not give more effective control over the money supply so long as the central bank creates a correspondingly larger amount of reserves. The plan would immobilize a part of member bank holdings of Government securities, but would not likely affect a sufficient portion of the transactions in these obligations to impart any significant amount of stability to the Government securities market. It also has the serious disadvantage of placing no restrictions whatsoever on the liquidation of Governments by nonbank holders, and to the extent these securities were purchased by the Federal Reserve under a policy of supporting the price of Government securities, an equal amount would be added to bank reserves and bank deposits. Furthermore, there is the danger that the plan might become a device for financing Federal deficits cheaply rather than a tool which would contribute to effective monetary policy.

In short, if the Federal Reserve System has effective control over the supply of reserves under a flexible open-market policy, a supplementary reserve is unnecessary; without such control, a supplementary reserve would be ineffective.

31. Discuss the advantages and disadvantages of requiring during the national defense emergency a supplementary reserve to be maintained against increases in either loans and investments or deposits. Illustrate with a specific plan or plans

Joint answer

The principal objective of requiring banks to keep a supplementary reserve against increases in either loans and investments or deposits during the national defense emergency would be to provide more effective control over credit expansion and the money supply.

For purposes of illustration, let us assume a 100 percent reserve requirement against increases in deposits above a certain base level. By eliminating a multiple expansion of deposits (e. g., $5 of deposits on the basis of $1 of reserves when the reserve requirement is 20 percent), a 100 percent reserve requirement would tend to provide more effective restraint on further deposit expansion. It would reduce substantially the profit incentive for banks to expand their earning assets since under present conditions banks need provide immediately only a fractional reserve against the deposits resulting from an expansion of their loans (and can usually count upon some time interval before the full amount of such newly created deposits will be withdrawn).

However, it does not necessarily follow that the ability of the banks to expand credit would be reduced. Their capability for expansion would be checked only if additional reserves were not freely available to the banks to enable them to meet the 100 percent reserve requirements. On the other hand, the likelihood of expansion would probably be considerably lessened.

The effectiveness of a complete cash reserve against increases in deposits, as a restraint upon monetary expansion, would largely depend upon whether the central bank has effective control over the volume of reserves it creates. If the central bank does not have effective control over the volume of reserves, as under a policy of supporting the price of Government securities at some fixed level, it is unlikely that even a 100 percent supplementary reserve requirement will provide effective restraint.

The supplementary reserve requirement would not make Government securities more attractive to nonbank holders. Therefore, the plan would neither reduce the sales of nonbank holders during periods of inflationary pressure nor the amount the banking system as a whole would have to absorb. Commercial banks faced with a stiff increase in required reserves would tend to liquidate Government securities to meet the new requirement. Unless the market for Government securities were permitted to decline markedly the Federal Reserve System would be forced to purchase a much larger volume of Government securities than if commercial banks were required to maintain only the primary reserve against deposit increases. If the Government were borrowing large amounts of new money the System would be forced to buy large quantities under a policy of maintaining a supported market. It is likely, therefore, that under such conditions a

large part of the presumed effectiveness of a 100 percent supplementary reserve would be dissipated in a shift of Governments from the commercial banks and others to the Federal Reserve banks. This proposal overlooks the fact that the real key to control over deposit expansion stems from both the percentage reserve required and the ability and the willingness of the central bank to limit the amount of reserves it creates.

A high supplementary reserve requirement against deposit increases has other important disadvantages. Development of our national defense economy is likely to require large shifts of economic resources from one region to another. A high supplementary reserve against increases in loans and investments or deposits would tend to impair the desired mobility of funds. Banks in rapidly growing areas would need to expand their loans and investments to provide the funds needed for industrial and commercial expansion. However, these are the very banks that would be penalized by a high supplementary reserve requirement against loans and investments or deposit increases. On the other hand, banks in declining areas would be able to meet their credit demands more easily, thus tending to retard the shift of resources to other communities.

It is difficult to envision a plan that would accomplish its presumed purpose and yet be equitable and administratively feasible.

Comment of Hugh Leach, Richmond

[Mr. Leach submitted the following supplementary comments on questions 30 and 31 of the joint answer:]

While the inequities and administrative and other difficulties inherent in these proposals are fully recognized, it is conceivable that a situation might arise in which consideration of individual equities and administrative feasibility should be subordinated to the immediate national interest. If a situation developed in which existing general and selective controls proved inadequate, it would be necessary to explore further these and other plans tailored to the need of the specific emergency, despite the important shortcomings of such proposals as have been suggested. Just as we feel that additional selective credit controls are undesirable but might have to be considered under some circumstances, we would not rule out the possible need for exploring other types of reserve requirements.

32. Discuss the advantages and disadvantages generally of maintaining bank reserves against classes of assets rather than against classes of liabilities as at present.

Joint answer.

The primary reason for basing reserve requirements on deposits is that deposits are money, and it is the volume of money that reserve requirements are designed to influence. Hence this method accomplishes directly what a structure of requirements based on types of assets would accomplish only indirectly. Linking requirements to deposits also recognizes that movements of deposits are accompanied by shifts in reserves.

On first thought it might appear that a structure of requirements based on classes of assets would enable the central bank to direct the flow of funds into selected areas of the economy. It is unlikely,

however, that the proposal would be effective in achieving that objective. Experience with selective regulation of credit indicates that such regulations must be based on functions rather than institutions. If the flow of lending is to be directed effectively, it would be necessary to regulate all lenders. Basing bank reserve requirements on classes of assets might, of course, affect the relative attractiveness of different classes of assets for bank lending and investing. But this could easily result merely in offsetting changes in the loan and investment policy of other lenders rather than influencing the flow of funds into various channels. The wide distribution of Government securities in the hands of lending institutions and individuals would greatly facilitate such shifting. Other lenders could simply sell Government securities and lend the proceeds to those borrowers whose loans and securities were subjected to higher requirements if held by banks. The banking system, in turn, would buy the Government securities against which the reserve requirements presumably would be less. The net result, however, would be that neither the total volume of deposits nor the flow of funds would be controlled. It should not, of course, be concluded that application of reserve requirements should be extended from banks to all lending institutions and individuals. It should be understood, however, that even if this were done it would still be necessary to control the total volume of reserves as well as the proportional requirements against classes of assets. In other words, a flexible central bank open-market policy would still be necessary.

The operation of a structure of reserve requirements based on classes of assets would encounter very serious administrative difficulties. It should be recalled in this connection that it has taken a long time and many decisions on individual cases to establish a clear-cut definition of time deposits. But this problem was simple compared with the problem of actually defining types of assets. Business firms and individuals spend for a variety of purposes, and it is a matter of indifference which particular dollars, whether those secured from sales or from borrowing, are used for specified purposes. If, however, different reserve requirements were applied to loans for different purposes, it might become important for the borrower to earmark his receipts in such a way that the borrowed dollars could be used for purposes against which requirements were lowest. It is not certain that either total spending or the direction of spending would be affected at all. The administration of such a system, in an attempt to try to assure the desired results, would require a large staff of highly trained persons whose decisions, in the nature of the case, would often be arbitrary.

Another difficulty is that it is not always desirable to encourage or discourage given activities to the same degree throughout our wide and diverse economy. At the present time, for example, it is generally desirable to limit the construction of houses, but it is also desirable to encourage their construction in certain defense areas. It is difficult to envision the full complexities of a structure of reserve requirements designed to deal with such diverse objectives.

Difficulties and possible injustices would be encountered in initiating the system. Banks that happened to have relatively more assets requiring higher reserves would be penalized. The penalized banks might be those that had done most to help develop their own communities, including the assumption of greater risks through the exten-

sion of private credit. This would not be true, of course, if higher reserves were required against Government securities than against other earning assets. If the new structure of requirements were to be superimposed on the present structure and made applicable only to future increases in types of assets, the administrative difficulties would be greatly increased.

33. State the statutory authority for the power, if any, of the Board of Governors, the Federal Reserve banks, or of any agency of the United States Government to control directly or to ration the extension of credit by individual banks. Specify the (legal) circumstances under which such rationing could occur and the control of the President over its operation. Under what (economic) circumstances, if any, would you recommend the use of credit rationing? Describe the manner in which you believe that such a system would operate.

Joint answer

The principal provisions of law which might possibly be construed to authorize the control or rationing of the extension of credit by individual banks are the provisions of section 5 (b) of the Trading With the Enemy Act of 1917 (as amended) and section 4 of the Emergency Banking Act of 1933. Section 5 (b) of the Trading With the Enemy Act authorizes the President, through any agency that he may designate—

> during the time of war or during any other period of national emergency declared—

by him to—

> investigate, regulate, or prohibit * * * transfers of credit or payments between, by, through, or to any banking institution * * *.

During World War II, pursuant to the authority conferred upon the President by section 5 (b), he issued Executive Order No. 8389 designating the Secretary of the Treasury to administer the so-called blocked accounts. Under this authority the President also issued Executive Order No. 8843 conferring upon the Board of Governors authority to control consumer credit.

Section 4 of the Emergency Banking Act of March 9, 1933 provides that—

> * * * during such emergency period as the President of the United States by proclamation may prescribe, no member bank of the Federal Reserve System shall transact any banking business except to such extent and subject to such regulations, limitations, and restrictions as may be prescribed by the Secretary of the Treasury, with the approval of the President.

The President pointed out in his memorandum of February 27, 1951, that the Secretary of the Treasury, under the authority vested in him, subject to the President's approval, by the Banking Act of March 1933—

> could by regulation delegate the administration of this program to the 12 Federal Reserve banks, each to act in its own Federal Reserve district—

but this was not done.

The exercise of the authority conferred by Congress upon the President under section 5 (b) of the Trading With the Enemy Act and the issuance of any regulations by the Secretary of the Treasury, pursuant

to section 4 of the Emergency Banking Act of March 9, 1933, are predicated upon the existence of a national emergency. The national emergency declared by the President by the banking holiday proclamations of March 6 and 9, 1933, has never formally been declared at an end, and on December 16, 1950, the President issued a proclamation of national emergency in connection with the Korean situation. It is for the courts to decide whether the national emergencies as declared by these proclamations constitute a legal basis for action by the President and the Secretary of the Treasury under the Trading With the Enemy Act and the Emergency Banking Act of 1933 with respect to control of extension of credit by individual banks. We believe it would be undesirable to institute direct controls over the extension of credit by individual banks under the provisions of these laws for purposes and under circumstances not contemplated at the time of their enactment. It would be preferable to have specific action by Congress authorizing such controls, if they were to be undertaken.

The question implies that rationing of credit by banking institutions only would be contemplated. If that were done, the tendency would be to shift demands for credit to nonbank lenders not subject to the control. Even if such lenders financed their extensions of credit by attracting the savings of the public, many of their loans and investments might be for purposes contrary to those permitted for banks. Furthermore, it is quite likely that, in the face of heavy demands for credit which the banks were not permitted to extend, the nonbank lending institutions might finance a considerable part of their extensions of credit through sales of Government securities, which, if they were absorbed by the commercial banks or by Federal Reserve banks, would result in indirect extensions of bank credit for unapproved purposes. To avoid such developments, not only banks, but all other lenders, would have to be brought under the controls, if they were to be effective, and that would involve an extremely difficult enforcement problem.

If a form of credit rationing were to be undertaken under conditions short of an extreme emergency, probably the simplest approach would be to give mandatory status to something like the current voluntary credit restraint program. But to make such a program compulsory would imply enforcement procedures to assure that lenders generally conformed to the rulings of the central organization directing the program. The policing problem would be of a magnitude far beyond anything previously experienced. Probably the most feasible and manageable part of such a program would be control over capital issues. It is conceivable that a Government-sponsored capital issues committee, with authority to enforce its decisions, might be needed in the event of another full-scale war.

A possible approach to a more thoroughgoing system of credit rationing might be to prohibit all extensions of credit except those specifically authorized. Even the first step in such a procedure, however, would involve serious difficulties. For example, if credit extensions to war contractors were exempted from the general prohibition, it would be necessary to limit the amount of credit they could obtain to that required for the execution of their war contracts. Presumably that would mean setting up a certification procedure which would include not only certification of the need for credit, but also of the

amount and perhaps the duration of the need as well. Otherwise, some of the credit might be used for nonwar purposes, for which competitors would be unable to obtain credit. But to certify the amount of credit required would necessitate thorough examination of such factors as the prospective borrower's present and prospective position with respect to current assets and liabilities and cash flow.

The certification procedure might be applied also to defense-supporting activities, but that would probably involve even more difficult problems of ascertaining the actual needs for credit for approved purposes. Beyond the field of war contracts and supporting activities, the classification of demands for credit, according to the degree of essentiality and urgency of need, would become much more nebulous and correspondingly more difficult. It might become necessary to pass upon individual loan applications, in which case a huge staff of men experienced in credit analysis, and competent to judge the purposes and permissibility of credit extensions in individual cases, would be required to administer the rationing—very probably an impossible requirement.

Even if this difficulty could be surmounted, the problem of determining the precise use of credit applied for and deciding whether or not it was essential would be almost impossible. A large part of business borrowing is for working capital purposes. That may include such variables as the financing of larger inventories (in physical amount, cost, or both), larger receivables, a reduction in trade credit, or the maturing of tax liabilities. To appraise the legitimacy of the need for credit it would be necessary to arrive at a judgment as to the necessity of the items giving rise to the demands for credit, the necessary level of inventory, for example. Aside from the problem of classifying potential borrowers as to the degree of essentiality of their activities and the extent of their actual need for credit, a credit-rationing system would encounter other difficulties. For example, the creation of a large war industry might result in an extraordinary growth of the community where it was located and require the financing not only of a large amount of housing construction, but also of a great variety of servicing facilities, the financing of which in other communities might not be approved. Exemptions from the general prohibitions in such cases would need to be carefully restricted to avoid the financing of nonessential activities or unnecessary amounts of essential activities. To take account properly of such local variations in credit needs and administer exceptions to the general restrictions fairly, in addition to more fundamental responsibilities, would be likely to constitute an almost impossible task for the central organization.

One other aspect of the matter may deserve mention. A thorough review of applications for credit, of the sort outlined above, would necessarily be time-consuming. The time required to obtain approval of loan applications and actual extensions of credit might, in a number of cases, impede essential activities.

In summary, we have a repugnance to regulating credit transactions on a case-by-case basis. We do not believe that the Federal Reserve System or a governmental agency could estabish and administer standards which presumably would be substituted for the judgment of lenders in individual transactions. Even with the best standards the

decisions of members of the large enforcement staff would necessarily be arbitrary. Were it possible to overcome these difficulties, rationing would be ineffective if applied to banks alone. For these reasons we do not recommend, save possibly in catastrophic emergency, the use of direct rationing of extensions of credit by individual banks.

Delos C. Johns, St. Louis

[Following are Mr. Johns' comments on the joint answers to questions under section D. General Credit and Monetary Policies.]

The joint replies prepared under the direction of a special committee of the presidents of the Federal Reserve banks represent my general opinion with respect to the questions 13 through 33, in this section. I have no major substantive differences with these replies and my comment is primarly supplementary and general. In this section, however, comment is tied more specifically to the particular questions than it has been in the three previous sections. In certain cases it is included mainly to supplement the joint reply with some information on the eighth Federal Reserve District.

Open-market operations.—With respect to questions 13 through 17, which deal with open-market operations and their effects, I am in complete agreement with the joint replies. I have just two supplementary comments to make. In the joint replies to question 16 it is pointed out that under full-scale war conditions direct controls (on prices, wages, allocations, and rationing) are needed; an opinion in which I concur. I wish to emphasize strongly, however, my opinion (1) that successful application of such direct controls depends in large measure upon monetary and fiscal policies aimed at restricting growth in private purchasing power, and (2) that it is generally wiser to place most dependence upon indirect controls such as monetary and fiscal policy which permit greater flexibility in the economy. The great economic danger of the direct controls, as I see it, is the introduction of rigidities into the economic system and the probable resultant impairment of dynamic strength, which is the basic factor in our productive power. The longer direct controls operate, the greater the distortions generated by rigidities become.

Discounting and moral suasion.—I have no supplementary comment with respect to the joint replies to questions 18 and 26, which deal with the discount function and with the use of moral suasion.

Selective-credit regulations.—The joint replies to questions 21 through 24, which deal with the selective-credit regulations, coincide with my opinion almost exactly. I agree that these selective-credit instruments are supplementary to general quantitative-credit regulation through action on the volume of reserves and that they cannot be taken as a substitute for such general credit regulation. I also am in agreement with the statement concerning the four tests to be met by a prospective selective-credit-regulation device and with the conclusion that the present selective-credit instruments meet those tests and are useful. I further agree that selective regulations other than those over consumer, real-estate, and stock-market credit are neither feasible nor desirable, as stated in the joint replies to question 24, but I would amend that statement mildly by including the phrase "under present conditions and given the present institutional structure and state of knowledge." It is conceivable that future developments could result in discovery of means to make selective regulation in other fields admin-

istratively feasible and perhaps desirable. In other words, I concur in the statement as of the present, but I am inclined to be somewhat less certain about the future.

Voluntary credit-restraint program.—With respect to question 25, which concerns the voluntary credit-restraint program, I have two comments. One involves a point brought out in the joint reply, the other merely is a note on eighth-district experience with the program.

The joint reply indicates that the committee (or a similar group) might be given certain additional powers (under adequate supervision) in the event of total war; that such action would be preferable, from the standpoint of economic efficiency, to instituting "credit rationing" administered by Government. I question most seriously the desirability of administered "credit rationing" whether performed directly by Government or by groups such as the National Voluntary Credit Restraint Committee or the regional committees. In my opinion the function of "credit rationing" is performed best by the individual lender who is on the local scene and is conversant with local conditions. This is his economic justification for being; he is expected to channel credit to essential uses and to efficient users. Limitations on general credit supply should be general limitations and permit the lender to exercise his best judgment as to where his credit should flow. In other words, "credit rationing" by Government or an administrative body, when it is called for, should apply to the economy as a whole, and "credit rationing" in individual cases should be left to the determination of individual lenders. By this approach the economy is kept flexible and dynamic and hence stronger.

Furthermore, this approach seems to me most in keeping with our basic American political philosophy. The commercial-banking system in this country is unique among financial institutions in that it has the power to create money (bank deposits) through extension of credit. That power has laid upon the commercial banking system the correlative responsibility to create (in a broad sense) no more and no less money through its credit operations than is necessary for the smooth functioning and stable growth of the economy. The Federal Reserve System was established to share this responsibility and does so by making reserves more or less available and costly to the commercial banks. Thereby, it establishes a broad over-all maximum limit and provides the basis for a minimum limit to the money supply. Within those broad limits the commercial banking system and the individual banks exercise their responsibilities to select the desirable and economic users and uses of credit. I believe it would be undesirable to eliminate those responsibilities, not only on the grounds of economic efficiency as noted above but also under the general democratic principle that responsibilities should be roughly correlative with powers.

This comment applies also to question 33, and is my only supplementary comment on that question.

The voluntary credit-restraint program has been taken quite seriously in the eighth Federal Reserve District. The Eighth District Commercial Banking Voluntary Credit Restraint Committee was established at the inception of the program and originally served banks throughout the district. Subsequently a Little Rock (Ark.) Regional Commercial Banking Voluntary Credit Restraint Commit-

tee was established to serve banks in the Little Rock branch zone (most of Arkansas); the eighth-district committee continues to serve banks in the rest of the district. An Eighth District Savings and Loan Voluntary Credit Restraint Committee also has been established to serve all savings and loan associations in the district.

In line with the point made in the joint reply, it is not possible to measure precisely what the program has accomplished in the eighth district. It is noteworthy, however, that total loans at all member banks in the district rose just $86 million from the end of May 1951 to the end of October 1951, as compared with an increase of $276 million in the like period of 1950, and a 3-year (1947–49) average gain for the same period of $146 million.

It is also noteworthy that the record of business-loan changes at large district banks indicates some channeling of credit to defense activities and away from nondefense activities. In the 5 months (June–November 1951) new credits for defense contracts at these banks totaled $16 million and for defense-supporting activities totaled $31 million. In the same period the net increase in outstanding business loans of these banks to all nondefense activities was just $56 million (less than expected on seasonal grounds). While the defense-loan figure is not large, it should be recognized that defense contracts in this district have lagged behind the amount that might have been expected, given the district's proportion of national industrial capacity.

Reserve requirements.—I concur fully in the joint replies to questions 27 to 32, inclusive, which deal with the general topic of reserve requirements and methods for fixing such requirements. I have, however, one supplementary comment which relates to reserve requirements applying to nonmember banks.

The joint reply to question 27 indicates that the major reason for reserve requirements is to give the central bank influence over the total money supply. The joint reply to question 28 indicates that nonmember banks should be made subject to the same reserve requirements as member banks. I argee, and my opinion is based on three points, as follows:

(1) As noted in the joint reply to question 28, the nonmember-bank deposits are part of the money supply just as are deposits in member banks. It would be in keeping with our constitutional development to have the Federal Reserve System, as the agent of Congress, exercise the same degree of direct control over that part of the money supply held as nonmember-bank deposits as is exercised over that part held as member-bank deposits.

(2) In a very real sense, the legal requirement to hold reserves may be viewed as a price paid, a contribution made, by the banks for greater economic stability. The reserve burden should be shared equitably by all banks.

(3) The fact that nonmember banks hold only a small part of the Nation's bank deposits theoretically does not impair central banking action with respect to total reserve volume and its influence on the total money supply. However, more than half the number of banks are nonmember banks. Practically, the fact that nonmember banks are not subject to member-bank reserve requirements may well inhibit central banking action at various times. The System is keenly aware

of the problem of equity, noted in my second point, and naturally finds it repugnant, when restrictive measures are called for, to widen further the disparity in reserve burden between member and nonmember banks. This question of equitable treatment is very sharply outlined in the eighth district, where two-thirds of the banks are nonmember banks.

I should stress the fact that I am not advocating compulsory membership, but only the application of member-bank reserve requirements to nonmember banks. Membership in the Federal Reserve System involves many more responsibilities than the keeping of reserves with the Federal Reserve bank. Generally speaking, nonmembers are not subject to the same degree of responsibilities as are members. In my opinion, membership should be predicated on full appreciation of the responsibilities involved and should, for State banks, be voluntary.

Finally, I probably should note, as does the joint reply, that making member-bank reserve requirements apply to nonmember banks would not break down the dual banking system, which rests basically upon the chartering and supervisory authority of Federal and State governments.

Credit policy and an expanding economy.—Questions 19 and 20 have to do with credit policy and supervisory activity and their roles in an expanding economy. The joint replies to these questions coincide with my views. I should emphasize my belief that supervisory policy and the bank-examination function are aimed at preservation of the soundness of individual banks and through them a sound banking system. Promotion of this objective should aid promotion of the objectives of the Employment Act.

I see no basic conflict between measures to restrain excess demand by credit control and the need for an expanding economy. As the joint reply indicates, the way resources are used and by whom they are used are the keys to expanding the economy. As I pointed out earlier, the economic function of finance in general is to channel credit to essential uses and efficient users. Credit policy aimed at restraining excess demand creates the climate for the exercise of this economic function of finance and hence should contribute to promotion of an expanding economy. By preserving balance between the money supply and the goods supply, credit policy helps assure that less efficient and less essential producers cannot bid up prices and absorb resources better used elsewhere.

E. THE BANKING STRUCTURE

34. Will you please submit a memorandum discussing the adequacy of banking facilities in your district? For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities

Answer for the First Federal Reserve District (Joseph A. Erickson, Boston):

The economic age, development and geographic make-up of the first Federal Reserve District is such that we have in our opinion

a mature and adequate banking structure. With very few exceptions banking facilities, both deposit and loan, are within convenient reach of all persons and business firms and so far as practicable there exists the opportunity of choosing between two or more competing banks. This does not necessarily mean that every town and village in New England has one or more banks located therein. It does mean that such facilities are available on a competitive basis within easy commuting distances. There are attached at the end of this reply a series of scaled maps of the New England States which present in graphic form the location of banking facilities in New England in relation to density of county population (commercial banks exhibit A 1–6, savings banks exhibit A 7–12).

As of December 30, 1950, there were 518 commercial and 342 mutual savings banks in New England as reflected by exhibit B. In addition to commercial and mutual savings banks there are 104 State-chartered savings, building and loan associations, 175 cooperative banks, 56 Federal savings and loan associations and 13 other types of financial institutions operating in New England aside from numerous credit unions both State and Federal and small-loan companies.

	Cooperative banks and State-chartered building and loan associations	Federal savings and loan associations	Other types
Connecticut	31	17	9
Maine	30	5	2
Massachusetts	179	29	
New Hampshire	24	2	2
Rhode Island	7	1	
Vermont	8	2	
Total	279	56	13

Comparative figures indicate that banking has kept pace with the increase in population in New England over the past 10 years. In the following tabulation column A gives the comparative population in 1940 and 1950 per commercial bank facility, column B the comparative population per commercial and savings bank deposit facility, and column C the population per supervised loan and depository, exclusive of credit unions, small loan companies, and the like.

	A		B		C
	1940	1950	1940	1950	1950
Connecticut	12,800	12,000	8,300	8,300	7,000
Maine	6,700	6,800	5,300	5,400	4,400
Massachusetts	13,500	13,000	7,900	7,800	5,800
New Hampshire	7,400	6,800	4,470	4,700	3,800
Rhode Island	11,800	10,000	9,900	8,600	8,000
Vermont	4,100	4,600	3,500	3,800	3,500
Recapitulation	10,700	10,400	7,000	7,000	5,600

Reference is made to exhibit C which shows the population per banking office by counties for the New England States.

Banks are recognized as quasi-public institutions. To warrant their existence they must serve the community. To serve a community well

requires that each bank as well as the entire banking structure be sound. The extent to which expansion of present facilities is needed and could be undertaken on a sound basis is a moot question. Need for additional banking facilities and the ability of the area to support new facilities is evidenced in part by the fact that only 12 applications have been filed for new State and National commercial and savings bank charters during the 10-year period ended December 31, 1950. Of this number only eight charters were granted.

	Connecticut	Maine	Massachusetts	New Hampshire	Rhode Island	Vermont
Granted	4	0	1	3	0	0
Declined	1	0	1	2	0	0
Withdrawn	0	0	0	0	0	0
Total received	5	0	2	5	0	0

Lack of growth prospects and of evidence that the area could support a bank were the reasons for declining four of the applications filed.

On the other hand expansion has occurred in banking facilities during the past 10 years, as is evidenced by the data contained in exhibit B. Referring thereto it will be noted that although there has been a decrease from 546 to 518 commercial banks in New England during the 10-year period ended December 30, 1950, branches operated by such banks have increased from 243 to 371, resulting in a net increase of 100 in commercial banking facilities. Mutual savings banks during the same period decreased from 356 to 342. Branches of these banks, however, also showed an increase from 48 to 70, with the result that there was also a net increase in this type of banking facility of 8. There was accordingly a net increase of 108 in these two types of banking facilities during the 10-year period.

The decrease in the number of commercial and savings banks reflected by exhibit B has been to some extent the result of mergers, consolidations, and liquidations, with the resultant purchase of assests and assumption of liabilities by other banks. However, the result has been not only to expand the banking facilities of New England but to bring better and more adequate service to the smaller communities of our region, since in the vast majority of cases the resultant or acquiring bank has been the more progressive with better organization and broader banking services.

EXHIBIT B.—*First Federal Reserve District—Number of banks*

	Commercial and stock savings banks [1]			Mutual savings banks			Total banks		
	Dec. 31, 1940	Dec. 31, 1945	Dec. 30, 1950	Dec. 31, 1940	Dec. 31, 1945	Dec. 30, 1950	Dec. 31, 1940	Dec. 31, 1945	Dec. 30, 1950
Connecticut: [2]									
Banks	117	117	112	72	72	72	189	189	184
Branches	16	16	50	1	0	5	17	16	55
Total banking units	133	133	162	73	72	77	206	205	239
Maine:									
Banks	68	64	63	32	32	32	100	96	95
Branches	58	66	71	2	2	2	60	68	73
Total banking units	126	130	134	34	34	34	160	164	168
Massachusetts:									
Banks	201	192	182	192	190	189	393	382	371
Branches	117	139	177	33	33	47	150	172	224
Total banking units	318	331	359	225	223	236	543	554	595
New Hampshire:									
Banks	64	65	75	43	42	34	107	107	109
Branches	2	3	2	1	1	1	3	4	3
Total banking units	66	68	77	44	43	35	110	111	112
Rhode Island:									
Banks	23	25	16	9	9	8	32	34	24
Branches	38	45	60	2	2	6	40	47	66
Total banking units	61	70	76	11	11	14	72	81	90
Vermont:									
Banks	73	72	70	8	8	7	81	80	77
Branches	12	9	11	9	9	9	21	18	20
Total banking units	85	81	81	17	17	16	102	98	97
Recapitulation, New England:									
Banks	546	535	518	356	353	342	902	888	860
Branches	243	278	371	48	47	70	291	325	441
Total banking units	789	813	889	404	400	412	1,193	1,213	1,301

[1] Includes 9 stock savings banks located in New Hampshire.
[2] Includes Fairfield County.

Answer for the Second Federal Reserve District (Allan Sproul, New York)

As the wording of this question implies, there are various possible tests for the "adequacy of banking facilities." The test upon which this question focuses attention is the physical accessibility of banking offices to the persons and business firms having need of them. While there are banking facilities available within a reasonable distance and over adequate roads for virtually all individuals or businesses located in the second Federal Reserve district, ready accessibility must always be measured in relative terms, taking into account the density of population in the area being served. A sparsely settled area obviously cannot support as many banks as a densely populated area of similar size. A summary of the variations in the distribution of banking offices among regions within the district, in terms of population per square mile and the number of square miles per banking office, will consequently constitute the major portion of this reply.

It should be noted, however, before turning to the statistical data, that the operation of a banking office must meet the usual test con-

Exhibit A-1

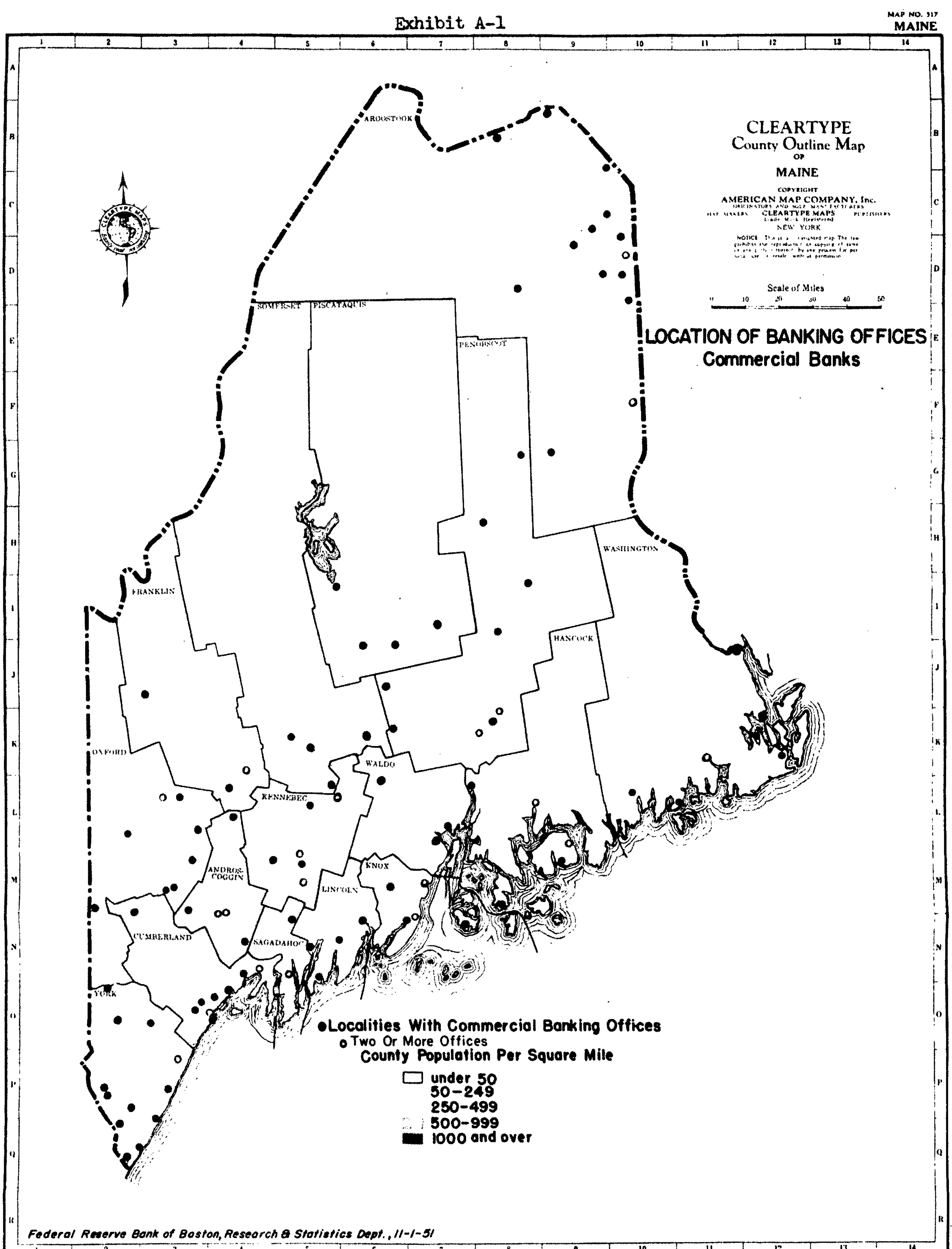


Exhibit A-2

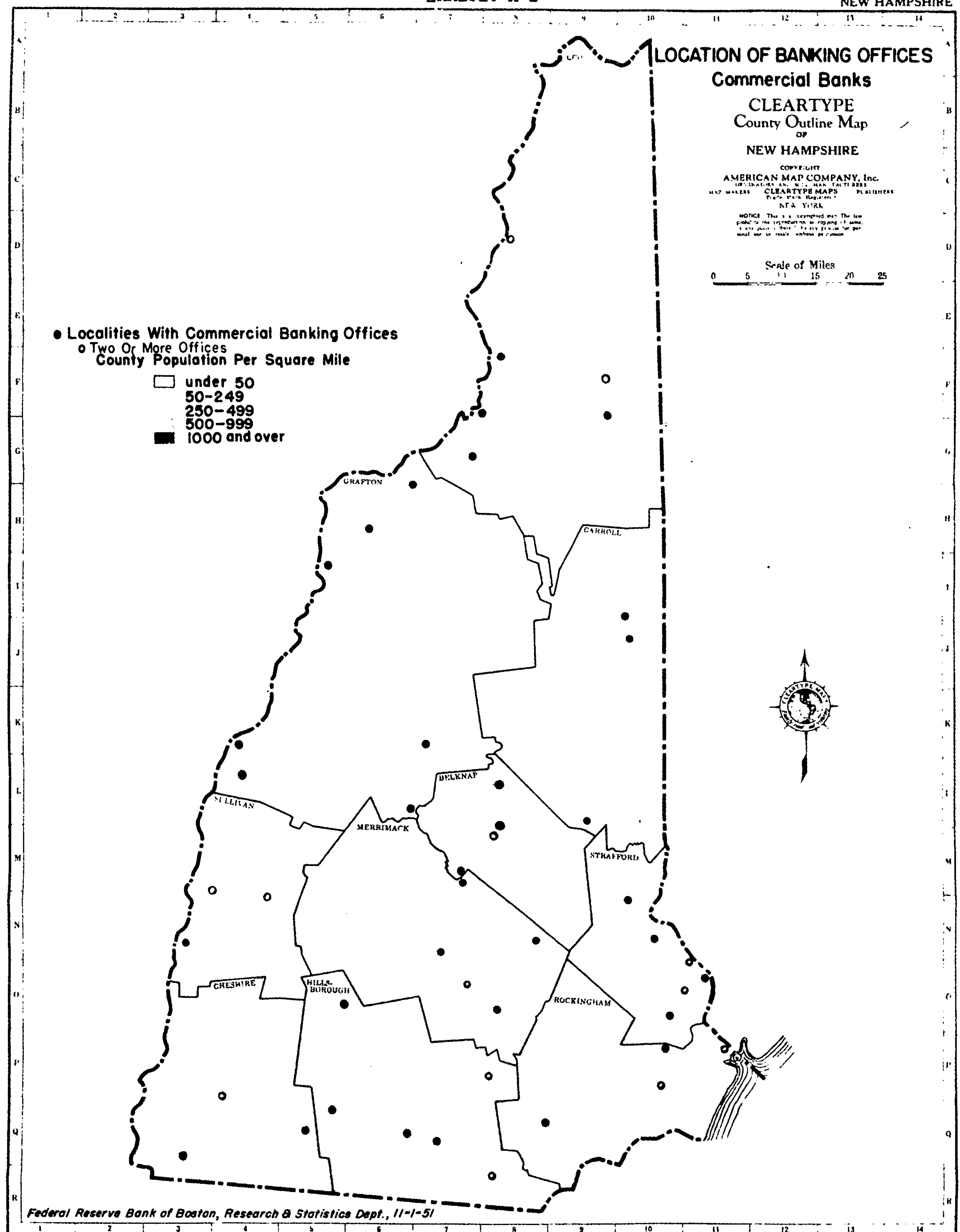
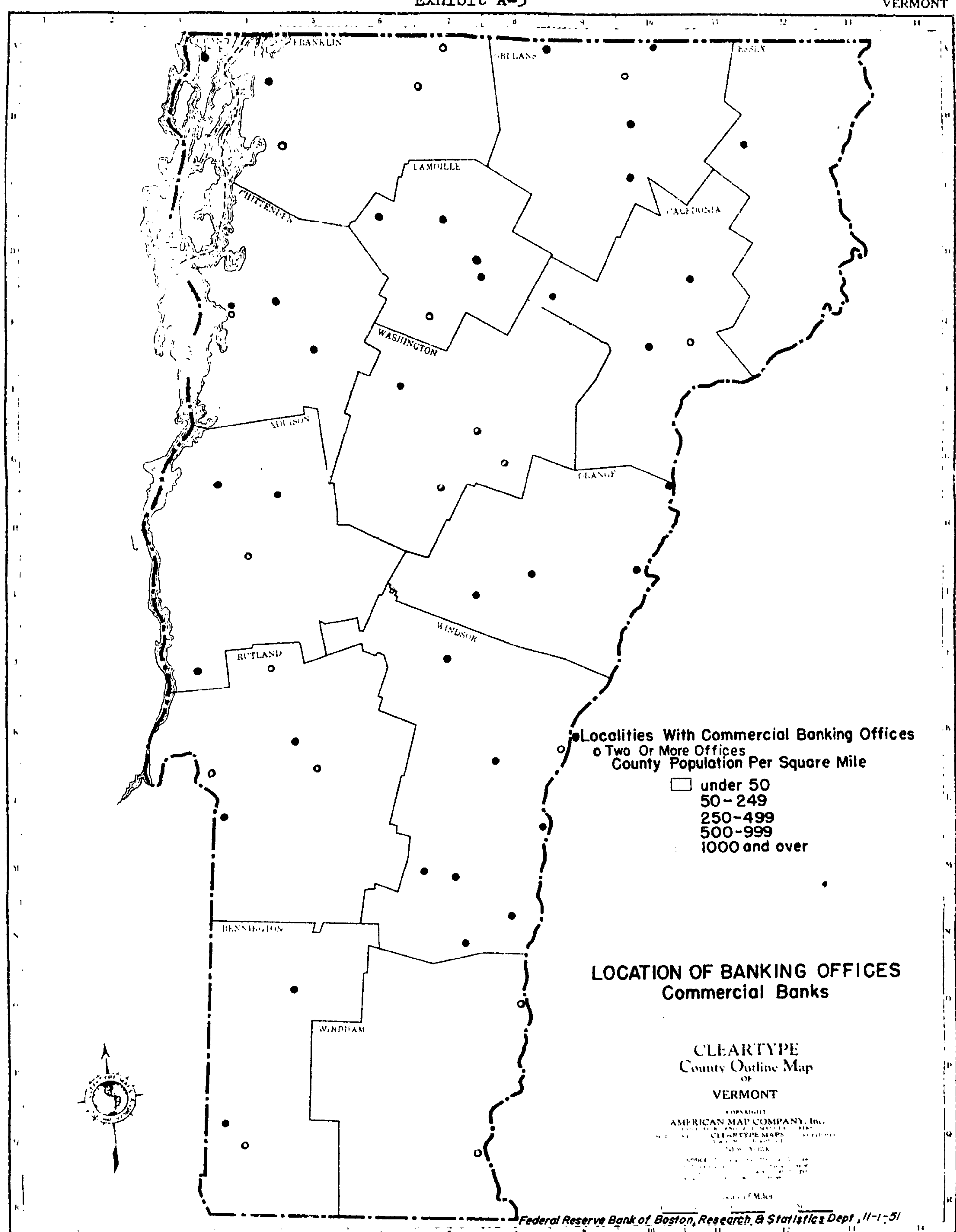


Exhibit A-3



LOCATION OF BANKING OFFICES
Commercial Banks

CLEARTYPE County Outline Map of MASSACHUSETTS

AMERICAN MAP COMPANY, Inc.

ESSEX

MIDDLESEX

HAMPSHIRE

HAMPDEN

SUFFOLK

NORFOLK

BRISTOL

BARNSTABLE

NANTUCKET

● Localities With Commercial Banking Offices
○ Two Or More Offices
County Population Per Square Mile

under 50
50-249
250-499
500-999
1000 and over

Federal Reserve Bank of Boston, Research & Statistics Dept., 11-1-51

Exhibit A-4

MASSACHUSETTS

92245 O - 52 - pt. 2 (Face p. 740) No. 4

Exhibit A-5

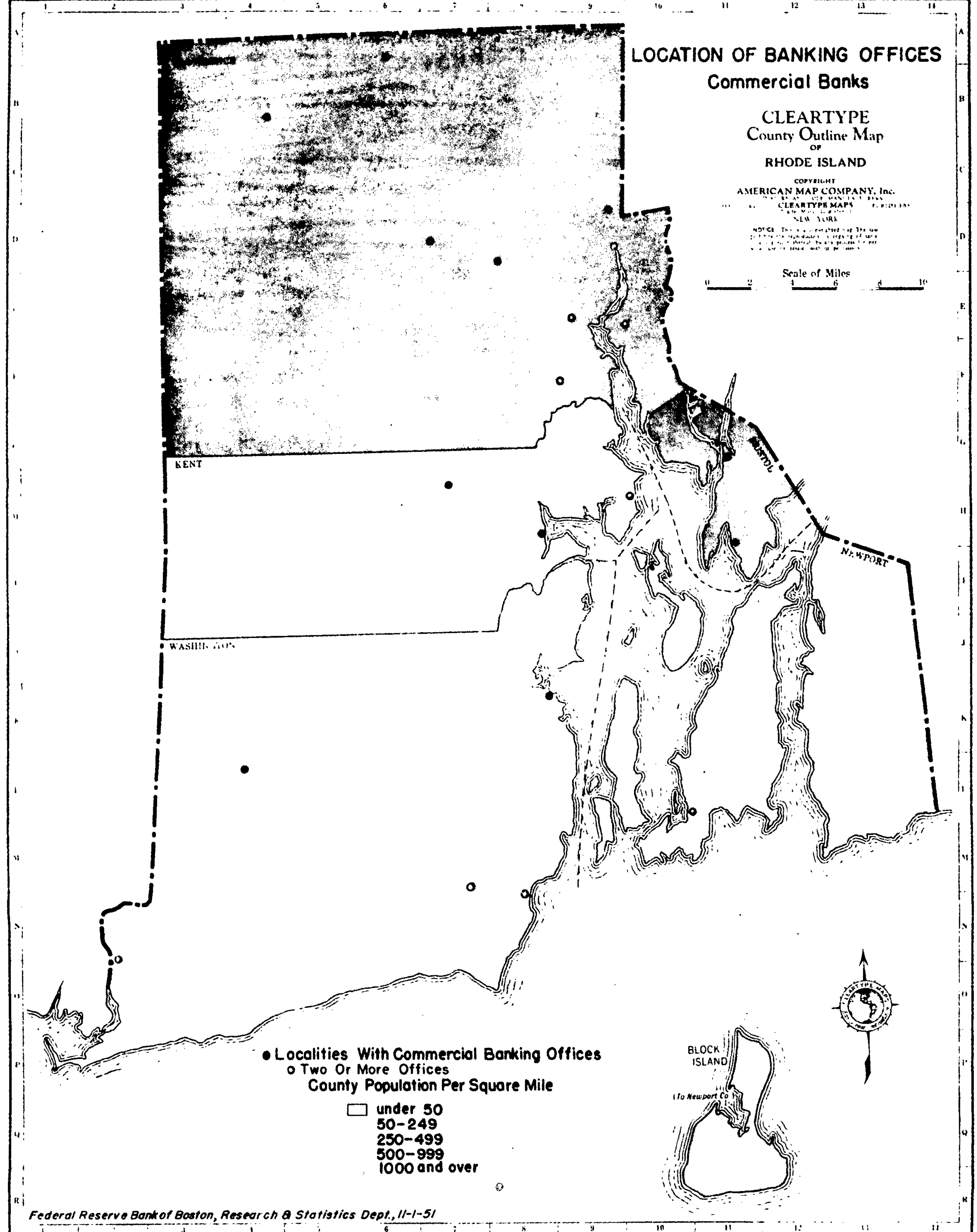


Exhibit A-6

92245 O - 52 - pt. 2 (Face p. 740) No. 6

Exhibit A-7

MAP NO. 517
MAINE

CLEARTYPE
County Outline Map
OF
MAINE

AMERICAN MAP COMPANY, Inc.
CLEARTYPE MAPS
NEW YORK

Scale of Miles
0 10 20 30 40 50

LOCATION OF BANKING OFFICES
Savings Institutions

AROOSTOOK
SOMERSET
PISCATAQUIS
PENOBSCOT
WASHINGTON
FRANKLIN
HANCOCK
OXFORD
WALDO
KENNEBEC
KNOX
ANDROSCOGGIN
LINCOLN
CUMBERLAND
SAGADAHOC
YORK

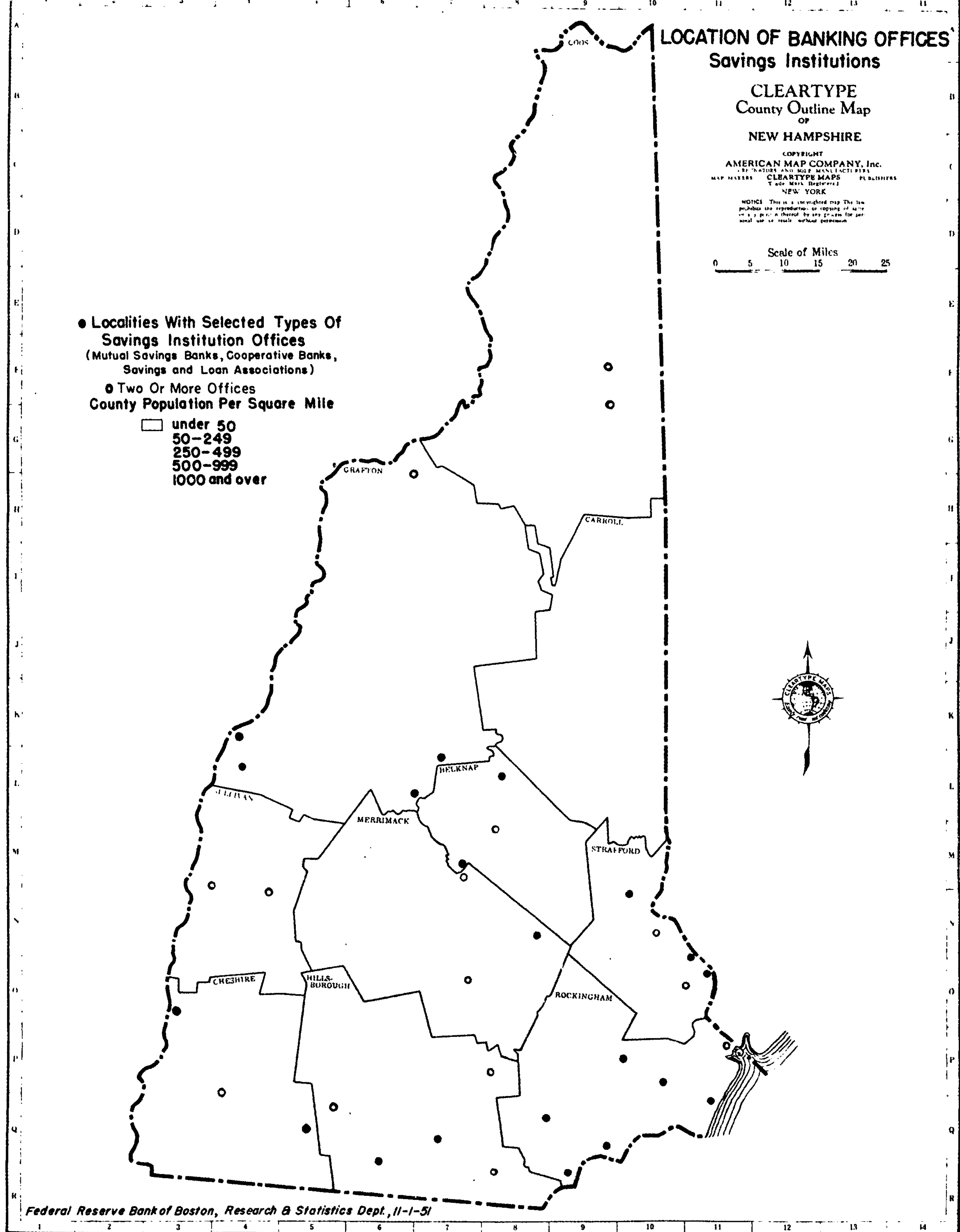
● Localities With Selected Types Of Savings Institution Offices
(Mutual Savings Banks, Cooperative Banks, Savings and Loan Associations)
o Two Or More Offices

County Population Per Square Mile

- under 50
- 50-249
- 250-499
- 500-999
- 1000 and over

Federal Reserve Bank of Boston, Research & Statistics Dept., 11-1-51

Exhibit A-8



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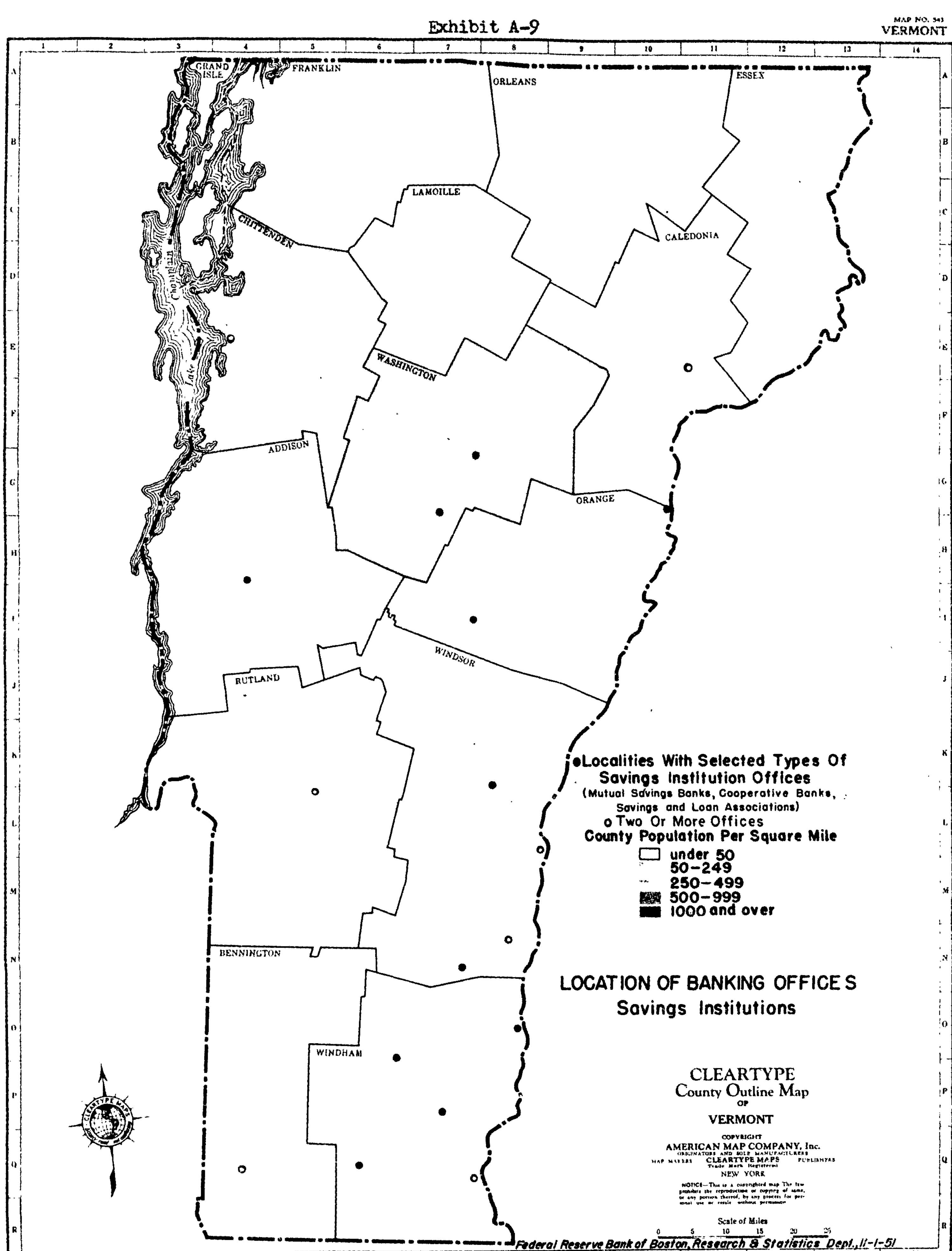

Exhibit A-10

LOCATION OF BANKING OFFICES
Savings Institutions

CLEARTYPE
County Outline Map
OF
MASSACHUSETTS

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CLEARTYPE MAPS
NEW YORK

BERKSHIRE
FRANKLIN
WORCESTER
HAMPSHIRE
HAMPDEN
NORFOLK
SUFFOLK
PLYMOUTH
BRISTOL
BARNSTABLE
DUKES
NANTUCKET

● Localities With Selected Types Of Savings Institution Offices
(Mutual Savings Banks, Cooperative Banks, Savings and Loan Associations)

○ Two Or More Offices

County Population Per Square Mile

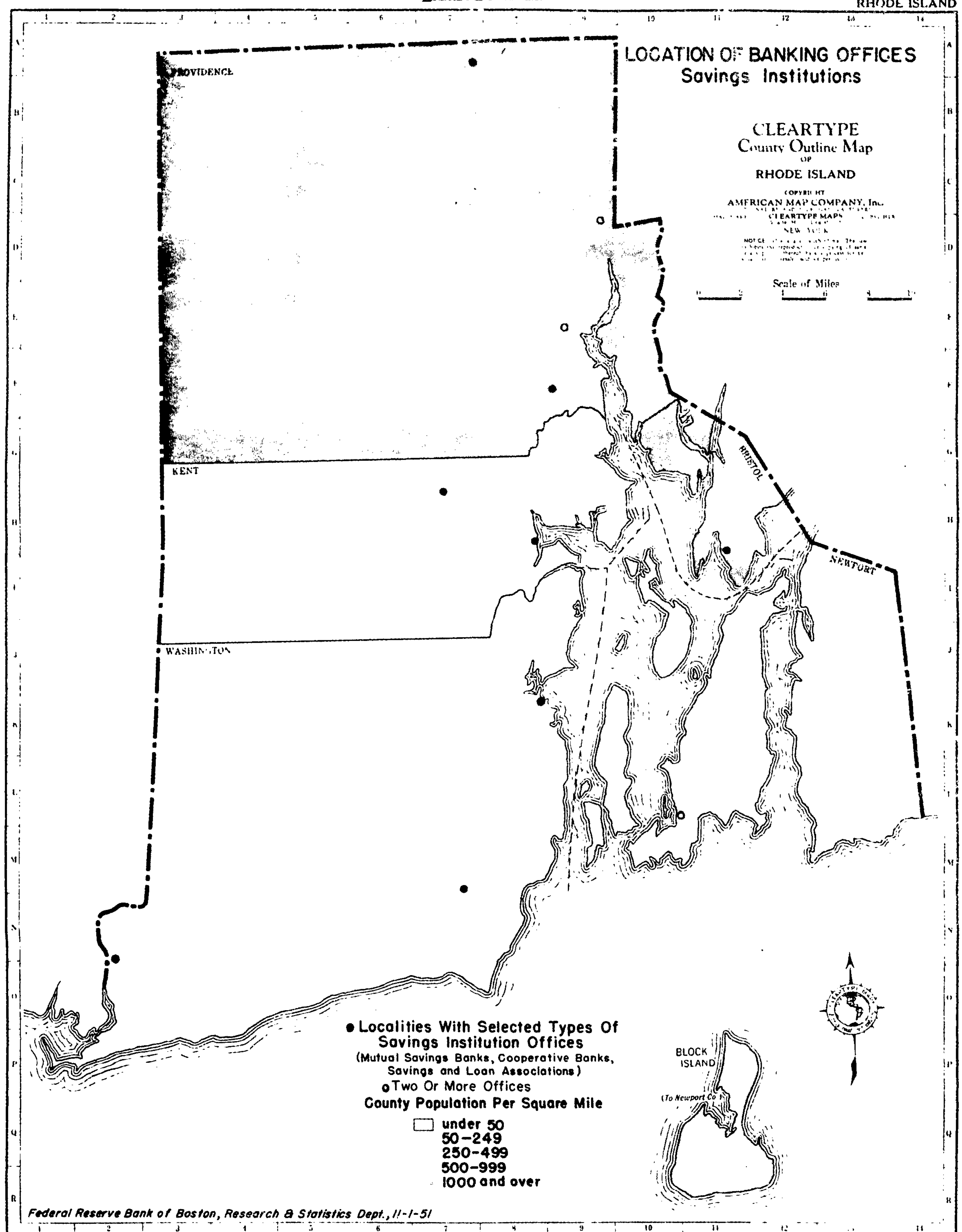
- under 50
- 50–249
- 250–499
- 500–999
- 1000 and over

Federal Reserve Bank of Boston, Research & Statistics Dept., 11-1-51

MASSACHUSETTS

92245 O - 52 - pt. 2 (Face p. 740) No. 10

Exhibit A-11



92245 O - 52 - pt. 2 (Face p. 740) No. 12

Exhibit A-12

LITCHFIELD

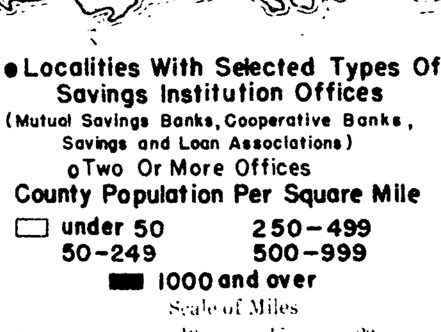
HARTFORD

NEW LONDON

NEW HAVEN

MIDDLESEX

LOCATION OF BANKING OFFICES
Savings Institutions



CLEARTYPE
County Outline Map
OF
CONNECTICUT

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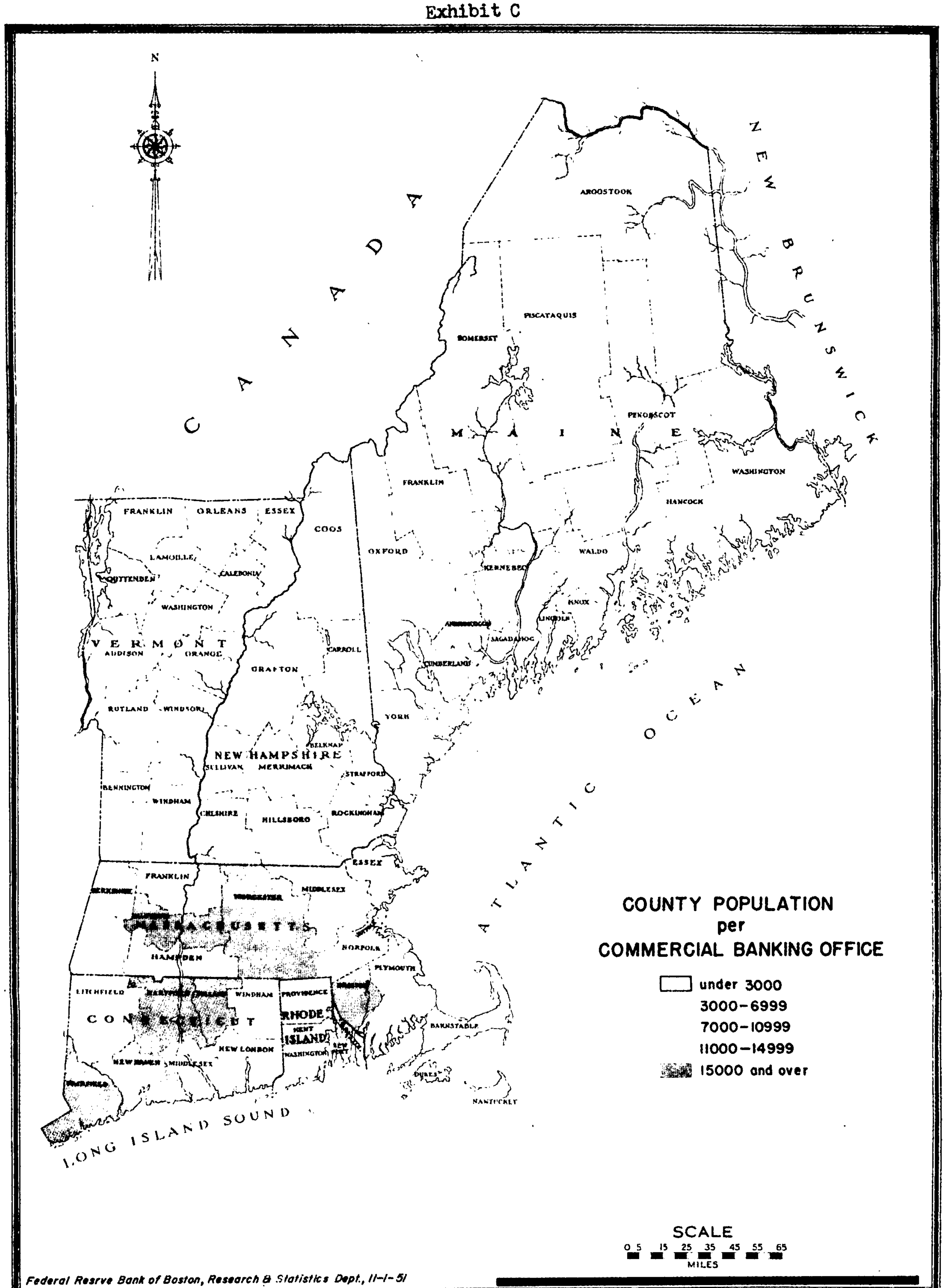
NEW YORK

CONNECTICUT

Federal Reserve Bank of Boston, Research & Statistics Dept., 11-1-51

Exhibit C



92245 O - 52 - pt. 2 (Face p. 740) No. 13

fronting any business functioning in a private enterprise economy. That is, the office must be able to extend its services to a group that is sufficiently large to provide a volume of business that will cover costs and yield a satisfactory profit. On this criterion, the evidence suggests that commercial banking facilities have for some time been extended into all regions or localities of the district where profitable operation is a reasonable possibility. The way is always open for enterprising individuals or groups to apply for new bank charters, or to open new banking offices, where there appears to be room for the successful operation of additional banks. There have been very few requests for new bank charters in this district over the past two decades. Banking offices have been opened as branches of existing banks, however, in a number of instances where the shift or growth of population opened up new opportunities for profitable banking services. By and large, it has been our observation that the elemental stimulus of the enterprise system—seeking out opportunities for extending services wherever there is an opportunity to function at a profit—has assured the provision of economically adequate banking facilities in this district. For New York State, this observation will soon be further tested by a detailed study of the present distribution and adequacy of banking facilities, particularly with a view to the possibility of approving additional branch offices for savings banks, which has recently been inaugurated by the New York State Bankers Association, in cooperation with the Savings Banks Association, at the request of the State Superintendent of Banks.

The statistical data which we have prepared summarizes the distribution of banking offices in the second Federal Reserve district as a whole, including the entire State of New York, the 12 northern counties of New Jersey, and Fairfield County in Connecticut. Within the district there are 868 banks with 1,847 offices. The total number of banks include 850 which are classified as commercial banks, 5 classified as private banks, and 13 industrial banks (only industrial banks in New York State are included; the 3 industrial banks in the segment of Connecticut included within the second district have not been listed because they are not authorized to accept demand deposits). Among the 1,847 offices of these various banks, there are 5 offices which operate only on a seasonal basis, and 2 which are merely paying or receiving stations. All these banking offices, except the two just mentioned, offer both loan and deposit facilities. Thirteen branch offices located on military reservations have not been included in the total of banking offices because they are not open to the general public. The geographical distribution of these banks and banking offices, in relation to the density of population, will be discussed further below.

While in the aggregate these banking facilities provide an adequate network of both deposit and loan accommodation throughout the district, there are in addition a large number of other financial institutions which also provide loan facilities (and in many cases a specialized type of deposit facility also). No attempt will be made to compare their location within the district with that of commercial banks, primarily because none of them can accept demand deposits. Nonetheless, as repositories for savings, and as sources of loanable funds, these other institutions provide a wide range of financing facilities that are superimposed on the commercial banking structure. The

following table lists a variety of institutions which together maintain nearly 3,000 offices within the second district:

Some financing institutions in the second district, 1951

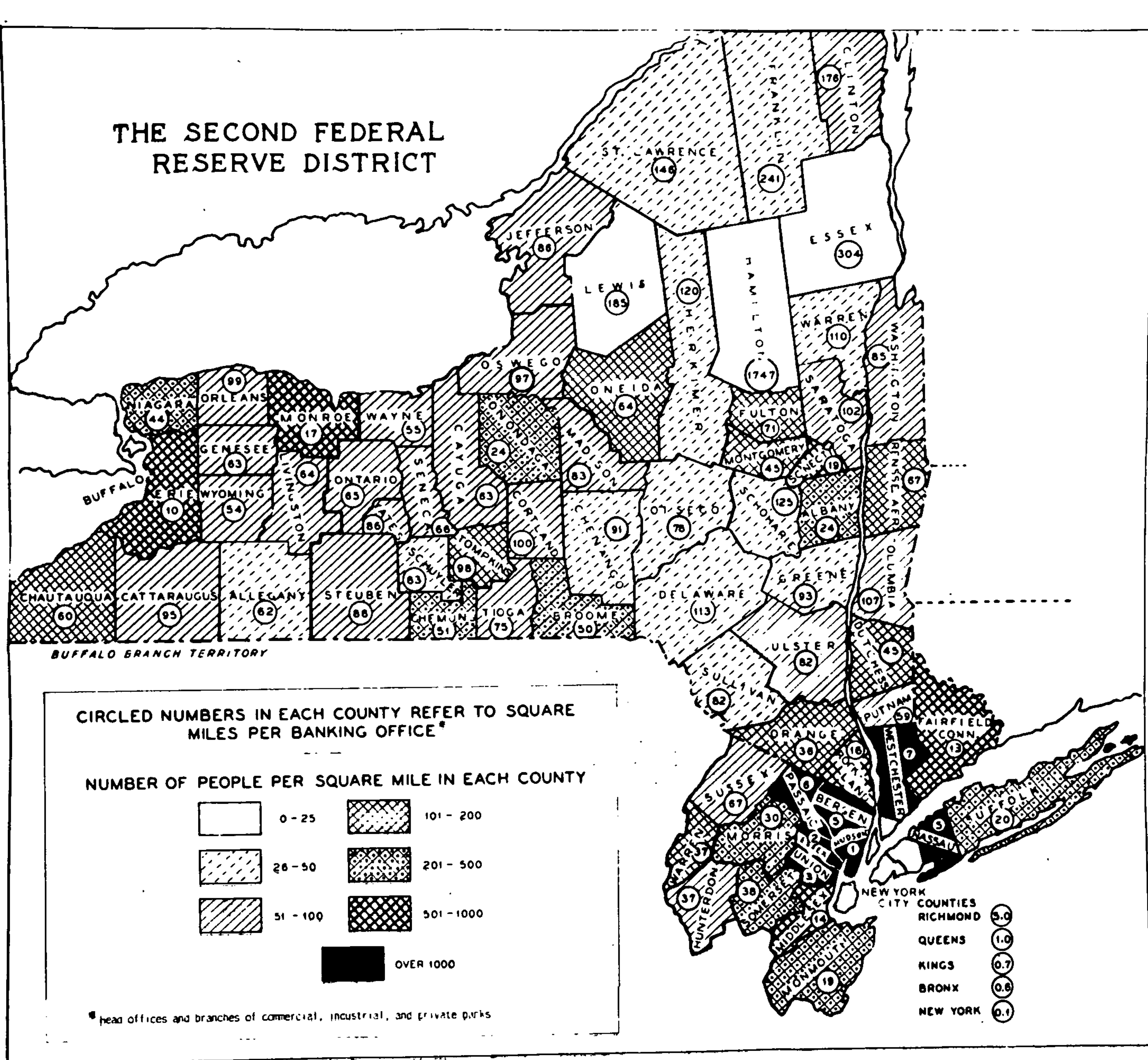
Type of institution	Number of head offices	Number of branches	Total number of offices
Mutual savings banks	165	111	276
Savings and loan associations	544	50	594
Small loan companies	[1] 220	[1] 325	[1] 545
Commercial finance companies [2]	7	305	312
Credit unions	1,086		1,086
Production credit associations	17		17
National farm loan associations	32	24	56
Total	2,071	815	2,886

[1] Approximate number.
[2] New York State only.

In addition, most of the life-insurance companies, some specialized investment companies, several independent factoring concerns, and a number of large manufacturing or sales concerns (who sell on installment terms) conduct active lending operations within the district. Data on the number of actual offices through which these lending activities may be conducted are not available, and, of course, many policy loans from insurance companies are arranged through local insurance brokers whose functions could not be considered those of a loan office.

So far as commercial banking offices are concerned, for the district as a whole there is an average of 1 office for each 28 square miles of territory. The average bank serves 10,300 people within its geographical area. Any such average is, however, merely a statistical convenience; in order to provide a better indication of regional differences within the district, each county has been studied separately. The shading on the accompanying map indicates the differences among counties in population density (measured as the number of people per square mile in each county). A small circle superimposed upon each county indicates the number of square miles per banking office. By and large, although each bank generally serves a much larger area in counties where the population is relatively thin, the actual number of persons served by each bank in such counties is relatively low. Thus, in most of the counties which have no more than 100 persons per square mile, the population per banking office is actually less than the figure cited above as the average for the district as a whole. This simply means that in the thinly settled areas banks serve many fewer people per banking office than are served by banking offices located in the larger metropolitan centers. At the other extreme, while the counties representing the various boroughs of New York City include large numbers of banking offices within a limited area, each of these banking offices serves many more persons than the number indicated as the average for the district as a whole.

Within New York City, the county of New York (borough of Manhattan), has a banking office located on the average within each one-tenth of a square mile, while the counties of the Bronx, Kings, and Queens have banking offices for each 0.6, 0.7, and 1.0 square miles, respectively.


THE SECOND FEDERAL
RESERVE DISTRICT
BUFFALO BRANCH TERRITORY
CIRCLED NUMBERS IN EACH COUNTY REFER TO SQUARE MILES PER BANKING OFFICE*
NUMBER OF PEOPLE PER SQUARE MILE IN EACH COUNTY
0 - 25
26 - 50
51 - 100
101 - 200
201 - 500
501 - 1000
OVER 1000
* head offices and branches of commercial, industrial, and private banks
NEW YORK CITY COUNTIES
RICHMOND 5.0
QUEENS 1.0
KINGS 0.7
BRONX 0.8
NEW YORK 0.1

these counties is naturally low and ranges from one bank for each 304 square miles of territory to one bank in each 146 square miles. The remaining sparsely inhabited counties are those lying outside the large concentrations of population previously mentioned. Among these counties there are eight in which there is one bank for each 100 to 125 square miles, 15 counties where there is one bank for each 75 to 99 square miles, and 14 counties in which the average area per bank is 51 to 74 square miles. Further details concerning each county are presented in the following table.

Banking offices in relation to nature of economic activity, population, and area, by counties, Second Federal Reserve District

[Banking offices as of October 1951; population, census of 1950]

County	Nature of county	Total of banking offices	Population per office	Population per square mile	Average square miles served by each office
NEW YORK STATE					
Albany	Mixed industrial, governmental, and agricultural.	22	10,881	451	24
Alleghany	Agricultural, oil industry	17	2,576	42	62
Bronx	Residential industrial	66	21,989	35,397	.62
Broome	Industrial, agricultural	14	13,193	260	50
Cattaraugus	Agricultural, oil industry	14	5,564	58	95
Cayuga	Agricultural, fruit farming	11	6,376	100	63
Chautauqua	Agricultural	18	7,510	125	60
Chemung	Industrial, farming	8	10,853	211	51
Chenango	Medical and knit goods	10	3,914	43	91
Clinton	Fruit farming	6	8,937	51	176
Columbia	Agricultural	6	7,197	67	107
Cortland	do	5	7,432	74	100
Delaware	Dairy and agricultural	13	3,417	30	113
Dutchess	Agricultural	18	7,599	168	45
Erie	Industrial	104	8,647	853	10
Essex	Resort, agricultural	6	5,848	19	304
Franklin	do	7	6,404	27	241
Fulton	Glove industry	7	7,289	103	71
Genesee	Agricultural	8	5,948	95	63
Greene	Resort and agricultural	7	4,106	44	93
Hamilton	Forestry	1	4,105	2	1,747
Herkimer	Resort, wood products	12	5,117	43	120
Jefferson	Resort, mining	15	5,701	66	86
Kings	Residential, industrial	108	25,353	38,566	.65
Lewis	Mining	7	3,217	17	185
Livingston	Agricultural	10	4,026	63	64
Madison	Dairy farming, silverware	8	5,777	70	83
Monroe	Industrial	40	12,191	725	17
Montgomery	Agricultural	9	6,622	146	45
Nassau	Residential, industrial	63	10,679	2,243	5
New York	Financial, industrial	288	6,806	89,096	.07
Niagara	Fruit farming, industrial	12	15,833	356	44
Oneida	Copper and knit goods, dairy farming	19	11,729	182	64
Onondaga	Industrial	33	10,355	431	24
Ontario	Fruit farming	10	6,017	93	65
Orange	Agricultural	23	6,620	184	36
Orleans	do	4	7,458	75	99
Oswego	do	10	7,718	80	97
Otsego	do	13	3,905	50	78
Putnam	Fruit and dairy	4	5,077	86	59
Queens	Residential	87	17,826	14,360	1
Rensselaer	Industrial	10	13,261	199	67
Richmond	Residential, industrial	12	15,963	3,361	5
Rockland	Residential, agricultural	11	8,116	502	16
St. Lawrence	Mining, fruit, dairy farming	19	5,205	36	146
Saratoga	Resort and agricultural	8	9,359	92	102
Schenectady	Locomotives and electrical industries	11	12,991	684	19
Schoharie	Agricultural	5	4,541	36	125
Schuyler	do	4	3,546	43	83
Seneca	Fruit farming	5	5,851	89	66
Steuben	Glassware, agricultural	16	5,715	64	88
Suffolk	Agricultural	46	6,003	299	20
Sullivan	Resort	12	3,394	41	82
Tioga	Dairy	7	4,309	57	75
Tompkins	Industrial, dairy	5	11,824	120	98

In the semicircle of counties immediately around New York City and in Richmond County, which is part of the city proper, the density of the population in each county is in excess of 1,000 persons per square mile and the available banking facilities are correspondingly numerous. Among these counties, Hudson County, N. J., which embraces Jersey City, has a population density of 10,800 per square mile and the banking offices are spaced on the average at one to the square mile. In Essex County, N. J., which includes Newark, the third largest city in the district, the population density is 6,900 to the square mile and banking offices average one to every 2 square miles. Union County, N. J., which includes the city of Elizabeth, has a population density of 3,800 per square mile and its banking offices each serve an area of 3 square miles. In five other counties—Richmond County (Staten Island), Nassau and Westchester Counties in New York State, and Bergen and Passaic Counties in New Jersey—the population density ranges from 1,400 to 3,400 people per square mile and the banking facilities are spaced at one for each 5 to 7 square miles.

In up-State New York and in the Connecticut portion of the second district there are 5 cities with a population in excess of 100,000, namely, Buffalo, Rochester, Syracuse, Bridgeport, and Albany. Erie County, in which Buffalo, the second largest city in the district, is situated, has an over-all population density of 850 persons to the square mile. It contains 104 banking offices or branches, on the average, one for each 10 square miles of territory. Monroe County includes the city of Rochester. It has a population density of 725 persons per square mile and is served by 40 banking offices, 1 for each 17 square miles. Onondaga County includes the city of Syracuse and has a population density of 430 people to the square mile. It contains 33 banking offices or 1 for each 24 square miles. Albany County, with 450 people per square mile, is largely similar to Onondaga County in population density, and the coverage of banking facilities, 1 for each 24 square miles, is exactly the same. Fairfield County, Conn., has the city of Bridgeport within its boundaries and it is also relatively close to New York, so that it receives a certain amount of New York's commuter population. It has a population density of 800 persons per square mile and contains 48 banking offices, one for each 13 square miles of territory.

There are four additional counties with a relatively dense population that are about as far removed from New York City as Fairfield County. They are Middlesex and Monmouth Counties in New Jersey, and Suffolk and Rockland Counties in New York. The incidence of banking facilities in these counties ranges from one office for each 14 square miles to one office for each 20 square miles.

Among the sparsely inhabited counties of the district, Hamilton County in the heart of the Adirondack Forest Preserve is outstanding with but one commercial bank for the entire area of 1,747 square miles. Relative to the population, however, Hamilton County with only 4,050 all-year residents, may be considered a sufficiently "banked" county. The other northerly counties, namely, Essex, Franklin, Lewis, Clinton, St. Lawrence, and the northerly part of Herkimer County, are all either part of the Adirondack Preserve or are devoted mainly to resort areas and agriculture. The incidence of banking facilities in

Banking offices in relation to nature of economic activity, population, and area, by counties, Second Federal Reserve District—Continued

[Banking offices as of October 1951; population, census of 1950]

County	Nature of county	Total of banking offices	Population per office	Population per square mile	Average square miles served by each office
Ulster	Resort	14	6,616	81	82
Warren	Resort and agricultural	8	4,901	44	110
Washington	do	8	5,893	56	105
Wayne	Fruit farming	11	5,211	94	55
Westchester	Residential	65	9,628	1,439	7
Wyoming	Agricultural	11	2,984	55	54
Yates	Fruit farming	4	4,404	51	86
CONNECTICUT					
Fairfield	Mixed industrial, residential	48	10,476	797	13
NEW JERSEY					
Bergen	Residential, shopping	52	10,314	2,171	5
Essex	Industrial	80	11,261	6,930	2
Hudson	do	60	10,769	10,769	1
Hunterdon	Agricultural	12	3,557	97	37
Middlesex	Mixed industrial and farming	23	11,507	817	14
Monmouth	Resort, agricultural	29	7,700	415	19
Morris	Agricultural	16	10,288	343	30
Passaic	Mixed industrial and residential	32	10,541	1,704	6
Somerset	Agricultural	8	12,342	324	38
Sussex	Dairy farming	8	4,289	64	67
Union	Industrial	34	11,693	3,786	3
Warren	Dairy farming	10	5,441	149	37

The detailed analysis of data concerning banking offices located within each county still tends to conceal, however, instances in which particular communities may only be served by a single bank, or perhaps in some instances may not contain any banking offices. There are, of course, many smaller communities in which, by force of economic circumstances, no more than one bank can be supported. Competition is generally provided, however, through the operations of other banks in nearby communities, as well as through other lending institutions or agencies. To illustrate the way in which nearby banking facilities may supplement those available within a given community, an additional study has been made. The following table lists all municipalities within the second Federal Reserve district whose population exceeds 14,000 persons and whose local commercial banking facility is limited to no more than one institution. In every case, as the table also indicates, there are additional commercial banking offices within a relatively short radius. In most of the communities listed, there are also offices of savings and loan associations or savings banks—in some instances several such offices exist in the same community. However, the details presented in the table relate only to the existence of commercial banking facilities.

Cities of over 14,000 with only 1 commercial bank office, Second Federal Reserve District, 1951

Location	County	Population	Commercial banks in nearby cities	Approximate distance in miles
NEW YORK STATE				
Floral Park	Nassau	14,535	New Hyde Park (1)	1½
			Franklin Square (1)	2
			Garden City (1)	3
Garden City	do	14,364	Floral Park (1)	3
			Franklin Squate (1)	3
			New Hyde Park (1)	3
			Hempstead (2)	2
			Mineola (3)	2
			West Hempstead (1)	2
Valley Stream	do	26,833	Lynbrook (2)	2
			Malverne (1)	3
			Woodmere (1)	3
			Springfield Gardens (1)	2
Hornell	Steuben	15,649	Canisteo (1)	5
			Arkport (1)	5
Johnson City	Broome	18,039	Binghamton (4)	4
			Endicott (3)	4
North Tonawanda	Niagara	24,730	Tonawanda (2)	1
Ogdensburg	St. Lawrence	16,126	Heuvelton (1)	7
			Lisbon (1)	8
Oswego	Oswego	22,611	Fulton (1)	12
Watervliet	Albany	15,036	Troy (3)	1
NEW JERSEY				
Bergenfield Borough	Bergen	17,611	Tenafly (2)	2
			Englewood (2)	3
			Teaneck (2)	4
			Dumont (1)	1
Cliffside Park Borough	do	17,123	Edgewater (2)	1
			Fort Lee (2)	2
			Ridgefield (1)	1
East Paterson	do	15,391	Paterson (6)	2
			Garfield (2)	3
			Fair Lawn (1)	1
Fair Lawn	do	28,865	Glen Rock (1)	2
			Hawthorne (1)	4
			Paterson (6)	3
North Arlington Borough	do	15,977	Belleville (2)	2
			Kearny (2)	3
			Newark (9)	5
Hawthorne	Passaic	14,828	Paterson (6)	2
			Glen Rock (1)	2
			Prospect Park (1)	2
			Wyckoff (1)	4
			Ridgewood (2)	4
Linden	Union	30,434	Rahway (1)	3
			Cranford (2)	4
			Roselle (1)	2
			Elizabeth (4)	4
			Carteret (2)	4
Rahway	do	21,287	Linden (1)	3
			Carteret (2)	4
			Woodbridge (1)	3
Roselle Borough	do	17,646	Linden (1)	2
			Cranford (2)	2
			Roselle Park (1)	1
			Elizabeth (4)	2
West Orange	Essex	28,624	Orange (4)	2
			Montclair (2)	5
			Livingston (1)	4
			South Orange (2)	3
			Maplewood (1)	4
			Verona (1)	3

Answer for the Third Federal Reserve District (Alfred H. Williams, Philadelphia)

Banking facilities in the third Federal Reserve district appear to be adequate both from the standpoint of depositors and borrowers. There are 839 commercial banks and 10 mutual savings banks in the district doing both a deposit and loan business. The commercial banks are

distributed throughout the district so that banking facilities are within a convenient distance of all residents, except possibly for a few living in isolated mountain areas where population and wealth are insufficient to support a bank within a radius of a few miles. In addition, most people have an opportunity to choose either among two or more banks in the same town or among towns and villages each with one bank in their general area which are readily accessible with modern transportation facilities. In fact, excess banking facilities, in the sense of insufficient wealth in the community to provide all of the existing banks with the minimum resources necessary for strong, efficiently operated institutions, are probably a greater problem in the third district than inadequate banking facilities.

Banks in relation to population.—One index of the adequacy of banking facilities is the number of banks in relation to the population—their potential customers. This relationship in the third district is shown in chart I.

Of the 60 counties in the district, 15 or one-fourth have a banking office for each 4,000 or less population. These 15 counties, 12 in Pennsylvania, 2 in Delaware, and 1 in southeastern New Jersey, are mainly agricultural, some of them also having diversified manufacturing, mostly small scale. Most of these counties are sparsely populated as compared to the density of population for the district as a whole and have a number of small villages with only one bank.

The largest number of counties, 27 or nearly one-half, fall in the classification of one banking office for each 4,000 to 7,000 population. Typically, these counties are agricultural, diversified manufacturing, or coal mining areas with few, if any, large cities. However, in general, they are more densely populated than the counties with a banking office for each 4,000 population or less.

There are 12 counties with a banking office for each 7,000 to 10,000 people. Four of these counties are in the soft coal region of Pennsylvania, two are in the heart of the anthracite region, each with a medium-size city; five are close to the metropolitan area of Philadelphia, and one is in the heart of the resort area along the New Jersey coast.

Six of the counties have a banking office for each 10,000 population or over. These are densely populated industrial areas so that the large number of people per banking office does not indicate any lack of adequate banking facilities conveniently available.

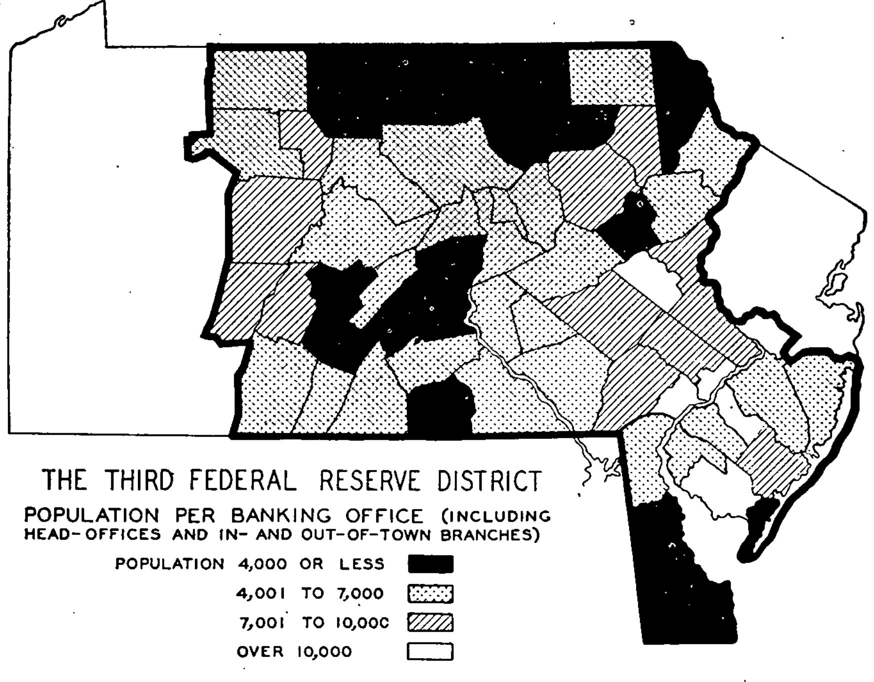
Geographical distribution of banks.—Another requirement of adequate banking facilities is that the banks be distributed so that residents of the district have convenient access to a banking office. The distribution of the banks in the third district is shown in chart II, the open circle representing a single bank or branch office and the solid dot representing towns with two or more banks.

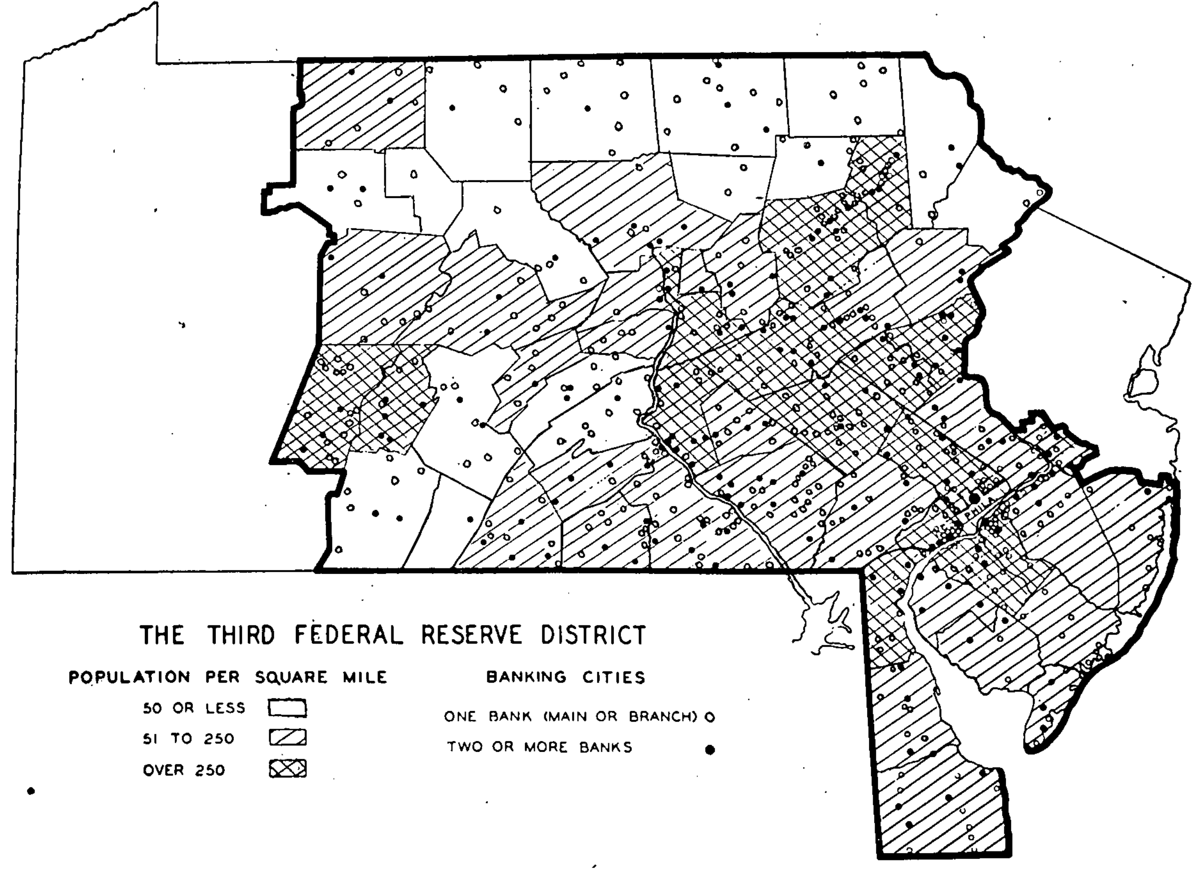
The average number of banking offices per county is 17. There are 25 counties with 10 or fewer banking offices, and 1 county, Philadelphia, has 127 banking offices.

It is clear from the chart that the banks tend to be concentrated in the densely populated areas. There is, however, a good distribution of banks in the sparsely populated counties except for a few in the most rugged mountain regions. In these counties there are relatively large areas without a bank, but the primary reasons are inadequate resources and population to support one.

Additional lending facilities.—Other lending agencies, such as savings and loan associations, insurance companies, production credit associations, mortgage companies, finance companies, and credit unions, supplement the credit facilities of the commercial and mutual savings banks. Savings and loan associations, insurance companies, and mortgage companies are very active in the real-estate loan field; especially residential mortgages. The production credit associations supply a substantial amount of short-term credit to farmers. Personal and sales finance companies and credit unions specialize in credit to the consumer, either directly or through the purchase of consumer credit paper from stores and dealers as in the case of sales finance companies.

Data are not available on the number and the distribution of these various lending agencies in the third district. However, they are numerous, and one or more of these institutions supplement the credit facilities of the banks in nearly every community. They not only enlarge the total credit facilities available but also provide competing sources of funds. In view of the wide distribution of these institutions, as well as commercial banks, there are probably very few, if any, residents of the district who do not have access to more than one lending institution.




THE THIRD FEDERAL RESERVE DISTRICT
POPULATION PER SQUARE MILE
50 OR LESS
51 TO 250
OVER 250
BANKING CITIES
ONE BANK (MAIN OR BRANCH)
TWO OR MORE BANKS
PHILA.

Answer for the Fourth Federal Reserve District (Ray M. Gidney, Cleveland)

The accompanying maps (exhibits A, B, and C) indicate that banking facilities are within convenient reach of virtually all persons and business firms throughout the fourth district, and that, except perhaps in the most sparsely populated areas, ample opportunity exists for depositors and borrowers to divert their patronage from one bank or lender to another in response to competitive conditions.

Exhibit A shows the approximate location of each of the 1,440 banks and branch offices in the fourth Federal Reserve district. The map shows that the offices are more thickly located in the heavily populated areas than in the less heavily populated areas but that they are well distributed throughout the district and that the distances between banking offices are not excessive, particularly when consideration is given to the quality of our modern transportation facilities, to the character of our highway system, and to the widespread ownership of automobiles.

Location alone of banking offices is not a sufficient measure of adequacy of those facilities. The most important question is whether the number of offices, the resources, and the variety of services available are sufficient to facilitate the commerce, industry, and agriculture of the community and to finance the reasonable growth and development of the community and its business. We have not developed data on the volume of business and incomes of different communities but, instead, have used density of population as our measure, and have related banking facilities to population. Exhibit B shows how the banks compare with population in each county. Viewed on this basis, certain general observations can be made.

1. Banking offices and banking resources tend to concentrate in densely populated centers with a large volume of business. In the fourth district these centers include such cities as Cleveland, Cincinnati, Pittsburgh, Toledo, Dayton, Columbus, and Youngstown. These places can be located on the map by the clusters of dots. The fact that some of the dots are small is without significance; they have been made small in an effort to get them crowded into a small space.
2. Because of the density of population in the larger centers, the number of persons per banking office tends to be greater than in the rural areas. This does not indicate less adequate facilities in the cities; rather it reflects the fact that the facilities tend to become larger and provide more varied services to their local clientele.
3. In the rural areas the banking offices tend to be pretty well distributed geographically so that distances between offices are not excessive.

Urban centers.—In most of the 22 counties of the fourth district with population of more than 100,000, there is one banking office for each 10,000 to 20,000 population. In five of the centers the ratio is one banking office for each 6,000 to 10,000 population. The largest in this latter group is Hamilton County (Cincinnati) with 83 banking facilities for 725,000 persons.

The densely populated urban areas, because of the concentration of people, have more and generally larger banking offices for a given unit

of area but fewer offices per unit of population than do the less heavily populated rural areas.

The banks in the larger centers tend to be larger, are generally able to provide directly a more diversified service, and can also make larger loans, thus serving the needs of larger business firms than can many of the smaller banks. Furthermore, by acting as correspondent banks the larger city banks enable the smaller rural or country banks, in turn, to provide their local communities with a wider variety of services than would be possible if the smaller rural banks tried to do it all themselves. Thus, both in the large cities and in the rural areas mere numbers, size, and location are not a sufficient test of adequacy. Rather, the whole range of banking practices and of interbank relationships must be considered. In my opinion, those who have a need and use for banking facilities in the fourth district have reasonably satisfactory access to adequate facilities.

Areas with the most numerous banking offices in proportion to population.—In nearly one-fourth (39) of the counties of the fourth district, there is one banking office for each 4,000 population or less. These counties are shaded black on the map (exhibit B). Most of the 39 counties are located in western Ohio and northern Kentucky, where almost without exception, the major economic activity is agriculture. In those areas the population is prosperous, relatively evenly dispersed throughout the counties, and not concentrated in large urban communities.

The largest of the 39 counties is Wayne County in Ohio, with a population of 59,000. There are 15 banks in the county, in 12 different municipalities, which means that banking facilities are within easy reach of nearly every part of the county. Most of the 15 banks have total assets of less than $4,000,000 each, and therefore, do not provide, in themselves, the wide range of services normally associated with banking offices in large metropolitan centers. Throughout this analysis, however, it should be remembered that in the broad sense banking facilities are not necessarily a function of size or architecture.

In the Pennsylvania portion of the fourth district, the largest county with a large number of banking offices in proportion to the population is Clarion with a population of 38,000, also predominantly rural. The county has 11 banking offices, located in 9 municipalities. Here, too, the offices are well distributed throughout the county.

In Kentucky (fourth district portion) there are 15 counties in which the population is less than 4,000 per banking office. The largest is Lincoln, with a population of less than 19,000 but with six banking facilities divided among four different communities.

It might be added that the median county (of the 39 well-covered counties) is Harrison County, Ohio, with a population of 19,000 and six independent banks located in six different towns or villages.

Presumably only a favorable combination of circumstances will warrant, or permit, such a relative abundance of banking facilities as exist in the rural areas described above. These circumstances include prosperous business and high agricultural incomes, well distributed.

Areas with the fewest banking offices in proportion to population.—In contrast to the foregoing well-covered counties, there are 10 counties in the fourth district each of which contains only one banking

office per 20,000 persons (or more). These 10 counties do not possess a common economic characteristic.

Menifee County (almost in center of fourth district, Kentucky), with a population of 4,800, has had no bank since 1933. Because of mountainous topography, farming is on only a limited scale, and there is practically no industry in that section of the State.

Far more populous are five counties in southeastern Kentucky which also contain relatively few banking offices. The largest of this group is Pike County with a population of over 80,000, but with only three banking offices. Another is Harlan County with the same number of facilities for some 70,000 persons. It is believed that the character of the economic resources and the relatively low economic income per capita in these counties, from poor farm land and from mining, are partly responsible for the scarcity of banking facilities. The existence of many mining-company commissaries is also a factor.

Two counties at the southern tip of Ohio (Scioto and Lawrence) likewise have a very small number of banking offices in relation to population. The former with a population of over 80,000 has only four banking offices, three of which are located in the county seat of Portsmouth. Lawrence with a count of 49,000 has only two offices, both in Ironton. In both instances, it may be explained that the respective county seats are the only areas of appreciable industrial activity in those counties and that the hinterland consists of sparsely populated and rugged terrain.

Another below-average area is Lake County in northeastern Ohio, which has a population of around 75,000, served by only three banking offices. The relative scarcity of banking facilities in such a built-up area can be explained in part by the fact that the population has grown rapidly in only recent years, as a consequence of the expansion of the Cleveland metropolitan area, without a corresponding increase in number of banking offices. There has been some discussion among local interests looking to the establishment of additional facilities in the county.

Summit County is the largest of the counties, with relatively few banking offices in proportion to population. This reflects, in considerable part, the density of population of the city of Akron itself, for the balance of the county seems to be in line with many other similar areas. Akron has a population of more than 300,000 and six banking offices with total resources of more than $300 million. The remainder of the county is predominantly rural and its 100,000 people appear to be well served by the six banking offices located in six communities of the county.

LENDING FACILITIES

The incidence of banking facilities is determined not only by the potential volume of deposits that may be available but also by the number and character of competitive lending institutions present in any respective area, such as building and loan associations, credit unions, finance companies, mortgage companies, insurance company lending offices or agencies, production credit associations, and national farm-loan associations. The relation to population of all such lending agencies, including banks, in each county is shown in exhibit C. The count of lending agencies, other than banks and savings and loan

associations, used in this report is based largely on registrations under regulations W and X.

Large metropolitan centers.—The number of lending agencies in the metropolitan centers of the fourth district is large, competition is keen, and there does not appear to be a shortage of facilities for those who can qualify for their use. Under ordinary circumstances the chief qualification for use of the facilities is demonstration of ability and intention to repay. We are informed that, currently, lenders are denying loans to applicants in many instances because the purposes of the loans do not meet the tests of the voluntary credit restraint program discussed in the answer to question 25. Such a rejection is not a reflection of an absence of lending facilities but of inability of the applicant to meet the tests of credit worthiness now being employed.

Counties with a large number of lending agencies in relation to population.—In nearly one-third of the fourth district counties, there is one lending agency (bank or other) for each 3,000 of population (or less). These areas are roughly coterminous with those containing a relatively large number of banks, that is, they are predominantly rural in character. (Compare exhibits B and C.)

As in the case of banks, most of the counties with the greatest number of lending facilities in relation to population are predominantly agricultural. Two of the largest such counties are Wayne and Wood (both in Ohio). Each county has a population of nearly 60,000 and is served by 20 lending agencies, or 1 for each 3,000 persons. Nearly 40 percent of all Ohio counties have almost that many lending institutions and lending agencies in proportion to their population. The northwestern portion of fourth district Kentucky also is relatively well supplied with lending facilities.

Counties with a relatively small number of lending agencies per unit of population.—In contrast to northern Kentucky, the southeastern portion of that State represents the largest single area of relative sparsity, which for the most part is attributable to the economic situation in that area and the resulting comparatively low per capita income.

Ohio also contains 7 counties in which there is only 1 (or less) lending agency for each 7,000 population. The same seven counties also ranked low in banking density. The relatively small number of banking offices in those seven has not been offset by a corresponding abundance of other lenders, which suggests the presence of some economic factors that may be hindering the proliferation of lending facilities. In fact, in both exhibits B and C, the incidence of the various shaded areas does not occur at random (which would be the case if banking density were a function of personal economic power in each locality) but follows a clearly perceptible pattern, reflecting above all else levels of income and the type of agricultural, industrial, trading, or mining activity carried on within each single or multicounty section.

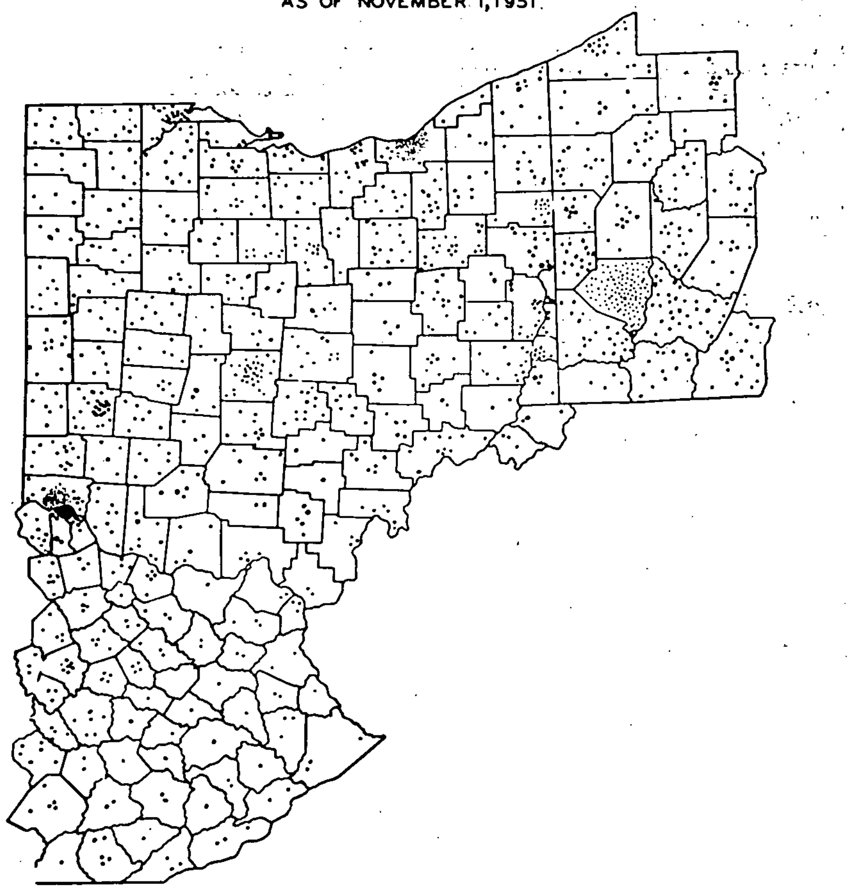
This relationship is similar to that shown to exist between the economy of the community and the presence of business opportunities as well as the availability of capital and credit therefor, indicated in the answer to question 35.

Answer for the Fifth Federal Reserve District (Hugh Leach, Richmond)

The fifth Federal Reserve district, comprised of Maryland, District of Columbia, Virginia, West Virginia (excluding the six-county pan-

LOCATION OF BANKING OFFICES—FOURTH FEDERAL RESERVE DISTRICT

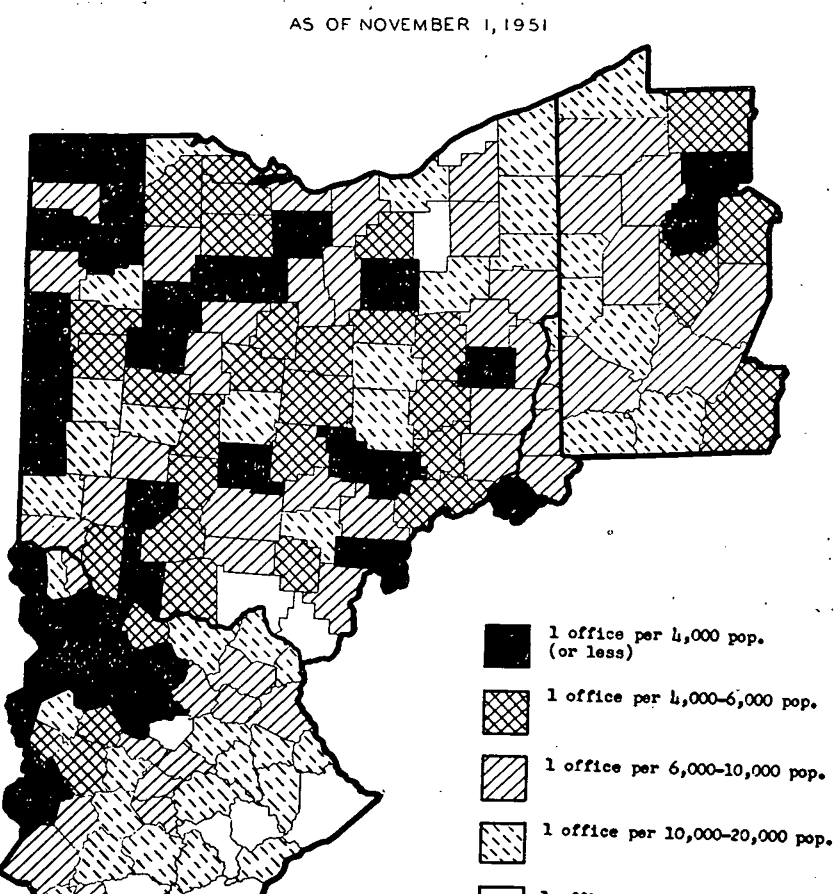
AS OF NOVEMBER 1, 1951



handle), and North and South Carolina, has 7.9 percent of the banks and branches in the United States, 5 percent of the land area of the continental United States, 9.6 percent of the population, and 7.7 percent of the Nation's income payments to individuals (1950). The average density of population per square mile in the fifth district is 96.4 as compared to 50.6 for the Nation. The relatively high figure for the district is in large part a consequence of the large population concentrations in three metropolitan areas: Baltimore, the District of Columbia, and Hampton Roads. These three areas account for almost one-fourth of the total population of the fifth district.

Almost one-fourth of the 319 counties in the district, arbitrarily counting the District of Columbia as a county, have one banking office for each 5,000 persons or less. This is a low ratio when compared with 13,567 for the city of Baltimore, 9,596 for the city of Richmond, and 8,378 for the city of Charlotte. The national average is, incidentally, just over 7,000.

Four out of five counties in the fifth district have two or more banks and branches. In 62 percent of the counties there is one banking office



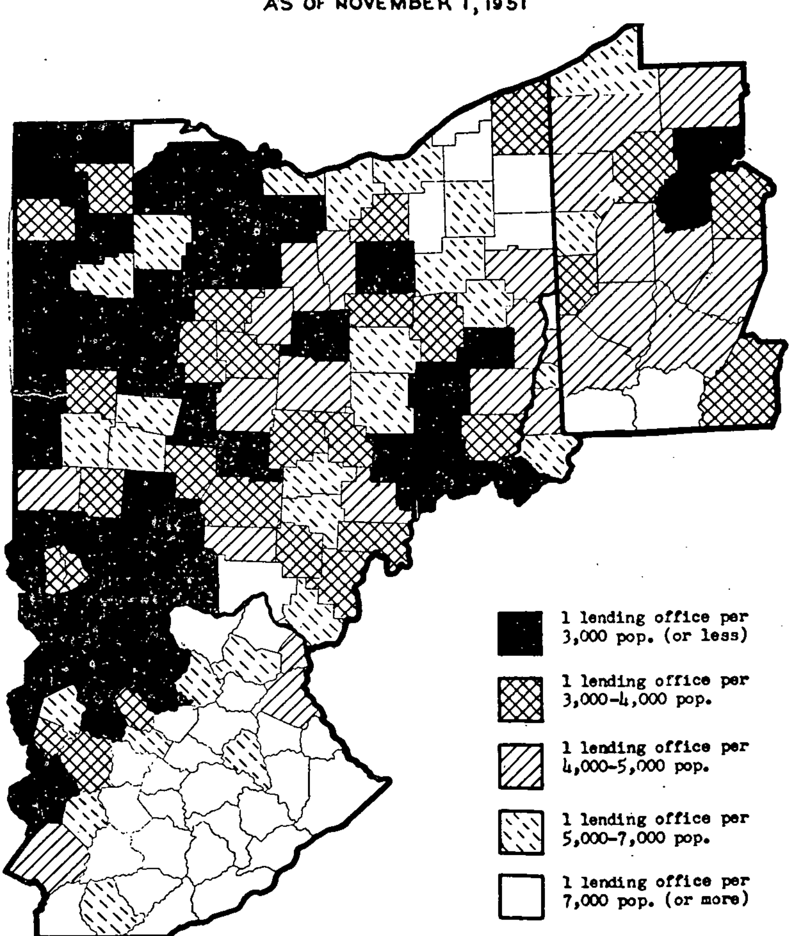
for each 10,000 population or less. Thirty-one percent of the counties have a ratio of population to number of banks and branches between 10,000 and 20,000, the majority of which are found in North and South Carolina. Only 16 counties in the entire district have only one banking office per 20,000 population or more and only 5 counties out of the total of 319 have no banks.

It would appear that, as indicated on the accompanying maps, banking facilities are adequately distributed throughout most of the district to meet the needs of individuals and business enterprises. Similarly, there is throughout most of the five-State district reasonable opportunity for depositors and borrowers to choose between two or more banks.

In some instances misleading impressions may arise from the presentation of data by county. Frequently people living in counties with high ratios of population to banking offices have access to banking facilities across county lines. This is particularly true when we con-

LENDING ENTERPRISES AND AGENCIES IN FOURTH DISTRICT*

AS OF NOVEMBER 1, 1951



* Including banks, savings and loan associations, credit unions, finance companies, mortgage companies, insurance companies, Production Credit Associations, and National Farm Loan Associations.

sider contiguous counties comprising an area of homogenous economic characteristics.

Less than 2 percent of the counties embraced in the fifth Federal Reserve district are "no bank" counties—New Kent, Charles City, King and Queen, and Cumberland Counties in Virginia, and Camden County, North Carolina. Despite the absence of within-county banking facilities, analysis of these counties indicates that competing facilities are reasonably convenient (for the purpose of this memorandum, facilities within 20 miles are regarded as reasonably convenient) across county lines to depositors and borrowers throughout each of the five counties. Supporting this conclusion are the following characteristics common to all five counties: (1) sparse population; (2) no urban

areas; (3) virtually no manufacturing activity; (4) low per capita income; (5) "shoe-string" shape (maximum width 12 miles); and (6) reasonable proximity to competing banking facilities in adjoining counties.

There are 54 one-bank counties in the fifth district, but only 13 of them do not have competing banking facilities within reasonably convenient reach of all parts of the counties. These counties are Floyd in Virginia; Calhoun, Morgan, Pendleton, and Webster in West Virginia; Allegheny, Currituck, Dare, Graham, Pender, Tyrrell, and Washington in North Carolina; and McCormick in South Carolina.

In every one of the 13 counties there is a low density of population per square mile (average, 26.2; range, 12.7–39.2), and every one of the counties has a relatively low ratio of population to banking offices (average, 9,997; range, 5,048–18,423). In the majority of these cases it is extremely doubtful that the sparse population and slender economic resources could support the additional banking facilities necessary to put all portions of the counties within convenient reach of more than one banking office. Only relatively small areas within each county are without reasonably convenient competing banking facilities, and in two cases the deficiency is corrected by crossing State lines. Manufacturing activity is nil or insignificant in every county; the average number of census-classified manufacturing establishments for the group is 12, with a range from 2 to 25.

There are in the fifth district only 16 counties (5 percent of the total) with ratios of population to banking offices of 20,000 or over. In most of these cases, however, banking facilities appear reasonably adequate and individuals and businesses do have access to competing banks. The basic factors considered in arriving at this conclusion were availability of banking facilities in adjacent counties, economic environment, urban concentrations, and supplementary bank-type services such as those provided by large coal companies.

Three of these counties—Buchanan, in Virginia; Logan, in West Virginia; and Henderson, in North Carolina—do not appear to provide individuals and businesses with a choice between two or more competing banks. Based on population alone, Logan County, in West Virginia, with one bank and a population of 77,000, does not appear to have adequate banking facilities. Yet rugged topography, scattered population, and coal-mining emphasis, with company stores and credit, seem to give a reasonably common-sense answer to the possible query as to why there are no more banks.

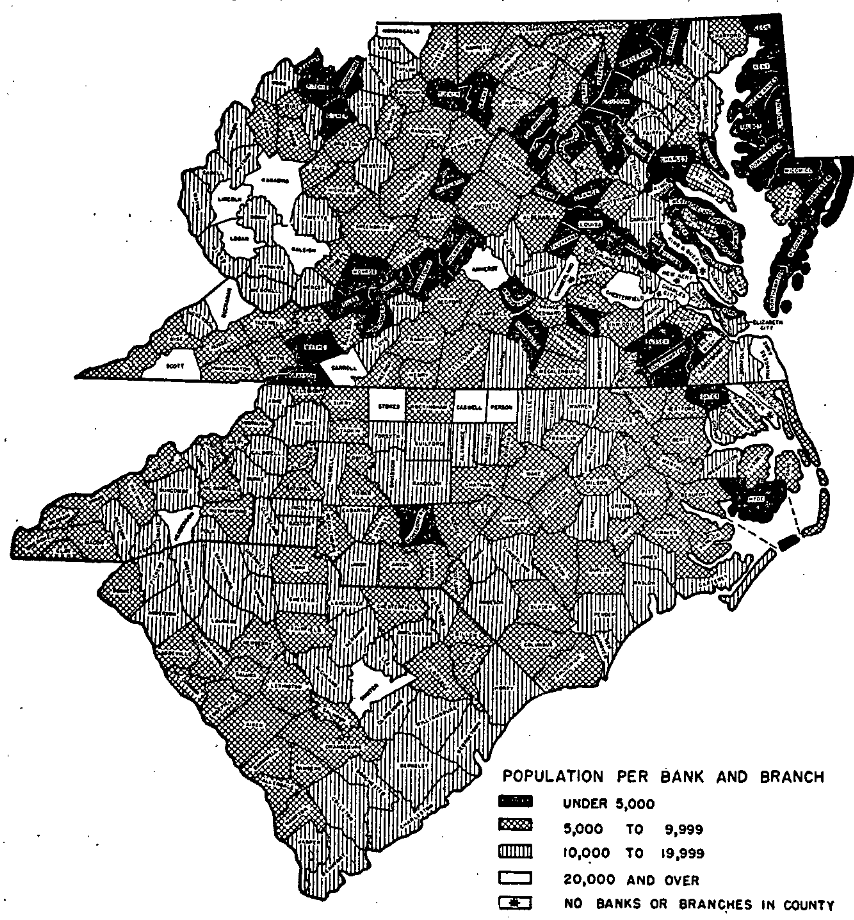
Note on deposit-lending facilities.—The appended map showing location of fifth district banks includes 23 depositories in South Carolina. These depositories accept demand deposits, but may only make loans to the extent of their surplus or as brokers for individual depositors.

Also included are all tellers' windows licensed as branches. These may or may not make loans, though all accept deposits. As a general rule, they also accept payment on loans and receive credit applications for processing at the head office, so that in effect loan facilities are available at many of these tellers' windows. To our knowledge, there is only one branch in the district which handles loans but does not accept deposits; this branch is included on the map.

Tellers' windows not licensed as branches and deposit facilities at military installations (unless licensed as branches) are not included. Data indicating the number of such facilities and tellers' windows are not available.

FIFTH FEDERAL RESERVE DISTRICT

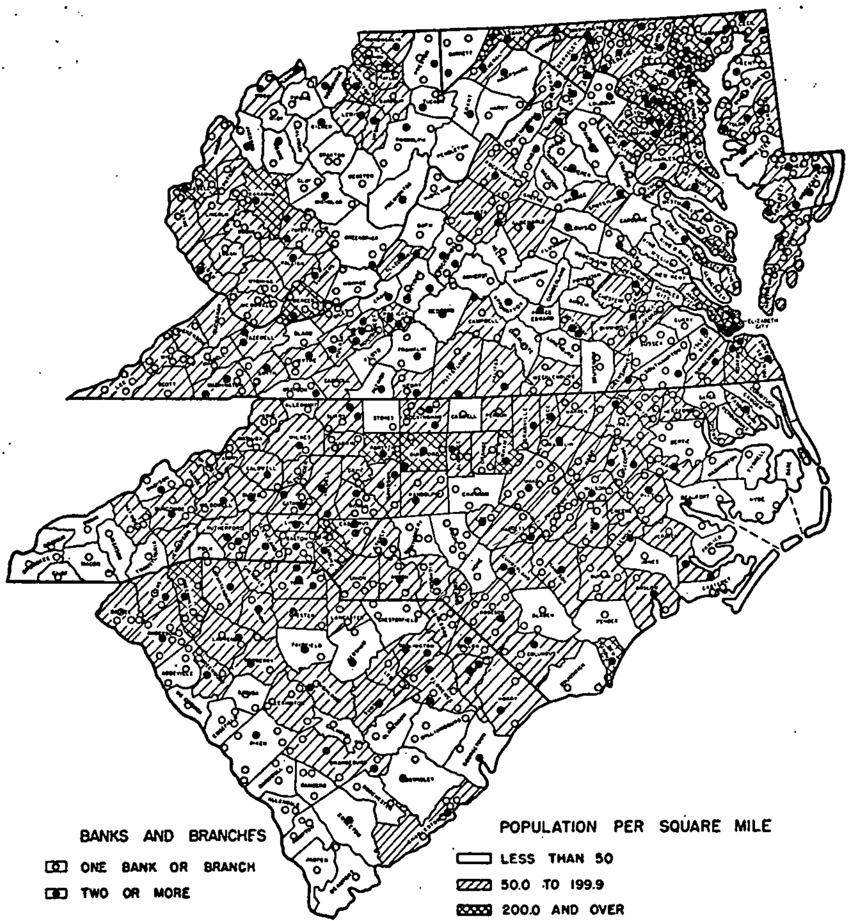
RATIO OF POPULATION TO BANKS AND BRANCHES



Answer for the Sixth Federal Reserve District (Malcolm Bryan, Atlanta):

Judged on the basis of being within the convenient reach of all persons and business firms having need of them, banking facilities appear to be adequate in practically all parts of the sixth Federal Reserve district. Facilities are conveniently available to residents of most rural areas as well as to practically all urban residents. Moreover, in most urban and rural areas there is the opportunity of choosing between two or more competing banks. In addition, other types of lending facilities are available in large numbers.

THE FIFTH FEDERAL RESERVE DISTRICT



Services to rural areas.—In practically all the area now included in the Atlanta Federal Reserve District—Alabama, Florida, Georgia, the southern halves of Louisiana and Mississippi, and the eastern two-thirds of Tennessee—agriculture at one time was the predominant economic activity. As a consequence, population was not concentrated in large urban centers. To meet the needs of the people, the States were subdivided into numerous small counties. In general, the area of each county was such that a resident of any part of the county could go and return from the county seat by horse-drawn transportation and transact his business well within 1 day.

Although many areas of the district are now predominantly urban, and although modern transportation has vastly increased the distance that may be conveniently traveled in order to transact business, the original county boundaries have been retained for the most part. The existence of a bank or banks within a county, therefore, means that for the rural resident banking facilities are as conveniently avail-

able as practicable. Indeed, so small are some of the sixth district counties that the residents of many of them have a choice of several trading and banking centers not only in their own counties, but in adjoining counties as well. The average land area of a sixth district county is 564 square miles. Since this means an area only 23.7 miles square, the existence of banking facilities in the county would mean that the distance to a bank on an average would seldom exceed 12 miles for any rural resident.

Out of the 439 counties included in the Atlanta Federal Reserve District there are only 12, or 2.7 percent, with no banking facilities whatsoever. (Banking facilities include unit banks and branch offices.) In all but 125 counties—28 percent of the total—residents have the opportunity of choosing between two or more banks within the county. In many cases, because of the small size of the county, they have the opportunity of conveniently choosing the services of banks outside the county if they so desire. (See exhibit A., p. 763.)

Each county in Alabama and Tennessee contains at least one banking office. Three counties in Florida have no banking facilities—Glades, Liberty, and Wakulla. Only one of them has a population of over 5,000. None of them contains a city of over 2,500 persons. Per capita retail sales of $550, $557, and $217, respectively, compared with the State average of $853 cast doubt on the possible profitable operations of banks in these counties.

There are no cities of 2,500 or over in the five Georgia counties without banking facilities. Residents of Banks County normally do a great part of their trading in Gainesville nearby. Dade County lies within the Chattanooga, Tenn., trading area. Dawson County residents have ready access to the banks in Dahlonega and Cumming. Oconee County residents are near Athens, Ga., a major trading center. Chattahoochee County is within the Columbus, Ga., trading area, and residents of Quitman County can be served by the banks in Eufaula, Ala., just across the State border. Per capita retail sales range from $75 to $222 in these counties compared with the State average of $615.

In Louisiana, there are no banking offices in Cameron and Plaquemines Parishes. The former is within the Alexandria-Lake Charles trading area, and Plaquemines Parish, near the mouth of the Mississippi, contains no cities of over 2,500, and is ordinarily served both in its trading and banking activities by institutions in the New Orleans area.

The sole county in Mississippi not served by a bank, Issaquena, has 4,958 inhabitants, and per capita retail sales of $132 compared with $440 for that part of Mississippi within the sixth district. It contains no city of over 2,500 persons.

Services to urban areas.—In approximately 94 cases out of 100, residents of sixth district cities with populations of 2,500 or over have banking facilities within their own city. In 56 cases out of every 100 they may choose between the services of competing banks. As indicated in table 1, the likelihood of such choice increases with the size of the city. Oak Ridge, Tenn., is the one city of over 25,000 population with only one banking office and this is a special case.

No cities of 10,000 population or over have no banking facilities whatsoever. Eleven of the twenty cities of 2,500 to 5,000 population with no banking facilities are located within major metropolitan areas

where competing banking facilities are available. The remaining cities of this size with only one bank are for the most part suburbs of other cities. Both of the cities of 5,000 to 10,000 population without banks are within a major metropolitan area.

Banking facilities in relation to population.—Because banks are privately owned businesses, operating for a profit, private enterprise will not knowingly open a bank unless it believes the community is economically capable of supporting it. More banks in the community than can be profitably supported can lead to bank failures and losses not only to owners but to the public as well. Such a condition existed prior to and during World War I, and it was a large factor in the cause of a large number of bank failures during the twenties.

One factor, although not the only one, that is considered in determining the practicability of establishing a bank is the size of the population that might be served. As a general rule, a bank may provide a more complete range of services to its customers when it is serving a population sufficiently large to compensate for the services it renders than when the population is small.

Exhibit B., page 764, shows the variation in ratios of population to banks by counties. In preparing the map, data for counties with no banking offices were combined with neighboring counties where banking transactions would normally be carried on.

Exhibit B shows that the population served by many of the banks is relatively small, particularly in the rural areas. The addition of more banks, therefore, might reduce the services that the banks might offer to the residents if they were to still operate profitably and might also make it impracticable to establish competing banks.

Loan facilities.—Loan facilities are available even more conveniently than bank facilities alone. Specialized lending institutions, including credit unions, savings and loan associations, sales finance companies, production credit associations, Federal farm mortgage associations, mortgage companies, and insurance companies, increase the opportunity of choosing between competing lenders.

The ratio of population to loan facilities by counties is shown in exhibit C, (p. 765).[3] As indicated by the map, lending facilities are even more conveniently available throughout most of the area than banking facilities alone. So far as numbers of lenders are concerned, loan facilities are in convenient reach of practically all persons and businesses that have need of them.

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[3] The numbers of lenders were derived from registration statements filed with the Federal Reserve bank pursuant to regulation W and regulation X. Although the list is as reasonably complete as possible, some lenders have probably not been included. The data used in exhibit C include the institutions listed in the preceding paragraph as well as banks and their branches.

TABLE 1.—*Banking offices in sixth district cities classified by State and size of city*

State and size of city	Number of cities	Number of cities with banking offices as specified		
		None	1 office	2 or more offices
Alabama:				
2,500 to 5,000	32	4	17	11
5,000 to 10,000	25	0	5	20
10,000 to 25,000	13	0	4	9
25,000 or over	6	0	0	6
2,500 or over	76	4	26	46
Florida:				
2,500 to 5,000	50	8	37	5
5,000 to 10,000	18	0	13	5
10,000 to 25,000	14	0	5	9
25,000 or over	14	0	0	14
2,500 or over	96	8	55	32
Georgia:				
2,500 to 5,000	55	5	16	34
5,000 to 10,000	21	0	4	17
10,000 to 25,000	15	0	1	14
25,000 or over	7	0	0	7
2,500 or over	98	5	21	72
Louisiana:[1]				
2,500 to 5,000	20	2	15	3
5,000 to 10,000	16	1	7	8
10,000 to 25,000	7	0	0	7
25,000 or over	4	0	0	4
2,500 or over	47	3	22	22
Mississippi:[1]				
2,500 to 5,000	13	1	6	6
5,000 to 10,000	5	0	1	4
10,000 to 25,000	5	0	0	5
25,000 or over	5	0	0	5
2,500 or over	28	1	7	20
Tennessee:[1]				
2,500 to 5,000	14	0	12	2
5,000 to 10,000	18	1	2	15
10,000 to 25,000	10	0	2	8
25,000 or over	5	0	1	4
2,500 or over	47	1	17	29
District:				
2,500 to 5,000	184	20	103	61
5,000 to 10,000	103	2	32	69
10,000 to 25,000	64	0	12	52
25,000 or over	41	0	1	40
2,500 or over	392	22	148	222

[1] That part within the sixth district.

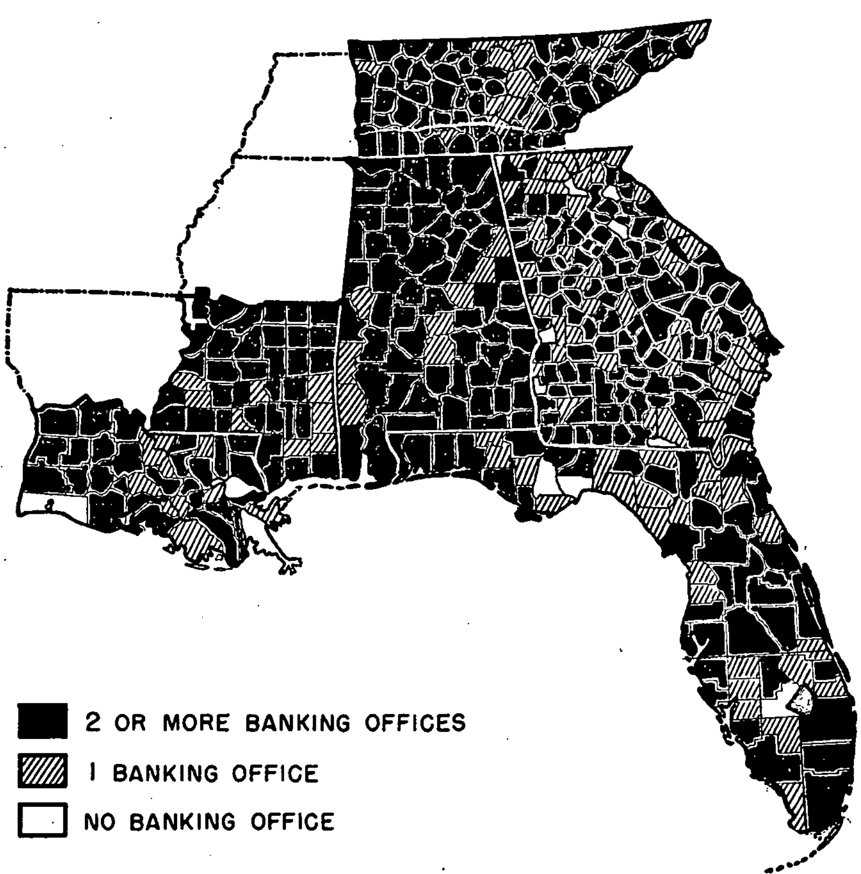
Answer for the Seventh Federal Reserve District (C. S. Young, Chicago)

In the seventh Federal Reserve district, banking service is available to each person in the county in which he resides. Moreover, there are two or more banking facilities from which to choose in all but six counties, all of which have a population of less than 6,500 each.

For the district as a whole, there is an average of one banking facility for every 7,060 persons. Illinois, with 11,660 persons per facility, has the lowest banking density relative to population of the five district States. This reflects, of course, the concentration of population in

EXHIBIT A

BANKING OFFICES IN SIXTH FEDERAL RESERVE DISTRICT
AVAILABILITY BY COUNTIES

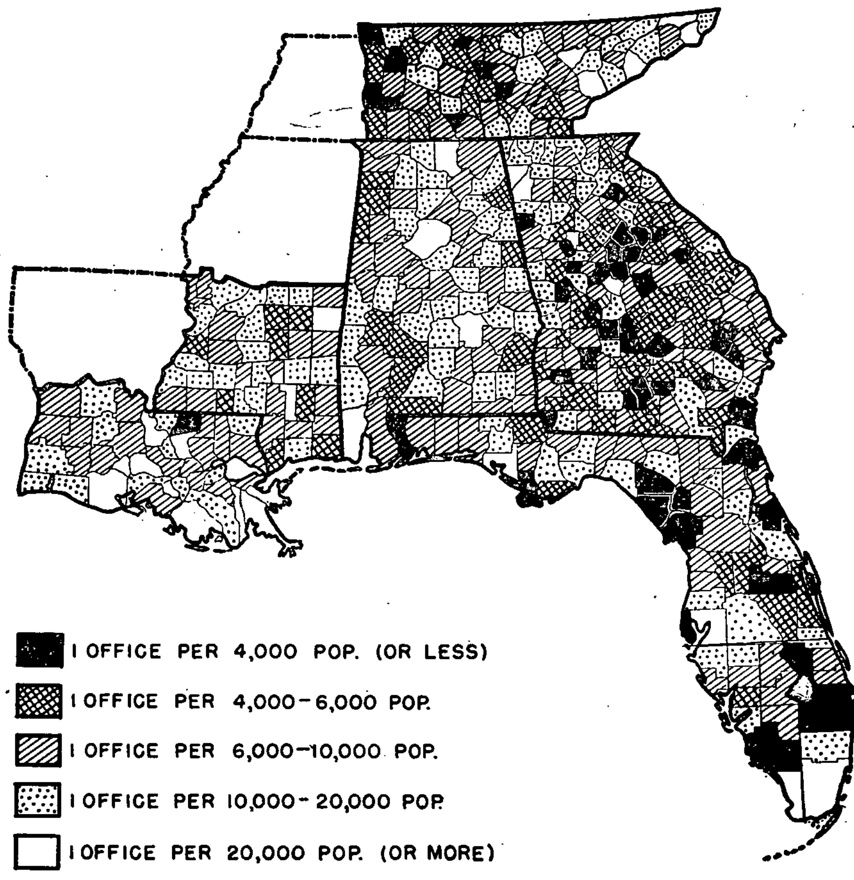


the Chicago area, and a higher-than-average asset size per bank. A similar situation in Wayne County, Mich., results in a lower than average density of one facility per 9,430 persons in that State.

Banking density in most counties, therefore, is above the district average. Of the 337 counties, one-third have a facility for every 3,000 or fewer people, and over four-fifths of the counties have a density of one bank per 7,060 or fewer persons (the average). In general, agricultural counties have the highest banking densities, because of their relatively low population and the dependence of farmers on banking services. Lowest densities occur in heavily populated industrial areas, where competing nonbank facilities are available and many persons are not in need of banking services, and in the more sparsely settled counties, where land use is marginal.

EXHIBIT B

BANKING OFFICES IN SIXTH FEDERAL RESERVE DISTRICT
POPULATION PER BANKING OFFICE BY COUNTIES

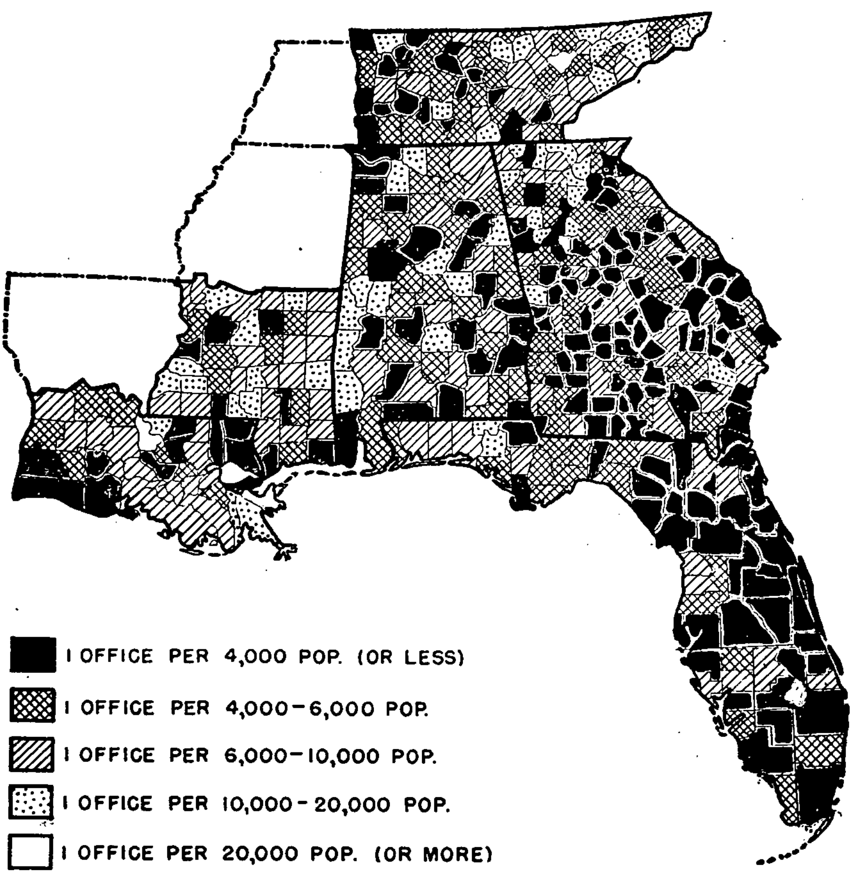


With the addition of competing institutions (715 savings and loan associations, 1,284 small loan company offices, and 311 mortgage companies and brokers), the density of lending facilities increases substantially over the district. The average coverage is increased to one facility for every 4,050 people; here, as is the case with banking facilities, the States with lowest densities are Michigan and Illinois. Almost two-thirds of the counties in this district have one facility per 3,000 people, and only eight have one facility per 7,060 or less (the bank average).

In addition, other lending facilities are widely available, including insurance companies, production credit associations, national farm loan associations, credit unions, and industrial loan companies. These have not been included in the accompanying statistical tables for one or

EXHIBIT C

LENDING OFFICES IN SIXTH FEDERAL RESERVE DISTRICT
POPULATION PER OFFICE BY COUNTIES



more of the following reasons: (1) They do not normally provide credit to business, (2) their location is of no special significance, or (3) they are too few in number to affect the density data importantly.

The existence of multiple-banking facilities in virtually all counties strongly suggests that the district's facilities are adequate for the great majority of persons and business firms having need of them. The distances to be traveled in rural areas generally are not unreasonable, and bank-by-mail services are commonly offered. In addition, over three-fourths of the district's population live in communities where banking facilities are locally available.

Of the 8,112 towns of all sizes in the seventh district, over 36 percent have a banking facility, with the range extending from less than 1 percent for towns of 1 to 99 people to 100 percent for all towns with a popu-

lation of 25,000 or more. Most of the towns without banking facilities are very small, and consequently 91 percent of the district's town population live in places with at least one facility and 75 percent live in towns where two or more facilities are located.

There are 20 cities with populations of 5,000 or more which do not have banking facilities. All of these, however, are located near large cities where deposit and lending facilities are centrally available. Three of these cities, Calumet City and Brookfield, Ill., and Van Dyke, Mich., have populations of more than 15,000. They are, however, in the densely populated Chicago and Detroit metropolitan areas. Both Illinois cities have savings and loan associations and Brookfield has a small loan office as well.

Lending institutions other than banks also are locally available to a large proportion of the district's town population. Generally, these institutions are located in towns where a bank is also functioning, and thus they do not add a significant number of towns to those served by commercial banks. They do increase the proportion of the town population having two or more competing facilities locally available, however, from 75 to 82 percent. In addition, these nonbank institutions increase the density of lending facilities substantially, particularly in the larger cities.

TABLE 1.—*Seventh Federal Reserve District—Major deposit and lending facilities*

	Number of facilities	Number of persons per facility
Institutions:		
Commercial bank facilities	3,125	7,060
Member banks	1,010	21,842
Nonmember banks	1,491	14,796
Branches [1]	624	35,354
Savings and loan associations [2]	721	30,598
Small loan company offices	1,284	17,181
Mortgage brokers	200	110,306
Mortgage companies	111	198,750
States: [3]		
Seventh district	5,441	4,054
Illinois	1,431	5,150
Indiana	1,011	3,195
Iowa	1,139	2,293
Michigan	1,003	5,990
Wisconsin	857	3,314

[1] Includes paying and receiving stations. Branch banking is prohibited in Illinois, Iowa, and Wisconsin, but certain paying and receiving stations are permitted in Iowa, and such stations or branches in Wisconsin established before May 17, 1947, may be operated as branches.
[2] And 6 mutual savings banks.
[3] Seventh district portions.

TABLE 2.—*Seventh Federal Reserve District—Commercial banking facilities, by size of town*

Size of town	Towns[1]	With banking facilities	1 deposit facility	1 bank (or lending branch)	2 facilities	3 or more facilities
	Number of towns					
0 to 99	3,504	25	11	14	0	0
100 to 499	2,612	660	177	481	2	0
500 to 999	756	535	56	461	18	0
1,000 to 2,499	651	503	16	434	53	0
2,500 to 4,999	235	193	1	112	79	1
5,000 to 9,999	161	146	0	50	88	8
10,000 to 24,999	108	103	0	38	51	14
25,000 to 49,999	46	46	0	2	14	30
50,000 and over	39	39	0	0	2	37
All towns	8,112	2,250	261	1,592	307	90
	Total town population (thousands)					
0 to 99	175	1	1	1	0	0
100 to 499	784	198	53	144	1	0
500 to 999	567	401	42	346	14	0
1,000 to 2,499	1,139	880	28	760	93	0
2,500 to 4,999	881	724	4	420	296	4
5,000 to 9,999	1,208	1,103	0	383	660	60
10,000 to 24,999	1,890	1,803	0	666	893	245
25,000 to 49,999	1,725	1,725	0	75	525	1,125
50,000 and over	9,452	9,452	0	0	105	9,347
All towns	17,821	16,287	128	2,795	2,587	10,781
	Percent of town population					
All towns	100.0	91.4	0.7	15.7	14.5	60.5

[1] Includes all towns and cities listed in the 1951 edition of the Rand-McNally Commercial Atlas, whether incorporated or unincorporated. Incorporated towns in the district number 2,918, with distribution by size group as follows: 0 to 99, 63; 100 to 499, 1,042; 500 to 999, 689; 1,000 to 2,499, 564; 2,500 to 4,999, 212; 5,000 to 9,999, 157; 10,000 to 24,999, 106; 25,000 to 49,999, 46; 50,000 and over, 39; all towns, 2,918.

TABLE 3.—*Seventh Federal Reserve District—Other lending facilities, by size of town*

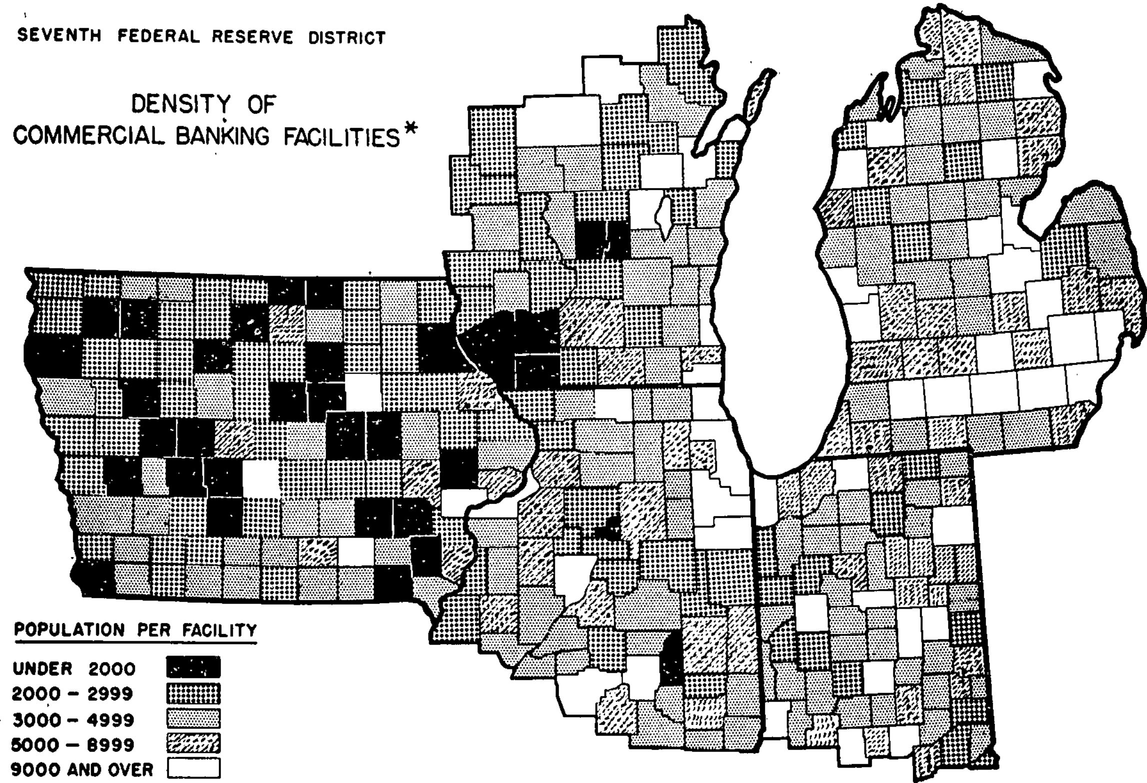
Size of town	Towns [1]	With facilities	Savings and loan association or mutual savings bank	Small loan company office	Mortgage or broker
	Number of towns				
0 to 99	3,504	0	0	0	0
100 to 499	2,612	17	16	1	0
500 to 999	756	30	29	4	0
1,000 to 2,499	651	99	87	23	2
2,500 to 4,999	235	111	82	62	2
5,000 to 9,999	161	123	101	95	6
10,000 to 24,999	108	90	77	81	9
25,000 to 49,999	46	46	40	45	16
50,000 and over	39	39	39	39	26
All towns	8,112	555	471	350	61
	Total town population (thousands)				
0 to 99	175	0	0	0	0
100 to 499	784	5	5	0	0
500 to 999	567	23	22	3	0
1,000 to 2,499	1,139	173	152	40	4
2,500 to 4,999	881	416	308	233	8
5,000 to 9,999	1,208	923	758	713	45
10,000 to 24,999	1,890	1,575	1,348	1,418	158
25,000 to 49,999	1,725	1,725	1,500	1,688	600
50,000 and over	9,452	9,452	9,452	9,452	8,590
All towns	17,821	14,292	13,545	13,547	9,405
	Percent of town population				
All towns	100.0	80.2	76.0	76.0	52.8

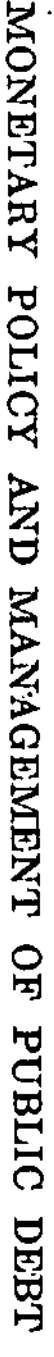
[1] See table 2, footnote 1.

TABLE 4.—*Seventh Federal Reserve District—Deposit and credit facilities, by size of town*

Size of town	Towns [1]	With no facilities	3 or more facilities	2 facilities	1 facility
	Number of towns				
0 to 99	3,504	3,479	0	0	25
100 to 499	2,612	1,949	0	13	650
500 to 999	756	215	4	39	498
1,000 to 2,499	651	143	19	118	371
2,500 to 4,999	235	41	66	74	54
5,000 to 9,999	161	14	108	19	20
10,000 to 24,999	108	3	79	12	14
25,000 to 49,999	46	0	46	0	0
50,000 and over	39	0	39	0	0
All towns	8,112	5,844	361	275	1,632
	Total town population (thousands)				
0 to 99	175	174	0	0	1
100 to 499	784	585	0	4	195
500 to 999	567	161	3	29	374
1,000 to 2,499	1,139	250	33	207	649
2,500 to 4,999	881	154	247	278	203
5,000 to 9,999	1,208	105	810	143	150
10,000 to 24,999	1,890	52	1,382	210	246
25,000 to 49,999	1,725	0	1,725	0	0
50,000 and over	9,452	0	9,452	0	0
All towns	17,821	1,481	13,652	871	1,818
	Percent of population				
All towns	100.0	8.3	76.6	4.9	10.2

[1] See table 2, footnote 1.


SEVENTH FEDERAL RESERVE DISTRICT
DENSITY OF
COMMERCIAL BANKING FACILITIES*
POPULATION PER FACILITY
UNDER 2000
2000 – 2999
3000 – 4999
5000 – 8999
9000 AND OVER
* INCLUDES ALL COMMERCIAL BANKS AND BRANCHES.



SEVENTH FEDERAL RESERVE DISTRICT

DENSITY OF DEPOSIT AND LENDING FACILITIES*

POPULATION PER FACILITY

UNDER 2000

2000 - 2999

3000 - 4999

5000 - 8999

9000 AND OVER

* INCLUDES COMMERCIAL BANKS AND BRANCHES, SAVINGS AND LOAN ASSOCIATIONS, MUTUAL SAVINGS BANKS, SMALL LOAN COMPANIES, AND MORTGAGE COMPANIES AND BROKERS.

Answer for the Eighth Federal Reserve District (Delos C. Johns, St. Louis)

I believe that banking facilities in the eighth Federal Reserve district are generally adequate for the district, considering the standards noted in the question. My opinion is based on the following facts.

1. There is no county within the eighth Federal Reserve district not served by at least one bank.

2. Most counties (329, or 90 percent of all district counties) have two or more banks to choose between.

3. Of the 34 counties with only one bank, virtually all (33) are below the district average in population and are in areas where per capita income is substantially below the district average. In other words, these counties probably can support no more than one bank (table I, p. 773).

4. Each of the counties with one bank is abutted by at least two counties having more than one bank.

5. Individuals and businesses of each eighth district county have more than $1 million of local (county) banking resources available to them except in five cases: Four counties in Arkansas and one in Missouri.

This estimate of banking resources available to supply the needs of the individuals and businesses in each county is based upon total deposits, a very rough measure of total banking resources. On the one hand not all deposits are available for lending to individuals and businesses. On the other, resources available to supply a county's credit needs are many times greater than total deposits within the county, if consideration is given to (*a*) the ability of a particular member-bank to rediscount its loans with the Federal Reserve bank, (*b*) the ability of a particular bank (member or nonmember) to call upon the resources of its correspondent banks or the Federal Reserve System's 13b and V-loan programs or, in case of some types of loans, upon insurance company direct lending and participation programs.

6. In terms of total district population (10,500,000), the eighth Federal Reserve district's 1,500 banking facilities average 1 to every 7,000 persons. People-per-bank ratios range from 4,200 to one bank in the least populous counties to 24,900 to one bank in the most populous counties. As shown on the map and in table II, one-half of the district's population living in the less populous counties have access to nearly three-fourths (72 percent) of the total number of the district's banks. More individual banks are needed, and exist, to serve a given number of people scattered in rural areas than are necessary where population is concentrated as in a city or metropolitan area.

7. In this district it seems generally true that each county has the number of banks the area can support. Avenues are open to formation of new, independent banks anywhere in the district; the chartering agencies in no way prohibit applications for more banks and give careful consideration to community needs as one of the factors in passing on applications. One-bank counties, almost without exception, lie in areas characterized by relatively low per capita income and presumably relatively low per capita holdings of liquid assets.

8. In this district most banking facilities combine both deposit and loan features. There are 18 tellers' windows with only limited banking facilities in Arkansas. Similarly there are six cooperative exchanges in Arkansas offering only limited services. Restricted fa-

cilities serve seven military posts within the eighth district. Otherwise the 1,500 banking facilities in this district provide both loan and deposit services.

The above relates only to regular banking facilities. There are in addition numerous other financial institutions, both public and private, that provide either deposit or loan facilities or both.

TABLE I.—*Eighth district counties, with one banking facility, population estimates, and per capita income for area*[1]

State and county	Population 1950	Per capita income in 1950 for general area[2]	State and county	Population 1950	Per capita income in 1950 for general area[2]
Arkansas:			Kentucky Continued—		
Baxter	11, 683	$543	Hancock	6, 009	976
Calhoun	7, 132	789	Meade	9, 422	996
Conway	18, 137	613	Simpson	11, 678	659
Grant	9, 024	730	Spencer	6, 157	723
Johnson	16, 138	953	Trigg	9, 683	616
Lincoln	17, 079	730	Mississippi:		
Marion	8, 609	588	Attala	26, 652	554
Miller	32, 614	662	Itawamba	17, 216	619
Montgomery	6, 680	650	Tunica	21, 664	696
Nevada	14, 781	662	Missouri:		
Newton	8, 685	588	Douglas	12, 638	627
Perry	5, 978	613	Hickory	5, 387	820
Saline	23, 816	802	Knox	7, 617	1, 210
Scott	10, 057	953	Ozark	8, 856	627
Stone	7, 662	543	Putnam	9, 166	950
Van Buren	9, 687	613	Ripley	11, 414	508
Illinois: Pope	5, 779	684	Stone	9, 748	700
Kentucky:			Wayne	10, 514	508
Clinton	10, 605	382			

Total population of 34 counties	407, 967
Average county population of 34 counties	11, 999
Average county population, eighth district	28, 850
Per capita eighth district income, 1950	$1, 055

[1] Population figures from the census; 1950 income estimates by the Federal Reserve Bank of St. Louis. Count of banking facilities based on deposit ownership surveys by Federal Reserve Bank of St. Louis and tabulations prepared by Board of Governors of the Federal Reserve System. Deposit ownership surveys list no within-county branches of banks.

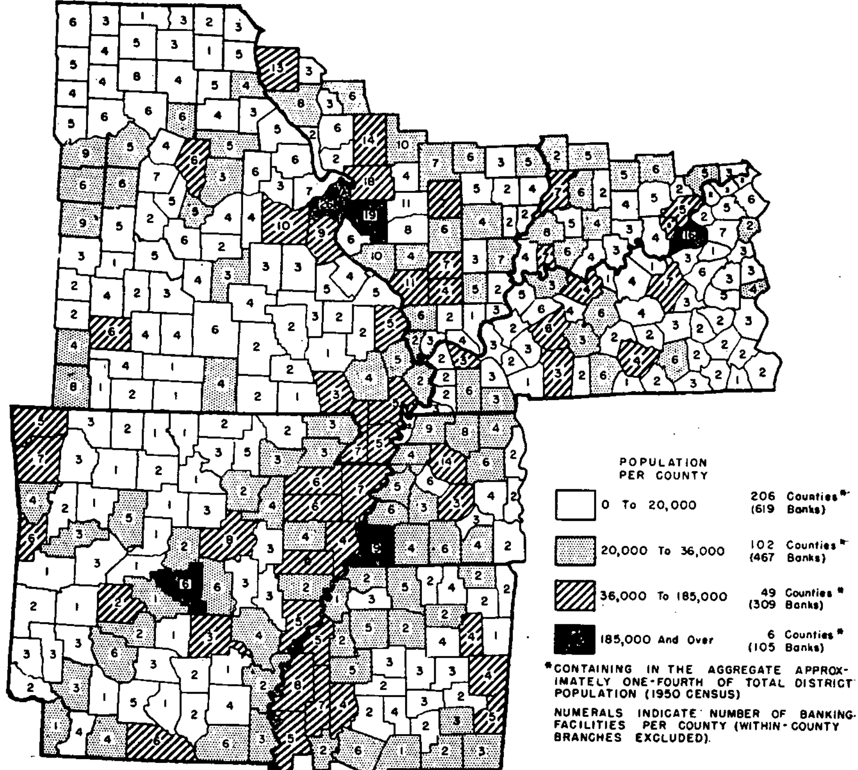
All banking facilities listed in table are independent banks except in case of Itawamba County, Miss. where the facility is a branch office of a bank in another county. All facilities listed provide both deposit and loan service to their communities.

[2] The Federal Reserve Bank of St. Louis has prepared annual estimates of per capita income in 97 district areas. Each area contains one or more district counties. The general area referred to is the income area in the particular county noted.

TABLE II.—*Banking facilities and population, eighth Federal Reserve district*

Population quartile	Number of counties in group	Number of banks	Percent of total number of banks	People per bank (rounded to nearest hundred)	Average number of banks per county	Range in number of banks per county
First quartile (least populous)	206	619	41	4, 200	3	1–8
Second quartile	102	467	31	5, 600	5	1–11
Third quartile	49	309	21	8, 500	6	2–18
Fourth quartile (most populous)	6	105	7	24, 900	18	6–29
Total or average	363	1, 500	100	7, 000	4	

EIGHTH DISTRICT BANKING FACILITIES AND POPULATION
BY COUNTIES



Answer for the Ninth Federal Reserve District (J. N. Peyton, Minneapolis)

On August 31, 1951, there were 1,275 banks on which checks are drawn and 112 branches and bank offices in the ninth Federal Reserve district. The population of this district as of April 1, 1950, was 5,730,908. Thus one commercial banking office existed for each 4,132 persons in the district.

A study of banking facilities in the district indicates that in counties where only one or two banks exist, the population almost invariably is sparse. The accompanying maps show that in all these areas the population per square mile is less than 10. In most one-bank counties, population per square mile is less than five persons; in several it is two or less.

In these sparsely populated areas it is very doubtful that an additional bank would be a profitable enterprise.

Available evidence and general observation lead to the conclusion that the number of banking offices in the ninth Federal Reserve district is adequate, especially in areas where a small number of banks exist. In only 7 of 305 counties in the district does the number of persons per bank exceed 10,000. These are the more densely populated

areas where deposit facilities of commercial banks are within easy reach of all people who wish to use them, and where many types of credit facilities other than those of commercial banks are available.

Loan facilities are available in practically all banking offices in the ninth Federal Reserve district where deposit facilities are present. In a few very small towns served by branches or stations of banks with main offices in other towns, loan applications must be referred to main offices, but this procedure usually applies only to the larger loans. In general, loan facilities and deposit facilities are not separable banking functions.

Answer for the Tenth Federal Reserve District (H. G. Leedy, Kansas City)

In our judgment, banking facilities in the tenth Federal Reserve district are adequate, and, to the extent that it is practicable, competing facilities generally are available. As is apparent from the accompanying map on bank location and population density, there is a large range in the density of population in the district (from 0.5 to 7,169 persons per square mile on a county basis), and the number of banks and their distribution varies according to the population density. This is the result of the differences in the type of economic activity found in the various parts of the district, as the nature of the economic activity and the size of the population have determined the needs for banking institutions. As both loan and deposit facilities are provided by all commercial banks and branches in the district, these statements apply to both types of facilities. There may be isolated points, unknown to us, where banking facilities are considered inadequate. A number of applications for bank charters have been granted in recent years in this area, and it may be that others will be necessary in the future.

The largest number of persons per bank are found generally in the metropolitan areas, such as Denver, Kansas City, Oklahoma City, Omaha, Tulsa, and Wichita; but in those locations a substantial number of competing banks are available to the public within the immediate community. Generally speaking, banking facilities, including competing facilities, are available within relatively short distances throughout the more populous eastern half of the district, including western Missouri, and the greater part of Kansas, Nebraska, and Oklahoma. The same condition exists in the principal population centers of the Mountain States in the western part of the district.

In large portions of the western half of the district, including most of Colorado, New Mexico, and Wyoming, population is of low density. That also is true of western Kansas, north central and western Nebraska, and the Panhandle of Oklahoma. The counties shown in white on the map have an average population density of less than five persons per square mile, ranging downward to an average of less than one person per square mile. In western Kansas, western Nebraska, and the Panhandle of Oklahoma, larger wheat farms and grazing predominate; in fact, many of the wheat farmers live in the towns. The Sand Hills of north central Nebraska are devoted to cattle raising. Except in the irrigated sections in parts of northeastern Colorado, northwestern New Mexico, and north central Wyoming, the areas in Colorado, New Mexico, and Wyoming shown in white on the map are either mountainous or devoted largely to range operations for cattle

and sheep, with farming operations limited largely to production of feed. Along with grazing, wheat farming is important in eastern Colorado. The availability of improved roads and the adjustment of the whole mode of living to greater distances helps to make banking facilities more readily available in these areas of sparse settlement, in which it could hardly be expected that banking facilities would be as close at hand for all people as in the more populous areas.

Answer for the Eleventh Federal Reserve District (R. R. Gilbert, Dallas)

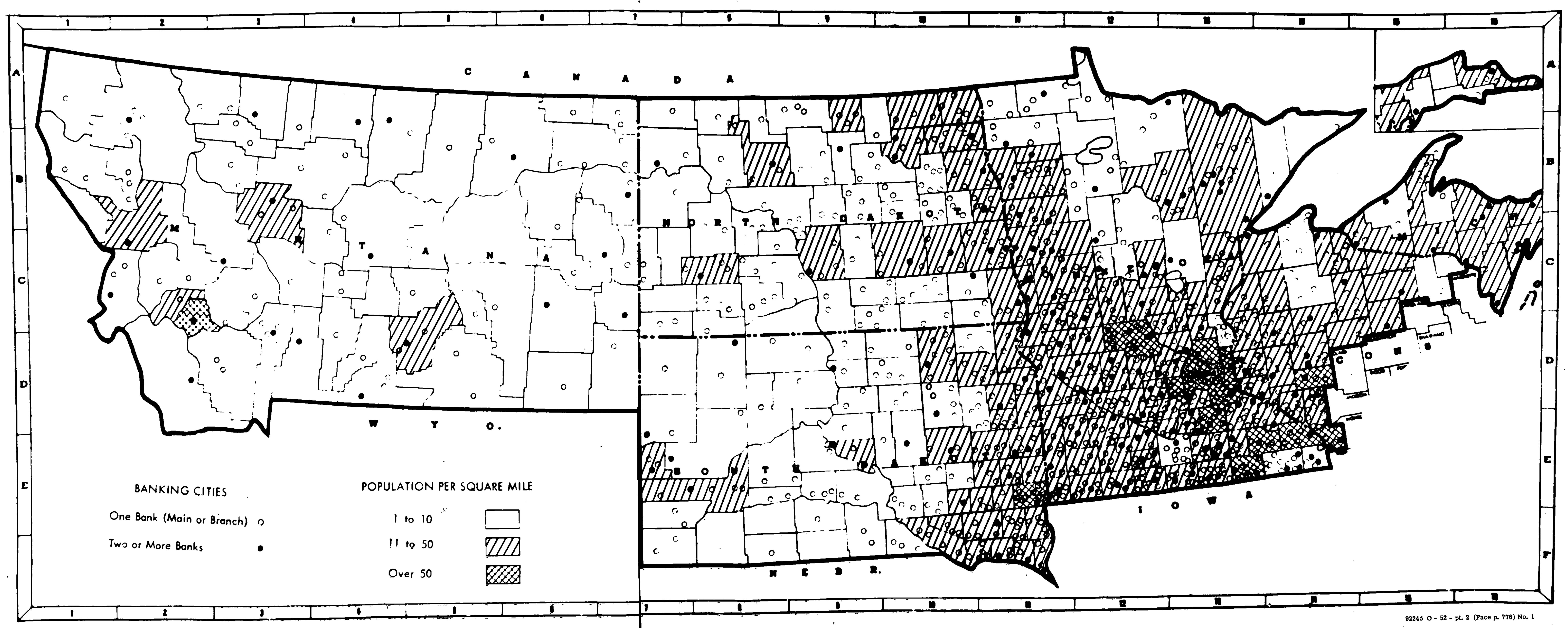
On June 30, 1951, there were 1,101 commercial banks (including branches, agencies, and facilities of parent banks) in the 311 counties of Arizona, Louisiana, New Mexico, Oklahoma, and Texas which comprise the eleventh Federal Reserve district. These banks serve a local population in excess of 9,000,000, which means that for the district taken as a whole there are approximately 8,250 persons per bank. In the larger metropolitan areas where the density of population is much greater than in the smaller cities and towns each bank provides services, on the average, for approximately 19,600 persons. Conversely, in the more sparsely populated areas each bank serves a much smaller number than the average.

Of the 311 counties in the eleventh district, there are 12 which have no banks and 66 in which there is only 1 bank per county. Sixty-two of the counties in these two categories are in Texas, almost entirely in the relatively thinly populated western half of the State. The 12 counties which have no banks account for less than one-third of 1 percent of the district's population, while the 66 counties which have only 1 bank per county account for slightly less than 5 percent. Forty-eight of these counties have populations of 7,000 or less. The absence of a bank in some counties and the existence of only one bank in others does not necessarily mean, however, that these localities are without banking services or that they do not have the opportunity of choosing between two competing banks. For example, the county seat of each of those counties which have no banks lies within a radius of 35 miles of another town or city in which there is one or more banks. Moreover, in two-thirds of those counties having only one bank, each county seat is also within a radius of 35 miles of another bank. In those relatively few counties where a second bank lies more than 50 miles away from the county seat—in New Mexico, Arizona, and the western part of Texas—the relatively greater distances separating towns and the sparse population are characteristic.

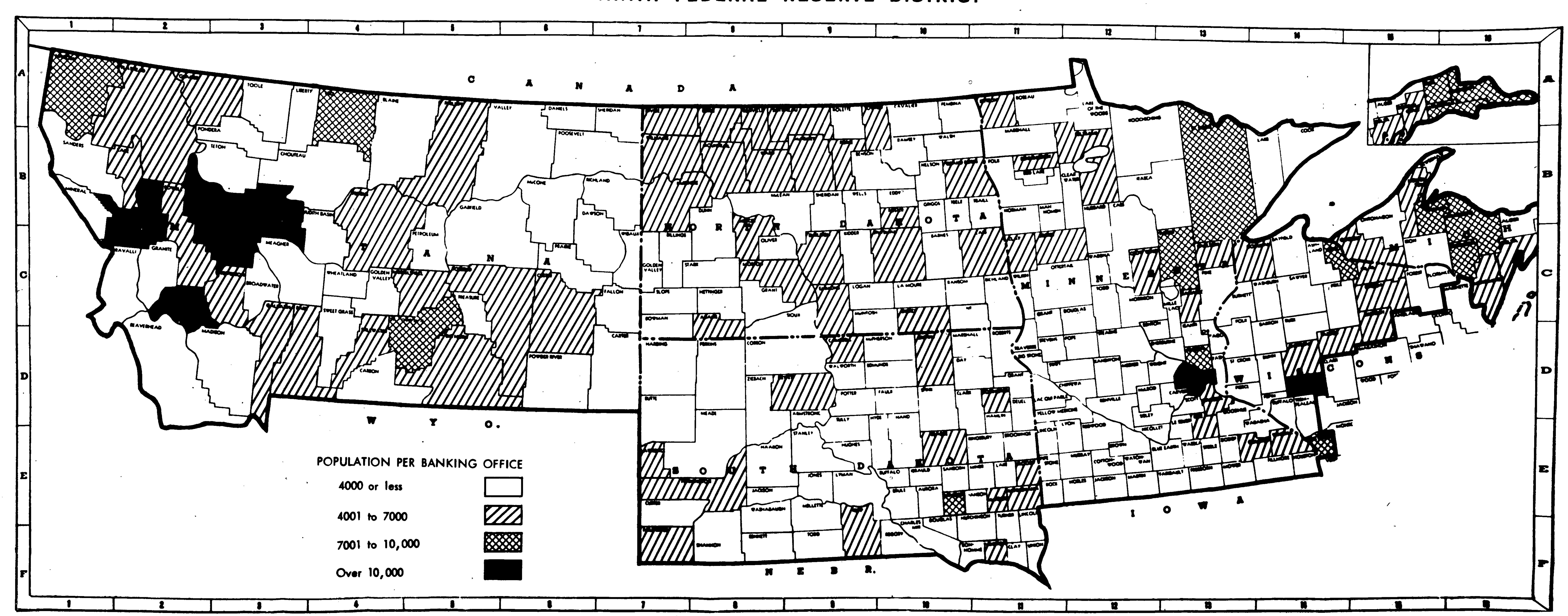
There are 754 towns and cities in the district in which there is at least one bank. Five hundred and forty-eight of these are one-bank towns, while two hundred and six have two or more banks. The one-bank towns predominate in localities where either personal income or population considerations would not warrant the establishment of a second bank. For example, about 47 percent have populations of less than 1,000. As in the case of one-bank counties, other banking facilities lie within reasonable reach of all except a relatively few one-bank towns.

Among the 1,101 commercial banking offices in the district, there are 41 branch banks, 5 agencies of commercial banks (all in New Mexico), and 24 facilities of commercial banks maintained at military

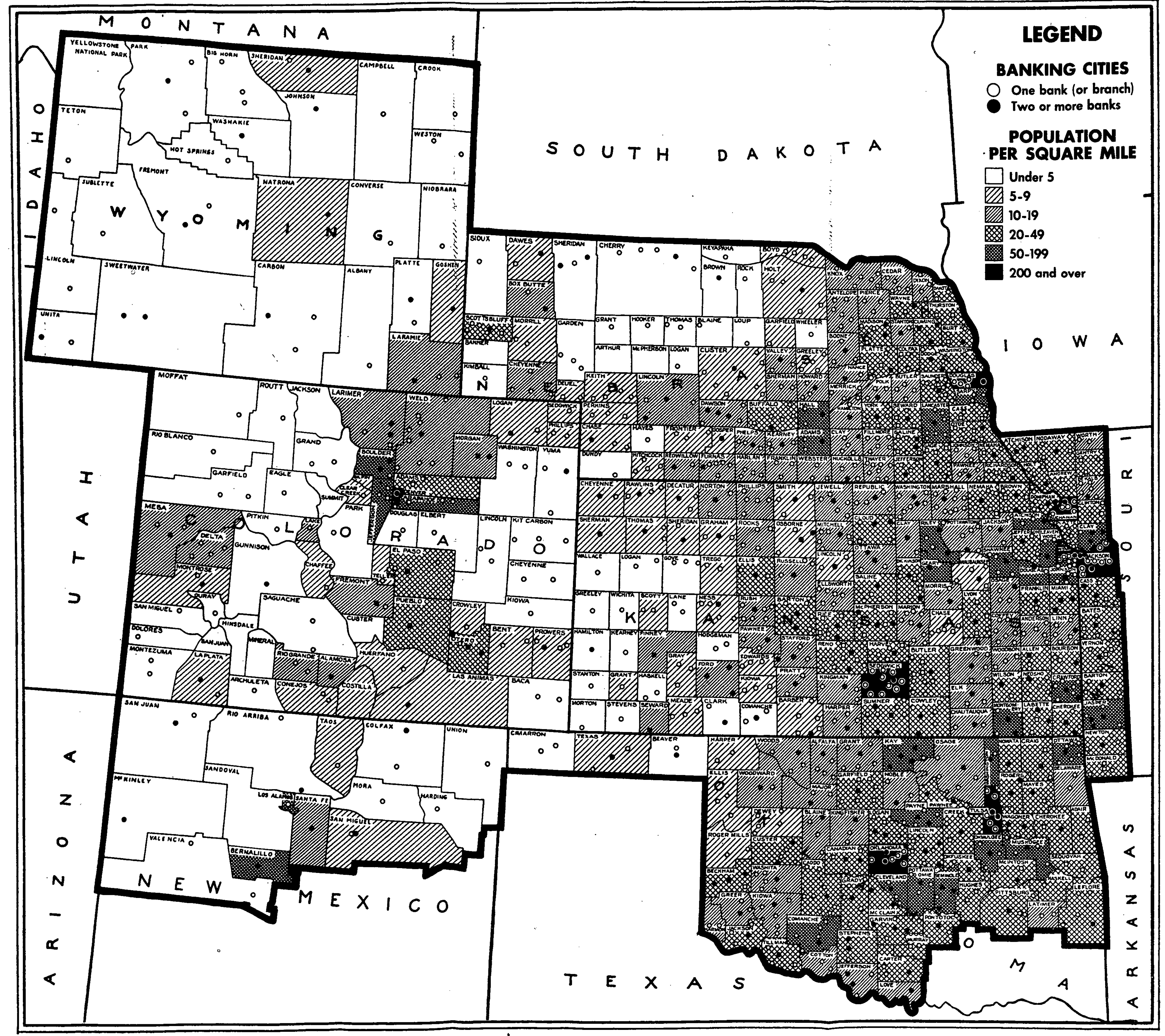
NINTH FEDERAL RESERVE DISTRICT



NINTH FEDERAL RESERVE DISTRICT



TENTH FEDERAL RESERVE DISTRICT



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reservations. In most cases, the distinction between loan facilities and deposit facilities is significant at these institutions. At the remaining 1,031 banks the distinction is not important, since each institution is an entity fully competent, both by law and custom, to provide the two services. Facilities provided at military installations are primarily for the purpose of cashing checks and providing other services not involving the making of loans or the accepting of deposits. The cashing of checks, acceptance of deposits, and other services are provided at branches and agencies, while loan facilities on a limited basis are provided only at some of these offices. Branch banking facilities in the district are relatively insignificant, except in Arizona (20 branches) and Louisiana (21 branches).

During the 3 years 1948–50, 19 charters for new national and State member banks in the eleventh district were approved by the supervisory authorities. Ten applications were either disapproved or withdrawn. In addition, the Federal Deposit Insurance Corporation received applications for insurance coverage for 61 proposed new State nonmember banks in the district. Twenty-one were approved and chartered, while 40 were rejected or withdrawn. Lack of sufficient evidence that the establishment of a new bank was warranted was among the reasons for the rejection or withdrawal of applications for new charters during the 3 years.

Notwithstanding the fact that 12 counties of the district have no banks and an additional 66 counties have only 1 bank per county, banking facilities are within reasonable reach of all persons, except a very small proportion of the total population. Using as a criterion, the—

> ideal of bringing banking facilities within the convenient reach of all persons and business firms having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks—

the eleventh district has adequate banking facilities on the whole. There is little question that the establishment of additional banks or branches in some counties or towns would be of considerable convenience to small numbers of people in widely scattered areas, largely as a result of the provision of deposit facilities. The economic justification for supplying these services, however, appears questionable.

Convenience to the public cannot be accepted in every case as an overriding principle, or always even as a major factor, in determining the adequacy of banking facilities. In an economy such as ours where commercial banks are privately owned, economic considerations must be taken into account and must form a part of any criterion of adequacy. For example, even though 73 percent of the towns and cities of the district in which there is at least one bank are one-bank towns, this fact alone is not necessarily significant as an indication of insufficient banking facilities. It is highly significant, however, that the range of deposits (as of December 30, 1950) at banks in the 66 counties having only one bank was from $609,000 to $8,552,000, with average deposits amounting to $3,122,000. It is very probable, if not certain, that economic factors would not support the establishment of additional banks in any except a very few of these counties.

Due to the fact that banking is subject to a high degree of regulation and control, the area in which competition is permitted or is practicable is limited rather severely. The prevalence of full competition between two banks in the same town does not guarantee the existence

of more adequate banking facilities. In fact, in towns where two banks are not economically justified, banking services would be improved, in all probability, by the elimination of one bank.

Answer for the Twelfth Federal Reserve District (C. E. Earhart, San Francisco)

The twelfth Federal Reserve district includes nearly one-fourth of the area of the Nation, but only 11 percent of the population. Because of the topography of and the climatic variations over the district, population is very unevenly distributed. That some sections are heavily settled and others very sparsely settled is indicated in the following tabulation of twelfth district counties:

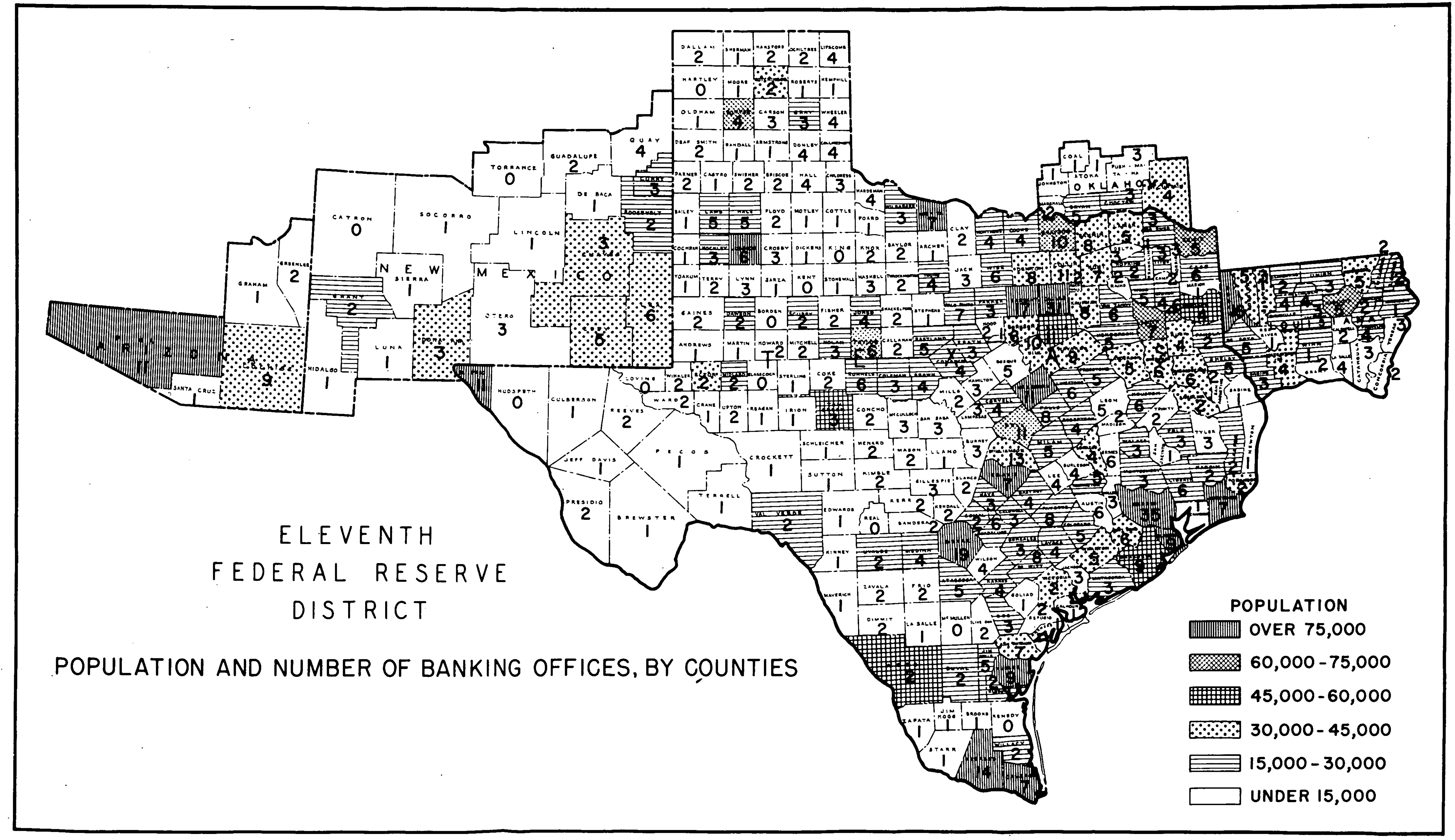
County population per square mile	Number of counties	Percent of district total	
		Population	Area
More than 50 persons:			
Metropolitan areas	20	61	4
Other counties	13	6	2
10 to 50 persons	76	25	24
Less than 10 persons	123	8	70

In the more densely populated sections banking facilities are within convenient reach of nearly all persons and business firms having need of them, and the majority of bank depositors and borrowers do have a reasonable opportunity to choose between two or more competing banks. In some of the sparsely populated sections banking offices are not within convenient reach, and in others facilities are offered by only one banking organization. In such areas, however, the volume of business done is so small, as a rule, that additional banking facilities, whether unit banks or offices of branch banks, could not adequately be supported.

The supervisory authorities, in considering an application for the establishment of a new banking office, must be satisfied that the establishment would be in the public interest, which includes a reasonable prospect for the development of a sufficient volume of business to meet expenses and maintain a sound bank. While competition among banking offices is highly desirable, it is not in the longer run public interest to permit the establishment of a competing bank in an area where only one healthy banking facility can exist.

Where opportunities develop for new banking facilities, as they have in connection with the marked growth of population and business activity in the Western States, existing branch banking organizations are usually eager to extend their services through additional branches, and in certain instances some group proposes to establish a new bank. The growth of banking offices in this district, particularly since World War II, is illustrated by the following figures: 1,640 banking offices in 1935; 1,653 in 1940; 1,674 in 1946; and 1,866 in mid-1951.

Currently these 1,866 banking offices represent 439 banks with not more than one branch, 63 head offices of multiple branch banks, and 1,364 branch offices of branch banks. Only 19 of the district's 502 banks are savings banks (14 stock savings banks and 5 mutual savings banks). The fact that most commercial banks operate substantial



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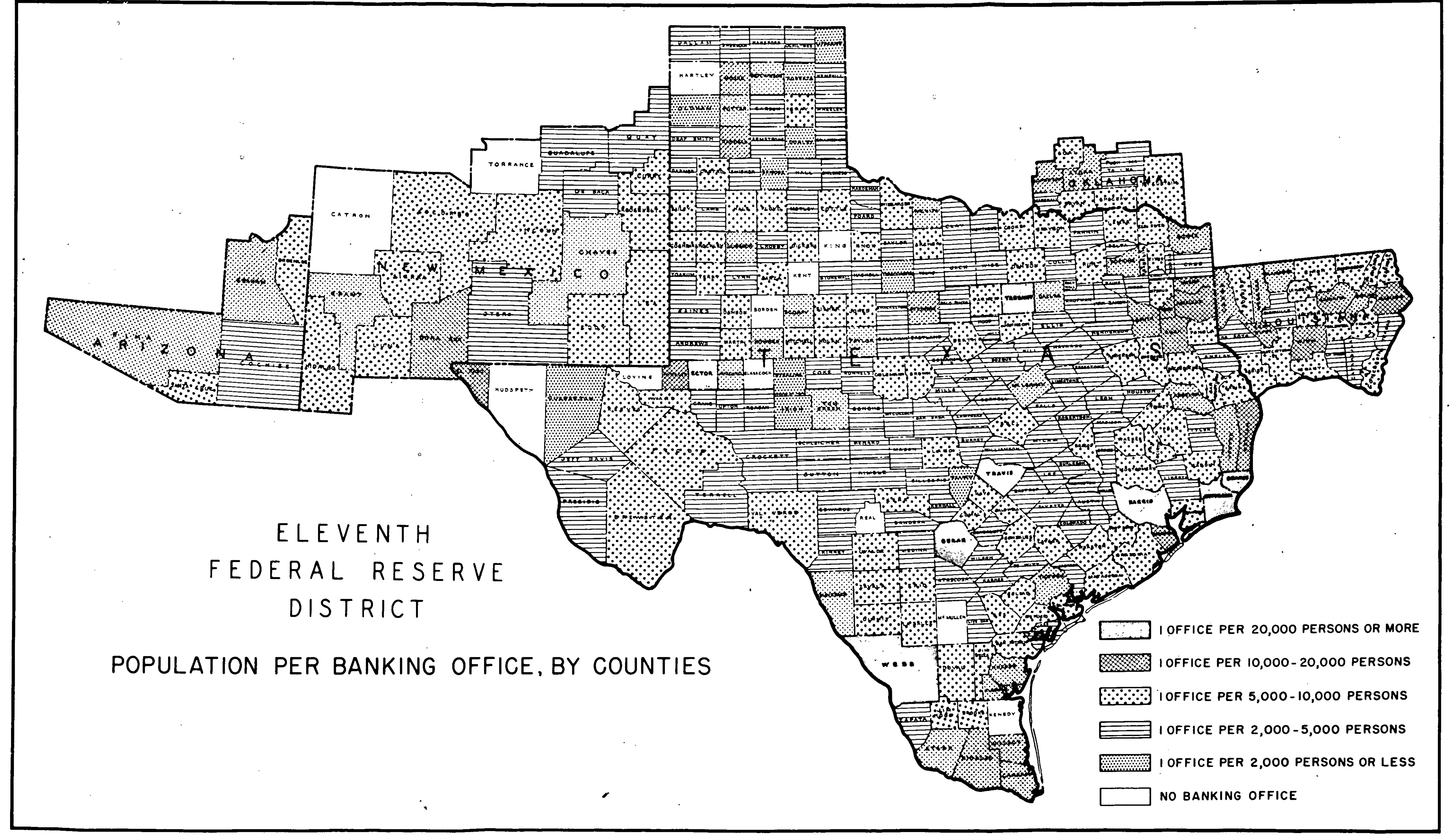

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savings departments is the principal reason for the relatively few banks that are strictly savings banks.

Branch banking is more important in the twelfth district than in any other district. While the growth of branch banking has brought no decline, but has probably caused an increase, in the number and availability of banking facilities, it has undoubtedly resulted in a reduction in the number and availability of competing banking organizations.

It is difficult to measure in an exact sense how adequately the district's 1,866 banking offices are distributed, but the following facts may throw some light on this question. In the entire district there are 15 counties without banking facilities. These counties are in relatively remote mountain and desert areas, however, and have a total population of only 57,000 people, half of whom are in one Arizona county (Apache), which has a large Indian population.

Altogether there are some 130 towns in the district of 1,000 or more population, unincorporated as well as incorporated,[4] outside of so-called urban fringe areas, without banking facilities. However, many of these are suburbs of, or close to, smaller cities; and there are only 10 such places located more than 20 miles from the nearest banking point (one or more banks); 6 of these towns are in Utah, 3 are in Arizona, and 1 in Nevada, and all are under 2,000 population.

With further reference to the opportunity of choosing between 2 or more banks, there are some 640 towns with only 1 banking office. Most of these towns are in metropolitan areas or close to other cities. There are 171 one-bank towns located more than 20 miles from the nearest competing bank. In addition, nine towns without banking facilities, that are within 20 miles of a bank, are more than 20 miles from the next nearest bank. Altogether there are 190 towns located more than 20 miles from at least 2 banks, but 180 of these have 1 bank in the town or within 20 miles. (There is a second office of the same branch banking organization within 20 miles of a number of these 180 towns, but such an office is not considered a second bank for the purpose of these statistics.)

As shown on the accompanying maps, most of the 190 places more than 20 miles from two or more banks are located in thinly populated areas. In counties with a population density of less than 10 persons per square mile are found all 10 of the places of over 1,000 population that have no banking facilities within 20 miles, and 112 of the other 180 towns more than 20 miles from a second bank. Virtually all of the other 68 towns, located in the more densely populated counties, including the 10 towns located in counties with more than 50 persons per square mile, are not in heavily populated areas. The maps do not reflect this situation, however, since it was not feasible to chart population density for areas smaller than counties. All but 42 of the 190 towns more than 20 miles from 2 banks have less than 2,500 population, and only 8 have a population of more than 5,000.

Many commercial banks in the twelfth district make available to their customers not just demand deposit and commercial loan facilities but offer savings deposit, real estate and consumer loan, and other facilities as well. For the most part these facilities are available in

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[4] Not including unincorporated towns in California of from 1,000 to 2,500 population. See note, p. 780.

smaller communities as well as in large cities. While insured commercial banks in this district hold 12 percent of the total resources of all insured commercial banks in the United States, 20 percent of the time deposits, 25 percent of the real-estate loans, and 18 percent of the consumer installment loans of such banks are held by banks in the twelfth district.

Statistical note.—The lower limit of 1,000 persons, with respect to places with no banking facilities, was used as a reasonable limit and because of ready reference to census tabulations on that basis. For California it was necessary to use a lower limit of 2,500 with respect to unincorporated places, since the more detailed census tabulation is not yet available. This should not make any appreciable change, however, in the number of such places more than 20 miles away from two or more competing banks.

It should also be pointed out that in the measurement of distances between towns it was necessary to make estimates in many instances. Such distances were over rather than under estimated, however, and in all cases were estimated along available highways or roads.

In determining whether there were two or more competing banks in an area, branches of the same bank were not considered to be separate banks. However, in some instances, the "competing" bank may be a holding-company affiliate of the first bank, but further refinement of our classifications on this basis was not attempted in the time available.

LEGEND FOR STATE MAPS

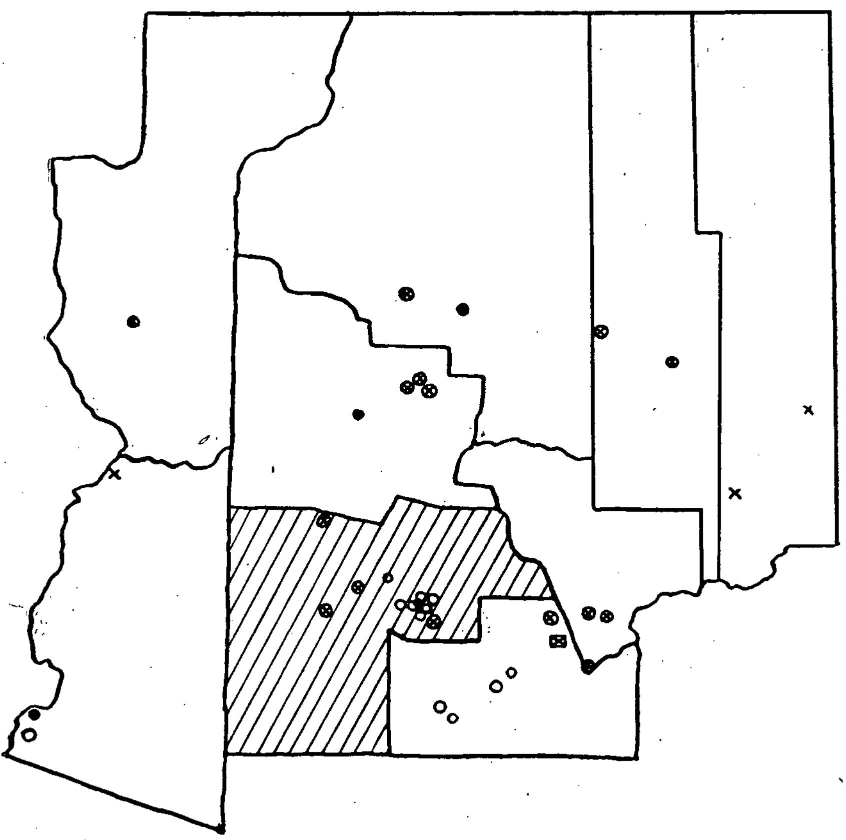
County Population Per Square Mile

Symbol	
▱ (blank)	Less than 10
▱ (single hatch)	10 to 49
▱ (cross hatch)	50 and over

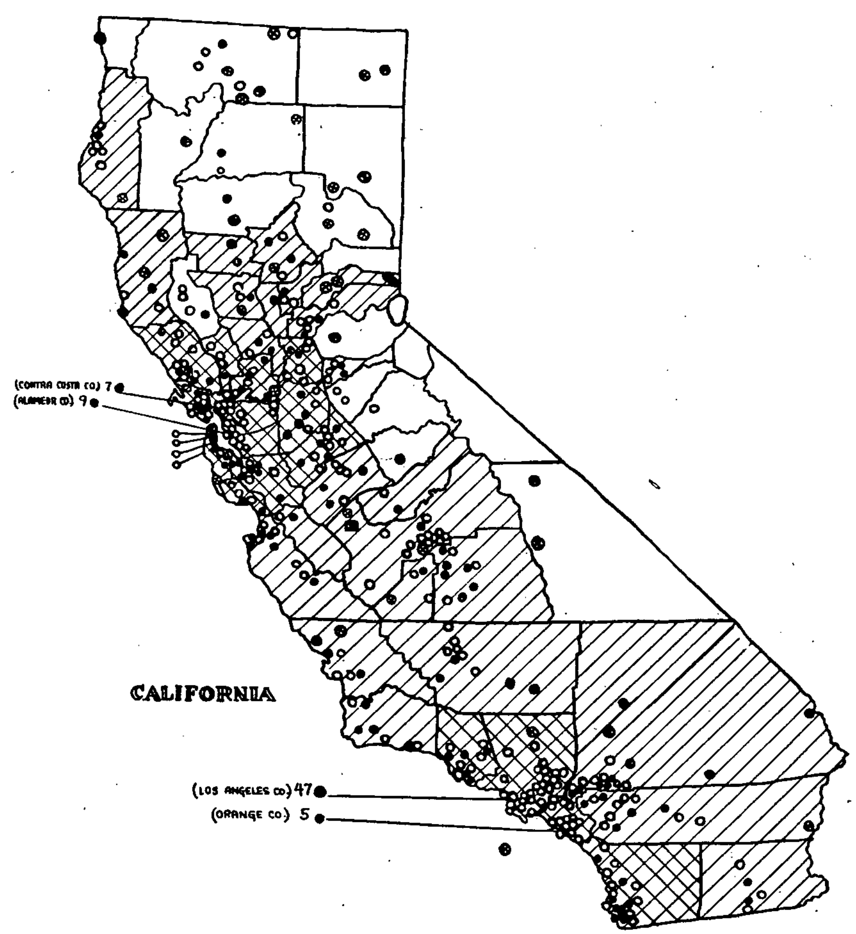
Bank Population of Towns

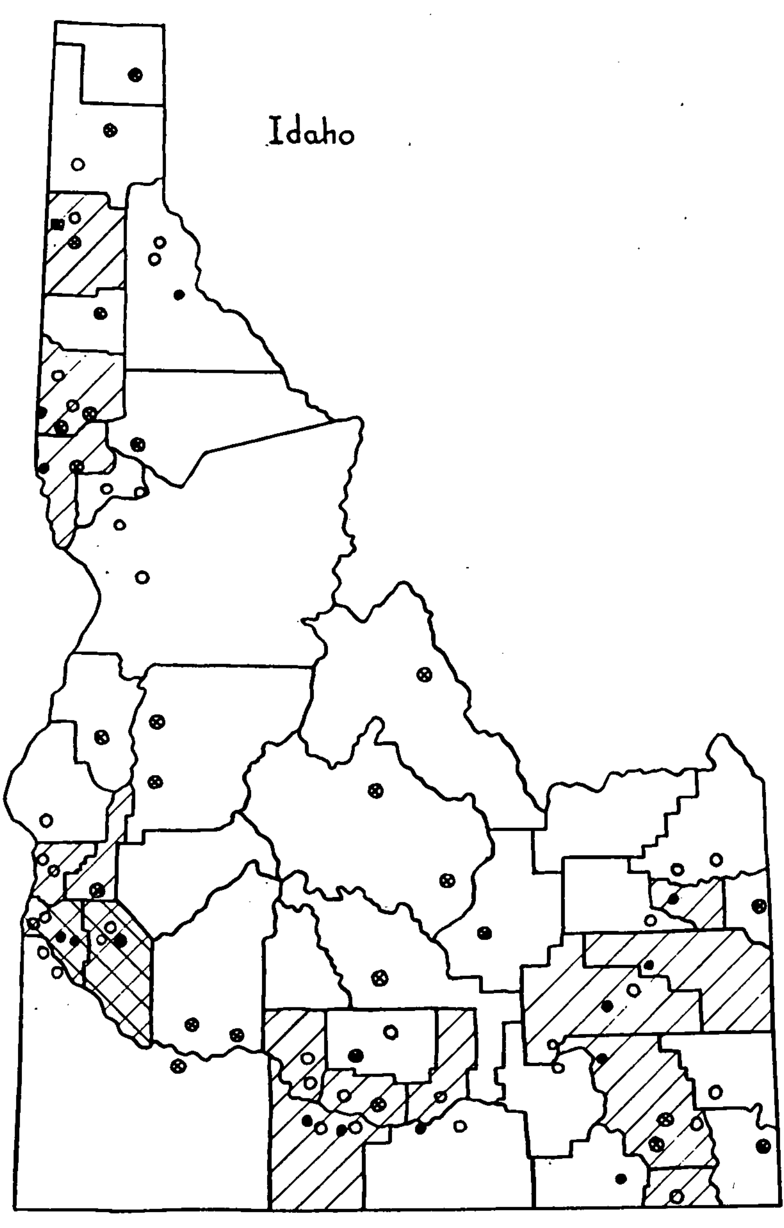
Symbol	
X	Non bank town* with no bank within 20 miles
⊠	Non bank town* with one bank within 20 miles but more than 20 miles from second bank
⊗	One bank town more than 20 miles from second bank
○	One bank town with second bank within 20 miles
●	Town with two or more banks

*With 1,000 or more population (except for unincorporated towns in California where the lower limit is 2,500).



Arizona
TWELFTH DISTRICT COUNTIES


(CONTRA COSTA CO) 7
(ALAMEDA CO) 9
CALIFORNIA
(LOS ANGELES CO) 47
(ORANGE CO) 5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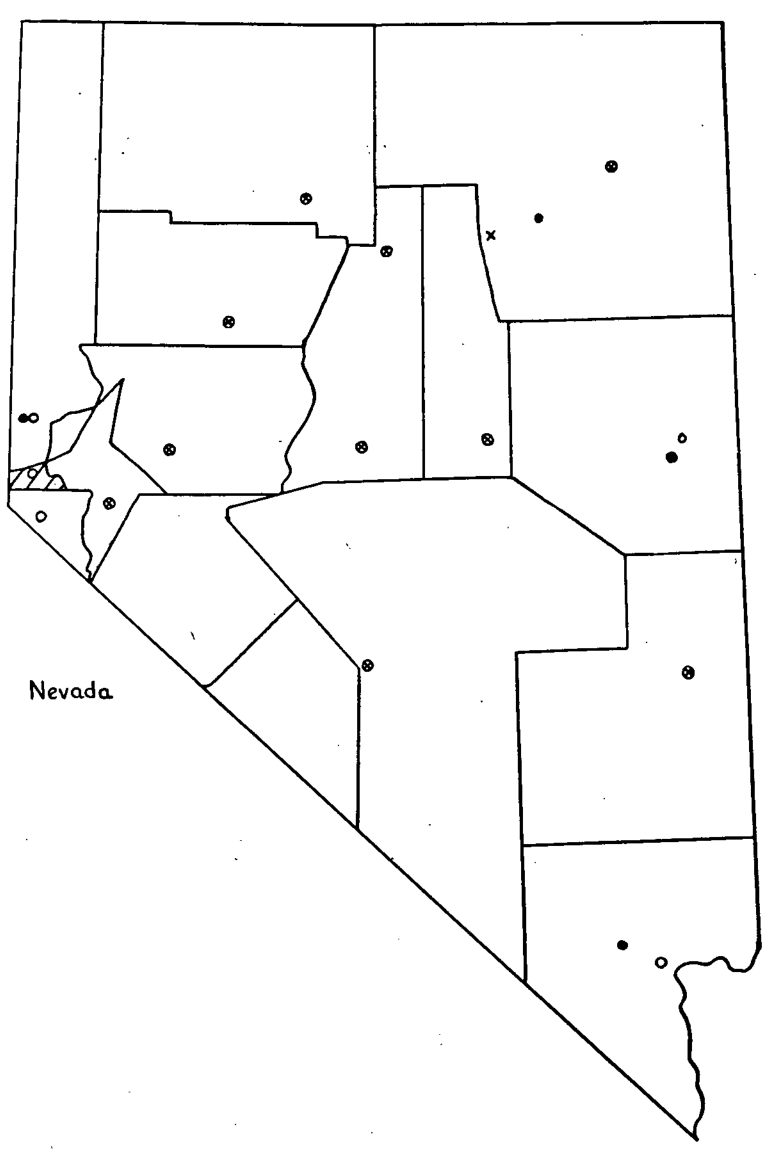
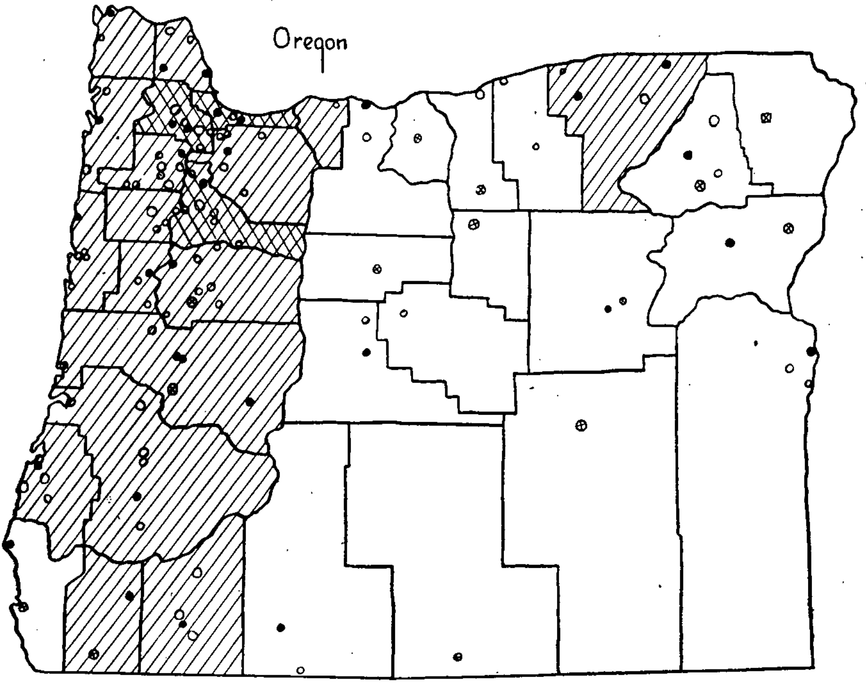
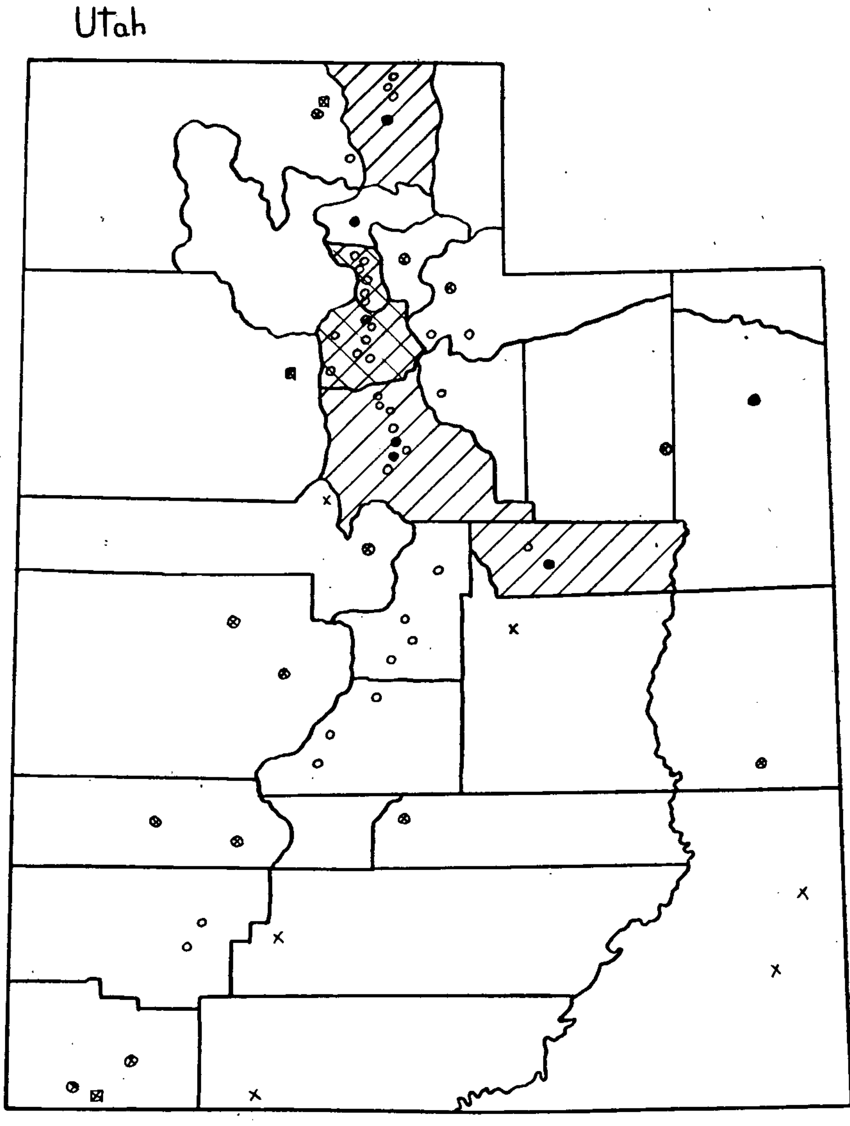
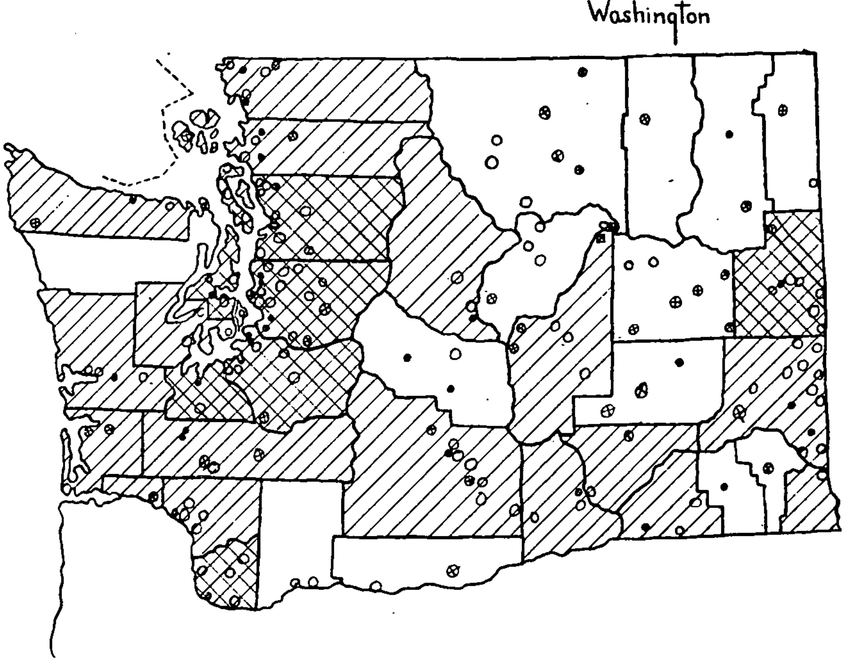

Nevada


Oregon


Utah



F. AVAILABILITY OF CAPITAL FOR SMALL BUSINESS

35. On the basis of information available about your district, discuss the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred? Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

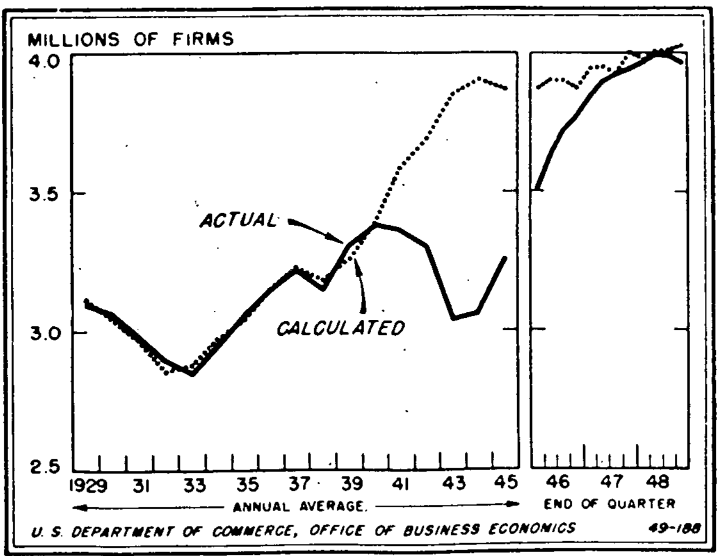
Joint answer

The problems of financing small business are sufficiently common to all districts to warrant a joint reply to some parts of this question. We believe that the growth and diversification of lending facilities over the past 25 years has increased the access of businesses of all sizes to the types of credit accommodation suited to their economic needs. So far as capital is concerned (as contrasted with credit) it is essential in a free enterprise economy that the equity interest in a business carry with it a measure of control commensurate with the greater risks undertaken by the stockholder. Consequently, while aware that some businesses, and particularly smaller businesses, may at times be unable to obtain all of the capital funds which they would like to have to

support their plans for development, we do not favor an attempt to provide equity capital in such cases through governmental facilities. We do favor the encouragement of privately managed regional facilities designed to channel the funds of local investors into concerns which have a definable economic need for added capital.

While no categorical statement can be made as to whether or not it has become more or less difficult to finance small business, we do not believe that difficulties in obtaining capital and credit for small businesses, as compared with other businesses, have increased sufficiently over the past 25 years to lessen the diffusion of economic power for that reason or to weaken the dynamic character of the economy.

One test of the adequacy of capital and credit to finance business is the rate of business organization. Except for periods of war and business depression, the rate of formation of businesses has been maintained at a level which has produced America's dynamic and flexible business structure—a structure which has, in spite of cyclical fluctuations, provided more opportunity for self-employment, a higher overall standard of living, and a more widespread diffusion of income and wealth than any other existing system. Studies by the Department of Commerce indicate that the number of firms now in existence is about what would be expected on the basis of past experience in terms of the volume of business now being transacted. This is illustrated graphically in the chart at the bottom of this page (the chart has been reproduced from page 20 of the Survey of Current Business for June 1949). The dotted line labeled "calculated" indicates the number of firms that would be expected to be in existence each year on the basis of the total volume of business, as measured by gross national product. The solid line labeled "actual" shows the number of firms actually in existence. The chart reveals that, except for the war and early postwar period, the actual number has corresponded closely with the expected number. By 1948, the wartime deficiency had been fully replaced and the actual number again equaled the expected number.



Firms in Operation, Actual and Calculated

The number of businesses organized since World War II appears to be greater than for any comparable period, and the number in operation increased by between 700,000 and 800,000. The rates of formation and of discontinuance of small businesses have been substantially higher than those of larger businesses, and the net rate of additions has also been higher for smaller businesses. Three-fourths of all firms in existence on March 31, 1948 had less than four employees, and 95 percent of all firms had less than 20 employees. These are high proportions, and it would be difficult for them to be much higher. It would appear, therefore, that small-business men have been able to raise enough capital or to borrow enough to sustain the rate of business organization at levels comparable with those of the past.

Notwithstanding the high rates of organization of small businesses, as compared with large businesses, and the relatively larger number of small businesses in operation today, there is some evidence that the proportion of the business handled by large firms, particularly in manufacturing and utilities, has increased over the past 25 years. The increasing importance of the very large firms may lessen the diffusion of economic power, although this may be arguable as a matter of definition. It is not evident that the dynamic character of the economy has thereby been lessened. A number of factors have contributed to this increasing concentration, among which may be listed the following:

1. Increasing importance of the durable goods industries, requiring large capital outlays and correspondingly large-scale operations.
2. The increasing complexity of the business process with its more complicated equipment and products, multitudinous legal problems involving contracts, labor practices, wages and hours, social security, taxes and franchises, and its more detailed and burdensome requirements of record keeping and reports. These indirect costs can be borne more readily by larger than by smaller businesses.
3. A general trend toward integration.
4. The effects of income and inheritance tax laws which make it profitable to dispose of businesses for capital gains and difficult to assure succession in family or personal ownership in the event of death of the proprietor.
5. Increasing use of retained earnings as a source of capital which gives some advantage to larger businesses because of the magnitude of the sums involved, regardless of considerable differences in rate of earnings.
6. Growth of successful small businesses which inevitably marches them toward the ranks of the "bigs."

Whatever the causes of the tendency for an increasing proportion of business to be handled by larger firms, it does not appear to be due to a reduction in the relative number of small firms. Nor do we believe it to be attributable in any significant degree to difficulties encountered by small-business men in raising capital or in borrowing.

It is important to distinguish between the roles of capital and of credit in the financing of business. Capital represents the values put into the business on a permanent basis by the owners. Credit represents funds made available to the business on a temporary basis, the repayment of which is contemplated, and which takes precedence over

the right of the owner to withdraw his capital. Credit may be extended on a short-term or long-term basis, but its repayment is contemplated. Capital may consist not only of money but also of goods and ideas—the ideas of those organizing or reorganizing a business. However, we shall confine our discussion of capital to the actual money or plant, machinery, and goods made available permanently to the business.

We turn first to the question of the supply of credit available to business. Credit (or borrowed funds) may be obtained from trade sources; or through loans obtained from commercial banks, insurance companies, savings banks, industrial banks, small-loan companies, finance companies, commercial factors, and private individuals (including friends and relatives); or from the sale of interest-bearing notes or securities in the market. Although security issuance is often not practicable for the smaller concern, the wide variety of other sources available combine to provide an adequate source of borrowed funds. For most smaller concerns, trade credit is generally the largest single source of outside financing. The commercial banks are next in importance as a source of credit for business.

An intensive survey of loans of member banks as of November 20, 1946, revealed that three-fourths of the total number of member bank loans then outstanding to business were extended to small business. For the purposes of this survey, small business was defined in terms of total assets as follows: manufacturing and mining, under $750,000; wholesale trade, under $250,000; retail trade, service, construction, public utility (including transportation), and all other (including sales finance), under $50,000. As would be expected, the proportion of loans to small business was higher in the smaller banks—more than 90 percent—than in the larger banks. Even in the large banks, however, most of the loans numerically were to small business. The figures are shown in the accompanying table. A more detailed discussion of member bank loans to small business will be found in the Federal Reserve Bulletin for August 1947.

Inasmuch as the nonmember banks tend to be smaller on the average than the member banks, we would expect an even larger proportion of the loans of the nonmember banks as a whole to have been made to small businesses.

While the data relate to November 1946, we have no reason to believe that the pattern changed significantly between that date and the time of the outbreak of the Korean war. Any changes in the pattern that may have occurred since the outbreak of the Korean war, and of this we have no evidence, would be likely to reflect the effects of war and the defense program rather than of underlying economic forces.

Among the difficulties that may be experienced by small business in obtaining credit may be listed the following: Lack of business experience and of credit history; absence of previous banking relationships; and improvement in credit practices of lenders requiring borrowers to provide more adequate financial statements and to maintain adequate records. Many small-business men do not have the time, facilities, or talent for maintaining such records.

Even though the failure record of smaller businesses may be proportionally no worse than that of larger businesses, the greater numbers of small businesses which bring losses to creditors may tend to

Member bank loans to small businesses, Nov. 20, 1946, as a percentage of all business loans, by size of bank

[Estimates of outstanding loans]

Size of bank (total deposits)	Number of member banks in United States[1]	Number of loans	Amount of loans	As a percentage of all business loans in each size group	
				Number	Amount
Less than $2,000,000	1,870	33,000	$74,000,000	91.9	82.9
$2,000,000 to $10,000,000	4,204	174,000	606,000,000	85.7	66.7
$10,000,000 to $100,000,000	1,397	216,000	1,250,000,000	74.9	43.3
$100,000,000 to $500,000,000	143	61,000	670,000,000	61.4	17.7
$500,000,000 and over	25	31,000	288,000,000	67.8	5.2
All banks[2]	7,639	514,000	2,888,000,000	76.6	21.9

[1] For use in loan survey, number includes branches of certain member banks which were considered separate lending institutions for sampling purposes and excludes some member banks with no commercial and industrial loans outstanding.
[2] Detailed figures may not add to totals because of rounding.

Source: Federal Reserve Bulletin, August 1947, p. 965. The definition of "small business" used in this survey is given on pp. 963 and 965.

make the latter more cautious with regard to credit extensions during depression periods. Consequently, the difficulties encountered by business generally in obtaining credit during periods of recession and depression may be intensified for small businesses. However, we do not find from our experience that lenders, even during depressions, discriminate against the small businesses because they are small.

Depression has not been the characteristic of recent years; small businesses exist in large numbers, are active, and show great vitality; business loans are in record volume and most of them are to small businesses. We conclude, therefore, that in recent years adequate credit facilities have been available to provide for the over-all needs of small business. While numerous cases undoubtedly exist in which businessmen have been unable to get the credit they desire, it is impossible in most such cases to secure agreement as to the credit-worthiness of the applicants, and we do not believe that difficulties in borrowing have been sufficient to lessen the diffusion of economic power or the dynamic character of the economy.

We have reason to believe that the developments in lending practices over the past 25 years have increased the ability of small businesses to borrow. These lending practices include increasing use of term loans, field warehouse loans, loans secured by accounts receivable or chattel mortgages, and consumer installment loans. The increased use of accounts receivable and consumer installment financing enables the small-business man to transfer the financing of his customers to financial institutions and to use his own capital and credit for his own operations.

In addition to the private financial institutions listed earlier, a large number of Federal lending or loan guaranty agencies have been brought into existence or have had their activities expended. These agencies include:

1. Reconstruction Finance Corporation
2. Federal National Mortgage Association
3. Federal Home-Loan Banks
4. Commodity Credit Corporation
5. Rural Electrification Administration
6. Farm Security Administration
7. Federal Housing Administration
8. Defense and Administration services agencies in guaranteeing V-loans
9. Veterans' Administration

More than 140,000 veterans have been aided in establishing or operating businesses by loans aggregating more than $430 million guaranteed by the Veterans' Administration.

Midway between the private institutions and the wholly owned Federal agencies are the Federal Reserve banks with their authority to extend loans directly to established business for working capital purposes in cases where credit is not otherwise available on reasonable terms.

We turn now to consideration of the question of capital. While we believe that it has probably become more difficult over the past 25 years, barring temporay cyclical influences, for small businesses to raise capital, we do not believe that the increase of difficulties for small businesses, as compared with those common to all businesses, have been sufficient to lessen the dynamic character of the economy.

A study in the ninth Federal Reserve district conducted by the Federal Reserve bank of Minneapolis indicates that small-business enterprise secures its equity capital from five sources: (1) the person organizing the business, (2) relatives and close friends, (3) other business concerns, (4) local and nearby capitalists, and (5) the security market. Proprietors have been the most important source of capital. The other sources have varied in importance depending in part on type of business and in part on size.

Studies of the Department of Commerce indicate that for the most part new businesses have been organized in different regions of the United States in about the proportion to be expected from the volume of business and the income of the regions. This is revealed by the chart shown at the bottom of page 793 (this chart has been reproduced from page 13 of the Survey of Current Business for December 1949). The fact that the number of firms in operation in each State is proportional to the total income payments received in the State is revealed by the straight line which slopes upward at an approximately 45-degree angle, and by the way in which the dots for the individual States cluster about the line. The chart shows clearly that, in general, the States with higher income payments have more businesses in operation, and those with lower income payments have fewer in operation. The over-all limiting factor in organization of new businesses in the different regions of the country, therefore, would appear to be the wealth and business opportunities of the community rather than the availability of capital. It should be borne in mind, of course, that income, wealth, business opportunities, and availability of capital are not unrelated to each other.

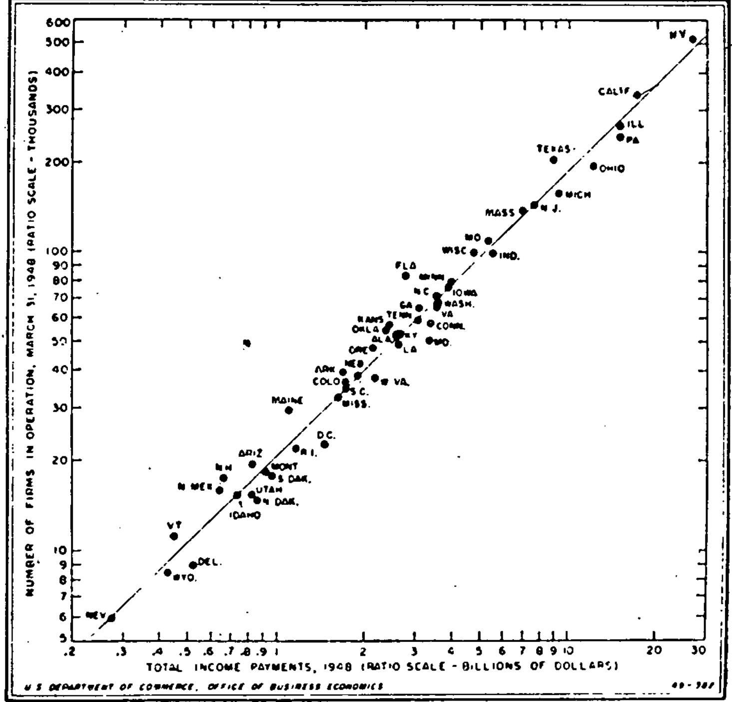
Where shortages of capital exist they are primarily local problems, and can best be dealt with at the local level rather than at the national

level. Local individuals and institutions are better acquainted with the persons and problems involved, and can give better consideration to the merits of individual cases.

Lack of capital does not appear to have been a dominant cause of business failure. The most important factor in success or failure of a business appears to be the quality of the management. Once a business gets into difficulty, the difficulty will probably sooner or later show up in the capital account, and thus appear superficially to indicate lack of capital. Increased capital or credit may temporarily alleviate the distress, but the basic cause of the difficulty appears to lie in the quality of the management, its skill in picking business opportunities, in getting business, in operating a plant, shop, or store, and in controlling expenses.

Most of the businesses which have failed had been in existence less than 5 years. It would appear, therefore, that while some, and perhaps many, worthy and competent individuals cannot raise sufficient capital to go into business for themselves as they might wish, enough capital is available to permit a substantial number of incompetent businessmen to go into business and subsequently fail. Furthermore, sufficient capital appears to be available to permit enough persons to go into business who are competent to keep their businesses going and growing, in order to contribute to the growth, vitality, and health of the American economy.

We know of no way to assure that all worthy aspirants for independent business will get the capital they need and can use effectively,



RELATIONSHIP BETWEEN NUMBER OF FIRMS IN OPERATION AND TOTAL INCOME PAYMENTS, BY STATES, 1948

and that those not competent to conduct a business enterprise will be denied such capital. Under our present system, those who provide capital generally do so directly and bear the corresponding risks of the enterprise. Within the limits of their ability, their own self-interest impels them to make the best possible choice to assure safety and maximum return on their investment. We believe that it would not be in the best interests of the American enterprise system to dissociate risk bearing from the investment decision in the organization of new businesses.

Some complaints are made that the providers of capital, when other than the businessman himself, insist on control of the business, thus limiting the freedom of action and the opportunity of the small-business man. Ordinarily, control does go with capital. The control of each new business, and of each established business as well, is a matter of negotiation and agreement among those contributing to the business. So long as one person does not provide all of the capital of the business, his independence is correspondingly reduced. This is a characteristic of American business, from the smallest to the largest enterprise, forged out of generations of experience with the most flexible, aggressive, dynamic, and productive system so far established by man. To insist on a change in this characteristic is to attack the very foundations of the American system.

The following steps might bring about a more liberal supply of capital and credit to small business, but we are by no means convinced that a more liberal supply of capital and credit for small business would necessarily contribute to the diffusion of economic power and to the dynamic character of the economy.

1. Improved business practices by small-business men, particularly with regard to accounts, records, and financial statements.

2. Encouragement of thrift so that more savings of individuals would be available for financing small businesses. Two possible devices would be to provide higher returns on savings and some tax incentive for savings. The former would require higher levels of interest rates.

3. Maintenance of economic stability. Inflation is usually accompanied by a high rate of organization of new businesses and temporarily by a low rate of failures. As the forces of inflation reach their inevitable climax and as readjustment gets under way, business failures become more numerous. The firms that are most susceptible are the newer, less well established ones which frequently have been instituted on a high-cost basis and have difficulty in adjusting their costs downward. A policy of economic stability requires flexible monetary and fiscal policies.

4. Adjustments in our system of taxation so that those who invest in new business ventures would not be so severely penalized. To offer a simple illustration, under present tax rates a single person with an income of $50,000 who invests $25,000 and gets a 10 percent return would have a net yield on his additional income after taxes of about 2½ percent. A person with an income of $25,000 under similar conditions would have a net yield of 3½ percent. These returns are scarcely high enough to provide an incentive for the risks of new enterprise by individuals who should be best able to assume the risks of financing such enterprise.

5. Preferential tax treatment for small and newly established businesses.
6. Reconsideration of inheritance taxes with a view to facilitating continuity of control and ownership in successful small businessess.
7. Encouragement of local institutions to facilitate the financing of business.
8. Increased guaranties or grants of capital or credit by governmental agencies.

Every reasonable effort should be made to achieve steps 1, 2, 3, and 7. They will contribute to increasing the stability, prosperity, and vitality of American business. Steps 4, 5, and 6 involve broad questions of public policy, in addition to those relating to small businesses, which require careful consideration, and we are not prepared to make recommendations in the tax field.

We believe that the establishment of additional governmental facilities on the national level to provide capital or credit, or guaranties, for small business would not be necessary or desirable. The establishment of additional agencies to provide capital or credit, or guaranties, for small business would, in fact, tend to be harmful in the long run to the American enterprise system and the public welfare for the following reasons.

1. Such agencies are unlikely to have the intimate knowledge of all aspects of the affairs of individual businesses that is needed to enable them to provide the type of service, supervision, guidance, and counsel appropriate to protecting the investment and providing management aid.
2. Those making the final decisions bear no risk and are not penalized for their errors of judgment.
3. There is danger of the infiltration of special influence and corrupt practices which tend to destroy fair and impartial administration.
4. A deliberately generous granting of Government financial aid would inevitably lead to the creation and financing of more new businesses than the economy could support, and thus produce increasingly uneconomic competition as well as increased failures among small businesses. Competition is the essence of the American system and it is also the dynamic force that betrays incompetent management and causes businesses to fail. Government subsidization of uneconomic enterprises would be damaging to sound enterprises while ultimately failing to assure the survival of the less competent.

For these reasons we believe that additional direct Government financing of private enterprise should not be undertaken. If it should be concluded that there is sufficient evidence of a need for additional facilities for supplying capital to promising enterprises, the first approach should be to undertake to reduce or eliminate obstacles to private financing. If anything further should appear to be needed, assistance by public or semipublic institutions to privately managed local or regional institutions organized to seek out sound opportunities for the employment of capital in small enterprises would be far preferable to direct Government financing.

As we have indicated earlier, we believe that difficulties in obtaining capital and credit for small business as a whole have not been

sufficient to weaken the dynamic character of American business, and we are doubtful of the extent to which they may have lessened the diffusion of economic power. Where such difficulties may exist they are essentially local in character and except for tax adjustments can best be dealt with on the local rather than national level.

As in other war periods, the problems of small business arising out of the current national defense emergency are more those of materials, markets, sales, and labor than of capital and credit. Credit facilities are available for small businesses. The usual facilities serve their ordinary needs, and the V-loan program is available for financing their needs on defense contracts. The following tables show that a high proportion of the number of V-loans is being made to relatively small businesses.

Percentage distribution of V-loans, September 1950 to July 1951

Size of guaranteed loans authorized		Size of borrowers receiving loans	
Dollar amount of loan	Percent of total number of loans	Assets of borrower	Percent of total number of loans
Under $25,000	4.2	Under $25,000	1.6
$25,000 to $49,999	4.8	$25,000 to $49,999	3.5
$50,000 to $99,999	12.8	$50,000 to $99,999	9.5
$100,000 to $249,999	19.5	$100,000 to $249,999	17.3
$250,000 to $499,999	20.1	$250,000 to $499,999	18.6
$500,000 to $999,999	15.5	$500,000 to $999,999	15.9
$1,000,000 to $4,999,999	17.5	$1,000,000 to $9,999,999	27.4
$5,000,000 to $9,999,999	2.6	$10,000,000 to $49,999,999	5.1
$10,000,000 and over	3.0	$50,000,000 and over	1.1

Source: Board of Governors of the Federal Reserve System, press release, Sept. 11, 1951.

Supplement for First Federal Reserve District (Joseph A. Erickson, Boston)

We believe that credit needs are being met with reasonable adequacy in the first Federal Reserve district. A sample study of the financial needs of small manufacturers made in 1950 in the Pioneer Valley, which comprises three counties in western Massachusetts, bears out this conclusion. Although one out of six of the small manufacturers interviewed had unsatisfied financial needs, the greatest need was for permanent investment. Only 6 of the 92 firms covered by the study reported unsatisfied requirements for short-term loans, and all 6 had poor financial records.

Most of the complaints about the adequacy of credit in the first district are in fact concerned with the adequacy of capital rather than credit. Because capital is not available in unlimited supply and because not everyone wanting capital inspires the confidence of investors in his ability to employ capital profitably, there are almost always far more projects seeking capital than can be financed. Because investment in new or small enterprises which cannot obtain capital from ordinary sources involves many elements of judgment regarding products, costs, markets, and especially management ability, most such investments are of a marginal type. Some may turn out in fact to be sound but many will turn out to be bad. It has yet to be demonstrated that the gains will offset the losses in this marginal type of investment.

A number of new institutions have been set up to deal with capital or credit problems of new or small businesses. The experience of

these institutions affords information of considerable value in considering the need for additional financial aid to small business.

The industrial foundation is one type of institution which has been widely used in New England and elsewhere to encourage new businesses or expansions by reducing the capital requirements for such enterprises, largely by providing factory space on a rental basis. The businesses so encouraged are usually small and medium-size concerns which want to expand by establishing new plants. A survey published by the Federal Reserve Bank of Boston in July 1950 disclosed that 166 plants in New England had been made available on a lease basis by 17 New England industrial foundations. These plants were leased by almost 200 firms, most of which were of small to moderate size. Several additional plants have been built by such foundations since that survey was published.

The equity capital corporation is another type of institution established to provide capital or, as a substitute in many cases, long-term credit, primarily to new concerns. The outstanding example in the first district is the American Research & Development Corp., founded by private investors in 1946. It has made 25 investments totaling over $3,000,000 since it was established, and is currently profitable.

Another example of an institution supplying marginal capital and credit is the Development Credit Corp. of Maine, established in 1949. This corporation, and a similar one established this year in New Hampshire, have limited themselves to advances to manufacturing and processing concerns which banks and other lenders will not make. From its beginning in February 1950 to the end of September 1951 the Maine corporation has made 16 advances totaling $363,000. The advances range in size from $3,000 to $75,000. It still has unemployed funds at its disposal. The New Hampshire corporation is just being organized and has not yet done any business.

From the experience of these institutions certain principles can be derived which afford valuable guidance in this field.

1. The number of firms having an unsatisfied demand for capital (or longer-term capital-like credit) is ordinarily large in relation to the number whose demand can be satisfied even by institutions specializing in meeting their needs. For example, American Research has had about a thousand applications per year but has found only 25 firms justifying investment of its funds. The Development Credit Corp. of Maine screened 206 applications totaling about $2,250,000 to make 16 advances; the risks involved, particularly in management, caused most of the others to be turned down, although 7 loans totaling $165,000 were approved but not used by the borrowers.

2. The task of developing, screening, and appraising applicants from the marginal group is time-consuming and expensive and can be done most efficiently and economically by having on call the services of a large number of people who are best able to render the judgments necessary. The Maine and New Hampshire corporations make use of a large number of lending institutions and experienced businessmen to develop and screen prospects, and the American Research & Development Corp. is assisted by a panel of consultants for appraising as well as by a large group of stockholders and friends for developing prospects. In addition, these corporations usually offer continuing assistance to the managements of the concerns to which they make advances.

3. There is available a sufficient number of reasonably good prospects to provide an adequate supply of business to institutions set up to invest in marginal enterprises. Whether these institutions will finally be profitable has not been finally determined, but prospects appear so far to be favorable.

4. These specialized institutions increase the supply of capital or marginal credit beyond that extended by the institutions themselves because in many cases outside sources are opened up following investigation of the applicant by the specialized institution. For example, although American Research has invested $3,000,000, it has secured the direct investment by friends of the corporation of another $1,000,000, and the companies it has financed initially have later been able to secure $3,800,000 from the public. The Development Credit Corp. of Maine has secured financing for its applicants from others in excess of $200,000, although it has invested only $363,000 of its own funds. Because these institutions take a secondary or an equity position in the firms they finance, they make possible loans by other financing institutions which otherwise might not be made.

5. The successful operation of these institutions calls for knowledge, organization, know-how, and judgment which cannot be obtained in any one man or even in several men. So wide is the variety of talent required for this type of operation that it is questionable that it could support the cost of specialized personnel devoting full time to the job. We are led to the conclusion that it probably could not be performed satisfactorily by a Government agency staffed with full-time Government employees.

In my opinion, this function can and should be carried on by private enterprises established in those areas and regions which are unsatisfied with their current rate of growth or state of economic development. If development proceeded along these lines, it would assure that the financing facility would be located near applicants and that local bankers and businessmen would support the enterprise and provide the field organization and specialized knowledge and judgment, without which the enterprise probably could not be successful.

Supplement for Second Federal Reserve District (Allan Sproul, New York)

There is reason to believe that the accessibility of credit to the small-business man has widened considerably over the past 25 years in the second Federal Reserve district. A number of new types of financing facilities have been developed which make it possible for all sizes of business to borrow more readily on specialized kinds of collateral, such as accounts receivable, warehouse merchandise, or equipment. The development of more systematic and adequate records on individual businesses also has facilitated the extension of credit on a sound basis. Moreover, 25 years ago almost all bank loans to business were customarily made in short-term form. Today most banking and financial institutions in the district extend credit for periods in relation to the nature of the uses for which the credit is required. Popularization of the term loan and the amortization method of repayment, as well as the use of an analysis of the cash flow through an individual business, have greatly increased the adaptability of credit terms to the many varying needs of individual businesses.

So far as capital is concerned, it has been an inevitable attribute of the American free-enterprise system that the investment of equity funds in smaller or newer businesses must come largely from individuals or firms which participate in the actual management to some extent. The greatest impediment to a sustained flow of new equity capital into smaller business concerns over the past 25 years has been the almost continuous increase in income tax rates affecting individuals and business corporations. Nonetheless, partly because of the greater diversity in the methods through which credit is made available, a vigorous community of smaller business concerns has played an active part in the economic development of this district over the entire period.

Adequate data concerning the business population, and the changes occurring in it, have only been available for the country as a whole since World War II. For New York State, which constitutes the greater part of the second Federal Reserve district, data have been available since 1939. For this later segment of the 25-year span to which the subcommittee question refers, the data suggest three conclusions. First, the rigidities and controls made essential by the Nation's all-out effort in World War II resulted in a sharp decrease in the formation of new businesses, and led to some reduction in the business population. Second, the high levels of income and employment maintained since World War II have provided an environment in which the formation of new businesses (mainly small) has been at a rapid rate and, despite numerous discontinuances, failures, or mergers, the business population of New York State alone increased by more than one-third from the low point in 1944 to 1950 (the latest date for which comprehensive data are available). Third, a high and growing proportion of the net additions to the business population has occurred in lines of business activities in which the individual concern is characteristically small—unfortunately precise data by size of business for each year are not yet available for a significant portion of the postwar period. In all three States of the district, new business formation has occurred at a rate of 1 new business for every 10 existing businesses throughout that part of the postwar period for which data are available. The new business formations have, of course, been accompanied by the discontinuance or failure of other businesses. The net results, appearing as the actual business population year by year, are presented in the following table.

Business population of 3 States, 1940–50 [1]

[In thousands of concerns]

Year	New York	New Jersey	Connecticut
1940	467		
1944 (low point)	410	117	46
1945	423	120	47
1946	470	131	54
1947	527	143	59
1948	555	[2] 143	[2] 58
1949	571	[2] 143	[2] 57
1950	579	(3)	(3)

[1] Data are available only by States; consequently, the entire States of Connecticut and New Jersey have been included although only parts of each State lie within the second Federal Reserve district. Data for New York, prepared by New York State Department of Commerce, are yearly averages, and are not directly comparable with data prepared by the United States Department of Commerce, as of Mar. 31 for each year, for the other two States.

[2] Preliminary.

[3] Not available.

Supplement for Third Federal Reserve District (Alfred H. Williams, Philadelphia)

The supply of credit appears to be adequate to meet the needs of small business and other borrowers in the third district, as explained in more detail in the reply to question 34. Also, funds which are available from various sources, including those indicated in the general reply to question 35, appear generally adequate to meet the capital needs of small business in this district. However, because of the greater reliance of the small business on retained earnings as a source of funds for capital expansion, some form of tax adjustment would be desirable as already recommended above.

There are three additional sources of funds which deserve special mention. One is the 13b loans which can be made by the Federal Reserve banks for working-capital purposes. These loans, which were authorized in 1934, can be made either directly or in participation with commercial banks and other lending agencies. The Federal Reserve Bank of Philadelphia is continuing to make these loans to business firms in the district which are unable to secure credit from private lenders on suitable terms. At the present time this bank has 28 loans outstanding for a total of $8,974,757 in which its participation is $3,575,721. These loans are primarily to small firms which represent diversified types of business. However, the fact that on the average only 28 applications a year were received during the period 1946 to 1950 indicates a relatively small demand for this source of credit.

A second development worthy of mention is the establishment of special loan programs for small business by some of the larger banks. These programs represent an effort to provide more adequate lending facilities for meeting the credit needs of small business. Loans are made for a variety of purposes and they include term loans of over 1 year as well as short-term loans. These banks make loans directly to small-business firms and upon request participate with local banks in extending such credit. Recent reports indicate that these programs have been well received by small-business men.

Another source of funds is that supplied by community development programs. In 1949, this bank made a comprehensive survey of community activities in the third district in providing financial aid to business. The information gained points to two major conclusions: (1) The community's need for industrial expansion determines whether aid will be given and determines the type of financial aid to be provided; (2) the great variety of methods employed indicates the ingenuity of the local community in meeting the needs of a specific situation.

In communities where the need for new industries is great, the establishment of an industrial development corporation has been a common approach to the problem. Sometimes the existence of such a corporation stimulates lending institutions and even individuals to extend credit to assist in bringing in new business. In communities where there is relatively less need for industrial expansion, financial aid is usually by more informal methods. The local chamber of commerce, for example, may bring together a prospective new business and a lending institution, thus facilitating the working out of financial arrangements. In many cases, a small group of prominent businessmen cooperate in extending credit to help bring in a new business.

The survey disclosed that there were at least 17 industrial development corporations and about as many other communities which were helping to finance industries by other methods. The following list, although not necessarily complete, gives the towns and communities which reported some arrangement for providing financial aid for local industrial development.

Towns with corporations

Town	Corporation
Pennsylvania:	
Allentown	Allentown Business Extension Corp.
Altoona	Altoona Enterprises, Inc.
Bellefonte	Bellefonte Industrial Development Corp.
Clearfield	The Clearfield Foundation, Inc.
Eldred	Eldred Real Estate Corp.
Freeland	Freeland Industrial Development Corp.
Hazleton	Hazleton Industrial Development Corp.
Johnstown	Johnstown Industrial Commission, Inc.
Lansford Tamaqua Coaldale Summit Hill Nesquehoning	Panther Valley Industrial Association
Nanticoke	Nanticoke Industrial Commission
Pottsville	Pottsville Industries, Inc.
Reading	Greater Reading Development Fund
Scranton	Scranton Lackawanna Industrial Building Co. Scranton Industrial Development Co. Scranton Plan Corp.
Shamokin and nine surrounding communities	Shamokin Area Industrial Corp.
Shenandoah	Shenandoah Chamber of Progress
Wilkes-Barre	Wyoming Valley Industrial Development Fund, Inc. Wyoming Valley Industrial Building Fund, Inc.
Delaware: Laurel	Laurel Industries, Inc.

Towns with other arrangements to provide for erection of industrial buildings

Pennsylvania:
- Bangor
- Chambersburg
- Downingtown
- Dushore
- Lebanon
- Lock Haven
- Pittston
- Tyrone

Pennsylvania—Continued
- Williamsport
- York

Delaware:
- Dover
- Lewes
- Middletown
- Smyrna

The operations of industrial development corporations vary widely. In many cases funds are subscribed through bond issues on which interest is paid. In others outright contributions may be solicited from individuals or there may be a combination of bonds and contributions. The uses to which the funds are put also vary. The corporation may make loans, but these are seldom working-capital loans. Apparently the major need is not for this type of credit. In cases where long-term loans are made, commercial banks individually or sometimes as a group often participate. The most frequent type of financial assistance is the construction of a new plant which is leased to an industrial firm on a long-term basis. In communities where the need

for new businesses is great the corporation may give the plant to the company or at least contribute a part of its cost.

From the information gained in this survey, it appears that many communities which were really in need of new businesses have found the funds for providing financial aid. The financing nearly always takes the form of long-term debt rather than equity financing. Financial aid has been given to both small and large businesses, but there appears to be some tendency to seek a branch plant of a larger outside company rather than to give aid to local firms.

A recent recheck shows that the situation now is about the same as when the survey was made 2 years ago. It appears that financing activities of these community organizations have diminished somewhat, as nondefense capital expansion programs have declined and as expansion for defense purposes has increased, since the latter is not associated so closely with local development programs.

Supplement for Fifth Federal Reserve District (*Hugh Leach, Richmond*)

In considering the question of changes during the last 25 years in the capital or credit position of small business in the fifth Federal Reserve district, it should be noted that adequate information is not available to provide a categorical answer. However, in general terms, (*a*) short- and long-term credit appear to be more readily available due principally to the leadership of commercial banks in developing new lending practices and techniques, but in part reflecting improvements in small-business accounting, inventory, and other operating policies which have improved their credit position; and (*b*) equity capital may be less readily accessible to small businesses, possibly because of changes in the tax structure which have adversely affected individual venture capital and retained earnings as sources of funds.

With more specific reference to the fifth district, the following changes relating to the ease or difficulty with which small-business men are able to raise capital or to borrow have occurred:

1. There has been an absolute and relative growth in the financial resources of this area, reflected in such basic factors as bank reserves and life-insurance-company assets.
2. Banks and other financial institutions in this area have tended increasingly to adopt new and more liberal lending techniques which in turn adapt these resources more successfully to the credit needs of small business.
3. The Federal Government has in some instances supplemented existing facilities for longer-term credit to small business in this area through credit guaranties and direct loans by the Federal Reserve banks and the Reconstruction Finance Corporation and other governmental lending agencies.
4. Community industrial development corporations have emerged in scattered areas throughout the district, though their activity has to date been limited.

Commercial-bank resources constitute one of the major sources of short-term working-capital funds and, increasingly, of intermediate-term capital funds of small business. In this connection, bank reserves are a significant measure of the credit potential of any given region, since regionally, as well as nationally, bank reserves control the expansion of earning assets by the commercial banking system. Data

on bank reserves reveal an absolute and relative growth in the fifth Federal Reserve district during the past 25 years.

Fifth district member bank reserves as percent of United States, selected dates, 1925–51

	Amount (millions)	Percent of United States
End of year:		
1925	$68.0	3.07
1929	64.7	2.75
1932	52.0	2.07
1939	283.0	2.43
1945	727.2	4.57
1950	695.0	4.05
Mar. 28, 1951	748.0	3.93
June 30, 1951	811.3	4.26

Similarly, life-insurance companies in this area have experienced a sharp growth in assets over the past 25 years; a recent study on the Economic Resources and Policies of the South by Calvin B. Hoover and B. U. Ratchford reports:

Although southern companies are relatively quite small, they had a considerably greater growth between 1929 and 1946 than did nonsouthern companies. Southern companies increased their admitted assets by 308 percent against 172 percent for nonsouthern companies; for insurance in force the figures were 153 percent and 57 percent; and for premium income southern companies were ahead by 247 percent to 57 percent.

In the postwar period commercial banks in the fifth district have been actively engaged in using their expanded financial resources to meet the short- and intermediate-term credit needs of small business. This is reflected in the postwar growth in fifth district bank loans (both absolutely and relatively) and more particularly in the so-called business loans, including term loans. It is generally accepted that smaller business concerns account for a substantial proportion of such loans in this district.

From June 30, 1945, to June 30, 1951, total loans of all active banks in the district almost tripled and rose from 3.9 percent to 4.7 percent of the United States total. Business loans (commercial and industrial) of district member banks in this same period expanded even faster; on June 30, 1945, they accounted for 20 percent of the $1.1 billion total loans of all active banks in the district; by June 30, 1951, they accounted for 25 percent of total loans of $3.0 billion. Although comparative data are not available, a special survey of business loans of fifth district member banks as of November 20, 1946, revealed that more than 85 percent of the business borrowers on that date had total assets of less than $250,000 and accounted for almost 45 percent of the total commercial and industrial loans outstanding on that date. (See table 1, p. 806.) This same survey revealed that nearly 11,000 loans, or 26 percent of the total, were outstanding to businesses formed since 1942. These loans were made principally to unincorporated businesses with assets of less than $250,000 and amounted to $65 million, or 13 percent of the total business loans. (See table 2, p. 806.)

This recent absolute and relative growth in the extension of business credit (and, as indicated, mainly small-business credit) reflects the increased effort of financial institutions in this area to adapt their

resources to the needs of small business. Developments in banks' lending practices in recent years, including the increased use of term loans, field warehouse loans, loans secured by accounts receivable or chattel mortgages, and consumer installment loans, all appear to represent a better adaptation of short- and intermediate-term credit facilities to the needs of small business. Furthermore, increased availability of accounts receivable and consumer installment financing has enabled the small-business man to shift the financing of his customers to the banks and therefore to utilize more fully his own capital and credit resources.

Evidence of these developments in the fifth district may be found in the previously noted survey (November 20, 1946) of fifth district member bank loans which revealed that term loans (defined as loans of more than 1-year maturity) amounted to more than 20 percent of total commercial and industrial loans outstanding on that date. Loans of longer than 5-year maturity constituted nearly 10 percent of total commercial and industrial loans outstanding on that date. (See table 3, p. 807.)

Additional evidence as to the efforts being made by financing institutions in this area to develop and utilize a wide range of different financing arrangements adapted to the special needs of prospective business borrowers may be found in the results of last year's poll of Virginia banks by the Advisory Council on the Virginia Economy. In response to the question, "Has your bank ever handled business loans of the following types?" answers indicated a very high proportion of banks making term loans and actually utilizing a large number of different financing arrangements, as follows.

Types of financing offered Virginia business by Virginia banks

	Percent of total banks reporting		
	Yes	No	No answer
Has your bank ever handled business loans of the following types?			
(a) Assignment of accounts receivable	42	57	1
(b) Pledge of notes receivable	70	29	1
(c) Public warehouse receipts	37	61	2
(d) Field warehouse receipts	17	81	2
(e) Floor plan or trust receipts	41	58	1
(f) Factor's liens	5	91	4
(g) Unsecured term loans under special loan agreements	50	48	2
(h) Term loans against plant liens or other security	48	50	2
(i) Liens on machinery, motor vehicles, or other equipment	99	1	0
(j) Assignment of contracts	55	44	1
(k) Assignment of property leases	39	60	1
(l) Assignment of life insurance	96	3	1
(m) Monthly or other regular installment payment loans	98	1	1
(n) Construction advances on individual or group housing projects	70	30	0
(o) Subordination of existing debts owing to principals or others	20	77	3
(p) Assignment of Government contracts under Assignment of Claims Act of 1940	17	81	2
(q) Participations with RFC	37	62	1
(r) Participations with Federal Reserve bank	8	88	4
(s) Loans with final maturities as long as:			
2 years	80	9	11
5 years	71	18	11
10 years	65	28	7

On balance, it appears that commercial banks in this area, as elsewhere, have taken the initiative in developing different forms of lending which have enabled small-business men to finance over longer

periods necessary purchases of facilities, equipment, and machinery, and to obtain credit on the basis of assets formerly considered unacceptable as collateral. These lending activities have been supplemented by the direct lending and guaranteeing activities of the Federal Government and the Federal Reserve banks. The record of 13b loans in this district indicates that in large part these loans and commitments have been used to finance small, rather than large, business. Likewise, a large proportion of V-loans currently being made may be considered as relatively "small business." (See attached table 4.)

For the most part, then, the credit needs of small business are being handled effectively by existing financial institutions and agencies. Attempting to expand this over-all supply of credit would be particularly inappropriate under the current emergency; the expanding business credit is in fact one of the major factors contributing to underlying inflationary pressures at the present time. The Federal Reserve banks and commercial banks working together on the voluntary credit restraint program are trying to curb extensions of business credit, especially to new businesses not contributing commensurately to the defense effort.

The equity capital position of small business is not as clear cut. Claims of capital shortages undoubtedly have exaggerated the role of capital in the success or failure of new business. The management factor is probably most important, and inability to obtain capital or use it effectively may simply be a reflection on management. From the demand-for-funds side, another factor which may superficially indicate a shortage of capital is the fact that small-business men traditionally do not like to give up the control necessarily incident to obtaining additional capital.

It may be that existing sources of funds do not meet all of the demands of deserving enterprisers. But, again, where shortages of capital actually do exist, our present system of taxation may be an important deterrent to availability of funds. Significantly, under present personal income tax rates, net yields do not provide sufficient incentive for risk investment by those individuals who, in terms of income, are normally best able to assume such risks. Also, corporate tax laws which do not distinguish sufficiently between small newly established enterprises and large established concerns may reduce the possible use of retained earnings, which in the past has been one of the major sources of funds for growing enterprises.

Within the last 25 years, a number of community industrial development corporations have been formed in the fifth district for the purposes of raising money to build new plants to be leased to individual concerns desiring to locate in the area, providing space in older plants, making loans, providing capital, and making grants to encourage a business to erect a plant in the vicinity. One of the oldest and most frequently cited examples of the successful community development corporation is the Industrial Corp. of Baltimore City, originally organized in 1915 to facilitate the making of investigations and appraisals of applicant enterprises, the maintenance of engineering and related facilities for counseling, and arranging financing from outside sources. Community industrial financing plans of various types have been adopted by a number of other localities in this district, but the aggregate amount of capital provided to small business to date has not been significant.

Recognizing that to the extent additional capital can be made available to meritorious small business, this would in turn contribute to the already dynamic character of the economy; nevertheless, we do not believe that the establishment of additional governmental agencies on a national level to provide capital or loan guaranties for small business is either necessary or desirable. It is our view that such shortages of capital as may exist are primarily local problems and can best be dealt with locally rather than nationally. Local individuals and institutions are better acquainted with the persons and problems involved and are in a better position to consider the merits of these individual cases. Across-the-board financial aid by Government subsidy could lead to uneconomic development of new businesses with consequent damage to sound enterprises and to normal competition which is the most dynamic force in our economy.

To whatever extent there can be shown a real need for additional facilities to supply capital to promising enterprises, this need should be met, first of all, by basic changes in our tax structure—changes designed to reduce or eliminate obstacles to private financing. Revision of tax laws to encourage individual risk investment would go far toward solving any problem of capital shortage. In addition, further preferential treatment to small and newly established enterprises could be considered. If further need should then be demonstrated, assistance by public and semipublic institutions to privately managed local or regional institutions organized to seek out sound opportunities for the employment of capital in small enterprises would be far preferable to direct Government financing.

TABLE 1.—*Commercial and industrial loans by size of borrower, member banks, fifth Federal Reserve district, estimated—Nov. 20, 1946*

Total assets of borrowers	Number of loans	Percent of total number	Amount of loans	Percent of total amount
			Thousands	
Over $5,000,000	655	1.5	$86.619	17.4
$750,000 to $5,000,000	1,269	3.0	88,532	17.8
$250,000 to $750,000	3,056	7.2	92,158	18.6
$50,000 to $250,000	12,013	28.3	144,300	29.0
Under $50,000	24,690	58.1	74,418	15.0
Unclassified	814	1.9	10,867	2.2
All borrowers	42,497	100.0	496,894	100.0

TABLE 2.—*Commercial and industrial loans to firms organized since 1942, member banks, fifth Federal Reserve district, estimated—Nov. 20, 1946*

Total assets of borrowers	Amount of loans			Number of loans		
	Total	Corporate	Other	Total	Corporate	Other
	Thousands	*Thousands*	*Thousands*			
Over $5,000,000	$350	$350		14	14	
$750,000 to $5,000,000	6,948	6,506	$442	51	43	8
$250,000 to $750,000	8,206	5,626	2,580	202	80	122
$50,000 to $250,000	23,071	7,788	15,283	1,390	418	972
Under $50,000	25,385	5,819	19,566	9,079	1,129	7,950
Unclassified	711	552	159	81	12	69
All borrowers	64,671	26,641	38,030	10,817	1,696	9,121

TABLE 3.—*Commercial and industrial loans by maturities, member banks, Fifth Federal Reserve District, estimated—Nov. 20, 1946*

Maturity	Amount	Percent of total
	Millions	
Demand	$87.1	17.5
Less than 90 days	118.8	23.9
90 days to 6 months	136.0	27.4
6 months 1 day to 9 months	26.6	5.4
9 months 1 day to 1 year	12.2	2.4
1 year 1 day to 2 years	22.6	4.6
2 years 1 day to 3 years	15.2	3.1
3 years 1 day to 4 years	9.2	1.8
4 years 1 day to 5 years	21.2	4.3
5 years 1 day to 10 years	45.0	9.0
Over 10 years	2.9	.6
Total	496.8	100.0

TABLE 4.—*Percentage distribution of V-loans, Federal Reserve Bank of Richmond, September 1950 to October 1951*

Size of guaranteed loans authorized		Size of borrower receiving loans	
Amount of loans	Percent of total number of loans	Assets of borrowers	Percent of total number of loans
Under $25,000	22.9	Under $25,000	0.0
$25,000 to $49,999	17.1	$25,000 to $49,999	17.1
$50,000 to $99,999	8.6	$50,000 to $99,999	14.3
$100,000 to $249,999	17.1	$100,000 to $249,999	34.3
$250,000 to $499,999	20.0	$250,000 to $499,999	8.6
$500,000 to $999,999	5.7	$500,000 to $999,999	14.3
$1,000,000 to $4,999,999	8.6	$1,000,000 to $9,999,999	11.4
$5,000,000 to $9,999,999	.0	$10,000,000 to $49,999,999	.0
$10,000,000 and over	.0	$50,000,000 and over	.0
	100.0		100.0

Supplement for Sixth Federal Reserve District (Malcolm Bryan, Atlanta)

We believe that there are few, if any, problems concerning the availability of capital and credit to small business that this district does not share with other sections of the country and that these problems are adequately discussed in the joint reply. That the growth in the number of sixth-district business firms in operation has been in accordance with the national situation is indicated by the chart presented in the joint reply showing the relationship between the number of firms in operation by States and to income payments.

The most recent data available, for November 1946, reveal that small businesses are by far the most numerous borrowers at sixth-district member banks. Retail concerns with assets of less than $50,000 constituted 72 percent of the retail borrowers. Manufacturing concerns usually carry on their operations on a larger scale than the retailers, and consequently require financing in larger amounts. Even in this field of lending, however, the banks reported that their loans to small manufacturing concerns were many times greater than the number of those made to larger concerns. Manufacturing concerns having assets of less than $50,000 accounted for 45.9 percent of the total number of loans in this category. In manufacturing as well as in retailing, the majority of the borrowers were unincorporated,

and such unincorporated concerns accounted for 59.6 percent of the total amount of manufacturing loans.

The problem of raising capital, as outlined in the joint reply, is separate from the problem of securing credit. If the district, together with other parts of the South, has lacked capital in relation to its total resources, this condition has applied to large businesses as well as to small ones. Within the last 25 years, however, lack of capital has become a less acute problem because of the growing financial resources of the South. That interest rates on loans to businesses in the sixth district were found, in 1946, to be approximately the same as those on loans to concerns of comparative size throughout the country as a whole is an indication of these growing resources. Further expansion of savings out of which additional capital financing for small businesses as well as large will come, in our opinion, will depend upon the factors outlined in the joint reply in this area as much as throughout the country as a whole.

Supplement for Seventh Federal Reserve District (C. S. Young, Chicago)

Although we concur in general with the views of the System committee, it may be worth while to discuss briefly certain aspects of the small-business problem as they have been observed in the seventh district. Important changes have occurred in the methods of financing business during the past 25 years, both in business practices and in the institutional arrangements by which the needs for funds are satisfied. Like the System committee, we are not prepared to state categorically whether or not it has become more difficult to finance small business, since it is impossible to quantify an answer. Certain changes have tended to restrict the availability of funds, while other developments have worked in the opposite direction.

On balance, it is our considered opinion that, in this area, the supply of capital and credit to small business is sufficiently liberal to maintain a progressive economy and prevent undue industrial concentration. Government undertakings designed to increase the flow of funds to business may result in less efficient use of resources. This is especially true in a time such as the present, when available men and materials, for the most part, are fully utilized.

The magnitude of the problem.—To what extent are the legitimate needs of small firms for capital and credit unsatisfied at the present time? The problem is not easily approached statistically. For example, tabulations of the number of loans granted to small business are of limited usefulness. This is because (1) the term "small business" has no generally accepted meaning, and (2) such data describe the loans which were granted; they do not give information about the firms which were unsuccessful in their search for funds.

Small-business men who are earnestly seeking credit or capital which they cannot obtain through the usual channels are likely to turn to an organization which has been established to aid them in meeting these needs. Such institutions include the RFC, the Veterans' Administration, the Federal Reserve banks, or the venture-capital companies. Many of the prospective borrowers applying to the special lending agencies are found to be in an impossible financial position as a result of mismanagement or an overambitious expansion program. In other cases the risk is of a marginal nature which a private bank is willing

to undertake if the Government agency participates in the loan, or agrees to come in later upon request.

On the matter of equity investment, the organized venture-capital companies report that only about one in a hundred of the applications they receive results in actual investments. There will always be a large number of individuals seeking funds for grandiose plans which could not find economic justification in the eyes of qualified analysts.

Several schemes have been advanced for the creation of "capital banks" which would lend to or invest directly in small firms. There is no evidence that their search for suitable new investments would be more fruitful than those of existing private organizations of this type.

The availability of short-term credits.—Short-term bank loans constitute a residual source of funds for most business firms. Such credit is temporary by its very nature and is paid off as and if adequate funds become available. Assuming fairly constant credit standards, and the absence of severe cyclical disturbances, fluctuations in the volume of outstanding business loans of commercial banks are largely the result of changes in demand. Most banks are anxious to grant business loans which promise reasonable assurance of repayment on schedule. This is because of (1) a desire to serve customers and the community, and (2) the opportunity to increase earnings.

The relative importance of bank loans has declined in the past 25 years. In the twenties total loans of seventh-district member banks amounted to about 70 percent of deposits. At the end of World War II this ratio was less than 15 percent. In mid-1951 it was still less than 30 percent. On the demand side, many businessmen who had unfortunate experiences with excessive debt in the early thirties have attempted to decrease their reliance on credit. Total loans of seventh-district member banks in mid-1951 were only 60 percent greater than they were in 1929. During the same period, total output of goods and services in the Nation rose by over 200 percent.

The relative decline of loans in commercial-bank portfolios is the result of a great increase in bank assets in comparison to the increase in the demand for loans. This situation is largely traceable to the huge increase in the Federal debt and the money supply which has occurred in the past 20 years. In the thirties and during the war, most banks became accustomed to using Government securities as an outlet for their excess reserves, and, indeed, these were the only obligations available in sufficient supply to satisfy the demand. In the twenties, banks looked to short-term commercial loans which could be rediscounted at the Federal Reserve bank for liquidity. In recent years holdings of Governments have served this function.

A number of other changes in the banking structure in the past quarter-century may have affected the availability of credit and capital for small business. These are (1) more careful examination of banks, (2) broader regulatory powers of Federal and State banking authorities, (3) the separation of commercial banking from investment banking, and (4) the decline in the number of banks through failures and consolidations.

By themselves those changes have tended to restrict credit availability. Other factors, however, have worked in the opposite direction. These include (1) the use of term loans of 3 to 5 years' maturity,

(2) the growth of several security devices not used extensively in the twenties, and (3) the aggressive lending programs of certain banks in the larger cities which have tended to stimulate loan activity of other institutions.

The question of whether a firm is large or small does not of itself have much influence on decisions as to the risk involved in granting a bank loan. Of course, the mere fact that a firm has become large and has been in business for a considerable number of years suggests a greater degree of stability than would be true in the case of the average small firm. For a large centrally located bank, very small loans may not be considered desirable because such credits involve a more than proportional expenditure of time and effort.

The short-term credit system appears to rest on a firmer basis than was true 25 years ago. If more loan applicants are turned away than was formerly true, it is probable that these cases are of a doubtful nature. Business firms have been formed and have grown when there was a need for them. The business failure rate in recent years has been only about one-third of what it was during the prosperous decade of the twenties.

A borrower cannot expect to look to the banking system for "easy" credit since the loan officer's first responsibility is to the bank's depositors. Many banks, however, are willing to give special consideration to the needs of small firms which give promise of future growth which will make them more valuable customers. Part of the problem is inadequate knowledge on the part of small-business men as to the type and size of bank which can best serve their interest. The RFC and the Federal Reserve banks attempt to refer bankable loans to suitable institutions who can grant credits in the usual manner.

Long-term credits and equity investment.—Smaller firms probably had somewhat easier access to the capital markets 25 years ago than today. This is true for both stocks and bonds, but since stock financing has never been a major source of funds for small business the changing character of the bond market is of particular importance.

In the twenties individuals purchased substantial quantities of corporate bonds for their personal investment portfolios, or for trust funds. Often the bonds were obligations of relatively small firms who floated their securities with the aid of investment-banking affiliates of local commercial banks. Today, life-insurance companies buy almost all new corporate-bond issues. Life-insurance-company holdings of industrial bonds rose from less than 1 percent of assets in 1926 to over 15 percent today. In large part the insurance-company market is geared to handle economically only large issues of substantial firms, often through private placement.

Although most of the life-insurance money has been invested in fairly large firms, some companies have made an effort to seek out smaller businesses with sound futures. In this case, funds have usually been made available in the form of term loans. The term loan granted by either a bank or insurance company has helped to take the place of bond financing for smaller firms in the past 15 years. Term loans with amortized payments plus greater reliance on internal sources of funds have contributed to the strong financial position of business today relative to the era before the depression.

Business firms, large and small, have greater difficulty in interesting outside investors in new and untried stock issues than was true in the

twenties. In recent years the small investor has reentered the stock market in larger numbers than at any time since the "crash." Interest has centered, however, in "blue chips"—the shares of large well-established firms—far more than was the case in the late twenties.

The difficulties encountered by business in general, and smaller firms in particular, in raising money through stock sales has been traced by some observers to the existence of Securities and Exchange Commission regulations. It is doubtful that the existence of SEC has had much adverse effect on small-business finance. Very small firms have never sold stock in appreciable amounts, and when they did it was not listed on the organized exchanges. Small to medium-sized firms can usually sell their shares only at a considerable expense—perhaps 20 percent of the selling price. Finally, it was the very abuses which the SEC legislation was intended to correct which have placed stockholdings in an unfavorable light with a large number of small investors.

The greater reliance placed upon retained earnings and depreciation reserves by business, generally, as sources of funds is not necessarily an unfavorable development. The fact that a firm is able to earn the money with which to expand is in itself a justification for that expansion. On the other hand, the ability of a new or relatively small firm to sell stock to the public is often a reflection of high-powered merchandising rather than an indication of the economic worth of the enterprise.

In the northeastern part of the United States a number of venture-capital companies have been formed in the past decade with the object of locating desirable investments in small new firms. Such organizations have not been established in the seventh district on a formal basis. There are, however, a number of wealthy individuals who have created investment-research groups of their own on a private basis. These organizations operate in much the same manner as the venture-capital companies, but do not publicize their activities.

Possible aids to small-business finance.—Many of the proposals to aid small business which have been advanced in recent years have involved modification of the corporate-income tax. On balance, it is probable that the postwar tax structure has tended to encourage the formation of equity capital in small corporations. This is because of the differential between the capital-gains tax of 25 percent and the high marginal rates on large personal incomes. Keeping the earnings in the business shields them from the individual tax. This is especially important in the case of small, closely held corporations. Many wealthy individuals have invested money in small firms in recent years without ever intending to receive dividend income. They expect to sell out at some future date after the growth of the firm has enhanced the value of the stock.

Small business in the defense economy.—In the present international emergency the restrictions upon new credit extensions and allocations of materials are serving to limit expansion opportunities. These developments may adversely affect levels of production and sales for business firms which are unable to participate in defense work.

The Nation's business population fell by 300,000 from 1941 to 1944. Any deepening of the present crisis would doubtless tend the same way. Retail and service establishments would decline in num-

ber as their proprietors are taken into the Armed Forces or as the commodities they sell become unobtainable. Many small processors unable to obtain subcontracts would find their supplies of strategic materials reduced further or cut off entirely.

A partial solution for this problem may be found in a greater attempt by the procurement agencies to award contracts to smaller firms, and a greater ingenuity on the part of the small-business men themselves in fitting their establishment into a war or semiwar environment. In the years immediately ahead the problems created by the defense emergency will far outweight the difficulties which small business will encounter in obtaining an adequate amount of credit and capital.

Supplement for Eighth Federal Reserve District (Delos C. Johns, St. Louis)

The joint reply prepared under the direction of a special committee of the presidents of the Federal Reserve banks covers many of the general problems of financing small business which are common to all districts. I am in agreement with the statements made in that joint reply. I have confined my own reply, therefore, mainly to conditions and developments in the eighth Federal Reserve district.

By way of introduction, the following points should be recognized for they influence my general conclusions.

(1) The financing of small business is but one of many problems relating to the stimulation of small-business birth and growth, to the diffusion of economic power, and to the dynamic character of the economy. In fact, the financing problem does not seem to rank as high on the list as do various others. Perhaps the greatest boon small business could receive would be maintenance of general economic stability. Changes in tax policy to permit higher net returns on investments and more funds available for investment and for buying the products of small business would rank high on the list of aids. Improvement of managerial ability would lead to fewer failures; more widespread availability of technical and managerial assistance would be useful. Actually, whatever financing problems exist for small business almost certainly would be lessened in magnitude and kind if the three factors noted could be made more favorable.

(2) Programs designed to aid small business should be examined with great care to see that they really serve the purpose of contributing to the diffusion of economic power and the dynamic character of the economy. Under our system of democratic capitalism everyone should have equal opportunities to test his abilities as a businessman. He should be able to test those abilities on fair terms of competition with other businessmen. Our economic resources of manpower, materials, and capital are limited, however, and there can be no guaranty that everyone, regardless of ability, can command as much of these resources as he wishes or that they should be prorated on a per capita basis. The more efficient businessman naturally will come closer to meeting resource requirements than will the less efficient. Attempts to distribute resources on other bases would likely lead to resource wastes, to the holding back of efficient producers, to lowered output and hence to less dynamic strength in the economy.

(3) Precise and complete information with respect to the specific question of availability of capital to small business in this district over the past 25 years simply is not available. The difficulty encountered in obtaining concrete statistical evidence has its roots partly in the lack of a clear-cut definition of "small business." In turn this leads to considerable confusion in defining the problems and in making recommendations designed to aid small business. Actually much of the public discussion about small business seems to reflect concern about what might be better termed "intermediate sized business"—the upper range of the so-called small business group.

Official definitions of small business use volume of employment in some cases, sales or assets or earnings in other cases, and shift from one yardstick to another depending on the nature of the study involved. By and large, however, almost all of the official classifications result in making practically all business establishments, perhaps 90 to 95 percent of the total, "small business."

This situation obtains in the eighth Federal Reserve district as well as in the Nation. Of the more than 225,000 businesses in this area, somewhere between 90 and 95 percent would meet the general standards of classification as small business establishments.

(4) The eighth Federal Reserve district is a low-income region. It is composed of the entire State of Arkansas, the southern portions of Illinois and Indiana, the western half of Kentucky and the western third of Tennessee, the northern half of Mississippi, and all of Missouri except the western tier of counties. Over the past several years the research staff of the St. Louis Bank has made fairly extensive studies of the district income structure and of per capita income in small areas of the district.

In 1950, per capita income in the district as a whole was $1,055 or just 73 percent of the national average. One district area (in western Kentucky) had an average income of only $382 in 1950 or less than one-third the national average. The highest per capita income registered in the district last year was in the St. Louis area ($1,824).

While district income runs well below the national average, over the past decade it has increased relatively faster than the national average. Between 1940 and 1950 total income in the eighth district rose 194 percent as compared with a gain of 186 percent for the Nation as a whole. Since the district showed a smaller net population gain than did the Nation as a whole, 3 percent against 15 percent, the increase in per capita income here as against the Nation was even more favorable—187 percent as compared to 150 percent.

While the district can be proud of its record over the past decade, the above figures indicate that it is an area which has some distance to go to catch up with the rest of the Nation. That catching-up process necessarily involves continued shifts of district workers to jobs of higher productivity. Thus it may well mean a sustained growth rate in the number of business establishments in the area.

(5) Business numbers have increased here. A study made by the staff of this bank more than a year ago indicated that the number of business establishments in this district had grown from approximately 183,000 in 1944 to 227,000 in 1949. Further growth probably has taken place since 1949.

The increase in number of business establishments in the district over this 5-year period was perhaps a little smaller relatively than

growth in the Nation as a whole. In this connection it is worth noting that for the country as a whole the ratio of the number of business enterprises to the population has remained relatively steady since the turn of the century. Also, as indicated by the chart at the bottom of page 793 in the joint reply to this question, there is a close relationship between number of businesses and income in a State. The periods of interruption from a statistical normal have been occasioned by war and widespread depression.

The smaller growth rate in business numbers in this district than in the Nation apparently reflects largely the smaller than average population gain here. Actually, adjusting for relative population changes, growth of the number of business establishments in this area compares very favorably with that for the Nation as a whole. It also gives indication that income growth and business growth go hand in hand.

These five points bear on the general question of small business growth and development in this district. The balance of my reply deals, as specifically as the available data and evidence permits, with the financing problems of small business. I discuss them under three major headings: Short-term credit, intermediate and long-term credit, and equity capital.

Bank (short-term) credit.—As noted earlier, there have been cases over the past quarter-century where credit-worthy businesses in this district could not obtain short-term bank credit. Statistical measurement of the extent of this condition is not available, but it probably was most prevalent around the time of the great depression. Responsibility for the failure to satisfy worthy demand rested partly on the lenders and partly on the borrowers. To the extent that failure was due to bank shortcomings or banking system shortcomings two factors suggest that a change for the better has taken place: Improved public confidence in banks and certain institutional changes that make bank credit more readily available to small businesses.

Restored public confidence in banks generally has lessened the strain on each individual bank to meet daily demands within itself, that is from cash in vault, primary reserves above requirements, and very short-maturity secondary reserves. Under present conditions banks may safely carry a larger share of assets in intermediate and long-term loans and investments than they could when public confidence in banks was less firmly established. Furthermore, the relatively large proportion of the United States Government securities to total loans and investments of all banks today compared with prewar serves to give the bankers a feeling of confidence in their ability to meet any unusual daily demands and, therefore, to induce in them a greater willingness to lend than they had in the early 1930's.

Secondly, there have been several institutional changes that have improved the individual bank's accommodation of credit-worthy businesses. The Federal Reserve System's ability to meet currency demand is no longer hampered by a need to back the currency only with eligible paper and gold. Also the Reserve banks may now make industrial loans under section 13b. While extensive use of this additional lending power has not been made, System authority to lend helps assure credit-worthy established industrial businesses that their bank credit needs will be filled more adequately than before 1934. (In fact, assuming only proper administration of the direct lending authority,

the relatively inconsequential use of section 13b would suggest that industry's bank credit needs have been fairly well taken care of by the commercial banks over the past 15 years.)

The Reserve banks' V-loan guaranty program, likewise, assures business that the necessary bank credit for defense production will be made available.

Judgment on the adequacy of short-term bank credit to small business in this district is that virtually no credit-worthy demand is unsatisfied today. A survey of business lending by banks, made in 1946, indicated widespread bank financing of all sizes of business. This situation is not believed to have changed appreciably in the past 5 years.

While admittedly the number and volume of loans made is no complete measure of unsatisfied demand, it is significant that the 1946 Business Loan Survey showed some 28,870 loans by district member banks to business outstanding at that time with the average loan being for $18,947. (Nonmember banks were not included in this survey. While member bank resources account for the bulk of banking resources in the district, there are about twice as many nonmember banks as member banks.) The bulk of the loans (number) was made to small businesses. Almost 26,000 of the loans were to businesses with assets of less than $250,000. Another 2,000 were to businesses with assets from $250,000 to $750,000. At that time, the Federal Reserve Bank of St. Louis in summarizing the results of the survey noted:

> One of the most significant results of the survey with regard to asset size and type of business borrower is the close correlation between the number of loans going to businesses with assets of less than $250,000 and the proportion of all small businesses to total number of businesses. About 9 of every 10 business loans made by banks in this district went to borrowers which (in terms of asset size) would be classed as small business. According to most widely accepted definition, about 9 of every 10 business firms in the United States are small businesses. This district, representative in so many respects of the Nation as a whole, probably is equally representative in its proportion of small business establishments to all business establishments. Similarly the proportion of total dollar amount of loans to borrowers in the two smallest classes is in general agreement with the relative share of employment or of sales volume of small business firms as traditionally defined. It appears, therefore, that the banks of this district are not neglecting the financing of small business.

Intermediate and long-term credit.—In the intermediate and long-term credit fields the statistical picture is not quite as clear. Improvement, however, has occurred in the past quarter century in these fields, and today small business credit needs for intermediate and long-term borrowed funds seem to be met reasonably well.

Over the past 25 years, term lending by banks has expanded. Further, participation on the part of smaller banks with their larger correspondent banks or with insurance companies has permitted the smaller banks to accommodate individual businesses in their communities with larger credits than would be possible from their own resources and for longer terms.[5] Establishment of the System's 13b

[5] The Chase National Bank of New York, for example, in 1950 set up a fund of $10 million to furnish intermediate-term credit to small businesses all over the country in cooperation with its 3,700 correspondent banks (at least one in virtually every county in the 48 States). Loans are made through local banks. The Chase Bank may agree, after a period of review, to take up to 90 percent of the loan, allowing a half of 1 percent to the local bank as a service fee. Minimum rate to the Chase Bank was fixed at 4½ percent; maximum loan, $25,000. (This fund has reportedly not been used extensively to date.)

program also helped term lending to businesses, moderately insofar as actual extension of term credit or commitments to extend term credit are concerned, but substantially in setting examples for commercial banks and small businesses to follow. Finally, the growing acceptance by commercial banks of the amortized loan principle has aided very small businesses in financing their intermediate-term credit needs and has aided small or intermediate-size businesses to escape the task of directly financing their customers, thus leaving the working capital of the small business to serve other purposes.

In addition to the improvement in bank lending, a number of Federal lending or loan-guaranteeing activities have appeared in the past 25 years or have been extended. Particularly important have been the RFC direct lending and participation programs and the VA loan guaranty program.

If there is any appreciable lack in the credit field for small business in this district it probably lies in the long-term area (maturities of 10 years and more). In part, any such lack reflects an institutional shift from equity capital to long-term credit which in turn reflects a variety of factors including the preoccupation with security, the institutionalization of savings, high income-tax rates, and so on. In other words, the demand for long-term funds now focuses more than in the past on credit and less than in the past on capital investment. Thus part of any failure of long-term credit supply to meet demand really reflects this shift away from equity investment.

Small firms cannot tap the organized security markets for long-term loans as easily as can larger, older and more well-known firms. Most of the long-term credit needs of small business thus necessarily are met by real estate mortgage credit, much of it granted by financial institutions other than commercial banks. Traditionally the commercial banks have been only minor factors in this long-term credit field. In most cases, the long-term credit needs of small business seem to be served, but there probably is some unsatisfied, worthy long-term credit need. The record of new business starts and business growth in this district over the past decade, however, would suggest that any such unsatisfied demand was of no appreciable magnitude.

Capital.—The question concerning adequacy of equity capital for small business is more difficult to answer than those concerning credit adequacy. One important source of funds (relatives and friends) shows greatly increased liquid assets and should, therefore, be more adequate to help small-business men with their equity capital problem today than a decade ago. But two factors apparently have offset, at least in part, the improvement in individuals' dollar incomes and liquid asset holdings: (1) the increased capital requirements in dollars, and (2) the increased income-tax rates compared with 25 years ago. The increased dollar-capital requirement is partly because of higher average prices for buildings, machinery and equipment and inventories, and partly because of an almost universal increase in technologies of production.

The question of capital for small business is partly a matter of availability of local funds. The importance of having funds actually within a region is often overlooked or discounted in the belief that money is not regional in character, that it will flow where it is most needed and most useful (that is, where it will command maximum

return consonant with risk). In practice, despite improving communication and transportation, this flow of funds lacks the perfect fluidity it theoretically possesses. Established programs and traditional practices introduce impediments to free movement. Distance and lack of personal contact tend to obscure the need of funds and to magnify the apparent risk of advancing them. Often prospective borrowers cannot identify prospective lenders and vice versa.

The growth in funds held in relatively underdeveloped regions like the eighth district is of prime importance to small business growth. In this connection it is noteworthy that the increase in home-owned funds in the eighth district over the past decade has been relatively larger than that for the Nation as a whole. For example, eighth district bank deposits have increased by about $5 billion since the end of 1939, a gain of 220 percent as against the national average growth of 170 percent. Within the district, deposit growth has been relatively larger at rural than at urban banks, thus further distributing available funds geographically.

During the war years, from 1941 through 1945, the St. Louis district ranked seventh among Reserve districts in demand deposit growth. Its relative gain, however, was appreciably larger than the national average and considerably more than that in the eastern districts. Since the end of the war, deposit growth in this area has continued to run above the national average. At eighth district member banks, private demand deposits increased 32 percent from December 1945 to December 1950, in contrast with a Nation-wide gain of 25 percent.

As noted, however, the growth in home-owned funds has been accompanied by larger capital requirements of business, and the tax laws (plus the emphasis on security as against opportunity) have made equity investment somewhat less attractive than it was a quarter century ago.

On balance, then, it seems likely that there is some gap, small but important to an area like the eighth district, between supply of long-term funds and worthy need for such funds.

My position on the problem of channeling a more liberal supply of long-term credit and equity capital into small business in this region is that two lines of approach should be emphasized. I would prefer not to foster either approach at present, partly because of the potential inflationary dangers still confronting us and partly because I do not see great need for such steps under the present emergency situation. At an approprate time, however, I would favor (1) the activation and promotion of local and area development programs, and (2) the establishment of pilot private investment trusts to provide mechanisms whereby current savings could be moved into productive use by small businesses. These trusts would generate experience from both lender and borrower points of view on proper profitable techniques.

Supplement for Ninth Federal Reserve District (J. N. Peyton, Minneapolis)

The question is of special interest to the ninth Federal Reserve district for it represents an economy predominantly composed of small business firms. From east to west, the district includes the upper peninsula of Michigan, the 26 northwest counties of Wisconsin, and

the States of Minnesota, North Dakota, South Dakota, and Montana. This territory is sparsely populated. As a result, markets are small and the average or typical business firm falls within the category of small business.

In the last 25 years, a number of changes in the structure of the economy have had a bearing on the ease or difficulty experienced by small-business men in raising capital or securing credit. Nevertheless, it is difficult to ascertain precisely how important an effect each change may have had on the financing of small business.

The steady advance in technology has increased the amount of capital required to establish a business. Rapid strides made in the mechanization of factory operations have resulted in the use of an ever-increasing number of specialized machines. In the production of the simplest products, complicated equipment is a prerequisite.

Technological progress also has resulted in the perfection of more complex products. Durable consumer goods have grown rapidly in the last 25 years. Economical production of these items requires large-scale equipment with correspondingly large capital outlays.

Even in the distribution of merchandise and services, where opportunities for mechanization have not been as great as in production, more fixtures and equipment now are required to display effectively the merchandise or render efficiently the services.

At the same time that more capital is required to establish a new business or purchase a going concern, higher rates on income and inheritance taxes have made it more difficult for individuals to accumulate sufficient amounts of capital. Individuals looking forward to the opportunity of entering business for themselves must rely more heavily on outside sources of capital.

Offsetting these changes in the economic environment which have added to the difficulty of financing small business, the general business prosperity of the forties has enabled the rank and file to accumulate small savings as never before in the last 25 years. Small business enterprise secures its equity capital almost entirely outside of the organized money market. A case study made by the Federal Reserve Bank of Minneapolis in 1948 disclosed five principal sources of equity capital:

1. The entrepreneur himself.
2. Relatives and close friends.
3. Business concerns.
4. Local and nearby capitalists.
5. The security market.

On the basis of this case study, the individual establishing a new business or purchasing a going concern generally had some capital of his own to invest in the venture. This was the case in 89 out of 122 firms called upon in this survey. Relatives and close friends comprised the second most frequent source of capital. In 23 concerns, they contributed to the original equity capital. Established business concerns supplied the initial capital for a number of new firms. Equity capital was secured in relatively few instances from local or nearby capitalists or through the security market. A number of corporations included in the study had been reorganized and at that time they secured capital through the sale of securities.

Although sources of equity capital for small business are almost entirely outside of the organized money market, sources of borrowed

capital or credit are principally the prevailing lending institutions. There exists a wide range of private, quasi-private, and Federal lending institutions supplying credit to small business. When a firm has acquired its essential equity capital, it is in a position to secure credit by pledging some of its collateral.

Private lending institutions and Federal lending or loan guaranty agencies have increased the supply of credit available to small business. Commercial banks have devised floor planning which enables manufacturers and distributors to carry their stocks of merchandise on bank credit. The term loan has grown into familiar use for the purchase of large and complex equipment which depreciates slowly. Installment loans are granted frequently when the creditor has only the particular equipment to pledge as collateral.

Industrial banks, small loan companies, and finance companies are organized for the purpose of granting small loans to individuals who have little or no collateral to offer as security. These companies loan to individuals for their business operations as well as for their family needs.

In the lending field, the Federal Reserve banks are in between private lending institutions and Federal lending agencies. They have authority to extend loans directly to established business firms for working capital provided the credit is not available on reasonable terms from private lending institutions. Experience has proven that the demand for such credit prevails only during periods of depressed business conditions. After this authority was granted to the Federal Reserve System in June 1934, Federal Reserve banks received a substantial number of applications for loans. In the early forties, the number of such applications received by the banks tapered off sharply and none were received during the war years, but with the slight business recession in 1949 the number of applications again rose significantly.

Federal lending or loan guaranty agencies, which lend directly or indirectly to business concerns, include the Reconstruction Finance Corporation, Rural Electrification Administration, banks for cooperatives, Defense and Administration Services agencies in guaranteeing V-loans, and Veterans' Administration. Other agencies, such as the Federal National Mortgage Association, Federal Home Loan Banks, Federal Housing Administration, and Commodity Credit Corporation, loan exclusively either on residential properties or on agricultural products.

In the case study made by the Federal Reserve Bank of Minneapolis, it was disclosed that small-business enterprise secured borrowed capital from numerous sources, chief of which was the commercial bank. Banks supplied slightly over one-half of the long-term total. In the purchase of a going concern, proprietors frequently found previous owners willing to leave some of their capital in the business; they were the second most important source of long-term borrowed capital. Other sources constituted relatives and close friends, suppliers of tools and equipment, and capital pools created by communities for the purpose of financing new enterprise. These latter sources were seldom used and contributed only a small amount of capital.

Commercial banks supplied most of the short-term borrowed capital. In the firms included in the survey, they supplied over half of

the total. Relatives and close friends loaned a small amount. In a few instances, the proprietor borrowed from a close business friend who secured it from a bank and reloaned it at a substantially higher rate of interest. For short periods, personal loans were secured from finance companies. Suppliers of tools and equipment frequently extended credit, the proprietor making a down payment that exceeded the depreciation on the equipment. Trade credit was generally relied on in some measure to finance the stock of merchandise.

The rate of business organization is a measure of the amount of capital and credit available to supply business. According to statistical information available, it appears that more businesses were organized sinse World War II than in any previous period. In the ninth Federal Reserve district, the growth in business establishments has been concentrated in manufacturing. For example, between 1939 and the first quarter of 1949, the number of manufacturing concerns in Minnesota increased by 1,119. A similar proportionate growth in such concerns occurred in other States of this district as well as in the entire Nation. The basic statistics are assembled in the accompanying table I.

During World War II, many retail and service establishments were liquidated. In this district where the population growth during the decade of the forties was held to 3 percent due to the emigration of labor to other regions, the number of retail stores and service establishments in 1948 when the business census was taken still was noticeably less than those in existence in 1939.

The liquidation of these business concerns during the war was traced to other causes rather than to a lack of capital and credit. Some proprietors entered the armed services while others were faced with a shortage of labor or found more profitable employment. The conversion of industry to the production of war materials reduced the supply of civilian merchandise, which forced some concerns into liquidation.

Following the end of World War II, the number of annual business failures was at an all-time low. With business boom conditions receding in 1949, business failures rose significantly. Inefficient management and not lack of capital or credit appears to be the dominant cause of these failures.

The success or failure of business ventures are not predictable with any degree of accuracy. Consequently, no technique has been devised which will assure all worthy prospective entrepreneurs the capital and credit they need and can use effectively, and deny them to those who are not competent to manage their business ventures successfully. While some, and perhaps many, worthy and competent individuals cannot raise sufficient capital to go into business for themselves as they might wish, enough capital is available to permit a substantial number of incompetent businessmen to go into business and subsequently fail.

In our private enterprise system, capital is invested in and credit is granted to business concerns on the judgment of individuals who bear the risk of failure of such concerns. If we wish to retain this highly efficient system, the risk-bearing function cannot be dissociated from the investment and credit decisions in the initiation of new business firms.

TABLE I.—*Number of manufacturing establishments in ninth district and in United States from 1909 through first quarter of 1949*

	1909	1919	1929	1939	1947	First quarter 1949
Michigan	9,159	8,305	6,549	6,311	9,892	10,914
Minnesota	5,561	6,225	4,206	4,008	4,567	5,127
Montana	677	1,290	553	585	652	735
North Dakota	752	894	346	350	362	367
South Dakota	1,020	1,414	588	468	494	553
Wisconsin	9,721	10,393	7,323	6,717	6,979	7,317
United States	268,491	210,959	206,663	184,230	240,881	274,890

Source: Data from 1909 through 1947 were taken from the census of manufactures. Data for the first quarter of 1949 were compiled from the old-age and survivors insurance program and published by U. S. Department of Commerce and Federal Security Agency.

TABLE II.—*Number of retail establishments in ninth district and in United States in 1929, 1939, and 1948*

	1929	1939	1948
Michigan	53,952	67,414	68,689
Minnesota	29,206	40,448	35,241
Montana	6,521	8,481	8,108
North Dakota	7,611	8,549	8,201
South Dakota	8,330	9,817	8,993
Wisconsin	38,045	47,604	46,500
United States	1,476,365	1,770,355	1,769,540

Source: Census of business.

TABLE III.—*Number of service establishments in ninth district and in United States in 1939 and in 1948*

	Personal, business, and repair service		Amusements		Hotels		Tourist courts	
	1939	1948	1939	1948	1939	1948	1939	1948
Michigan	20,567	21,376	1,825	2,623	865	1,136	436	1,441
Minnesota	11,904	10,104	1,066	992	804	818	765	1,063
Montana	2,384	1,942	295	222	492	398	246	392
North Dakota	2,363	1,955	256	247	232	219	23	61
South Dakota	2,617	2,087	333	333	194	194	164	224
Wisconsin	11,547	10,935	841	1,004	670	862	407	749
United States	570,057	559,559	44,917	50,347	27,987	29,650	13,521	25,919

Source: Census of business.

Supplement for Tenth Federal Reserve District (H. G. Leedy, Kansas City)

The answer to this question on credit and capital availability to small business as presented in the joint answer of the Reserve bank presidents is generally applicable to the situation in this district, within the limits of information available. The Federal Reserve System's survey of business lending in the fall of 1946, referred to in the joint answer, indicated that commercial bank lending in this district is predominantly to small business. Under the classification of small business stated in the joint answer, small business accounted for 80 percent of the number and 35 percent of the dollar volume of business loans extended by member banks. Subsequently, the volume of busi-

ness loans has expanded very substantially, and under present circumstances the chief concern has been that the amount of credit extended might be excessive in view of the price-inflation threat. While data of the type obtained in the 1946 survey are not available on a current basis, there is reason to believe that the proportion of loans and loan volume going to small business compares favorably with 1946 and that the demands of both small and large business firms for bank credit are currently being met in a satisfactory manner.

No comparable study of capital, or credit from sources other than commercial banks, has been made in this district. On the basis of less specific information, our understanding of the capital situation and our views with respect to the problem so far as this region is concerned are essentially in accord with the presidents' joint answer to the question.

Supplement for Eleventh Federal Reserve District (*R. R. Gilbert, Dallas*)

In my opinion, there are no changes which have developed in the eleventh Federal Reserve district during the last 25 years that have been peculiar to this district and have increased the difficulty of small-business men to raise capital or to borrow. Such changes as have occurred in the district during the past 25 years have in general been expansive and may have strengthened the ability of small-business men to raise capital or to borrow. The strong growth factors in the district should make the formation of new businesses more attractive and more promising than might be the case in other parts of the country where expansive forces and growth factors have been less pronounced. I know of no statistical measure that would indisputably establish the adequacy of capital available to small business, but, on the other hand, it is a fact that the economic growth and expansion in the Southwest has been more pronounced than for the country as a whole. It is possible, of course, that had there been even greater capital availability there might have been greater growth, but this cannot be established. On the other hand, the Southwest's remarkable economic growth is an established fact. In my opinion, the same set of factors and conditions which are developed in the general answer to this question are also applicable to small business in the eleventh district, modified only to the extent that the more rapid economic expansion of the Southwest would tend to make this area offer more attractive capital-investment opportunities than other areas.

Supplement for Twelfth Federal Reserve District (*C. E. Earhart, San Francisco*)

It is not surprising that no definition of small business is given in this question, since small business is not a concept capable of exact measurement. To establish fixed upper limits in terms of some quantity, such as sales, number of employees, or assets, serves no particularly useful purpose here. By the same token, however, since an appropriate definition depends upon the discussion at hand, it is necessary that the use of the term "small business" be understood. With respect to the question of availability of equity capital and credit, we assume that small business, in a broad sense, includes all enterprises not large enough to have recourse to security markets. However, we

assume that the question is directed, to a considerable extent, to very small business; that is, to businesses, many of which are individual proprietorships, which have relatively few employees, and in which the capabilities of one or two persons are likely to be decisive factors in success or failure. This is the area in which many of the complaints regarding lack of funds originate. It is also assumed that the question is directed toward the relation between access to funds and the ability to launch new small enterprises.

Growth of the business population.—In our opinion, the conclusions in the joint reply (pp. 787–796) regarding the financing of small business are, in general, applicable to the twelfth district. Population growth in the district has been accompanied by vigorous and extensive business expansion, including the formation of new businesses at an active rate. In December 1949, a Department of Commerce study in the Survey of Current Business reported that the total number of businesses in the far West, including four of the seven twelfth district States, increased 56 percent between March 1944 and March 1949. During this period, the number of contract construction firms more than tripled, wholesale firms became 83 percent more numerous, public utilities and concerns in transportation increased 82 percent in number, manufacturing firms 60 percent, service establishments 53 percent, and retail trade concerns 40 percent. This area led the Nation in the relative increases in number of firms in all businesses, and in manufacturing, transportation and utilities, retail trade, and wholesale trade.

Between 1929 and 1947, the number of manufacturing firms in the district with less than 50 employees increased by more than 30 percent and accounted for some 70 percent of the total numerical increase in manufacturing firms. During a roughly similar period, retail concerns increased by about 50 percent or 58,000. It is safe to assume that the great majority of such retail firms are small businesses, with only a few employees per establishment. Our observation indicates that many of the district's contract construction firms are realtively small, and that many of substantial size have grown quite rapidly from small organizations.

From the evidence available as to the growth in number of business firms, it appears that small businesses in this district have had reasonable access both to equity funds and to credit in recent years. In the absence of generally adequate sources of funds, many of these businesses could not have come into being.

Equity capital.—Whether equity capital has become more or less readily available to small business over the past 25 years cannot be demonstrated conclusively. While it may have become more difficult for small businesses to raise equity capital, we should like to emphasize that many of the difficulties that confront small businesses and that may discourage investment in small business would not necessarily be corrected by a more liberal supply of credit. For example, compared with the situation 25 years ago, a man wishing to start or expand a neighborhood grocery store may be deterred far more by the competition afforded by chain stores and supermarkets than by a lack of funds.

As has been indicated (p. 128), the most important source of equity capital for most very small businesses is the proprietor and his relatives and friends. In this regard, mention has been made of the difficulty of accumulating personal funds for business investment in

the face of rising income tax rates. Without disagreeing with this for business generally, it should be pointed out that, in the postwar period, both liquid asset holdings and incomes of individuals have been at record levels and have apparently been more equally distributed than they were before the war. Consequently, it may be that persons seeking to launch very small businesses, who are usually persons of moderate income, have been able to supply equity capital and to obtain it from their families and friends with little more difficulty since World War II than previously.

Credit.—In our opinion, credit has become more readily accessible to small businesses over the past 25 years in the twelfth district, and in recent years has been adequate for their over-all needs. That district banks have been responsive to small-business demands is indicated by the loan survey made as of November 1946. At that time, almost 78,000 out of a total of 124,000 loans to business were made to firms with capital of less than $50,000.

Loans of banks to small business in the district include not only short-term loans for working capital purposes but also term loans of a year or more, with the majority of such term loans on an installment basis. With respect both to term loans to business and consumer installment credit, twelfth district banks have been in the forefront.

The November 1946 loan survey showed that, at that time, term loans of twelfth district banks accounted for nearly 30 percent of the national total in numbers, although for only 10 percent of the dollar amount. The next district in terms of the number of term loans (New York) had ony 15 percent of the national total. In the twelfth district, one out of three of all member bank business loans was a term loan, compared with one out of four in the next highest district (Minneapolis), and about one out of five in the country as a whole.

On the average, outstanding term loans of banks in this district were considerably smaller in amount than the average term loan for all districts combined. The average term loan of district member banks was also smaller in size than the average size of all business loans of those banks.

During the 1930's, banks had large excess reserves and limited investment opportunities. Though some banks had already shown considerable interest in lending to small business, it was not until the 1930's that they entered the installment lending field to any great extent. A large portion of the paper was acquired from retail dealers, and many small businesses used this method of financing to acquire equipment.

Through bank credit, business firms have been able in recent years to finance the acquisition of automotive equipment, tools, furniture, fixtures, and machinery, as well as inventory. Bank purchases from dealers of consumer installment paper have, in effect, financed accounts receivable in substantial amounts; direct lending to consumers, while of lesser importance, has served the same purpose indirectly.

In recent years, some of the larger banks in the district have developed small business departments and advisory services. These departments do more than process loans to small business; they also supply information and advice on business conditions, legislative developments, record keeping, and the like, that is useful to small business. Such practices have strengthened the position of many small firms.

That small businesses do have reasonable access to credit also eases the problem of equity capital to some degree. First, the borrower can extend his operations beyond the limits of his capital investment so that he can achieve a given scale of activity with a smaller equity; second, if the additional business supported by borrowing is profitable, he is able to increase his equity out of retained earnings at a more rapid rate. In view of the extent to which credit has been made available to small business in this district, we believe these factors to be of significance with respect to the availability of equity capital.

In conclusion, we should like to emphasize that any discussion of the access of small business to equity capital and credit is apt to be inconclusive. There are always unsatisfied seekers of funds. Whether these demands would be met if loanable funds or funds for investment in equities were made more plentiful is open to question. Investors, whether institutions or individuals, might still be reluctant to make funds available if there were little evidence that a sound business could be developed. Certainly, it is essential that new enterprises be permitted to enter the business arena, and that small businesses have an opportunity to expand, if we are to continue to have an expanding and dynamic economy, but to lower standards and supply funds without reference to reasonable prospects of successful operation would lead to an increased number of business failures and a waste of economic resources.

In the twelfth district, at least, it is our opinion that lack of access to credit and equity capital, as a factor of and by itself, is not a barrier to the establishment and growth of small businesses that, in terms of management, markets, and the other foreseeable factors relevant to success or failure, have a reasonable chance of meeting the test of the market, which is simply profitable operation.

36. Discuss the effects of bank examinations on the lending policies of banks in your district, particularly as they apply to loans to small-business men. Distinguish if necessary between examinations by different examining authorities.

Joint answer

The Board of Governors of the Federal Reserve System and the Federal Reserve banks have endeavored to develop uniform standards and practices in bank examination and supervision, and a joint answer to this question will serve to describe this common basis. The answer to this question should also be considered in conjunction with the answer to question 20 which deals with the role of bank examination and bank supervision in furthering the objectives of the Employment Act.

The banker is the custodian of other people's money. He watches over and provides the deposit currency on which the economic life of the community depends. Banking laws, practices, and ethics require that loans be made only when the banker is convinced that the chances of repayment are reasonably good.

In a broad sense bank examinations with regard to the lending policies of banks are designed: (1) to insure the observance by bank managements of applicable laws and regulations relating to loans, and (2) to encourage the making of loans of appropriate bank quality,

well diversified as to obligors, industries, collateral, etc., and under competent administration. No supervisory authority with whom we have contact criticizes or discourages small loans or loans to small-business men because of size, since supervisory authorities generally prefer a wide distribution of loans to concentration of loans to a few borrowers or to a limited number of industries.

An examiner, in appraising credits in any bank, reviews the data in the bank's credit files supporting the loans and, in addition to such information, gives weight to the loaning officer's expressions and personal knowledge of the borrowers. He considers the invested capital of the borrower, capacity, and character, as well as the conditions under which the borrower is conducting his business; he reviews, of course, the borrower's past earning record, the appraisal of "know-how" employed in the business, and its future prospects. Inability of the small-business man to furnish (or of the banker to obtain) adequate credit information may expose loans to small business to more criticism from the bank examiner than loans to larger, better established firms with more adequate records.

A review of banker attitudes following bank examinations, particularly as they relate to the effects of bank examinations on lending policies, indicates that officers in the medium- and small-sized banks are probably influenced more by examiners' appraisals and criticisms than are the officers of the larger banks. The lending officers in the larger banks generally are more thoroughly schooled in the analysis of credits, and have more complete credit information in their records.

For the reasons (1) that records, statements, and credit information of small businesses are frequently less satisfactory than those of larger businesses, (2) that loans to small businesses are more important in the smaller banks than in the larger banks, and (3) that officers of smaller banks tend to be influenced more by examiners' criticisms than do those of larger banks, the examiners' criticisms may have a stronger influence on the extension of credit to small businesses than on extensions to larger businesses. The examiners, however, criticize loans not because they are small, but because of adverse factors. That these factors may happen to be more prevalent among small businesses is not a function of size of firm but rather of the ability and experience of the businessman. That these adverse credit elements do in fact exist more frequently among small businesses, particularly when they are new, is revealed by the larger proportion of small businesses that go out of existence each year. As we have indicated earlier, however, examiners do not discriminate against loans to small businesses as such. That the criticisms of the examiners, in general, do not prevent small businesses from getting sufficient credit to maintain the vitality of small business in the economy is revealed by the large number of bank loans made to small businesses and by the record of the growth of the business population (compare the reply to question 35).

We cannot distinguish with confidence among the examining practices of the different examining authorities as those practices affect the extension of credit, particularly to small businesses. Some differences in practices undoubtedly exist but whether they are differences of examining authorities or of individual examiners would be difficult to ascertain. The appraisal of assets in an examination is a matter of judgment.

Whatever the differences may be, we believe that bank examinations do not interfere with the extension of adequate credit by banks to businesses, large or small. Loans today are in record volume and the evidence indicates that the overwhelming proportion of the number of business loans of banks is to small businesses.

Supplement for First Federal Reserve District (J. A. Erickson, Boston)

Criticism of a particular loan by the examiner may result from adverse available information or a lack of information. Lack of adequate information is a constant point of criticism. Such criticism, however, is not necessarily a reflection on the quality of a particular credit but rather a reflection on bank management in not obtaining information necessary to service properly the loan and to appraise the credit.

Most criticism by examiners is aimed at bank management rather than individual credits or types of credit. Many factors aside from the individual credit are involved in arriving at the examiner's conclusions such as the general over-all condition of the bank, the capabilities of bank management in servicing various types of credit, the size of the total loan portfolio, concentrations of credit, proportion of classified or marginal and long-term loans, and local and general business conditions.

There is little doubt but that a number of the smaller country bankers in their day-to-day consideration of loan applications reflect to some extent the past criticism of examiners. In years past, particularly during the 1930's, some bankers were prone to use the bank examiner as the reason for declining applications for credit. Most bankers today accept the responsibility for the management of their loan portfolios and no longer use the examiner as a scapegoat since they realize that if quality is present and the credit adequately supported by facts their loans will be favorably considered by the examiner.

That the criticisms of the examiners, in general, do not prevent small businesses from getting sufficient credit to maintain the vitality of small business in the economy is revealed by the large number of bank loans made to small businesses and by the record of the growth of the business population (compare the reply to question 35). A further survey of short-term commercial loans of 24 member banks in New England, who handle approximately 90 percent of the total commercial loans in this area, disclosed that of the new loans of this type made during the period September 1–15, 1951, 42 percent were in the $1,000 to $5,000 range, 17.7 percent in the $5,000 to $10,000 range, and 18.1 percent in the $10,000 to $25,000 range.

Supplement for Second Federal Reserve District (Allan Sproul, New York)

Bank examiners and supervisory authorities in the Second Federal Reserve District do not differentiate between loans to small business and loans to big business in their appraisal of the loan portfolios and lending practices of the banks they examine and supervise. Consequently, no data are available to indicate directly whether or not loans to small business have been, on the average, subject to more

criticism than loans to large business. It is the belief of our examining staff and supervisory officers that bank examinations have tended to promote improvement in the lending policies and practices of banks supervised with respect to small and large businesses alike, so that criticized loans are relatively few.

Tabulation of the most recent examinations of all member banks in this district, conducted during the past year, indicates that only 1.09 percent of the total loans reviewed were classified by our examiners as substandard, doubtful, or loss. The criticism of such a small proportion of the loans is significant evidence that bank examiners have not been so severe in their appraisals as to cause restriction of the availability of credit to the business community where a sound basis for credit exists. The following table summarizes the total loans and the total "classified" (or criticized) loans of the 739 member banks in this district.

[In millions of dollars]

Number and location of banks	Total loans	Total classified loans	
		Amount	Percentage
86 large city banks	$11,091	$112	1.01
653 all other banks	1,653	27	1.61
Total	12,744	139	1.09

The percentage of loans criticized has been moderately greater in the 653 of these member banks which are not located in large cities within the district. This difference might possibly indicate that a slightly higher proportion of small loans has been criticized, since the banks other than the large city institutions generally have a somewhat higher proportion of small loans in their total portfolios. Such an inference must be qualified, however, since no records are available from which we can determine whether the criticized loans at these banks were proportionately greater among loans granted to small businesses. The difference in any event is slight, and, to the extent that it has meaning, probably reflects the relative ability and business experience of the lender and the borrower, rather than the attitude of the examiner.

It is not the practice of examiners in this district to criticize new loans—that is, loans made since the previous examination—unless there is evidence of the development of material weakness in the position of the borrower and the safety of the loan. A loan is classified as substandard, doubtful, or loss only after the examiner has discussed it with the management of the bank and reviewed all pertinent records, and usually has obtained the agreement of the bank's management as to the appropriateness of the classification. The examiner does not attempt to dictate the lending policy of a bank.

We do not believe that there are any significant differences in the effect of the examinations made by the different examining authorities on the lending policies of the banks in this district.

Supplement for Third Federal Reserve District (*Alfred H. Williams, Philadelphia*)

In the third Federal Reserve district, bank examination policy is also directed toward discouraging an undue expansion of the total loan

portfolio. No specific maximum ratio of loans to total assets or to total deposits can be laid down which would be appropriate for all banks or under all circumstances. In all instances, the objective is to appraise the nature and degree of risk in the assets, including loans and investments, and relate the total exposure to the capital account, earning power, and managerial capacity. Such a policy is considered necessary if examinations are to serve as the chief tool of the supervisory authorities in their endeavor to insure the maintenance of sound banking conditions with due regard to the appropriate interests of the depositors, other creditors, and the public.

In some instances, a few national bank examiners in this district have taken the position during the past few years that a loan ratio in excess of 45 percent of total assets calls for a very careful examination of all pertinent factors to determine whether the total loan portfolio may be excessive. However, a careful analysis of the examiners' report in such cases suggests that their criticism was concerned primarily with an excessive amount of substandard loans and the failure of the bank managements to provide sound loan administration rather than at the size of the loan portfolio.

We know of no instances in this district where bank examinations have served to discourage loans to small-business men if such loans are supported by reasonable net worth, earning capacity, and managerial competence. Examinations do discourage loans to individuals and businessmen, both large and small, which provide what is, in effect, equity capital or fixed capital when inadequate credit information is on file or if the information available indicates a lack of earning power or paying ability to insure the liquidation of the loans within periods of time appropriate to the type of credit extension. It is felt that equity capital and long-term capital for businesses of uncertain prospects, where justified, should be provided by organizations which are not employing depositors' funds subject to immediate or early withdrawal and protected by relatively moderate capital accounts.

Supplement for Fifth Federal Reserve District (Hugh Leach, Richmond)

It might be well to preface the answer to this question by mentioning the close relationship between supervisory authorities and bankers in the development of credit policies and techniques. The development of new types of loan outlets, the changing needs of commerce and industry, and constant study by lending officers have given rise to many changes in lending policies during the past 15 to 20 years. As a consequence, many loans are made now that in earlier times would have been unsatisfactory or even unsound. It should be emphasized that new credit developments have evolved without restricting credit to any class of borrower and without any line of distinction being drawn in bank examinations between loans to large and small businesses or between one type of loan and another. In the development of these improvements bankers and examiners have learned much from each other, with the latter serving also as a medium for the dissemination—particularly to smaller banks—of new and improved methods of credit extension.

If specific faulty lending practices are observed by examiners, an effort is made to influence the bank's lending policies by suggesting

that it be more analytical of credits applied for and granted and adopt sounder credit administrative policies. Some of the principal practices urged are the following:

1. The bank should obtain borrowers' agreements to repayments prior to credit extensions.
2. As a general policy, loans should be paid seasonally, at the conclusion of the specific need, or reduced regularly at intervals designated by the particular circumstances.
3. Detailed information should be obtained that will disclose the source, dependability, and adequacy of borrowers' funds available for debt retirement.
4. Risks inherent in concentrations of credit extended to the same or related interests should be weighed carefully; such concentrations should be avoided to the extent deemed appropriate after thorough analysis.

Experience shows that capable bankers obtain necessary credit data from small as well as large enterprises and that failure to secure such information is a consequence of the attitude of the bank management rather than nonavailability of the information. It is generally true, however, that large businesses maintain more complete records of operations and are better equipped to furnish full credit information than are small concerns.

Examiners' appraisals of loans made by the great majority of member banks in the fifth district do not disclose a significant number characterized by an unwarranted degree of risk. Well-calculated risks are taken readily, administered carefully, and in such circumstances the banks' exposure is not considered unduly high. Where this is the case there is little or no need for conscious influencing of lending policies, and examinations of such banks have no particular effect in this respect. In the absence of examinations of such banks, however, it is probable that legal regulations would not be observed as carefully as they now are and that competitive pressures might result in unsound credit policies.

In a relatively small number of banks, examinations have disclosed substantial amounts of loans involving a very high degree of risk. Here bank examination and supervision do have a direct impact on lending policies in pointing out unsound loans and in suggesting desirable changes in credit policy. Frequently loans regarded as unsatisfactory would be proper and sound if made on suitable bases and terms. It is the purpose of bank examination and supervision to promote lending policies that will serve best the interests of both borrowers and lenders.

The examiner's principal concern is the quality of individual loans, but there are times when he must question the aggregate loans of a bank in relation to prospective demand from depositors and the capital protection available. Instances of this sort are relatively few and ordinarily rise in banks whose portfolios include a high volume of substandard credits. In such cases, there is frequently an excessive risk in relation to capital protection, a general lack of flexibility in asset distribution, and a consequent danger of serious loss. These conditions are usually found in small banks whose management is not as alert, experienced, or as capable as desired. It is the responsibility of examinations and supervision to encourage such banks to pursue sound lending policies, to reduce the exposure re-

sulting from unsound credits, and to gear the total loan volume to the ability of the bank to assume normal risks and maintain a sound and flexible asset position.

No supervisory authority with whom we have contact criticizes or discourages a small loan or a loan to a small-business man per se. In fact, these authorities prefer a wide distribution of loans to concentrations of credit to a few borrowers or to a limited number of industries.

We have not observed any differences in the practices of the various examining authorities with respect to loans to small business.

Supplement for Seventh Federal Reserve District (C. S. Young, Chicago)

In addition to the qualitative appraisals of individual loans described in the general answer, the several supervisory authorities operating within the seventh Federal Reserve district set rather flexible standards for the relative quantity of loan assets. Federal Reserve Bank of Chicago examiners place emphasis upon the ratio of capital accounts to "risk assets" (assets other than cash and Government securities), with appropriate allowance made for quality of the risk asset portfolio. In cases where an individual bank begins to fall appreciably below the desired minimum ratio, recommendations are made for improving the ratio. Except in the small number of instances in which an individual bank's capital ratio becomes very unfavorable, however, examiner recommendations stress additions to capital accounts rather than curtailment of loan expansion as a remedial action.

Quality and quantity standards followed by Federal Reserve Bank of Chicago examiners in appraising loans are designed primarily to protect the solvency of individual banks. When bank portfolios of earning assets contain an imprudent degree of risk, some reduction in additional risk assumption becomes necessary if the integrity of deposit liabilities is to be assured. Occasionally, temporary reduction in the availability of credit from a specific bank is part of the price which must be paid if the continued solvent operation of that bank—and therefore the continued availability of its credit facilities within the community—is to be insured over the years.

On those rather rare occasions when examiner criticism of the size or quality of loan portfolios has appeared to induce a tightening of lending policies, there seems little reason to believe that such tightening has disproportionately constricted the borrowing opportunities of credit-worthy small businesses. Credit extensions to new, untried, and undercapitalized businesses are undoubtedly among the first types of business credit to be affected under such circumstances, and a large portion of these firms would naturally be small in size. Over the years, however, the great bulk of business credit extended by most banks in the seventh Federal Reserve district has gone to small concerns. Because business firms are generally considered to be more desirable customers than individual borrowers, extensions to reasonably well-managed and well-established businesses, both large and small, are usually among the last types of loans restricted by a bank in any tightening of its general credit policy.

Supplement for Eighth Federal Reserve District (Delos C. Johns, St. Louis)

The joint reply covers adequately the situation in the eighth district. As indicated in my reply to question 35, the growth record of district business and district income would suggest that examination procedure in this region has not hampered credit-worthy small business in obtaining credit, either short or long term. Examination procedure would have little, if any, effect on capital investment.

(*Supplement for Ninth Federal Reserve District (J. N. Peyton, Minneapolis)*

Bank examinations are intended primarily to determine soundness and solvency of banks for the protection of depositors and for the national economic welfare. In making such a determination, individual assets are appraised and criticized if in the judgment of the individual examiner such criticism is justified.

Examiners visit many banks during the course of a year and have an opportunity to observe policies and practices in effect at each of the banks. In the course of each examination they are able to make suggestions based on their experience and it is our belief such suggestions are welcomed and have a beneficial effect. This holds true not only with respect to the over-all examination, but with respect to the examination and appraisal of individual loans.

Bankers are businessmen, interested in increasing their volume of business and hence the volume of business in their trade territories. They are solicitous of the needs and welfare of small businesses as well as large. In actual practice, bankers spend more time and devote more effort to the small-business man than they do to the large-business man, because the former is frequently getting started and needs more financial help as well as more counsel in getting his business established. The large-business man has generally proven his ability and needs less guidance.

Examiners understand the bankers' point of view and recognize the importance of developing small businesses to promote the national economy and to develop the communities in which the banks are located, just as fully as the operating officers of the banks. Suggestions and criticisms by examiners are made with a view to helping the bankers better to perform their functions in their communities and not to hinder them in those efforts.

That more small businesses fail than large business establishments cannot be attributed to bank examination policies. It is our belief that bank examinations have no adverse effect on small businesses. On the contrary, examiners, because of their observations of the experiences of many banks, are able to give helpful advice indirectly to small-business men through bankers. Failures among small businesses are attributable to many factors which bear no relationship to bank examinations. No bank examiner, whatever the examining authority under which he serves, as far as we have observed in our district, has criticized or discouraged loans to small businesses because of size of business.

Supplement for Eleventh Federal Reserve District (R. R. Gilbert, Dallas)

In the eleventh Federal Reserve district the Federal and State supervisory and examining authorities have cooperated closely for the purpose of coordinating their policies, standards, and practices to the greatest extent practicable. In fact, the Federal Reserve bank examiners conduct joint examinations of State member banks with the State examining authorities. In addition, the Federal Reserve Bank of Dallas has held an annual conference attended by supervisors and examiners during each of the past several years for the purpose of enabling the Federal and State supervisory and examining authorities to have the opportunity to discuss policies and practices toward the end of achieving most satisfactory coordination. On the basis of my observation and knowledge of practices in effect in this district, I believe that such differences as may exist between the different authorities are relatively minor in importance. I am not aware of any policies or practices relating to bank examination or supervision on the part of any of the authorities that would have the effect of interfering with the extension of adequate credit by banks to businesses regardless of the size of the business unit.

Supplement for Twelfth Federal Reserve District (C. E. Earhart, San Francisco)

Our experience in the twelfth district supports the statements in the joint reply to question 36. However, we doubt that bank examinations in this district have much more of an influence, so far as the banking structure as a whole is concerned, upon loans to small businesses than to larger ones. With the prevalence of branch banking, approximately three-fourths of the loans of district banks are held by the 15 largest banks (banks with assets of $300,000,000 or more). As a rule, the influence of examiners' comments is probably less in the larger banks. Moreover, the larger the bank, the higher is the minimum loan limit below which examiners cannot feasibly check every loan in detail. Many small loans to small-business men, particularly those which are in the personal or installment loan categories, may not be reviewed, unless they are past due.

While financial statements and other credit data of small businesses tend to be less comprehensive than those of larger businesses from the standpoint of the bank loaning officer and the bank examiner, small business records have improved considerably in recent years, in our opinion. This is due in part to the educational efforts of credit men and their organizations, and in part to the increasing necessity of maintaining adequate records for tax purposes and in order to comply with other Government regulations.

Certainly this bank's examiners do not discriminate against loans to small businesses as such, nor are we aware of any discrimination in terms of the size of the borrower on the part of examiners of other supervisory agencies in the twelfth district. All factors considered, we doubt that bank examinations have a markedly greater influence upon loans to small businesses than upon loans to larger concerns; in any event, it is our definite opinion that bank examinations do not prevent small businesses from obtaining adequate bank credit in the twelfth district.

APPENDIX TO CHAPTER IV

Questions Addressed to the Presidents of the Federal Reserve Banks

(The questions on this list, insofar as they refer to country-wide practices and conditions, may be answered jointly by the presidents if they so prefer—each president, of course, adding such supplement or dissent as he desires.)

A. OWNERSHIP OF THE FEDERAL RESERVE BANKS AND THEIR RELATIONSHIP TO THE GOVERNMENT

1. Describe the present arrangements with respect to the ownership of the stock of the Federal Reserve banks. What are the implications, advantages, and disadvantages of this ownership as compared with ownership by the Federal Government?

2. Who, in your opinion, owns the surplus of the Federal Reserve banks?

3. Do you consider the Federal Reserve banks to be part of the United States Government? Part of the private economy? If neither, or partly one and partly the other, discuss their status.

4. State the congressional policy directives applying to the Federal Reserve banks, citing appropriate statutes. In what respects, if any, do you believe that these directives should be altered?

B. ORGANIZATION OF THE FEDERAL RESERVE BANKS

5. Describe the roles of the presidents and the boards of directors of the Federal Reserve banks and of the Board of Governors in the management of the Reserve banks.

6. State the qualifications required for election as class A and class B directors of the Federal Reserve banks, and the method of electing such directors. Include in your description both qualifications and procedures prescribed by statute and those established by customary usage, distinguishing between them when necessary.

7. Do you believe that all of the directors of the Federal Reserve banks should be chosen as public representatives rather than as representatives of specified groups? If so, how should they be chosen? If representation of specified groups is to be continued, do you believe that labor should be added to the groups represented? If so, how should the labor representatives be chosen?

C. DISTRIBUTION WITHIN THE FEDERAL RESERVE SYSTEM OF AUTHORITY ON CREDIT POLICIES

8. Discuss the extent to which it is possible to maintain regional credit policies differing from national credit policies. Who is responsible for the formulation of such policies and what are the instrumentalities by which they can be maintained?

9. Describe the role played by the boards of directors and the presidents of the Federal Reserve banks in the formulation of national credit policy.

10. Trace the historical development of open-market operations covering both their significance as instruments of monetary and credit

policy, and the nature and composition of the bodies which have successively had control over them.

11. What is the rationale of the present assignment of authority over open-market operations to a body other than the Board of Governors? Why should the allocation of responsibility for open-market policy differ from the allocations with respect to discount rates and reserve requirements? Do you consider these differences desirable? Why, or why not?

12. Can open-market policy, discount policy, and reserve requirement policy pursue different general objectives or should these various instruments always be directed toward a common policy? When differences of viewpoint among the different policy-determining groups must be compromised in order to adopt a common policy, what are the factors of strength and weakness in the position of each of the parties to the compromise—i. e., the Board of Governors, the Federal Reserve Bank President Members of the Federal Open Market Committee, and the boards of directors of the Federal Reserve banks?

D. GENERAL CREDIT AND MONETARY POLICIES

13. Analyze the effects of the rising yield upon short-term Governments between August 1950 and March 1951 from the standpoint of (*a*) effect upon the volume of bank loans, (*b*) effect upon the level of private interest rates and the differential between those rates and the yield on Governments, (c) effect upon the market prices and the volume of sales of long-term Governments, (*d*) effect upon the policy of the Federal Reserve System to support the long-term Governments.

14. Describe the mechanism by which a general tightening or easing of credit, and the changes in interest rates which may result, is expected to counteract inflation or deflation. Discuss the impact on borrowers and lenders in both the short-term and long-term credit markets and on spending and savings. Indicate the effect on each of the broad categories of spending entering into gross national product. What are the (actual or potential) capital losses or gains that would be brought about by changes in interest rates? To what extent is the effectiveness of a program of credit restraint affected by or dependent upon expectations with respect to subsequent changes in interest rates? Distinguish in your discussion between small changes in rates and large changes in rates.

15. How rapidly and to what extent would you expect the volume of bank loans to respond to measures of general credit control under present conditions?

16. Compare the applicability of general credit and monetary measures and the resultant increases in interest rates as a means of restraining inflation (*a*) when the Treasury is not expected to be a large borrower in the foreseeable future, (*b*) when a large volume of Treasury refunding operations will have to be effected in the foreseeable future, (*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future, (*d*) under conditions of total war.

17. To what extent is the demand for United States Government and other high-grade, fixed-interest-bearing securities by nonbank investors influenced by (*a*) the current level of interest rates, (*b*) ex-

pectations with respect to changes in interest rates, (c) other factors?

18. What is the reason for the relatively slight use by commercial banks of the Federal Reserve discount and borrowing privilege? Do you believe that greater reliance should be placed on this privilege as a means of obtaining Federal Reserve credit? Under what conditions, if any, would you expect to see a greater use made of the discount privilege?

19. Do you believe that there is any conflict between measures to restrain excess demand by credit control and the need for expanding the economy to meet the requirements of a continuing readiness to resist aggression and a continuing high standard of living? If so, how can the effects of this conflict be mitigated?

20. What do you believe to be the role of bank examination and supervision in furthering the objectives of the Employment Act?

21. What do you consider to be the role of selective regulation of consumer credit in restraining inflation under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16? What attention should be given by the controlling authority to inventories and price and employment changes in the particular industries affected by the regulation? Discuss the operation of regulation W since its revival in the fall of 1950.

22. What do you consider to be the role of selective regulation of real-estate credit in restraining inflation under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16? Discuss the operation of selective regulation of real-estate credit during the past year.

23. What do you consider to be the role of selective regulation of stock-market credit in restraining inflation under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16?

24. What selective regulations, other than those over consumer credit, real-estate credit, and stock-market credit do you consider to be feasible? What would be their applicability under the conditions of each of the assumptions with respect to the magnitude of Government borrowing stated in question 16?

25. Explain and evaluate the Voluntary Credit Restraint Program which has been developed during the past year. What are the precautions taken to insure fair treatment of competing firms? What do you consider to be the role of voluntary credit restraint under each of the assumptions with respect to the magnitude of Government borrowing stated in question 16?

26. Discuss the use of moral suasion as a tool of credit control. How has this been used in the cases of member banks and of savings institutions, including life insurance companies?

27. What is the function of bank reserves? What are present reserve requirements with respect to banks?

28. Should nonmember banks be required to maintain the same reserves as member banks? Why, or why not?

29. Discuss the advantages and disadvantages of basing reserve requirements on types of deposits irrespective of the geographical location of banks.

30. Discuss the advantages and disadvantages of requiring additional reserves which might be held in whole or in part in the form of Government securities. Illustrate with a specific plan or plans.

31. Discuss the advantages and disadvantages of requiring during the national defense emergency a supplementary reserve to be maintained against *increases* in either loans and investments or deposits. Illustrate with a specific plan or plans.

32. Discuss the advantages and disadvantages generally of maintaining bank reserves against classes of *assets* rather than against classes of liabilities as at present.

33. State the statutory authority for the power, if any, of the Board of Governors, the Federal Reserve banks, or of any agency of the United States Government to control directly or to "ration" the extension of credit by individual banks. Specify the (legal) circumstances under which such rationing could occur and the control of the president over its operation. Under what (economic) circumstances, if any, would you recommend the use of credit rationing? Describe the manner in which you believe that such a system would operate.

E. THE BANKING STRUCTURE

34. Will you please submit a memorandum discussing the adequacy of banking facilities in your district? For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities.

F. AVAILABILITY OF CAPITAL FOR SMALL BUSINESS

35. On the basis of information available about your district, discuss the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred? Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

36. Discuss the effects of bank examinations on the lending policies of banks in your district, particularly as they apply to loans to small-business men. Distinguish if necessary between examinations by different examining authorities.

LETTER FROM THE DIRECTORS OF THE FEDERAL RESERVE BANK OF BOSTON

In addition to the general statements and answers to particular questions by the Presidents of the Reserve banks, the Subcommittee received the following communication, with enclosure, signed by all

of the members of the board of directors of the Federal Reserve Bank of Boston:

BOSTON, MASS., *December 13, 1951.*

To the Members of the Subcommittee on General Credit Control and Debt Management of the Joint Committee on the Economic Report, Washington, D. C.

GENTLEMEN: The individuals whose names appear below as signers of this letter are all Directors of the Federal Reserve Bank of Boston. In our capacity as Directors we naturally have a vital interest in the forthcoming hearings before your Committee.

It is our hope that the answers which you receive to the questionnaires which your Committee has addressed to various groups will prove of value in the adoption of sound measures for general credit control and debt management. It is possible that the findings of your Committee will recommend some changes in existing procedures in connection with those problems. For example, we hope that greater, rather than lesser, responsibilities may be given to the individual Boards of Directors and that System policy matters may be settled only after some form of consultation with those Boards. Since the men picked as Directors of the Federal Reserve Banks truly represent the business and banking judgment of their districts, it would seem that their views should have real value both to the Board and to Congress which is the final control of the System's functions.

Although we as individual Directors were not asked to submit answers to a questionnaire, we should appreciate the opportunity to be recorded on one fundamental point which we feel lies at the heart of any investigation such as that which you are conducting. It is our strong and unanimous feeling that one of the chief essentials of a sound economy is the continued independence of the Federal Reserve System, which in our judgment should be free of domination by the Executive, the Treasury, or any branch of Government other than the Congress which created the System.

In connection with this matter of System independence we are taking the liberty of submitting for your consideration the enclosed paper which we believe bears directly upon the matters subject to your scrutiny. It was written originally by Mr. L. Sumner Pruyne, Vice President of The First National Bank of Boston, for presentation to a private organization of which he is a member. It represents his personal views; it was not written with the thought of being presented to your Committee; and no effort has been made on the part of any of the undersigned to influence or to change the views as originally expressed by the writer.

When this paper came to our attention, it appealed to us for presentation to your Committee as pertinent background for the study which you are conducting. The paper outlines in general terms what has happened to our money supply in the years 1940 to 1950, inclusive, but it lays chief emphasis on the opportunities which were missed to reduce that money supply, and thereby to reduce the inflationary dangers, in the postwar years 1946 to 1950, inclusive. Some of us doubtless might have expressed the thoughts of this paper somewhat differently, and some of us may feel that the writer's criticism of the activities of the Federal Reserve System in the years 1946 to 1949, inclusive, was perhaps not entirely justified. However, in spite of these more minor reservations as to details and as to emphasis, we are in agreement on one point. We believe that the paper as a whole represents a fair and a clear sketch of what happened in the period in question; that it points up the dangers inherent in our present situation resulting from the huge increase in our money supply during the war years and our failure to reduce that supply in the postwar years; and that above all it emphasizes in our minds the necessity of maintaining the independence of a Federal Reserve System which can be free to perform its function of contracting credit in the face of these inflationary dangers.

Very truly yours,

FREDERICK S BLACKALL, Jr.
LLOYD D. BRACE.
RUSSELL H. BRITTON.
KARL T. COMPTON.
HAROLD D. HODGKINSON.
HARVEY P. HOOD.
ROY L. PATRICK.
EARLE W. STAMM.
AMES STEVENS.

ENCLOSURE ACCOMPANYING LETTER

Each of us know in a general way what inflation is and each of us is all too conscious of the impact of inflation on our daily living. We may all feel poor in terms of the purchasing power of our dollars, but we are conscious that there has been a marked increase in the money supply of the country in the past decade. Had this increase been advertised as due to the unrestrained printing of dollar bills by our Government, it would be easily understandable. The increase, however, took place largely in the field of bank deposits, and since this method of inflating the supply of money is more roundabout and less noticeable, the means by which it comes to pass are far less generally understood. To the extent that this study adds to an understanding of what lies behind the ballooning of our money supply in the past 10 or 12 years, it will accomplish its purpose.

Inflation has been rather inelegantly described as "too many dollars chasing too few goods." This phrase immediately indicates that there are two components involved in inflation: namely, money and goods. However, for the purpose of this discussion we shall make only the briefest mention of the second component by assuming that a shortage of goods was not, and is not, the primary cause of our present inflationary dangers.

It is perfectly true that we have had shortages of particular items at particular times in the recent past. During the war, for example, we obviously could not have an adequate supply of tanks simultaneously with a normal supply of automobiles. Furthermore, in the first few years after the war the factories of the country could not suddenly supply both the normal civilian demand and the abnormal demand resulting from wartime shortages. However, in spite of these particular periods when certain items were limited, there were relatively few actual necessities of life missing from our daily living, certainly in contrast with the rest of the world. Actually, except for a short period during the war itself, the supply of civilian goods has been far above prewar levels. We learned, in other words, the tremendous productive capacity of this Nation, its ability to turn out both guns and butter, and its resiliency to very great obstacles. Because of our productive capacity shortages of goods have been, and seemingly will be, only temporary. On this basis the assumption appears justified that inflation in this country is far less the result of shortages of goods than the result of an excess money supply.

When we focus our attention on the money supply, we are immediately confronted with a realization that there are primarily two forms of money: currency and bank deposits. It is true that money in circulation between the end of 1939 and the end of 1945 quadrupled from $6 billion to $26 billion. However, this increase cannot be regarded as too surprising in view of the intense business activity during that period, greatly increased employment, higher wages, and higher prices. Large as was the rise in currency in circulation, it was almost dwarfed by the rise in bank deposits during that same 6-year period, such deposits having almost tripled from $58 billion to $150 billion, for the staggering increase of $92 billion.

Up to this point we have narrowed down our line of thought from an over-all discussion of inflation to a concentration on the increase in the money supply and have moved from that to a further concentration on the increase in bank deposits. From here on the going will become more rough due to the unfortunate fact that any discussion of bank deposits requires an understanding of how the banking system functions in the creation of deposits and particularly of the role of the Federal Reserve banks in the over-all picture. Thus some of the succeeding discussion will be of a technical nature, even though every effort will be made to phrase the discussion in language reasonably familiar to the layman.

To understand the "why" and the "how" of a change in the deposits of commercial banks, it is necessary to go back to our college economics for a review of the factors which cause such deposit changes. There are five major factors which individually or collectively will always be found to be primarily responsible for any marked increase in commercial bank deposits. Each of these will be described briefly, though not necessarily in the order of their respective importance.

The first factor might be described as an inflow of gold to this country. Irrespective of who the seller may be, the Government will pay for the gold by the issuance of a check to the order of the importer and when the importer deposits that check in his own bank, the deposits of the banking system automatically are increased.

The second factor tending to increase bank deposits is found in a reduction of actual currency. We previously noted that money takes the form either of currency or of bank deposits, and since they are interchangeable, a reduction in currency automatically increases deposits. For example, at the end of the Christmas season a department store will find itself holding much more actual currency than it needs for its normal operations. When it returns the excess currency to its bank, its account at the bank goes up and the deposits of the banking system have been increased by that amount.

The third factor increasing deposits of the commercial banking system is found in an increase of loans made by those banks. For example, the XYZ Corp. borrows $1,000,000 from Bank A and receives the amount of the loan in the form of a deposit credit on the books of Bank A. Deposits have been increased $1,000,000. Even though the borrowing corporation may draw the money out of Bank A immediately by issuing 10 checks of $100,000 each, those checks in turn may be redeposited by the recipients in 10 different banks, perhaps located in different sections of the country. The fact remains, however, that the original increase in the deposits of the banking system is not extinguished until the loan is repaid.

The fourth factor of increase is similar to the third. For the commercial bank described as Bank A, instead of making a loan, purchases securities. For example, Bank A may buy Government bonds directly from the Government or from one of its customers. In either case it pays for the bonds by crediting the seller on the books of the bank, thereby increasing deposits. Again the seller—whether it be the Government, an individual, or a corporation—can check this deposit out of Bank A, but it will reappear in some other bank in the system and will not be lost as an increase in the total deposits of the system until Bank A or some other bank sells an equivalent amount of securities.

The fifth factor of deposit increase results from a purchase of securities by the Federal Reserve Banks. Assume, for example, that the Federal Reserve, through a dealer as an intermediary, buys $1,000,000 of Government bonds from the ABC Insurance Co. The minute the insurance company deposits that money in Bank A or in any other bank, deposits are increased correspondingly.

Having outlined the five major factors resulting in deposit increase, it is now necessary to note a highly important distinction between the potential effect of the fourth factor, in which Bank A (i. e., the commercial banking system) purchased the securities, and the fifth factor, in which the Federal Reserve Bank was the purchaser. If the purchase in each case was $1,000,000, the actual initial increase in deposits was $1,000,000, whether Bank A made the purchase or whether it was made by the Federal Reserve Banks. The *potential* effect, however, was very different.

The difference arises from the requirement that the commercial banks carry with the Federal Reserve Banks a reserve amounting to approximately 20 percent of deposits. Because of this reserve requirement, the commercial bank described as Bank A actually would have been unable either to make a loan or to buy securities in an amount which would raise its deposits $1,000,000 unless it already had excess reserves at the Federal Reserve Bank in an amount at least $200,000 greater than its actual reserve requirements on the date of the purchase. Assume, however, that the Federal Reserve Bank buys $1,000,000 of securities from a customer of Bank A. In this case we have already seen that the deposits of Bank A rise by $1,000,000. The more important significance, however, of this latter transaction is the fact that when the customer deposits in Bank A the check on the Federal Reserve Bank, the *reserves* of Bank A at the Federal are increased $1,000,000. With its reserves at the Federal thus up by $1,000,000, Bank A is potentially in a position to make loans or to purchase securities in amounts which will result in a total increase of deposits of $5,000,000. This is because its excess reserves at the Federal potentially can become required reserves when needed and $1,000,000 excess reserves at the 20-percent rate thus will support a $5,000,000 increase in deposits.

Because this distinction between the activity of Bank A (the commercial banking system) and the activity of the Federal Reserve System is as important as it may seem complicated, perhaps it can be restated and summarized as follows: On the initial transaction a purchase of securities either by Bank A or by the Federal Reserve is equally effective in raising deposits by the amount of the purchase. *Potentially*, however, a purchase by the Federal Reserve is five times as effective as a purchase by Bank A since the purchase by the Federal Reserve creates excess reserves, the ultimate use of which will lead to an in-

crease in deposits five times as great as that which results when Bank A is the purchaser.

With this necessary background behind us, we can now return to our original study of how and why the money supply as represented primarily by bank deposits has risen so drastically in recent years. For the sake of clarity the time since the beginning of World War II will be divided into two periods. The first period is one of 6 years, beginning at the end of 1939, when we were first conscious of the necessity of rearming, and ending at the close of 1945 shortly after the end of the World War. The second period is represented by the first five postwar years beginning at the close of 1945 and ending at the close of 1950.

For any periods of this length and for any subject as complicated as that of the money supply, one has to choose between brevity and clarity on one hand and detailed discussion of all factors concerned on the other hand. In what is to follow we shall pursue the former course and attempt to hit only the major high spots of what has happened. We admit in all frankness that by so doing the discussion will seem to ignore some of the more minor factors which had a bearing on this problem and will also seem to ignore shorter-term periods within the full 11 years when trends were somewhat divergent from the main trend which we shall follow.

First let us look at the 6-year period from the end of 1939 to the end of 1945, which we shall refer to as the Wartime Period. During those 6 years the fact of major interest to us is this: The supply of money as represented by total deposits plus currency in circulation practically tripled from $64 billion to $176 billion, a staggering increase of $112 billion. As previously mentioned, a relatively small part of this was represented by an increase in currency. By far the largest part, however, represented an increase in bank deposits. This increase in bank deposits, in turn, was caused primarily by an increase of $105 billion in the holdings of Government bonds by the banking system.

The background of this terrific increase in bank-held Government debt is not difficult to discern. We had a tremendously costly war to finance, so costly in fact that it obviously could not be financed as a practical matter out of current taxation but had to the financed in part by borrowing. Everyone connected with the financing effort recognized that as much of the borrowing as possible should be accomplished through sales to individuals and institutions outside the banking system in order to avoid the inflationary dangers of a drastic deposit increase. All of us well remember the strenuous efforts made to sell bonds to the public and to nonbanking institutions. In spite of those efforts more bonds had to be sold than could or would be absorbed in the nonbank field. The balance or residue of the financing necessarily had to be placed with the banks.

Remembering our previous discussion of bank reserve requirements, the commercial banks could only buy if they had access to increased reserves. Those reserves could only be supplied by the Federal Reserve Banks themselves, and they were supplied through Federal Reserve purchases of part of the Government security offerings. In view of our previous discussion it is interesting to find that the actual figures for this Wartime Period bear out the technique previously described. The Federal Reserve Banks absorbed approximately 20 percent of the residual financing, or $22 billion. Their purchases and the reserves which were created thereby allowed the private banking system to absorb the other 80 percent of the residual financing, or approximately $83 billion.

From the standpoint of our postwar and future economy, we well might wish that it had not been necessary to finance as much of the wartime borrowing through the banking system as was actually the case. However, it probably would be difficult and unfair to assign the blame for what happened to any one individual or group other than possibly Mr. Hitler. The main job was to win the war and to the extent that money to finance it was not available, it was necessary to manufacture it, not in this case by the printing of currency but by the printing of bonds. Tax rates were relatively high and there was a natural and general reluctance to raise them further. Individuals as a class subscribed to the bonds in relatively heavy amounts both directly and through savings banks and insurance companies. Whether they saved and subscribed to the fullest extent possible probably varies greatly in the case of one individual or another, but we do know that it was a period during which individual saving was necessarily diminished by high taxation. The subscriptions of the commercial banks and of the Federal Reserve Banks were necessarily as large as, but limited to, the amount of financing which could not be absorbed by other investors.

It would be difficult to be dogmatic about the role of the Government during this period of wartime financing. Considering the fact that the Government debt during the 6 years in question increased by a total of $231 billion, any fair observer should give the Treasury Department and the Federal Reserve Banks distinct commendation for an adroit job of raising this colossal sum of money. The adroitness and their technique are particularly noteworthy when one remembers that, during the raising of this money, rates on Government securities were not allowed to rise from the time the wartime pattern of rates was set in early 1942 to the end of the period in 1945. The free-spending and easy-money proclivities of the administration prior to the war may have had something to do with a reluctance on the part of some investors to subscribe for their full quota of securities, and the burden of debt and taxation which had been built up in the prewar years did not add to the ease of financing the war itself. On balance, however, the Government should be given all due credit both for raising the money and for their efforts to place it outside the banking system. Furthermore, although the yields afforded by the securities offered during the war were relatively meager, especially after the impact of taxation, the future interest burden of the Government was reduced thereby and it is questionable whether a much larger proportion of the financing would have found its way into nonbank hands had interest rates at that time been slightly higher.

Having completed our study of what happened during the Wartime Period, it is interesting to visualize the situation and the problem which, at the end of 1945, faced those charged with the management of our debt and of our fiscal affairs. Included in that latter group are particularly the Executive Department, the Treasury Department, Congress, and the Federal Reserve System. Any student of our economy could hardly fail to be impressed with the dangers inherent in a money supply which had practically tripled over a 6-year period as a result of the staggering increase in that supply of $112 billion. Furthermore, he could know with certainty that, unless drastic measures were taken to offset it, the money supply would be automatically increased by a rise in loans necessary to finance the resumption and enlargement of our productive facilities in order to make up for all of the shortages of goods created by the waste of war. Even though we are looking at this problem with the benefit of hindsight, it seems rather obvious that certain steps were absolutely requisite in attacking this problem. These would include immediate and continuing curtailment of unnecessary Government expenditures; a continuation of relatively high rates of taxation; a consequent budget surplus which would allow some reduction of Government debt to decrease, at least in part, the money supply in a manner converse to the manner in which it was increased; a willingness to see interest rates rise by an amount necessary to attract individuals and nonbanking institutions to purchase Government securities held by the banks; a policy on the part of the Federal Reserve System to restrict and to contract credit to the greatest extent possible without interfering with the creation of legitimate credit for productive purposes.

If these were logical objectives for the Postwar Period, we are justified in critically examining the years after the war and in using as our criterion of success or failure the extent to which these objectives were reached. Unfortunately, the picture which we find is not a happy one and if the Wartime Period could be characterized as one of "necessary evils," the Postwar Period probably should be characterized as one of "missed opportunities."

One of the objectives on which special stress was laid was a reduction of the supply of money as represented by total deposits plus currency. If we describe as the Postwar Period the 5 years between the end of 1945 and the end of 1950, it is discouraging in the extreme to find that the money supply not only did not decrease at all but actually increased $4 billion. Incidentally, it should be remembered that this particular 5-year period includes only 6 months of the Korean War and that, although the so-called cold war had started earlier, the 5 years in question were essentially years of peace

Considering the objectives which seemed so logical for our money managers to consider and to stress at the end of 1945, it seems almost incredible that no progress was made in reducing the money supply during the next 5 years. To seek the causes for this failure within the framework of both brevity and clarity, again it is necessary to concentrate entirely on the major highlights in analyzing the happenings of that period. The two chief factors affecting the money supply in those 5 years were represented by an incerase of loans of approximately $30 billion and a decrease of outstanding Government debt of $22 billion. Because of the importance of these two factors, each of them will be discussed briefly.

Since the increase of loans obviously tended to hold up the total supply of money, it would be only natural to ask if this loan expansion were not inflationary. Logical as the question is, it cannot be answered categorically. The reason is this: The loans created deposits, or money, and to that extent they were inflationary. On the other hand, there is little question but that the great bulk of those loans were for the primary purpose of rehabilitating on enlarging our Nation's facilities for the production and distribution of goods, and to this extent they were antiinflationary. It would be useless to argue and impossible to prove the net effect of this loan increase as far as the single issue of inflation is concerned. It is probably safe to assume, however, that on balance the largest part of the loan increase was both desirable and almost necessary for the particular period in question.

In view of this necessary and large expansion of loans, it was indeed fortunate that a large part of the deposit increase reulting from the loan expansion could be offset during the same period by a reduction of $22 billion in the Government debt. Unfortunately, however, the Government cannot be given credit for any part of that debt reduction because of one very large joker in the situation. In December 1945, just before the start of this Postwar Period, the Government borrowed about $23½ billion at the time of what was called the Victory Loan Drive. Since the war was over at that time, there has always been a question as to why the Government thought it needed to borrow such a colossal sum, but at least the financing was successful in the sense of placing a large amount of the debt outside of the banking system.

As a result of this financing the General Fund balance of the Treasury Department at the start of the Postwar Period on January 1, 1946, was over $26 billion, or perhaps $22 billion in excess of normal cash requirements. It became evident quite soon that they had overborrowed in excess of their actual needs by roughly that amount, and they started quite promptly to pay off debt. What this joker really indicates is that in the first five postwar years the Government simply reduced its debt by the amount of its overborrowing in December 1945. Or to put it another way, there was *no* real reduction in debt during the entire 5-year period.

Here again the reason is not hard to find because in those particular five calendar years the Government had a budget surplus of only about $1 billion. To call this a "missed opportunity" of the first magnitude would be to put it mildly in view of the high state of business activity during this particular 5-year period. The administration, for example, has always been more than willing to endorse the philosophy of Lord Keynes that governments are justified in operating at deficits for the sake of stimulating the economy during a period of depression. However, during this period of prosperity they showed all too clearly how difficult it is for a free-spending administration to follow that part of the Keynes philosophy which recommends the building of government surpluses during periods of high business activity. While giving lip service to economy and while urging a higher level of taxes than Congress was willing to vote, the administration provided the poorest possible leadership in any real move to combat inflation by its unwillingness to cut nonessential spending and by its almost eager willingness to be found on the side of higher wages and higher farm prices. Congress also must accept its proper share of the blame during this same period for not insisting on the budget cuts about which so much was said and written but toward the achievement of which so little was done. It can also be charged with the failure to keep taxes high enough to provide a real budget surplus each year. Here again, however, Congress well knew that the voters and taxpayers would both resent and resist increased taxes at a time when the administrative leadership was making no real effort to control or to reduce the terrific cost of Government operations.

If we return to the list of logical objectives which the money managers might have set as their goal at the end of the war, we will recall that one of those objectives was to reduce the money supply by transferring debt from the hands of the commercial banking system to the hands of individuals and other institutions. In other words, even if total debt were not really reduced, can we not at least hope to find that its ownership has been transferred to less inflationary hands? Remembering that the total debt during this postwar period was reduced $22 billion, we are at first pleased to find that holdings of Government securities by commercial banks and by the Federal Reserve banks declined during these 5 years by almost $32 billion. Thus at first blush it would appear that the Treasury Department had been able to effect a $10 billion transfer in ownership by the sale of securities to nonbank investors.

Immediately, however, we are confronted with another joker which is all too little understood by citizens generally. Each year the Government collects in special taxes, particularly the Social Security Tax, substantial sums of money aggregating between $3 and $4 billion. These taxes are invested in Government bonds by the administrators of the various funds in question and the bonds are held against the future liabilities of the Social Security and other programs. During the first five postwar years the investment of those various funds in Government bonds rose by $12 billion. Thus $12 billion of Government debt found its way through the involuntary method of taxation into the portfolio of these Government agencies, and we have already found that $22 billion of debt was retired by the proceeds of overborrowing in 1945. Since this total of $34 billion is in excess of the actual $32 billion reduction in Government securities held by the banking system, it is obvious that on balance the Treasury Department was not able to persuade individuals and nonbanking institutions to add a single bond to their holdings during the 5 years in question. In fact, there was a net reduction in such nonbank holdings during that period.

If we are justified in looking upon this record as another "missed opportunity," we are also justified in seeking the reasons therefor. Chief among these appears to have been the reluctance of the Treasury Department during practically all of this period to depart from its almost stubborn fondness for very easy money and low rates on its security offerings. Any official of the Treasury Department can be pardoned for a natural tendency to wish to keep down the cost of debt service. However, the colossal rise in our money supply during the war obviously had placed a powder keg of potential inflationary dynamite under our whole economy. Under such circumstances it would have seemed that inflation was a considerably greater danger than a modest rise in the cost of borrowing. The logic of this statement becomes apparent when one considers the following three points:

(1) Any increase in interest cost would apply not to the total debt but only to that portion which is refunded at maturity or by exchange offers.

(2) The Treasury Department would automatically recapture a substantial part of any increased interest costs through taxes levied on the income of holders of these securities.

(3) The Government is the world's largest single buyer and consumer of goods and services. The easy money policy of the Treasury Department following the war tended substantially to "freeze in" the inflationary potentials which resulted from the war. Thus the Government's own policies may well have raised the cost of everything which the Government buys by amounts far in excess of the relatively modest net cost of higher interest on its securities.

Not only did the Treasury keep rates low, but it insisted on confining practically all of its offerings to short maturities. For a period of 4 years—from the end of December 1945 to December 1949—the Treasury offered to the public no securities with a maturity of over 18 months, other than savings bonds and savings notes. Even as late as December 1949, when the potential demand for long-term securities by nonbank investors was indicated by a price of 103½ on the long-term 2½ percent bond, the Treasury Department, instead of meeting that demand, offered a 4¼-year 1⅜ percent note of obviously no interest to long-term buyers. Thus its choice of maturities served to complement its easy-money policy in failing to attract buyers outside of the banking system.

In earlier sections of this study we noted the potentially sharp impact which open-market purchases and sales of securities by the Federal Reserve System could have upon the money supply. It therefore becomes pertinent to examine the role played by the Federal Reserve in these first five postwar years. Their operations admittedly are influenced and complicated by varying, and at times conflicting objectives. For example, it should be granted that the size of their holdings was at times influenced by changes in the rates of reserves which the commercial banks were required to hold against deposits. During this period the Federal Reserve System also had to consider the desirability of creating credit conditions which would make it possible for industry to expand its productive facilities.

However, one would have thought it logical for the Federal Reserve System to consider inflation as Public Enemy No. 1 and to take as its primary objective the reduction of the money supply at the end of the war. In the light of that objective it is probably not unfair to determine what contribution, if any, the Reserve System made toward the attainment of that objective. We have previously found that the total debt of the Government was reduced $22 billion

and that an additional $12 billion of the debt was transferred to the ownership of the various Government agencies. If this total of $34 billion could have been applied to the reduction of debt held by the banking system, we would normally expect to find the holdings of the Federal Reserve Banks reduced at least by 20 percent thereof, or by $6.8 billion. Instead of that we find that the holdings of the Federal Reserve System in the first five postwar years were reduced by only $3½ billion. Thus, even making allowance for some necessity of creating an atmosphere favorable to productive loans, it seems evident that the Federal Reserve System can also be charged with a "missed opportunity" through its failure to contribute to the reduction of the money supply.

This failure on the part of the Federal Reserve System is attributable to the one basic fact that the open-market operations of the Reserve System during most of the 5 years in question were geared to the preservation of the easy-money rates favored by the Treasury Department. It has already been pointed out that during the war the Federal Reserve and the Treasury worked closely in cooperation with the result that the colossal amount of wartime financing was handled with remarkable smoothness and at a remarkably low rate of interest. There is good evidence to indicate that at least some prominent officials of the Federal Reserve were not equally enthusiastic about the easy-money policy favored by the Treasury Department after the war.

Despite their reluctance, however, the actual open-market operations of the Reserve System until the latter part of 1950 were handled in such a way as to support prices of Government securities at levels designed to facilitate continued Treasury offerings at low rates in spite of the inflationary implications. For example, between November 1947 and November 1948 the Federal Reserve Banks purchased approximately $7 billion of long-term Government bonds to prevent those issues from selling below par. In justification for this action the fact is sometimes cited that *total* holdings of the Reserve System went up in that 1-year period by only $1 billion. This seeming inconsistency is explained by the fact that the Treasury had a very substantial cash surplus during that particular period. Had there been agreement that the fight against inflation was the No. 1 objective, the cash surplus could and should have been used to reduce debt held by the banking system and consequently to reduce the money supply. Instead of that, the Federal Reserve operation of supporting the Government bond market in effect practically used up and wasted the anti-inflationary ammunition which was available.

The illogical nature of the Federal Reserve operations during the Postwar Period becomes evident if we look at the primary function which has been delegated to the Reserve System. This primary function is "to regulate the supply, availability, and cost of money with a view to contributing to the maintenance of a high level of employment, stable values, and a rising standard of living." Thus there seems little question that the proper function of the Federal Reserve in a period of inflationary pressures was to *reduce* the supply of money by *reducing* its holdings of Government securities.

Contrast that normal and orthodox functioning of the Federal Reserve System with what actually happens under a policy whereby the Federal supports Government bonds at fixed prices. Under a fixed support policy the Federal Reserve not only becomes a buyer on balance, instead of a seller, but loses all initiative as to the amount of securities which it has to purchase. In order to protect a fixed price level, it must purchase from all holders of Government bonds irrespective of the use to which the proceeds are to be put. It no longer becomes a central bank for bankers but a residual buyer from bondholders generally, with the decision as to whether the Federal will buy and how much it will buy resting not with the Federal but with the individual and institutional bondholders. Instead of contracting the money supply, this central bank under a policy of fixed price support becomes potentially the most powerful factor in *increasing* the supply of money.

Fortunately, the completely illogical position in which the Federal Reserve System found itself came, in the latter part of 1949, under the scrutiny of a subcommittee of Congress under the able chairmanship of Senator Paul Douglas, of Illinois. In January 1950 this subcommittee released a report pointing out that the vigorous use of a restrictive monetary policy as an anti-inflationary measure had been inhibited since the war by the policy of supporting the prices of Government securities. The committee in effect recommended restoring to the Federal Reserve freedom to restrict credit as an important contribution to the fight against inflation. It was recognized that such credit restriction might well involve a higher level of interest rates, some increase in the cost of

servicing the Government debt, and a possible abandonment of Federal Reserve support of Government bonds at fixed prices. The recommendations of the subcommittee were never actually acted upon by Congress, but they undoubtedly helped materially to strengthen the backbone of the Federal Reserve officials in their continuing controversy with the officials of the Treasury Department on this vital subject.

Finally, in March 1951, announcement was made of an "accord" which had been reached between the Federal Reserve and the Treasury Department concerning the terms of a new bond issue carrying a higher rate than any which had been offered since the beginning of the war. There is nothing on the record to indicate whether the "accord" included a willingness on the part of the Treasury Department to allow outstanding long-term bonds to sell at prices below par. The fact remains that within a relatively short time of the announcement just mentioned long-term Government bonds actually were allowed by the Federal Reserve to fall below par for the first time in a decade. Thus this particular phase of our study ends on a somewhat happier note than the other phases. In the 5 years ending with the close of 1950, the Federal Reserve System could be cited with other agencies of Government for their failure to attack the swollen money supply. Shortly thereafter, however, the Reserve System regained its independence from the Treasury Department, and we can hope that it will continue to retain and to exercise that independence in the fight against inflation and in the maintenance of a more stable economy.

Our study may be summed up briefly with a look to the future. During the Wartime Period our money supply was increased to a tremendous figure and no progress was made in reducing that supply in the first five postwar years.

In looking at the pessimistic side of the future outlook, we find an administration which as yet has given no evidence of any constructive leadership toward economy in even the nonessential items of Government operations. Most Members of Congress appear interested in cutting expenses or in keeping taxes at realistic levels only if those economies and those taxes can be devised in a manner to hurt their particular constituents the least. There likewise remains the suspicion that the Treasury Department is less interested in the battle against inflation than in the maintenance of relatively easy money rates. Naturally, the most pessimistic factor of all is the international situation as exemplified by the attitude of Russia. One might not be accused of being too cynical if he suspected that the Russian leaders hope by their series of warlike maneuvers and incidents to do more harm to this country by fostering further inflation here than they might be able to do by force of arms.

On the more optimistic side of the future outlook we can cite the regained independence of the Federal Reserve System and particularly the tremendous productive capacity of our country. There is a third factor which potentially could exert a powerful influence toward high-level decisions which would put us back on the road toward a real and sustained attack on the basic causes of inflation. This factor would be found in a broadened understanding by the public generally of what has really happened to our money supply, the reasons behind it, and the cures for it. To the extent that this study makes any contribution to that understanding, it will have fulfilled its purpose.

OCTOBER 1951 L. SUMNER PRUYNE.

CHAPTER V

REPLY BY THE COUNCIL OF ECONOMIC ADVISERS (LEON H. KEYSERLING, CHAIRMAN; JOHN D. CLARK,[1] ROY BLOUGH)

A. Congressional Policy Directives

1. Do you believe that the congressional declaration of policy contained in the Employment Act of 1946 is balanced in its emphasis upon high-level employment and upon price stability respectively, as objectives of Federal Government policy? If not, what changes have you to suggest?

Two passages in the Employment Act of 1946 give the documentary basis for commenting on this question. The act declares that it is the "continuing policy and responsibility of the Federal Government" to create and maintain "in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power." At another point the act states that it shall be the duty of the Council of Economic Advisers "to develop and recommend to the President national economic policies to foster and promote free competitive enterprise, to avoid economic fluctuations or to diminish the effect thereof, and to maintain employment, production and purchasing power."

The emphasis in the act upon the objective of high-level employment is clear. The Council is of the opinion that this emphasis is a proper one: first, because high-level employment is a prerequisite of the production that is necessary to raise and maintain standards of living, to build up industrial capacity and, when the occasion demands, to strengthen the Nation's military defenses; second, because only when there is high-level employment can the largest number of people share to the greatest extent in the national output, through their own participation in its creation; and third, because the opportunity to be useful is both an individual good and a social good.

While price stability is not specifically mentioned as an objective in the Employment Act, there is no doubt that it is implicit in several of the stated objectives. "Economic fluctuations," mentioned in the second quoted passage, usually involve price fluctuations as an important aspect. Severe price fluctuations interfere with the maintenance of high levels of employment and production. The objective of maximum purchasing power can scarcely be achieved unless the real purchasing power of workers and all others who take part in production

[1] Mr. Clark did not participate in the development of these answers. His separate note in the Annual Economic Review of the Council of Economic Advisers is reprinted on p. 892.

is safeguarded from declines in the value of the dollar, and from the arbitrary and inequitable redistribution of real income that accompanies inflation and deflation. Moreover, the framework of free competitive enterprise, within which the declared objectives of the Employment Act of 1946 are to be achieved, would be threatened by wild gyrations of prices. Prolonged and excessive price movements would invite the collapse of the system of market pricing that is essential to the functioning of a free-enterprise economy. Price stability thus is considered not primarily as an end in itself, but as a means to the attainment of more fundamental economic goals.

Price stability should not, of course, be interpreted to mean price rigidity. The process, referred to above, by which prices serve to guide production in a free economy, necessitates freedom of movement for individual prices; and this flexibility of prices, coupled with the free decisions of businessmen and consumers which it reflects, inevitably leads at times to changes in price levels. Such general price changes could be absolutely prevented only by setting up a system of permanent price controls, and by taking from businessmen and consumers their freedom of choice. Such steps should be contemplated, even as temporary measures, only in periods of national emergency. If the objectives of the Employment Act of 1946 are to be achieved "in a manner calculated to foster and promote free competitive enterprise" the economy must have tolerance for limited price fluctuations. Some degree of price instability is unavoidable if there is to be economic growth under a free system.

Since the objective of price stability, though unnamed, seems clearly implicit in the language of the act, the Council does not suggest that the Employment Act of 1946 be rewritten to include price stability among the enumerated objectives. An explicit statement would run the risks of causing useless controversies over the meaning and desirable degree of price stability and of making price stability a goal that competed with the objectives of maximum employment, production, and purchasing power instead of assisting in their achievement.

B. Formulation of Fiscal and Monetary Policy

2. Do you believe that, subject to the statutes and general directives laid down by Congress, the fiscal and monetary policy of the United States Government should be formulated under the direction of the President? If not, what suggestions have you for the coordination of the policies of agencies not under the direction of the President with those of agencies which are under his direction? How urgent do you consider this problem to be?

This question raises fundamental issues concerning the structure of government and the allocation of responsibility among public bodies. Such issues are for determination on the basis of the Constitution of the United States by the Congress as a law-making body and by the President as the Chief Executive. The Council ventures to respond to the question because, quite aside from the jurisdictional aspects, the allocation of powers referred to in the question has great significance for the development of a comprehensive and consistent program of economic policies.

In answering this question it is necessary to make a distinction between fiscal and monetary policies. Fiscal policy, as the term is used here, is focused mainly on Federal receipts, expenditures, and debt management, while monetary policy deals with the availability and cost of credit and the supply of money. Monetary policy, as the term is used in this context, does not include the regulation of the banking business.

As far as executive responsibilities are concerned, fiscal policy is formulated and executed under the direction of the President. Some difference of opinion exists about the responsibilities for the formulation of monetary policies under existing statutes. There is no question that the Congress has delegated substantial authority to the Federal Reserve System with respect to monetary policy. The statutes, of course, also delegate certain functions to other agencies, but this does not relieve the President of his responsibility for supervising these activities. Nevertheless, the Federal Reserve System was so designed as to make it clear that the Congress intended to give the System a greater degree of independence than is implied in the position of most other executive departments and agencies.

Independence of the monetary authority has been supported by the argument that the borrower and the lender—or the spender of money and the creator of money—should not be under the same immediate control. It must be recognized, of course, that it is the Congress that determines both the amount of spending and the method of financing, whether taxation or borrowing. Nevertheless, we do not question the desirability of making monetary policy chiefly the responsibility of an authority having some degree of independence from all Government departments and agencies engaged in borrowing or lending.

The fact that the President does not have the same supervisory function with respect to the Federal Reserve System that he has with respect to other Government agencies should, however, not be confused with the question of whether the President is ultimately responsible for monetary as well as all other fiscal and economic policies of the Government. It is with this latter question that the Council is concerned.

The President scarcely could discharge his general constitutional responsibilities as Chief Executive, and certainly could not discharge his specific responsibilities under the Employment Act of 1946, if monetary policy were not regarded as one of the "functions and resources" of the Government to be coordinated and used in promoting maximum employment, production, and purchasing power. The Employment Act directs the President to include in his Economic Report a program for carrying out the objectives of the act. If such a program is to achieve its goal with maximum effectiveness and minimum cost, the various elements in the program to the greatest extent possible must be consistent with each other and part of an integrated whole. Unless this is done, one policy in the program may in effect contradict other policies, thus making for impotence of policy and waste of public funds.

Consistency and integration are needed not only in the formulation of recommendations to Congress, but also in carrying out policies adopted by Congress. This is particularly true with regard to achieving economic stability where a general policy in favor of stabilization may require quick action to deal with unstabilizing forces.

Even if economic stabilization were the only objective of the Government, there might exist at least the theoretical possibility that agencies under the direct supervision of the President on the one hand and independent agencies on the other might take contradictory actions based on different interpretations of the economic outlook. A problem of greater practical importance, however, is presented by the fact that stability is only one of the objectives of the Government, and monetary policy is only one of the methods of achieving stability. When various objectives must be promoted simultaneously, a combination of policies needs to be chosen that will promote these different objectives without tearing down one to build up another.

Furthermore, there is need for integration within the area of monetary policy itself. While the Federal Reserve System administers the principal instruments by which the availability and cost of credit and the money supply are influenced, the Treasury can significantly affect money and credit by the way in which it exercises such powers as the issuance of gold certificates, the depositing of receipts and the investment of trust funds. Likewise, the activities of Government lending and loan-guaranteeing agencies have a bearing on the volume and cost of certain forms of credit.

Accordingly, it is imperative that there be effective integration in the adoption of various policies to meet a variety of Government objectives under changing economic conditions. The President, as Chief Executive and head of the executive branch, is the only one person in the Government in whom this power of policy coordination can be lodged.

In its second part, the question solicits suggestions for "the coordination of policies of agencies not under the direction of the President with those agencies which are under his direction." Our view that monetary policy does come under the responsibility of the President although he does not "direct" the monetary authority in the same manner in which he supervises other executive agencies may seem anomalous, but the anomaly is more apparent than real. The need to coordinate monetary and fiscal policies with the other economic policies of the Government has been generally recognized. What conflict there has been in this area has been caused more by a clash of ideas regarding the contribution that certain specific monetary policies would make to the various economic objectives of Government than by a denial of the principle that monetary policy should be coordinated with other fiscal and economic policies. Moreover, in spite of the independence of the Federal Reserve System as an agency, a good deal of reconciliation among the various objectives of fiscal and monetary policies has been brought about under the general initiative and responsibility of the President.

The point to be emphasized is that difficulties have arisen from the complexity of various objectives and the ramifications of economic and fiscal policies, and have been reflected only secondarily in jurisdictional disputes. We believe that the same sorts of problems would have arisen even if there had been no jurisdictional question, and even if the most perfect machinery for coordination had existed.

We recognize, of course, that the coordination necessary for the development of a consistent economic program is greatly facilitated by the provision of appropriate coordinating machinery. We believe

that one of the chief purposes of the Employment Act is to provide such machinery within the legislative and executive branches of Government. On the executive side, interagency committees have been established as part of the general procedure for preparing material on behalf of the President for the Economic Report. One of these informal committees concerns itself with fiscal and monetary matters. In the final stages of preparation of material for the Economic Report, the Council has consulted regularly with the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and other officials concerned with monetary and fiscal policies. For other purposes, other arrangements for determination of fiscal and monetary policies have been made.

The Council believes that there is room for the further development of such informal methods of coordination. Whether experience has proved this method to be adequate, or whether effective coordination will require basic changes in the structure, is, as we have said, a fundamental policy question for the Congress to determine.

3. Discuss the rationale, advantages, and disadvantages of the present division of authority in the Federal Reserve System over the control of discount rates, open-market operations, and changes in reserve requirements.

The present division of authority in the Federal Reserve System—permitting the Reserve banks to participate in discount rate and open-market policies, but assigning to the Board of Governors undivided authority over reserve requirements—can be characterized, for the most part, as an historical anomaly. At the time of the drafting of the original act, there was no developed understanding of central banking functions as we think of such functions today. The main objectives, as stated in the act, were "to furnish an elastic currency, to afford means of rediscounting commercial paper," and "to establish a more effective supervision of banking in the United States." It appeared to the Congress that these objectives could be met most effectively by establishing a system of regional banks, which would be relatively autonomous and able to adjust their operations to the needs of their respective districts. This approach was also encouraged by the widespread fear that a single Federal Reserve bank might fall under the control of one group of bankers and become an agency of monopoly. As attitudes changed and the country became more aware of the importance of central banking operations in the promotion of economic growth and stability, the autonomy of the Reserve banks in decisions involving general credit policy was greatly reduced, at first by nonstatutory changes and later by important amendments to the act.

The only question of any import raised by the existing division of authority concerns open-market operations. As already noted, control over reserve requirements of member banks is centralized in the Board of Governors. The Board's power over discount rates is virtually as complete as its control over reserve requirements, in spite of the provision in the law that the Board go through the formality of calling on the Reserve banks to "establish" discount rates, over which it then has the power of "review and determination." There

is no dispute, today, as to the Board's authority not only to approve discount rates referred to it by the banks, but also to initiate changes.

Open-market operations, on the other hand, are directed by the Federal Open Market Committee, which consists of the seven governors and five members elected by the directors of the Reserve banks, with the different banks grouped in order to assure fair representation. The representatives must, by law, be presidents or vice presidents of the banks. Since the Board constitutes a majority of the Open Market Committee, it can control the committee, provided it is unanimous. If the Board is not unanimous, and if the bank representatives do not side with the majority of the Board, decisions can be made which are not consistent with actions taken by the Board with respect to discount rates and reserve requirements.

As a practical matter, however, the coordination of views is such that there is little opportunity for a policy conflict of this sort. The Board, as a regular practice, maintains close contact with the executive officers of the Reserve banks and gives full consideration to their views on all phases of credit policy. An additional factor which undoubtedly makes for increased harmony of views is that the appointment of the top executive officers of the Federal Reserve banks is subject to the approval of the Board before they can assume their respective bank posts.

For these reasons, it is difficult to see either important advantages or disadvantages in the present division of authority with respect to open-market policy, or any harm that might develop if the division were eliminated. The Board can obtain the benefit of the judgment of the banks' officers, whether or not there is a formal committee with joint Board and bank representation. It is uncertain that the division has merit simply as a compromise gesture, although, in 1935, when the monetary control structure was last modified, there was insufficient support for legislation providing for a more complete departure from the original concept of a regional Federal Reserve System.

C. Credit and Debt Management Policy

4. Describe the mechanism by which a general tightening or easing of credit, and the changes in interest rates which may result, is expected to counteract inflation or deflation. Discuss the impact on borrowers and lenders in both the short-term and long-term credit markets and on spending and savings. Indicate the effect on each of the broad categories of spending entering into gross national product. What are the (actual or potential) capital losses or gains that would be brought about by changes in interest rates? To what extent is the effectiveness of a program of credit restraint affected by or dependent upon expectations with respect to subsequent changes in interest rates? Distinguish in your discussion between small changes in rates and large changes in rates.

The effectiveness of the credit-control mechanism at any given time depends, in part, upon the exact nature and magnitude of the inflationary or deflationary pressures to be counteracted and, in part, upon the extent to which support is obtained from other policy instruments available to the Federal Government. For these reasons, it is difficult to generalize about the operation of the credit-control mechanism, or

to discuss its effectiveness in the abstract. A realistic appraisal of credit control must allow for the full range of contingencies as to economic setting and for the operation of other controls. In addition, the appraisal must take into account the uncertainty as to the exact nature of consumer and business reactions to changes in the availability and terms of credit. The operation of credit policy is dependent upon relatively variable psychological responses, probably to a greater extent than, say, fiscal policy or direct controls. We have in mind, for example, the impact of credit policy on incentives to save or consume, and the impact on incentives to invest or hold funds idle.

Various specific aspects of the credit-control mechanism are dealt with at other points in this questionnaire. In this answer our attention is focused on those broader aspects which seem to be of critical importance in determining the over-all effectiveness of the mechanism.

The functioning of the credit mechanism.—A general tightening or easing of credit is expected to counteract inflation or deflation by influencing the demand for goods—primarily private demand. Accordingly, to assess the contribution of credit controls in counteracting inflation or deflation, it is necessary to review the various ways in which the demands of consumers and businessmen are financed and to analyze the manner in which the tightening or easing of credit affects each means of supporting private spending. Private spending and investing can be financed out of (1) current income, (2) existing liquid assets, and (3) new bank credit. One of these means of payment can often be substituted for another, as when a business draws more heavily on its cash assets because bank credit has become less easily available. The employment of one method of payment sometimes increases the possibility of the use of another; for example, the spending of previously idle funds or of new bank credit increases incomes.

The functioning of the credit mechanism can be illustrated by the expected effects of a general tightening of credit. If bank lending is curtailed because reserve funds are more difficult to obtain or are more costly, or because the demand for loans has been reduced by higher interest rates, both the immediate and the future demand for goods may be lessened. Since a bank loan adds to the present spending of the borrower, and also to the future spending power of those who will receive higher incomes as a result of his spending, a decline in bank lending has a double tendency to hold down demand.

The actual results of this tendency may be large or small depending on the circumstances. Thus the restraint of lending is likely to have less effect if individuals and businesses are well supplied with liquid assets than if they are not. It is necessary to distinguish, of course, between liquid assets in the form of cash, which can be spent or loaned, and liquid assets in the form of securities, which must be sold for cash, perhaps on an uncertain market, before spending or lending can take place. General credit restraint cannot directly limit either the spending of available funds, or the transfer of idle funds to others to finance an increase in spending. However, the general tightening of credit may impede the liquidation of marketable securities, both directly by reducing the ability of commercial banks to buy them or to finance their purchase, and indirectly by causing a decline in the price of the securities, thereby discouraging the security holders from selling them, in view of the losses involved. The tightening of credit

cannot, of course, prevent the holders of nonmarketable redeemable securities from turning them into funds to be spent or lent.

A remaining question is whether tighter credit can counteract inflation by lowering the rate of spending out of disposable income, that is, whether it can lift the rate of saving. Tighter credit might result in a reduction in the distribution of business profits, in order to replace borrowed funds with internal financing, thus increasing the rate of business saving. The chief effect of a restrictive credit policy on saving is commonly believed to be brought about by the rise in interest rates. To the extent that higher interest rates encourage saving, they are a part of the mechanism of counteracting inflation. However, the available evidence gives little support to the view that the rate of personal saving is significantly affected either by the level of interest rates, or by changes in that level.

Effect of credit tightening on lenders.—A general tightening of credit can be accomplished in different ways. For the most part, we associate credit tightening with various actions which restrict the availability of bank reserves and, thereby, the availability of bank credit. Changes in bank reserve requirements accomplish a tightening of credit in this way, as do open-market operations and changes in Federal Reserve discount rates. "Moral suasion," on the other hand, does not operate through changes in bank reserves, but rather through its direct effect upon the willingness to lend.

The distinction between curtailment in lending power and curtailment in willingness to lend can be an important one. For example, increases in discount rates and other preliminary evidences of a shift to tighter credit conditions may lead to more cautious lending policies long before any scarcity of lendable funds materializes. Similarily, changes in reserve requirements may bring about a more than commensurate change in willingness to lend. It is equally possible, however, for the reverse to happen, that is, for lenders to resist in every possible way the efforts of the control authorities to restrict their lending power. When lenders follow such a policy, it is not necessarily because there is a basic disagreement with the monetary authorities. It may be rather because the desire of lenders to protect their competitive position appears to leave them little choice.

In view of the fact that commercial banks make little use of the rediscount privilege, the direct impact of discount rate policy on bank lending is bound to be small. Nevertheless, discount rate policy may accomplish a substantial credit tightening through its psychological impact on the willingness of commercial banks and others to lend. Increases in reserve requirements impose a more direct restraint on lending activities, although this restraint may not be appreciable when, as has been true in the postwar period, banks are able to meet higher requirements by reducing their holdings of Federal securities which then find their way into the Federal Reserve banks. Perhaps the most certain way of tightening credit is through open-market operations, although such operations must be carefully meshed with debt-management policy, as described in the answer to question 8.

We are impressed with the fact that, under existing conditions, general credit tightening cannot be achieved by a simple turn of the screw. For one thing, the large volume of existing funds could be used more actively. Moreover, even when the avenue of Federal Reserve credit

is closed to the banks, except for rediscount privileges, individual banks can usually obtain lendable funds by permitting their holdings of Government securities, which are largely short-term obligations, to run off. Such action would not expand the reserves of the banking system as a whole, except when the net result was to force the Treasury to rely more heavily on Federal Reserve credit.

When banks are short of lendable funds, they are forced to ration their loans. Steady customers are likely to be given preference, and many other firms will probably be disappointed. There will also be a tendency to tighten the terms of lending, including shortening of the length of loans, raising collateral requirements, and increasing interest rates. The banks may be guided by the economic effects of the loans when they are requested to do so by the monetary authorities, although such requests are generally of limited effectiveness because they are in no way binding upon the banks. Thus, there is ordinarily no assurance that the least important loans will be the ones reduced the most as the result of a general credit tightening.

Effects of credit easing on lenders.—It is far simpler to achieve a general easing of credit than a tightening. When reserve requirements are lowered and the Federal Reserve makes open-market purchases, the supply of lendable funds is increased and there is no real incentive for banks to resist such developments. The problems of achieving desired results through credit easing are serious ones, but they do not relate to the effect on the actions of lenders, but rather to the effect on the actions of borrowers.

Effect of credit tightening on borrowers.—Borrowers are affected by general credit tightening measures to the extent that lenders, as a result, grant smaller, shorter term, or more costly loans, or no loans at all. Borrowers may take several courses of action. At the one extreme, they may decide to abandon whatever plans they had for using the borrowed funds, either because the terms of lending are unattractive or because they cannot obtain loans and have no alternative means of financing. At the other extreme, they may decide to go ahead, regardless, paying any higher interest that is required and, when possible, obtaining funds from other sources, as, for example, liquidation of asset holdings, diversion of funds originally set aside for other purposes, and sale of equity securities. There are many in-between possibilities. Borrowers may scale down or temporarily defer their plans. Or they may speed up their programs, acting in the belief that credit will be even tighter in the future and that it would be to their advantage to arrange the necessary financing as quickly as possible and on the best terms that can be obtained.

Which are the most likely developments? It would seem that, in most cases, the net result, after sufficient time for the credit tightening to take hold, will be a lower volume of borrowing than would otherwise prevail. How much lower will depend upon the extent of the credit tightening, on the one hand, and the strength of demand pressures, on the other. When the tightening takes the form of a small increase in interest rates, the effect on borrowers will tend to be small. This would be generally true whether we think of borrowers of short-term or long-term funds, or of borrowers for business or consumer purposes.

In the case of businesses seeking short-term funds, the restriction on their borrowing would likely be more a consequence of their inabil-

ity to obtain funds than of their unwillingness to pay the higher interest cost. When funds are to be used to finance inventory accumulation or other working-capital requirements, interest costs are not likely to be a major consideration. Likewise, consumer credit, which is essentially short-term financing, would be affected by changes in the availability of credit, but would not react to any great extent to interest-rate changes. The mortgage market, on the other hand, seems to be somewhat sensitive to rate changes as such, as well as to credit availability, and this is even more true of long-term industrial financing.

A more restrictive credit policy, which places a tight limit on the available volume of lendable funds, may have a substantial effect on all classes of borrowers. Obviously, more funds cannot be borrowed than financial institutions and individuals are willing to lend. Yet this restriction can be deceptive, since the supply of lendable funds cannot be treated as a quantity that can be accurately controlled by credit policy. Even if the credit-control measures are sufficiently powerful to fix the volume of bank reserves, the supply of lendable funds may vary depending on the completeness with which all banks exhaust their lending power, and the extent to which liquid funds in nonbank hands are made available for loans in one way or another. When the demand for loans is strong, interest rates may rise while, at the same time, the volume of lending continues to expand.

Effect of credit easing on borrowers.—The easing of credit, by adding to funds available for lending, permits an expansion of loans, but such an expansion will not automatically follow. In deflationary periods it is not easy to induce businesses and consumers to apply for additional loans, or lenders to grant them. Anticipations that add up to the prospect of losses rather than profits, and further depression rather than early recovery, are not changed merely because credit is made more abundant and less costly. The experience of the early thirties is so clear on this point that there is no need for any elaboration.

Effect of credit tightening on volume of spending.—The extension of credit permits an immediate increase in the volume of spending and a generally higher level in the future. A reduction in credit tends in the reverse direction, but it should be apparent from the discussion so far that the relationship between credit tightening and the volume of spending is not a simple one. The effects of credit tightening may be limited by the fact that a large proportion of business investment is internally financed and consumers also have sizable funds of their own. However, insofar as spending is being financed by loans, and other sources of funds are not available to replace the loans, there will be a reduction in spending and a contraction in the income flow.

The immediate anti-inflationary effectiveness of credit tightening essentially depends upon the over-all size of the net reduction in spending, yet the character and distribution of the reduction cannot be ignored. We have already seen that the main impact of credit tightening is likely to be felt in the long-term credit market, so that the largest reduction can be expected in expenditures dependent upon such credit. Established customers for short-term credit will feel the impact to a much smaller extent, but new businesses may find themselves relatively hard hit. Larger and well-established firms will fare better than others for the additional reason that they are more likely to have

alternative sources of funds at their disposal. Since moderately higher interest rates do not greatly discourage consumer borrowing, consumers may not be much affected by credit tightening unless the general measures are accompanied by selective credit controls. Because of the increased cost, State and local governments may abandon certain projects which were to have been loan-financed.

Other objectives than counteracting inflation commonly are present and these require more discriminating action than merely limiting the total volume of spending. In the present defense emergency, for example, the types of spending curtailed are of critical importance. A credit policy which impeded the flow of investment funds into defense industries could not be tolerated. Accordingly, a policy of general credit tightening cannot be pursued safely without provision being made for such requirements.

Effect of credit easing on volume of spending.—Because of the rather loose connection between an easing of credit and an expansion of borrowing, there is little to say under this heading. Plentiful funds and low interest rates can help to stem a deflationary movement and to facilitate recovery, and they are tremendously important because of this fact, but, a business downtrend once established will ordinarily be dominated by forces which are outside the control of monetary action.

Effect of interest rate changes on capital values.—Changes in interest rates cause a revaluation of all assets. With respect to fixed-interest securities regularly traded on the large exchanges, this revaluation is quickly reached. For assets which are not being continually tested in the market place, the revaluation may be submerged under the influence of other factors affecting values. When assets are not traded, the revaluation takes place only on paper.

The import of such changes in capital values for credit policy lies in the effect on the supply of lendable funds. A credit tightening which brings on higher interest rates may gain additional effectiveness by virtue of the resultant decline in security prices. Financial institutions and other potential lenders may prove reluctant to incur a capital loss on securities which would have to be sold in order to obtain funds to make new loans. This reluctance would tend to persist unless interest rates on loans rose to the point where it became advantageous to switch into loans despite the immediate capital loss on securities.

Influence of expectations regarding future interest rates.—The influence of expectations as to changes in interest rates is pretty much limited to the long-term credit market. When only short-term commitments are involved, there is little need for borrowers and lenders to concern themselves with speculations regarding the probable trend of interest rates.

The influence of expectations will vary, depending on whether there is general agreement about the future and what this agreement is, or whether there is widespread uncertainty. In the latter event, both borrowers and lenders will prefer to limit themselves to short-term financing as much as possible, and activity in the long-term market will decline. Should this uncertainty give way to, say, a general expectation of a rise in long-term interest rates, lenders will be inclined to hold off making additional commitments, except for temporary investments in short-term obligations, while borrowers will be in-

clined to speed up their financing arrangements. These adjustments, however, are not likely to have a great effect, except to hasten the rise in interest rates with the result that the expected higher level will come into being sooner than otherwise. When the opposite set of expectations holds, the pressures will be reversed, but, again, they will be of passing importance. In the event that the expectations prove to be abortive, the anticipatory increases or decreases in interest rates likely will be of temporary duration.

Large traders in securities are, of course, highly sensitive to changes in interest rates and bond yields, even when such changes involve only small fractions of a percentage point. For these traders, expectations as to interest-rate changes play the same role as expectations as to price trends in the stock market play for the speculator in stocks. Such sensitivity has a direct bearing on the day-to-day market decisions of dealers in securities, but its bearing on the trend of investment tends to be remote and uncertain.

Summary appraisal.—This reply has been primarily concerned with the effectiveness of general credit tightening as a counter-inflationary policy instrument. For reasons already indicated, credit easing has been treated only briefly.

We believe that an appraisal of the credit-control mechanism should allow for the following: (*a*) the relationship of credit control to other instruments of economic policy, since maximum effectiveness is possible only when several instruments are used in carefully coordinated fashion; (*b*) the obstacles to making credit tightening effective against lenders; (*c*) the alternative courses of action open to potential borrowers; (*d*) the uncertainty over the sensitivity of different classes of spending to credit-tightening measures; and (*e*) the absence of selectivity in the impact of general credit-tightening measures on spending.

By stressing these limitations, we have attempted to call attention to the importance of placing general credit control in perspective in relation to other measures. As indicated in our answers to subsequent questions, some of these limitations can be met by supplementing general credit-control policies with selective credit measures. In the area of Government economic policy, there is no cure-all. The more desirable approach is the judicious application of a family of related instruments, with the policy officials retaining the maximum practicable freedom of action to relax or tighten each control measure as circumstances warrant.

5A. How rapidly and to what extent would you expect the volume of bank loans to respond to measures of general credit control under present conditions?

The rapidity and extent to which bank loans respond to measures of general credit control is determined in part by the nature of the controls employed and the degree of severity with which they are applied. To a considerable extent the actual or apparent effect of general credit controls is also influenced by other special factors that under present conditions modify the impact of controls or bring about by themselves changes in the volume of loans.

The significance of the character and intensity of the controls used is illustrated by some of the actions taken since June 1950. The first

step to tighten credit generally after the Korean outbreak, other than official requests for voluntary restraint by lenders, was an increase of one-fourth percent in Federal Reserve discount rates. This rise in rates could have had only slight, if any, direct effect on the availability of credit. Commercial bank borrowing from the Federal Reserve banks was at a low level, as it had been for many years; and, even if banks had been relying heavily on this source of lendable funds, the increase in rate was not great enough to be a penalty on discounting. The increase in the discount rate did serve as a traditional warning signal that the Federal Reserve authorities viewed the rate of expansion in bank lending as excessive and were beginning a policy of restraint that, largely through the use of other measures, might be expected to make lendable funds relatively more scarce in the future. The warning having been served, a further rise in discount rates, even a substantial one, would for the reasons given probably have little impact on the volume of bank loans.

Another measure of credit policy, higher reserve requirements for member banks, became effective in January and February 1951. The amount of the increase was necessarily limited, since the Board had already nearly exhausted its authority to raise reserve ratios. Most banks had little difficulty in acquiring the additional reserves that were needed.

The most important measure adopted after June 1950 to curb the growth of bank credit took the form of a new open-market policy, which the Federal Reserve System developed in two stages. Immediately after it announced the rise in discount rates in August, the Federal Reserve System initiated a policy that was intended to reduce the sale of Government obligations to Federal Reserve banks, which had been the largest source of new bank reserves. Since early 1942, that source had been readily available because the banks owned large quantities of Government obligations and the Federal Reserve System followed a policy of market support. The essential element of the new policy was withdrawal of Federal Reserve banks as buyers from the market for Government short-term securities at prevailing rates. The new policy resulted in higher interest rates and yields on short-term Government obligations, which result tended to discourage existing holders from selling such obligations and to invite purchases by other buyers, thereby promoting the System's desire to reduce its purchases.

In March 1951, the new open-market policy was extended to Government long-term bonds. To achieve the goal of reduced System purchases of such bonds, it was desirable that the reintroduction of price flexibility into the market for these securities be accomplished smoothly and with due regard to other objectives. Open-market operations, since they are carried out in the market for Government securities, must be reconciled with the needs of Treasury financing or refinancing. Furthermore, much of the demand for credit was to finance essential operations, such as expanding defense production and increases in productive capacity to meet long-run goals for both military and civilian output. A drastic application of open-market policy might have deprived business of the credit required for the growth of production.

Restraint in the management of open-market policy will probably become more important during the next stage of the mobilization period. If, as is likely, the Treasury finds it necessary to borrow large sums of new money during the next few years, the objectives of debt management may make it inexpedient to rely heavily on this policy instrument to limit the volume of bank lending.

The rapidity and extent to which the volume of bank loans changes after the application of general credit controls are influenced by various other factors, some of which affect the operation of the controls and others of which have an independent impact on the volume of loans. Because of the multiplicity of forces that alter the amount of bank loans outstanding, it is not possible to measure the effect of credit controls in themselves, much less to determine the impact of individual controls.

The following factors are significant:

(1) Vigorous application of selective credit controls can reduce the demand for credit, and thereby restrict the growth of bank loans. If selective controls are in effect at the same time as general credit restraint, total loans outstanding will naturally respond to both. Regulations W and X, and the Government-agency counterparts of the latter, all imposed after June 1950, apply to substantial segments of commercial banks' total lending activity. Many bank loans are also subject to Regulation U, which sets minimum margin requirements on bank loans on stocks. Margin requirements were increased by the Board of Governors in January 1951.

(2) The speed with which general credit policy restricts bank lending is influenced by some conventions of commercial banking. Banks commonly extend lines of credit to their regular borrowers; and, while these agreements to extend credit do not typically take the form of contractual obligations, bankers are slow to change and reluctant to break them. If it were necessary to do so, banks might be expected to sell securities at a substantial loss in order to fulfill existing loan agreements. Even in the absence of lines of credit, the highly personal relationship that exists between the banker and most of his business borrowers limits the speed and extent of the effects of general credit restraints. The banker tries to "take care" of his established customers, and he is more likely to adjust his investments—even at a sacrifice—to supply them with funds than to adjust his loan policy to meet new conditions in the securities market.

(3) The volume of business loans, in particular, is subject to seasonal change, rising during the second half of the year, falling somewhat during the first quarter, and falling more markedly during the second quarter. General credit controls have the appearance of being more quickly effective if they coincide with a seasonal decline than if they coincide with a seasonal rise.

(4) General credit policy can be assisted in efforts to hold down the volume of bank loans by the effects of direct controls over prices, wages, and materials. To the extent that direct controls serve to halt a rise in prices and wages, they moderate or terminate that part of the business demand for credit that is a consequence of rising costs. Price ceilings also help to curtail borrowing to finance speculation in commodities. Controls over materials reduce the demand for credit by restricting certain kinds of production. The general price and

wage controls imposed in January 1951, and the growing network of regulations governing the use or accumulation of materials have been significant auxiliaries of credit policy because they helped to curtail demand for loans at the same time that credit measures were limiting the supply. As direct controls over materials further retard nonessential production during the next phases of the defense period, the business demand for credit may be held down enough to make added measures of general credit restraint unnecessary.

(5) The rapidity of the response of the volume of bank loans to general measures of credit restraint is slowed down by the fact that lending activity at any period of time reflects business decisions about spending which were made at an earlier time. This lag is likely to be particularly great if a rapid expansion of business plans for investment preceded the adoption of the measures of credit restraint since extensive plans for business spending build up a strong pressure in the demand for credit.

5B. Discuss recent changes in the volume of bank loans.

Under the impetus of the surge in private demand after Korea and the expansion of output, outstanding loans of all commercial banks rose $7.4 billion or nearly 17 percent during the second half of 1950. Seasonal credit needs of many industries contributed to the upward movement. General credit restraints were applied midway in the third quarter, but these had to combat a powerful demand for credit and could not be expected to halt at once an expansion largely based on buying orders already placed and lending agreements already entered into. General controls received almost no help from the residential mortgage regulations in slowing down the advance of total bank loans until well into 1951, because of the large backlog of mortgage-financing commitments. The measures of general credit restraint did receive some assistance from consumer installment-credit regulations, beginning in the fourth quarter of the year. Price and wage controls were not yet in effect to help check that part of the demand for credit that arises from inflation itself. Materials controls were only just beginning to appear and were not yet significant in holding down the credit demands of businessmen.

During the first quarter of 1951, bank loans expanded $2.2 billion or about 4 percent, though in these months some net contraction usually occurs as a result of seasonal repayments. Several factors were responsible for this relatively large growth. When the year opened, private spending was rising to another crest, following the Chinese intervention in Korea. When buying began to subside later in the quarter, the credit needs of many firms continued to rise as inventory accumulation, partly involuntary, occurred at an unprecedented rate. Loans related to defense production were emerging as a factor in the demand for credit, but were to be of greater importance later in the year. The price and wage ceilings announced in January could not immediately halt the rise in business costs that were the basis of some demand for additional credit; and the growing system of materials controls had not yet had a great impact on business investment. Funds for lending were still relatively ample, in spite of the increase in reserve requirements early in the quarter. The Federal Reserve System's more restrictive open-market policy and the campaign of voluntary credit restraint were not inaugurated until March. Dur-

ing the initial stages of both the August and March open-market operations, Federal Reserve banks, in order to maintain an orderly market, had to purchase some United States Government securities, many of which were offered for sale by those who anticipated greater difficulties in selling, or greater losses, later on.

In April, total loans remained at the March level, but during the next 2 months they rose moderately. Instead of the usual marked second-quarter decline, loans expanded $0.4 billion or about 1 percent in the 3-month period. Factors, in addition to the seasonal, that tended to reduce the volume of loans were the general and selective credit restraints, particularly the general measures introduced in March, and the many other elements in the complex of factors that ushered in the 1951 business lull. Factors that tended to increase loans, and which together more than offset the opposing influences over the second quarter, included the still rising need for inventory credit and the gradual acceleration of defense production.

Total bank loans declined in July, but rose during August and September, with the result of a net expansion of about $1.2 billion or 2 percent during the third quarter. Much of the growth reflected the increased demand for credit to finance defense contracts and defense-supporting activities. Seasonal factors, mainly associated with the marketing and processing of farm crops, were increasingly responsible for the rise as the quarter progressed. In addition, the volume of consumer installment credit, which had varied within a narrow range for several months, began to show signs of entering a period of moderate expansion following the relaxation of the terms of Regulation W in accordance with the provision of the Defense Production Act Amendments of 1951.

6A. What is the reason for the relatively slight use by commercial banks of the Federal Reserve discount and borrowing privilege?

The chief reason for the relatively slight use of the discount privilege is that commercial banks have several other sources of reserve funds in addition to discounts at Federal Reserve banks. In combination, these other sources have generally been adequate, or more than adequate, to furnish banks with lending power. Each of these alternate sources appears to banks to have some advantage over discounting. Net gold imports, which have frequently been large, furnish the banking system with new reserves without the need of any action on the part of the individual bank. Federal Reserve bank purchases of Government securities have been the other major source of commercial-bank lending power. During the years of close support of the market for Government securities when the Federal Reserve banks stood ready to buy at pegged prices, commercial banks had in their possession an abundant and assured means of obtaining lending power at fixed and relatively low costs, without going into debt.

The institution of the correspondent relationship among banks remains strong. Many member banks prefer to seek temporary financial aid from their correspondents, partly because these loan transactions are free of such regulations and considerations of credit policy as govern Federal Reserve bank discounts. Member banks can also borrow the surplus Federal Reserve balances of other member banks.

Another reason for the slight use of the discount privilege is the unwillingness of commerical banks to borrow from other banks particularly as a regular means of obtaining funds for lending. This

reluctance to borrow had its origin in the pre-Federal Reserve period when banks acquired the habit of relying on their own resources in finding funds for lending or for paying the claims of depositors. The habit was in part an outgrowth of the policy of giving preference in lending to so-called self-liquidating, short-term commercial loans, which were expected to help make the individual bank inherently liquid. Moreover, most bank earning assets consisted at the time of customer notes that did not have an open market, and could not readily be endorsed and used to obtain funds from other institutions. The circumstances that made borrowing uncommon also made it appear undesirable. When banks did resort to borrowing, it was often because they were in financial difficulties, and borrowing naturally came to be looked upon as evidence of unsoundness.

6B. Do you believe that greater reliance should be placed on this privilege as a means of obtaining Federal Reserve credit?

If it were feasible to increase the use of this source of lending power, it would be desirable to do so. If Federal Reserve funds flowed to banks more commonly through discounts, it would be possible to put a more effective control over the supply of Federal Reserve credit than is possible when, for example, additional reserves can be obtained through the acquisition of Government obligations by Federal Reserve banks.

6C. Under what conditions, if any, would you expect to see a greater use made of the discount privilege?

If banks were unable in other ways to secure funds needed for loan expansion, bankers in time undoubtedly would overcome to some extent their reluctance to discount and would make greater use of this privilege. For example, if the Board of Governors were granted authority to change reserve requirements in line with suggestions made in the answer to Question 13, it would be possible in many situations to offset or to curtail new lending power arising from other sources, with consequent increase in the importance of discounting as a means of obtaining lendable funds. Unless there is such an increase in the authority of the Board over reserve requirements, it is not likely that a condition in which banks cannot obtain substantial quantities of lending power by other means will appear for many years because of the mass of Government securities held outside the Government trust accounts. These securities must, of course, be held by someone, and when outstanding obligations in the possession of other investors are reduced the consequent transfer of securities to Federal Reserve banks creates additional reserves with resultant new lending power. Furthermore, gold imports may again become a large source of new lending power.

Some increase in discounting might result from continuation of the policy of allowing greater flexibility in the movements of prices and yields in the market for Government securities than prevailed during the period of close support of the market.

The use of the discount privilege would probably be stimulated if there were a further relaxation of the statutes and regulations governing the duration of the several types of rediscounts and advances, and the eligibility of bank assets for rediscounts or as collateral for

advances. Many of the laws and regulations appear to be unnecessary from the standpoint of credit policy. The exceedingly restrictive requirements of the original Federal Reserve Act were not conducive to use of the discount right. The liberalization of the statutes and regulations during the 1930's made the discount privilege more valuable, without opening it to abuses. The elimination of a few more technicalities might be helpful in making discounts relatively more desirable than at present.

7. Discuss the economic effects of the increase in short-term interest rates between August 1950 and March 1951, and the subsequent increase in long-term interest rates.

Since the answers to other questions contain the economic analyses underlying the answer to this question, the comments here will be limited to a brief statement of conclusions.

The increase in short-term rates contributed to a shift in demand from long-term to short-term Government securities and greater purchases of short-term securities by nonbank investors. The increase in the return on short-term obligations increased their attractiveness to investors, at least until there was a corresponding rise in the yield on alternative forms of investment. Anticipations that long-term rates might also rise, which developed as a consequence of the Federal Reserve System's action on short-term rates, were also a factor in this shift. (The effect of anticipations with respect to the demand for Government securities is also discussed in the answer to Question 15.) The subsequent rise in long-term rates made investors even more uncertain about future interest rates and further increased the desire to hold short-term securities. Another factor in the preference for short-term obligations was the continued absence of demand for Government securities by financial institutions that hold a high percent of long-term investments. For example, life insurance companies rather than buying were selling to obtain funds to meet real estate mortgage and other loan commitments. Much nonbank buying was by nonfinancial corporations with short-term funds arising from tax accruals.

The increase in short-term rates had little effect in reducing lending by commercial banks. Banks held a large quantity of short maturity Government obligations, many of which they could redeem in cash, and the balance of which could be sold, if necessary, at losses that would be offset at least in part by rising rates of interest on business loans. Furthermore, relatively large market offerings of Government securities by both banks and other investors, resulting from uncertainties about future prices and yields or from adjustments of holdings in response to Treasury refinancing operations, led at times to Federal Reserve bank purchases that added to the lending power of banks. During the 8 weeks preceding the change in Federal Reserve support operations in the market for short-term Government securities, Federal Reserve bank holdings of Government obligations rose $655 million; in the next 8 weeks the increase was $1.2 billion.

Partly as a result of the rise in short-term rates, and the anticipated and later actual rise in long-term rates, but more largely as a result of the other factors described above, all Treasury issues of marketable securities, in the comparatively large refinancing and new financing operations of 1951, were of the short-term type.

The increase in market interest rates as reflected in lower prices of long-term Government obligations, likewise, did little to curtail lending by banks. As explained above, large holdings of short-term Government securities made banks less subject than other lenders to the impact of lower prices of long-term securities. Insurance companies and other nonbanking institutions with relatively large investments in long-term Government obligations were undoubtedly restrained from making some loans by the capital losses that would result from sales of these obligations to secure lendable funds. As their mortgage loan and other commitments were large, the restraint did not show up as an immediate decline in lending but in reluctance to make new commitments. The higher yields on Government long-term bonds that could be bought at below-par prices began to compare favorably with net returns on mortgages with a 4¼ or 4 percent interest ceiling. As this group of lenders had been investing substantial sums in residential mortgage loans guaranteed or insured by the FHA or the VA, the reluctance to enter into new commitments often took the form of a refusal.

Neither the higher short-term interest rates nor the rise in the long-term rates significantly reduced the demand for credit. The higher interest rates businessmen had to pay had slight effect on their costs compared with the rise in prices and wages. Business demand for materials, services, and credit did not slacken, because of the anticipation of long-continued profitable markets for goods. Even the demand for long-term loans to finance new construction, a demand that is usually very sensitive to actual or expected changes in interest rates, remained strong, partly because of the urgent need for expansion of productive capacity to support the defense effort and partly because of the highly favorable long-run outlook for profits. The demand for consumer and residential mortgage credit was curtailed by the requirement of higher down payments and shorter maturities and by a reduced supply of funds rather than by increases in interest rates.

Though the rise in interest rates did not in itself discourage the growth of bank loans, the aggregate of general and selective measures of credit restraint undoubtedly held down the total volume of loans.

The declining prices and rising yields on long-term Government bonds were reflected by like movements in other securities. Several corporate and State and local government issues about to be placed on the market at specific rates had to be withdrawn.

8. Discuss the appropriate roles of direct controls, selective credit controls, and a generally restrictive credit policy as means of restraining inflation (*a*) when the Treasury is not expected to be a large borrower in the foreseeable future, (*b*) when a large volume of Treasury refunding operations will have to be effected in the foreseeable future, (*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future, (*d*) under conditions of total war.

This question has two interrelated facets. It appears to aim first at the broad problem of the interrelationship between governmental programs and different methods of inflation control. The situations (*a*), (*b*), and (*c*) obviously refer either to peacetime conditions or conditions of a defense and mobilization program short of total war, while (*d*) refers to conditions of total war. Direct controls such as

allocations and wage and price ceilings, selective credit controls, and general credit policies necessarily play different roles during these different phases of a national emergency.

At the beginning of the present defense program in July 1950, when an increase of $10 billion in military appropriations was contemplated, the Council, in its report to the President on "The Economic Situation at Midyear 1950," stated:

> * * * we find firm ground for believing that it will be possible to make and maintain substantial enlargement in these (military) expenditures without resorting to all of the controls of a war economy but we must take some important steps now. The first and most important of these is to use fiscal and credit policies to the fullest extent feasible for the restraint of inflationary pressures.

For reasons which will be discussed in the second part of the answer to this question, and which have been already referred to in the answers to other questions, the Council placed particular emphasis on higher taxes and selective credit controls, and somewhat less emphasis on general credit restraints. The need for control of materials was also recognized.

Six months later, in the Council's January 1951 Report to the President, it was realized that a national security program of the general magnitude of "much closer to 150 than 100 billion dollars for the fiscal years 1951 and 1952 combined would be needed" (p. 67). An anti-inflation program was recommended which added direct controls over prices and wages to the controls previously recommended (see pp. 97–119 of the Annual Economic Review, January 1951) and emphasized the mutually supporting character of the different types of controls. The same emphasis was repeated in the report on The Economic Situation at Midyear 1951, pages 120–161.

If the international situation should force a further substantial upward revision in the security program, the role of direct controls, particularly allocations and limitations, probably would further expand. If a larger portion of productive resources were diverted to defense purposes, measures such as allocation of materials, limitation orders, price and wage controls, and selective credit controls would become more dominant, and general credit controls would assume more of a supporting role. As the diversions for defense purposes were increasingly enlarged, a situation would be reached which, in economic respects, would begin to be similar to one of total war. By stating that in such a phase of an emergency program general credit controls assume a supporting role, we do not mean to suggest that this role in any sense would be a minor one.

The preceding remarks are intended to make clear that if the question aims at clarifying the changing relationship between direct and indirect controls during various phases of a national emergency, it must include other aspects besides Treasury operations and the budget outlook. Obviously there are powerful factors, in addition to these, which influence the course of the economy, inflationary trends, and the selection of appropriate policies. The size and kinds of business investment, the propensity of consumers to spend or save their incomes, the dynamics of price-wage adjustments, the anticipations of producers and buyers concerning future economic developments, all have powerful effects on economic trends and consequently have important bearing on the consideration of economic policies. There-

fore, the appropriate and respective roles of direct controls, selective credit controls, and a general restrictive credit policy must be based upon an analysis of all these factors and not simply upon consideration of the current position or prospective operations of the Treasury.

These other factors of importance may include not only current economic developments but also objectives of national economic policy. For example, question 11 raises the issue of whether the use of monetary measures to restrain inflation may not depend in part upon production objectives, which would mean that they could not depend entirely, and possibly not even mainly, upon the Treasury situation. The significance of the production objective is illustrated by the situation that developed after Korea. Defense production was then in a preparatory stage, and it was desirable to use resources and manpower to the fullest extent on types of private investment that would have to be curtailed later as defense production expanded. Credit was being used at the time to modernize and expand plant and equipment and to accumulate inventories. Rigorous general credit controls aimed at combating inflation would also have hit production and business investment.

Consequently, the Council of Economic Advisers has endeavored to base its appraisal of the respective utility of the various types of selective and general controls, both direct and indirect, upon careful analysis of the entire economic situation, and also upon the analysis of our primary economic objectives in terms of the world situation. In this analysis, consideration of Treasury operations and the budget outlook has occupied an important place but by no means a decisive one.

Besides this general relationship between the use of various anti-inflation measures and the phase of the national emergency, the question apparently aims more specifically at the relationship between problems of debt management, on the one hand, and credit policy, on the other hand.

Obviously, considerations of debt management have conditioned the use that has been made of general credit policy. Thus, it was stated in the report on credit policies, submitted to the President by the Director of Defense Mobilization, the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Council of Economic Advisers, on May 17, 1951:

> In the postwar period, Federal Reserve use of traditional instruments to restrain credit was conditioned by the objective of maintaining a market for (Government) securities without a substantial and general increase in interest rates. This latter objective limited the effective use of open-market operations for purposes of counteracting inflation.

The reasons why debt management should aim to maintain a stable long-term bond market will be set forth in answer to question 16 below. In the hypothetical situation when neither deficit financing nor refunding operations were currently required or in prospect, the maintenance of a stable Government securities market would have relatively little importance. But this is not a realistic assumption. It is obvious that the reasons for a stable bond market become stronger in a period of large Treasury refunding operations. The reasons become still stronger when prospective budget deficits require large new Treasury

financing, since additional purchasers must be found to hold the larger total of outstanding securities.

When, as defense production increases, expenditures of consumers and businesses are restricted through allocations and limitations, it should become easier to reconcile the objectives of debt management and credit policy. Under such conditions, business funds, pension funds, and funds of other nonbank investors should be increasingly available for investment in Government securities. This would be a situation approaching in economic terms that of total war.

9. Discuss and evaluate the Voluntary Credit Restraint Program which was initiated in the spring of 1951.

It is very difficult to evaluate in quantitative terms the contribution that the Voluntary Credit Restraint Program has made to the fight against inflation, and to the achievement of at least temporary relative stability during most of the year 1951. While the rate of increase in loans has been lower since the adoption of the Voluntary Credit Restraint Program than during the comparable period a year before, it would be impossible to measure the specific contribution made by that Program in holding down loan expansion.

The period during which the Voluntary Credit Restraint Program became effective was the period during which a substantial change in inventory accumulation took place. The first 12 months after the Korean attack was for the most part a period of rapid inventory accumulation which slowed down substantially during the second half of 1951. What happened to bank loans during the last 6 months of 1951 was probably more the result than the cause of the change in inventory accumulation, in view of the softening of retail markets that developed. Nevertheless, there seems to be general agreement among observers that the Voluntary Credit Restraint Program has made lenders and borrowers aware of the desirability of restraint, and it seems to be a fair guess that without that program there would have been greater loan expansion.

The Voluntary Credit Restraint Program is designed not only to hold down credit expansion in general, but it is specifically designed to curtail credit expansion in a selective manner, that is, to permit loan expansion for purposes of financing defense contracts and defense-supporting and other essential activities, while holding down loans for less essential activities.

The Federal Reserve System has instituted a reporting system which shows changes in commercial and industrial loans on a sample basis, broken down by the purposes for which the borrower uses the money. For 7 months through October 31, 1951, loans for defense contracts were expanded by about $550 million; for defense-supporting activities by $620 million. The aggregate net increase in classified loans extended by banks included in the sample amounted to $1,900 million. Of this increase, approximately 29 percent was for purposes of financing defense contracts; 32 percent for financing defense-supporting activities; 39 percent for financing nondefense activities. Net loans extended to commodity dealers were reduced by $27 million during this period. The fact that more than one-third of the increase in total loans was for nondefense purposes, and that loans to commodity dealers were again on the rise, is undoubtedly in large part a reflection of the normal seasonal increase in the demand for credit and not an

indication of the failure of the Voluntary Credit Restraint Program.

Because the figures are not conclusive, the evaluation of the Voluntary Credit Restraint Program must be based largely on general considerations. The advantages and the weaknesses of the program obviously stem from the same fact, namely, its voluntary character.

1. In a nation in which businessmen value highly the right of making their own decisions, voluntary controls are more acceptable than mandatory controls. It should, however, not be overlooked that any collective voluntary program involves an element of coercion. Some businessmen may prefer a clear legal mandate to a situation in which cooperation is enforced by the threat of social or economic ostracism.

The effectiveness of a voluntary program depends largely on the number of institutions which have to cooperate, and on the extent to which their activities are a matter of public knowledge. In the field of commercial and industrial loans, it is possible for a firm seeking funds to "shop around" after one bank has refused the loan. Another bank may grant the loan, hoping that the fact does not become known. The situation is different when public capital issues are involved, as the experience with the Capital Issues Committee of World War I demonstrated. In this field, it is more easily possible to enforce a voluntary agreement. In the case of proposed State loans which were believed not in accord with the criteria established by the National Voluntary Credit Restraint Committee, public issues were impossible because the investment bankers refused to underwrite them.

2. The second advantage of the program is its selective character. The main idea of the program is that under the guidance of the mobilization agencies standards and criteria are developed which are designed to help the individual banker distinguish between defense and non-defense-related activities and between essential and nonessential purposes.

3. Voluntary campaigns for credit restraint have a flexibility difficult to achieve in direct mandatory controls of lending, especially if these controls embrace all classes of lending institutions. Restraint through the effort of private lenders is automatically adjusted to reflect conditions among the several kinds of lending institutions. Voluntary restraint of credit also has flexibility in the sense that its lending criteria can be quickly and easily altered to meet changing conditions.

The weaknesses of a voluntary program can be diminished to some extent by the way the campaign is organized and supplemented by other measures.

1. The main weakness lies in the fact mentioned above as an unavoidable feature of a voluntary program, namely, that there is no assurance that all competing banks are equally willing to cooperate. This limits not only the effectiveness of the program, but it also undoubtedly creates a condition in which some business may move from those banks which cooperate more scrupulously in the program to those which are less cooperative or which believe they are less in the public eye. Moreover, the standards and criteria developed by the Committee under the guidance of the mobilization agencies must necessarily remain of a general nature, and leave room for considerable differences of interpretation. If lenders are requested to grant loans only to defense or defense-supporting industries, it

may be found that nearly every prospective borrower can demonstrate that his activities have at least some indirect relationship to the defense effort. The selectivity is probably most effective when certain types of loans, for instance for speculative inventory holdings or for certain real estate transactions, are designated as undesirable.

The effectiveness of a voluntary credit restraint campaign is increased by other measures to tighten credit. Then the main emphasis of the voluntary effort lies in the appeal to bankers to be guided in the selection of borrowers by the criteria and standards formulated in consultation with the mobilization authorities. It follows that the Voluntary Credit Restraint Program should not be regarded as an alternative to the proposals made in response to question 13, which are designed to enable the Federal Reserve System to exercise more effective general control over credit expansion.

2. While competitive conditions limit the effectiveness of a voluntary program, there is also the danger that any attempt to "enforce" cooperation may lead to monopolistic misuse of the voluntary campaign, or to discrimination against certain borrowers. In order to diminish the danger of these kinds of abuses, the Defense Production Act made all voluntary agreements subject to review by the Attorney General and the Federal Trade Commission. The fact that a Federal Reserve representative has been placed on the various voluntary credit restraint committees gives some assurance against the possible misuse of voluntary agreements, but the danger is not an imaginary one.

3. When the Voluntary Creit Restraint Program was initiated, fear was expressed by many bankers that some of the lenders who were refused credit by private bankers might obtain loans from Government lending institutions. The administration has taken determined action to apply the same standards of selectivity to Government lending. The Council has cooperated with the Office of Defense Mobilization and the Budget Bureau in a review of the lending activities of Government agencies, and the Budget Bureau, under the direction of the President, has issued directives to these agencies for the enforcement of these standards. We believe that this problem deserves continuing attention.

4. Every voluntary effort runs into the difficulty that it is likely to lose its force after some time unless it is institutionalized in a cartel-like arrangement. It is not easy over a long period to maintain enthusiasm in restricting profit-making activities. It is, of course, most difficult to maintain enthusiasm if it turns out that some lenders disregard the program and secure a great deal of new business at the cost of those who are cooperative.

Summing up the achievements and the limitations of the Voluntary Credit Restraint Program, we believe—although we cannot offer quantitative proof—that the program has contributed to holding down bank loan expansion and, to some extent, to diverting funds from less essential to more essential usage. But we do not believe that any voluntary program could be heavily relied on to be sufficiently effective if the pressures for credit expansion should assume much larger proportions over a prolonged period. As previously indicated, the effectiveness of the program to some extent depends on supplementary measures for more effective general control, continuing corresponding action on Government lending, and continuing measures of mandatory selective control, such as those related to real estate and consumer installment credit.

While we feel it is our duty to point out the limitations of the program, we do not wish to underrate either the patriotic spirit of cooperation with which the program is being carried forward, or the present usefulness of the program.

10A. Do you believe that under existing law any agency of the Federal Government has the power to control directly or to "ration" the extension of credit by individual banks?

While this is a question for legal interpretation, there is reason for believing that power to control credit directly is provided by existing statutes. The Trading With the Enemy Act of October 6, 1917, as amended, states that "during the time of war or during any other period of national emergency declared by the President, the President may, through any agency that he may designate, or otherwise, and under such rules and regulations as he may prescribe * * * investigate, regulate, or prohibit * * * transfers of credit or payments between, by, through, or to any banking institution. * * *" The Emergency Banking Act of March 9, 1933, in amending the act of 1917, added a section which provides that "* * * during such emergency period as the President of the United States by proclamation may prescribe, no member bank of the Federal Reserve System shall transact any banking business except to such extent and subject to such regulations, limitations, and restrictions as may be prescribed by the Secretary of the Treasury, with the approval of the President * * *."

The Executive order of August 1941, in accordance with the terms of which subsequent controls were placed on consumer credit, was based on the authority of this legislation. It appears to us that the statute is broad enough to permit the use, under the conditions prescribed, of other mandatory credit controls, including the imposition of ceilings on the volume of loans that may be made by individual banks as well as all other lending institutions. The power to impose controls on lenders other than commercial banks is suggested by the broad scope of the Executive order of August 1941, which defines a banking institution as "any person engaged as principal, agent, broker, or otherwise in the business of making or holding extensions of credit."

10B. Under what economic circumstances, if any, would you recommend the use of this authority?

This authority should be used only when (1) the continued upward movement of bank credit is creating severe inflationary pressure and (2) there is serious doubt that other methods of credit control will together be adequate to control the inflationary pressure.

In designing direct controls over bank loans it would be necessary to take the following into account: (1) Some banks have shown more restraint than others in making loans; (2) bank loans are subject to seasonal movements that vary widely in different parts of the country and even within the same region; (3) much of the demand for loans from some banks is for defense and other essential purposes while the demand for loans from other banks is more largely for purposes of low priority; (4) production in some communities is expanding because of defense orders or other factors while in other communities the volume of production is stable or declining; (5) newer banks may not have

built up their loans to normally expected levels, while older institutions may have attained the maximum volume of loan expansion.

The problems involved in the direct control of bank loans are indicated by the disadvantages of some of the bases that have been proposed for loan ceilings. If the total loans a bank could hold were fixed as a percent of its capital accounts, total deposits, or total assets, it might be found that, because banks differ considerably in the ratio of outstanding loans to these other quantities, some banks could expand their loans substantially, while others would have to contract loans. The fact that laws limiting total real estate loans held by a national bank to a percentage of its capital and surplus or time and savings deposits have resulted in no great hardships or inequities, should not be interpreted as meaning that ceilings can be placed on total loans with equal success. Real estate loans are usually only a relatively small part of the total loans of national banks. Moreover, ceilings were imposed when these banks first received the authority to make real estate loans. As the national banks were just entering a new lending field, all could expand real estate loans under the ceilings.

If the loan ceilings were related to a bank's total loans outstanding on some base date, other problems would appear. Banks that had been holding down loan expansion would be discriminated against compared with banks that had been following less conservative policies. As the volume of bank loans changes seasonally, a moving base might have to be used. New banks would be handicapped, compared with older institutions, if loans were held close to existing amounts, and a special base might have to be provided for the former institutions. Furthermore, economic development would be impeded if loans that could be made by banks in growing communities were frozen at the amounts outstanding on a given date.

Any direct over-all control of lending has the disadvantage of being a possible obstacle to the expansion, or even maintenance, of essential production, military or civilian. To avoid the effect of such control, exceptions would have to be provided for individual loans in excess of ceilings—and such exceptions would involve a difficult administrative problem—or needed credit would have to be supplied, in some cases, by Government agencies. Expansion of the lending activities of the latter institutions under such conditions understandably would be considered to be unfair governmental competition by private lenders.

Despite the difficulties in the direct control of bank lending, the Council believes that certain circumstances may warrant use of this method. If bank credit expansion becomes severely inflationary, and other means to cope with the problem prove ineffective, the damage that might be done because of the arbitrary character of loan ceilings would be less than the damage from inflation. However, to minimize hardships in the event of its use, the potentialities, problems, and means of applying this method of control should be more fully explored. It may be possible to devise an administratively feasible plan that will recognize differences among banks and avoid interference with needed production.

11. Do you believe that there is any conflict between measures to restrain excess demand by monetary means and the need for expanding the economy to meet the requirements of a continuing readiness to resist aggression and a continuing high standard of living? If so, how can the effects of this conflict be mitigated?

The choice of the several means employed to hold down demand, and decisions concerning the intensity of their application, must be made with reference to two facts: (1) demand at some times is an engine of inflation; and (2) demand at all times supplies the driving force necessary for production. In a free economy, private demand is the principal determinant of the character and volume of output. Unless demand is sustained at an adequately high level, businessmen will not make full use of existing facilities and available labor to turn out goods, and will not add to the productive capacity of the Nation. If the economy is to grow, demand must be permitted to grow. If demand is restrained generally in the effort to attain the stability objective, the objective of expanding production may suffer from the impact of that restraint. It is difficult to determine, of course, the level of demand that would attain the desired degree of stability and at the same time would make possible desired expansion. It is probable that at times demand great enough to achieve high production and expansion goals may involve inflationary pressures, since in order to expand output, demand must be strong enough to overcome the frictions which result from the fact that resources and labor do not have perfect mobility.

When demand is in excess of available supply, some demand must be curtailed—either Government demand, or demand for plant, equipment, inventory accumulation, and housing, or consumer demand. If this curtailment of excess demand is not accomplished by restrictive policies, it will be curtailed by the effect of an inflationary price rise.

If the only objective of Government policy were to combat inflation, it would not make much difference which kind of demand was curtailed. This, however, is not the present situation. In the present situation, the purpose of combating inflation must be reconciled, as the question states, with the purposes of economic expansion "to meet the requirements of a continuing readiness to resist aggression and a continuing high standard of living." From the viewpoint of achieving these objectives, there are higher priority demands for goods and services that are necessary to the achievement of the objectives and lower priority demands for goods and services that make little or no contribution to achieving the objectives. Reconciling the fight against inflation and the pursuit of other vital programs requires that the lower priority demands be curtailed and the higher priority demands be impeded as little as possible.

Drastic general credit restrictions would possibly curtail some speculative inventory accumulation and low priority construction, but at the same time would possibly also curtail some vitally important expansion of defense-supporting industries, construction of houses in defense areas, and purchases of raw materials by munitions producting industries. On the other hand, general credit restrictions would not touch at all those low priority demands that are financed not by credit but out of consumers' or businesses' own resources. The

fact that credit expansion serves as a vehicle for inflation does not necessarily mean that it is only credit-financed demand which should be regarded as inflationary and should be curtailed.

It follows that combating inflation at a time when some economic expansion is needed cannot be accomplished by means of general monetary or credit restrictions alone, but only by a combination of policies. Such a combination of policies should include, of course, some general tightening of credit, but not such a severe tightening that high priority activities would be impaired or that over-all employment and production would be cut sharply. Such severe tightening to be sure would reduce inflationary pressures but it would also imperil the security and productivity of the economy. To the extent that credit must be restrained, it should be done in a selective manner. This suggests the use of selective credit controls, but also the use of programs like the Voluntary Credit Restraint Program which can be operated in a selective manner. More important, credit policies must be complemented by allocations, limitations, and similar physical controls.

Because of the complex nature of the current situation, the Council of Economic Advisers has repeatedly insisted that a wide range of tools must be used in workable proportion to reallocate resources and effort, to stimulate some lines of activity, and at the same time to contract others.

The resort to physical controls as a method of restraint is justified only under conditions of war or a large defense program. But even under more ordinary circumstances, the selection among various economic policies involves the evaluation of competing objectives. For example, a tax policy that would be desirable if only revenues were to be considered may not be desirable from the viewpoint of incentives or equity. Or, an antitrust policy which might be appropriate if the sole objective were to encourage small business might not be appropriate when the economy also needs many of the qualifications of big business. While these competing objectives always exist, they are perhaps never so acute as when a defense emergency confronts the Nation at once with the imperative need to fight inflation and the imperative need to bring about that extraordinary utilization of manpower and other resources which in its immediate impact may add to the inflation.

While there are no perfect guides to the correct admixture of this wide variety of policies toward a wide variety of ends, it is clear that the policies can be most effective when the objectives sought are defined as quickly and clearly as feasible. In order to know how far a generally restrictive credit policy can be pushed without impairing necessary production, there must be some quantification of the main lines of production which are most needed for the defense effort and for a strong economy, set off against the lines of production which we can afford to contract without serious impairment. This quantification, in turn, depends upon increasing clarification of the size of primary military objectives, stockpiling, industrial build-up, international commitments, and satisfiable consumer demand in the face of these other requirements. Thus a consistent and improved programming of available supply and competing requirements is essential to improved decision with respect to the various types of economic policy which may be applied effectively. At that stage in the process where the

problem of restraining total demand seems more urgent than the problem of selective expansion, relatively greater weight can be given to general credit contraction and heavier general taxation; where the greater urgency seems to shift toward selective expansion, more selective control measures are needed to allocate resources rapidly in that direction and correspondingly to cut down the competing use of resources.

12. What do you believe to be the role of bank examination and supervision in furthering the objectives of the Employment Act?

In contrast to general credit policy, which aims to prevent swings in the total volume of credit which would have a destabilizing influence on the economy, bank examination and supervision policies are directed toward maintaining the soundness of individual banks. Inasmuch as sound banks are a basic institution of a prosperous economy, bank examination and supervision activities further the objectives of the Employment Act. In addition, these activities can help reduce cyclical fluctuations and thereby aid in the maintenance of maximum levels of employment, production, and purchasing power. For instance, during periods of inflation, emphasis on sound banking practices may encourage the banker to discount inflated prices, with the result that he may grant a smaller volume of loans than if his attention were not directed to the risks of price declines.

Bank examination and supervision should seek to prevent general fluctuations in the market values of assets from having disruptive effects on the aggregate loan volume. This objective was aided by the decision of the FDIC and other supervisory agencies to allow banks to carry high-grade investments in their statements at values reflecting their ultimate worth rather than volatile market prices. The policy of judging the soundness of a bank on a long-run basis, which is implicit in accepted methods of valuing securities, might find other applications. Provided there is no threat to the interests of depositors, temporary declines in the book value of a bank's assets or its liquidity, when these declines arise from general business conditions, should not serve as the basis for interfering with the bank's lending activities. It may be best for the bank, the community, and the economy to make financial aid readily available to the bank in such cases, in order to permit it to continue its normal lending operations.

As a general policy, bank examination procedure should look at the average value of assets over depression and prosperity periods and should impose basically the same standards in both depression and prosperity. Flexible standards, designed to aid stabilization policy by being made tighter in periods of inflation and maximum employment than in periods of unemployment, do not appear to be administratively feasible. Furthermore, bank confidence in the judgment of examiners and supervisory authorities would not be enhanced if these officials approved today what they had disapproved yesterday.

13A. Discuss the economic functions of bank reserve requirements.

A traditional function of bank reserve requirements is to assure a degree of liquidity and solvency in individual banks. The contribution that the required reserves might make to liquidity is largely negated by the restrictions placed on their use. The bank is penalized

for using its legal reserves to meet the claims of its depositors, and is made to appear to be in an unsound condition whenever its reserves fall below a rather arbitrary statutory minimum. Resultant suspicions about its ability to pay may lead to heavier withdrawals, and further impairment of its liquidity. Moreover, the practical necessities of banking operations would force banks to hold cash and other liquid assets, even if there were no legal requirements. Legal requirements may even lead some banks to carry lower reserves than they would otherwise, since minimum standards are frequently interpreted as optimum standards.

Bank reserve requirements also make a contribution toward keeping a bank solvent. Since the reserves are a fraction of total liabilities, however, the solvency of the typical bank is much more largely determined by the quality of its loans and investments than by its legally required reserves. Moreover, the solvency of the individual bank is largely dependent on the general economic situation existing in the country. A bank reserve requirement which contributes to economic stability is likely to be more of a protection to depositors and other creditors of individual banks than are reserve requirements aimed solely at the liquidity or solvency of the individual bank.

It is for this reason that the primary economic function of bank reserve requirements today is to serve as an instrument of controlling the volume of credit. The principle underlying this control is that changing the ratio of reserves to bank deposits alters the total amount of deposits that can be supported by a given amount of reserves. Since deposits are chiefly created by bank loans, raising reserve ratios restricts bank lending power, and lowering reserve ratios expands bank lending power. An increase in cash reserve requirements can also be used to offset increases in lending power arising from net gold imports or Federal Reserve bank acquisitions of Government securities.

Because of their original function of maintaining liquidity, reserve requirements are generally related to bank deposits. However, where reserve requirements are used as a tool of credit policy, it is possible to relate reserves not only to deposits but to assets. There appear to be several advantages in using assets as a base for reserve ratios. When an individual bank expands its loans, its assets held in this form necessarily rise but its deposits may not, because of shifts of deposits to other banks. If a bank's required reserves were increased by some percent of the rise in the dollar value of its outstanding loans, it might be more effectively discouraged from expanding loans than it would be by an increase in reserve requirements which are related to deposits. Moreover, when reserve ratios are based on deposits, an increase in required reserves affects all banks whether or not they have been expanding their loans. Relating reserves to assets would also permit reserve requirements to be applied selectively. For example, higher reserves might be required with respect to the increase of a particular class of a bank's loans or investments.

In recent years purchases of Government obligations by Federal Reserve banks have been the largest source of new commercial bank reserves. It has become necessary to find ways either to restrain the movement of Government securities to Federal Reserve banks, or to limit the volume of bank lending made possible by such transfers, without at the same time interfering unduly with Treasury financing

or refinancing operations. Reserve requirements appear to be a promising means of easing the task of reconciling credit- and debt-management policies. If regulations permitted banks to carry specified earning assets in their reserves, such as certain types of Government securities, banks would have an incentive to hold these assets. The merit of such reserve requirements as a tool of credit policy is that they would be useful both in checking transfers of Government obligations to Federal Reserve bank and in offsetting resultant increases in bank cash reserves, with a minimum of disturbance in the market for Government securities.

13B. What suggestions, if any, do you have for changes in either the nature, applicability, or amount of existing requirements? If you consider that each of several proposals for change has important elements of attraction, discuss each.

Several changes in the authority of the Board of Governors over reserve requirements appear to be desirable if the potentialities of these requirements as a tool of credit policy are to be fully realized. Flexibility and discretion seem preferable to rigid regulations that leave no room for administrative judgment. And the substance of reserves and the bases employed in setting reserve ratios should be reconsidered in the light of the policy function. It is not suggested that the reserve structure be completely rebuilt in an effort to make reserve requirements serve solely as an aid to policy, with no consideration of the liquidity objective. For one thing, our long tradition of liquidity reserves would make a drastic remodeling impractical. It is suggested, rather, that since the policy function is the principal one now requiring attention, the existing system of requirements be reexamined, and modified in a manner that would make it a more valuable tool to control the volume and the character of bank lending.

The Council offers the following suggestions:

(1) The Board of Governors should receive an increase in authority over reserve requirements that would give it considerable latitude in determining the amount and content of reserves, and the bases to which reserves may be related. An increase in authority is very desirable because the Board has nearly exhausted its present power to lift reserves, and inflationary credit expansion may again become a threat to the economy. Latitude in the use of such power is desirable for many reasons. The exercise of the Board's power over other weapons of general credit policy is not held to a narrow range by law. Each stabilization problem with which the Board must deal is novel, and each calls for a different combination of credit measures. A reserve formula suitable in one situation might be inappropriate in another.

So that the Board may be more fully prepared to cope with various problems of control, its authority over reserves should include the right to permit banks to carry in their legal reserves Government securities to be specified by the Board. This device, which the Council has frequently recommended, would be an important addition to the means by which objectives of credit policy and debt management can be reconciled. The Board should also be authorized to require that at least a portion of legal reserves be related to changes in the volume of classes of assets to be designated by the Board.

(2) The Board's discretionary authority should include the right to classify banks and bank deposits for reserve purposes. Administrative instead of statutory determination of such matters would make it possible to end the present classification of member banks on the basis of location, which is an illogical vestige of banking practices and customs that no longer exist. It would also permit deposits to be defined and classified in a manner most suitable to attainment of the purposes of reserve requirements.

(3) For the most effective use of reserve requirements in credit policy, all commercial banks should be subject to reserve requirements comparable to those imposed by the Board of Governors. At present the reserves of about half of the Nation's banks cannot be regulated by the Board of Governors. This nonmember group owns only about 15 percent of total bank resources, and the effectiveness of the Board's reserve requirements may not seem to be greatly impaired with this small percentage of the banking business not obliged to observe them. But it is probable that any considerable increase in reserve requirements for member banks would raise the number of nonmember banks.

14. Have you any suggestions other than those implied in the answer to the preceding question for insulating public debt securities from the impact of restrictive credit policies designed primarily to discourage the growth of private debt?

Complete insulation of public debt securities from the impact of restrictive policies would be possible only if we could have a debt that consisted entirely of nonmarketable, nonredeemable obligations. Total insulation of the debt by this means, however, is not feasible since the demand of individuals and private institutions for this kind of security would scarcely be substantial even at considerably higher rates of interest than were paid on other securities. The only practical opportunity for increasing the volume of nonmarketable, nonredeemable securities is offered by the Government trust funds which at present are the only holders of obligations having virtually these characteristics. If social security programs were expanded as suggested in the answer to question 17, larger contributions would add to the trust funds and make possible the issuance of more of the special securities in which most Government trust funds are invested. These issues are nonmarketable, nonredeemable in effect, and they are affected by measures of credit restraint only insofar as these measures lead to changes in the average rate of interest on the public debt. The interest rate on some of the special issues, according to law, is determined by the average rate on the interest-bearing public debt.

Another method to withdraw more of the privately held Government debt farther away from the influence of restrictive credit policies is to place as much of the debt as possible in long-term nonmarketable, redeemable securities. The redemption value of these securities is not affected by movements of prices and yields in the market for Government obligations. However, the fact that they can be redeemed, although at a sacrifice, makes the attractiveness of holding them somewhat dependent on the financial markets. Accordingly, they are not fully insulated from the effects of major credit restrictions.

It was pointed out in the answer to question 13 that it might be desirable to allow commercial banks to carry some Government securities in their required reserves. While the holding of Government obligations in reserves would not remove those obligations from the impact of changes in market prices and yields resulting from measures of credit restraint, it would help to prevent Government securities from shifting in ownership in a manner that interfered with the success of credit policy. A more complete insulation of securities held by banks could be achieved by requiring banks to hold part of their reserves in the form of special nonmarketable, redeemable securities made available in limited quantities for reserve purposes only.

Selective credit controls can be used to reduce certain kinds of private loans without interfering with the market for Government obligations. Priorities and allocations of materials, by restricting investment outlets, similarly may reduce or restrict private loans without adverse effect on the Government securities market.

15. To what extent is the demand for Government securities by nonbank investors influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

It is doubtful if the absolute rate of interest has much effect on the demand for Government securities by nonbank investors, although conceivably interest rates might reach such a low point that investors would prefer to hold their funds in cash than to purchase securities.

The relative rate of interest offered by Government compared with rates being paid by private borrowers undoubtedly has important effects on the demand for Government securities. The extent of these effects depends on the alternatives available to the investor.

(1) Though individuals give less consideration to interest rates than do institutional investors, a continuing and well-publicized opportunity to receive higher rates of return on savings placed in banking and similar institutions offering high degrees of safety to funds entrusted to them, might in time substantially reduce the demand for Government obligations paying lower rates. Individuals in lower income classes probably respond less rapidly and to a lesser extent than those in higher income brackets to chances of obtaining higher interest rates from alternative forms of investment.

(2) Since there are relatively few short-term securities available other than short-term Government obligations, nonfinancial corporations desiring to invest in short-term securities cannot move a great volume of funds from Government to private securities, whatever the interest rate on the latter. The demand of these nonfinancial corporations for short-term Governments might be more substantially curtailed if interest rates on time accounts in commercial banks were comparatively more attractive.

(3) Large individual investors and institutional investors in long-term securities would be most likely to have competing outlets for their funds and would accordingly be most affected by changes in relative rates of interest.

If interest rates were expected to rise beyond current levels, purchases of all except short-term Government securities would be discouraged. Great uncertainty about the direction of future changes

in interest rates might likewise lead many investors to place funds in short-term obligations while they awaited clearer signs of future trends. On the other hand, an expectation that long-term rates were about to decline would stimulate the purchase of long-term Government securities.

There are many other factors besides interest rates which affect the demand of nonbank investors for Government obligations:

(1) Both individual and institutional investors may desire a high degree of liquidity, in the form either of a stable market for salable obligations or the right to redeem nonmarketable securities on demand, or on very short notice. If investors expected wide fluctuations in prices and yields on long-term marketables, they might prefer to place their funds in short-term obligations paying lower rates of interest. Likewise, the demand for nonmarketable securities that could not be easily and quickly redeemed at the will of the holder at any time soon after their purchase, would probably not be great.

(2) Investors who are likely to buy Government bonds seek a safe investment, one that is an obligation of a debtor who will be financially able to pay. Individual savers in lower income classes are especially concerned about safety because they can little afford to take risks. Likewise they are not usually in a position to evaluate different degrees of risk. Investors in this group have therefore understandably shown a decided preference for obligations of the Government, the safety of which no one questions. However, the development of alternate outlets for savings that provide virtually equal assurance of safety may in time divert more funds of small investors from Government obligations. The insurance of bank deposits and of deposits or shares in savings and loan associations are illustrations of measures by which the Government increases the comparative attractiveness of some types of private obligations.

(3) The demand for Government obligations, like that for all similar liquid assets, is influenced by inflation. Should expectations of a chronic or uncontrollable inflation ever be allowed to become widespread, then the certainty that Government obligations will be paid, liberal redemption features, and even high interest rates might not be sufficient to maintain the desired market for Government securities among nonbank buyers. The demand for Government obligations by individual investors, who are more directly concerned with the buying power of the holdings, is undoubtedly influenced more by expectations of inflation than is the demand of institutional buyers whose obligations are of fixed dollar amounts.

(4) The demand of nonbank investors for Government securities, of course, is influenced also by the volume of lendable funds at their disposal and by the availability of other investment outlets.

16. What advantages do you see in a stable long-term Government bond market? What weight should be given to the desirability of stability in the Government bond market in determining credit policy under each of the assumptions with respect to the volume of Government borrowing stated in question 8?

Stability of the long-term Government bond market is a relative term, which can be best defined by noting the different kinds or degrees of movements in bond prices which may take place. At the one ex-

treme there may be no change in the prices and market yields of long-term Government bonds because prices have been pegged. Second, the market prices may fluctuate moderately around some level of prices. Third, prices likewise may fluctuate moderately, but move gradually in either an upward or downward direction. Fourth, market prices may fluctuate wildly.

The first of these conditions we would consider a rigid or absolutely stable market if prices were supported at the pegged level over a long period of time; the second, we would consider a practically stable market; the third, an orderly market; and the fourth, a disorderly market.

Of importance in characterizing the nature of the market is not only what actually has happened to prices but also the expectations of the public regarding future price changes, including expectations regarding actions by the Federal Reserve or the Treasury. Ordinarily, price behavior, both current and anticipated, is closely related to Government policy. For instance, a rigid market is one in which prices not only remain unchanged, but also one in which it is expected that, through a Government-support policy, price changes will be prevented. In a stable market, the public is not certain that bonds can always be sold at a fixed price, but is assured that, if necessary, the Federal Reserve System or Treasury will prevent major price changes. The same applies, with proper modification, to the expectation of an orderly market. A disorderly market implies that the public does not expect any official intervention, irrespective of what happens to prices. A free market, of course, is not necessarily a disorderly market.

The volume of marketable long-term Government issues is large, but it is less than one-fifth of the Federal debt available to the public, and, of course, a much smaller percent of the total amount of debt that is influenced by forces spreading out from the long-term bond market. If we define long-term bonds to include those securities which reach their maturity or first call date more than 5 years in the future, there are outstanding about $41 billion par value of marketable long-term securities. Of these, $5 billion are bank-eligible and $36 billion are not, although the great majority of these will become bank-eligible over the next 3 years. More than five-sixths of the bank-eligible issues are held by commercial banks. Insurance companies and mutual savings banks are the largest holders of the bank-restricted issues, although nearly 40 percent are held by private investors other than the major financial institutions and about 15 percent are held by Federal Reserve banks and United States Government investment accounts.

The significance of conditions in the market for long-term Government bonds is magnified by the fact that changes in prices and yields on these securities are interrelated with changes in prices and yields on other securities, both public and private. The market prices of long-term Government securities eventually affect in various ways all other issues, including short-term marketables and nonmarketable securities. For example, a prolonged upward movement in yields on long-term bonds would require changes in the terms of new issues of nonmarketables. An important relationship is the reciprocal one between movements in prices and yields on long-term Government bonds and prices and yields on corporate and State and local government securities, a relationship that will continue as long as a large part of the public debt is not insulated against the impact of credit policy.

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Because of this connections, support operations in the Government bond market are one of the factors that influence the entire structure of interest rates, and thus affect private as well as public-investment projects needed for economic growth.

A stable market for long-term Government bonds has important values for debt management. Bond market stability, by reducing speculative fears, encourages the sale and continued ownership of long-term Government bonds outside the banking system, and thereby contributes to economic stability. By reducing the risks of holding them, a stable market adds to the attractiveness of long-term bonds and thus permits their issuance at lower rates of interest than would otherwise be possible. The objective of holding down the rates of interest paid on Government securities is desirable, since an increase in interest rates would increase the cost of Government. For example, an average increased rate of one-half percent in the interest paid on the Federal debt would amount to approximately $1¼ billion a year when the increase in rate became fully effective on all debt.

A stable bond market has other advantages. It helps to uphold the credit of the Government, and the Government's credit has an important bearing on international relations, as well as on the success of the Treasury in financing operations. Furthermore, the purchasers of Government securities are protected against substantial loss if the bond market is stable, which is valuable for the maintenance of internal morale. Lastly, a stable market for long-term Government bonds has the advantage of making it easier to assure that interest rates on long-term loans in general will remain at levels required for economic expansion. As has been pointed out, a stable market for Government bonds is conducive to stability in the markets for other securities, private as well as public. Increases in interest rates might give rise to speculative movements that forced interest rates still higher, until they reached a level that interfered seriously with the future ability of the economy to produce and to expand its productive capacity. While the increase in interest rates might be intended as temporary, it would tend to be perpetuated since, after investors have become used to higher rates, they are only gradually persuaded to accept lower rates.

On the other hand, although stability in the market for long-term Government bonds is generally considered desirable, objection has been raised to efforts to bring that stability about by support operations. These support operations can be carried out through purchases and sales by the Federal Reserve System, and, to a limited extent, through transactions of Government trust accounts. It has been argued that a policy of price maintenance, when extended to all marketable Government securities and continued indefinitely, practically erases the difference between long-term and short-term obligations, and makes any considerable spread in interest rates or yields discriminatory and costly to the Government. The buyer of long-term bonds may receive a relatively higher rate of interest, while at the same time his investment is virtually as liquid as cash. Under such conditions the Government pays a long-term price for short-term money, while the liquidity of security holders is increased.

This argument, which relates to only one factor in the total picture, appears to be most applicable to a rigid and absolutely stable market

with pegged prices; it applies with lesser force to a practically stable market, as previously defined. The moderate fluctuations of prices in a stable long-term Government bond market constitute an element of risk to the investor. As distinct from a pegged market, a stable market does not make long-term bonds the equivalent of cash. By offering some protection to the Government against large-scale "dumping" of securities, a stable market justifies a moderate spread between short-term and long-term yields.

It is also argued that supporting the bond market limits or makes impossible Federal Reserve System anti-inflationary open-market operations. During a period of inflationary pressures accompanied by strong demand for private credit, the action indicated for the Federal Reserve would be to sell Government securities on the open market and thereby reduce bank reserves and bank lending power; or at least the Federal Reserve should not buy Government securities and thereby increase bank lending power. With the pressure for private loans very strong, however, banks and other lending institutions are tempted to sell Government securities in order to secure funds to make such loans. If the market for Government securities is maintained at a fixed price, it will be necessary for the Federal Reserve to buy these securities when they are offered. As a result, bank reserves and bank lending power are expanded at a time when they should be contracted.

However, if the Federal Reserve System maintains the kind of stable market that has only moderate fluctuations but does not assure fixed prices, some anti-inflationary use of open-market operations is possible. In this case, the Federal Reserve banks would probably have to make net purchases of Government securities during periods of strong demand for private loans, but the amount of the purchases might be relatively small. The support methods involved in such an operation have not been definitively tested but it seems probable that relatively stable prices can be maintained without the Federal Reserve purchasing all securities offered and that the prospect of even moderate losses keeps some prospective sellers out of the market. Nevertheless, while Federal Reserve purchases of Government securities may be less under these conditions than when prices are pegged, it must be recognized that the maintenance of either kind of stable market for Government securities limits, under some circumstances, the use of open-market operations for restraining credit and combating inflation. In view of the other factors limiting the use of a truly flexible open-market policy for anti-inflationary purposes during the foreseeable future, we discount extreme claims made by some economists as to the degree of importance to be attached to which of these alternatives is followed. There is room for variance of opinion concerning their relative merits.

Support operations in the Government securities market have a bearing on the lending activities of banks and other financial institutions mainly because such operations influence one source of lendable funds, but also, in part, because they affect the liquidity of the lender. When prices of securities are pegged and this is expected to continue, financial institutions can maintain desired degrees of liquidity partly by holding long-term Government obligations, since these could readily be converted into cash without loss. With stable prices that showed some flexibility of movement, however, the liquidity of many institu-

tions would be less than in the previous case, since long-term Government obligations could not be looked upon as the equivalent of cash. To achieve desired liquidity, these institutions would need to hold more cash and short-term securities than when the Government bond market was pegged. The lending of the institutions accordingly would be affected.

The argument that the support of the long-term Government bond market inhibits the Federal Reserve System's use of its strongest instrument of general credit restraint is a matter of concern only in certain economic situations. Obviously, at times when inflationary conditions do not exist, the several advantages of a stable bond market can be sought, through support operations if necessary, without any conflict with measures that are used to check the expansion of credit. Again, in the case of all-out war, the problem might actually be less serious than under other circumstances. Conditions of all-out war would probably mean that relatively little nonmilitary investment was going forward. With private outlets for lendable funds narrowly restricted, the objective of maintaining a stable Government bond market would be less complicated by the need of using open-market operations to curb private credit expansion.

The question of the conflict between efforts to stabilize the bond market and the employment of open-market operations to maintain economic stability is of significance primarily in a period in which inflationary pressures and private demands for credit are strong, and substantial Treasury refunding or new borrowing is necessary. In this conjuncture, the case for a stable bond market is particularly strong because it is an important objective of debt management to place firmly the largest possible quantity of long-term Government obligations in the holdings of individuals and institutions other than banks. Of course, the importance of stability in the long-term market would depend to a considerable extent on whether any long-term funds would be seeking investment under any market conditions. The desirability of maintaining a stable market for long-term securities is less if no long-term funds would be available in any event than if investors held such funds and would purchase long-term bonds under conditions of stable prices but not otherwise.

When inflationary credit expansion is taking place, the case for an anti-inflationary open-market policy often is strongly urged even if it coincided with substantial Treasury refunding or new borrowing. Those who believe that drastic credit restraint is the most appropriate method for combating inflation, irrespective of its cause and character, will be inclined to conclude that the use of open-market operations is indispensable for this purpose, and that other objectives of Government should be subordinated. The Council cannot follow this reasoning. The Council believes that each inflationary situation requires a different strategy of counteraction, and that open-market operations, while an important instrument, are by no means the answer in every case of inflation. For example, in the answer to question 11, the Council pointed out why it believes that under the conditions of the defense program a drastic unselective credit restraint could do harm to the needed expansion in defense-related industries. Moderation and, particularly, adaptation of credit restraints to the specific conditions are necessary if interference with the defense program is to be avoided.

It should also be borne in mind that stability in the price of Government bonds under many circumstances operates to keep the debt in private hands and to encourage private purchases of additional debt, and to that extent, the stability of bond prices is in itself a stabilizing factor in the economy. The maintenance of a stable long-term bond market may have a more quieting effect than would monetary policy steps that resulted in a decline in the price of long-term Government bonds and efforts on the part of the bondholders to dispose of them before the market fell even further, since in the process of preventing a disorderly market the Federal Reserve might find itself obliged to purchase larger amounts than if stability had been continued.

It is also necessary to consider the effect of higher interest rates, that would follow the employment of open-market operations to restrict private credit, on production, and on the growth of productive capacity in later years. Success in curbing a current rise in the volume of loans might be bought at the price of a tenacious level of higher interest rates that would be an obstacle to future economic expansion.

If the use of open-market operations to hold down lending to private borrowers were thought more important than the maintenance of a stable market for long-term Government bonds at a time when the Treasury was engaged in borrowing substantial sums of new money, the Government would be forced into an interest rate race with private borrowers. The Government might have to offer higher and higher rates of interest to sell securities. Undoubtedly under some circumstances a small increase would be sufficient. But when private demand for loans was strong, this competition for funds would be an effective means of combating inflation over any continuing period of time only if the private demand for credit were thereby substantially reduced or if private lenders turned from private loans, even at the loss of the higher interest that they might receive. As we point out in response to question 7, we believe that a rise in interest rates has only a limited effect on the private demand for credit. With a continuation of strong private demand for credit, the Government might have to pay a disproportionately high price for an uncertain contribution to economic stability.

Another basic point to be borne in mind is the close interrelation between the demands for private credit and the stability of the Government bond market. If, instead of achieving a restriction of private credit through open-market operations in Government securities, private credit were restrained in other ways, any conflict between economic stability and the stability of the Government bond market would largely disappear. It is for these reasons that we have placed stress on the increase in reserve requirements and on other ways for holding down private credit.

In summary, the advantages and disadvantages of maintaining a stable market for long-term Government bonds under inflationary conditions when demand for private credit is very strong must be judged in the light of all the circumstances, including the availability of other measures to cope with the inflationary threat. During the defense period, when large refundings and new financing will be necessary, we believe that great weight should be given to the maintenance of stability in the Government bond market. If other measures of

restraint are availed of, bond market stability is to a large extent consistent with and even complementary to the objective of economic stability for the whole economy.

17. Under what conditions, if any, do you believe it would be desirable to resort to compulsory methods in the sale of Government securities to (*a*) banks, (*b*) other financial institutions, (*c*) other corporations, (*d*) individuals? Discuss the philosophy which underlies your views on this matter.

Compulsory lending has some characteristics of taxation and some characteristics of voluntary lending. Like taxation, it compels persons to surrender purchasing power. But the person who surrenders the purchasing power is given a receipt in which the Government promises to repay at a later time. Because of the promise to repay, compulsory lending has some characteristics of Government borrowing. It adds to Government indebtedness either in the form of a book credit or some kind of bond or note issued to the lender.

The use of compulsory lending appears to have certain advantages over either taxation or voluntary borrowing from the point of view of the taxpayer and the point of view of the Government. For the taxpayer, it is an obvious advantage to be reimbursed for at least a part of his present payments. As contrasted with voluntary lending, the person who in an emergency patriotically is willing to forego present consumption may welcome the knowledge that everybody is contributing according to some measurement of ability to pay. Particularly, some people may prefer legal compulsion to the social compulsion of a high-pressure campaign.

For the Government, compulsory saving has the advantage over voluntary saving that within limits the amount can be determined according to requirements and does not depend on the people's voluntary cooperation, and also that the terms of the loans can be determined by the requirements and purposes of the Government rather than by the wishes of the buyer. Finally, the Government can control the time of repayment and thereby try to prevent return of the funds at times when they might add to inflationary spending.

In spite of these apparant advantages of compulsory lending, we believe that as a general principle taxes should be used as a compulsory method of fund raising and the voluntary purchase of Government securities as a method of borrowing. The greatest possible amount of the public's compulsory contribution should be in the form of taxes—taxes in the traditional sense with no provision for repayment. A large volume of Government obligations, whether placed in the hands of investors by compulsory or voluntary sale, is a reservoir of purchasing power for future spending. It is sometimes urged that this would be an advantage of compulsory lending, since the Government could support purchasing power by repaying the loans during periods when demand was inadequate to support a high level of employment and business activity. One difficulty is that popular demand might force redemption during a period of strong inflationary pressure. If at some future time economic conditions should require that consumer and business demand be stimulated, there exist other means of monetary and fiscal policy which can be used.

The use of compulsory placement of Government securities could be justified only under very exceptional conditions of a national emergency, namely, when existing taxes and voluntary saving combined will not bring about the needed absorption of purchasing power; and if higher taxes (*a*) are not feasible, or (*b*) there is reason to believe that additional taxes will have an adverse effect on production incentives, or (*c*) the limit has been reached beyond which a further increase in taxes will result in irresistible demands for compensating wage and salary increases. The best case can be made for a policy of compulsory lending if, in addition, there is reason to believe that the emergency is of short duration and that the problem of postemergency redemption of bonds is not likely to add to postemergency inflation, but rather serve to support postemergency stabilization policy.

These conditions are not existent at the present time. We are not convinced that we have reached the limits of taxation. We also believe that voluntary lending both by individuals and nonfinancial corporations can be increased, and that the willingness to lend will particularly increase when restrictions on the supply of consumer durable goods and business investment limit the possibility of spending by individuals and enterprises. Most of all, the present emergency may possibly be of long duration, and the character of the postemergency situation is even more uncertain than that of the situation after a war.

In the present and prospective situation, an expanded social security system appears as the only defensible form of increasing lending by other than voluntary means. Contributions for additional social security or special annuity benefits are more acceptable to workers than additional taxes. Such contributions would offer little ground for compensating wage demands. Moreover, there is no conflict between increasing payments for social-security benefits and intensifying the campaign for voluntary purchase of Government securities. As social security payments are spread out over long periods in total amounts not subject to abrupt changes, this method of compulsory lending does not present the problems of debt redemption and of waves of spending that exist in the case of other forms of compulsory loans. We emphasize that this form of compulsory surrender of purchasing power is recommended only as an addition to and not as a substitute for needed taxation.

We see no reason for using compulsion to sell bonds to banks or other financial institutions. Their lending power can be directed toward Government bonds by measures of credit control. In addition, the purpose of compulsory lending is not so much to raise money for Government expenditures as to reduce the spending power of consumers and business firms. The compulsory sale of bonds to banks and other financial investors would contribute little to that objective. It would not add directly to individual saving out of current income, and it would not significantly reduce private borrowing below levels which could be obtained from the use of other measures of credit policy.

Besides these reasons, the use of compulsory placement of bonds with banks and other private financial institutions would raise even more administrative difficulties than the compulsory sale of securities to individuals, because separate regulations would have to be drawn up for each of the many classes of lending institutions, and numerous ad-

justments and exceptions would have to be made because of variations among institutions in each class.

In connection with the compulsory sale of bonds to banks, it should be noted that the recommendation for changes in bank reserve requirements, discussed in the answer to question 13, includes the proposal to permit banks to carry Government securities as part of the legal reserve. While such permission would give banks an incentive to hold Government securities, it would not provide for compulsory purchase.

18. Discuss the merits and demerits of the proposal for the issuance of a bond, the value of which would be guaranteed in terms of purchasing power.

As a means of stimulating individual saving, a proposal has recently been made that the Government issue bonds which are payable at maturity in a sum of dollars having the same total purchasing power as the money paid for the bond. Because such a bond would be bought mainly as a safeguard against inflation, the proposal was that the bond carry a low or no interest rate. In order to prevent speculation in such bonds they were thought of as nonmarketable, and redeemable above face value, in the event of higher prices, only if held until maturity. The proposal also provided a limit for the amount of such purchasing power bonds that could be bought by any one person.

Such bonds might have considerable attraction at a time when many investors are concerned about the future value of the dollar. They might attract some money that otherwise would compete for commodities in short supply, or that might be invested in stocks and real estate and other inflation hedges.

In spite of the possible attractiveness and apparent equity of a purchasing power bond, we cannot recommend its adoption under present and foreseeable circumstances.

The issuance of a purchasing power bond would imply a defeatist attitude toward the problem of inflation. Widespread ownership of purchasing power bonds would add another group to those who think themselves sheltered from the effects of inflation, and would weaken public support of a stabilization program. Instead of making preparation for the consequences of defeat in the stabilization effort, it is more appropriate for the Government to marshal and improve its resources of policy toward achieving economic stability. It is too early to concede that stability cannot be attained. Actually, while people are very much concerned with the price rise of many essential commodities, there are no indications that there is a widespread fear of a general deterioration of the dollar.

Purchasing power bonds would add another escalator to the mechanism of inflation. The dynamic process of inflation is speeded by the existing price and wage escalators that cause one price rise to lead to increases in other prices. The most effective method for preventing escalation is to prevent or minimize the first initial price rise. Once prices have risen, escalation means that the full impact of an accelerated price rise will fall on those who are not protected. To permit prices to rise and to try then to protect everybody against inflation must result in more rapid inflation with the threat of virulent inflation from which nobody can find refuge. The advantage of at-

tracting some additional saving would be far outweighed by the aggravation of the inflationary spiral which might result from that saving.

The proposal for purchasing power bonds applies the principle only to a limited amount of bonds. The Government would thus add an admittedly attractive feature to one type of security offered to the public in competition with other Government bonds and such other forms of assets or contracts as currency, demand, time and savings accounts, shares in savings and loan associations, and life insurance policies. It is very likely that great pressure would develop to extend the purchasing power clause also to other investments, public and private. The greater the number of persons who considered themselves shielded from inflation, the greater would be the possibility of its occurrence.

Besides the economic deficiencies of the proposal, its alleged equity is more apparent than real. It would be unfair discrimination to protect a few investors at the expense of all taxpayers.

19. Discuss the advantages and disadvantages of marketable and nonmarketable securities (*a*) under present circumstances, (*b*) in the event of the necessity for substantial net Government borrowing.

In answering this question, we find it necessary to treat separately three different types of nonmarketable securities (leaving aside the special issues sold to Government trust funds):

(*a*) Nonmarketable redeemable securities, which are demand obligations of the savings bond type, nontransferable but cashable by the holder at any time after a brief waiting period. The yield is ordinarily graduated according to the length of time the security is held, thus providing incentive to hold the security until the maturity date. (Treasury savings notes also belong in this general category.)

(*b*) Nonmarketable convertible securities, which are nonredeemable, but convertible at the owner's request into lower-yielding marketable securities. The only time this type has been used was in an exchange offering in March 1951.

(*c*) Nonmarketable nonredeemable, nonconvertible securities, which must be held until maturity (although provision might be made for redemption under special circumstances). The Federal Government has never made use of this type in a public offering.

The advantages and disadvantages of the different types of securities should be considered both from the viewpoint of the Treasury's immediate interests and from the viewpoint of the economy as a whole. It is also necessary to take into account the classes of investors that are likely to have lendable funds and the types of securities in which these investors will be most interested. It is an academic gesture to develop types of securities that no one wishes to buy.

It is easy to see why, from the Treasury's standpoint, securities of the nonredeemable, nonconvertible type offer important advantages over other types, first, because the Treasury would be protected against paying out cash on demand, and, second, because such securities would be insulated from the impact of general credit restrictions. (In the latter connection, see the answer to question 14.) On the other hand, it is doubtful that illiquid securities of this type would find much of a

market, even if they carried substantially higher interest rates than are paid on other securities. Compulsory placement would, of course, be unacceptable, except possibly in an all-out war situation.

The remaining types of nonmarketable securities provide more practicable alternatives to the conventional marketable issues. Sale of nonmarketable redeemable securities to individuals is a particularly advantageous form of Federal borrowing, under present circumstances as well as in a period of more substantial net additional borrowing. Such securities are attractive to individuals because of their demand character, yet experience has shown that most individuals are quite cautious about redeeming them. The low interest yield that is typical of these securities when redemption occurs before the maturity date provides an incentive to hold them for the full period, and it also makes it unnecessary for the Government to pay long-term interest rates for short-term money. Finally, it should be observed that the savings-bond type of security, being both highly liquid and riskproof (apart from the risk associated with changes in purchasing power), is the only type which is well adapted to the needs of the millions of small investors who would not ordinarily consider putting their savings into securities. For this reason, the savings-bond type can serve an anti-inflationary purpose much more so than other types can.

Nonmarketable redeemable securities, which are, in essence, interest-bearing demand deposits, are not a particularly satisfactory means of borrowing from investors other than individuals. Unlike individual investors, business concerns and financial institutions would show no hesitancy in unloading their holdings of redeemable securities whenever more profitable investment opportunities appeared. The Treasury would thus be under the constant threat of a sudden drain on its cash resources. The monetary authorities, too, would be handicapped because of the weakening of their control over the money supply.

Marketable securities have an advantage in that the Government is protected against the necessity of paying out cash on demand prior to the maturity date. They have the advantage, too, of being acceptable to investors, provided the interest rate is in line with the market. On the other side of the ledger is the fact that, as the volume of outstanding marketable securities increases, there is a possibility of further impairment of monetary controls. The critical significance of this consideration is developed elsewhere in this questionnaire. (See question 16.)

It is difficult to appraise nonmarketable securities of the convertible type, because of their rather novel character and because so much depends upon the market value of the securities offered in exchange. This type has the characteristics of a compromise plan, since they provide the Treasury with the advantages of a marketable issue and the monetary authorities with the advantages of a nonmarketable issue. Its attractiveness to investors depends upon the rate of interest and the value of the conversion privilege. As this privilege is made more attractive, however, the advantages of nonmarketability become less. On the whole, we think it quite possible that the convertible type can be developed into a useful instrument of debt-management policy, for example, as a means of absorbing the funds that will be seeking new investment outlets as private capital outlays are curtailed.

A continual aim of policy, while the possibility of renewed inflation remains a real one, should be to place the largest possible volume of securities outside the banking system. This suggests a careful tailoring of marketable issues to serve the needs of nonbank investors. In the event of the necessity for large-scale borrowing, there would be greater need to encourage purchases of savings-bond type securities and to find ways of insulating the holdings of other investors from the impact of restrictive credit policies. This may call for new types of securities.

20. What new types of securities, if any, do you believe should be given serious consideration for use (*a*) under present conditions, (*b*) in the event of the necessity for substantial net Government borrowing?

We have pointed out in the answer to question 19 that the greatest possible emphasis should be on securities which are placed outside the banking system, and which the buyer is likely to hold. This is desirable under present conditions, with the need for considerable refinancing and some new financing, but it would be even more desirable if still heavier new financing should become necessary.

We have, however, no recommendation for specific new types of securities that might be issued in furthering the attainment of this objective.

D. Deposit Insurance

21. Discuss the advantages and disadvantages of extending Federal deposit insurance to all deposits in insured banks.

One advantage of extending Federal deposit insurance to all deposits is that it would be a great step toward giving all forms of money the full protection that seems to be a corollary of a government's responsibility for the monetary system. It has long been recognized that one of the major responsibilities of a central government is to establish a monetary system. That function was performed in early times by providing the public with coins from the government mint. But for more than a century the principal forms of money have been notes and deposits in banks operating under varying degrees of government control or supervision.

Beginning with the period of the Civil War, the Federal Government has prevented the issuance of State and private bank notes by taxes and has protected the owners of bank notes issued by banks under Federal supervision from loss growing out of bank failure. Every bank note issued since that time carries, directly or indirectly, the full guaranty of the Federal Government. Much later, in 1933, a Federal system for protection of bank depositors was also set up, through the FDIC. The insurance the FDIC affords is at present limited, however, to $10,000 in the case of an individual account. While under this insurance ceiling about 99 percent of individual accounts in insured banks receive full protection, only a little more than half of the dollar volume of accounts in insured banks is covered. A case can be made for giving the deposits not covered under the present law the same guaranty or insurance that the Government has applied to other bank credit money.

Complete insurance of bank deposits would also be an important aid in maintaining economic stability. Widespread losses by bank depositors disrupt the operation in the economy and aggravate depressions, as was demonstrated in the early thirties.

Extension of FDIC insurance to all deposits, regardless of size, would eliminate a source of contention in the present law. As all banks pay FDIC assessments on all deposits, less some adjustments, regardless of the aggregate dollar amount insured under the $10,000 ceiling, many banks with a high percent of large accounts consider themselves the victims of inequity.

Extending FDIC protection to all deposits in insured banks would not represent a great departure from actual practice. Because of FDIC policy of merging failed or failing banks with other institutions, whenever it is possible to do so, instead of liquidating the weak banks, FDIC insurance has in recent years resulted in a virtual 100 percent protection of deposits.

On the side of disadvantages, it has been objected that full protection of depositors would eliminate an important present safeguard to sound bank management—the watchfulness of the owners of deposits in excess of $10,000. While we recognize that the desire of bankers to attract and hold large deposits provides some incentive for prudent management, the watchfulness of depositors has not in the past prevented widespread losses.

The fear has also been expressed that full insurance would give Federal bank supervisory authorities further opportunity for encroachment on the affairs of privately-owned banks. However, as has been noted above, there can be no real question of the Government's invasion of private rights where the monetary system is concerned. Money is a responsibility of Government.

Moreover, full coverage of deposits would increase the contingent liabilities of the FDIC and might require an increase in the assessments paid by insured banks. It is doubtful that a higher basic rate of assessment would be feasible. On the other hand, the amount of losses that the FDIC may be called on to pay under any level of insurance coverage is an uncertain quantity, and it is possible that the basic rate of assessment in the present law would be adequate to supply the FDIC with all the resources needed even if insurance were extended to all deposits.

Separate Note by Mr. Clark

Mr. Clark did not participate in the development of the answers to the questions submitted to the Council by the Subcommittee. There is here reprinted for the convenience of the members of the Subcommittee and of the public generally the "Separate Note by Mr. Clark upon Monetary and Credit Policy," which appeared on pages 142–144 of the Annual Economic Review by the Council of Economic Advisers, transmitted to the Congress on January 16, 1952.

Separate Note by Mr. Clark Upon Monetary and Credit Policy

No economic theory relating to the stabilization of the economy is more important than that of general monetary policy, which many believe can of itself accomplish the stabilization purposes of the Employment Act of 1946,

but the usefulness whereof in a strong inflationary movement has been challenged in former reports of the Council of Economic Advisers.

Early in 1950, the Douglas committee regretfully commented that "Our monetary history gives little indication as to how effectively we can expect appropriate and vigorous monetary policies to promote stability, for we have never really tried them." This is not quite accurate. Monetary policy was used vigorously in 1920, and the resulting "stabilization" was a disaster the farmers have not yet forgotten. It was used again in 1928–29, and of that episode the British expert, Hawtrey, has said, "The dear money policy accomplished its purpose in the end. It stopped speculation by stopping prosperity."

We are now able to study efforts to establish the stabilization value of monetary policy in our greater economy in which the institution of banking has been revolutionized by a great national debt which has multiplied the liquid assets in bank portfolios. The Council of Economic Advisers, which, unlike other Government agencies, has the responsibility of considering all national economic policies and their effect upon each other, must give attention to the collateral consequences when it studies our recent experience. In the light of the problems of a defense program which must be integrated, the following anomalies created by monetary policy stand out.

It has enabled the banks to increase their earnings more than enough to match the heavy increase in their taxes in 1951. Nearly every other business and industry found net profits reduced as a result of Government policies under the defense program.

An increase of one-third in the basic commercial interest rate of larger banks, leading to general increases in other bank interest rates, was hailed as a valuable contribution to economic stability. All other businessmen are criticized when they exploit a situation by raising their prices by a much smaller percentage.

When restraint must be imposed elsewhere upon the freedom of decision, the Nation imposes positive control, as in forcing young men into military service, in limiting the production of General Motors, and in fixing prices. To limit the expanding activity of banks, we are offering them larger profits upon the existing level of loans.

The cost of new private capital has been increased and an effort has been made to tighten credit for industry. Vital defense-related industries must expand and the Government will have to finance their expansion to the extent that private capital is inadequate.

The Government is spending large sums to assemble and distribute business information in order that businessmen may reduce to the minimum their uncertainties about the trend of the economy and may plan more confidently. Monetary policy is being based upon the principle that the financial world must be kept in great uncertainty about future interest rates and the availability of credit.

There is general agreement that every effort should be made to place the Government debt in long-term bonds in nonbank hands. The Treasury now finds no market for long-terms and its heavy financing has to be in the form of short-term securities eligible for bank portfolios.

When the size of Government expenditures is giving us deep concern, the interest charge on the Government debt is increasing.

If these miscarriages were the unavoidable results of a monetary policy which is a successful instrument to stabilize the economy, they might be accepted. I do not believe that monetary policy can be successfully used for that purpose in the kind of economy and institutions which we now have. In recent action, that policy has had utterly perverse consequences.

The advance in short-term interest rates in August 1950 was followed by the greatest expansion of business loans in our history.

The increase in long-term rates in March 1951, coming after the price freeze in January had taken the steam out of boiling markets and when a seasonal contraction of business borrowing was due, had no effect upon new business investment.

The more rigorous the use of monetary policy, the more rapid was the increase in new investment in plant and equipment, the very channel through which monetary policy, if effective, operates on its way to the final objective of dampening inflationary forces.

And to complete the topsy-turvy picture, the more rapid the growth in money supply, creating "more dollars chasing goods," the quieter became the consumers' markets.

APPENDIX TO CHAPTER V

Questions Addressed to the Council of Economic Advisers

A. CONGRESSIONAL POLICY DIRECTIVES

1. Do you believe that the congressional declaration of policy contained in the Employment Act of 1946 is balanced in its emphasis upon high-level employment and upon price stability, respectively, as objectives of Federal Government policy? If not, what changes have you to suggest?

B. FORMULATION OF FISCAL AND MONETARY POLICY

2. Do you believe that, subject to the statutes and general directives laid down by Congress, the fiscal and monetary policy of the United States Government should be formulated under the direction of the President? If not, what suggestions have you for the coordination of the policies of agencies not under the direction of the President with those of agencies which are under his direction? How urgent do you consider this problem to be?

3. Discuss the rationale, advantages, and disadvantages of the present division of authority in the Federal Reserve System over the control of discount rates, open-market operations, and changes in reserve requirements.

C. CREDIT AND DEBT-MANAGEMENT POLICY

4. Describe the mechanism by which a general tightening or easing of credit, and the changes in interest rates which may result, is expected to counteract inflation or deflation. Discuss the impact on borrowers and lenders in both the short-term and long-term credit markets and on spending and savings. Indicate the effect on each of the broad categories of spending entering into gross national product. What are the (actual or potential) capital losses or gains that would be brought about by changes in interest rates? To what extent is the effectiveness of a program of credit restraint affected by or dependent upon expectations with respect to subsequent changes in interest rates? Distinguish in your discussion between small changes in rates and large changes in rates.

5. How rapidly and to what extent would you expect the volume of bank loans to respond to measures of general credit control under present conditions? Discuss recent changes in the volume of bank loans.

6. What is the reason for the relatively slight use by commercial banks of the Federal Reserve discount and borrowing privilege? Do you believe that greater reliance should be placed on this privilege as a means of obtaining Federal Reserve credit? Under what conditions, if any, would you expect to see a greater use made of the discount privilege?

7. Discuss the economic effects of the increase in short-term interest rates between August 1950 and March 1951 and the subsequent increase in long-term interest rates.

8. Discuss the appropriate roles of direct controls, selective credit controls, and a generally restrictive credit policy as means of restrain-

ing inflation (*a*) when the Treasury is not expected to be a large borrower in the foreseeable future, (*b*) when a large volume of Treasury refunding operations will have to be effected in the foreseeable future, (*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future, (*d*) under conditions of total war.

9. Discuss and evaluate the Voluntary Credit Restraint Program which was initiated in the spring of 1951.

10. Do you believe that under existing law any agency of the Federal Government has the power to control directly or to "ration" the extension of credit by individual banks? Under what economic circumstances, if any, would you recommend the use of this authority?

11. Do you believe that there is any conflict between measures to restrain excess demand by monetary means and the need for expanding the economy to meet the requirements of a continuing readiness to resist aggression and a continuing high standard of living? If so, how can the effects of this conflict be mitigated?

12. What do you believe to be the role of bank examination and supervision in furthering the objectives of the Employment Act?

13. Discuss the economic functions of bank reserve requirements. What suggestions, if any, do you have for changes in either the nature, applicability, or amount of existing requirements? If you consider that each of several proposals for change has important elements of attraction, discuss each.

14. Have you any suggestions other than those implied in the answer to the preceding question for insulating public debt securities from the impact of restrictive credit policies designed primarily to discourage the growth of private debt?

15. To what extent is the demand for Government securities by nonbank investors influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

16. What advantages do you see in a stable long-term Government-bond market? What weight should be given to the desirability of stability in the Government-bond market in determining credit policy under each of the assumptions with respect to the volume of Government borrowing stated in question 8?

17. Under what conditions, if any, do you believe it would be desirable to resort to compulsory methods in the sale of Government securities to (*a*) banks, (*b*) other financial institutions, (*c*) other corporations, (*d*) individuals? Discuss the philosophy which underlies your views on this matter.

18. Discuss the merits and demerits of the proposal for the issuance of a bond, the value of which would be guaranteed in terms of purchasing power.

19. Discuss the advantages and disadvantages of marketable and nonmarketable securities (*a*) under present circumstances, (*b*) in the event of the necessity for substantial net Government borrowing.

20. What new types of securities, if any, do you believe should be given serious consideration for use (*a*) under present conditions, (*b*) in the event of the necessity for substantial net Government borrowing.

D. DEPOSIT INSURANCE

21. Discuss the advantages and disadvantages of extending Federal deposit insurance to all deposits in insured banks.

CHAPTER VI

REPLY BY PRESTON DELANO, COMPTROLLER OF THE CURRENCY

A. GENERAL PURPOSES OF OFFICE

1. Describe briefly the functions and mode of operation of your Office.

The main functions of the Office of the Comptroller of the Currency relate to the organization, operation, expansion (branchwise or through amalgamation), and liquidation of national banks. At the present time there are approximately 5,000 national banks (with over 2,000 branches), organized and operating in accordance with the National Bank Act and other Federal legislation, which hold slightly over half of the total banking resources of the United States.

The Federal statutes confer upon the Comptroller of the Currency broad discretionary powers either to approve or reject applications for the organization of new national banks, the conversion of State-chartered banks into national banks, and consolidations of banks under Federal charter. The establishment of branches within the United States by national banks also is permissible only upon authorization by the Comptroller.

The Bureau exercises general supervision over the operations of all national banks. Upon notification by the Comptroller, each national bank is required by law to publish a report of its current condition, at least three times each year. National bank examiners, under the direction of the Comptroller, are required by law to examine every national bank not less than twice annually.

In case of deliberate violation of law by a national bank, suit may be brought in the name of the Comptroller for the forfeiture of the bank's charter. In the event of continuous violation of law or unsafe or unsound banking practices, the Comptroller may initiate action designed to remove the officers and directors responsible therefor. If it appears to the Comptroller that a national bank is in an insolvent condition, he is empowered to establish a receivership to take over its affairs.[1]

The operations of the Bureau are performed by less than 200 persons in the central office in Washington, and somewhat over 900 persons located throughout the country.

The Washington office consists of the Comptroller of the Currency (appointed by the President, by and with the advice and consent of the Senate, for a term of 5 years), three Deputy Comptrollers who perform duties assigned to them by the Comptroller and who function

[1] The Bureau is charged with comparable duties with respect to all banks and certain credit unions in the District of Columbia. The Office also performs duties with respect to the issuance and redemption of Federal Reserve notes.

in his place in the event of his absence or inability to perform his duties, and the following divisions:

Examining Division.—The reports of examination, reports of condition, and other data submitted to the Comptroller are reviewed and analyzed by this Division, consisting of the Chief National Bank Examiner, seven Assistant Chief National Bank Examiners, and their clerical assistants.

Organization Division.—Reviews and analyzes applications, reports, and other data relating to the basic corporate organization affairs of national banks.

Statistical Division.—Compiles statistics relating to national banks and other banking institutions for the information of the Comptroller, the Congress, and others.

Division of Insolvent National Banks.—Supervises liquidation of the insolvent banking institutions for which the Comptroller has appointed individual receivers.

Legal Division.—Advises the Comptroller and his staff on legal problems involved in the performance of the Bureau's functions.

Federal Reserve Issue and Redemption Division.—Performs functions in connection with the custody, issuance, and redemption of Federal Reserve notes.

Personnel Office and Miscellaneous Division.—Recruitment of employees, transfers, promotions, employee relations, retirement, resignations, budget matters, time and leave.

Disbursing Division.—Makes disbursements to cover payrolls, travel expenses, and miscellaneous expenses; makes purchases of equipment and supplies.

Auditing Division.—Maintains a continuous internal audit of all operations of the Bureau. The Division reports directly to the Comptroller.

The field staff is organized into 12 geographic districts corresponding to the 12 Federal Reserve districts covering the United States. Each district is under the supervision of a district chief national bank examiner with offices in the city in which is located the Federal Reserve bank. Under each district chief examiner is a staff of examiners, assistant examiners, and clerks, who perform the required examinations and other functions with respect to national banks situated in the district. Field personnel includes slightly over 250 national bank examiners, about twice that number of assistant examiners, and approximately 125 clerical employees. National bank examiners are commissioned from the ranks of assistant examiners on the basis of experience, demonstrated ability, and written and oral examination. The work of the field force is, of course, coordinated and closely supervised by the Comptroller and his immediate staff in Washington.

2. Describe the nature of the supervision exercised through examinations of banks by your Office. Specify the basic purpose or purposes of examination, and the principles which guide your examiners. Distinguish between bank examination and bank audit, as evidenced by the methods followed by your examiners in their work.

Broadly speaking, the supervision exercised by our Office through examinations of banks consists chiefly of the following:

1. Determination of amount and nature of assets.
2. Determination of amount and nature of liabilities.
3. Evaluation of assets; determination of estimated losses.
4. Evaluation of management (directors and officers) and policy.
5. Evaluation of practices and procedures.
6. Determination of nature, adequacy, and value of plant and equipment.
7. Analysis of expenses, earnings, and adequacy of capital structure.
8. Compliance with requirements of law.
9. Analysis of trends; recommendations and criticism.

The general purposes served by the examination process are to ascertain—

(*a*) Whether the bank is solvent and its capital structure satisfactory;

(*b*) Whether the bank is being managed competently and in accordance with legal requirements;

(*c*) What constructive and corrective action, if any, is called for to strengthen the institution or to preserve or enhance its stability and usefulness.

Our Office has prepared, and furnishes to every examiner, a volume of 130-odd printed pages, entitled Instructions to National Bank Examiners. Even this volume does not do more than outline most of the important principles of bank examination. As indicated by its Foreword, it does *not* include—

a detailed and exact step by step account of the functional and physical procedures to be followed in proving, auditing, appraising, and examining each asset and liability account . . .

If desired by the subcommittee, copies of the Instructions will be furnished for its confidential study, as well as copies of the looseleaf Digest of Opinions of our Office, which is furnished to every national bank and periodically supplemented.

In the hands of the examiners, the Instructions supplement and give definite form to the elements of judgment and knowledge of mechanical technique which have been absorbed by the examiner in his work as well as during years of preparatory work as an assistant examiner [2] and, prior to that, as a bank employee, in almost all cases. This practical experience is supplemented by university training or courses of study—sometimes quite extensive—in the American Institute of Banking and the several graduate schools of banking.

In the broadest sense, the work of a national bank examiner consists of an analysis of a national bank for the purpose of determining its soundness, the capacity and policies of its management, its methods of operation, and whether it has complied with all applicable laws.

The examiner must determine and report to the Comptroller of the Currency not only upon the assets and liabilities of the bank, but also with reference to whether the management is observing and conforming with sound business conceptions, banking laws, and regulations of the Comptroller. The reports submitted to the Comptroller by his examiners are set up in such form as to present the examiner's

[2] Assistant examiners are furnished with a book of instructions outlining their duties and procedures in some detail.

considered judgment as to the status of any given national bank, its management and policies, and to facilitate appropriate action to correct any deficiencies or delinquencies.

The examiner's analysis includes an examination of all assets, a proving of liabilities as reflected by the records, a determination of sound values of assets through appraisals and the like, a review and inspection of records and files for the purpose of determining their adequacy, and a review and investigation of activities to ascertain whether there has been a compliance with legal requirements and limitations. In performing this part of his work, a national bank examiner is engaged primarily in fact finding. However, if unsound or unsatisfactory conditions or violations of law are revealed as the result of such fact finding, the examiner has the further duty of initiating such action as may be necessary to effect correction thereof. In most instances these corrections can be accomplished through discussions with the active officers or board of directors. In other cases, conferences are arranged between representatives of the bank and the district chief national bank examiner of the district in which the bank is located, the Chief National Bank Examiner in Washington, one of the Deputy Comptrollers, or the Comptroller, depending upon the nature and importance of the situation. These functions of the examiners are corrective or advisory activities, rather than fact finding.

The files of this Office will bear witness to the fact that throughout the years, in instances too numerous to mention, corrections have been made through the changing or strengthening of management, revision of weak or unsound loan and investment policies, the adjustment or fortification of capital structure, and the merger of weak and unsound banks with strong competitive institutions at the instigation of the examiner after a full discussion of the facts with the boards of directors. Although it is essential that examiners act in an advisory capacity, such activities must be conducted by examiners who are trained to use their discretion and judgment. Under no circumstances is an examiner permitted to give advice or recommendations to the management with reference to the desirability or undesirability of making particular loans or investments.

* * * * * * *

The last sentence of this question calls upon us to—

distinguish between bank examination and bank audit, as evidenced by the methods followed by your examiners in their work.

The primary purpose of bank examination has been indicated in this and the preceding question. They are carried into effect through examination and evaluation of the assets, and proving the liabilities recorded in its books.

On the other hand, a complete audit of a bank involves, among other things, a thoroughgoing verification of liabilities (by contacting all known depositors and other creditors) and—unlike bank examination—has as one of its primary purposes the detection of dishonesty by the officers or employees.

This matter of the fundamental distinction between bank examination and bank audit, and their purposes, unfortunately has been the subject of considerable misunderstanding, and consequently a somewhat extended discussion of the matter is justified.

Quite often, after discovery of embezzlement, the question is raised why every such dishonest act is not promptly discovered during the next governmental examination after its occurrence. To this there are a number of answers. In the first place, there are certain methods available to a defaulter (particularly if he is the chief executive officer of a bank, assisted in his dishonesty by other employees) which no conceivable auditing technique would inevitably discover. This is not to say there are any detection-proof embezzlement schemes; there are none. But in some circumstances the clue to exposure must come from a source other than auditing procedures.

However, it is true that by and large a thoroughgoing and careful audit of a bank usually will disclose any dishonest manipulations which are taking place. In larger banks, separate auditing departments are maintained for this very purpose, and internal checks constitute a continuing safeguard against the generality of dishonest practices. In some banks the services of public accountants are sometimes utilized for thorough audits, either periodically or at irregular intervals. In addition, the board of directors of every national bank should make or have made for them regular independent surveys which should include certain basic elements of auditing techniques designed to detect irregularities. In a booklet entitled "Duties and Liabilities of Directors of National Banks," which is sent to every national bank, we have advised directors that in connection with their annual or semiannual surveys of the bank, the individual ledger balances should be verified in such manner as the directors may deem advisable by calling in passbooks, by sending out reconcilements of certain accounts selected by the directors, or in some other suitable way; and other suggestions are made which, if followed, would enable them in most cases to establish the authenticity of the bank's records, and the actual amount of its assets and liabilities.

It cannot be emphasized too strongly that bank examination does not involve a complete audit of the institution. It has always been understood that the primary function of governmental bank examination is to judge the assets and the operations of banks, and to effect improvements therein, wherever necessary, through recommendations or definite orders. National banks, like banks of the State systems, must be operated in accordance with applicable laws and regulations, as well as in accordance with principles of safe and sound banking practice. Accordingly, the chief duty of a national bank examiner is to ascertain that the statutory requirements and restrictions enacted by Congress, and administrative regulations adopted thereunder, are being complied with, and that the lending and investment policies of the bank, and its operating procedures, are such as to minimize the dangers to the banking system which are inherent in excessive and hazardous loans, investments which are speculative or not readily marketable, obsolete or inadequate internal practices, inefficient personnel, and the like.

It will be noted that this description does not include detection of embezzlement or other dishonesty as one of the *primary* functions of the examiner. Generally speaking, such irregularities take place through manipulation of the bank's liability accounts, most frequently through fictitious entries in deposit accounts. The detection of such dishonest practices is the function of the bank's own audit department, directors' periodic surveys, and audits conducted by independent public

accountants retained for this purpose. Bank examiners are highly trained men whose special abilities as analysts of loans, securities, and bank management and methods, would not be properly utilized if they were to devote themselves largely to the mechanical aspects of detection of dishonesty.

It is true that defalcations are very frequently discovered by bank examiners through well-developed methods not amounting to complete audits, and their years of experience sometimes develop a sixth sense which enables them to react with suspicion to circumstances which would pass unnoticed by others. Perhaps because of their achievements along this line, many people are not aware of the distinction between an audit and an examination and erroneously believe that an examiner's *principal* task is the detection of dishonest acts on the part of bank officers and employees.

It is unnecessary to refer to the numerous authorities in which it has been explicitly recognized, at various times during the last half century, that bank examination does not include bank audit. Perhaps as clear a statement as can be found with respect to this subject was made by Mr. Thomas P. Kane, who was a Deputy Comptroller of the Currency from 1899 to 1923, in a volume devoted to operations of the Bureau:

> When an examiner satisfies himself that the books of original entry are correct and the assets found in the bank are equal in value to the amount called for by the books, he is bound to assume that the original individual credits which go to make up the grand total are correct, and he cannot know otherwise except by a complete audit of the books, unless errors or false entries are discovered by accident or otherwise.
>
> There is only one way of determining the absolute accuracy of an individual ledger or a certificate of deposit register, and this is by calling in and balancing or otherwise verifying all of the depositors' pass books and by verifying each individual certificate of deposit. It would require weeks of time to do this. No examiner could undertake such a task, and is not expected or required to perform such services.
>
> An audit of a bank calls for the performance of this work and similar detail. An examination does not. Yet when a defalcation is disclosed, which has extended over a period of several years undiscovered by the examiner, the latter is invariably charged with incompetency or superficiality in the performance of his duty, and in most cases unjustly so because of the failure of the critics to discriminate between an examination and an audit.

This essential distinction between bank examination and bank auditing is recognized by all Federal bank supervisory agencies as well as the overwhelming majority, if not all, of bank supervisory departments of the 48 States. Occasional attempts have been made to introduce a substantial element of auditing into the work of the bank examiners. The results have not been satisfactory. No Federal bank supervisory agency today attempts in the course of ordinary examinations to verify the correctness of a bank's books through contacting depositors.

It should be borne in mind that, over the years, embezzlement and other dishonesty have been minor factors in bank failures. Generally speaking, dishonest practices are on a small scale, as compared with the total resources of the bank and the total number of bank personnel, and, far from jeopardizing the accounts of depositors, are rarely of sufficient magnitude, before discovery, to cut deeply into the capital, surplus, undivided profits, and reserves of the institution. Even in the exceptional case, where the embezzler is the major executive officer

of and dominating influence in the bank, and is assisted by a large percentage of its employees, additional protection is afforded by the substantial fidelity bonds upon which our office insists, and by the responsibility of directors in the event that their negligence contributed to the magnitude of the shortage.

During the eighty-odd-year history of the national banking system, defalcations were a contributing factor in only a small percentage of national bank insolvencies. It is clear that dishonesty is far less of a danger than are weak or incompetent management, excessive and ill-advised loans, speculative investments, and other major causes of insolvency. Therefore, it would be a disservice to the Nation's banking system if examiners were to spend less time in the important fields in which their abilities enable them to render substantial assistance to banks, and were to devote themselves instead to the extensive mechanical tasks involved in detection of dishonesty.

If bank examiners were to serve also as bank auditors, it would require governmental examining forces many times as large as those now maintained. It would keep our entire examining force continually occupied merely to conduct complete audits of only a few of the largest national banks. In our opinion such an expansion of the size and functions of bank supervisory agencies is not advisable or justified. It is our belief that safeguards which are recommended by bank supervisors (such as adequate fidelity bonds, rotation of employees, compulsory vacations, audits by public accountants, establishment of an adequate internal audit system where practicable, etc.) and which are being adopted by steadily increasing numbers of banks, constitute a more efficient and desirable protection than would a system of governmental audit.

The supervision of national banks rests upon the National Bank Act and other congressional enactments. Those statutes have never required bank examination to be supplemented by thorough auditing of the affairs of each bank examined. As far as we are aware, it has never been suggested that such legislation be enacted, although it has been repeatedly brought out in standard texts, reports, addresses, and otherwise that Government's functions in this field do not include that of detailed auditing.

Undoubtedly, the Federal Government could employ some tens of thousands of auditing personnel, and develop auditing procedures suitable for banks of various magnitudes, types of business, and geographical situations. It is even likely that, over a period of years, these methods could be so perfected as to reduce still further the present infrequent occurrence of serious dishonesty.

However, it is our firm conviction, after consideration of this problem for many decades, that the benefits of such a step would not justify its cost, not only in money but in the effect on certain fundamental American principles. We consider that the extremely small amount of loss through dishonesty does not call for the creation and maintenance of a large Government bureau and the imposition upon American banking of governmental control in an additional field. We consider it clearly more desirable for thorough auditing of banks to remain a matter of internal management, encouraged and guided by the supervisory authorities. In other words, we are satisfied that the possible benefits to be derived from legislation of the type described would not justify the necessarily increased governmental employment, the

additional expense, and the consequent great expansion in public control of private enterprise. We would like to see the banks remain free from unnecessary governmental supervision.

3. What directives, if any, have been given to your Office by Congress with respect to the economic objectives which it should seek to further in its operations? Cite appropriate statutes.

The Federal laws relating directly to the national banking system do not contain any directives with respect to "economic objectives," in the narrow sense of that term. It must be borne in mind that the National Bank Act, which is the nucleus of the laws governing the system, was enacted in 1863–64. At that period in our history, it was not customary for Congress to give explicit directives with respect to economic objectives.

The scope of congressional action during the nineteenth century with respect to fundamental economic currents, including what is now called the business cycle, was considerably narrower than it is today. This policy may have been due in part to the relatively lesser significance of the business cycle in that era, and also to the absence of developed economic theory as to what could and should be done by the Federal Government in those circumstances.

In any event, it was generally understood that the economic objectives of Congress, in most cases, were limited rather than general, and ordinarily these purposes, although not explicit, were fairly obvious from the provisions of the enacted legislation, clarified, where necessary, by the history of the legislation.

This was the case with respect to the National Bank Act. Its original purposes were primarily twofold: First, to provide the country with a uniform and reliable paper currency, fully backed by Government bonds; and, secondly, to assist in wartime financing through sale of Government bonds, which were purchased by national banks to provide the basis for the issuance of their currency.

Although these were the immediate dominant aims, they necessarily rested upon at least one other, namely, the continued existence of solvent individual banks constituting the national banking system. This was the chief responsibility of the Bureau of the Comptroller of the Currency, and has remained so during its almost 90 years of existence.

During the earlier decades of the Bureau's operations, it was generally felt, in accordance with the prevailing economic philosophy, that no considerations should be recognized in chartering and supervising national banks other than whether a *proposed* bank had a reasonable chance of solvent operation for the foreseeable future, and whether an *existing* bank was currently in solvent condition. The national bank examiners considered that Congress had charged them with the duty of seeing that national banks obeyed the laws applicable to them and did not engage in practices which might endanger their financial stability and their obligations to depositors and other creditors.

To recapitulate: Congress has not given this Office, specifically, any directives with respect to broad economic objectives which it should seek to further in its operations. The general tenor of banking legislation over almost a century is that our primary supervisory function

is to maintain and further a safe, sound, and adequate system of banking institutions, qualified to perform the functions required of a commercial banking system under existing conditions. To a more limited—and somewhat undefined—extent, the Comptroller of the Currency, in exercising his discretionary powers, also takes into consideration his understanding of broad national economic policies, as exemplified by the declaration of policy in the Employment Act of 1946.

4. What weight do you give in the conduct of your Office to the congressional declaration of policy contained in the Employment Act of 1946, where it is stated:

> The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, *to coordinate and utilize all its plans, functions, and resources* for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power. [Italics supplied.]

Do you believe it would be desirable that Congress give your Office a more specific directive that it should govern its activities, wherever practicable, in the light of the general objectives of economic stability and high-level employment? If not, are there any other economic directives which you would consider desirable ?

Questions 4, 5, and 6 are closely interrelated. Question 4 asks what weight is given, in the conduct of our Bureau, to the declaration of policy in the Employment Act of 1946. Question 5 inquires as to the role of *bank examination* in furthering the objectives of that act, and question 6 asks how we endeavor to further the objectives of economic stabilization through *means other than bank examination.* Since the latter two are simply segments of the operations of the Bureau, there is necessarily some repetition in our answers to these three questions.

In the formulation of its policies and procedures, the Bureau of the Comptroller of the Currency has always been aware, of course, that the Bureau was created, and its functions assigned, for the purpose of advancing the general economic welfare of the people of the United States. As indicated in answers to previous questions, one of the primary purposes of the National Bank Act (1863–64) was to strengthen the currency system of the Nation and to put an end to the era of "wildcat banking" and note issue which had impeded the commercial and industrial growth of the country for many years.

After the establishment of the Federal Reserve System in 1913, the currency functions of the national banking system became of rapidly diminishing importance, and ended, for practical purposes, in 1935. However, both before and since that development, the Bureau has considered its chief duty to be the preservation and advancement of the national banking system as a major factor in American commercial banking.

It is hardly necessary to stress the fact that the industrial and commercial growth of the country during the twentieth century could not

have taken place without the aid of the resources and facilities of commercial banks. Without agricultural loans, seasonal loans (to manufacturers, wholesalers, and retailers), real-estate loans, consumer-paper loans, and many other categories, our economic progress would at least have been seriously retarded.

The foreging suggests the character of our answer to the first sentence of question 4, asking what weight is given in the conduct of this Office to the congressional declaration of policy contained in the Employment Act of 1946. As it applies to the Comptroller's Office, that policy is one of utilizing functions to create and maintain conditions making for employment opportunities, and "to promote maximum employment, production, and purchasing power." It is the philosophy of this office that its greatest contribution to these ends, over the long run, can be made by bending its efforts to maintaining and strengthening a commercial banking system which is safe and sound, and able to meet all legitimate credit needs of individual communities and the Nation as a whole.

During the past 20 years, since Federal governmental policy has been directed toward energetic efforts to ameliorate cyclical economic swings and to improve the general economic environment, the Comptroller (together with all other bank supervisory authorities) has been faced with the question whether bank supervision should be *directly* utilized as an additional implement in these efforts.

Few responsible people would deny that amelioration of the business cycle is a desirable objective. But it would be a gross oversimplification to argue: "Economic stability is a desirable condition. Therefore, let us examine various possible courses of action. If a particular course of action is likely to contribute to economic stabilization, it should be adopted."

Such an approach, of course, would overlook several crucial questions. *Other things being equal*, economic stability is a highly desirable condition, but the American people probably would feel that a small increase in economic stability would not be worth while if it were to be accompanied by great loss of individual economic and social freedom and also would result in a lower standard of living. Obviously, these are not necessary concomitants to economic stability, but they illustrate the principle that efforts toward economic stability cannot sensibly be made in utter disregard of the possible undesirable "side effects."

Similar principles are applicable with respect to the adoption of *means* to a desired goal. A particular proposed legislative or supervisory measure might promise some gain toward economic stability, but it might also involve a much greater net evil in its repression of enterprise and initiative. Furthermore, in an economic system as complex as ours, great care must be exercised to determine, as definitely as possible, whether a contemplated step will contribute to an objective such as economic stability, even disregarding any unfortunate incidental results. Consequently, it is essential not only that we evaluate conflicting objectives, but also that we inquire whether a suggested means will contribute materially to that objective and whether such means may give rise to evils greater than the evil we are seeking to eradicate.

It is undeniable that commercial bank credit is an important sector of the economic front in our Nation today. The stringency or easy

availability of commercial bank credit may exaggerate or moderate the extent of both booms and depressions. At first glance, there is much plausibility in the suggestion that, since bank examiners employed by the Federal Government constitute continuing, direct, and forceful points of contact with almost the entire banking system, the economic policies of the Federal Government in this sphere could be effectively advanced through the efforts of national bank examiners and those of other Federal bank supervisory agencies.

Unquestionably, something could be achieved by this means in the way of tightening or loosening bank credit, in accordance with governmental economic objectives. However, we are inclined to believe that bank examiners are not in a position to accomplish as much in this direction as has sometimes been supposed, and that the plan has definite draw-backs.

When a particular extension of credit contains an important element of weakness, an examiner can persuade the banker to take steps to strengthen the loan or to reduce or collect it, and dissuade him from continuing to pursue a lending policy under which similar loans would be made. Needless to say, our examiners do exactly this every day; it is one of their most important functions.

The foregoing, however, is very different from efforts by examiners to convince banks that loan volume should be reduced, not because of any credit weaknesses or doubts as to collection, but because the Federal Government believes that the economic welfare of our country calls for a contraction of bank lending. Generally speaking, bankers are quite alert to the presence or absence of an undue risk element in a loan, although some may occasionally depart from the soundest practices. If an examiner criticized loans which both he and the banker knew to be sound and collectible, it is unlikely, in our opinion, that the bank's lending policy would be modified in accordance with the examiner's suggestions; it is more probable that the banker would simply lose faith in the examiner.

Even greater obstacles would stand in the way of efforts by examiners to induce a *more generous* lending policy in accordance with broad governmental economic objectives. Self-interest is sufficient, in most cases, to induce a banker to grant every application for a loan which he believes will be collectible and profitable. Consequently, the examiners could only (1) urge bankers to extend credit beyond the limit dictated by their own banking judgment, or (2) refrain from adverse criticism of loans, already made, which in the examiner's judgment involve an excessive degree of risk. It is obvious that either of these practices would involve grave hazards.

Perhaps even more fundamental than these difficulties would be the loss of confidence on the part of bankers in the singleness of purpose of bank examiners and their primary concern with the soundness and welfare of the particular institutions under examination, thus destroying the principal source of strength of our organization. However, as pointed out later in our answer to question No. 6, supervisory action at the Washington level, while based upon factual reports received from field examiners, takes into consideration prevailing economic trends and attempts the difficult task of adjusting its many supervisory activities in accordance with those trends. This is accomplished through letters of criticism which pass from the Washing-

ton office to individual banks, from conferences arranged with the management of individual banks, and from pronouncements and opinions as made to the representatives of the national bank division of the American Bankers Association and to the banking public in general.

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It is of significance that the declaration of policy in the Employment Act emphasized the promotion of "free competitive enterprise and the general welfare." The point of view underlying the policies of this Bureau are summed up, in a general way, in those words. As suggested in the answer to a previous question, an important portion of our operations relates to authorization of the establishment of new national banks and branches. In the exercise of his authority in these matters, the Comptroller has always placed first emphasis on whether the management, capitalization, location, and so on, of the institution are such that it has a good chance of functioning successfully and thereby aiding the economy of its community and area. Less important only in degree, however, is the fostering of healthful competition among banking institutions.

Extremely difficult problems occasionally arise in which the banking facilities of an area can be strengthened only by permitting a very large institution to absorb a weaker one or to establish additional branches, or by permitting a "bank holding company" to establish additional banking subsidiaries. In all cases, it is our practice to encourage the organization of an independent locally owned institution wherever that is feasible. But where that alternative course is not open, a choice necessarily must be made between two goals—providing adequate banking facilities, on the one hand, and promoting healthful bank competition, on the other. Although no hard and fast rule of thumb can be followed, a study of actual decisions over a period of years reveals that, faced with this choice, the office generally has decided that its first duty is to assist in satisfying every *real* need for additional banking facilities.

It has been our conviction that the Bureau can make its greatest contribution to the general welfare, as well as to "maximum employment, production, and purchasing power," by concentrating its efforts upon the maintenance of a system of sound and well-managed banks, adequate in number, location, and resources to satisfy the Nation's needs for the services they perform. This attitude has been reexamined, during the past 5 years, in the light of the congressional declaration of policy in the Employment Act of 1946, and our decision was that the underlying purpose of the act, and the declaration of policy, would be best served by this office through a continuation of its traditional approach. In other words, our efforts are directed toward the improvement and maintenance of a great and powerful machine in good condition, but we believe that, over the long run and in the broadest sense, we would injure rather than advance the general welfare if we attempted to dictate also the manner in which the machine was to be utilized.

The Bureau of the Comptroller of the Currency believes that its present policies and activities already are governed "in the light of the general objectives of economic stability and high-level employment." If Congress is in agreement with our views as to the appro-

priate role of bank supervision in the national economy, no more specific directive is called for.

5. What do you believe to be the role of bank examination in furthering the objectives of the Employment Act?

To a considerable extent, this question has been answered in our reply to question 4.

Insofar as the actual process of examination is concerned (that is, the work of the examiner and his assistants on the condition of a particular institution, and his report thereon), it is our conviction that the objectives of the Employment Act are most effectively to be furthered by factual, objective judgment. In our opinion, to inject into the examiner's method of operation a deliberate effort to affect future economic trends by a "hard" or "soft" attitude would undermine, at one stroke, the foundation on which rests much of the effectiveness of the bank-examination procedure.

Each report of examination of a national bank serves several purposes. It is primarily for the use of the Comptroller of the Currency in his supervision of the bank. In addition, those reports are also used by the Federal Reserve System and the Federal Deposit Insurance Corporation in the performance of their duties with respect to national banks as members of the System and of the Corporation, respectively. It is absolutely essential that these supervisory authorities be furnished with accurate, objective reports, not only for the sake of effective supervision, but also to provide, in the aggregate, a dependable statistical basis for ascertainment of trends and the formulation of policies.

The report of examination serves another valuable purpose. A copy of each report is furnished to the particular bank for its confidential use, and study of the report by the bank's directors and officers is a very important secondary value of the examination process. Together with the oral comments, suggestions, and criticisms made by the examiner during the course of examination, it provides the bank, twice a year, with the results of a painstaking examination by a disinterested expert, whose judgments are formed upon the basis of his examination of numerous banks in the same area, and of the economic conditions existing in the area.

The management of a bank may regard a particular examiner as a man of exceptional or mediocre intelligence, or as a keen or a weak judge of credits. With practically no exceptions, however, national bankers entertain no doubts regarding the integrity of the examiner or the purpose and attitude with which the examination is made. They *know* that his conclusions as to whether particular loans are "substandard" or contain definite "loss" elements are based *solely* upon the examiner's informed views as to the likelihood of full payment of specific loans—*in the light of the credit weaknesses involved and existing conditions* as he sees them.

If the bank examiners were to serve as active direct tools in a governmental program intended to flatten out the crests and troughs of economic cycles, this change in policy inevitably would become known to bankers, and their confidence in the trustworthiness of reports of examination would be seriously shaken. It is our belief that comments in the course of examination, in the examination report, and in our

communications thereon are perhaps the greatest single influence our office can bring to bear in keeping a bank on a desirable course or persuading it to abandon unsound policies. This beneficial effect of the examination process would be lost, to a considerable extent, if bankers became convinced that our examiners were forming their judgments not on the basis of existing conditions, but rather with the deliberate purpose of affecting future conditions by encouraging banks to adopt generous or restrictive credit policies in accordance with the current economic program of the Federal Government.

As we have previously indicated, intelligent bank supervision makes a very definite contribution toward economic stability and actually does serve as a steadying force in the economy. However, it does not—and in our opinion, should not—do this by attempting, through examination practices, to control or influence bank credit policies for the deliberate purpose of stimulating the Nation's economic activity during recession periods and dampening that activity when it is believed to be excessive. By concentrating their efforts on the preservation of sound and serviceable individual banks, examiners can do more than could be accomplished by using bank examination as a minor adjunct to the numerous appropriate means for achieving economic stability, such as policies in the fields of governmental budget, debt management, and central banking (including bank-reserve requirements and open-market operations).

In brief, we are satisfied that the actual and potential effect of bank examination upon credit conditions has been exaggerated by some persons; actually it could be only a relatively slight force in that direction. And even if this force were used to the utmost, the resulting perversion of the true and valuable functions of bank examination would, in the long run, do more to injure than to advance economic stability and the general welfare.

The appropriate role of bank examination in furthering the economic welfare of the Nation is in the preservation of a strong and vigorous banking system competent to meet (1) its responsibility to depositors, i. e., maintaining solvency and adequate liquidity, and (2) its responsibility to the communities served, i. e., accommodating legitimate and meritorious credit demands. Functioning in this way, bank examination is calculated to foster and promote *sound* free competitive banking enterprise, capable of discharging its responsibilities and being itself an affirmative force of consequence and solid strength in furthering the objectives of the Employment Act of 1946.

6. In what ways, if any, other than through bank examination, does your Office endeavor to further the objectives of economic stabilization?

To a considerable extent, this question has been answered in our reply to question 4.

In the performance of a number of functions not directly related to bank examination, our Office seeks to make its maximum contribution to the objective of economic stabilization. By virtue of the nature and prestige of our organization, the Comptroller and other officials of the Bureau can and do provide leadership in developing and recommending among the Nation's bankers sound policies designed to maintain our economy on an even keel.

An example of this is our participation with the Federal Reserve in developing and sponsoring the voluntary credit restraint program over the past year. In annual reports, speeches, articles, conferences, and conversations with individual bankers and others, we have emphasized that the self-interest of banking institutions, as well as the general welfare, are best served by formulating credit policies and allied policies with a view to long-term benefits to individual customers, the community, and the Nation, rather than by having in mind only the maximum immediate dollar income. Development of bank policy at this level calls for extremely delicate balancing of conflicting factors, but it is our belief that American banking is learning to perform successfully this difficult art.

Another example of our effort to gear our activities to economic needs, to the extent that such action is feasible and appropriate, is the policy we have adopted, and in which the other two Federal bank supervisory agencies have concurred, whereby we decline to give our consent, in the existing economic climate, to bank amalgamations in which the capital structure of one of the institutions is returned to shareholders and thus becomes additional inflationary purchasing power. Exceptions are made in applying this policy to take care of necessitous cases, but they are rare.

We adhere to a similar principle in passing upon applications to invest in banking premises amounts in excess of the ordinary limits, as well as applications to establish new branches or new banks which would generate additional loans and hence create additional deposit currency. Here again exceptions are made where the need of a community for additional banking facilities is so great as to outweigh the inflationary aspects of the proposal.

As previously emphasized, our day-to-day supervisory actions are made in the light of our concept of the basic task imposed on this Bureau by the Congress—namely, the maintenance of a strong national banking system comprised of sound individual units, whose operations, in meeting the financial needs of their communities, are directed not by Government but rather by persons who are primarily concerned with the advancement of the welfare of their institutions and the public which they serve.

Nevertheless, staff members of the organization constantly bear in mind the ever-increasing importance of the objective of economic stabilization and govern their actions in accordance therewith, to the extent that this can be accomplished without infringing upon the fundamental purpose for which the Bureau was established.

This is accomplished, as far as possible, by having the field examiners form their opinions and formulate their reports on the basis of local facts and conditions as they see them. The Comptroller and his immediate staff in Washington act upon those reports, individually and in policy formation, with a view to general Nation-wide economic conditions, trends, and needs. The moderation or intensification of supervisory action on the basis of the examiners' reports, in the light of the prevailing economic trends, can be done best by the Washington staff because of the necessity for extremely close integration and uniformity of viewpoints and actions. It should be noted, however, that all actions of this nature must be taken with only one aim: The maintenance of each national bank in such sound condition that it can play its proper

part in meeting the banking needs of its community and hence further the objectives of economic stabilization.

7. What use do you make of the results of economic analysis in the conduct of your Office?

At the highest policy level of our Office considerable attention is given to the results of economic analysis, and it affects, to a substantial degree, certain major activities of the Office. In his annual report to Congress, as well as in public addresses and discussions with individual bankers and groups, the Comptroller and his deputies present their conclusions regarding probable trends in general economic conditions as they impinge upon the banking structure, and their views as to the likely course of financial conditions as a result of such forces. As a matter of course, the bank supervisory actions of the Comptroller and his immediate staff must be and are geared to their concept of economic conditions as gleaned from daily contact with economic problems and an analysis of economic thought and material.

As previously indicated, this is not true, in the same sense, with respect to our examination procedure. Bank examining methods and objectives are not altered on the basis of forecasts of national or worldwide economic conditions. Nevertheless, our examiners are not insulated from current economic thinking, and they develop a high degree of familiarity with economic conditions in their particular districts, and with respect to the main agricultural, industrial, and commercial activities therein. Consequently, examinations of individual banks, and the resulting recommendations and criticisms, inevitably stem in part from the examiner's views with respect to general economic conditions and trends in a particular industry or geographic area.

B. RELATIONSHIP TO THE GOVERNMENT

8. To what extent does your Office operate under the direction of the Secretary of the Treasury? Discuss in the light of both the statute and customary usage.

From the origin of the national banking system, the National Bank Act has provided that the Comptroller of the Currency "shall perform his duties under the general directions of the Secretary of the Treasury," R. S. 324 (12 U. S. C. 1).

As a matter of customary usage, the various Secretaries of the Treasury have exercised their directory powers over the Comptroller of the Currency only to a limited extent. The basis of this policy, as applied by the present Secretary, was recently expressed by him as follows:

> Effective governmental regulation of national banks has rested at all times upon the exclusive preoccupation of this Bureau with the well-being of the individual banks and their performance of all the banking services called for by a vigorous and expanding economy. With very few exceptions, the individual banks of the national banking system have consistently responded to the recommendations and suggestions of the Comptroller of the Currency, and this has been true, to a considerable extent, because of their realization that the Comptroller's Office is not only thoroughly and intimately acquainted with the affairs of all national banks but has no other purpose or function than maintaining the soundness and progress of those banks.
>
> I need hardly stress the value of such a relationship of trust and confidence, built up over many years of contact through carefully worked out and consist-

ently applied examination and supervisory procedures. By virtue of this relationship, with which the directors and officers of every national bank have been familiar throughout their banking careers, the Comptroller's Office serves as a coordinating, steadying, and vitalizing force in the entire banking system.

In the course of his duties, the Comptroller of the Currency exercises a number of quasi-judicial powers of great importance. In my judgment, it is highly desirable that all such functions in this field should be performed by an official whose duties are definitely and permanently related to the national banking system alone. It should be borne in mind that under present law the Comptroller performs his duties "under the general directions of the Secretary of the Treasury," and this provides an entirely adequate integration of the general policies of the Bureau with those of the Department.[3]

In some respects, the status of the Comptroller of the Currency is unique in that he performs certain quasi-judicial functions which are not subject even to judicial review, in the absence of fraud or caprice—for example, determining whether a national bank is insolvent, chartering new national banks, authorizing the establishment of national bank branches, and the like.

To reiterate, in actual practice the Comptroller of the Currency, operating in accordance with relatively limited general policy directions of the Secretary of the Treasury, makes his own decisions on matters relating to the operations of the Bureau and the administration of the Federal laws and regulations applicable to banks under his supervision.

9. Does your Office operate under the direction of the President except as this direction is exercised through the Secretary of the Treasury?

The Office of the Comptroller of the Currency operates under the direction of the President only as that direction is exercised through the Secretary of the Treasury.

10. Describe the relationships, from your point of view, among the three Federal bank supervisory agencies. To what extent is there coordination of policies and procedures, and how is such coordination brought about? To the extent that policy conflicts arise, how are such conflicts resolved at the present time?

Federal supervision of banks is divided chiefly among three agencies: The Comptroller of the Curency, the Federal Reserve System, and the Federal Deposit Insurance Corporation. The Comptroller supervises national banks and banks operating in the District of Columbia. The Federal Reserve System exercises some degree of supervision over all member banks, but examination and related activities are conducted by the 12 Federal Reserve banks primarily with respect to State member banks. The FDIC has responsibilities with regard to all insured banks, but it supervises actively only nonmember insured banks.

The functions of banking supervisors include: (1) Passing on applications for charters for new banks, applications for branch permits, proposed mergers and consolidations, and proposed changes in banks' capital structures; (2) liquidation of closed banks; (3) issuance of regulations, rulings, instructions to supplement or clarify legislation; (4) periodic detailed examinations of the condition, op-

[3] Excerpt from letter to Senator John L. McClellan, dated April 7, 1950.

erations, and policies of individual banks; (5) taking corrective action; (6) counsel and advice to bankers; (7) compilation of reports and statistical data.

The Federal banking statutes today are the product of an evolutionary process covering almost a century. They are voluminous and complicated. Many provisions were enacted to meet emergencies, specific situations, and competitive conditions as they developed. Although the broad fields occupied by the three principal Federal supervisory agencies are fairly well defined, there are numerous instances in which specific prerogatives or responsibilities of one agency, whether utilized or not, touch or supplement the prerogatives or responsibilities of one of the other agencies. For example, the FDIC under law has authority to examine national banks and State member banks. In actual practice such examinations have been rare and have been made usually in anticipation of financial assistance by the FDIC in a rehabilitation program, or where a member bank desires to continue as an insured bank after ceasing to be a member of the Federal Reserve System. Similarly, the Federal Reserve banks do not examine national banks, although with approval of the Board of Governors they have the legal power to do so.

Applications for *domestic* branches of national banks are approved or denied by the Comptroller. Like functions with respect to *foreign* branches of national banks are performed by the Board of Governors.

The banking statutes also provide machinery for the removal of a director or officer of a national bank for continued violations of law or continued unsafe and unsound banking practices in the conduct of business of the bank. While such action is initiated by the Comptroller of the Currency, the proceedings are conducted by the Board of Governors, and it is this body that makes the final determination as to whether the officer or director is to be removed from office.

Several interesting intertwining relationships between the supervisory agencies exist as the result of regulations issued by one agency under a statutory grant of power. The investment securities regulation issued by the Comptroller of the Currency is applicable to State member banks as well as national banks. While most of the regulations issued by the Board of Governors apply to member banks, one regulation (regulation U, relating to loans for the purpose of purchasing or carrying stocks registered on a national exchange) applies to all banks. Another (regulation F, relating to trust powers of national banks) is directed to national banks only. Still another (regulation H, which relates to State bank membership) is applicable only to State banks. The FDIC promulgates some regulations that are applicable only to nonmember insured banks, and others that are applicable to all insured banks.

The FDIC, as the insurer of deposits in national banks up to $10,000, has an interest in the soundness of these risks. Copies of reports of examination of all national banks are made available to the Corporation by the Comptroller's Office and are carefully reviewed by that organization. A similar procedure is followed by the Federal Reserve authorities with respect to reports of examination of State member banks.

The FDIC may institute proceedings for termination of insurance whenever it finds that an insured bank has not, after citation, effected

corrections of unsafe or unsound practices or violations of law or regulations. Upon termination of the insurance of a national bank by the Corporation, the Comptroller is required to appoint the FDIC as receiver for the institution. The FDIC also may require any insured bank (including national banks) to provide protection and indemnity against burglary, defalcation, and any other similar insurable losses.

Since national banks are members of the Federal Reserve System, the condition, policies, and methods of operation of those banks are of concern to the Federal Reserve authorities. From copies of our reports of examination, furnished to them, the 12 Federal Reserve banks are able to keep informed of the status of the national banks in their respective districts.

Despite these numerous interrelationships among the three agencies, in actual operation their basic supervisory functions—within the framework of the governing laws and regulations—are quite separate. National bank examination and related duties are performed by the Comptroller's Office; State member banks ordinarily are visited by no Federal examiners except those of the Federal Reserve System; and nonmember insured banks look to the FDIC for this service. (All State banks, of course, are also subject to primary supervision by the supervisory authorities of the several States.)

Needless to say, continuing efforts are made to coordinate the policies of the three supervisory agencies. This coordination is achieved through frequent conferences and consultations, both among the top officials of the agencies and members of their staffs, for the purpose of developing tentative programs and policies with respect to new subjects and problems, and changes in policies and procedures to meet changed conditions. In this connection it may be pointed out that an important tie-in exists between the Office of the Comptroller of the Currency and the FDIC by reason of the fact that the Comptroller is by statute an ex-officio member of the Board of Directors of the Corporation. Thus he is able to bring to the Corporation the extensive background and long experience of his Bureau.

The following are examples of the types of coordinated action which are constantly being achieved:

1. A uniform understanding has been reached by the three agencies with respect to (*a*) the eligibility of securities as bank investments, their evaluation, and the treatment of any depreciation in their market prices; and (*b*) loan classification designations and definitions in classifying loans involving varying degrees of credit weakness.

2. Each application to organize a new national bank is investigated independently by examiners from the Comptroller's Office, the FDIC, and the Federal Reserve bank of the district. While sole responsibility for chartering a new national bank rests with the Comptroller, the advice and counsel of the other two agencies is carefully weighed.

3. A free exchange of information is had between the three agencies with respect to pending applications for the establishment of branches. Such a procedure serves to reduce the possibility of an overbanked situation and the fostering of unhealthy competition.

4. The FDIC furnishes the Comptroller's Office with copies of all memoranda prepared by its staff on national banks considered to be problem cases. This makes possible a ready comparison of the views of the two organizations with regard to a particular bank and often leads to the development and consummation of a constructive program of correction.

5. Figures derived from reports of condition and reports of earnings and dividends filed in the Comptroller's Office by national banks are made available to the Federal Reserve Board and the FDIC, thus making possible the assembly of uniform statistics with respect to the condition and operations of all commercial banks.

6. The forms of examination reports, reports of condition, and reports of earnings and dividends have been substantially standardized for the three agencies, and major changes therein are made only after thorough interagency study and exchange of views.

All three Federal supervisory agencies direct their efforts to the same broad general objective, namely, the establishment and preservation of a sound banking system. In seeking to achieve this goal, there are almost certain to be some differences in the standards and techniques applied. However, the area in which such policy conflicts occur between the agencies is limited, and the disparity in viewpoints is usually not a broad one. Whenever a policy conflict arises, an effort is made to resolve the matter through conference, consultation, or an exchange of correspondence by the top officials of the agencies involved, and in most cases, this procedure ultimately has provided adequate solutions. Of course, if such procedure does not produce agreement, each agency establishes its own policy in the light of a full and intelligent evaluation of all of the factors involved, subject always to congressional determination or clarification of the particular matter.

In conclusion it is our view that the working relationship presently existing between the three Federal bank supervisory agencies rests on a high plane and serves to reduce to a minimum conflicts and potential duplication of effort.

11. Does your Office follow the practice of submitting its proposed reports to Congress on pending legislation to the Bureau of the Budget to determine whether or not they are in accordance with the program of the President? If it submits some, but not all of such reports, what are the criteria by which those submitted are selected? Does the Bureau of the Budget submit proposed reports of other agencies of the Government to the Comptroller's Office for comment?

This Office submits all of its proposed reports to Congress on pending legislation to the Bureau of the Budget, through regular Treasury Department channels, to determine whether they are in accordance with the program of the President. The Bureau of the Budget does not submit reports of other agencies directly to this Office. However, when reports which pertain to the work of our Office are submitted to the Treasury Department, they are transmitted by it to our Office for comments and recommendations.

12. Do you have any suggestions for legislation relative to your Office?

In view of the character and functions of the Joint Committee on the Economic Report and of the Subcommittee on General Credit Control and Debt Management, as reflected by the subject matter of the several questionnaires, it is assumed that the interest of the subcommittee is primarily in suggestions which have a major bearing upon the general purposes of our Office, its internal operations, its relationship to other parts of the Government, and the adequacy and soundness of that portion of the Nation's banking system which it regulates and supervises. However, it is deemed appropriate also to mention, although not in detail, the need for a considerable number of legislative changes of lesser moment, ranging from moderately significant to almost negligible.

The National Bank Act has been amended scores of times since its enactment almost 90 years ago. In addition, national banks are subject to a large number of other Federal statutes ranging from the Federal Reserve Act, the Banking Acts of 1933 and 1935, the act of November 7, 1918, relating to bank consolidations, and other landmarks in banking legislation, down to two- or three-line laws on matters of no significance whatever under present conditions.

These major laws themselves have been amended on numerous occasions.

The National Bank Act was drafted in the light of governmental, banking, and legal concepts, institutions, and practices of the 1860's, and to some extent for purposes which are no longer operative. As the result, many of the laws relate or refer to the currency-issuing function of national banks, which terminated in 1935. In addition, it was perhaps inevitable, with a body of laws so voluminous and complex, that existing laws would be amended, and new laws enacted, without making necessary accompanying changes in related laws. As a result, the laws relating to national banks contain numerous inconsistencies, ambiguities, and obsolete provisions.

A few examples may illustrate these shortcomings. The right of a national bank to use a subsidiary corporation to hold title to its banking premises is subject to considerable doubt, in some situations, as the result of conflicting provisions in sections 23A and 24A of the Federal Reserve Act, as amended (12 U. S. C. 371c and 371d).

R. S. 5200, as amended (12 U. S. C. 84), in general prohibits a national bank from making advances to any one customer in excess of 10 percent of the bank's capital and surplus. However, there are 11 enumerated exceptions to this limitation, which permit national banks to lend a customer in excess of the 10 percent limit in reliance upon obligations which meet specified standards, considered by Congress to provide exceptional strength and assurance of repayment. These exceptions have been added piecemeal over more than 80 years, with the result that some contain terminology, the meaning of which has changed considerably; others contain loopholes not contemplated by the enacting Congress, as the result of changed business practices; and inconsistencies and overlapping exist among the exceptions. These developments make more difficult our task of interpreting and applying the statute, because the necessary effort to harmonize the exceptions and make them carry out the congressional purpose has given rise to intricacies of interpretation which are not clear on the

face of the law and are not readily understood and accepted by the national banks to which they apply.

A minor example of these difficulties, but one which is especially clear, relates to R. S. 329 (12 U. S. C. 11), which has not been amended since its enactment in 1864. It provides:

It shall not be lawful for the Comptroller or the Deputy Comptroller of the Currency, either directly or indirectly, to be interested in any association issuing national currency under the laws of the United States.

Although the officials concerned have been meticulous in observing the spirit of this enactment, it is obvious that it does not accomplish its purpose, viewed as a legal enactment. It relates only to [financial] interests in an "association issuing national currency under the laws of the United States," and there are no such associations at the present time.

Even if this defect were disregarded, the statute in terms applies only to the Comptroller and "the Deputy Comptroller of the Currency." At the time of its enactment, there was only one Deputy Comptroller, appointed under R. S. 327 (12 U. S. C. 4). Since that time, Congress has provided for two additional Deputy Comptrollers (acts of March 4, 1909, and March 4, 1923; 12 U. S. C. 5 and 6), but on neither occasion was the necessary amendment made in R. S. 329. Consequently, that statute refers only to one of the three Deputy Comptrollers, although its principle is equally valid with respect to all of them.

Finally, R. S. 329 probably should be made applicable to all officials and employees of the Bureau. In 1864 Congress may have considered that no person in the Bureau other than the Comptroller or Deputy Comptroller would be likely to be financially interested in any national bank. Changed conditions have made stock ownership in national banks much more available—to employees of the Bureau among others—and since the underlying principle of the law appears to cover all persons engaged in the work of the Bureau, its scope should be so expanded.

The foregoing are examples of the types of statutory problems which call for congressional correction from time to time. Some 10 years ago a compilation was made of many of these, but they were not submitted for congressional consideration during the war years, since it was felt that they were not of sufficient importance to justify expenditure of the necessary time by Congress and its committees. During the past 5 years, with their numerous exigent problems, no time has seemed appropriate for extensive revision of the Federal banking laws.

However, as particular problems become sufficiently pressing, appropriate corrective legislation is recommended, and drafted if necessary. Thus, within recent years certain exceptions have been added to R. S. 5200. Important new securities issues have been exempted from the ordinary requirements of R. S. 5136 (12 U. S. C. 24) with respect to eligibility of securities for national bank investments. Section 24 of the Federal Reserve Act (12 U. S. C. 371) has been amended to permit national banks to make loans secured by leasehold interests in some circumstances. The Eighty-first Congress enacted a law providing for conversion of national banks into State banks and their merger and consolidation with State banks, in order to

establish the so-called two-way street between the Federal and State sectors of the dual banking system.

At the present time, the possible recommendation of additional legislation is being considered. One of these relates to the power of national banks to operate travel departments. Another has to do with the authority of a national bank to purchase stock (or otherwise invest) in a corporation which will provide parking facilities in its area—a problem which is becoming increasingly important with the increase of traffic congestion in our cities. A third has to do with possible reduction of unnecessarily high capital requirements imposed by statute upon national banks which desire to establish out-of-town branches.

The foregoing will indicate to the committee the types of legislative problems which exist in the numerous laws applied and administered by our Bureau, and the manner in which these problems are being dealt with. It is believed that the Committee's studies and objectives would not be furthered by an extensive detailing of these matters. Consequently we are not submitting any recommendations for legislation in connection with this questionnaire.

C. INCOME AND EXPENSES OF THE COMPTROLLER'S OFFICE

13. What has been the income of your Office in each year since 1933? Classify this income in any way which you believe will be helpful to the committee.

(Answered together with question 14. See below.)

14. What have been the expenses of your Office in each year since 1933? Classify the expenses in any way which you believe will be helpful to the committee. Relate the administrative expenses of the Office (i. e., express them as percentages of) (*a*) the gross national product of the United States; (*b*) the expenses of all national banks.

The data in tables I, II, III, and IV (pp. 920–921) as to total income and total expenses of the Office of the Comptroller of the Currency for the years 1934 to 1950 exclude figures for the Federal Reserve Issue and Redemption Division and the Division of Insolvent National Banks, for the reason that the income and expenses of those divisions are unrelated to the expenses of supervision of active national banks and the total costs of operation of active national banks. However, as a matter of information, data with respect to the total income and total expenses of those two divisions are presented in tables V, VI, and VII (pp. 921–922).

TABLE I.—*Income of the Office of the Comptroller of the Currency relating to supervision of active national banks, 1934 to 1950, inclusive*

Years	Appropriated funds	Funds reimbursements by banks	Total income
1934	[1] $241,750	$2,762,812	$3,004,562
1935	[1] 245,546	3,302,264	3,547,810
1936	[1] 231,244	3,206,208	3,437,452
1937	[1] 240,811	3,311,573	3,552,384
1938	[1] 225,906	3,179,296	3,405,202
1939	[1] 270,689	3,461,428	3,732,117
1940	[1] 273,187	3,801,185	4,074,372
1941	[1] 273,993	3,696,168	3,970,161
1942	262,752	4,242,110	4,504,862
1943	289,813	4,184,356	4,474,169
1944	289,805	4,079,458	4,369,263
1945	296,918	4,603,515	4,900,433
1946	153,245	4,508,230	4,661,475
1947	5,392	4,237,376	4,242,768
1948		5,241,729	5,241,729
1949		7,118,707	7,118,707
1950		7,826,722	7,826,722
Total	3,301,051	72,763,137	76,064,188

[1] Data for fiscal years ended June 30.

TABLE II.—*Expenses of the Office of the Comptroller of the Currency relating to supervision of active national banks, 1934 to 1950, inclusive*

Years	Salary payments	Per diem and travel expense	Retirement system costs	Miscellaneous expense [1]	Total expenses
1934	$2,058,344	$664,832		$162,671	$2,885,847
1935	2,333,946	699,385		142,879	3,176,210
1936	2,268,864	634,810	$99,567	181,580	3,184,821
1937	2,326,941	647,015	175,545	199,615	3,349,116
1938	2,448,724	707,875	187,437	191,728	3,535,764
1939	2,584,700	725,767	194,505	171,007	3,675,979
1940	2,692,502	699,196	203,086	247,255	3,842,039
1941	2,790,466	730,565	214,008	148,830	3,883,869
1942	2,856,028	851,231	222,251	165,324	4,094,834
1943	3,114,774	801,308	208,348	139,892	4,264,322
1944	2,964,846	731,466	321,489	124,203	4,142,004
1945	2,924,030	692,016	323,949	128,315	4,068,310
1946	3,497,576	789,323	501,517	163,724	4,952,140
1947	3,964,286	884,286	507,064	227,002	5,582,638
1948	4,573,551	974,248	[2] 328,904	230,293	6,106,996
1949	5,050,402	1,229,688	(2)	292,392	6,572,482
1950	5,207,891	1,463,470	(2)	294,463	6,965,824
Total	53,657,871	13,926,481	3,487,670	3,211,173	74,283,195

[1] Includes rent, furniture and fixtures, communications, supplies, etc.
[2] The retirement system of the Office of the Comptroller of the Currency was terminated effective Aug. 8, 1948, through transfer of the affairs thereof to the civil service retirement system and transfer of the assets thereof (totaling $5,548,119) to the civil service retirement and disability fund, both pursuant to provisions of Public Law 849, 80th Cong., approved June 30, 1948 (62 Stat. 1163).

TABLE III.—*Expenses of the Office of the Comptroller of the Currency relating to supervision of active national banks, 1934 to 1950, inclusive*

Cost classifications	Expenses paid from appropriated funds	Expenses reimbursed by banks	Total expenses
Salaries	$2,969,925	$50,687,946	$53,657,871
Per diem and travel	0	13,926,481	13,926,481
Comptroller's retirement system	0	3,487,670	3,487,670
Miscellaneous [1]	331,126	2,880,047	3,211,173
Total	3,301,051	70,982,144	74,283,195

[1] Includes rent, furniture and fixtures, communications, supplies, etc.

TABLE IV.—*Expenses of the Office of the Comptroller of the Currency relating to supervision of active national banks, expenses of all national banks, and gross national product of the United States, with relative percentage values, 1934 to 1950, inclusive*

Years	Expenses of Office (in thousands)	Expenses of all national banks (in thousands)	Gross national product of the United States (in millions)	Percent total expenses of Office to—	
				Expenses of national banks	Gross national product (in thousandths of 1 percent)
1934	$2, 886	$557, 667	$64, 868	0. 5175	4. 449
1935	3, 176	549, 148	72, 193	. 5783	4. 399
1936	3, 185	565, 013	82, 483	. 5637	3. 861
1937	3, 349	586, 221	90, 213	. 5712	3. 712
1938	3, 536	577, 272	84, 683	. 6125	4. 175
1939	3, 676	581, 264	91, 339	. 6324	4. 024
1940	3, 842	599, 444	101, 443	. 6409	3. 787
1941	3, 884	641, 648	126, 417	. 6053	3. 072
1942	4, 095	695, 034	161, 551	. 5891	2. 534
1943	4, 264	670, 628	194, 338	. 6358	2. 194
1944	4, 142	725, 248	213, 688	. 5711	1. 938
1945	4, 068	816, 688	215, 210	. 4981	1. 890
1946	4, 952	951, 572	211, 110	. 5204	2. 345
1947	5, 583	1, 080, 740	233, 264	. 5165	2. 393
1948	6, 107	1, 184, 386	259, 045	. 5156	2. 357
1949	6, 572	1, 248, 324	257, 348	. 5264	2. 553
1950	6, 966	1, 337, 068	282, 630	. 5210	2. 465
Total	74, 283	[1] 13, 367, 365	2, 741, 823	. 5557	2. 709

[1] Exclusive of taxes on net income for years 1943 to 1950, inclusive, in amounts of from $75,806,000 in 1943 to $255,490,000 in 1950.

TABLE V.—*Office of the Comptroller of the Currency, income relating to Federal Reserve Issue and Redemption Division and Division of Insolvent National Banks, 1934 to 1950, inclusive*

Years	Federal reserve issue and redemption division	Insolvent division	Total
1934	[1] $58, 299	$1, 101, 381	$1, 159, 680
1935	[1] 56, 730	1, 538, 030	1, 594, 760
1936	[1] 54, 243	1, 761, 661	1, 815, 904
1937	53, 352	1, 637, 461	1, 690, 813
1938	57, 222	1, 310, 180	1, 367, 402
1939	55, 123	358, 005	413, 128
1940	52, 994	62, 999	115, 993
1941	54, 108	740, 265	794, 373
1942	48, 560	308, 861	357, 421
1943	56, 834	253, 403	310, 237
1944	41, 002	104, 946	145, 948
1945	45, 744	76, 704	122, 448
1946	60, 657	47, 582	108, 239
1947	67, 620	65, 067	132, 687
1948	89, 512	9, 482	98, 994
1949	98, 550	8, 755	107, 305
1950	107, 366	73, 426	180, 792
Total	1, 057, 916	9, 458, 208	10, 516, 124

[1] Data for fiscal years ended June 30.

TABLE VI.—*Office of the Comptroller of the Currency, expenses relating to the Federal Reserve Issue and Redemption Division, 1934 to 1950, inclusive*

Years	Salary payments	Miscellaneous expense [1]	Total expenses
1934	$57,409	[2] $890	[3] $58,299
1935	55,840	[2] 890	[3] 56,730
1936	53,458	[2] 785	[3] 54,243
1937	52,009	829	52,838
1938	56,421	609	57,030
1939	54,744	223	54,967
1940	52,809	364	53,173
1941	51,778	279	52,057
1942	48,527	885	49,412
1943	56,913	753	57,666
1944	40,159	527	40,686
1945	42,385	625	43,010
1946	58,972	692	59,664
1947	64,092	1,637	65,729
1948	88,965	1,423	90,388
1949	97,836	1,209	99,045
1950	105,752	1,219	106,971
Total	1,038,069	13,839	1,051,908

[1] Includes supplies, printing, furniture and fixtures, rent, communications, etc.
[2] Estimated.
[3] Data for fiscal years ended June 30.

TABLE VII.—*Office of the Comptroller of the Currency, expenses relating to the Division of Insolvent National Banks, 1934 to 1950, inclusive*

[NOTE.—All insolvent national banks were assessed on a uniform basis to cover the cost of supervision by our Division of Insolvent National Banks. However, some services of the Washington staff which were definitely allocable to particular receiverships were charged to, and collected from, those institutions. The following figures exclude all such special service expenses which were so recovered.]

Years	Salary payments (unrecovered)	Per diem and travel expense (unrecovered)	Miscellaneous expense [1] (unrecovered)	Total net expenses (unrecovered)
1934	$626,052	$2,559	$126,688	$755,299
1935	758,450	15,544	181,770	955,764
1936	936,300	18,001	189,291	1,143,592
1937	815,939	10,281	370,459	1,196,679
1938	692,296	1,592	281,377	975,265
1939	627,185	25,884	238,203	891,272
1940	552,838	35,863	210,237	798,938
1941	494,276	37,806	208,352	740,434
1942	324,043	[2] 10,871	143,397	456,569
1943	311,884	2,576	100,341	414,801
1944	223,236	[2] 16,314	89,399	296,321
1945	239,837	2,644	81,808	324,289
1946	242,219	1,460	70,784	314,463
1947	207,978	[2] 23	67,174	275,129
1948	97,482	393	4,258	102,133
1949	77,871	149	4,806	82,826
1950	58,282	194	4,229	62,705
Total	7,286,168	127,738	2,372,573	9,786,479

[1] Includes supplies, printing, furniture and fixtures, rent, communications, etc.
[2] Red figure: In these years recoveries exceeded current expenditures.

15. Describe the budgetary procedure of your Office. Is its budget reviewed by the Bureau of the Budget? Are changes in its budget made by the Bureau binding upon your office? How are its expenditures subject to congressional control? What suggestions, if any, do you have for changes in any of the procedures described in this question?

The funds upon which this Office operates are derived from assessments against the banks (and their affiliates) which it supervises.[4]

[4] There is an exception: The cost of operating our Issue and Redemption Division, which handles Federal Reserve notes, is reimbursed to us by the Federal Reserve System.

Congress has provided, by statute, that these funds "shall not be construed to be Government funds or appropriated monies" R. S. 5240 (12 U. S. C. 481 and 482). Consequently, our budgetary procedure is not reviewed by the Bureau of the Budget.

The rate of assessment is fixed as a percentage of the assets of the bank examined in accordance with a formula adopted by the Comptroller under congressional authority. The rate so fixed by him must apply to all examined banks uniformly, and the amount of the fee determined by the application of the formula is remitted to the Office at the conclusion of each examination. Hence, the amount of funds derived from assessments depends upon how many banks are examined each year, as well as the amount of their resources at the time of examination. Therefore, it is possible to know at the beginning of each calendar year the approximate amount of the Bureau's income for the year.

The rate of assessments is designed to produce enough income to cover our expenses and to provide a modest cushion. If the fund at any time becomes too large, the rate of assessment for the next year is revised downwards in order to avoid excessive charges against the examined banks. If it appears probable that, by virtue of unavoidably increased costs of operation, the income derived from assessments at the existing rate will be inadequate, the rate is revised upwards. However, in order to provide uniform treatment for all banks examined, the rate should not be changed except at year ends, and, as a matter of fact, it is altered very infrequently.

As indicated by data presented in answer to other questions, the expenditures of the Bureau in its bank-examining activities are fairly steady and predictable. By far the largest element in the Bureau's expenditures is the item of salaries of bank examiners and assistant examiners. The number of these employees is increased only when it appears that the existing corps of examiners is inadequate to perform the volume of work. In such situations, the district chief examiner submits to the Washington office his request for authority to increase his force by the employment, for example, of two additional assistant examiners. Any such request for a staff increase must be accompanied by an adequate factual justification for the proposal.

Similar principles govern the subject of pay increases for employees. Generally speaking, the Bureau's personnel receives periodic pay increases on a basis comparable to that applicable to the great bulk of the Federal civil service. Departures from this normal routine, whether on the high or low side, occur in relatively few instances and only on the basis of exceptional reasons for such action.

Our recruitment and compensation plans and programs are formulated under the direction and with the approval of the Treasury Department.

Our incentives for operating as economically as possible are primarily a sense of good government and sound administration, plus a desire to accumulate, as afore-mentioned, a modest cushion adequate to carry us through any relatively short emergencies in which for any reason examinations could not be conducted and consequently fees could not be collected, and a desire to avoid the necessity of increasing the rate of assessments, which naturally is unpalatable to the examined banks.

These factors in our operations, together with the relatively small size of the Bureau (1,115 persons on December 31, 1950), explain the absence of need for more formal budgetary procedures. At various times in the history of the Bureau, budgetary forecasts and allocations have been used, but the results did not appear to justify the time, expense, and effort. The data presented in our answer to question 14 is evidence that the absence of formalized budgetary procedures in the Bureau has not resulted in excessive expenditures.

Each year, our annual report to Congress presents a summary of significant data, including the number of employees and their distribution as to function, the number of examinations performed, and the aggregate expenses. Comparison of these figures from year to year would reveal any unusual increase in relative cost of the service performed. Over the years, it has never been suggested, to our knowledge, that the cost of operating the Bureau is disproportionate or in any respect uneconomical.

Perhaps because of the fact that our funds are in a theoretical sense unlimited, there is no incentive to use up any surplus funds. Consequently, our recruitment is designed to procure only enough trained employees to perform the task assigned to us. The history of the Bureau reveals that we have been able to determine with fair accuracy the number of employees needed from time to time and that deviations from the ideal have been in the direction of understaffing rather than an excessive number of employees.

Our employment and compensation plan was especially designed by us to meet our particular situation; i. e., the need to obtain men with bank training whose intellectual qualifications and personalities are such as to enable them to deal on an equal basis with bank officers and directors, as well as the necessity of competing with banks for the services of such persons. Although our examining force is excepted from the competitive civil service—temporarily at least—each person is selected on an impartial, nonpolitical, selective basis, and all examiners must have advanced through the assistant examiner stage. We will be glad to furnish a copy of our employment and compensation plan for the *confidential* information of the committee, if it so desires. Our clerical staff, on the other hand, is within the competitive civil service and is treated accordingly.

Finally, we wish to note that our organization is so small and well integrated that the Comptroller and his staff can and do keep well informed concerning the adequacy of the organization and quality of individual performance, as well as the expenses incurred in operating the Bureau. Hence much of what is ordinarily considered "budgeting" takes place in our day-to-day operations and is, therefore, more closely scrutinized than is possible in many other organizations.

It is our belief that the existing procedure has worked well throughout the years.

16. Are the accounts of your Office audited by any other department or instrumentality of the United States Government? If so, by whom? Are the powers of the auditing authority limited to reporting or does it have authority to disallow expenses? To whom are the reports of auditing authority sent?

All of the accounts of this Office are audited by a special internal auditing unit on a permanent and continuous basis. This unit re-

ports directly to the Comptroller. It is completely independent of the disbursing officials and it is charged with the duty of calling to the attention of the Comptroller and his immediate staff all expense items which are beyond the limits of applicable regulations or other authorization, inadequately supported, or otherwise irregular or questionable in any respect. The decisions as to allowance or disallowance are made by the Comptroller or a designated deputy in the light of those recommendations.

As an additional safeguard, an annual, comprehensive audit is performed for the Comptroller, at his request, by representatives of the Bureau of Accounts of the Treasury Department. Although the Bureau of Accounts does not have authority to disallow expenses, their reports are made directly to the Comptroller. This serves as a check on our own auditing unit. The contents of those reports reflect favorably upon the quality of our audits.

17. List and discuss any expenses which have been incurred by your Office during the period since 1946 for the purpose of influencing public opinion on controversial matters. Expenses for the preparation of material in standard expository format and for the distribution or presentation of such material in written or oral form to persons who might be expected to have a regular business or professional interest in it may be omitted. Any expenses during this period for the preparation of motion pictures, illustrated brochures, or any other special material should be included, however, irrespective of your personal opinion as to whether or not the material they contain is controversial in character, in order that the subcommittee may, if it desires, consider them on a case-by-case basis.

Since 1946, our Bureau has not incurred any expenses of the types referred to in this question.

D. THE BANKING STRUCTURE

18. Will you please submit a memorandum discussing the adequacy of banking facilities in the United States? For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities.

Within less than a generation, the number of commercial banks in the United States has been halved, while the business transacted by the commercial banking system has multiplied many times. During that period, hundreds of small, rural American communities have become "bankless towns", and many others are served by only one bank in place of the two or three which existed in the 1920's.

These facts suggest superficially that the commercial banking system has not kept pace with the growth of the economy, and that existing units may be inadequate in number and may fail (1) to bring banking facilities within convenient reach of all persons having need of them, and (2) to provide the healthful conditions of competition among banks generally considered desirable.

Actually, there is relatively little basis for the first conclusion. It must be remembered that in 1920 the rural population of the United States amounted to 51½ million, or 48.8 percent of the total population. During the succeeding 30 years, the rural population remained relatively static, and the 1950 census disclosed only a small increase to 54½ million, or 36.3 percent of the total population. Urban growth, on the other hand, was substantial between 1920 and 1950, this segment of the population increasing from 54 to 96 million, the latter representing 63 percent of the total population. These figures reveal there has not been a growing need over the last 30 years for banking facilities in rural areas. The increased need has been centered in urban areas able to accommodate it through expansion of existing units or the addition of new units. There is somewhat greater foundation for the allegation that the *ideal* level of competition is not being completely achieved.

Our experience with banking conditions throughout the country over many decades has proved that a substantial lack of adequate and convenient banking facilities in communities large enough to support them almost invariably will give rise to an effective demand for such facilities, usually in the form of an application for a new bank charter, either State or national, or a branch thereof where permissible. Nevertheless, during the past decade there have been relatively few applications for national-bank charters and branch permits, as indicated in our answer to question 20. It is our understanding that the experience of State supervisory authorities has been substantially similar.

It is not difficult to ascertain why 15,000 banks [5] can render several times as much service as was formerly provided by 30,000 banks,[6] and can do this with greater convenience to their communities and the country at large. Many of the banks which have disappeared were situated close to banks which are still in operation, and the loss of their facilities has been compensated for by expansion of continuing institutions and adoption of more efficient and time-saving methods by present-day banks. This great increase in efficiency, and the ability of banks to handle increased volume have resulted from such changes as improved physical lay-out, increased mechanization of operations, drive-in windows, popularization of banking by mail, creation of more branch offices, and the like. Furthermore, in many parts of the country, 30 years ago, a local bank was more essential than now in very small towns; today our complete network of high-speed, all-weather roads makes it possible, without severe inconvenience, to do business at the bank located in the county seat, 5 or 10 miles away. We are satisfied that there are very few places in the United States, which are able to support a unit bank on a profitable basis, which experience extreme inconvenience as the result of inadequate banking facilities.

But there are some situations in large cities, and many situations

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[5] For over 10 years the number of banks in the country has been stabilized at somewhat less than 15,000. On December 30, 1950, there were 14,666 unit banks with 5,034 branches. A quarter century ago (June 30, 1924) there were 28,996 unit banks with 2,293 branches.

[6] The disappearance of some 15,000 unit banks took place through voluntary liquidation, receiverships, consolidations of two or more institutions, absorption of one bank by another through purchase of assets and assumption of liabilities, and so on. In the great majority of cases, a banking office ceased to exist as such. In a smaller—but still significant—number of instances, the banking office was continued as a branch of another institution.

in small, bankless, rural communities, where additional banking facilities would be a decided convenience to many people. In many of these situations a new bank is not the answer, for the amount of available business is inadequate to permit profitable operation, and an unprofitable bank cannot long retain competent employees, and hence it gradually deteriorates and becomes a hazard to the economic life of the community. On the other hand, these communities could, in a great number of instances, readily support a branch office of a sizable institution. However, in many cases the absence of State laws permitting banks to have branches in those areas precludes the use of this corrective measure, inasmuch as national banks cannot have branches in States where State banks are prohibited from operating them. The problem could be solved if national banks were authorized to establish branches with the approval of this office, irrespective of State laws, but such legislation might adversely affect the operation of the dual banking system, in which national banks and State banks operate competitively.

There are still some communities in this country which are served by two or more banks, where a lesser number undoubtedly would be more "efficient" from the point of view of immediate dollars-and-cents economy and resulting profit. On the other hand, there are many communities served by one bank which could profitably support another. In almost all these cases there is a conflict between the pressure of business economics, on the one side, and the broader desirability of active bank competition, on the other. Since the initiative lies with practical businessmen, interested primarily in the net dollar return on the dollars invested, the trend toward amalgamation and branch banking remains strong, a trend which is away from the "ideal" of giving all persons the opportunity of choosing between two or more competing banks.

It is our opinion that existing *deposit* facilities of the banking system are generally satisfactory and perform reasonably well their important role in our economic life, except with respect to a very small percentage of the total population located, for the most part, in towns too small to support a unit bank.

Not infrequently, one hears expressions of dissatisfaction, even in cities, regarding the number and location of banking offices, the shortness of banking hours, and so on. Needless to say, it would be very convenient for all of us if there were a banking office in every shopping center and department store, open from morning to night, 6 days a week. However, it must be remembered that, despite its unique character, banking is a business like any other, which must operate at a profit as well as render service.

In States where branch banking is not permitted, additional banking facilities of the type described could exist only through the establishment of new unit banks. Regardless of the added convenience in those situations, the banking office could not long exist without paying its way, and banking authorities would not be justified in authorizing a bank with poor prospects of success. Where branch banking is permissible, such additional facilities doubtless could be successfully established and maintained in some cases. Such a development would be attractive to some of the larger banks, which could afford to operate such branches, as well as to the department stores which would receive the benefit of the advertising value of those banking facilities.

However, extensive "cubbyhole" banking by large institutions would be detrimental to many smaller banks, whose business would be jeopardized by such competition. Finally, it is questionable whether the public would continue to welcome this expanded banking service when it was eventually realized that it must be paid for.

Loan facilities of banks are utilized to a lesser extent by the public than are the deposit facilities, and we believe that the loan facilities are adequate in a quantitative sense, as well as with respect to geographic availability. Whether such facilities actually are placed at the service of all deserving would-be borrowers is a much argued question. (In this connection, see our answers to questions 21 and 22.)

In the opinion of this office, our commercial banking system is capable of meeting practically all legitimate credit needs of American business. However, it is our feeling that in some situations, the availability of credit could be broadened, and its cost to American business reduced if a feasible means could be devised for achieving effective banking competition in all communities and areas. It is our belief that this is a relatively minor shortcoming in our commercial banking system, and is an unavoidable concomitant to the spirit of initiative and efficiency upon which the American economy has been built.

19. Discuss in general your policy in acting on applications for new national banks. Stress your concept of what constitutes ample banking facilities—especially the degree of competition which you believe to be necessary or desirable.

Preliminary to action on a new bank application, the Comptroller has before him for review and study:

(*a*) A detailed report of investigation made by a national bank examiner who visits the community in which it is proposed to organize the bank. Such report among other matters contains information as to (1) the general character, financial responsibility, and experience of the organizers and of the proposed officers, directors, and principal stockholders, (2) the adequacy of existing banking facilities, the need for further banking services and the competitive aspects of the proposed bank, (3) the prospects for growth and development of the area in question, (4) the methods and banking practices of existing banking units, (5) the local sources of income and wealth, (6) the extent of profitable business which could be generated by the proposed new institution, (7) the adequacy of the capital proposed for the new bank, and (8) the banking history of the community, and in case of conversion, the history of the State bank, et cetera.

(*b*) A review of the investigation report by and the recommendation of staff members, including the district chief examiner, the Chief of the Organization Division, the assistant chief examiner, chief examiner, and three Deputy Comptrollers.

(*c*) Reports and recommendations of the Federal Deposit Insurance Corporation and the Federal Reserve bank for the district in which the proposed bank is to be located, with respect to the factors enumerated in (*a*) above.

There can be no hard and fast rule in deciding upon the merits of new bank applications because of the variety of factors which must be considered in individual cases, which vary greatly in different communities. As an example, an economically poor and static community of 2,000 or 3,000 population might not be able to provide support for

even one bank because of the inadequate volume of deposits and profitable credit outlets, whereas a thriving and expanding community possessing considerable wealth with a similar population might need and could amply support more than one bank. It is therefore the Comptroller's policy to weigh all pertinent information developed in relation to each individual case with the view of determining whether the needs of the community for, and the prospects of successful operation of, the proposed bank under the management selected are such as to warrant favorable action on the application.

However, one of the fundamental tenets of our views and actions on applications for charters and branches is the desirability of competition wherever possible. We believe that sound and healthy competition between banks redounds favorably to the public welfare through increased adequacy of credit facilities, fair rates of interest, and the prevention of undue concentration of monetary and economic power. Hence, in considering applications for new banking offices in communities having only one bank, we give considerable weight to this factor. In communities where competition already exists, the factor is given much less weight, for excessive competition can result in such a weakening of existing banking institutions as to bring consequences so injurious to the welfare of the community as to outweigh any benefits to be anticipated from increasing the intensity of competition in such cases.

In short, we believe thoroughly in competition in the field of banking, and endeavor to provide it wherever possible to do so without jeopardizing existing institutions. We do not believe in unbridled competition—either by unit banks or branch banks, because of the risk involved to depositors and to the economy of the community and the Nation.

20. Submit a statistical analysis showing year by year for the past 10 years the number of applications filed for national bank charters, branch permits, authority to convert into a national bank, and authority to consolidate. State the number of such applications approved, the number rejected, and the causes for rejection, classified by such principal reasons as (*a*) existence of ample banking facilities, (*b*) no prospect of successful financial operation, (*c*) inadequate capital for the establishment of the bank or branch, (*d*) no satisfactory evidence that competent management would be available. Submit also statistics with respect to voluntary liquidations of national banks. Comment on this analysis in any manner which you consider appropriate.

The following tabulations, with their explanatory notes and comments, contain the information called for by this question.

Applications for authority to organize national banks, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Applications approved	5	3	2	9	26	29	17	16	12	9	[1] 128
Applications rejected	4	0	5	5	11	20	20	16	15	18	114
Total	9	3	7	14	37	49	37	32	27	27	242

[1] Applications approved as distinguished from charters issued.

Reasons for rejections of 114 applications for authority to organize national banks (classified according to number of times each reason occurred), 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Insufficient need	4	0	4	4	8	18	19	15	15	17	104
Unsatisfactory management	1	0	4	4	8	14	0	2	0	0	33
Earnings prospects unfavorable	0	0	2	0	3	7	11	7	11	16	57
Inadequate capital	1	0	1	0	3	1	0	0	0	0	6
Control ownership of stock objectionable	0	0	0	2	1	0	0	1	0	0	4
Inadequate banking quarters	0	0	0	0	1	3	0	0	0	0	4
Poor distribution of stock	0	0	0	0	0	1	0	0	0	0	1
Promotion scheme	0	0	0	0	0	0	1	0	0	0	1
Application submitted by another group at the same time appeared to more nearly meet requirements and standards for national bank	0	0	0	0	0	0	0	1	0	0	1
Bank would function primarily as savings bank	0	0	0	0	0	0	0	0	0	1	1
Total	6	0	11	10	24	44	31	26	26	34	212

Applications by national banks for authority to establish branches, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Branches authorized	29	19	12	22	57	85	108	108	100	159	699
Applications rejected	14	6	3	4	38	56	50	29	37	46	283
Total	43	25	15	26	95	141	158	137	137	205	982

Reasons for rejections of applications by national banks for authority to establish branches, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Insufficient need	5	1	2	1	17	26	35	19	21	16	143
Insufficient need; future prospects unfavorable					7	1	3	3	4	20	38
Priority of another bank's application	1	2			4	11	4	3	8	3	36
Not in public interest	3				2	11					16
Inadequate capital structure	1	1		1	4	4	4	2	1	2	20
Inadequate capital structure; unsatisfactory or unproved management	3	1		2	2	1		1	1		11
Inadequate capital structure; possibility of bank acquiring a too dominant position							3				3
Insufficient need; unsatisfactory or unproved management		1			2				1		4
Inadequate capital structure; insufficient need	1						1				2
Detrimental to another bank						2		1		1	4
New bank, needed more time to prove that management and policies are sound									1	1	2
Unsatisfactory management			1							2	3
Additional investment in real estate not warranted; inadequate capital structure										1	1
Total	14	6	3	4	38	56	50	29	37	46	283

Applications by State banks for authority to convert into national banks, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Applications approved	5	8	11	13	15	14	8	6	4	4	[1] 88
Applications rejected	3	0	1	0	1	1	0	1	1	1	9
Total	8	8	12	13	16	15	8	7	5	5	97

[1] Applications approved as distinguished from charters issued.

NOTE.—Between Aug. 17, 1950, the effective date of Public Law 706, and Dec. 31, 1950, 1 national bank was converted into a State bank.

Reasons for rejections of applications by State banks for authority to convert into national banks, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Insufficient need for banking services in a town to which bank proposed to move	1										1
Condition of State bank desiring to convert only fair; earnings poor; unsatisfactory management	1					1					2
Bank had been in operation for only 2 months. Considered it should go through "seasoning" period before applying for conversion	1										1
Inadequate capital; failure to work out banking house situation					1						1
Future of bank believed limited			1								1
Application for FDIC insurance rejected								1			1
Type of business emphasized by State bank desiring to convert made it appear successful operation as national bank not possible									1	1	2
Total	3	0	1	0	1	1	0	1	1	1	9

Number of banks consolidated with national banks under national bank charters, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Number of national banks	1	1	1	3	5	[1] 10	[1] 2	[1] 5	5	4	37
Number of State banks	3	0	1	6	2	[1] 9	[1] 10	[1] 3	3	12	49
Total	4	1	2	9	7	[1] 19	[1] 12	[1] 8	8	16	86

[1] In each of the years 1946, 1947, and 1948, 1 consolidation program was consummated in which 1 national bank and 1 State bank were consolidated into another (continuing) national bank.

NOTE.—As indicated by the preceding notes a total of 83 consolidation programs were consummated during the period 1941 to 1950, inclusive.

Tentative consolidation proposals are thoroughly discussed with representatives of the consolidating banks by field or office representatives of this office prior to the submitting of formal applications, by national banks, to this office for approval and authority to consolidate. No tabulation of rejections can be made, since no statistical record is maintained of proposals discussed and abandoned by the banks before reaching the state of submitting formal applications to this office for permission to consummate the consolidation program agreed upon.

Voluntary liquidations of national banks, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Take overs by other national banks	12	21	20	11	25	13	20	19	16	15	172
Take overs by State banks	19	17	20	13	16	19	8	8	13	8	141
Liquidated without take-overs by other banks	6	7	10	6	2	3	2	------	3	1	40
Total	37	45	50	30	43	35	30	27	32	24	353

Reasons for national banks being placed in voluntary liquidation, 1941 to 1950, inclusive

	1941	1942	1943	1944	1945	1946	1947	1948	1949	1950	Total
Uneconomic banking units; towns overbanked; poor prospects or insufficient earning power	12	13	22	6	10	10	3	5	4	4	89
Age of officers; disinclination to continue; family differences or necessity to realize on investment	1	5	10	4	10	10	2	6	14	9	71
Purchased by branch banking system for expansion purposes	1	3	4	5	6	5	9	4	12	2	51
Shareholders' desire to liquidate stock holdings	3	5	7	4	4	5	2	------	------	6	36
Asset condition	4	15	2	3	------	1	------	------	------	------	25
Absorbed into principal bank of holding company	1	------	------	1	------	------	9	9	------	------	20
Desire to take advantage of more liberal State laws	2	1	1	1	4	2	1	------	1	------	13
Unwillingness to increase common stock	2	------	------	2	4	1	------	3	------	------	12
Embezzlement	1	1	------	2	------	------	3	------	1	3	11
Purchased for removal to another town	------	------	------	1	------	------	------	------	------	------	1
Reason unknown	10	2	4	1	5	1	1	------	------	------	24
Total	37	45	50	30	43	35	30	27	32	24	353

E. AVAILABILITY OF CAPITAL FOR SMALL BUSINESS

21. Discuss the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred? Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

The first portion of this question relates to—

> * * * the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow.

In the first instance it seems important to us to point out that there often exists in the public mind a confusion between capital (i. e., equity funds) and loans. A great deal has been said of late about the difficulty of small business in obtaining funds with which to operate.

There is a vital point in understanding clearly the division between capital and debt, both of which contribute to the successful operation of practically all businesses. Capital represents ownership in the business; debt is made up of credit obligations, including loans. Strictly speaking, furnishing of capital is not a banking function. The satisfying of requirements for debt upon sound and proper conditions is a banking function. Relative availability of *capital* (i. e., equity funds) is a matter which we are not qualified to discuss as experts. In our opinion, numerous factors, some of them psychological, enter into this matter.

One factor bearing upon the ease or difficulty of raising capital for small enterprises is the availability of personal savings for this purpose. Twenty-five years ago there was a fairly high level of accumulation of savings; during the depression years, national income was down and savings were necessarily low; during World War II years, accumulation of savings was extremely rapid but opportunities for utilization were limited; within the past 5 years, personal savings have accumulated more slowly, but the dammed-up savings of the war years are still available to a large extent.

Obviously, the volume of funds potentially available for capital investment has a powerful bearing on the ease or difficulty with which capital can be raised in a particular period. Psychological factors are of great significance in this field. When potential equity investors anticipate a period of recession, they are naturally less inclined to supply capital funds, not only because of the supposed poor prospects of profitable use within the near future, but also because a falling price level for capital goods may permit more economical use of the funds a year or two later.

The foregoing discussion relates chiefly to the ease or difficulty of raising capital. We do not feel qualified to attempt a more definite analysis of the nature of the changes which have occurred during the last 25 years in this field.

Inquiry has been made also regarding changes during the last 25 years in the ease or difficulty with which small-business men have been able to borrow. Presumably, this aspect of the question has to do chiefly with bank-credit facilities open to such entrepreneurs.

It is undoubtedly true that giant corporations with large resources, which have been long established and which have a certain dominance in their markets, have a better access to bank credit than the smaller and younger enterprise, even if there is comparable soundness. However, there are a great many small concerns, well managed and financed and with good records, which are well taken care of in the credit field. These concerns do not draw the national attention which is enjoyed by the great corporations, but the flow of credit to them, except in cases of profound national distress, is adequate, although less spectacular than that accorded to their big brothers.

During the 1940's, particularly the war years, the bank-credit needs of small business were satisfied almost completely, since those needs arose either from activities related to the war effort or in connection with production for, or services to, the civilian market. To the extent necessary, war-connected needs were satisfied through the medium of loans supported by various form of governmental guaranties. Because of general shortages of goods and services, the civilian market

was well-nigh insatiable, so that the credit needs of small businesses operating in that field were sound bankable risks, particularly attractive in view of the relatively small volume of loan business available to banks during that time.

With respect to national banks (and this is at least equally true of State banks), it must be remembered that the overwhelming majority are situated in small towns and have little, if any, contact with the larger concerns and their credit needs. Their customers are small- or medium-sized manufacturers, wholesalers, retailers, farmers, and other groups, with small to moderate credit needs.

It must also be borne in mind that during the past 25 years lending techniques have been developed or enlarged to enable banks to advance, with a greater degree of safety, a more liberal measure of credit to small businesses in relation to their invested capital and other pertinent credit factors than formerly was considered prudent. These techniques include the pledging of accounts receivable, discounting of notes receivable, pledging inventory via field warehousing, and the term loan on a regular amortization basis.

Banking institutions are operated as profit-making concerns, and sound loans usually constitute the most profitable available use of a bank's resources. Consequently, in most cases, self-interest is an important factor in the consideration of demands for small-business loans.

The same principles are applicable, in almost equal degree, with respect to even the largest city banks. With few exceptions, such banks do not confine their lending activities to large established concerns. Not only are loans to small and new enterprises, when properly made and serviced, a source of additional income, but the small or new enterprise of today may be the industrial giant of the next decade. Most banks are aware that an institution which does not extend credit to smaller customers in all justifiable situations not only cuts itself off from presently profitable business, but, in all probability, will fall behind its more enterprising competitors in volume of deposits, loans, and other major sources of bank income.

In certain fields of industrial activity, it is possible that proposed enterprises of relatively small size may have difficulty obtaining bank credit today, despite an apparently reasonable cushion of risk capital, whereas a similar proposal might have received the needed banking assistance 25 years ago. It is believed that this is often due to the increased mechanization and large-scale or medium-scale character of the most efficient industrial unit, rather than to increased reluctance on the part of bank officials to furnish credit in appropriate cases. For example, in 1925 an electrical engineer with satisfactory character and experience, and $20,000 of capital, might be granted a short-term loan of $10,000 to enable him to begin the manufacture of radio receivers. In 1950, an application for a loan of the same size for the manufacture of a similar product might be denied, in the exercise of sound banking judgment. The reason would not be that the bank is less willing to furnish credit where it seems justified, but that the loan officer doubts the possibility of designing, engineering, producing, and selling radio receivers, with a reasonable prospect of profit, on total funds of $30,000.

Question 21 also requests our opinion as to whether—

a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy.

In our opinion, this inquiry must be dealt with in two parts.

It seems unquestionable that a more liberal supply of capital and credit to small business would contribute for a time to the diffusion of economic power. In a particular field of manufacturing or merchandising, for example, which is presently occupied by some 10,000 concerns, 70 percent of the business might be done by 2,000 of the concerns classified as "big business." If the remaining 8,000 enterprises had available a more liberal supply of capital and credit, many of them undoubtedly would expand. As a result, the 8,000 "small business" concerns might substantially increase their proportion of the available business, from 30 to 40 percent, for example. This undoubtedly would constitute a "diffusion of economic power," in that the larger concerns in the field would find their share reduced from 70 to 60 percent, thereby also diminishing their dominance.

Whether such a diffusion of economic power would be temporary or permanent is most uncertain. For one thing, the answer would depend upon the liberality, in both amount and terms, of the "liberal supply of capital and credit." If the sources were governmental, the amount practically unlimited, and the interest and repayment terms very generous to the borrowers, the resulting diffusion of economic power might be extensive and long-continued, even to the extent, possibly, of intense industrial competition, leading to the distress of established concerns with obligations undertaken prior to the "liberal" era.

On the other hand, if the increased supply of capital and credit were advanced in limited volume and on ordinary business terms, the diffusion in many cases would be a more temporary and limited phenomenon, resulting within a short time in the insolvency of a number of smaller marginal concerns which came into being, or expanded unwisely, on the basis of the liberal supply of capital and credit.

The extent to which—

> a more liberal supply of capital and credit to small business would contribute * * * to the dynamic character of the economy—

is a quite different question from the effect on diffusion of economic power. The expression "dynamic character of the economy" may be defined in a number of ways. Presumably the subcommittee has in mind the extent to which a more liberal supply of capital and credit to small business would contribute constructively to the energetic and forceful nature of the economy.

Where adequate capital and other essential elements are present, we believe that, with few exceptions, there are no serious shortages of bank credit for either small or large businesses. On the other hand, as stated above, it may be that various factors, including increasing difficulty of savings accumulation in adequate amounts, prevent the formation or obtaining of capital to launch or expand smaller enterprises. The extent to which this is true cannot be known accurately.

Granting this premise, we are faced with the question what can be done about it, and whether available means of dealing with the matter are desirable. A great deal of thought has been given to, and volumes have been written about, such possibilities as especially favorable tax treatment for small enterprises, the creation of so-called "capital

banks," and the like. Examination of the capital-bank proposals inclines us to believe that much more work will have to be done to discover the advantages and disadvantages. With respect to the alternative of especially favorable tax treatment, it seems probable that this approach, properly utilized, might yield some benefits, but we are not in the position to propose specific procedures.

The question asks that we—

> distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

We see no evidence that the program of national defense is being materially impeded by lack of financial assistance. Perhaps the reference is to an alleged tendency for an undue proportion of national defense production contracts to be awarded to big business, to the detriment of smaller enterprises.

It is not clear to us how a more liberal supply of credit and capital to small business would relieve the situation. If defense contracts are given to the larger concerns, it is probably because the undertakings are of a magnitude which could not be handled by smaller companies except at much greater cost and with considerable delay and uncertainty. If this is correct, increased availability of funds to small business would not be a solution—at most, they might simply enable some small enterprises to expand into the category of big business.

22. Discuss the effects of bank examinations on the lending policies of banks, particularly as they apply to loans to small-business men. Distinguish if necessary between examination by different examining authorities.

Bank examination exercises a considerable influence on lending policies, in the broadest sense, through its insistence upon sound standards. In their emphasis on such standards, examiners do not differentiate between credits advanced to large concerns or smaller ones. The officers and directors of a national bank know that by adhering to high standards, their bank will avoid criticism. However, an even stronger factor in molding a bank's credit policies is its management's desire to operate a safe and profitable institution in a creditable manner.

When a loan application is under consideration, the primary questions are (1) the degree of certainty of repayment, and (2) whether the bank's income from the transaction will be sufficient in view of the degree of risk, the cost of servicing the loan, the availability of more attractive outlets for credit, and so on. The attitude of the bank examiner is an important factor only when some aspect of the loan is questionable.

If a proposed loan is sound and for a legitimate purpose, and the bank is not "overloaned" in relation to capital structure, character of management, and nature of the credits extended, the loan officer knows that there is no reason to anticipate adverse action by the bank examiner. If the individual loan is weak in some respect, or the bank's lending policy is unwise, such criticism can be anticipated; and to the extent that a tendency to extend unsound credits, whether to large or small concerns, is checked in this way, it is a highly desirable result.

In a relatively small number of cases a tendency of a lending officer to build up loan volume regardless of an excessive risk element may be held in check by a realization that the character of his operations will come to the attention of the board of directors through adverse comments in the bank examiner's report.

The notion that bank credit is withheld in many meritorious cases because of restraining instructions from bank examiners, or fear of adverse criticism by them, has gained currency from a practice which probably is as old as the institution of governmental bank examination. Particularly in smaller cities and towns, some bankers are reluctant to incur the danger of community ill-will which may follow from rejection of a loan application and the resulting antagonism of the would-be borrower. This antagonism can be avoided, in some cases, by telling the applicant that the rejection is not due to any lack of confidence in his financial or moral responsibility or judgment, but is due to the instructions or unduly repressive attitude of the bank examiners.

For this reason, a relatively small number of bankers, unwilling to extend credit because the loan would be a weak one for some reason, prefer to tell the applicant that the bank would be glad to make the loan, but that it is prevented from doing so by the supervisory authorities. This very human desire to shift the onus, although not straightforward or courageous, is relatively harmless, unless it leads to unwise legislation or other action based on the false idea that bank supervision prevents American banking from doing its job properly.

As pointed out in our answer to question 21, American banking has developed a number of techniques within the past 20 years which facilitate the making of certain classes of loans in situations that formerly would not have been considered suitable for bank credit. Bank examiners have attempted to keep abreast of these developments, and have rarely criticized their use in appropriate cases. On the other hand, our answer to question 21 also points out that in certain fields, particularly some types of manufacturing enterprise, there is today relatively less opportunity for small business than was the case 25 years ago. This condition, however, has resulted from general industrial developments, rather than from changes in the purposes or attitudes of the Nation's banks.

In conclusion, we believe that, with insignificant exceptions, whatever difficulties are being encountered by small business in financing itself are not due to failure of banks to extend needed and deserved credit or to an adverse attitude on the part of bank supervisors.

APPENDIX TO CHAPTER VI

Questions Addressed to the Comptroller of the Currency

A. GENERAL PURPOSES OF OFFICE

1. Describe briefly the functions and mode of operation of your office.

2. Describe the nature of the supervision exercised through examinations of banks by your office. Specify the basic purpose or purposes of examination, and the principles which guide your examiners.

Distinguish between bank examination and bank audit, as evidenced by the methods followed by your examiners in their work.

3. What directives, if any, have been given to your office by Congress with respect to the economic objectives which it should seek to further in its operations? Cite appropriate statutes.

4. What weight do you give in the conduct of your office to the congressional declaration of policy contained in the Employment Act of 1946, where it is stated:

> The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, *to coordinate and utilize all its plans, functions, and resources* for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power. [Italics supplied.]

Do you believe it would be desirable that Congress give your office a more specific directive that it should govern its activities, wherever practicable, in the light of the general objectives of economic stability and high-level employment? If not, are there any other economic directives which you would consider desirable?

5. What do you believe to be the role of bank examination in furthering the objectives of the Employment Act?

6. In what ways, if any, other than through bank examination, does your office endeavor to further the objective of economic stabilization?

7. What use do you make of the results of economic analysis in the conduct of your office?

B. RELATIONSHIP TO THE GOVERNMENT

8. To what extent does your office operate under the direction of the Secretary of the Treasury? Discuss in the light of both the statute and customary usage.

9. Does your office operate under the direction of the President except as this direction is exercised through the Secretary of the Treasury?

10. Describe the relationships, from your point of view, among the three Federal bank supervisory agencies. To what extent is there coordination of policies and procedures, and how is such coordination brought about? To the extent that policy conflicts arise, how are such conflicts resolved at the present time?

11. Does your office follow the practice of submitting its proposed reports to Congress on pending legislation to the Bureau of the Budget to determine whether or not they are in accordance with the program of the President? If it submits some, but not all of such reports, what are the criteria by which those submitted are selected? Does the Bureau of the Budget submit proposed reports of other agencies of the Government to the Comptroller's office for comment?

12. Do you have any suggestions for legislation relative to your office?

C. INCOME AND EXPENSES OF THE COMPTROLLER'S OFFICE

13. What has been the income of your office in each year since 1933? Classify this income in any way which you believe will be helpful to the committee.

14. What have been the expenses of your office in each year since 1933? Classify the expenses in any way which you believe will be helpful to the committee. Relate the administrative expenses of the office to (i. e., express them as percentages of):

(*a*) The gross national product of the United States, and

(*b*) The expenses of all national banks.

(The purpose of these comparisons is to "deflate" the expenses of the office by factors which measure its workload in a rough manner and automatically reflect changes in the price level.)

15. Describe the budgetary procedure of your office. Is its budget reviewed by the Bureau of the Budget? Are changes in its budget made by the Bureau binding upon your office? How are its expenditures subject to congressional control? What suggestions, if any, do you have for changes in any of the procedures described in this question?

16. Are the accounts of your office audited by any other department or instrumentality of the United States Government? If so, by whom? Are the powers of the auditing authority limited to reporting or does it have authority to disallow expenses? To whom are the reports of the auditing authority sent?

17. List and discuss any expenses which have been incurred by your office during the period since 1946 for the purpose of influencing public opinion on controversial matters. Expenses for the preparation of material in standard expository format and for the distribution or presentation of such material in written or oral form to persons who might be expected to have a regular business or professional interest in it may be omitted. Any expenses during this period for the preparation of motion pictures, illustrated brochures or any other special material should be included, however, irrespective of your personal opinion as to whether or not the material they contain is controversial in character, in order that the subcommittee may, if it desires, consider them on a case-by-case basis.

D. THE BANKING STRUCTURE

18. Will you please submit a memorandum discussing the adequacy of banking facilities in the United States? For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities.

19. Discuss in general your policy in acting on applications for new national bank charters. Stress your concept of what constitutes ample banking facilities—especially the degree of competition which you believe to be necessary or desirable.

20. Submit a statistical analysis showing year by year for the past 10 years the number of applications filed for national-bank charters,

branch permits, authority to convert into a national bank, and authority to consolidate. State the number of such applications approved, the number rejected and the causes for rejection, classified by such principal reasons as (*a*) existence of ample banking facilities, (*b*) no prospect of successful financial operation, (*c*) inadequate capital for the establishment of the bank or branch, (*d*) no satisfactory evidence that competent management would be available, etc. Submit also statistics with respect to voluntary liquidations of national banks. Comment on this analysis in any manner which you consider appropriate.

E. AVAILABILITY OF CAPITAL FOR SMALL BUSINESS

21. Discuss the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred? Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

22. Discuss the effects of bank examinations on the lending policies of banks, particularly as they apply to loans to small-business men. Distinguish if necessary between examinations by different examining authorities.

CHAPTER VII

REPLY BY MAPLE T. HARL, CHAIRMAN OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

A. GENERAL PURPOSES OF THE CORPORATION

1. Describe briefly the functions and mode of operation of your Corporation.

The function of the Federal Deposit Insurance Corporation, as stated in section 1 of the Federal Deposit Insurance Act of 1950, is to insure the deposits of banks entitled to such benefits under the act. This law provides a maximum coverage of $10,000 for each depositor. The benefits of the act are extended: (*a*) to all banks, both National and State, that are members of the Federal Reserve System (required to be insured); and (*b*) to banks of deposit incorporated under State law, including the law of any Territory, Puerto Rico, the Virgin Islands, and the District of Columbia, which are not members of the Federal Reserve System (approved for insurance by the Board of Directors of the Corporation after considering factors enumerated in the deposit insurance law).

The Corporation discharges its responsibilities through its Board of Directors and the appointed officers. Operations are conducted through several divisions. The Executive Division consists of a Secretary of the Corporation and special assistants to the directors, including the necessary staff. The Treasurer of the Corporation heads the Division of Finance and Accounts. The other divisions are as follows: Examination, Service, Research and Statistics, Legal, Audit, Liquidation, and Personnel.

Recommendations with respect to corporate action are prepared in the appropriate division and most of them are reviewed by committees before presentation to the Board of Directors for formal action. These committees typically consist of one director of the Corporation, special assistants to the directors, and representatives of various divisions.

The Corporation has two principal committees: (1) The Board of Review which considers recommendations submitted by the Division of Examination relative to applications from banks for insurance, retirement of capital, establishment of branches, and other similar purposes; and (2) the Committee on Liquidations, Loans, and Purchases of Assets which considers recommendations from the Division of Examination relative to loans or purchases of assets from banks and recommendations from the Division of Liquidation relative to such activities. Other committees include a committee on assessments, a committee on administration, and a special committee which considers matters that are not within the scope of the regular committees.

2. What directives, if any, have been given to your Corporation by Congress with respect to the economic objectives which it should seek to further in its operations? Cite appropriate statutes.

The purpose of the Federal Deposit Insurance Act of 1950 is to protect depositors in the insured banks. The Congress has set out to achieve this major "economic objective" by creating the Corporation and giving it the necessary powers and responsibilities. Since the Federal Deposit Insurance Act of 1950 is the only statutory directive which the Corporation has from the Congress, this act embodies all of the directives "with respect to the economic objectives which it should seek to further in its operations."

3. What weight do you give in the conduct of your Corporation to the congressional declaration of policy contained in the Employment Act of 1946, where it is stated:

> The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, *to coordinate and utilize all its plans, functions, and resources* for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power. (Italics supplied.)

Do you believe it would be desirable that Congress give your Corporation a more specific directive that it should govern its activities, wherever practicable, in the light of the general objectives of economic stability and high-level employment? If not, are there any other economic directives which you would consider desirable?

The principal purposes of Federal deposit insurance are to protect depositors, to maintain the confidence of depositors in banks, to raise standards of bank management, increase the soundness of the banking system, and to aid in protecting the circulating medium. The accomplishment of these purposes contributes to economic and financial stability and thus serves to further the purposes of the Employment Act of 1946.

Inasmuch as all the powers and duties of the Corporation are in conformity with the declaration of policy contained in the Employment Act of 1946, we do not see any advantage in a specific directive by the Congress that the Corporation "should govern its activities, wherever practicable, in the light of the general objectives of economic stability and high-level employment." Nor is there any other economic directive which we would consider desirable for insertion in the Federal Deposit Insurance Act.

B. ORGANIZATION OF THE CORPORATION AND ITS RELATIONSHIP TO GOVERNMENT

4. What is the responsibility of your Corporation to the President?

The management of the Federal Deposit Insurance Corporation is vested in a Board of Directors consisting of three members, one of

whom is the Comptroller of the Currency, and two of whom are appointed by the President, by and with the advice and consent of the Senate, for terms of 6 years. One of the appointive members, designated by the Board of Directors, acts as its Chairman and presides at all its meetings. The Board of Directors is responsible for the performance of all duties, and exercises all powers, vested by law in the Corporation. The Board of Directors has assigned certain functions to the several officers, committees, and divisions of the Corporation for the performance of which they are responsible to the Board.

The Corporation submits a report to the Congress on its operations as soon as practicable after the first day of January each year. This report covers all phases of the Corporation's activities. It stresses developments in banking which may be of concern to deposit insurance.

5. Can any policy conflicts between your Corporation, other Government agencies and the Federal Reserve System always be resolved in the last resort by the President (*a*) insofar as action by your Corporation is required, (*b*) insofar as action by other Government agencies is required, and (*c*) insofar as action by the Federal Reserve System is required? Do you believe that the President should be empowered to resolve all such conflicts, if this is not at present the case? If you do not believe that the President has or should have such power, what means of resolving policy conflicts would you suggest?

The functions of the Federal Deposit Insurance Corporation which are related to those performed by the Federal Reserve System and other Government agencies pertain principally to the examination of banks, the collection of reports from banks, and the publication of bank statistics. Coordination of policy and work in these fields has been achieved by consultations among officials and staff members of the agencies. Since coordination is already achieved and we are not involved in any policy conflicts, we have no comments or suggestions to offer in this connection. Insofar as the Federal Deposit Insurance Corporation is concerned, we do not believe that any additional power by the President to resolve policy conflicts is required.

6. Does the Federal Deposit Insurance Corporation follow the practice of submitting its proposed reports to Congress on pending legislation to the Bureau of the Budget to determine whether or not they are in accordance with the program of the President? If it submits some, but not all of such reports, what are the criteria by which those submitted are selected? Does the Bureau of the Budget submit proposed reports of other agencies of the Government to the Federal Deposit Insurance Corporation for comment?

The Corporation follows the general practice of submitting proposed recommendations to the Congress to the Bureau of the Budget to determine whether they are in accordance with the program of the President. This applies to recommendations originating within the Corporation and to requests by congressional committees or Members of Congress for an expression of opinion by the Corporation on proposed legislation. When a request for the opinion of the Corporation

calls for a reply so quickly that submission to the Bureau of the Budget before making the reply is impractical, the Corporation responds directly. In this circumstance, a statement to this effect is made in the reply, and a copy of the reply is sent to the Bureau of the Budget.

The Bureau of the Budget submits to the Corporation for comment proposed reports of congressional committees and other agencies of the Government when the Corporation is deemed to be affected thereby.

7. Do you have any suggestions for legislation relative to your office?

The Corporation has no suggestions with respect to such legislation.

C. EARNINGS AND EXPENSES OF THE CORPORATION

8. What have been the earnings of your Corporation in each year since its organization? Classify earnings by (*a*) net proceeds of deposit-insurance assessments, (*b*) interest on funds arising from accumulated deposit-insurance assessments, and (*c*) other. Eliminate earnings arising from interest on Government capital.

The earnings of the Corporation for each year since its organization, classified in accordance with the above request, are given in table 1.

TABLE 1.—*Income of the Federal Deposit Insurance Corporation, 1933–50, excluding interest on Government capital*

[In millions of dollars]

Calendar year	Income, excluding interest on Government capital			
	Total	Deposit-insurance assessments	Interest on funds arising from assessments [1]	Other
1933–50	$1,301.0	$1,078.2	$186:1	$36.7
1950	84.6	54.0	30.6	----------
1949	148.3	119.8	28.5	----------
1948	146.2	119.3	23.8	3.1
1947	152.9	114.4	20.0	18.5
1946	125.1	107.1	17.8	.2
1945	115.4	93.7	14.3	7.4
1944	93.7	80.9	11.8	1.0
1943	80.9	70.0	8.9	2.0
1942	63.6	56.5	6.7	.4
1941	56.2	51.4	4.8	----------
1940	50.1	46.2	3.5	.4
1939	45.4	40.7	3.4	1.3
1938	42.0	38.3	3.6	.1
1937	42.3	38.8	3.3	.2
1936	38.0	35.6	2.4	----------
1935	14.9	11.5	2.3	1.1
1933–34	1.4	(2)	.4	1.0

[1] This Corporation has never segregated "interest on funds arising from accumulated deposit-insurance assessments" from "earnings arising from interest on Government capital." Therefore, any allocation of interest earned must be based upon arbitrary determinations. In order to eliminate "interest on Government capital" for this report, it was computed at the rate of interest specified by the Congress in section 13 (f) of the Federal Deposit Insurance Act as the rate of return to be paid on capital stock during the time such stock was outstanding. "Interest on funds arising from assessments" consists of all interest earned on U. S. Government obligations owned, after deducting provision for amortization of premiums, plus interest and allowable return received on funds advanced to protect depositors in insured banks, minus "interest on Government capital" as computed for this report.

[2] Assessments collected from insured banks, members of the temporary insurance funds, were credited to their accounts in total at the termination of the temporary funds, and were applied toward payment of subsequent assessments becoming due under the permanent insurance fund, resulting in no income to the Corporation from assessments during the existence of the temporary insurance funds.

9. What have been the expenses of your Corporation in each year since its organization? Classify expenses as (*a*) administrative expenses, (*b*) liquidation expenses, and (*c*) deposit-insurance losses. Relate administrative expenses to (i. e., express them as percentages of): (*a*) the gross national product of the United States, and (*b*) the expenses of all insured banks.

Under the provisions of the Federal Deposit Insurance Act of 1950 all of the Corporation's expenses and deposit-insurance losses are recoverable from the assessment income. The expenses of the Corporation for each year since its organization, classified in accordance with the above request, are given in table 2.

The annual amount of administrative expenses of the Corporation per million dollars of gross national product of the United States and per million dollars of expenses of all insured banks are shown in table 3. Expressed as percentages, the administrative expenses of the Corporation have averaged less than three one-thousandths of 1 percent of "gross national product" and less than three-tenths of 1 percent of the current operating expenses of all insured banks.

TABLE 2.—*Expenses of the Federal Deposit Insurance Corporation, 1933–50, adjusted to Dec. 31, 1950*

[In millions]

Year	Total, excluding interest paid on capital stock	Administrative expenses	Liquidation expenses	Deposit-insurance losses [3]
1933–50	$97.4	$70.2	$0.41	$26.79
1950	7.7	6.4	.01	1.29
1949	6.4	6.1	.01	.29
1948	6.8	6.1	.01	.69
1947	5.6	5.5	.01	.09
1946	4.6	4.5	[2] .10	
1945	4.0	3.9	[2] .10	
1944	3.9	3.8	.02	.08
1943	4.5	4.3	.03	.17
1942	4.4	3.9	.05	.45
1941	4.3	3.7	.04	.56
1940	7.8	3.6	.01	4.19
1939	11.0	3.4		7.60
1938	5.4	3.0		2.40
1937	6.2	2.7	.01	3.49
1936	5.0	2.5	.01	2.49
1935	5.4	2.7		2.70
1933–34	4.4	[1] 4.1		.30

[1] Net after deducting the portion of expenses and losses charged to banks withdrawing from the temporary insurance funds on June 30, 1934.
[2] These figures used to round off to nearest $100,000. Actual liquidation expenses for these years amounted to approximately $10,000 each.
[3] Net after deducting profit on sales of and income derived from assets purchased to facilitate closing of liquidations.

TABLE 3.—*Ratios of administrative expenses of the corporation to gross national product of the United States and to the expenses of all insured banks*

Year	Administrative expenses of FDIC (in millions)	Gross national product [1] (in millions)	Current operating expenses of all insured banks [2] (in millions)	Amount of FDIC administrative expenses per million	
				Gross national product	Expenses of all insured banks
1933–50	$70.2	$2,741,823	$26,147.3	$26	$2,685
1950	6.4	282,630	2,560.0	23	2,500
1949	6.1	257,348	2,387.9	24	2,555
1948	6.1	259,045	2,264.3	24	2,694
1947	5.5	233,264	2,075.4	24	2,650
1946	4.5	211,110	1,848.1	21	2,435
1945	3.9	215,210	1,600.5	18	2,437
1944	3.8	213,688	1,443.3	18	2,633
1943	4.3	194,338	1,343.8	22	3,200
1942	3.9	161,551	1,246.6	24	3,129
1941	3.7	126,417	1,281.2	29	2,889
1940	3.6	101,443	1,209.9	35	2,975
1939	3.4	91,339	1,174.8	37	2,894
1938	3.0	84,683	1,170.8	35	2,562
1937	2.7	90,213	1,177.7	30	2,293
1936	2.5	82,483	1,137.9	30	2,197
1935	2.7	72,193	1,096.0	37	2,464
1934 [3]	4.1	64,868	1,129.1	(3)	(3)

[1] National Income and Product of the United States, 1929–50 (United States Department of Commerce, 1951), p. 151.
[2] Annual Reports of the Federal Deposit Insurance Corporation: 1950, pp. 250 and 272; and 1941, pp. 158 and 173.
[3] Administrative expenses of FDIC include expenses in 1933, and ratios are, therefore, not significant.

10. Present a statement of the expenses of your Corporation for each of the last 5 years, classified in such manner as will facilitate an analysis of your operations.

A classified statement of the expenses of the Corporation for each of the five calendar years 1946–50 is given in table 4.

TABLE 4.—*Expenses of the Federal Deposit Insurance Corporation, 1946–50, as adjusted Dec. 31, 1950*

Item	1950	1949	1948	1947	1946
Total losses and expenses	$7,758,599	$6,396,121	$6,734,365	$5,624,121	$4,535,234
Deposit-insurance losses and expenses	1,349,503	282,901	733,913	106,035	11,301
Operating expenses, total	6,409,096	6,113,220	6,000,452	5,518,086	4,523,933
Salaries	4,546,758	4,364,916	[1] 4,708,087	3,947,456	3,407,081
Professional services	21,443	21,876	3,579	42,212	6,918
Services of other governmental agencies	3,501	4,352	620	142	594
Transportation	227,159	213,077	165,627	160,588	132,815
Subsistence	951,380	815,069	545,701	511,880	424,199
Office rental	348,772	341,627	310,448	380,484	315,416
Printing, stationery, and supplies	156,424	143,443	136,452	132,293	82,438
Postage, telephone, and telegraph	42,486	40,796	41,403	72,905	62,183
Insurance and fidelity-bond premiums	5,411	6,826	5,487	2,971	937
Subscriptions	13,679	14,909	15,028	14,248	12,051
Equipment rental	22,406	21,760	15,983	16,941	10,117
Repairs and alterations	11,507	22,759	27,747	112,742	16,742
Transportation of things	9,635	15,413	14,472	84,928	13,904
Furniture, fixtures, and equipment	56,874	95,946	20,935	45,763	64,572
Miscellaneous	42,376	29,820	15,622	28,167	8,615
Less interdepartmental expense transfers and expense recoveries	50,715	39,369	26,739	35,634	34,649

[1] Includes $690,619 representing retroactive adjustment of expenses to take into the accounts for the first time the value of annual leave of employees which had accrued through Dec. 31, 1948.

11. Describe the budgetary procedure of the Federal Deposit Insurance Corporation. Is its budget reviewed by the Bureau of the Budget? Are changes in its budget made by the Bureau binding upon the Corporation? How are its expenditures subject to congressional control? What suggestions, if any, do you have for changes in any of the procedures described in this question?

The Federal Deposit Insurance Corporation controls its administrative expenses by means of an administrative expense budget which is submitted to the Bureau of the Budget for review. Thus far, any changes in the budget have been effected by mutual agreement between the Bureau of the Budget and the Corporation.

Congressional control of expenditures is maintained through the Federal Deposit Insurance Act, which provides for an annual audit of the Corporation by the Comptroller General. In this connection, the letter from the Comptroller General of the United States transmitting Report on the Audit of the Federal Deposit Insurance Corporation for the fiscal year ended June 30, 1950, contained the following statement:

> During our examination we observed no program, *expenditure*, or other financial transaction or undertaking which, in our opinion, was carried on or made without authority of law. [Italics supplied.]

We do not have any suggestions for improvement of the budgetary procedure of the Corporation.

12. Are the accounts of your Corporation audited by any other department or instrumentality of the United States Government? If so, by whom? Are the powers of the auditing authority limited to reporting or does it have authority to disallow expenses? To whom are the reports of the auditing authority sent?

The Federal Deposit Insurance Act, section 17(b), (c), and (d), provides for an audit each fiscal year of the accounts of the Corporation. The parts of this section that answer the question are as follows:

Section 17(b) provides that—

> The financial transactions of the Corporation shall be audited by the General Accounting Office in accordance with the principles and procedures applicable to commercial corporate transactions and under such rules and regulations as may be prescribed by the Comptroller General of the United States. * * *

Section 17(c) provides that—

> * * * The report to the Congress shall set forth the scope of the audit and shall include a statement of assets and liabilities and surplus or deficit; a statement of surplus or deficit analysis; a statement of income and expenses; a statement of sources and application of funds and such comments and information as may be deemed necessary to inform Congress of the financial operations and condition of the Corporation, together with such recommendations with respect thereto as the Comptroller General may deem advisable. The report shall also show specifically any program, expenditure, or other financial transaction or undertaking observed in the course of the audit which, in the opinion of the Comptroller General, has been carried on or made without authority of law. A copy of each report shall be furnished to the President, to the Secretary of the Treasury, and to the Corporation at the time submitted to the Congress.

13. List and discuss any expenses which have been incurred by your Corporation during the period since 1946 for the purpose of influencing public opinion on controversial matters. Expenses

for the preparation of material in standard depository format and for the distribution or presentation of such material in written or oral form to persons who might be expected to have a regular business or professional interest in it may be omitted. Any expenses during this period for the preparation of motion pictures, illustrated brochures, or any other special material should be included, however, irrespective of your personal opinion as to whether or not the material they contain is controversial in character, in order that the subcommittee may, if it desires, consider them on a case-by-case basis.

The Corporation has incurred no expenses since 1946 for the purpose of influencing public opinion on controversial issues.

D. DEPOSIT INSURANCE

14. Present the latest available data with respect to the number of banks which are members and the number which are not members of the Federal Deposit Insurance Corporation, the amount of deposits in each such class of banks, and the number and proportion of accounts and of deposits, respectively, in insured banks which are fully covered by deposit insurance. Please present the data for mutual savings banks and for other banks separately.

Table 5 gives the number and deposits of insured and noninsured banks on June 30, 1951, the latest date for which the amount of deposits is available. Data are given separately for (*a*) commercial and stock savings banks, (*b*) mutual savings banks, and (*c*) trust companies engaged in general fiduciary business but not regularly engaged in deposit banking.

Table 6 shows for September 30, 1949, the number and proportion of accounts in insured banks with balances of not more than $10,000, which would have been fully protected by deposit insurance under the $10,000 limitation, had that been the insurance maximum. The table also shows the amount of deposits in those accounts, and the insured and uninsured portions of deposits in larger accounts. Data regarding insurance coverage for a more recent date, September 19, 1951, are now being tabulated.

TABLE 5.—*Number and deposits of insured and noninsured operating banks, June 30, 1951*

Number or amount	All banks	Commercial banks [1]	Mutual savings banks	Trust companies not regularly engaged in deposit banking [2]
Number of banks, total	14,681	14,082	529	70
Insured banks	13,652	13,445	201	6
Noninsured banks	1,029	637	328	64
Amount of deposits (in millions), total	$172,680	$152,203	$20,404	$73
Insured banks	164,608	149,683	14,924	1
Noninsured banks	8,072	2,520	5,480	72

[1] Includes stock savings banks.
[2] Deposits of these companies represent uninvested trust funds and special accounts.

TABLE 6.—*Accounts and deposits, banks insured by Federal Deposit Insurance Corporation, Sept. 30, 1949*

Number or amount	Number or amount			Percent of total		
	All insured banks	Commercial banks	Mutual savings banks	All insured banks	Commercial banks	Mutual savings banks
Number of accounts (in thousands), total	104,003	91,452	12,551	100.0	100.0	100.0
Not over $10,000	102,559	90,044	12,515	98.6	98.5	99.7
Over $10,000	1,444	1,408	36	1.4	1.5	.3
Amount of deposits (in millions), total	$152,667	$139,252	$13,415	100.0	100.0	100.0
Accounts not over $10,000 (fully protected)	71,845	58,914	12,931	47.1	42.3	96.4
Insured portion of accounts over $10,000	14,442	14,085	357	9.4	10.1	2.7
Uuinsured portion of accounts over $10,000	66,380	66,253	127	43.5	47.6	.9

15. Present the data, as far as they are available, year by year since the establishment of the Corporation, showing the total amount of deposits in all insured banks, the amount of insured deposits, the amount of the insurance fund, and the ratio which the insurance fund bears to total deposits and to insured deposits, respectively.

Table 7 gives the estimated amount of insured deposits in all insured banks, together with the amount of the insurance fund and the ratio of the fund to such deposits, for the close of each year since the beginning of deposit insurance by the Corporation.

TABLE 7.—*Relation of the Deposit Insurance Fund to the deposits of insured banks* [1]

Dec. 31	Deposits in insured banks (in millions)		Deposit insurance fund (in millions)	Ratio of deposit insurance fund to—	
	Total	Insured [2]		Total deposits	Insured deposits
				Percent	*Percent*
1950	$167,818	$93,498	$1,243.9	0.74	1.33
1949	156,786	76,589	1,203.9	.77	1.57
1948	153,454	75,320	1,065.9	.69	1.42
1947	154,096	76,254	1,006.1	.65	1.32
1946	148,457	73,759	1,058.5	.71	1.44
1945	158,174	67,021	929.2	.59	1.39
1944	134,662	56,398	804.3	.60	1.43
1943	111,650	48,440	703.1	.63	1.45
1942	89,869	32,837	616.9	.69	1.88
1941	71,209	28,249	553.5	.78	1.96
1940	65,288	26,638	496.0	.76	1.86
1939	57,485	24,650	452.7	.79	1.84
1938	50,791	23,121	420.5	.83	1.82
1937	48,228	22,557	383.1	.79	1.70
1936	50,281	22,330	343.4	.68	1.54
1935	45,125	20,158	306.0	.68	1.52
1934	40,060	18,075	291.7	.73	1.61

[1] Annual Report of the Federal Deposit Insurance Corporation, 1950, p. 29.
[2] Estimated. For method, see Annual Report of the Corporation for 1949, p. 61. Amount for 1950 with $10,000 maximum per depositor; for other years with $5,000 maximum per depositor.

16. Describe the alternative techniques available under present law for the protection of depositors in failed or insolvent banks. Discuss the criteria by which the Corporation selects the manner in which it will handle each case. Do you consider it an element of potential inequity that some techniques result in the protection of all deposits while other techniques provide only for the protection of deposits up to $10,000?

The Federal Deposit Insurance Act of 1950 provides three general methods or techniques for the protection of depositors in failed or insolvent banks:

(1) Under the receivership method, the Corporation pays to each depositor of an insured bank which has been closed on account of inability to meet the demands of its depositors, the amount of each depositor's claim to a maximum of $10,000 as soon as the claim has been verified. The payment may be in cash or in the form of a deposit payable on demand transferred to another insured bank, or as a deposit in a new bank in the same community. If the Corporation finds it advisable, it may organize a new national bank to assume the insured deposits of the closed bank. A period of 2 years is provided by statute for disposing of the affairs of such a national bank.

(2) Section 13 (c) of the act provides that:

> In order to reopen a closed insured bank or, when the Corporation has determined that an insured bank is in danger of closing in order to prevent such closing, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community. Such loans and deposits may be in subordination to the rights of depositors and other creditors.

(3) The Corporation may provide financial aid to facilitate a merger or a consolidation of an insured bank in financial difficulty with another insured bank. According to section 13 (e) of the act:

> Whenever in the judgment of the Board of Directors such action will reduce the risk or avert a threatened loss to the Corporation and will facilitate a merger or consolidation of an insured bank with another insured bank, or will facilitate the sale of the assets of an open or closed insured bank to and assumption of its liabilities by another insured bank, the Corporation may, upon such terms and conditions as it may determine, make loans secured in whole or in part by assets of an open or closed insured bank, which loans may be in subordination to the rights of depositors and other creditors, or the Corporation may purchase any such assets or may guarantee any other insured bank against loss by reason of its assuming the liabilities and purchasing the assets of an open or closed insured bank. * * *

The Federal Deposit Insurance Act of 1950 specifies the circumstances wherein certain methods are appropriate for aiding depositors in failed and insolvent banks. A formula to determine applicability does not accompany each method. Nor does the act furnish any specific criteria for selecting the appropriate method. However, in exercising the discretion authorized by law, the Board of Directors assembles and takes into consideration all of the pertinent facts and circumstances available at the time of decision. For example, if a careful study of the total situation is convincing to the Board of Directors that the continued operation of an insured bank in difficulties is essential to provide adequate banking services in the community,

then the Board may exercise its statutory discretion and rehabilitate the bank. Likewise, action to facilitate the merger or consolidation of an insured bank with another insured bank is an appropriate method for protecting depositors whenever the available facts support the judgment of the Board of Directors that such action will reduce the risk or avert a threatened loss to the Corporation.

When the Corporation pays depositors in a closed insured bank (a receivership case), protection is limited to a maximum of $10,000 for each depositor. By contrast, the rehabilitation of an insured bank in financial difficulties or its merger or consolidation with another insured bank results in the protection of all deposits. Thus, there is in fact a difference in the amount of protection afforded depositors under these alternatives which is an incident of the Federal Deposit Insurance Act of 1950 and inherent in its provisions. The same was true under the Banking Act of 1935 which established the first permanent Federal deposit insurance law.

17. State for each year since the establishment of the Corporation the number and amount of liabilities of failed and insolvent banks which have been handled in accordance with each of the techniques discussed in the preceding question.

Table 8 gives the number and liabilities of failed and insolvent banks handled by the receivership and absorption methods, respectively, in each year since establishment of the Corporation. Deposits are included in liabilities.

TABLE 8.—*Protection of depositors by Federal Deposit Insurance Corporation—Number and liabilities of failed and insolvent banks, 1934–50*

[Amounts in thousands of dollars]

Year	Total number of banks [1]	Placed in receivership		Absorbed with financial aid of FDIC	
		Number [1]	Liabilities [2]	Number [1]	Liabilities [2]
1934–50	415	245	$119,725	170	$425,369
1950	4			4	5,964
1949	4			4	4,983
1948	3			3	10,455
1947	5			5	6,966
1946	1			1	316
1945	1			1	5,695
1944	2	1	456	1	1,459
1943	5	4	6,651	1	5,898
1942	20	6	1,817	14	17,195
1941	15	8	15,028	7	15,048
1940	43	19	6,113	24	136,890
1939	60	32	37,447	28	125,719
1938	74	50	11,509	24	49,597
1937	75	50	16,093	25	18,648
1936	69	42	11,335	27	16,307
1935	25	24	11,203	1	4,229
1934	9	9	2,073		

[1] Annual Report of Federal Deposit Insurance Corporation for 1950, p. 278.
[2] Annual Report of Federal Deposit Insurance Corporation for 1950, pp. 278 and 280. Does not include any portion of capital accounts.

18. Discuss the advantages and disadvantages of extending the coverage of deposit insurance to all deposits in insured banks. In your discussion, stress the role of deposit insurance in contributing to economic stability.

In August 1949, a Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, among other questions, asked us what would be the advantages and disadvantages of providing full insurance coverage of all deposits in insured banks. At that time we stated:

Those who favor changing the law to provide full insurance coverage for deposits have advanced the following arguments:

1. Approximately 50 percent of dollar amount of deposits are insured under present statutory limitations. If deposit insurance covering 50 percent of deposits is desirable and necessary, 100-percent insurance would be more effective and would result in a more complete fulfillment of the purposes of deposit insurance.

2. The present deposit insurance limit of $5,000 results in most of the larger deposits going to the big banks. Full insurance coverage would result in smaller banks getting more of deposits in excess of $5,000.

3. Due to the preponderance of large accounts in big banks, the proportion of insured deposits is relatively low. Since assessments are based on total deposits, it is claimed that the big banks carry more than a proportionate share of the costs of deposit insurance. The redistribution of deposits resulting from 100-percent insurance would shift some of the burden of deposit insurance protection from the big to the small banks.

4. In most cases of insured banks in difficulty, the Federal Deposit Insurance Corporation, under its merger procedure, protects all depositors in full, so why not require insurance protection in full by law and thus take full advantage of the psychological benefits of 100-percent insurance.

Those who do not favor changing the law to provide for full insurance for deposits give the following reasons in support of their view:

1. Full insurance coverage would necessitate the imposition of greater controls over the banking industry which would narrow the area of managerial decision by individual banks. It is questionable just how much more control can be imposed on the present free-enterprise system of banking without stifling it. Somewhere in the process of increasing controls, the point would be reached where the controls would do death to the system. Since this point cannot be ascertained by hypothetical means, this hazard to the free-enterprise system of banking must be taken into account when considering full deposit insurance coverage.

2. Full insurance coverage would destroy the influence for sound banking which is now exerted upon bank management by large depositors. This result, commonly called placing a premium on bad banking, would have a decidedly unfavorable effect upon banking practices in that it would break down bank-management standards developed to their present high quality over the past 15 years.

3. There is no satisfactory assurance that the insurance fund is adequate to provide full insurance protection.

4. Deposit insurance has achieved in full the objectives established for it and has functioned effectively during its entire existence. It is true that the Corporation has not faced a period of serious trouble in the banking system. However, deposit insurance was designed to aid in preventing severe financial crises and its effective functioning and the improvements and reforms in the banking and monetary system made in 1933–35 have greatly lessened the possibility of recurrence of such conditions. In view of the 15 years of successful deposit-insurance operations, it would be illogical to make such a drastic change based purely on speculation as to the necessity for and the results of such a change.

On balance, we do not favor amending the deposit-insurance law to provide full insurance for deposits as the disadvantages, in our opinion, substantially outweigh the advantages.

In the Federal Deposit Insurance Act of 1950, the Congress increased deposit insurance coverage from $5,000 to $10,000. We are

of the opinion that the Corporation under the present insurance coverage is making a maximum contribution to economic stability and there would be no benefit to be gained in extending the coverage of deposit insurance to all deposits in insured banks.

E. BANK EXAMINATION

19. What do you believe to be the role of bank examination and supervision in furthering the objectives of the Employment Act?

The role of bank examination and supervision is to see that banks are operated along sound management lines with primary thought to the full protection of their creditors and at the same time without imposing restrictions that may prevent banks from taking care of the legitimate credit needs of their respective communities. As a matter of course, bank examiners are required to see that banks subject to their supervision show proper respect for the limitations of the laws from which they derive their charters.

It is sometimes argued that bank examination and supervisory policies, in order to further the objectives of the Employment Act, should be an adjunct to the general credit or monetary policy of the Government. We do not believe that this is a proper function of bank examinations. Bankers and bank examiners, in appraising the quality of assets and the general condition of the bank, must have standards which are consistently maintained.

To attempt to use bank examinations for implementation of monetary policy would destroy the usefulness of bank examining procedures as a method of preventing the accumulation by banks of unsound or undesirable assets. Use of varying standards in evaluating assets would destroy the confidence of bankers and of officials of the Corporation in the results of bank examinations.

F. RESERVE REQUIREMENTS

20. Discuss the function of bank reserve requirements, stressing their role in credit control. What are the arguments for and against subjecting all insured banks to the same reserve requirements as member banks of the Federal Reserve System?

The function of bank reserve requirements is now, and for many years has been, control or at least strong influence upon the total volume of bank credit available for use as circulating medium. Percentage reserve requirements together with the amount of reserves available to the banks are by far the most important limitation upon the amount of bank deposits and hence upon bank loans and investments.

As a matter of practical operation of the banking system it is comparatively unimportant whether the reserve requirements of member banks of the Federal Reserve System are imposed upon other banks of deposit. The assets and deposits of the banks which are members of the Federal Reserve System are so large a part of the assets and deposits of all banks that little would be gained in the field of credit control by taking from the States their prerogative to establish the reserve requirements of the nonmember banks.

The various States had legal reserve requirements for their banks long before the Federal Reserve System was established. They have

continued to require legal reserves for nonmember banks, and in some States the requirements are equal to or greater than those of the Federal Reserve.

G. THE BANKING STRUCTURE

21. Will you please submit a memorandum discussing the adequacy of banking facilities in the United States? For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities.

It is doubtless true that the ideal banking situation would be to have "banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks." We believe that the extent to which this ideal is realized can best be determined by economic forces operating in a dual system of free-enterprise banking. That is to say, the practical interpretation of what constitutes need can best be measured by the willingness of individuals to supply capital for new or additional banking facilities. Communities in which a bank can be operated profitably are not long without banking facilities. The dual system of banking permits the organizer of a bank to apply either for a national or for a State charter.

Several States permit extensive branch banking, which may place banking facilities, particularly deposit facilities, within convenient reach of more people. Other States permit limited branch banking, and still others prohibit branch banking of any kind whatsoever. It is our belief that each State should retain the right to decide for itself whether or not the advantages to be gained from branch banking offset the disadvantages.

H. AVAILABILITY OF CAPITAL FOR SMALL BUSINESS

22. Discuss the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred? Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

We have no objective data which indicate the changes during the last quarter of a century in the ease or difficulty with which business-men can borrow or raise capital. The following comments are based upon our experience examining insured banks not members of the Federal Reserve System during the 18 years the Federal Deposit Insurance Corporation has been in operation. The banks we examine,

for the most part, are small institutions as shown by the fact that they constitute about half the insured banks, but have less than 15 percent of the deposits. These relatively small banks deal with small-business men, and, therefore, our observations on their behavior seem particularly applicable.

It was our experience that small-business men had great difficulties in the 1930's in obtaining bank loans relative to the ease with which they can be obtained today. In recent years banks have been eager to make loans and have had more funds available or readily obtainable for making loans than was the case when we first began examining banks.

During the past 18 years bank management has steadily improved. Bankers are more careful now than formerly to obtain statements of the financial condition of applicants for loans and review with more care the risk of the projects for which loans are desired. Accompanying this improvement in bank management, and probably influenced by it, management practices of small-business men have also been steadily improving. Therefore, small-business men whose affairs are in good financial shape have less difficulty now than they did during the 1930's in obtaining local bank loans. On the other hand, small-business men with their affairs in poor shape may have more difficulty in obtaining bank loans now than at that time.

It is our belief that the dual system of free enterprise banking has diffused economic power and stimulated the dynamic character of our economy. Under this system, the supply of credit available to a business enterprise, whether large or small, is determined by the free play of economic forces. We believe this is sound policy. Accordingly, our only suggestion as to the steps that should be taken to bring about a more liberal supply of bank credit to small-business men is to continue to work for adequately capitalized individual banks and a strong dual system of free enterprise banking.

In connection with these observations with respect to the availability of bank credit for small-business men, there are two special situations worthy of note. In the first place, during the current national emergency, study of the facts may reveal that special arrangements are necessary in order to finance small firms that are called upon to make a contribution to the defense effort. For example, some individual may be obliged to increase his scale of operations greatly or to embark upon a new line of activity. The customary bank credit available to such an individual may not be sufficient to meet the exceptional situation. Thus, to insure that the defense program will be facilitated, special arrangements for financing may be necessary.

The need for long-term or capital financing rather than short-term bank credit is the second apparent exception to the general observation that the banking system now furnishes an adequate supply of credit to small-business men. It has long been recognized that small-business men frequently need a type of financing which cannot be supplied appropriately by commercial banks, namely, equity capital or long-term loans. To expect the commercial banking system to extend this type of credit would call for a departure from sound banking practices.

23. Discuss the effects of bank examinations on the lending policies of banks, particularly as they apply to loans to small-business men. Distinguish if necessary between examinations by different examining authorities.

The viewpoint of the Corporation is that one of the basic functions of banks is to meet the loan needs of individuals and business enterprises in the communities in which the banks are located, irrespective of the size of the borrower. Our examiners are fully aware of this policy. In carrying out this principle, our examiners make no distinction between small and large business enterprises.

We have observed no disparity between the examinations by the different examining authorities with respect to the effect of examinations on the lending policies of banks.

APPENDIX TO CHAPTER VII

Questions Addressed to the Chairman of the Federal Deposit Insurance Corporation

A. GENERAL PURPOSES OF THE CORPORATION

1. Describe briefly the functions and mode of operation of your Corporation.

2. What directives, if any, have been given to your Corporation by Congress with respect to the economic objectives which it should seek to further in its operations? Cite appropriate statutes.

3. What weight do you give in the conduct of your Corporation to the congressional declaration of policy contained in the Employment Act of 1946, where it is stated:

> The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, *to coordinate and utilize all its plans, functions, and resources* for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power. [Italics supplied.]

Do you believe it would be desirable that Congress give your Corporation a more specific directive that it should govern its activities, wherever practicable, in the light of the general objectives of economic stability and high-level employment? If not, are there any other economic directives which you would consider desirable?

B. ORGANIZATION OF THE CORPORATION AND ITS RELATIONSHIP TO GOVERNMENT

4. What is the responsibility of your Corporation to the President?

5. Can any policy conflicts between your Corporation, other Government agencies and the Federal Reserve System always be resolved in the last resort by the President (*a*) insofar as action by your Corporation is required, (*b*) insofar as action by other Government agencies is

required, and (c) insofar as action by the Federal Reserve System is required? Do you believe that the President should be empowered to resolve all such conflicts, if this is not at present the case? If you do not believe that the President has or should have such power, what means of resolving policy conflicts would you suggest?

6. Does the Federal Deposit Insurance Corporation follow the practice of submitting its proposed reports to Congress on pending legislation to the Bureau of the Budget to determine whether or not they are in accordance with the program of the President? If it submits some, but not all of such reports, what are the criteria by which those submitted are selected? Does the Bureau of the Budget submit proposed reports of other agencies of the Government to the Federal Deposit Insurance Corporation for comment?

7. Do you have any suggestions for legislation relative to your office?

C. EARNINGS AND EXPENSES OF THE CORPORATION

8. What have been the earnings of your Corporation in each year since its organization? Classify earnings by (a) net proceeds of deposit insurance assessments, (b) interest on funds arising from accumulated deposit insurance assessments, and (c) other. Eliminate earnings arising from interest on Government capital.

9. What have been the expenses of your Corporation in each year since its organization? Classify expenses as (a) administrative expenses, (b) liquidation expenses, and (c) deposit insurance losses. Relate administrative expenses to (i. e., express them as percentages of):

(a) The gross national product of the United States, and
(b) The expenses of all insured banks.

(The purpose of these comparisons is to "deflate" the expenses of the Corporation by factors which measure its workload in a rough manner and automatically reflect changes in the price level.)

10. Present a statement of the expenses of your Corporation for each of the last 5 years, classified in such manner as will facilitate an analysis of your operations.

11. Describe the budgetary procedure of the Federal Deposit Insurance Corporation. Is its budget reviewed by the Bureau of the Budget? Are changes in its budget made by the Bureau binding upon the Corporation? How are its expenditures subject to congressional control? What suggestions, if any, do you have for changes in any of the procedures described in this question?

12. Are the accounts of your Corporation audited by any other department or instrumentality of the United States Government? If so, by whom? Are the powers of the auditing authority limited to reporting or does it have authority to disallow expenses? To whom are the reports of the auditing authority sent?

13. List and discuss any expenses which have been incurred by your Corporation during the period since 1946 for the purpose of influencing public opinion on controversial matters. Expenses for the preparation of material in standard depository format and for the distribution or presentation of such material in written or oral form to persons who might be expected to have a regular business or professional interest in it may be omitted. Any expenses during this pe-

riod for the preparation of motion pictures, illustrated brochures, or any other special material should be included, however, irrespective of your personal opinion as to whether or not the material they contain is controversial in character, in order that the subcommittee may, if it desires, consider them on a case-by-case basis.

D. DEPOSIT INSURANCE

14. Present the latest available data with respect to the number of banks which are members and the number which are not members of the Federal Deposit Insurance Corporation, the amount of deposits in each such class of banks, and the number and proportion of accounts and of deposits respectively in insured banks which are fully covered by deposit insurance. Please present the data for mutual savings banks and for other banks separately.

15. Present the data, as far as they are available, year by year since the establishment of the Corporation, showing the total amount of deposits in all insured banks, the amount of insured deposits, the amount of the insurance fund, and the ratio which the insurance fund bears to total deposits and to insured deposits, respectively.

16. Describe the alternative techniques available under present law for the protection of depositors in failed or insolvent banks. Discuss the criteria by which the Corporation selects the manner in which it will handle each case. Do you consider it an element of potential inequity that some techniques result in the protection of all deposits while other techniques provide only for the protection of deposits up to $10,000?

17. State for each year since the establishment of the Corporation the number and amount of liabilities of failed and insolvent banks which have been handled in accordance with each of the techniques discussed in the preceding question.

18. Discuss the advantages and disadvantages of extending the coverage of deposit insurance to all deposits in insured banks. In your discussion, stress the role of deposit insurance in contributing to economic stability.

E. BANK EXAMINATION

19. What do you believe to be the role of bank examination and supervision in furthering the objectives of the Employment Act?

F. RESERVE REQUIREMENTS

20. Discuss the function of bank reserve requirements, stressing their role in credit control. What are the arguments for and against subjecting all insured banks to the same reserve requirements as member banks of the Federal Reserve System?

G. THE BANKING STRUCTURE

21. Will you please submit a memorandum discussing the adequacy of banking facilities in the United States? For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing

between two or more competing banks. Distinguish between deposit facilities and loan facilities.

H. AVAILABILITY OF CAPITAL FOR SMALL BUSINESS

22. Discuss the changes which have occurred during the last 25 years in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred? Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

23. Discuss the effects of bank examinations on the lending policies of banks, particularly as they apply to loans to small-business men. Distinguish, if necessary, between examinations by different examining authorities.

CHAPTER VIII

REPLY BY STUART SYMINGTON, ADMINISTRATOR OF THE RECONSTRUCTION FINANCE CORPORATION

1. Discuss the changes which have occurred during the life of the Reconstruction Finance Corporation in the ease or difficulty with which small-business men have been able to raise capital or to borrow. What in your opinion are the reasons for such changes as you find to have occurred?

In the first period of its history, during the depression days of the early thirties, RFC was instrumental in salvaging and protecting the savings of approximately 20 million depositors and removing the threat of unemployment from hundreds of thousands of wage earners. Emergency aid was rendered to banks, insurance companies, railroads, and even school systems. The benefits to small business, while indirect, were substantial.

By 1934, liquidity and strength had, to a large extent, been restored to the banking system. Yet it soon became evident that private financing was unable to supply the needs of business. Congress, then, for the first time, authorized RFC to engage in direct lending to industrial concerns. (See appendix, p. 966.)

The upswing in business had reached such a point by 1937 that the President, by Executive order, terminated RFC's authority to make business loans.

RFC remained in a stand-by role for but a few months. Early in 1938, alarmed by the recession, Congress renewed RFC's authority to make loans to business enterprises.

Stimulated by defense orders from Britain and France, and by the beginnings of our own preparedness program, the economy resumed its upward swing, and demands for assistance from RFC dwindled.

Shortly after Pearl Harbor, monetary authorities stated that the financial and banking mechanism of the country was in a stronger position to meet any emergency than ever before.

The existing supply of funds and of bank reserves was described as fully adequate to meet all present and prospective needs of the Government and of private activity, and these resources could be augmented by the use of Federal Reserve System powers to whatever extent necessary.

Yet by the end of 1942 RFC had authorized 2,600 loans to aid in the national defense. These loans, being in direct support of the war effort, were made under collateral requirements which were less severe than those which had previously been in force.

National defense loans, through the end of 1942, averaged $215,000 in size, despite the inclusion of authorizations of $48,000,000 to Reynolds Metals Co. and of $27,500,000 to Permanente Metals, which were then beginning to contribute their production of aluminum to the

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expansion of the aircraft program which was at that time in the early stages of volume output.

In addition to the loans to small business for national defense, a program was instituted in 1942 to assist small business in carrying inventories which had become frozen because of rationing restrictions. Loans authorized for this purpose totaled 3,673 for $76,000,000, an average of less than $21,000 each.

By the end of 1945 RFC had authorized almost $2,000,000,000 in 11,700 national defense loans, excluding loans to its own war affiliates. Together with RFC's other wartime activities in the procurement of strategic materials and in the raising of the Nation's productive capacity to new heights through the activities of the Defense Plant Corporation, these loans aided medium-size and smaller firms not only to survive the storms of the war period but also to make full use of their tremendous production potential at a time when it was sorely needed.

Despite the activities on behalf of small business, national defense was, as it should have been, the overriding consideration.

Reconversion and reestablishment became the major problems of American industry. Wartime profits had been high for a large number of firms, but wartime taxes and renegotiations placed many of them in less favorable positions than they had anticipated.

Bank portfolios which before the war held loans and discounts as their principal earning assets were now bulging with Governments. At December 31, 1945, Governments constituted 57 percent of total bank assets, while loans and discounts were only 17 percent. From this wartime-imposed low level of credit extension the banks were called upon to resume operations.

Commercial lending began its long march upward. As a supplement to this increasing bank volume, RFC was called upon during 1946 to make or participate in the largest number of loans in its history.

Many of these were GI loans, made to returning veterans who could not, even with the guaranty provided by the Veterans' Administration, get credit at the bank.

The great bulk of the 12,286 loans authorized in 1946, however, were participations with private banks, arranged under the provisions of the blanket participation agreements. At the height of this program, 5,200 of the Nation's 14,700 banks had signed these agreements with RFC.

The basic need of the smaller, independently owned firms, as the Federal Reserve Board put it in its 1946 Annual Report, was for long-term funds. The costs of going to the capital markets for small business were—and are—prohibitive. There was a gap in private financing—in funds for modernization of plants, for additional facilities, for carrying greater inventories and larger receivables at higher prices.

Banks' capital had not increased to the extent that the enlarged volume of business and the higher prices called for. Legal restrictions often prevented the smaller banks from making adequate loans to the growing industries in their communities. By utilizing RFC's deferred participation agreements, they were able to make the necessary credit available and still stay within their legal limits.

The years 1946 and 1947 saw banks entering more actively into the field of lending on long terms to small businesses. Some part of this

change in bank policy was due to their ever-rising deposits, some to a changed attitude on the part of supervisory officials, and some must be credited to the RFC which, according to such students as Saulnier and Jacoby, helped to show the way. Studies made in those years by RFC indicated that a substantial number of applications were withdrawn by borrowers after approval by RFC, with the explanation that they had been able to secure financing elsewhere and would not need the RFC credit. It is evident that RFC's services in helping the borrower with his presentation of his affairs and with his estimates of future activity were instrumental in putting his loan in the bankable class.

By the end of 1946, the reconversion problem belonged to the past, but thousands of new enterprises were still being formed, and GI financing continued at a high rate. RFC discontinued its BPA program in January 1947 and substituted for it a small-loan program somewhat more restrictive in its terms. Lending volume dropped sharply between 1946 and 1947, and by 1948 loans authorized were less than 30 percent of the 1946 totals.

During 1948 and 1949, business was good and bank credit was available to most small enterprises. However, the credit gap still existed, as shown by the fact that 41 percent of RFC's authorizations during those years were made to borrowers whose banks had declined to make loans because the requested term was too long. Another 27 percent were declined by banks in vague terms, or because the type (not the value) of collateral was unacceptable to the bank. The remaining 32 percent were declined for various policy or credit considerations.

When the war started in Korea, the problem became one of building up the rearmament potential and cutting down on nonessentials. Consequently, RFC policies since the middle of 1950 have been directed primarily to the provision of credit for the defense effort, particularly in the area of the smaller enterprises whose products are perhaps once or twice removed from direct use by the military.

Total loans and investments of commercial banks have risen to record heights, but there does not at present appear to be any stringent over-all shortage of short-term credit for most essential purposes. However, there are indications that many banks are drawing close to their limits of loanable funds. With this situation, their financial judgment dictates that, given the choice, they make short-term loans and decline long-term requests.

A recent study of RFC loans brought out the fact that in fiscal year 1951, no less than 36 percent of the banks contacted by RFC borrowers indicated that they not only had every confidence in the applicant's probity and chances for success but that they would demonstrate their confidence by making short-term credit available to the applicant if and when RFC approved the long-term loan needed by the applicant. In 1948 and 1949 only 6 percent of the banks contacted made similar statements. It is apparent that a considerable number of small-business men would, without RFC, be unable to arrange the long-term credits necessary to permit them to participate in the increasing job of meeting essential civilian and military requirements. To a significant extent, also, it is anticipated that small-business men will need increasing amounts of working capital.

2. Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy?

The traditional American system of free enterprise depends to a major degree upon the existence of an economy where small business can succeed and new business can emerge.

In order to maintain a strong, well-balanced economy, we need the continued infusion of new independent ventures to furnish the competitive spirit so vital to our system of free enterprise. Successful competition of small business units with their contribution to the development of new methods, regional growth, and free markets is necessary to the diffusion of economic power.

An available supply of credit on a long-term basis for small business appears necessary as witnessed by the experience of the RFC over the last 18 years of business lending. Almost 90 percent of the approximately 62,000 loans made by the RFC have been authorized to small business enterprises in amounts of $100,000 or less. This fact would appear to bear out the conclusions of many students of the problem as to the inadequacy of private sources, particularly in the case of longer term credits for plant expansion, modernization, and purchase of machinery and equipment.

It is not so much a question of a more liberal supply of credit as it is an adequate supply when and where needed. If small business is to survive and grow, there must be a flexible credit system which will make funds available at the needed time and for the purposes which are essential at that time. Of course, if credit is too easy to obtain, without proper safeguards, then the result may well be inflation, unnecessary failures, and premiums for inefficiency. Greater economic concentration might follow a too easy as well as a too tight credit policy for small business.

3. What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable?

The question of the supply of capital and credit to small business must be answered in relationship to the business conditions at any given time. Studies conducted by the Congress and private research organizations have pointed up the problem of providing additional equity capital for the creation, maintenance, and expansion of small business enterprise.

Regarding long-term loans to small business, at the present period, RFC assistance is available, and the Corporation is making loans, to those enterprises engaged in national defense activities or in the production of essential civilian goods and services. At the present time there is a restriction on credit for those purposes which would have an inflationary effect. Should the Nation be faced with a contracting economy due to depression or to a large reduction of military expenditures, other measures may be necessary to assist small business in the credit field, particularly if commercial lending organizations are unwilling to grant credit under such conditions. It is believed that greater willingness on the part of commercial lending enterprises to participate with RFC would, during such a period, provide a stimulus to such lending.

4. Distinguish between the longer-term aspects of the problem and those of particular importance today during the current defense emergency.

The purpose of our armament program is to prevent any attempts to destroy the American system of free enterprise.

We must be careful that we do not do serious harm to our system by the very efforts we are making to preserve it.

We must bring about the fullest measure of production and services, which means utilizing to the utmost the capacities of our smaller enterprises.

The current problem is not so much a basic shortage of credit for all uses but rather a shortage for essential uses by small business.

Our twin goals are prompt production of our military needs, and preservation of opportunity for small business.

Some examples of RFC's contributions to these goals in recent months follow. These borrowers came to RFC because the credit they sought was not available elsewhere.

(1) A loan of $18,500 to a firm which had been making aluminum awnings. This firm will make metal stampings for the Air Force and ammunition boxes for the Ordnance Department.

(2) A loan of $50,000 to a wheelbarrow manufacturer who will make powder tanks for the Navy and tent frames for the Army.

(3) A loan of $30,000 to a maker of orthodontic equipment. He will produce rocket parts for Naval Ordnance.

(4) A loan of $74,500 to a maker of small tools. This firm is a subcontractor on small arms parts for the Ordnance Department.

(5) A loan of $12,000 to a plastics fabricator who was making fancy boxes for perfume, jewelry, etc. His new job is to make special plastic shields for use in B–36's.

(6) A loan of $13,500 to a manufacturer of cellar drains who will make crankshaft pins for aircraft and parts for Navy torpedoes.

Over the longer term, changing economic conditions will determine the extent of the need for supplemental credit.

RFC believes that the term "small business" is a relative one. A small steel works may look like a behemoth to the proprietor of the corner grocery store. It could have 2,000 employees and yet be classifiable as small business on the basis of its proportionate share of the total produced, or, even more pertinently, on its share compared to that of the top three or four in the industry.

RFC conceives its major role to be in the financing of small business firms when their product or service is in the public interest and the necessary credit is not otherwise available.

APPENDIX TO CHAPTER VIII

Question Addressed to the Administrator of the Reconstruction Finance Corporation

1. Discuss the changes which have occurred during the life of the Reconstruction Finance Corporation in the ease or difficulty with which small-business men have been able to raise capital or to borrow.

What in your opinion are the reasons for such changes as you find to have occurred?

2. Do you believe that a more liberal supply of capital and credit to small business would contribute to the diffusion of economic power and to the dynamic character of the economy?

3. What steps could be taken to bring about a more liberal supply of capital and credit to small business? Do you believe that any of these steps would be desirable?

4. Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

Reconstruction Finance Corporation—Loan authorizations to business enterprises by calendar year

Year	Grand total		Year	Grand total	
	Number	RFC liability (thousands)		Number	RFC liability (thousands)
1933 [1]	19	$1,752	1944	1,541	344,360
1934	752	46,704	1945	2,450	399,788
1935	1,905	106,971	1946	12,286	447,036
1936	1,446	71,436	1947	7,429	350,173
1937	641	26,985	1948	3,538	228,596
1938	4,919	142,227	1949	4,562	528,444
1939	2,041	116.564	1950	4,549	352,648
1940	1,267	87,383	1951 (9 months)	1,266	178,650
1941	808	202,456			
1942	7,525	853,118	Total	62,296	[2] 4,916,288
1943	3,352	430,997			

[1] Loans made indirectly to business enterprises through NRA mortgage loan program.
[2] Excludes $546,064,000.00 authorized to be taken by participating banks in deferred and immediate purchases of participations. Excludes SWPC, and DPA loans.

CHAPTER IX

REPLIES BY STATE BANK SUPERVISORS

1. What do you believe to be the role of bank examination and supervision in maintaining economic stability?

The State bank supervisors were of the opinion that the role of bank examination and supervision should be confined to seeing that banks are solvent, well-managed, and operated in accordance with the law. They did not believe that bank examination and supervision should be used as instruments for maintaining economic stability. (As noted in the summary of answers to the corresponding question addressed to bankers (No. 8) there is reason to believe that more sympathy might have been shown for some economic objectives—such as that of reducing the severity of a depression by restraint in pressing for liquidation of slow assets—if the question had been more moderately interpreted.)

Extracts from typical replies follow:

L. M. Campbell (Pennsylvania)

The economic stability of the country rests to a large degree upon the soundness and safety of the more than 14,000 privately owned banks which form our completely independent dual banking system. Bank supervision is essential to the public interest because banks, unlike other business institutions, accept deposits from persons who have neither the technical knowledge nor the time to determine whether a bank is in a sound condition or operating in a safe manner. Supervision and examination afford a considerable degree of protection, help to insure sound banking, and aid materially in maintaining economic stability. Thus, bank supervisors, in their rôle as representatives of the public in examining the affairs of banking institutions, are essential in keeping the confidence of the average citizen in the safety of his savings and investiments. It is this confidence which sustains and maintains the economic life of every community.

The role of supervision in maintaining economic stability is the adoption of careful examination and supervisory policies to the end that the best interests of depositors, shareholders, creditors, and customers of our independent banks will be protected.

It is believed that, generally speaking, good supervision is light supervision. By that is meant that the supervisor should not attempt to assume management of banks or interfere with their actual operations when legal. In Pennsylvania the supervisor's role is to serve as the impartial go-between in the relation of State banking institutions with the public. Thus, we have always recommended that the rights and powers of the banking department be specified clearly in law so that we would not have State bank supervision by means of arbitrary regulations.

It has come to our attention that certain officials in Washington have on occasion expressed the viewpoint that bank examination should be an instrument of credit policy. This viewpoint seems to believe that, in this role, bank supervision should be relaxed in times of deflation and made more stringent in times of inflation. It is our opinion that any attempt to use bank supervision in this role would result in violent disruption to the economic life of the entire country.

L. K. Elmore (Connecticut)

The main purpose of bank examination by State authorities can, in my opinion, be summarized as follows:

> We examine to make sure that the bank is complying with the law to which it is subject; that it is solvent; that it has the assets it claims to have; that its liabilities are clearly stated; that its operations are modern and efficient; and that its management is sound and likely to continue so.

These purposes are more fully delineated in the Connecticut State Banking Department's Manual of Instructions to Examiners, as indicated in the following excerpt:

> The examination of banks is an exercise of the police power of the State, and its fundamental purpose is the protection of bank depositors and stockholders. The bank commissioner and the banking department are charged by law with the duty of examining each bank at least annually "to ascertain whether its business has been managed according to law." Of equal, if indeed not greater, importance, although not so clearly expressed in the law, is the need to determine whether or not the bank is solvent, that is, whether or not its assets, at a fair valuation, are sufficient to pay all of its obligations, including its capital stock. The law also contemplates that the methods followed by the bank should clearly and accurately show the liabilities, earnings, and a proper classification of assets. Other sections of law indicate that the examination should determine that the condition of the bank and the policies, practices, and capacity of its management will now and in the reasonable future assure that it will preserve its assets, not defraud the public, be safe for it to continue in business, not dissipate its assets, remain solvent, and not indulge in unsafe and unsound practices in conducting the business.

The fulfillment of these purposes will, obviously, exert a stabilizing influence on our economy. The public interest aspect of bank supervision was expressed by the National Association of Supervisors of State Banks in 1940 in the following language:

> Bank supervision is essential to the public interest because persons and corporations have neither the opportunity, the technical knowledge, nor the time to determine whether a bank is in a sound condition or is operating in a safe manner. If confidence in the banks is lacking and failures result, not only do individual citizens lose some part of their savings but the entire economic life of the community suffers severe shock. Bank supervision affords a considerable degree of protection to the public and helps to insure sound banking. It is not contended that supervision affords perfect protection, which would imply absence of risk, an impossibility in a system of privately owned institutions, one of the principal functions of which is to extend credit to industry and agriculture.

J. M. Falkner (Texas)

We believe that bank examination should be directed toward ascertaining whether institutions are sound and management policies satisfactory. We do not think bank examinations should be an instrument of credit policy. Bank supervision affords protection to the public and helps to insure sound banking by analyzation of its earning, checking the attendance record of its directors and committees at meetings, reviewing the adequacy of management and audit control and investigation for violations of the banking law and other applicable

statutes, and reviews the action taken with respect to matters which have been the subject of comment or criticisms at previous examinations.

Thurman R. Hazard (Ohio)

Bank examinations are conducted to determine whether the institution is sound and if the management policies are satisfactory and sufficient for a proper and successful operation of the bank. Examinations of banks should not be considered instruments of credit policy, with degrees of relaxation and strengthening varying according to the credit policies of the moment.

The separate State authorities, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation are authorized by statutory law to make examinations of banks: to thoroughly examine the assets and liabilities and to ascertain if the banks under their supervision are conducting the business in a manner as prescribed by law. During the course of the examination an analysis of the earnings of the institution is made and a review is made of the extent and adequacy of the management and credit control. Investigation is made to determine if the board of directors of the bank has taken proper action on such matters as may have been the subject of comment or criticism at the time of the previous examination. Bank examinations and supervision afford a considerable degree of protection to the public interest and greatly help to insure sound banking.

Economic stability is the ideal mean in the ebb and flow of our country's economy, influenced by world economy and stability, and is controlled, helped, or hampered by acts of the United States Congress and the legislatures of the different States. If the people's confidence in our banks is weakened or adversely affected and bank failures result, then the people become alarmed and the entire economic life of our Nation is weakened.

Our State banking system will continue to hold the important and secure place which it now occupies in our State and National economy just so long as it safeguards the funds of our people and accepts its responsibility in the communities wherein the banks are located.

Randolph Hughes (Delaware)

Bank examination and supervision is required by State law to appraise the assets of the State-chartered banks to determine their true value and soundness. It is also the responsibility of the State banking authority to determine whether or not the various banks coming under his supervision have in any way violated the State statutes regulating them. As far as economic stability is concerned, it is the responsibility of supervision to determine the soundness of the various State financial institutions and to exert the necessary pressure to see that corrective measures are taken so that they might continue to operate as an integral part of the community.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

It has long been the view of this Department that examinations should be directed toward ascertaining whether institutions are soundly operated and management policies satisfactory. We have never agreed with the view, which has sometimes been expressed in governmental places, that bank examinations should be an instrument

of credit policy, with degrees of relaxation and stringency varying according to the credit policies of the moment.

Bank supervision is essential to the public interest because banks, unlike other business institutions, accept deposits from persons and corporations who have neither the opportunity, the technical knowledge, nor the time to determine whether a bank is in a sound condition or is operating in a safe manner. Bank supervision affords a considerable degree of protection to the public and helps to insure sound banking. It is not contended that supervision affords perfect protection, which would imply the absence of risk, an impossibility in a system of privately owned institutions, one of the principal functions of which is to extend credit to industry and agriculture. Originally, bank supervision was established to protect the noteholder. As banks changed from institutions of issue to institutions of deposit, the purpose of supervision also changed. Then, for more than half a century the emphasis of supervision has been upon the protection of the depositors, creditors, and stockholders of banks.

The depression which began in the late twenties, and which was one of the most severe in our history, produced conditions which caused bank supervisors to give greater attention to the question of whether our banking system was fully serving one of the important purposes for which it was established, the extension of credit. Encouragement has been given not only to the making of short-term, self-liquidating loans that have traditionally been a part of commercial banking, but to so-called long-term loans, loans for consumer purposes, mortgage loans, etc., thus bank supervisors have assumed the somewhat broader responsibility to assure the functioning of banks in the interest of the entire public.

Under our system of federated government, the States continue to possess primary power and responsibility over many phases of the life of their citizens. State banking systems have continuously demonstrated their adaptability to local needs over which the States exercise jurisdiction. In a Nation having the vast territory of the United States, a diversity of needs exists as between widely separated communities which can best be served by State banking systems developed and fostered under State jurisdiction and supervision in the light of the needs of local industry and agriculture.

The procedure in the conduct of an examination consists essentially of the proving of the assets and liabilities of the institution against a trial balance taken from its books of account and sworn to by one of its officers. The examiner also analyzes the earnings of the institution, checks the attendance record of its directors and committees at meetings, reviews the extent and adequacy of management and audit control, investigates for violations of the banking law and other applicable statutes, rules and regulations, and reviews the action taken with respect to such matters as may have been the subject of special comment or criticism at the time of the previous examination.

William A. Lyon (New York)

Economic stability is not a proper responsibility of the bank supervisor or examiner. The function of an examination is to determine banking practices, promote solvency, and enforce adherence to State laws. Other purposes of examinations are the maintenance of (*a*) the quality of bank assets, (*b*) an adequate capital cushion, and (*c*)

sufficient valuation and contingency reserves. The goal of supervision is the protection of the public interest in banking, particularly the interest of depositors and stockholders.

Exception should be taken to the view that bank examiners appraise risks and classify loans according to the economic climate of the moment, and hence exert a "destabilizing" effect.

It is equally fallacious to argue, conversely, that examiners should try to mitigate business fluctuations, by exorting bankers to expand loans during a recession, and pressing for loan reductions in prosperity. The duty of the bank supervisor, whether State, National, or FDIC, is to inquire into the condition of the individual bank, leaving it to the Federal Reserve to concern itself with the monetary and credit policies of the country.

G. M. Matthews (Wisconsin)

My conception of the role of bank examination and supervision is that our primary function is to protect the interests of the depositors in order that they may be assured of repayment in full of their deposits upon demand or at the end of the time contract, as the case may be. This requires that supervision and bank examination be on such a high level that the public will have confidence in the banking system and will thus refrain from making withdrawals because of fear the bank will not be able to pay everyone.

In answering this question I am mindful of the Federal Deposit Insurance Corporation which of course assumes the position of the original depositors in the case of a bank closing. However, it is the public confidence which must be cultivated.

L. R. Ritchie (Virginia)

* * * * * * *

The primary responsibility for a bank's investment (loans and bonds) policy rests squarely upon the board of directors. The examiner may offer worth-while suggestions, but the responsibility is still that of management, provided safe-and-sound practices are followed, and compliance made of the above-numbered items.

Bank examination and supervision is unquestionably an important factor in maintaining economic stability. It should be a continuing force that helps to bring about sound credit and bank-management policies. It should not be used in varying degrees so as to relax or tighten credit, except to the extent that it attempts to bring about full compliance with regulations promulgated by the Federal Reserve Board.

Homer E. Robinson (Maine)

We in Maine believe that the objects of bank supervision are threefold—

1. To determine solvency and to take steps allowed by statute to maintain solvency.
2. To police State laws regarding banking.
3. To appraise management policies which are likely to affect the foregoing conditions.

It seems to us that if we can keep our banks free from failures, we shall have made an appreciable contribution to the economic stability of our State and its businesses, and to the well-being of its citizens.

We do not feel that our function is to administer economic theories that arise on the Federal level, and that may be changed from time to time for reasons of political expediency.

A. A. Rogers (Oregon)

It is my opinion that the role of bank examination and supervision is to determine that the broad standards of law under which the institution operates are and have been complied with; that credit extended to their borrowing customers is on a sound basis and that, under normal economic conditions, same is collectible; that investments are not of a speculative nature, and that the liabilities are no greater than that shown on the books of the institution. I realize that the best results can only be obtained in a relation of cooperation and mutual understanding.

The examination, of course, must determine that the books are in balance, review the adequacy of management and audit control. I believe that our banking laws should always be administered so as to protect the depositor and not to penalize the banker.

Economic stability can be maintained on a sounder basis if the supervising authorities and the men who direct and manage our banks work together on all problems and when all realize that only well-managed banks can be an asset to a community.

H. G. Shaffner (Missouri)

It is believed that bank examination should not exceed the proving of the assets and liabilities of the institution from its books of account and sworn to by one of its officers. That also the earnings of the institution should be checked, as should the adequacy of management and audit control, investigation of violations of the banking laws, and the grading of investments held by the institution.

Roy W. Simmons (Utah)

I believe that examinations should be made for the purpose of determining the solvency of the institution concerned and no effort should be made on the part of the bank-supervising officials or agencies to guide or direct the economy of the Nation by relaxing or restricting credit requirements. When bank supervisory officials enter this field attempting to regulate the flow of credit, the job becomes political in nature.

Maurice C. Sparling (California)

(1) That a sufficient number, and only a sufficient number, of banks are chartered to adequately serve the public, and to profitably operate even in times of depression—to the end that there will be no bank failures.

(2) To insure that the Nation's banks are at all times financially sound, efficiently managed, and complying with all applicable laws.

Neither bank examination nor supervision should be used as instruments of effectuating credit policies.

The financial stability of the Nation's banks reflects the Nation's economic stability. Bank examination and supervision maintains the financial stability of the Nation's banks, and by maintaining the financial stability of the Nation's banks, bank examination and supervision maintains the economic stability of the Nation.

W. Royden Watkins (South Carolina)

Bank examination and the supervision of banks play a very important role in supporting economic stability. Certainly, the respect and confidence the public has for its banking facilities are in direct relation to the efficiency and sound policies of the supervising authorities. A brief look at the 1920's will point out that there was much bank examination of the operating banks during that period but little or no competent supervision, especially over organization of banks. No one can question the fact that the thousands of banks which were organized under an inept supervision, and which later failed, contributed to the collapse in 1930.

2. Discuss the advantages and disadvantages of extending the coverage of deposit insurance to include all accounts in insured banks. Do you believe that this should be done?

The supervisors were opposed to extension of deposit insurance. Many stated that the restoration of confidence in the banks and the prevention of mass "runs" had been achieved within the present $10,000 limitation and that these were the only legitimate objectives of the law. "Large depositors can take care of themselves." The views were generally expressed that extension would encourage lax banking practices and would inevitably result in an extension of the scope of examination and supervision with a corresponding extension of "Government control of business." There was no discussion of (previously published) data on the role of the withdrawal of large deposits in earlier bank failures. A number of the supervisors referred favorably to the practice of the Federal Deposit Insurance Corporation of merging failing banks into solvent institutions—which practice, in effect, extends insurance coverage to all deposits. None condemned this practice, although one said that it should not become an unvarying rule.

Extracts from typical replies follow:

L. M. Campbell (Pennsylvania)

Deposit insurance was intended primarily to afford protection to the average citizen who maintained a modest bank account. At the time the Federal Deposit Insurance Corporation was formed it was believed that, based upon economic conditions at that time, the maximum of $5,000 adequately covered deposit accounts maintained by a large number of the people of the country. It was also believed that the securing of these deposits would result in restoring the faith of the average citizen in our banking institutions. Experience has shown that this was accomplished, but as economic conditions changed the average citizen became the owner of larger bank deposits. This resulted in a demand that insurance coverage be increased to $10,000.

We see little advantage in extending insurance coverage to all bank deposits and several disadvantages. The extension would result in all deposits being insured, including those of persons and corporations who have the ability to select their banking institution on the basis of its condition as shown by its various reports. It would place on the insurance fund a substantially increased risk, and it is very questionable whether the deposits of the average citizen now covered up to $10,000 should be endangered by having the fund assume the risk involved in full coverage of all deposits.

Full insurance coverage would take away from the officers and directors of banking institutions responsibilities which they should assume. Bankers now, when considering management and investment problems, must always bear in mind that to some extent their depositors are not insured and must be governed somewhat in their action by their responsibility to their uninsured depositors.

There has been much criticism of the banking fraternity, because it is claimed that too many bankers want to be protected against their mistakes by some sort of Government or other guaranty. If deposit insurance were to be extended to cover all deposits, it would seem that this would be an additional extension of a guaranty and a form of socialization of the banking business.

L. K. Elmore (Connecticut)

Deposit insurance by the Federal Deposit Insurance Corporation, i. e., $10,000 per account per bank, adequately meets the purpose for which the insurance corporation was created. It fully insures a little better than 98 percent of all accounts in our commercial banks. Psychologically, it is effective in the public mind, forestalling panicky reactions.

I firmly believe that the insurance coverage should not be extended to all bank deposits in insured institutions. It is unnecessary; as stated above, and also because much can be accomplished by preventive and advisory steps in institutions where weak management tendencies start to show. Furthermore, it would concentrate possible controlling power in a single body, the insuring institution. Every effort should be made to preserve our dual banking and private enterprise system.

J. M. Falkner (Texas)

We believe that deposit insurance of $10,000 per account per bank will meet the purpose for which the Corporation was created. We do not believe the coverage should be extended further, because that would, in our opinion, tend to encourage unsafe and unsound practices on the part of management in some banks.

Thurman R. Hazard (Ohio)

It is conceivable that full coverage of deposits in all banks, under the protection of the Federal Deposit Insurance Corporation, would provide an ideal cushion in any specific failure. The extension of insurance coverage from $5,000 to $10,000 has insured approximately 99 percent of the number of deposit accounts in all insured banks and amply cares for what might be designated as distress accounts.

If the deposits in our banks during 1929 to 1933, inclusive, had been protected by insurance coverage of $10,000, there would not have been a banking holiday, nor would our banks have been subjected to the humiliating and disastrous results of the many runs which were made against banks of all sizes. The citizens of our country would have also been relieved of having experienced and endured the baneful and devastating effects which the banking holiday left in its wake.

The creation of the Federal Deposit Insurance Corporation was more instrumental in restoring the people's confidence in the banks of our Nation than any other one factor or influence. The cooperation and reciprocal relations which now exist between the banks and the Fed-

eral Deposit Insurance Corporation have been productive of excellent results which have aided immensely in better banking.

Table 17, page 29, of the 1950 Annual Report of the Federal Deposit Insurance Corporation shows that the present coverage of $10,000 takes care of only $93,498,000,000, or but 55.7 percent of $167,817,-696,000, which represents the total deposits in the banks of the United States.

Therefore, if the insurance coverage were extended to cover 100 percent of all the deposits in the insured banks, the Federal Deposit Insurance Corporation would be required to increase the premium rate or fee approximately 50 to 100 percent above that now paid by the banks to provide for the additional cost incurred by such extension of insurance coverage. Any increase of rate or fee for deposit insurance would, no doubt, be disapproved by the banks.

It is my considered opinion that, since the deposit insurance coverage as it is now constituted, $10,000 per account, has met the purpose for which the Federal Deposit Insurance Corporation was created, it would be impracticable, fundamentally unsound, and not in keeping with well-established principles of banking to extend the deposit insurance coverage to include all accounts in insured banks.

A. W. Hoese (Minnesota)

The advantage of extending deposit insurance to cover all accounts would be the coverage of a very few large accounts not now fully covered, in which cases we believe the depositors are usually well able or in a position to take care of that situation themselves.

The disadvantages of extending deposit insurance to cover all accounts are:

First. Deposit insurance of $10,000 for each depositor, for all practical purposes, covers most of the accounts now and has served the purpose for which it was created, primarily to stabilize bank deposits.

Second. It would increase the cost of deposit insurance for all banks.

Third. It would penalize the good bank or banker who over many years has operated a good, sound bank and has built up and gained the confidence of the depositors by the strength and soundness of the institution itself.

Fourth. In the minds of the public it might have a tendency of putting all banks on the same level and thereby put a premium on poor or weak management.

Fifth. It might have the effect of creating loose banking, as management could always lean on the Federal Deposit Insurance Corporation to bail them out if their banks got into trouble or became insolvent.

Finally, we believe that deposit insurance should not be extended to cover all accounts.

John H. Hoffman (West Virginia)

I believe the present coverage of $10,000 deposit insurance is ample at the present time.

Randolph Hughes (Delaware)

It is my feeling that deposit insurance is largely psychological, and therefore I do not believe there would be any great advantage in extending the coverage of deposit insurance beyond the present limitations. It seems to me that one of the values of deposit insurance is

through the joint examination by the Federal Deposit Insurance Corporation with the various State supervisory agencies.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

In the first instance our answer is "No" as to permitting the insurance coverage of the Federal Deposit Insurance Corporation to apply to all deposits.

The Federal Deposit Insurance Corporation should be retained permanently substantially in its present form. The success of the Federal Deposit Insurance Corporation has, in the opinion of this department, been due principally to the able management under which it has operated since its inception. This management has thought it advisable to organize and maintain an Examination Division which periodically conducts examinations of all State nonmember insured banks. In this activity the Corporation has at all times extended full cooperation to the State Banking Department of Maryland, and it is believed that with this policy of current examinations a minimum of inconvenience has been caused to the banks by reason of this additional examining agency.

Regarding the amount of deposit insurance coverage and the rate of insurance premium, it is the opinion of this department that action thereon can best be guided by the study and recommendations of the Insurance Corporation itself. So far as the situation in the State banks and trust companies of this State is concerned, we feel that the present rate and coverage are adequate and satisfactory.

In connection with the subject of insurance protection, we feel it essential that, regardless of any change which might be decided upon at some later date relative to the amount of insurance, the Federal Deposit Insurance Corporation should be permitted to retain the power now provided under the statute to make loans and/or purchases of assets as an alternative to actual payment under the terms of the insurance.

Deposit insurance was intended primarily to afford protection to the average citizen who maintains a modest checking or savings account in a nearby banking institution. It was believed by sponsors of the plan that the restoration and maintenance of confidence among this predominantly large class of depositors would provide necessary stability to the banking structure and at the same time insure against loss those persons least qualified to distinguish between strong and weak institutions. These aims and purposes have clearly been achieved by the operations of the Federal Deposit Insurance Corporation. Since this is true, it is the view of this department that the banking system is presently already realizing substantially the maximum benefits which may be expected to result from any system of deposit insurance.

William A. Lyon (New York)

The purpose of deposit insurance was originally to restore the withdrawal of funds. This goal was achieved even before deposit insurance was increased to $10,000 an account. The protection now afforded to depositors is more than sufficient to meet the intent of Congress in regard to the FDIC. Insuring all accounts would mean a further, and unnecessary, extension of control over private banks by the Government. Federal underwriting of all deposit risks would

undermine the basis and the fundamental reason for the private ownership of the banking system.

G. M. Matthews (Wisconsin)

I do not believe that bank accounts should be insured in full. In my opinion the present top of $10,000 is sufficient. I feel that raising the insurance would tend to develop the thought on the part of the public that a bank deposit is an investment, which, of course, it is not and should not be so considered.

L. R. Ritchie (Virginia)

To insure all deposits might tend to make banks more venturesome in investing their funds, realizing that if their institutions should become insolvent their depositors would be protected. The practice of the Federal Deposit Insurance Corporation in making loans in order to provide in effect full coverage on all deposits in certain banks which were in failing condition has, no doubt, accomplished much good. However, if this practice is to be continued, very careful consideration should be given to the size of the deposit liability of the institutions when loans of this character are to be made.

Homer E. Robinson (Maine)

We believe that Federal Deposit Insurance Corporation coverage, as now constituted, is adequate. Its reason for being was to allay fear, restore confidence, and offer a minimum protection to all depositors up to some reasonable level. Complete insurance of all deposits in insured banks would offer unnecessary protection to larger deposits, would tend to protect the strong more than it would the weak, and would be unfair competition to those banks that are not members of the FDIC. We have banks in Maine that are in excellent financial condition but which are not members of the FDIC from choice.

A. A. Rogers (Oregon)

I do not believe that deposit insurance should include all accounts of our banks. The limit of $5,000 per account was, in my opinion, high enough. Confidence was restored in the minds of the public; however, the increase to $10,000 coverage may be more in line with our present 50-cent dollar.

H. G. Shaffner (Missouri)

It is believed that the public has evidenced sufficient confidence in the original coverage of deposit insurance, therefore there is no need for increasing such coverage. As I understand, deposit insurance was introduced to regain the confidence of the public. At this time there is no way of extending such confidence.

Roy W. Simmons (Utah)

I believe that the present law of insuring bank deposits up to $10,000 per account accomplishes all that was originally intended under the act.

Maurice C. Sparling (California)

The present $10,000 coverage fulfills the purpose for which Federal Deposit Insurance was created, to wit: The creation of public con-

fidence in the Nation's banks and the protection of the savings in a reasonable amount and nest egg of every bank depositor.

The advantages gained by extending deposit insurance to include all accounts would probably be more than offset by the disadvantages. Generally speaking, it would indeed be nice for one to know that every dollar of his deposit in the bank is protected by insurance. On the other hand, the cost of such additional insurance would have to be taken into careful consideration and it might be prohibitive. With such insurance being furnished by a Government controlled agency (although wholly supported by private industry), the general belief is created in the minds of the public that their bank accounts are actually Government-insured. Once the Nation's bank accounts are Government-insured, the next logical step would probably be for the Government to own and operate the banks. No possible advantage to be gained through total deposit insurance could possibly offset such a disadvantage. Our banking system must continuously be privately owned. The Federal Government is already in far too many fields which should be conducted solely by private industry, and we certainly want no further such Federal expansion.

Nothing herein stated should be interpreted as opposing merging or selling of banks requiring financial assistance and intervention of the Federal Deposit Insurance Corporation with other banks, if such course does not constitute the invariable practice and policy of the Federal Deposit Insurance Corporation, but is only used where such course rather than the bank's liquidation receivership actually serves the best interests of all parties in interest, including the financial liability of the Federal Deposit Insurance Corporation.

W. Royden Watkins (South Carolina)

This writer subscribes to the belief that the extending of the coverage of deposit insurance to include all accounts in insured banks, through purchase and merger agreement, is advantageous to the FDIC, as well as to the public interest, provided reasonable values are believed to exist at the time the purchase or merger becomes effective. Such procedure would, of course, place much responsibility on the judgment of the directors of the FDIC in the valuation of assets.

3. What do you believe to be the principal functions of banks reserve requirements? Do you believe that all insured banks should be subject to the same reserve requirements as member banks of the Federal Reserve System? Why, or why not?

The majority of supervisors felt that the principal function of reserve requirements was to provide liquidity for individual banks. Many of them did not recognize the credit control function of reserve requirements as a valid one. Some said that required reserves should be related primarily to local conditions and that these were best understood by the State authorities. All of them believed that requiring nonmember banks to hold the same reserves as member banks would constitute a threat to the dual banking system.

Extracts from typical replies follow:

L. M. Campbell (Pennsylvania)

The principal function of bank reserves is to provide adequate liquid funds readily available for use by a banking institution in an emer-

gency when called upon to meet unusual demands of depositors. We believe this purpose of bank reserves is crystal clear in the original State and Federal statutes.

We do not believe that all insured banks should be subject to reserve requirements fixed by Federal authorities. Conditions differ widely in different areas in the country and when high reserves would be needed in one section, they might be unnecessary in another. For this reason, we believe that it is logical for authority over reserve requirements to be administered by the respective State jurisdictions.

Since bank reserve requirements apply only to banking institutions as one segment of the lending industry and Government lending agencies operate with practically no restrictions whatsoever, the use of the reserve to control credit expansion is not justified.

L. K. Elmore (Connecticut)

I think that the prime function of bank-reserve requirements, and more specifically of the Connecticut Reserve Act, is to afford desirable and necessary protection for deposits, a liquidity cushion against withdrawal demand. This is perhaps accentuated in times of high loan activity when the over-all liquidity factor is lessened.

I do not believe that nonmember banks should be subject to reserve requirements established by the Federal Reserve System. This would be a definite step against States' rights and the dual system. The main purpose of reserve control over nonmember banks is stated to be the matter of effective control of credit extensions. Assuming this premise to be valid, it would seem to be unnecessary, in any case, as Federal Reserve members now have 85 percent of the deposits in the country and the remaining 15 percent could not seriously affect the credit picture.

J. M. Falkner (Texas)

We believe the principal functions of bank-reserve requirements is to be able to maintain a desirable liquid condition in order to meet seasonal or anticipated shrinkage in deposits without the necessity of having to borrow or rediscount paper. We do not believe that all insured banks should be subject to the same reserve requirements as member banks of the Federal Reserve System, because to do so would, in our opinion, be a very definite step against State rights and inimical to the dual banking system.

Thurman R. Hazard (Ohio)

The principal function (singular) of bank reserve requirements is to help maintain additional liquidity of assets.

The extension of Federal authority over reserve requirements of State nonmember banks would tend to be discriminatory and inimical to our dual banking system. While we fully recognize the advantages and desirability of the control of cash reserves, through supervisory authority, we should not look with favor upon the enactment of any legislation which has for its purpose the vesting of control of reserve requirements for State nonmember banks in a Federal agency.

Legislative authority to permit State bank supervisors, with the consent of the State banking advisory board, to establish reserve requirements in accord with the interest of general economy, and for such authority to be limited by appropriate percentages or by the

extent to which reserves may be established for member banks, would, no doubt, be looked upon with favor and considered in keeping with sound banking principles by all banks.

Any legislative act which would subject the insured State nonmember banks to the same requirements as member banks of the Federal Reserve System would be a direct, definite, and dismaying step against State rights and our dual banking system.

Any legislation, the purpose of which would be to consolidate or combine the authority, duties, or activities of Federal banking agencies and to extend their authority and responsibility over State chartered banks, would be destructive to our State banking system.

A. W. Hoese, (Minnesota)

We believe the present functions of bank reserve requirements are control of credit, a cash working fund to meet daily transactions, to meet loan demands, and normal withdrawals of deposits.

We do not believe that all insured State banks should be subject to the same reserve requirements as member banks of the Federal Reserve System because it would be an intrusion of State rights and detrimental to the dual banking system.

The 1951 Minnesota Legislature enacted a law giving the commissioner of banks power to change reserve requirements whenever he shall determine that the maintenance of sound banking practices or the prevention of injurious credit expansion or contraction makes action advisable.

John H. Hoffman (West Virginia)

Reserve requirements of nonmember State banks in West Virginia are regulated by State law and I do not believe these banks should be subjected to any other regulation. The State banks which are members of the Federal Reserve System have voluntarily joined and, of course, must comply with their regulations in regard to reserve requirements.

Randolph Hughes (Delaware)

I believe that the principal function of bank reserve requirements is to force upon the banks a reasonable liquid position. I do not believe that all insured banks should be subject to the same reserve requirements as member banks of the Federal Reserve System. If this were a requirement, in my opinion, it would tend to defeat the necessity for the dual banking system. I do not believe that bank reserve requirements should be used to control credit.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

This Department considers that the average commercial bank should generally have liquid assets, including cash, reserves with the Federal Reserve bank, and other Reserve agents, due from other banks, short-term high-grade bonds, rediscountable paper, and loans secured by quick collateral, equal to at least 50 percent of the deposit liabilities. Such a degree of liquidity would be satisfactory in the case of most small or medium-sized banks which have a substantial proportion of time and/or savings deposits. A somewhat higher degree of liquidity is considered desirable in the case of the larger city banks having modest time and/or savings deposits and the deposits of which are in other respects more volatile than those of rural or country banks. It

is believed that the liquidity assured by such a standard would enable most banks to meet practically any demand for cash which might arise in the absence of an extreme emergency such as was encountered in the thirties. It is our sincere belief that the principal purpose of bank reserve requirements under the statute is to provide for immediate available funds for the use of the depositing public in the event that they require or demand it.

We do not favor nor do we believe that the law should require any nonmember insured or uninsured bank to be subject to the same reserve requirements as State member banks of the Federal Reserve System. Membership in the Federal Reserve System has always been on a voluntary basis since the very inception of the Federal Reserve Act, and it is our sincere belief that membership should continue to be on such an optional basis.

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William A. Lyon (New York)

The principal function of bank reserve requirements today is to control the supply of available credit. Discount rates and open-market operations accomplish the same results and are more satisfactory instruments for central bank operations. Reliance should be placed more on them and less on changes in reserve requirements. There is no necessity then to think of invading the States' powers in this field. For a number of years New York State has followed the lead of the Federal Reserve in fixing reserve requirements.

G. M. Matthews (Wisconsin)

I believe the principal function of bank reserve requirements is to provide liquidity against deposit withdrawals. I do not believe that all insured banks should be subject to the same reserve requirements as member banks of the Federal Reserve System. My answer is based upon the opinion that placing reserve requirements on one level and placing the control of them in the hands of a few individuals concentrates too much economic power in such hands with no assurance that it would be properly used.

There is also the factor that no two communities are alike and the need for reserves to meet withdrawals can very well be naturally greater in one area at a particular time than in another. As there is no uniformity in the conditions faced by banks why should there be uniformity in their operations.

L. R. Ritchie (Virginia)

Originally, the principal function of the bank reserve requirement was to maintain a reasonable amount of total deposits in liquid funds as a safeguard against unforeseen contingencies that might arise. With the advent of the Federal Reserve System, it became regarded mainly as an instrument of credit control. More recently in many circles the idea has been advanced that it should be used primarily to create a stable market for Government obligations at the lowest possible cost.

With about 85 percent of all deposits in banks now under the reserve requirements of the Federal Reserve System and with other controls which it has, it appears that the Federal Reserve banks have sufficient controls to provide an elastic currency and to regulate the orderly

flow of credit as was contemplated by the drafters of the Federal Reserve Act.

If the additional duty of maintaining a stable market for Government obligations at the lowest possible cost is to be imposed upon the Federal Reserve banks, it might prove to be a burden at a later date too great to be carried.

We do not believe that all insured banks should be subject to the same requirements as member banks of the Federal Reserve System. Any Federal legislation which will attempt to make it mandatory would constitute a further encroachment against States' rights and would endanger the dual banking system.

Homer E. Robinson (Maine)

We believe that reserve requirements were set up by statute to protect depositors, and to provide, insofar as possible, for all reasonable demands for cash from depositors. Our statute gives the bank commissioner sole authority to set reserves in this State. So far he has considered the reserve requirements set up by the Federal Reserve System to be reasonable, and has set State reserve requirements at the same level. However, any attempt to set reserves of all insured banks at the same levels of the Federal Reserve System, irrespective of the provisions of the Maine statutes, would, in our opinion, be an impairment of States' rights, and a body blow to the dual system of banking. This dual system may not be perfect but we consider it infinitely superior to centralized banking control.

A. A. Rogers (Oregon)

Bank reserves are established and maintained to meet ordinary and expected withdrawals of deposits. In this State reserves must equal 15 percent of demand deposits and 5 percent of time deposits which have been, of late years, sufficient. Oregon law provides that the superintendent of banks, with the approval of the banking board, may require an increase in reserves up to 30 percent of demand deposits and 10 percent of time deposits when it shall be determined that same is necessary for the maintenance of sound banking practices or the prevention of injurious credit expansion.

I do not hold the view that all insured banks should be subject to reserve requirements of member banks of the Federal Reserve System. This would be an encroachment against States' rights and our system of dual banking. Further, it is not necessary or in the interest of safe and sound banking.

H. G. Shaffner (Missouri)

The principal function of a bank's reserve requirement is to provide sufficient cash to take care of a reasonable emergency of deposit withdrawals. The banking laws of this State now require a sufficient cash reserve to take care of any reasonable withdrawals. It has long been the opinion of many in this State that nonmember State banks should not be subject to the same reserve requirements as member banks of the Federal Reserve System. All banks in this State carry a substantial amount in United States Government direct and guaranteed obligations which may also be converted to cash promptly in case of an emergency.

Roy W. Simmons (*Utah*)

It has long been the attitude of State bank officials that to subject State nonmember banks to the same reserve requirements as is required for member banks would be taking a great step toward unification of the banking system and abolition of what we know as dual banking. This would not only be an invasion of States' rights, but could lead to calamitous results for the banking world.

Maurice C. Sparling (*California*)

Banks must at all times definitely have a reasonable margin of liquidity. They must at all times be able to meet the ordinary, and to a reasonable extent, even the normally unexpected, and extraordinary, demands of the public for a repayment of deposits. Bank reserve requirements are for the purpose of maintaining such reasonable liquidity and margin of safety.

All insured banks should not be made subject to the same reserve requirements as a member of the Federal Reserve System.

In this Nation we have both State-chartered and nationally chartered banks. This constitutes what is known as the dual-banking system. This dual-banking system must be maintained at all costs. If not so maintained, we must revert solely to a State-chartered bank system, rather than solely to a national system. It is highly essential that we maintain our States' rights and immediately stop all further encroachments by the Federal Government. We already have entirely too much Federal control for the best interests of our Nation and citizens.

The States remain free and the predominant authority in the regulation of their State-chartered banks. State-chartered banks are today able to freely choose whether or not they wish to become members of the Federal Reserve System. This free choice must be maintained, and neither the Federal Reserve System, nor the Federal Government, should be allowed to dictate the reserve requirements for nonmember State banks. The disadvantage of so doing will outweigh all possible advantages. It may be further pointed out that reserves reasonably required will materially differ in various parts of the country at various times. While State bank supervisors should have the authority to require the State banks to maintain reserves at the same amount required of member banks, neither they, nor such State banks should be obligated by Federal law or regulation so to do.

W. Royden Watkins (*South Carolina*)

If the principal function of bank reserve requirements is to regulate bank loans, as some of the experts seem to believe, in my opinion that function has proven to be a failure. It is my opinion that its real function is to provide deposits on which the Federal Reserve banks can operate profitably, and carry on the Reserve banks' activities as fiscal agents for the United States Treasury and maintain the finest and most complete clearinghouse system ever devised. Banks under present conditions should maintain reserves so much greater than the legal requirements that it is hardy necessary to discuss the requirements. A competent discussion of reserve requirements seems to involve not a question of how much, but of where it is to be kept. We are opposed to the Federal Reserve requirements being placed on nonmember insured banks.

4. Discuss the adequacy of banking facilities in your State. For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities.

Most supervisors felt that banking facilities in their States were adequate, both with respect to deposit facilities and loan facilities. A number of them referred to the sharp reduction in the number of banking offices during the past 30 years but considered that this had been offset by the improvement in transportation and the greater concentration of population. Some said that temporary inadequacies were sometimes brought about by shifts of population but were soon cleared up by the opening of new branches or the establishment of new institutions. A number stated that they recognized the desirability of giving all persons the opportunity of choosing between two or more competing banks as an ideal, but said that it was not always practicable in sparsely settled areas. Some of these added that when competition was impracticable they generally found that a single bank gave good service to the community.

Extracts from typical replies follow:

L. K. Elmore (Connecticut)

Connecticut is a small State, with an area of 5,004 square miles, and has a fairly concentrated population of 2,007,280 as of the 1950 census. It is well blanketed with banking institutions. There are 55 State banks and trust companies with 33 branches; 47 national banks with 27 branches; 72 savings banks with 10 branches; 7 industrial banks; and 2 private bankers.

Eighty-eight out of the one hundred and sixty-nine towns in the State have banking facilities and these eighty-eight towns represent 91.1 percent of the population of the State. The towns having no banking facilities are sparsely settled and each village in these towns is within a 10-mile radius of a banking outlet.

I fully believe that Connecticut has adequate banking facilities for public need with sufficient competitive outlets but not such as to jeopardize independent banking units. This is equally true of both deposit and loan functions.

J. M. Falkner (Texas)

We are of the opinion that the approximately 900 commercial banks in Texas afford adequate banking facilities for every need. Texas is and has been growing industrially for the past few years but that growth with the need for additional banking facilities has been provided by the establishment of additional banks where the need was evident. By means of a very thorough investigation we attempt to determine the needs for new banks. If it is found that the anticipated volume of business is sufficient to enable a bank to operate profitably then it is assumed there is a need for a bank. Under the existing Federal law, national banks have no greater privileges to maintain branches than the law of the State in which they are located confers upon State banks. We think this policy of the Federal Government is sound and should be continued. Under such conditions the sponsors of new banks have the choice of choosing between State and national

charters. Accepting deposits is a banking function and can only be exercised by banks at their place of business, while loan facilities are available by numerous institutions, not banks.

Thurman R. Hazard (*Ohio*)

Banking facilities in Ohio, as provided by the division of banks and by national banks chartered to do business in Ohio, are deemed adequate to provide convenient places to handle existing demands.

When expenses and support are considered, it would seem unreasonable to assume that given communities should have at least two competing banks. Banks are established for the purpose of providing adequate banking service to people of a community. The establishment of a bank is predicated upon the need and not for the convenience of any group of individuals. The necessity of a bank is a community necessity.

Under existing Federal legislation, national banks have no greater privileges to maintain branches in the State than the law of the State in which they are located confers upon State banks. This policy of the Federal Government is considered to be sound and should be continued.

However, the present practice of the granting of branch authorizations to Federal savings and loan associations without regard to the laws and practices of the individual States governing the chartering of branches of State-chartered savings and loan associations is discriminatory against State-chartered savings and loan associations and inimical to the dual system of financial institutions. This practice should be discontinued.

The banking facilities of Ohio are adequate to meet the banking needs of its citizens. All banking institutions have been chartered with respect to need, capitalization, management, geographical location, and the community's ability to support the bank in the matter of deposits and loans necessary for the successful operation and continued life of the bank.

A. W. Hoese (*Minnesota*)

All the larger cities in Minnesota have adequate banking facilities through State or National banks, or both, and the smaller towns usually have at least one bank. In this State we have banks in towns as small as 51 in population. The small villages without banks are usually in easy reach to banking services in adjoining towns. Many of the small cities and villages, known as one-bank towns, are served by either a State or National bank which we believe is providing the public with a good safe place to deposit their funds and also providing the community with ample credit facilities.

The number of State banks in this State has been reduced by more than one-half from its peak in 1920 through liquidations, consolidations, and mergers. We do not believe that the public has been deprived of any essential banking services due to the reduction from 1,166 State banks, 9 savings banks, 24 trust companies, and 340 national banks in 1920 to 498 State banks, 1 savings bank, 4 trust companies, and 178 national banks at the present time.

We do not believe it is practical to give the public the choice between two or more competing banks when the community or volume of business in that particular area is only sufficient to sustain one good bank.

We believe that the public served by these one-bank towns is getting the identical services at about the same cost as in the communities where there are more than one bank.

Under the present Minnesota law, branch banking is prohibited and while our laws do not specifically prohibit branches for savings and loan associations, it has been the policy of this Department ever since the branch banking statute was enacted not to permit or encourage savings and loan association branches. We oppose the policy of the Federal Home Loan Bank Board permitting branches of Federal savings and loan associations in States whose laws or policies have prohibited them. One branch has been granted by the Board in our State over our protests. We consider this policy as discriminatory against our State-chartered savings, building and loan associations and not in keeping with the sound harmonious policy now in existence under our dual system of banking.

Randolph Hughes (Delaware)

The State of Delaware is a small State, both in area and population. I am confident that the banking facilities in this State are reasonably adequate. I feel that this is true not only as to deposit facilities but also as to loan facilities.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

The number of banking offices in this State, in our judgment, is adequate to supply the current needs for banking facilities, and there are few existing banking offices which could reasonably be considered unnecessary.

So far as we are aware, there is no community in this State not supplied with banking facilities within reasonable proximity of the area. It would be utterly ridiculous in the rural areas of any State for any supervisory authority to consider it necessary to supply banking needs to the remotest areas within the boundaries of the respective State.

It would be difficult to arrive at a rule of thumb or a mathematical formula for determining the proper number of banking offices or facilities in a given area. Many factors, including population, transportation facilities, and the extent of business activities, must be taken into consideration in answering this question. The preferable policy is to consider each application for banking services under the establishment of a new office on its own merits and determine by special investigation in each case whether the public convenience requires additional banking facilities in a particular locality, and whether the locality offers favorable prospects for profitable operation of the proposed new banking office.

William A. Lyon (New York)

The banking facilities of various kinds available to the people of New York State are in general adequate and provide a wide choice of different and actively competing institutions, both for the deposit of funds and the extension of credit. However, shifts of business and population require accompanying changes in the location of banking offices and give rise to new needs for banking establishments.

The urban areas of the State are best supplied with deposit and lending facilities, it being easier, under present provisions of the banking law, to accommodate their changing needs. Existing offices and

branches may be relocated and new branches may be permitted to open within the same banking district.

Outside the metropolitan area new needs have not as often been met with the same promptness. The difficulties in the way of providing services vary according to institutions. Commercial banks are hindered by the unduly high capital requirements for membership in the Federal Reserve System. This Department feels that these requirements should be brought to a more practical and still safe level.

The problem with regard to mutual savings institutions is more basic. Mutual savings banks are limited in their power of opening new branches to the few largest cities in the State, while savings and loan associations can establish only one branch, and that within 50 miles of the head office. In recent years it has become more difficult to raise the capital necessary for organizing a new mutual institution. Branch powers, as a result, have acquired greater significance.

The problems posed by this situation are now the subject of study by banking and supervisory authorities in New York State. In working out these problems it would be most helpful if the Home Loan Bank Board would join in the common effort and observe the statutes with respect to branches that exist in the various States. Congress has declared this to be the policy of the country for the national banking system. As for the home loan bank, there is no indication in the statutes what powers the Board has, if any, to authorize branches for Federal savings and loan associations. Such powers should be spelled out by the Congress to bring the policies of the Board into harmony with State laws.

G. M. Matthews (*Wisconsin*)

I consider banking facilities in this State adequate. In my opinion, there are sufficient deposit facilities and there are also sufficient loan facilities. As a matter of fact it appears to me that there is presently no need for as many Federal loan agencies as do exist.

L. R. Ritchie (*Virginia*)

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We consider the banking facilities in this State as reasonably adequate. Almost without exception where deposit facilities are available, so likewise loan facilities are available. While it is true many of our banks located outside of the principal financial centers are not prepared to extend credit to all of their customers in the forms and in the amounts desired by them, yet on the whole, the banks are most anxious to be of maximum service consistent with safety to depositors' and stockholders' funds.

Homer E. Robinson (*Maine*)

We believe banking facilities in this State are adequate. There are 33 national banks with 9 branches; 30 trust companies (State chartered commercial banks) with 65 branches and agencies; 32 savings banks with 2 branches and 30 loan and building associations. Equal opportunity for deposit or loan business is provided in every area of Maine that can support banking facilities. It is true that not every small town has a bank or branch, but in these days of banking by mail and fast transportation by cars and other means of travel, existing facilities are in easy reach of practically every inhabitant of incorporated towns

and cities. It would seem to us that a prospective customer could have a choice of two or more banks within a reasonable trading area.

A. A. Rogers (Oregon)

In my opinion there are two or three communities in Oregon, having no banking facilities, that could support a bank or branch, but this is being corrected as rapidly as banking personnel is available to staff new banks or branches. In Oregon we have two national banks that have branches in all counties but two. They hold more than 80 percent of our banking assets. In some localities they have no competition and where this is the case the residents do not now have an opportunity of choice. As a general rule they provide good banking service, but where a home-owned and locally managed bank is in competition the independent bank enjoys a very substantial part of the business of the community. Deposits of independent State banks of Oregon have increased during the past 10 years by 427 percent, loans by 381 percent; deposits of national banks have increased in the same period by 218 percent and loans by 306 percent.

H. G. Shaffner (Missouri)

It has been the policy of this division to be most cautious in extending banking facilities beyond the present number in this State. Most any community in the State at this time can show a need for a bank on the basis of deposits. The question is whether or not they can obtain a sufficient loan volume to provide a satisfactory income. This division has never hesitated to charter a bank where satisfactory income was in evidence. In this State there are many small towns in which no bank is located; however, in no instance is the distance to a bank unreasonable.

Roy W. Simmons (Utah)

I realize that there are certain areas within our State which do not have adequate banking facilities, and the primary reason for this is the unsatisfactory return which investors might expect in the face of rigid Federal requirements regarding reserves, coupled with an increasingly high tax load. I believe that all people should have the opportunity of choosing between two or more competing banks, but, in a sparsely settled area such as we have, this would hardly be possible.

Maurice C. Sparling (California)

Banking facilities in California are either completely adequate at this time, or conditions are such that they can be made immediately adequate through the chartering of additional banks or branches as conditions require. Both National and State banks may have branches in this State, and there is now no area in this State that does not have reasonable access to adequate banking facilities, and, generally speaking, to competitive banking facilities. This is true both as to deposit and loan facilities. In those instances where the local bank, or banks, are unable to make a loan of sufficient size, such loan can be obtained if merited, either through the larger city banks, or through such city correspondent banks' participation, with the local bank in the making of such loan. The bank and loan facilities in this State are adequate, through private banking facilities, and without the need of any Government lending agencies.

W. Royden Watkins (South Carolina)

With some exceptions, banking facilities in this State are reasonably adequate. Geographically, the State is small, but it is served by 25 national banks with 34 branches, 102 State banks with 14 branches, and 1 military facility, and 23 cash depositories, but the clamor for additional facilities goes on.

5. Discuss in general your policy in acting on applications for new State-bank charters. Stress your concept of what constitutes ample banking facilities—especially the degree of competition which you believe to be necessary or desirable.

The answers to this question placed greatest emphasis on prospects for profitable operation. When such prospects existed, the other factors which had to be taken into account were public convenience, the quality of management, and the competitive situation—the last in the dual sense of avoiding too much competition (i. e., enough to threaten the profitability of existing institutions) and to introduce some competition when little or none existed. There was a general anxiety to avoid the "over-banked" condition which existed in the twenties. A number of the supervisors stressed that bank charters had to be considered on a case-by-case basis at the discretion of the supervisory authority and should not be granted as a matter of right to any persons meeting the minimum qualifications prescribed by statute.

Extracts from typical replies follow:

L. M. Campbell (Pennsylvania)

It is believed that, generally speaking, banking facilities in Pennsylvania are adequate. While there have been few new State charters issued in the past 10 years, existing institutions, when necessary, have established branch offices to bring deposit and loan facilities to areas which were newly developed and entitled to banking service.

It would be difficult to arrive at a rule of thumb or a mathematical rule for determining the proper number of banking offices in a given area. Many factors, including population, transportation facilities, and character and extent of the business activity must be taken into consideration in answering this question. The preferable policy is to consider each application for authorization to establish a new bank or a branch office on its own merits and determine by investigation in each case whether the public convenience requires additional banking facilities in the particular locality and whether the locality offers favorable prospects for satisfactory operation of the proposed new banking office.

Presently there seem to be many shifts of population from one area to another. Business is obtaining new locations and with it go thousands of workers. These people are entitled to adequate banking service. Many of the newly developed areas are near places where banking facilities now exist. If these institutions will provide the necessary service for the additional people coming into the area they should be permitted to do so; if not, new facilities must be provided.

There must be no prejudices against branch banking in providing necessary banking facilities for every community. The need for branch offices should be considered and decided on the basis of the best

possible service to the agricultural and business community and to the public in general. The branch banking question has been too much argued, by banks and bankers, on the basis of immediate self-interest, sectional prejudices, and the competing and conflicting claims and aims of existing institutions, fighting to preserve or improve their positions.

L. K. Elmore (Connecticut)

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It is my opinion that any trade area large enough to support a successful bank or branch operation should have one or more outlets. Sound and ethical competition is, I believe, a healthy thing but, of course, not to the extent of hazard to existing independent banking institutions.

J. M. Falkner (Texas)

In passing on new bank applications the board must determine the following factors:

1. Public necessity.
2. Adequacy of capital.
3. Anticipated volume of business to insure profitable operation.
4. Experience and ability of directors and officers to successfully operate the bank.
5. Good faith of applicants.

In determining the adequacy of banking facilities for a town or community consideration must be given to the volume of business transacted, physical facilities, earnings, and population.

Thurman R. Hazard (Ohio)

The present policy of the Division of Banks of Ohio, in giving prompt consideration to all applications requesting the consent of the superintendent of banks to establish a bank, is believed to be wise and for the healthy economic being of the whole State.

If the promoters' presentation of the needs indicates a general demand and support of a bank, then a survey is made by competent examiners representing the supervisory authorities to determine the worthiness of the proposal. A careful and detailed investigation is made of business conditions, the character and reputation of the proposed incorporators of the bank, the adequacy of the banking premises for banking purposes, the competency of the proposed management to operate a bank, the proximity of other established banks in the community wherein the new bank is to be located, the opinions of the citizens of the community as to the advisability of opening a new bank, and the extent of their support of the bank in respect to deposits, etc. The report of the investigation is filed with the superintendent of banks who submits it to the State banking advisory board for its consideration. A meeting is held by the board on a certain specified date to consider the report, and both the proponents and opponents are notified of the meeting and are privileged to appear and show cause why the application should be approved or denied.

Banks in Ohio are not chartered unless the statutory capital requirements are fully met and the banks so located to warrant a population and community wealth which would provide adequate earnings to meet the operating expenses and assure the building up of a strong capital account.

A. W. Hoese (Minnesota)

All applications for Minnesota State bank charters are decided at a public hearing, which may be attended by opponents as well as proponents of the charter. Our laws contain certain statutory requirements which must be affirmatively shown before a charter can be granted. These include evidence that the incorporators are of good moral character and financial integrity, that there is a positive need for banking facilities in the community for which the charter is applied, that only necessary expenses are paid in the promotion of the charter, that the bank will be capably and safely managed, and that the granting of such charter will not endanger the solvency of existing financial institutions in the community affected. Usually the determination of the above factors, when properly brought out at the hearing, quite clearly indicates whether or not the charter can safely and properly be issued. As to the degree of competition which banks and financial institutions should have, this is, of course, a matter of opinion. As to the State of Minnesota, it can positively be shown that excessive competition was one of the chief contributing factors toward the large number of bank failures in the years from 1920 to 1933. A bank to be successful must make adequate profits and excessive competition is directly opposed to such result.

Randolph Hughes (Delaware)

The policy of acting on applications for State-chartered banks is largely dictated by law. Our statute requires that before approving the application for a new charter that the board of bank incorporation must satisfy themselves as to the convenience and necessity of the proposed bank. I believe that, due to the size of our State, the question of competition is not a very great factor.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

Originally the formation of a bank in Maryland was authorized by special legislative act. The legislature in 1910 prescribed that banks were to be authorized under general law and that charters be granted to anyone meeting the requirements enumerated in the statute The immediate results of this policy were excessive chartering, leading to destructive competition, and the establishment of institutions by many individuals who were not qualfied by ability or character to carry on the business of banking. It was later recognized that to insure a sound banking structure it was necessary to regulate the number of banks which might be established in a given community and to exercise reasonable care to prevent obviously unqualified persons from setting themselves up in the banking business.

If no chartering restrictions had been established, competition might ultimately have determined the proper number of banks in any given community, but experience with this rigorous policy proved too costly to the public. As failures occasioned loss to numerous individuals in the community, it was recognized that the business of banking differed in one fundamental respect from that of a tradesman or other entrepreneur. While the latter usually operates with his own funds or with other equity capital, the banker does business to a large extent with money left with him on deposit.

The chartering agency has a vital interest in the profitable operation of banks, for an adequate income is essential if banks are to acquire

assets involving a minimum of risk. Profitable operation is impossible if rival banking institutions are permitted to spring up without limit to divide the existing business.

Objections on the ground of monopoly are the only ones which can reasonably be made against a policy of restrictive chartering, or the so-called case-by-case method. Monopoly, however, if properly regulated, has long been recognized as redounding to the public interest in such fields as telephonic communications, electric and gas light, and power. Banking, on the other hand, has never been granted the completely monopolistic privileges that have been granted to the utilities. While a particular town or city may have only one telephone company, it will be granted more than one bank if its population and business needs justify additional banking facilities. Furthermore, other institutions of various kinds compete for certain types of business transacted by commercial banks, such as the acceptance of savings, the making of mortgage loans, and the extension of consumer and agricultural credit. Opposition on the ground of monopoly, therefore, is not well founded.

The consolidation of two or more banking institutions seldom raises any difficult question of policy. If investigation shows that the institution resulting from the consolidation will result in a sound condition, that a desirable degree of competition in any locality will not be eliminated, and that no community will be deprived of banking facilities to which it appears to be entitled, the proposed consolidation ordinarily is approved. The consolidation, however, usually will not be approved if it will result in an undesirable concentration of control over banking resources in any given locality or will leave any community without reasonably convenient and suitable banking facilities. In some cases, of course, the necessity or desirability of strengthening the banking structure in a given locality must necessarily outweigh other factors. For example, if a bank seriously in need of additional capital should be unable to raise such capital in any manner, its consolidation with another bank might be approved even under terms and conditions which would lead to disapproval if both constituent institutions were in good condition.

In the case of a statutory merger under the existing banking laws, it is unnecessary for this department, in determining whether to approve or disapprove said merger agreement, to base its final decision to any great extent upon the effect of the consolidation upon stockholders, since the statute affords them adequate protection. The holders of two-thirds of the stock of each constituent bank which is a party to the proposed merger must give affirmative approval, and the dissenting stockholders under the statute are given the right to have their equity in their stockholdings appraised and to receive cash in payment thereof for the reasonably sound appraised value of the same.

William A. Lyon (New York)

Ample banking facilities are the goal of the New York State Banking Department, as shown in the answer to question 4 above. The only limitations to a sound expansion of the banking system, in step with a growing population and industrial progress, would seem to be (*a*) the ability of a community to afford a new institution and (*b*) the quality of the new management, provided Federal and State laws as to capital, plans of operation, etc., are met.

The lessons of the twenties clearly show the dangers of overchartering banks relative to the available business in times of prosperity and how this may lead to destructive competition in times of recession, thus impairing bank earnings, bank capital, and finally public confidence in the banks. An illustration of this is to be found in the rate wars over interest paid on deposits which were an important contributing factor to the wave of bank failures in the thirties.

Between 1919 and 1929 there were 75 additions to the State-chartered banks and trust companies in New York; but, of the 381 institutions operating at the end of 1929, 79 institutions, or more than one-quarter, went out of existence in the next 5 years. Our policy, therefore, is predicated on the belief that new institutions, to truly serve the public convenience and advantage, must hold out reasonable promise of stable, sound, and profitable operations.

G. M. Matthews (Wisconsin)

In considering applications for new State bank charters, we are concerned with convenience and necessity and whether or not these two factors are sufficient to assure that a new bank, if efficiently managed, will be successful. Competition is not a factor unless there is a showing that existing facilities are not rendering satisfactory service by taking advantage of a monopolistic situation.

L. R. Ritchie (Virginia)

Our concept of what constitutes ample banking facilities may be summed up as follows:

(*a*) Will the bank or additional bank contribute to the financial growth and well-being of the community?

(*b*) Will it contribute to healthy competition as opposed to monopolistic tendencies in the banking business?

(*c*) Will the bank afford deposit, loan, and other facilities to a sizable group that is not presently being served?

(*d*) Is there a public need for banking or additional banking facilities with reasonable likelihood of profitable operations?

Homer E. Robinson (Maine)

Our statute gives the bank commissioner sole authority to grant State charters, giving due thought to "public convenience and advantage." In addition to surveying and evaluating the public's advantage, we also try to determine the prospect for eventual profitable operation. This is particularly true with branch applications, as we hesitate to allow facilities that will be a source of loss and embarrassment to the parent bank. In the case of new banks (none petitioned for since 1934) we should be particularly careful that probable business would be adequate to allow for safe operation with adequate protection to depositors.

Due to the fact that banking is a strictly regulated business by both State and Federal statutes, we believe that, although reasonable competition is healthy, an excessive amount of this would be a source of loss to all banks concerned. In fact, the unwise and too liberal chartering of banks prior to 1930 is supposed by many competent financial authorities to have been one of the causes of the bank holiday. It does not seem logical that banking can be expected to prosper and offer safe facilities to the public and still be subject to the degree of competition usually experienced by commercial enterprises, either

corporate or personal. The fact that banks are using the funds of the public, for the most part, should not be lost sight of when considering a desirable degree of competition.

A. A. Rogers (Oregon)

When application has been filed for authority to organize a new State bank, one of my requirements is that financial statements must be supplied by each applicant, all prospective directors and officers. In my investigation I try to develop full information as to the character, general fitness, and business ability of each person to be connected with the new bank. I personally visit the community and confer with a representative group of local residents. If in my opinion sufficient business can be developed to cover operating expenses, care for losses that may occur, build up reserves and surplus, and in time return some profit in the way of dividends to the stockholders; and if in my opinion the bank will employ competent officers and have a board of directors that will direct, I approve of the application. I require what I term as adequate capital but hold that capital ratios are not all-important, for the success or failure of the bank will depend on the management.

Ample banking facilities exist, in my opinion, where the banking offices in the city or community are capable of and are serving the banking and all legitimate credit needs of the city or community and not forcing certain would-be customers to go elsewhere to secure credit accommodations. It is a well-known fact that if a bank is to be successful it must make a profit or it soon ceases to be an asset to the city or community. No one bank can satisfy all residents of their city or community, but do not believe that as superintendent of banks I should approve a second bank in order to satisfy a small portion of the residents, especially where it seems evident that the existing bank would be weakened by the loss of a portion of the existing business and the new bank, while providing competition, would not be a successful institution.

H. G. Shaffner (Missouri)

As stated, there is no community in this State which could support a banking facility which does not have one. The communities without banks are within a reasonable distance of banks. It is a struggle for a small banking facility to earn enough income to pay expenses, including a dividend, and increase their capital account. Then, too, many small units in a short time will be faced with management and personnel problems as the present management and personnel retire. In this State there are now a number of banks which may find it impossible to obtain satisfactory management in the future.

Roy W. Simmons (Utah)

During the past 10 years there have been so few bank applications in our State it is difficult to discuss this question. The basic requirement is that the bank must show evidence that its deposits will be insured by the Federal Deposit Insurance Corporation if the charter is issued. Therefore, in order to receive a State charter the applicant must meet the Federal Deposit Insurance Corporation or Federal Reserve bank requirements.

Maurice C. Sparling (California)

New banks are only chartered in this State—

1. Where there is a public need to be served; and
2. Where there is reasonable assurance that the bank can be profitably operated, even in times of general depression.

In all instances when application for a bank is filed and such two conditions are met, the application is granted. Competent management is, of course, taken into consideration under the second condition above referred to.

When chartering banks, this department goes upon the theory that one strong bank in the community is much more desirable than two weak banks, and competition is not a reasonable public necessity in the case of banking. If the sole bank in the community is not adequately serving the public, the State supervising authority can generally bring sufficient pressure upon such bank to correct such deficiency. If the particular area needs and can reasonably support additional banking facilities without danger of seriously weakening the existing banking facilities, additional banking facilities are immediately chartered. An area has adequate banking facilities when the borrowing needs of the public are being met with reasonable safety to the bank; the public need not travel unreasonable distances to the banking facility or have to unreasonably wait in order to be served. There is no area in this State from which one would have to travel any unreasonably great distance in order to reach competitive banking facilities. Of course, much of banking is, and most conveniently can be, conducted by mail.

6. Would you please submit a statistical analysis showing year by year for the past 10 years the number of applications filed for State bank charters in your State, the number approved, the number rejected, and the causes for rejection, classified by such principal reasons as (*a*) existence of ample banking facilities, (*b*) no prospect of successful financial operation, (*c*) inadequate capital for the establishment of the bank or branch, (*d*) no satisfactory evidence that competent management would be available, etc.? Comment on this analysis in any manner which you consider appropriate.

Very few applications have been made for State bank charters in recent years. (The same is true of national bank charters, see question 20 for the Comptroller of the Currency.) The State of Maine, for example, has had no applications for State bank charters since 1934; the State of Delaware, none in the past 10 years. Even in the large State of Pennsylvania only three applications for charters (all granted) have been made since 1933. The only important exception to this rule is in the rapidly growing States of the Southwest. In Texas 298 State bank charters have been applied for and 255 granted in the past 10 years. The commonest reason for rejection is lack of profit prospects. In explaining the small number of applications, some supervisors pointed to the economic maturity of their States and their present complete network of banking institutions and some to the low level of banking profits relative to those in other industries. Some referred to the fact that bank stocks generally are selling below their break-up values and said that this left little induce-

ment to form new banks. As noted earlier, most of them considered banking facilities in their States reasonably adequate.

Extracts from typical replies follow:

L. M. Campbell (*Pennsylvania*)

* * * * * * *

Only three new banking charters have been formally applied for and granted since 1933.

None has been formally applied for and rejected.

* * * * * * *

L. K. Elmore (*Connecticut*)

Although there have been a half dozen or so informal discussions or inquiries during the past 10 years, there has been only one formal application for the organization of a State bank and trust company. This one application was processed and a new bank organized under State charter on September 19, 1949. The informal discussions and inquiries mentioned above never reached the formal stage because of the failure of the interested people to carry the matter forward and not because of any rejection on the part of the supervisory authorities.

During the same 10-year period, there have been four national banks organized in the State. The small number of new banks organized reflects the extent of the existing banking coverage. The reason for the preference for national charter is because of the lesser capital requirements under Federal law.

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J. M. Falkner (*Texas*)

Within the past 10 years 298 charter applications have been considered by the banking board. These are in addition to several which were withdrawn for one reason or another prior to coming before the board.

(*a*) Thirty were declined because of existence of ample banking facilities.

(*b*) Twelve were declined because of no prospect of successful future operations.

(*c*) None.

(*d*) One declined because of lack of competent management.

These factors are determined by an exhaustive survey by representatives of the Federal Reserve Bank, the Federal Deposit Insurance Corporation, and our State banking department.

Randolph Hughes (*Delaware*)

There have not been any applications filed for new State bank charters during the last 10 years. I think that the reason for this is that the economy of the State has not materially changed during the last 10 years. The majority of our State-chartered banks are small and the facilities have been adequate to sufficiently take care of the increase in both deposits and loans.

W. H. Kirkwood, Jr., and John D. Hospelhorn (*Maryland*)

In reviewing the files of this department, it is interesting to note that since 1935 through the present period, this department was only formally solicited for three State bank charters * * * in all three of these cases * * * approval was granted. * * *

William A. Lyon (New York)

Over the last 6 or 7 years the department has received a moderate number of inquiries regarding organization of new banks. These generally fall into three categories, namely, (*a*) requests for general information as to legal and administrative requirements for organization, (*b*) discussions with persons who had ideas that a bank offered a means of realizing large profits, and (*c*) discussions with interested parties from communities which were new or had experienced above average growth and expansion. In the latter cases existing banks, in some instances, found the territory attractive and profitable and subsequently provided branch facilities. * * *

G. M. Matthews (Wisconsin)

Over the last 10 years we had no applications for new charters in 1943, 1945, or 1950. We had one each in 1942, 1944, 1946, 1947, 1948, and 1949. All were approved except the one received in 1947. Two applications have been received so far in 1951. One was approved and the other is presently pending. The application in 1947 was rejected because there was no satisfactory evidence competent management would be available and, also, due to the fact that adequate banking facilities were available not far distant.

L. R. Ritchie (Virginia)

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No disapprovals of applications for certificate of authority to commence business of banking for years 1941 through 1950.

Homer E. Robinson (Maine)

No charters for separate banks (i. e. other than for branches) have been requested since 1934.

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7. Discuss the changes during the past 25 years in the ease or difficulty with which small-business men can borrow from their local banks in your State. Explain the reasons for such changes as you find to have occurred. Do you believe that a more liberal lending policy by commercial banks to small-business borrowers would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to foster such a policy? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

The majority of bank supervisors believed that it was easier for small-business men of sound credit to borrow in their States than was the case 25 years ago. A smaller number believed the reverse to be the case. The factor most generally referred to as working toward tighter credit facilities was the greater conservatism of bankers because of the hard lessons which they had learned during the 1920's and the early years of the depression. The major factors listed as working toward easier conditions were improved lending techniques (as through improved methods of lending on warehouse receipts, accounts receivable, etc.), improved accounting techniques on the part of small business itself, and the greater struggle for profits in the banking business due to lower interest rates and higher expenses and taxes. Apart from

comparisons with conditions 25 years ago, most of the supervisors appeared to believe that credit facilities for small business were reasonably adequate and that a further liberalization would involve losses to the lenders greater than consistent with sound banking practices and a waste of social capital.

Extracts from typical replies follow:

L. M. Campbell (Pennsylvania)

We are convinced that our banking institutions provide adequate credit for small-business men. Our examination reports in recent years reflect substantial increases in loans to small-business men and such loans, in the main, have proved very satisfactory.

Our banking institutions have broadened their service to small-business men through the use of term loans, trust receipt financing, consumer credit and other forms of installment lending. It is our opinion that every deserving small-business man does find ample credit available from our lending institutions, particularly if the credit he seeks will enable him to increase his contribution to goods produced for the war effort.

The only restrictions we have noted in available credit for small-business men arise through the wholehearted cooperation of the banking profession in the voluntary credit restraint program. The small-business men seeking to obtain credit solely for the purpose of building inventories will find difficulty in obtaining credit from the banking industry.

L. K. Elmore (Connecticut)

During the past 25 years, there has been a steady decrease in the size of the individual loan by banks, and increasing emphasis on the loan to the small borrower. There has been a steady increase in direct loaning by financial institutions to business and to individuals. The first break in the old method, i. e., the manufacturer carrying the distributor, the distributor carrying the retailer, etc., occurred in the twenties with direct loan to the purchaser on automobiles, largely, in fact, through finance company operation and when, after the stock market break, business started to turn from corporate financing to direct borrowing from banks. As time went on, however, the banks have participated more and more fully in this direct auto loan field. This lending philosophy spread to other fields and banks have increasingly stepped up their loans to business, with particular emphasis on small business.

I am convinced that the existing banking system of this Nation provides facilities ample to supply all legitimate demands for credit by industries, whether large or small, and that, with few or no exceptions, banks are anxious to accommodate the credit needs of both individuals and corporations.

* * * * * * *

J. M. Falkner (Texas)

It is our observation that over the past 25 years in which banking has undergone drastic changes that more and more banks have recognized the needs of small business and have met that need to their ability. This seems to be evident by the growth and development of our country during the period. We believe that the existing banking system of the Nation provides ample facilities to supply all legitimate

demands for credit by industries whether large or small, and that with few or no exceptions banks are anxious to accommodate the credit needs of both individuals and corporations.

Thurman R. Hazard (*Ohio*)

While considerable question may exist as to the merits of claims of unfulfilled needs, it is an era in which factual evidence does not exist and would be difficult to develop.

The so-called need for credit by small business falls into two types: (a) small personal business wanting modest credit accommodations, say up to $10,000, and (b) larger amounts, say up to $50,000 to $100,000, but not sufficiently established or capitalized to warrant accommodations under customary credit standards. This is a situation that must be clearly recognized by both banks and supervisory authorities.

Credit accommodations should be predicated upon ability to pay. Customary standards have been established to warrant credit accommodations, and if an individual or corporation making application for a loan, be it large or small, can qualify under these established standards and credit policies, it is sincerely believed that he or they can secure adequate support from the banks in that particular community wherein the applicant resides or from the correspondent banks of the local banks.

Banks are chartered under State and National laws which clearly define the scope of their business and accountability under the law. Whether a bank is conducting its day-by-day business in accordance with statutory limitations is to be determined by an examination of that bank as provided for under section 710–19 of the General Code of Ohio. The statute is very broad and gives the superintendent of banks and his examiners full authority to investigate thoroughly the manner in which the bank is being operated.

The banking statutes do not recite or indicate that good, safe, and sound banking is predicated upon loans to any particular class of borrowers. However, the statute does presuppose that all applications for loans should be considered in an unbiased and impartial way with respect to the borrower and in accordance to sound established loaning policies and standards. Security and ability to pay is basic in making bank loans. Small business loans, as well as large business loans, should be amply secured or substantiated by a satisfactory financial statement signed by the borrower or borrowers.

Enterprises seeking credit accommodations not available under customary lending standards causes concern lest any program which might be adopted by Congress be placed in the hands of persons without experience in banking operations; possibly the Federal Reserve banks would be the logical place for such a program.

The existing banking system of this Nation provides ample facilities to supply all legitimate demands for credit by industries, whether large or small, and that with few or no exceptions banks are anxious to accommodate the credit needs of both individuals and corporations.

The State banks of Ohio occupy a strong financial position and are extending credit for all worthy business and enterprise; and at the same time they are retaining a degree of liquidity which enables the banks to meet the demands for funds from depositors and borrowers.

A. W. Hoese (Minnesota)

It is our considered opinion that there has been relatively little, if any, difficulty on the part of small businesses to borrow funds adequate for their needs in this State at any time in the past 25 years with the possible exception of 1933, which was the year of bank reorganizations and at which time borrowing money was an extremely difficult matter for large as well as small businesses and for wealthy as well as for poor people. The fact that with the exception of a small number of metropolitan areas, Minnesota is mainly an agricultural State its so-called country banks serve urban as well as rural population. We believe that our banks, generally speaking, are adequately capitalized and have sufficient funds to take care of all bank credit needs whether by small business or farmers.

Randolph Hughes (Delaware)

I am confident that the small-business men have had adequate credit facilities during the past 25 years insofar as the local banks are concerned. I do not believe that a more liberal lending policy by commercial banks to small-business men is necessary. I believe that, on the whole, the banks in this State are fully adequate to meet the needs of the small-business men.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

Our studies and surveys of the banking institutions of our particular State, in our judgment, clearly reflect that the banks, both city as well as the rural institutions, are eager and willing to make loans either to large or small businesses, providing, of course, that the credit position of the applicant is such as to warrant the management to believe that the contracts for the debts will be met by the obligors in accordance with the terms. The experience gained by many bankers in the late twenties and through the early thirties has made them wiser in their credit selections, but in no way do these experiences make the banker prejudicial to local loans.

Our State is very small; however, for its size, we do have a reasonable amount of agricultural activity, industry, and commercial businesses in the large industrial areas, as well as the outlying county municipalities. Our experience in the thirties clearly shows that the greatest losses suffered, by far, in our banks which were in financial difficulty at that time, were not through causes from local loans, but mainly from investments of various kinds in the security field. It is our conviction that our banks are meeting satisfactorily not only the demands of the rural farmers, industries both large and small, but also consumer credit, as well as long-term mortgage financing.

We are convinced that the existing banking system of this country provides facilities ample to supply all legitimate demands for credit by industries whether large or small, and that with few exceptions, banks are anxious to accommodate the credit needs of both industries and corporations, consistent with the present program of maintaining the economic stability of this country.

William A. Lyon (New York)

Lending facilities for small borrowers are generally ample. Credit is more easily available now because of a keener search for loans, and the influence of 11 prosperous years on the credit standing of borrowers.

The establishment of personal loan departments in the banks of New York State since 1936 has opened up an additional avenue for lending to small-business men when greater-than-usual risks may warrant a higher loan return. The maximum legal rate in these departments is 12 percent per annum rather than the usual 6 percent on the unpaid principal balance. Repayments take place in instalments which extend for up to 2 years. The maximum loan principal ranges from $1,500 to $3,500, depending on the location of the bank. It may be noted that competition among the banks has reduced the effective average rate by about one-fifth below the legal maximum.

G. M. Matthews (Wisconsin)

I would say that in the main it is harder for small-business men to borrow money from banks now than it was 25 years ago. However, I have no reason to think that a small-business man of today who deserves credit and is a good risk cannot get it. Loans today are made on a sounder basis than they probably were 25 years ago. Many banks followed a too liberal loan policy, and that contributed to their downfall when the depression years were upon them.

In answer to the question of whether or not a more liberal lending policy would contribute to the diversification of economic power and to the dynamic character of the economy, I would say that there is great danger in being too liberal in making credit available. Liberal credit contributes to inefficient business operation, overexpansion, etc., and consequently many small-business failures have resulted therefrom. In my opinion, credit is not an inherent right of any individual or business but rather is a privilege which must be earned.

Emergencies must, of course, be considered when discussing the broad problem of credit. In a time of national emergency, undoubtedly there are times when credit should be liberalized provided the credit granted will contribute to the recovery or protection of our national interests, but a banker is a trustee for his depositors' funds and should not be asked to violate that trust without the consent of his depositors, even though for a worthy cause. By that, I mean in times of emergency arrangements should be made by government to make the emergency loans or to protect other lending agencies when they make them. The trouble is, too often the emergency itself is recognized but no one seems to recognize when the emergency is over and, as a consequence, there is a tendency to perpetuate the policies, practices, and agencies borne of the emergency.

L. R. Ritchie (Virginia)

As compared with 25 years ago, short-term and long-term credit is more readily available today to small-business men. Greater consideration is now given on the part of banks to make the term of the loan to coincide with the time that payments are received by the small-business man. Loans repayable on the installment plan have become increasingly popular. Field warehousing and "floor plan" loans have become more widely used. Banks more generally look with greater favor on purchasing conditional contracts of sale.

Small-business men are maintaining more adequate operating records, which is an important factor to any bank in extending credit. Bankers today, in making loans, are more careful to ascertain from prospective borrowers the expected source of income by which loans

will be repaid. They are also better informed as to the purposes for which the credit applied for will be used.

Of recent years, insurance companies have been making loans that were formerly made almost exclusively by banks. Many corporations that formerly borrowed from banks are now able to provide for their needs out of surplus funds.

We are of the opinion that the banks in this State are providing reasonably ample facilities to supply the legitimate demands for credit of small-business men.

We are also of the opinion that the banks in this State are most anxious to take care of the credit needs of all of their customers when they can do so on a safe basis and in keeping with the present policy of giving preference to the credit needs of borrowers who are contributing most directly toward our program of national defense.

Homer E. Robinson (Maine)

Small-business men, who are at all worthy of credit, have generally found accommodation in Maine. Probably facilities offered by many banks along consumer credit lines, with the use of "floor plans" and an indirect line of credit to merchants, have improved in the past few years.

It is generally agreed that not every applicant for credit is a reasonable risk. Banking is a credit business and subject to the risks involved in such a business. Hence the reasons for adequate capital and reserves are set forth in all banking legislation. However, depositors' money should not be loaned to every person who may think he can succeed in business, irrespective of experience, character, capacity, and some capital of his own. In short, we feel that Maine banks are taking care of reasonable needs now, and that too liberal an extension of credit would be a contributing factor to more business failures and would have an adverse effect on the Nation's economy.

We strongly believe that no economy can be dynamic when it is based upon false notions of what should constitute credit. Financial history of this country is replete with examples of the disasters stemming for the most part from unwise and speculative extensions of credit. We feel that no nostrum can be prescribed as a cure-all for "credit indigestion," other than an improved understanding between banks and businessmen, both large and small, as to what constitutes a bankable loan and what may be reasonable conditions under which both banker and businessman may avail themselves of the services of know-how possessed by each necessary segment of an economy based upon sound principles.

An interesting experiment in the use of border-line credit is being tried out in Maine. The Development Credit Corp. of Maine was organized about 2 years ago to form a pool of "risk capital" to be loaned upon businesslike principles to business borrowers whose credit was not fully established and whose loans were not considered bankable under present-day concepts. Capital was raised from businessmen, corporations, banks, and financial institutions. The contributions of the latter were limited to 2½ percent of capital funds available. Membership in the corporation is voluntary. Several loans have been made to new and smaller industries, and to industries lacking capital to expand for productive purposes. Although too early to judge the work of this corporation, we in Maine have great hopes that this idea

will be a vehicle that will contribute to a dynamic economy in the fullest sense of the word.

Our banks have pledged themselves, during the war emergency, to the well-known voluntary credit-restraint program so much desired by many financial authorities. It will be well-nigh impossible to adhere to this program with one hand and extensively liberalize credit with the other.

A. A. Rogers (*Oregon*)

Having been in the banking business myself for nearly 40 years, I believe that a great many banks were organized in this State that were not needed during the period from about 1903 to 1925. Many of these banks were established and managed by men who were not qualified, and some were operated by downright crooks. This situation has now been cleaned up by the failure and liquidation of some banks and by the reorganization and consolidation of others.

Many loans were made on an unsecured basis to individuals who may have been honest themselves but who had little or no experience in business management or practice.

I am of the opinion that the banks in Oregon are ready and anxious to supply all legitimate demands by business, both large and small, especially where the funds loaned are to be employed in the production or distribution of goods or commodities which will contribute to our economy. Many small-business men are not content to build on a sound basis and think that if someone else will supply the money that they could expand and branch out, and thus they find themselves in financial difficulty and blame the banks and bankers for not having been easier in granting them long-time credit.

I think that we will always have men in business who should be content to run their so-called small businesses. Some will not be content to operate on the scale of which they are qualified, but if they do build on a sound basis the banks of Oregon stand ready and are willing to extend the credit needs of both the individual and the corporation.

I do not hold the view that a bank supervisor should criticize risk loans simply because they are risks, but that some should and must be extended where there is, or appears to be, a reasonable chance that the money borrowed can be repaid from the business enterprise or from other reliable sources.

I would hold that, where loans are made for the financing of an industry engaged in producing goods and items useful only for national defense, the bank or banks advancing the funds should not be expected or required to assume any risk, since this should be the responsibility of all.

H. G. Shaffner (*Missouri*)

It is believed that the State-chartered banks have always supported small-business men when in need of borrowing; that the local banker is in a great deal better position to pass on such credit than any others. It is true that local bankers have not been too prone to accept the obligation of a small-business man on a long-term basis, though as a rule such difficulties have been worked out where the small-business man was taken care of.

Roy W. Simmons (*Utah*)

The past 25 years have seen a tremendous change in the attitude of the banker toward loans to the small-business man, and today it is cer-

tainly much easier for him to obtain money than it has been at any time in the past 25 years. However, there are still many cases wherein the local bank is unable to take care of such borrowers because of the length of time that the loan is needed or the size of the loan being too large for their limited capitalization. In such cases the local bank refers the business to their city correspondent, but in many instances the city bank is unwilling to assume the loan because of restricted policies, such as no loans in suburban areas with populations less than 5,000, etc. The loan may be too small for the city correspondent to justify the expenses involved in setting up and servicing the loan, etc. In such cases bank-RFC loans worked out very well.

I was just talking with an operator of a small-loan company, which company has loans in the State of Utah of approximately $500,000. The company is now getting too large for the local banks; yet, when considered in terms of national finance companies, he is considered a small operator; and he stated that when he recently applied for credit in New York City he was informed that his line was too small for them to handle. One of them, in fact, told him that if he needed $1,000,000 his chances for getting the loan would be much easier than the amount he desired.

I believe that some agency such as the Reconstruction Finance Corporation should guarantee loans to small-business men; and if these loans are properly made by the local bank, the agency would not compete with private enterprises any more than the Federal Housing Administration has competed with private lenders. Such a program will naturally meet resistance from some eastern bankers who would, in some cases, lose business just as the FHA when it was first introduced met vigorous opposition from insurance companies and large banks who had previously enjoyed a monopoly in home financing at rates of interest which were determined entirely by themselves.

If a program of this type could be introduced and a secondary market established for such loans, the net result should be another completely self-supporting agency similar to the FHA, which agency should always endeavor to help finance small business through local capital, with the Government only standing in the background as the insurer.

Maurice C. Sparling (California)

Banks are in business to make money. They make money through making loans. Banks are desirous of making loans. Unquestionably anyone whose integrity or financial security warrants the obtaining of a loan can obtain such loan in any amount from private banks, with but very few exceptions. (This statement is, of course, subject to the voluntary credit-restriction program now being followed by the banking fraternity of the Nation at the request of the Federal Reserve Bank and the Federal Government generally.)

Ninety percent of Government agencies making loans in competition with banks are wholly unnecessary. If the borrower's integrity or financial stability is not such as to justify a bank in making a requested loan, the Government should not provide an agency for doing so at the expense of the public taxpayers. Entirely too much publicity and political thought has been given to the small-business man and his alleged needs, to the entire exclusion of the small taxpayer and the fact that the taxpayer probably needs the money taken from him in

taxes just as much if not more than the small-business man to whom the Government loans the money so secured from the taxpayer.

Through the expansion of competitive banking and bank loaning policies, the opportunity for a small-business man to borrow from local banks has increased within the past 25 years. Banks are today making personal and consumer loans which they did not make 25 years ago. It is not believed that a more liberal lending policy by commercial banks is needed, or would benefit the Nation by contributing to the diffusion of economic power. No steps are needed or should be taken to foster such policy.

There is nothing to justifiably indicate that any change is needed, either over the long term or to meet today's current national defense emergency. The borrowing public, both large and small, is being, and can efficiently be, adequately served by the Nation's private banking system.

W. Royden Watkins (South Carolina)

Certainly, there has been much change in the lending methods by banks in the past 25 years, and more emphasis has been placed on giving business a safe and sound depositary and medium of exchange rather than on the granting of loans. Whether or not a "more liberal lending policy by commercial banks to small-business borrowers would contribute to the diffusion of economic power and to the dynamic character of the economy," I do not know. I believe credit of all kinds is too liberal now.

8. Discuss the effects of bank examinations on the lending policies of banks in your State, particularly as they apply to loans to small-business men. Distinguish if necessary between examinations by different examining authorities.

Most of the bank supervisors emphasized that bank examinations are designed mainly to insure the continuing solvency of the banks, and that, except as necessary for this purpose, no effort is made to "dictate" the lending policies of individual banks. All of them said that there was no discrimination in their examining policies between loans to small business and loans to large business, provided the loans had equally good prospects of repayment. Most of them said that in this respect there was no difference among the policies of the different examining authorities.

Extracts from typical replies follow:

L. M. Campbell (Pennsylvania)

We do not feel that our bank examinations have had any material effect on the lending policies of banks in our State. Furthermore, we do not believe that bank examinations should interfere in the sound lending policies of any independent bank. The primary responsibility for lending policies rests with bank management. This is particularly true as it applies to loans to small-business men. It is not the policy of this department to attempt to restrict sound loans of this nature. Our practice is to determine whether in our opinion there is reasonable belief that the borrower can meet the terms of the loan.

Many of our State banking institutions have used complete advertising programs to bring to the attention of the small-business man that they are interested in making loans to him.

L. K. Elmore (Connecticut)

I am quoting below an excerpt from the Connecticut State Banking Department's Manual of Instructions to Examiners on the subject of loan classification:

> Bank examinations are made to determine, among other things, whether depositors' funds are safe insofar as the bank's ability to meet its obligations with the assets it holds is concerned; whether depositors' funds are safe insofar as operations are concerned; and whether depositors' funds are safe insofar as future prospects are concerned. The manner of classifying and appraising loans has an important bearing upon these purposes and much thought has been given to a classified and uniform execution of this phase of bank examination.
>
> The loan classifications are expressions of the examiner's conclusions as to the different degrees of a common factor—the risk of nonpayment. All loans involve some risk, but the degree varies greatly. At one extreme are loans, or portions thereof, which are deemed uncollectible and worthless. These loans are classified as "Estimated loss." Other loans where the risk is also extremely high and collection in full is improbable are classified as "Doubtful." The next group, classified as "Substandard," includes loans in which the degree of risk is not such as to warrant an "Estimated loss" or "Doubtful" classification but is, nonetheless substantial and a cause for concern. The great bulk of loans is not detailed in examination reports because their ultimate payment seems reasonably assured.
>
> Sound loans are essential in all banks and contribute to the development of our national economy, as well as to the bank's profitable operation. Bankers and banking authorities should recognize that the practice of lending to sound businesses, small and large, for reasonable periods is a legtimate function of commercial banks, if there is adequate provision for the orderly or ultimate repayment of such advances. No sound loan should be classified by an examiner, even though it is not collectible over the short run. The principle that banks should make only self-liquidating or seasonal loans is not a valid basis for loan classification. Classification policies should be directed only toward those loans which are unsafe for the investment of depositors' funds.
>
> It is not, however, the responsibility of bank supervisors to determine what loans a bank should make. That is a responsibility of bank management. Each banker who is worthy of his responsiblity knows the character of his deposits and the type of loans best suited to his institution. Bank examination was never intended to assume the responsibility of bank management. The chief purpose of bank examinations is the protection of depositors. If a bank is not well run and the characteristics of its loans are such as to endanger the position of its depositors, it is the duty of examiners to report the facts and of supervisory authorities to demand correction.

The policies outlined above would certainly not in any way work against or have an adverse effect on the making of loans to small business by banks. We believe this represents the general approach of all supervisors.

J. M. Falkner (Texas)

It is our opinion that examinations do not have an adverse effect upon lending policies of banks to any type of borrowers when such loans are found to have been made in accordance with sound banking practices. In other words we, as supervisor, do not criticize or classify any type of loan if conforming in every respect and performing according to contract. In other words we do not dictate to banks the type of loans they should or should not make.

Our examinations are made for the purpose of determining the solvency of the bank, hence is supervisory in nature. We think the examinations made by the Federal Reserve bank of member banks and the Federal Deposit Insurance Corporation of insured nonmember banks should be purely fact finding.

A. W. Hoese (Minnesota)

It has never been the practice of this department in the past to dictate to the banks in the formulation of their lending policies and we do not expect to exercise such dictation in the future. We consider the setting up of bank-lending policies to be a very important function of the board of directors and we have never believed that our supervision should extend to the point of management of our State banks. While it is true that where the management of a bank has demonstrated weakness in its operations, we have recommended certain changes and these sometimes involve the operating as well as the lending policy of the bank. However, we still believe final determination as to any general loan policies is up to the directors and we encourage them to exercise this privilege after careful and due consideration of all factors.

John H. Hoffman (West Virginia)

Our State law requires the department to, at least once a year, appraise the assets of each institution under our supervision. This naturally brings to the front the lending policy of each bank; however, this would not in any way affect loans to small business so long as they were properly secured or were backed by proper credit information. Foremost in every examiner's mind is the protection of the depositors in each institution and under no condition will they approve a gambling proposition. However, it must be remembered that each bank is operated by a board of directors elected by the stockholders and they are responsible to them for the proper conduct of the bank.

In this State we conduct joint examinations with the Federal Deposit Insurance Corporation and the Federal Reserve bank, and so far there has never been a disagreement regarding the findings of the examiners and the recommendations to the directors.

Randolph Hughes (Delaware)

I do not feel that bank examination in any way tends to affect the lending policies of the banks in this State other than the soundness of the loans, nor do I feel that it is the responsibility of bank supervision to dictate the lending policies. I do not believe that the examinations made by the other supervisory agencies tend to interfere with the loan policies of the banks in this State. It is my belief that the banks are able to make the necessary loans to all small-business men. Of course, by State law, banks are limited as to the amounts that they can loan both unsecured and secured; but generally speaking, I do not believe that these limitations hurt the small-business man.

W. H. Kirkwood, Jr., and John D. Hospelhorn (Maryland)

The examiners of this Department, in line of duty, do not discriminate against long-term loans or real-estate loans as such. The granting of loans on the security of real estate is specifically authorized under the banking statutes of this State. Any comment or criticism in respect to real-estate loans would be confined either to the merits of the particular extension of such credit or to the matter of policy in the relationship of real-estate loans to the total time deposits of the institution involved, as well as the general arrangement of the asset portfolio.

Long-term loans, in the opinion of the Department, may within reasonable limits be regarded as an acceptable outlet for investment of bank funds. Loans in this category, however, are scrutinized particularly from the point of view of the adequacy of the security behind the credit risk and the suitability and feasibility of the repayment programs. Any comment or criticism which might be made would be in respect to these factors or possibly in connection with the relationship of the aggregate loans of such character to the general arrangement of the asset portfolio of the bank.

In respect to capital loans which we assume fall under the definition of loans to businesses where the repayment of such loans can only be effected either by curtailment or discontinuance of operations or out of profits from operations, no discrimination is made per se by the examiners in line of duty. Loans in this category, however, would be subject to particular scrutiny as to the degree of hazard and the prospect of realization in event the business would prove unprofitable and collection would be necessary through liquidation or curtailment of operation.

It may reasonably be assumed that bankers are influenced to a very limited degree in their lending policies by their contacts with the examiners and other staff members of the banking department. In some instances this influence may operate to prevent a few bankers from making loans which to them appear acceptable. In general, however, we believe that this influence is on the wholesome side and that deserving credit needs seldom, if ever, remain unsatisfied by reason of the influence of our examiners in the discharge of their official duties.

William A. Lyon (New York)

Banks with low capital funds are advised not to take on an excessive volume of risk assets. The size of borrower alone is not a criterion in classifying loan assets during examination, or in judging soundness. However, amount of loan is scrutinized relative to strength of borrower. Loans that are criticized are as likely to be large loans, especially if they represent undue concentration in one field of business.

G. M. Matthews (Wisconsin)

One of the purposes of a bank examination is to determine the quality of a bank's assets, including loans. The appraisal of the loans discloses the type of loaning policies being followed, either sound or unsound. Where unsound and too liberal loaning policies are apparent we make definite efforts to obtain correction of such policies. We point out to the banker what our observation in dealing with many banks shows to be weaknesses which may not be apparent to him because he is not in position to see the broad picture.

This may result in some tightening of credit, particularly in the lines where the most hazard exists. If the hazard exists in real-estate loans, then that is where credit would be tightened. If the hazard exists in small-business men's loans then that is where credit would be tightened. The tightening would result not because of the fact that it is small business that is involved as compared to big business or as compared to any other type of loan demand but because of the application of sound loaning policies to the case at hand.

Bank examinations in this State are definitely not aimed at curtailing loans to small business except to the extent that such loans are not warranted because of the hazard in a particular enterprise, be it because of general economic conditions, lack of management know-how, poor judgment, or like factors. I have no reason to think there is a difference in this respect between the examinations made under the supervision of State bank supervisors, the Federal Reserve Board, Comptroller of Currency, or Federal Deposit Insurance Corporation.

L. R. Ritchie (Virginia)

In regard to banks which have inadequate credit files and fail to adopt modern loan-management policies, the examiner offers constructive criticism. The examiner who goes from bank to bank is in a very good position to make such suggestions.

Homer E. Robinson (Maine)

Examination policies are beamed at avoiding in every way possible, unwise and dangerous extensions of credit, whether they be to governmental, corporate, or personal users of credit. Bank managements have the responsibility of establishing the reasonable worth of any and all extensions of credit. Beyond this we do not interfere with management, nor do we accent in any way the relative merits of such credit extension to large or small business. A $500 loan to a small grocer to take trade discounts or buy inventory has as much attention and no more from our examiners as a $50,000 loan to a manufacturer for a like purpose.

As far as we can ascertain, the examinations of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve examiners and those of our own State department have essentially the same objects—a safe and sane dual banking system, with proper regard for the safety of depositors' funds.

A. A. Rogers (Oregon)

No sound loan is ever criticized by this department or by the three Federal agencies. When security held by a bank is of a questionable nature and the financial statement of the individual, partnership, or corporation is such as not to support the advance made, it receives, and should receive, the same treatment whether the advance is to small- or large-business men. As inferred above, some small-business men want to increase their business beyond their financial position and their ability to manage. Some are inclined to believe that they are discriminated against by the banks and bankers because they are classed as small business.

Most big business started out on a small scale and with management, hard work, and strict attention to their business, fair and honest dealings with their employees and their customers and the public, they grew and prospered.

Roy W. Simmons (Utah)

I can find no bearing between the effect of bank examinations and lending policies in this State with respect to the small-business man. Our examiners certainly do not criticize loans to small-business men unless the same become delinquent or the credit does not meet good banking standards, etc.

W. Royden Watkins (South Carolina)

We hope that our examinations have tended to make the banks' lending policies conservative, especially where corporations, or individuals, wish to have the bank grant what examiners term "capital loans." We do not believe that capital loans have any place in commercial banking. We notice little or no difference in examination procedure by the different examining authorities.

APPENDIX TO CHAPTER IX

Questions Addressed to State Bank Supervisors

1. What do you believe to be the role of bank examination and supervision in maintaining economic stability?

2. Discuss the advantages and disadvantages of extending the coverage of deposit insurance to include all accounts in insured banks. Do you believe that this should be done?

3. What do you believe to be the principal functions of bank reserve requirements? Do you believe that all insured banks should be subject to the same reserve requirements as member banks of the Federal Reserve System? Why, or why not?

4. Discuss the adequacy of banking facilities in your State. For this purpose, take as your standard of adequacy the ideal of bringing banking facilities within convenient reach of all persons having need of them, and, so far as practicable, giving all persons the opportunity of choosing between two or more competing banks. Distinguish between deposit facilities and loan facilities.

5. Discuss in general your policy in acting on applications for new State-bank charters. Stress your concept of what constitutes ample banking facilities—especially the degree of competition which you believe to be necessary or desirable.

6. Would you please submit a statistical analysis showing year by year for the past 10 years the number of applications filed for State-bank charters in your State, the number approved, the number rejected, and the causes for rejection, classified by such principal reasons as (*a*) existence of ample banking facilities, (*b*) no prospect of successful financial operation, (*c*) inadequate capital for the establishment of the bank or branch, (*d*) no satisfactory evidence that competent management would be available, etc.? Comment on this analysis in any manner which you consider appropriate.

7. Discuss the changes during the past 25 years in the ease or difficulty with which small-business men can borrow from their local banks in your State. Explain the reasons for such changes as you find to have occurred. Do you believe that a more liberal lending policy by commercial banks to small-business borrowers would contribute to the diffusion of economic power and to the dynamic character of the economy? What steps could be taken to foster such a policy? Distinguish between the longer-term aspects of the problem and those of particular importance today during the current national defense emergency.

8. Discuss the effects of bank examinations on the lending policies of banks in your State, particularly as they apply to loans to small-

business men. Distinguish if necessary between examinations by different examining authorities.

The above questionnaire was sent to the chief bank supervisor in each of the 48 States. Replies were received from the following 21:

California, Maurice C. Sparling, State Superintendent of Banks
Connecticut, L. K. Elmore, Bank Commissioner
Delaware, Randolph Hughes, State Bank Commissioner
Idaho, E. F. Haworth, Commissioner of Finance
Maine, Homer E. Robinson, State Bank Commissioner
Maryland, W. H. Kirkwood, Jr., Bank Commissioner, and John D. Hospelhorn, Deputy Bank Commissioner
Minnesota, Arthur W. Hoese, Commissioner of Banks
Missouri, Harry G. Shaffner, Commissioner of Finance
Nebraska, J. F. McLain, Director of Banking
New Mexico, Alfred W. Kaune, State Bank Examiner
New York, William A. Lyon, Superintendent of Banks
Ohio, Thurman R. Hazard, Superintendent of Banks
Oregon, A. A. Rogers, Superintendent of Banks
Pennsylvania, L. M. Campbell, Secretary of Banking
South Carolina, W. Royden Watkins, Chief Examiner, Board of Bank Control
Texas, J. M. Falkner, Bank Commissioner
Utah, Roy W. Simmons, Bank Commissioner
Virginia, Logan R. Ritchie, Commissioner of Banking
Washington, R. D. Carrell, Supervisor of Banking
West Virginia, John H. Hoffman, Commissioner of Banking
Wisconsin, G. M. Matthews, Commissioner of Banks

CHAPTER X

REPLIES BY ECONOMISTS

1. What are your views of the effects of credit policies resulting in relatively small and relatively large changes in interest rates, respectively, upon (a) the lending policies of commercial banks, (b) the lending policies of nonbank investors, (c) consumer saving, (d) business plant expenditure programs, (e) business inventory policy?

This question was intended partly to high-light and elicit opinions on the recent disagreement of the Treasury and the Federal Reserve System concerning the effectiveness of "fractional changes in interest rates" as a means of combating inflation, and partly to elicit views on the specific ways in which restrictive credit policies are expected to restrain inflationary pressures. It will be noted that the question calls for views concerning "* * * the effects of credit policies resulting in relatively small and relatively large changes in interest rates * * *" rather than for views on the effects of the interest rate changes themselves, considered apart from the policies which occasioned them. A majority of the economists interpreted the question in this way, although many of them interpreted it as directed at the effects of the changes in interest rates themselves.

A substantial portion of the economists, following a trend which has received considerable prominence in the recent literature, laid major emphasis on the effects of changes in credit policies on lenders, as opposed to the traditional emphasis of effects on borrowers. Some economists thought that the effects of policies resulting in small changes in interest rates (considering effects on both borrowers and lenders taken together) would be negligible, while others thought that a great deal might be accomplished by policies resulting in only small changes in rates. Many said or implied that the effect of a restrictive credit policy in combating inflation would be roughly proportionate to its effects on interest rates.

The main current of answers indicated that the effects of restrictive credit policies would be greatest on the lending policies of commercial banks and that their principal effect on nonbank investors would be to change the direction rather than the aggregate amount of their lending. Effects of policies involving small changes in rates on business plant expenditure programs were generally considered to be small, although many replies stated that plant expenditure programs might be substantially curtailed by the restricted availability of credit and decreased optimism accompanying even small increases in rates. A few stated that such programs might be postponed as a result of moderate increases in interest rates, if rates were expected to fall later. Effects on consumer saving and business inventory policy were generally expected to be small, although some respondents

thought that the latter might be substantially affected by diminished credit availability.

Extracts from typical replies follow:

G. L. Bach (*Carnegie Institute of Technology*)

Over-all, under present circumstances I would expect the impact of further restrictive credit controls to be substantial if they were to involve further changes of the general magnitude involved in the 1951 "accord." This effect would come especially through the impact on bank and nonbank lenders, and slightly through drying up the demand for loans through higher interest rates. But insofar as the structure of private interest rates rose proportionately, the impact of the credit controls on lenders would be weakened because the incentive to shift from Government securities into loans would be preserved. I would expect the restrictive credit policies to have only a slight direct effect on consumer saving; this is because I doubt that consumer saving is greatly influenced by moderate changes in interest rates, and because most individuals who might be "frozen in" (and hence dissuaded from dissaving) by a decline in government security prices either hold redeemable savings bonds or are wealthy enough to have liquid assets beyond their long-term Government security holdings.

The reasoning underlying these conclusions is as follows:

Credit policies aimed at restraining inflation through control over the general quantity of money and credit may work through four different effects. First, such credit policies may restrict the availability of funds from lenders, both bank and nonbank lenders. Second, they may raise the interest cost of borrowed funds. Third, they may reduce the ease with which semiliquid assets (such as securities) can be converted into cash for direct spending by individuals and businesses. Fourth, they may change the public's expectations away from inflation and thus reduce current spending based on expectations of rising prices.

In my judgment, the restrictive effect of quantitative credit controls comes primarily through the first of these channels, with the direct impact of higher interest rates probably less important than the third effect of reducing the public's feeling of liquidity. Thus, I would judge the impact of restrictive credit controls not by the size of their effect on interest rates, but more heavily by their effects through the other channels mentioned.

V. Lewis Bassie (*University of Illinois*)

The effects of relatively small changes in interest rates may vary somewhat depending upon particular circumstances, but they are basically inconsequential for economic stability in any case. The effect of relatively large changes (that is, increases) would, in the end, be predominantly bad and should not be permitted if at all avoidable.

James Washington Bell (*Northwestern University*)

This question calls for a reappraisal of role of interest rates as an instrumentality of control in stabilizing our economy.

The view most commonly held since the impact of Keynesian theory seems to be that monetary policy is ineffective as a stabilizing device because its influence is exerted exclusively through its effects on interest rates; that interest rate changes have no significant functional relationship either to the amount of saving, on the one hand, or the

amount of investment on the other, and no effect on income and prices. In other words, the classical theory of interest is discarded. The classical and neoclassical economists hold that interest is the price of waiting or saving necessary to bring forth capital funds in the market, which funds are in demand by borrowers who see profit prospects in the use of such funds in making capital expenditures.

My own view is that the old theory still holds despite the attacks of the liquidity preference theorists. I believe that changes in interest rates, both small and large, do exert an influence on businessmen's decisions and can be made effective in stabilizing business. The amount of the change is a matter of degree, and the effectiveness depends not only on the rates but also upon business psychology, expectations, etc., and the economic conditions of the time.

A curiously illogical argument has become popular among Keynesian theorists, viz, that small increases (one-fourth to one-half percent) in interest rates are not effective in fighting inflation, but that large increases (2 to 4 percent or 5 to 10 percent) will cause chaos and disaster in the money market and will precipitate deflation.

The origin of this anomalous view can be traced historically to the failure of restrictive credit policies to restrain credit expansion in the late twenties and to the apparent futility of the easy-money policy in stimulating business recovery in the early thirties, and to the rationalization of these experiences by Keynesian theorists.

These theorists base their arguments on slender empirical evidence provided by an Oxford survey of the effects of interests costs on businessmen's decisions and a similar study at Harvard from which like conclusions were drawn. In Keynesian terminology, the argument is that a modest increase in interest rates is ineffective in significantly reducing personal consumption (C) or increasing personal savings (S) and decreasing possible expenditures on plant equipment or inventories (I) or Government expenditures (G). In other words, these theorists maintain that the market is insensitive to relatively small changes in interest costs and relatively insensitive to moderate inducements to save (liquidity preference) and relatively insensitive also to slight restraints upon expenditures. However, they admit that drastic increases in interest rates are effective in curbing loans and investments (on the demand side), in weakening reserve positions of banks (on the supply side), and even jeopardizing the solvency of financial institutions holding heavy portfolios of securities.

These arguments are not consistent. Either small increases have some effect in curbing inflation or large increases will not cause collapse (unless we assume that the collapse is due to a breakdown in confidence in the integrity of the monetary unit). High rates, e. g., 4 to 5 percent, would undoubtedly check inflation and might even cause deflation with its attendant fall in production, increased unemployment, etc.; but by the same token, a moderate tightening of money, e. g., one-half to 1 percent, has some effect on savings and investment and on the policies of lending institutions. Rate changes have effect on the demand for funds and even greater effect on the supply of funds. Effects on the supply of funds have been practically disregarded by Keynesian economists.

At bottom, the objection many opponents have to credit restriction policies is that they are too effective. That is, critics fear the conse-

quences of deflation—depression, failures, and unemployment—more than they fear the effects of inflation. They prefer the malady to the cure.

Rollin F. Bennett (New York Life Insurance Co.)

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However, the effectiveness of credit policies that are designed to influence the availability of bank credit may best be judged by reference to changes in the actual volume of such credit, regardless of whether these changes may happen to be associated with large or small movements of interest rates.

* * * * * * *

Chelcie C. Bosland (Brown University)

The restrictive effect of credit policies may be much more effective by changing the outlook and expectations of borrowers than by changing the cost of borrowing. A small rise in interest rates that bespeaks an attitude of intent to restrict credit by the monetary authorities may be quite effective in discouraging borrowing and making lenders cautious even though the added interest cost to borrowers would not in itself be effective. Relatively large changes in interest rates would have a double-barreled effect, discouraging borrowing both by the creation of adverse expectations and by causing substantially higher interest costs, particularly for heavy capital-using, long-term projects. It would also make lenders—banks and investors—more cautious. Small changes in interest rates would probably not materially affect consumer saving, but large increases might stimulate them, both because of added rewards and because of the diminished incentive to spend if the restriction brings the promise of stable or lower prices.

Raymond T. Bowman, Philip J. Bourque, Raymond T. Bye, H. LaRue Frain, Paul F. Gemmill, Amor Gosfield, Arleigh P. Hess, Jr., Almarin Phillips, Karl Scholz, Sidney Weintraub (University of Pennsylvania)

It is assumed that the credit policies referred to consist of actions designed to reduce reserve balances and/or to raise reserve requirements so as to effect a tightening of short-term credit and a rise in short-term interest rates. It is also assumed that the question is intended to get an opinion concerning the general role of the level of interest rates in restraining credit and that the credit policies to achieve a rise in rates include open-market operations which may force down the price of securities and raise yields and, hence, the general level of interest rates, if other actions fail.

In a period when inflationary factors are strong we do not think that small changes in interest rates (by themselves) will significantly affect the lending policies of commercial banks or nonbank investors, materially increase consumer saving, or reduce business-plant expenditure programs and inventory holdings. The level of interest rates, under conditions of strong inflationary pressures is not nearly so important as the expectations as to future rates. This expectation is, of course, more important for long-term rates than for short-term rates. Credit policies designed to control inflationary pressures must permit interest rates to rise so that the effect of any current rise will

be fortified by the knowledge that the credit policies are firm enough to insist upon higher interest rates if curtailment of credit is not achieved. This will, in our opinion, be a strong restraining influence. The point we are stressing is that, while modest increases in interest rates do not modify economic behavior significantly, a credit policy to control inflation is seriously handicapped if it cannot let interest rates rise.

It is difficult to answer the half of the question dealing with relatively large increases in interest rates. It would seem obvious that "large" increases would be more effective than "small" ones, but again we must abstract from expectation. It is clear, however, that the larger the increase in interest rates the more it will disturb the asset value of the long-term holding of insurance companies and other institutions with similar portfolios. This may be serious, but need not be if time holdings are well distributed and immediate sale for liquidity purposes is not required. In fact it points to significant pressures to curtail loans and certainly to curtail shifts from Goverments to non-Governments by nonbank investors and savings banks. So far as commercial banks are concerned it is our feeling that if the market is neutral to the new interest rates, commercial bank-lending policy will be neutral also.

William E. Dunkman (*University of Rochester*)

Before discussing the effects of interest rate changes as the question requires under (*a*)–(*e*), I should like to make a general statement on the place of interest rates in inflation. The question implies that changes in interest rates are significant because of their effects on borrowers and lenders. These effects are important. However, a still more important fact is that, for inflation to be stopped the creation of bank reserves must be stopped. When this is done interest rates will rise. What effect these rising interest rates have on borrowers and lenders is of secondary importance as the main result of the anti-inflation policy is to prevent the further expansion of loans. The essence of the matter is that when the creation of additional bank reserves ceases, the expansion of loans must also cease. Whether this come about as a result of higher interest rates, reduced availability of funds, or otherwise, such cessation of loan expansion will come to a halt.

With the above as my fundamental attitude toward inflation control, I think that the rising interest rates thus induced will have the following effects:

(*a*) *Effects on the Lending Policies of Commercial Banks.*—Through the commercial banks, rising interest rates will tend to spread to all types of loans. However, to the extent that rising interest rates change the relationships between rates on different types of loans and investments, there will be shifts in the character of bank portfolios. Rising interest rates, since they reflect a reduced availability of loan funds will stimulate the banks to exercise greater discrimination and choice among borrowers. These effects will follow small as well as large changes in interest rates.

(*b*) *The Lending Policies of Nonbank Investors.*—The effects on these investors will be similar to those on nonbank investors. More specifically, rising interest rates which are accompanied by falling bond prices will reduce the incentive to sell bonds thus reducing the availability of funds for other types of loans. Loans for which inter-

est rates are fixed by Government agencies such as the Veterans' Administration and the Federal Housing Administration will suffer most.

(c) *Consumer Saving.*—Small changes in interest rates will probably not have a measurable effect on consumer saving. Larger changes might.

(d) *Business Plant Expenditure Programs.*—Small changes in interest rates will probably have little effect. Large changes will have a substantial effect.

(e) *Business Inventory Policy.*—Neither small nor large changes are important although, of course, there is always some possibility that larger changes will have some dampening effect.

Stahrl Edmunds (Northwestern National Life Insurance Company)

I believe that the Government credit policy of removing the support for Government bonds at par, and allowing a relatively small increase in the interest rate, had a fairly significant effect on the lending policies of commercial banks and of nonbank investors following March of 1951. This took place because the banks and investors were unwilling to suffer a capital loss on their longer term maturities. They became relatively more short of available funds to lend. They were more selective in extending credit.

I do not believe, however, that as small a change in the interest rate would again have quite the same effect. The effect of unpegging the Government bond market in March was heightened because investors had assumed a high degree of liquidity to their longer-term maturities. This meant that banks, and to some extent nonbank investors, had not staggered or arranged the maturity of their investments with the same attention they would have if Government bonds could not readily be sold at par. The support by the Federal Reserve of bonds at par had the effect of enabling investors to reach for longer-term maturities than they would ordinarily. The process of unpegging has made investors aware that they must again pay close attention to their maturities. Once their portfolios have become adjusted again for this factor, a small change in the rate of interest will not have as significant an effect as it did during 1951. Nevertheless, I do feel that a change in the rate of interest does have substantial influence on the lending policies of bank and nonbank investors.

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Howard S. Ellis (University of California, Berkeley)

The main effect of credit ease or stringency is not to be found in the resulting changes in interest rates but in the availability of credit as determined by the magnitude of commercial bank reserves. Customer rates are relatively inflexible in the United States, and a very large reduction of credit availability and hence of inflationary pressure can be achieved without large increases in interest rates.

Of the five magnitudes enumerated, all except consumer saving are *sensitive* (although in somewhat varying degree) to the availability of credit. The less important aspect of credit policy, namely the variation of interest rates, probably affects business inventory policy most, though *differentials* in rates on Government securities and other forms of debt will substantially affect both bank and nonbank investors as to their investments, and investment is one form of lending.

Low interest rates on Government securities discourage lending to the Government and encourage lending to undertakings less directly related to the defense effort.

Larger changes in interest rates will attend a more rigorous credit policy but they are not its purpose, which is the greater limitation on the availability of credit. Consumer saving will not respond greatly to higher interest rates; but in the other four categories; expenditures or loans will be reduced in rough proportion to reduction in the availability of credit.

Milton Friedman (*University of Chicago*)

(*a*) The lending policies of commercial banks depend primarily on the reserves available to them, not directly on the interest rate. If they are "short" of reserves, they will be forced to limit their loans, and this will tend to raise interest rates; conversely, if they have unduly large reserves, they will be impelled to expand their loans, and this will tend to lower interest rates. The change in interest rates is in this way a result of their lending policies, not a determinant thereof. The larger the shortage of reserves the larger the effect on their lending policies and hence the larger the effect on the rate of interest. The only difference between a policy resulting in a small and one resulting in a large change in interest rates is one of magnitude. There is no qualitative difference between them.

The credit policies producing a rise in interest rates will mean a fall in the price of Government securities held by commercial banks. This may have a short-run effect on the fraction of the assets of commercial banks held in the form of Government securities, since it will establish an incentive to hold them to maturity. This effect, too, is quantitative, not qualitative. In particular, there is no merit, in my view, to the oft-repeated fear that a substantial fall in Government security prices will have seriously adverse effects on the stability of commercial banks.

(*b*) A rise in interest rates will tend to increase the willingness of nonbank investors to hold securities or loans in preference to currency or deposits. However, the credit policies producing the rise in interest rates reduce the volume of currency or deposits to be held or prevent an increase that would otherwise have taken place. In consequence, except through item 1 (c) (effect on consumer saving), this effect may not lead to any increase in holdings of loans and investments by nonbank investors; if it does lead to an increase, the increase cannot be as large as the decrease on the part of commercial banks (else the interest rate would not in fact rise). Again, the size of the increase affects, or better, is affected by, the magnitude of this reaction, but there is no qualitative difference between the effect of relatively small and relatively large changes in interest rates. Converse statements hold for a fall in interest rates.

(*c*), (*d*), (*e*) A rise in interest rates produced by credit policies will tend to increase the fraction of income saved by consumers, to reduce business expenditures on plant and on expansions of inventories, and conversely for a decline in interest rates. Again, the larger the change in interest rates the larger these effects. Again, also, the casual chain does not run solely one way. The larger the reactions in these directions, the smaller the change in interest rates produced by any given credit policies. My own guess is that the fraction of income

saved is only slightly responsive to a rise in interest rates, that business plant expenditure programs and inventory policy are much more responsive. However, the degree of responsiveness determines only the magnitude of the rise in interest rates required to discourage attempted expenditures, not the possibility or desirability of doing so.

Nat Goldfinger (*CIO Committee on Economic Policy*)

The curbing of inflationary pressures requires the curtailment of both personal and business spending. For it is the spending of income or borrowed funds that adds to inflationary pressures.

I do not believe that a relatively small change in interest rates will materially affect inflationary pressures one way or another. While it may be worth while to consider the possible effects of a relatively large change in interest rates from a theoretical viewpoint, it seems unlikely that such a change in Government policy would be practical. A large change in interest rates, it appears to me, would be undesirable in view of its effect on the public debt. Furthermore, I question whether even a large rise in interest rates, 3 to 5 percent, for example, would have any material effect on personal savings and business investment under the economic conditions of the past 6 years.

It does not seem to me that a ¼ to ½ percent rise in interest rates can have a significant effect in inhibiting consumer or business spending. It is unlikely that a small rise in interest rates will increase personal savings or curtail investment to any material degree, under the conditions that have existed since the end of World War II.

With a rising price level—a 45 percent increase in the Consumers' Price Index in the 6 years since 1945—it is difficult to see where a ¼ to ½ percent rise in interest rates can serve as an impetus to a large-scale increase in personal savings.

Those who support the view that a small rise in interest rates will increase personal savings possibly will point to the rise in net saving as a percent of disposable personal income since the second quarter of this year. Net personal savings have risen, but I do not believe that this rise has been related to the new Federal Reserve Board policy.

It would be erroneous to attribute the recent rise in net personal savings to the small change in interest rates. On the other hand, other conditions—including the psychological effect of the Government's price action of January 26, 1951, the accumulation of large inventories by both business and consumers in the 7 months after Korea, a price level so high that many consumers were priced out of the market, and the payment of long-term debts—obviously contributed to this increase in net savings as a percent of disposable personal income.

Likewise, I do not believe that a relative small rise in interest rates will tend to curb investment. Businessmen are not likely to curtail investment—under conditions of a rising price level and high profits—because of a one-fourth- or a one-half-percent rise in interest rates. And banks are not likely to be more restrictive in their credit policies when their extension of credit brings greater returns.

If a small rise in interest rates were to have a significant effect on investment, we should be able to find a material decline in bank loans, since the Federal Reserve Board permitted interest rates to rise. The facts, however, do not show any such decline in bank loans.

Commercial, industrial, and agricultural loans, reported by weekly reporting Federal Reserve member banks, reveal relative stability from March through July 1951. But such loans have increased since August. By October these business loans were 10 percent above their level for February 1951.

The relative stability of business loans during March–August and their subsequent rise—as in the case of the increase in net personal savings—can be traced to market conditions, rather than to the small change in interest rates.

The buying lull since February–March and the holding of large inventories accumulated in the period immediately following Korea were not conditions to stimulate a further rise in business loans. General market conditions after the failure of the Easter season to meet business expectations were responsible, in my opinion, for the relative stability of business loans in that period.

The rise in business loans since last August has been attributed to the increasing pace of defense production. This expansion of business loans occurred despite the previous small rise in interest rates.

The experience of the past several months seems to serve as ample evidence that investment and personal savings have responded to market and general economic conditions rather than to small changes in interest rates. Devices other than interest-rate changes will have to be developed if Government policy is to affect personal savings and business investment as means of influencing the course of our national economy.

This is not meant to deprecate the important, underlying influence of credit in our economy. On numerous occasions in the past, the CIO has pointed to the large-scale expansion of credit as a major factor underlying the inflationary pressures that we have experienced since 1946 and that followed the outbreak of the Korean war.

In his report to the recent CIO convention, President Philip Murray stated:

> Most businessmen bought goods after Korea to be placed in warehouses where they were held for release at a later date, to be sold at anticipated higher prices. This practice itself tended to send prices up by withdrawing goods from the market. Business inventories rose 22.5 percent from June 1950 to last March.
>
> Business hoarding was invited by easy bank credit. Weekly reporting banks, affiliated with the Federal Reserve System, reported a 41.2 percent rise in commercial, industrial, and agricultural loans between June 1950 and March 1951. With money readily available from the banks, businessmen invested heavily in inventory accumulation.
>
> Selective credit controls were placed on consumer purchases by the Federal Reserve Board. But nothing effective was done to curb commercial credit expansion. Businesses were left relatively free to borrow funds from the banks while down-payments were raised and the period for payments was decreased on purchases of homes and consumer durable goods.

President Murray's remarks point up the need for effective controls over the expansion of business loans. Small changes in interest rates, as indicated above, have no effect in curtailing such loans. Yet the rapid expansion of business loans feeds the fires of inflation and such expansion should be curbed in inflationary periods as part of an over-all stabilization program.

The effective curtailment of business credit would obviously curb investment—a necessary step to halt the growth of inflationary pressures. However, it does not seem that a small change in interest rates

will perform the task of stimulating personal savings and curtailing investment in periods of inflationary stress.

The effective curbing of the expansion of business loans—and the curtailment of business investment—requires the immobilization of part of the great sum of United States Government bonds in bank reserves. In this regard, it would be well to consider the establishment of special reserves, designed to immobilize part of the commercial banks' holdings of Government bonds. Under conditions of sharp inflationary pressures, the possibility of freezing the annual level of business loans, with flexibility for seasonal factors, should be considered in addition to a program of priorities and allocation of materials. The stimulation of personal savings in an inflationary period would be aided by a stabilized price level, which requires an over-all stabilization program adapted to the economic needs of the time.

Walter W. Haines (New York University)

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(*d*) Changes in interest rates will undoubtedly affect the volume of plant expansion, particularly in the short run when there is an expectation that a reversal of the change will occur in the future. Suppose that there is a rise in the interest rate for, say, grade A bonds from 2½ to 3 percent. Not only will this tend to discourage a corporation from expanding on borrowed funds if the project was considered to be just barely feasible at 2½ percent, but even a corporation which thinks that it can make a profit at 3 percent will not saddle itself with a 3 percent debt now if it expects that the rate will fall back to 2½ percent within a year or two, and if, of course, the project is reasonably postponable. This is because the added expense for interest will continue for a period of perhaps 20 years, which will more than counteract any short run advantage obtained by the additional production now. The greater the change in rate, the more important long-run considerations become.

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Burton C. Hallowell (Wesleyan University)

My conclusions may be summarized at the start. I believe that credit policies involving small increases in interest rates have had a restrictive effect, especially since March 1951. The significant effects fall not on borrowers but on lenders, who directly or indirectly restrict the availability of funds. Credit policies involving large interest rate increases would result, however, in a more rapid and more restrictive effect. Furthermore, credit policies involving small interest rate changes cannot always be relied upon to accomplish the aims of the monetary authorities.

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Seymour E. Harris (Harvard University)

In general a small rise in the interest rate is not likely to have a great effect. Much more important is the anticipated return from the use of money. Loans of commercial banks may well rise despite an increase of rates (as they did in 1950–51), when the expectation is more business, higher prices, and higher profits. Even should the increase of rates be a warning to banks of impending difficulties, restraint on their part may well be offset by increased participation by nonbanking lenders.

Why should the average borrower be dissuaded by an increase in rates of, say, one-half of 1 percent, when price rises have averaged about 8 percent a year for 10 years and when the average businessman contemplated price rises of 5 to 15 percent per year? Indeed, the lender anticipating a negative rate of interest (net return deflated by the annual rise of prices) might refrain from lending in order to maintain his capital unimpaired. But unfortunately this would be a successful policy only if concerted, and nonbanking lenders did not enter the arena. With prices continuing to rise, the reward for inaction would be an even greater impairment of capital.

It is especially important to emphasize the competition of banking and nonbanking lenders. On September 27, 1948 (New York Times, September 28, 1948), a former president of the ABA had this to say:

> As a source of credit the life-insurance companies and the nonbank-lending agencies have become so important that they must be considered along with the banks in the national credit picture. In the year ending June 30, insurance companies disposed of $3,000,000,000 of United States Government securities and increased their loans and investments by $6,000,000,000.
>
> Savings and loan associations, companies, mutual-savings banks, and Government credit agencies, excluding those extending foreign credits, increased their loans and investments $6,500,000,000. Nonmember banks increased their lending $3,000,000,000. In total all these agencies increased their lending over $15,500,000,000.
>
> Banks which are members of the Federal Reserve System increased their loans during the same period $5,000,000,000, only one-third of the total of nonmember institutional lending activity.

I do not believe that small changes in the rate of interest will have substantial effects upon lending policies of any lenders or upon consumers' savings, business plant expenditure programs, or business inventory policies. Obviously a given rise of rates will affect business plant expenditure programs more than inventory policies, since the commitment in the former case is for a longer period and hence a given rise of rates is more costly.

Of course, relatively large increases in the rate of interest would have a greater effect. But how large an increase is practical? In the discussions of 1949–51, a rise of about one-half of 1 percent was generally considered. With an average rate of 2 percent on Government debt and 2½ percent on commercial banking loans in 1948, even a one-half of 1 percent rise would be large. But assume that by a large increase here is meant 1 percent or roughly a 50 percent rise for Governments and 40 percent for the rate on bank loans. What would the effects be upon the economy? Again, the psychological effects may be of some importance. But much more significant again are the price, output, and profit prospects.

Note that the rate on bank loans (19 cities) rose from 2.1 percent in 1947 to 3.07 percent in June 1951, a rise of almost 50 percent. Yet, member bank loans at the end of June 1951 were $9 billion more than at the end of 1947, a rise of 9 percent. Despite this increase of rates (the yield on Moody's corporate bonds was 2.85 percent on September 1, 1951, as compared to 2.82 percent in 1948 and 2.66 percent in 1949), gross private domestic investment amounted to $30 billion in 1947, $43 billion in 1948, $33 billion in 1949, $49 billion in 1950, and $64 billion in the second quarter of 1951 (annual rate). There is little evidence here of any great effects of substantial rises of rates.

A rise of rates of 2 to 4 percent may have large effects; but in view of the effects on the prices on $1,000 billion of assets outstanding, this is not a practical policy. Indeed, when forces are balanced, price stability prevails and further expansion of output is not likely, then a substantial rise of rates may be effective. But is a rise desired at this point?

Consumer savings have been rather small in the postwar period. In 1946–49, liquid savings were but $27½ billion as against $148 billion in 1942–45. In 1949, personal savings were but 4 percent of personal income. In 1950, particularly, and despite higher rates, savings again were disappointing. The improvement in 1951 reflects not the increased incentive of higher yields, but rather the reaction to excess buying in 1950 and the slackening of the rise of commodity prices. Much more important than practical changes in rates are income levels, expectations of price movements, and availability of consumer goods.

Plant investment expenditures are to some extent influenced by market rates. But it should be emphasized that business increasingly depends upon its own funds for financing. Thus, in 1950, there were $4.4 billion of new issues, of which $1.2 billion were in stock, the latter not closely related to yields. Yet, in 1950, gross private investment amounted to $49 billion. The business account shows that, of these $49 billion, business provided out of profits and depreciation allowances $30 billion and received $19 billion from the outside. A substantial part of the $9 billion increase of bank loans went to business and accounts for part of the $19 billion above as do the $4.4 billion of new issues.

It is obvious that the major part of investment funds obtained internally is only indirectly and nebulously related to rates; that the businessman was able to obtain many billion dollars additional from banks and the security market despite somewhat higher rates. The record suggests that in periods of expanding output and rising prices, practical rises of rates are not greatly effective.

Allan B. Kline (American Farm Bureau Federation)

The effect of a specific credit policy is not necessarily determined by the change which it may bring about in interest rates. The important consideration is whether the policy results in an expansion or contraction of the volume of credit outstanding. Within the range of interest rate changes likely to occur in our economy, individual policies on lending, saving, and borrowing probably are affected more by the availability of credit and expectations of the future than by changes in interest rates.

Open-market operations of Federal Reserve banks are an important factor in determining the total volume of credit lenders can extend at any given time. It is the position of the American Farm Bureau Federation that the statutory responsibilities of the Federal Reserve System require that its purchases and sales of Government securities be related to the Nation's need for money and credit rather than to interest-rate considerations.

Wesley Lindow (Irving Trust Co., New York)

I do not think that this question can be answered with any precision. The same degree of general credit tightening may have negligible, mild, moderate, or severe effects at different times depending on

the circumstances. In general, tightening which results in small changes in interest rates will have small repercussions but it is not safe to count on this because under certain conditions a chain reaction may set in leading to much larger effects than desired.

Fritz Machlup (Johns Hopkins University)

Effects of Credit Policy Resulting in Changes in Interest Rates.—Several attempts have been made in recent years to prove at the same time that interest rates have little or no influence upon economic activity and that an increase in interest rates has a bad effect and should be avoided. It takes no great intelligence to recognize that it is impossible for both of these statements to be true. As a matter of fact, both are false. Changes in the interest rate may have very definite effects upon economic activity, and an increase in interest rates may sometimes be a necessary part of a program designed to avoid excessive inflation.

NOTE.—It is necessary for an understanding of the problems involved to give a sufficiently extensive interpretation to the meaning of "interest rates." In particular, we must not restrict the meaning of this term to discount rates or contractual rates on bank loans or on industrial advances, but we must include the actual yields on bonds and stocks. We must also include the effects of credit rationing upon the internal calculations of borrowers because, after all, a smaller ration of credit available to a business firm is equivalent to a higher rate of interest. The terms "increase" or "reduction" of interest rates should therefore not be understood too literally but in the wider meaning just indicated.

(*a*) *Effects on Lending Policies of Commercial Banks.*—The traditional textbook theories are still valid. It is possible through appropriate policies of the Federal Reserve Banks to bring about an increase in interest rates that will cause commercial banks to restrict their lending activities. Reduced excess reserves of commercial banks and higher yields of Government bonds will tend to reduce the incentive of banks to grant mortgage loans, consumer loans, and even business loans either at the same interest rates or in the same amounts as they otherwise would have. That is to say, sufficiently increased yields of Government bonds restrict the availability of funds to home owners, consumers, and business firms, and therefore restrict private expenditures that compete with Government for scarce resources and drive up prices.

(*b*) *Effects Upon Lending Policies of Nonbank Investors.*—Here the chief effects will be on the kinds of earning assets that nonbank investors seek for their portfolios. For example, at low yields of Government securities, insurance companies may invest large amounts in mortgage loans or construction programs; when the yield of Government securities is higher the insurance companies may prefer to give their funds to the Government. This would make new bank credit less necessary or unnecessary to finance Government expenditures, and thus would reduce inflationary pressures.

(*c*) *Effects Upon Consumer Saving.*—Many economists are too near-sighted to see these effects, which work chiefly in three ways:

First, consumer spending is enhanced by capital gains, and reduced by capital losses; higher interest rates depress the value of securities and other durable assets; consumers will reduce their expenditures when they have suffered capital losses and their wealth is reduced in relation to their income.

Secondly, many consumers find it more attractive to save when interest rates are higher and they can expect higher interest income from

their assets and have better chances for capital gains in the future when the depressed security prices may rise again.

Thirdly, higher interest rates raise the prices consumers have to pay for things bought on installment plans. For example, at higher interest rates given amounts of monthly installments will buy less automobiles or refrigerators than at lower interest rates. Thus, given amounts of consumers' outlay will make smaller demands on scarce resources.

(*d*) *Effects Upon Business Plant Expenditure Programs.*—Increased interest rates may have only small direct effects on business investment programs, but the indirect effects are important. The direct effects of increased interest rates, the increased difficulty of obtaining mortgage loans and of selling new securities to raise funds in the capital market, may extend to relatively few people, but the repercussions of the reduced purchases of even a few may be of considerable importance in reducing business investment programs. In other words, the indirect effects of increased interest rates reach most businessmen in a disguised form, namely, as reductions in the demand for their products. For example, if only a few residential builders were directly influenced by higher interest rates to postpone their projects, the demand for thousands of products that go into residential construction would thereby be reduced and incentives to expand plant capacity for thousands of producers' goods would be dampened.

NOTE.—There are those who try to learn about the effect of interest rates upon business investment by asking the businessman, "How are you affected by an increase in the interest rate?" But the businessman never knows, since what he would notice is hereby a slackening in the demand for his product and he would have no reason to connect this with interest rates. It is the economist's job to understand the relationships which the businessman cannot see. If economics were so simple that we could find out matters by asking businessmen, we would have no use for economists.

(*e*) *Effects Upon Business Inventory Policy.*—Considerable business inventories are held as a protection against rising prices. If the businessman expects that next year the prices of his raw materials will be 10 percent higher, it will certainly pay him to keep large inventories. But if the interest rate is 10 percent per annum, his incentive to carry large inventories is obviously diminished. Hence, an increase in interest rates tends to reduce the demand for materials to be held in stock.

James A. Maxwell (*Clark University*)

The evidence in support of the generalization that moderate changes in interest rates have small effects upon banking and business decisions is quite unconvincing. I would expect such changes to reduce lending by commercial banks and also business plant expenditure programs. While large changes in interest rates may well be so dangerous as to be undesirable, this should not be an excuse for debarring any changes in interest rates.

James J. O'Leary (*Life Insurance Association of America*)

The reply to this question must be made through two approaches: (1) The effects of interest rate changes per se, where they are the product of credit policies, and (2) the effect of credit policies in altering the availability of credit which leads to changes in interest rates.

Turning to part (a), it is clear that, by tightening or loosening the availability of commercial bank credit, credit policies which may involve only small changes in interest rates as a result can play an important part in influencing the lending policies of commercial banks and thus in contributing to economic stability. For the past few years, for example, credit policies which have tightened the availability of commercial bank credit from time to time have resulted in only relatively moderate rises in short-term interest rates, but they have played an important part with respect to economic stability. It goes without saying that the more drastic the credit policies, with greater effects on the availability of credit, the larger the effects achieved.

Interest rate changes per se also affect the lending policies of commercial banks more or less importantly, depending on the size of the changes, in the following way. Commercial banks carry Government securities in their statements at amortized cost values, not market values; hence, if they hold these securities market losses occasioned by declining Government securities prices are not incurred. However, if Government securities are sold after prices have declined below amortized cost, then losses are incurred. Thus, with a rise in rates such as has taken place this year, the emergence of potential losses on Government securities held by commercial banks has restricted the expansion of loans by commercial banks based on the sale of Government securities. Moreover, flexibility of interest rates introduces a degree of uncertainty as to future prices of Government securities and thus necessitates greater caution in new loan commitments.

Turning to part (b), it is especially important with respect to the lending policies of nonbank investors to think of credit policies in terms of the effects such policies have upon the availability of credit rather than upon the resulting changes in interest rates. To take a specific case, the decline in Government securities prices which took place following the "accord" between the Treasury and Federal Reserve last March led to only a relatively moderate rise in yield on long-term Government securities, but it had a significant effect upon the availability of long-term credit. Prior to the unpegging of Government securities prices, savings institutions tended to regard their holdings of Government securities as cash and proceeded in making forward commitments for investments in corporate bonds and real-estate mortgages on the expectation that Government securities could be sold at known fixed prices. With the decline in Government securities prices, along with the exchange offering of 2¾'s for Victory bonds, these institutions in general were much more inclined to confine their investments to the funds flowing in from current operations. The potential loss on sale of long-term Governments (along with other factors such as the removal of a large bloc of Victory bonds from the market as a result of the exchange offering of 2¾'s and the general desire of savings institutions to support the Federal Reserve-Treasury "accord" and the voluntary credit restraint program) became an important deterrent to further sales of these securities. The backlog of investment commitments plus the emergence of a potential loss on sale of Governments contributed importantly to reducing new lending. The result was that mortgage funds became much scarcer as well as the supply of funds available for the purchase of corporate bonds. This basic scarcity of capital funds relative to the demand

aided greatly in the success of the voluntary credit restraint program and helped to channel the funds which were available into more essential uses. The experience since last March has been a classic example of how general credit policies which result in relatively small interest changes can have a major effect toward restricting the availability of credit.

Changes in interest rates per se have an important effect on the lending policies of nonbank investors in the sense that changes in yield differentials within the structure of rates for different types of investments will promptly cause a shift to the higher-yielding outlets. Moreover, individual investors, as distinguished from institutional investors, are sensitive to some extent to changes in rates. For example, a rise of one-half of 1 percent in the return of E-bonds would probably stimulate the sale of these bonds noticeably.

With respect to part (c), it is more appropriate to think of the effect of small or large changes in interest rates per se upon consumer saving. It has become popular in recent years to hold that changes in interest rates have little or nothing to do with the propensity to save. Instead, it is argued that other factors such as the volume of disposable income and the availability of consumer goods are the determinants of saving. My view is that the deemphasis of interest rate changes as a factor influencing consumer saving has gone too far. At any given level of national income, interest rate changes are one of the factors affecting consumer saving, and the larger the changes the more powerful they become.

Turning to part (d), it is difficult to generalize about the effect of interest-rate changes on business-plant expenditure programs. For certain industries where the ratio of plant and equipment per unit of output is high and where the cost of capital is an important element of total cost, such as the utilities and construction, even relatively small interest changes may exert an influence on investment decisions. In the case of industries in which the ratio of plant and equipment per unit of output is low and the cost of capital does not bulk large in total cost, small interest rate changes do not exert much effect. As a generalization, interest rates are a factor in determining business-plant expenditure programs, and the larger the changes the more important the effect will be. Here again, however, it is misleading to focus attention entirely on interest-rate changes as the casual factor. The crux of the matter is how credit policies affect the availability of credit for business-plant expenditures. Thus, it is important to recall that the unpegging of Government securities prices and the resulting decline in these prices, involving only a relatively small rise in interest rates, have had an important limiting effect upon the availability of credit to business corporations for plant and equipment expenditures.

Finally, with respect to part (e), there is ground for believing that, from the viewpoint of the borrower, even relatively small interest rate changes can be influential in regulating business inventory policies. The cost of credit is an important factor in carrying inventories so that changes in interest rates would be bound to exert some influence. Here again, however, it is important to think in terms of how the credit policies have affected the availability of credit. For example, the decline in Government securities prices last spring undoubtedly had an important effect in restricting the availability of credit for the accumulation of business inventories. This is partic-

ularly true if we consider the employment of the voluntary credit-restraint program along with the general credit policy.

Roy L. Reierson (Bankers Trust Co., New York)

The effects of credit policies depend not only upon the magnitude of the resulting changes in interest rates but also upon the general economic environment, the price and credit developments prior to the change in credit policy, and the way businessmen and others interpret the reasons for the change and appraise the outlook. That is a basic reason why it is very difficult, and perhaps dangerous, to generalize about the effects of changes in interest rates.

Commercial banks.—Under present conditions, the effects which credit policies that result in relatively small changes in interest rates have upon the commercial banks are best illustrated by the consequences of the "accord" reached in March 1951 between the Treasury and the Federal Reserve authorities. It served as an announcement to the banks that reserves were not going to be made as readily available as had formerly been the case, and this had its impact on the thinking of bank managements. Subsequently, the decline in the prices of long-term Government bonds and the absence of significant support operations on the part of the Federal Reserve banks did in fact reduce the availability of reserves to the banking system. While the effects of these developments are difficult to trace in the case of an individual institution, they are important in determining the ability of the banking system as a whole to expand its loans.

In appraising recent trends, it is important that the role of credit policy be kept in proper perspective. The effectiveness of the change in credit policy was probably enhanced by the spirit of caution engendered among lending officers as a result of the strength of the inflationary forces that followed the outbreak of the Korean war. Furthermore, the rapid expansion in bank loans after mid-1950 had brought these loans to new high levels, and had further reduced the ratio of capital funds to "risk assets." Doubtless these factors also contributed to a more conservative lending policy and less eagerness in seeking loans.

The prospective increase in defense spending, with its accompanying requirements for funds, caused bankers to plan their operations so as to maintain their ability to meet these demands when they arose, and the voluntary credit-restraint program also helped to channel available credit into defense and essential civilian purposes. While general economic developments and seasonal factors certainly played an important part in the leveling off of bank loans in the second quarter of 1951, many bankers have indicated that the demand for bank credit continued strong during this period. On balance, therefore, we may conclude that a tightening of credit policy, even if reflected in relatively small changes in interest rates, tends to have a restrictive effect upon the expansion of bank credit, but that in the past several months, many other factors have also been active to this end. There seems little doubt that more restrictive credit policies, reflected by larger increases in interest rates, could, if pursued persistently, eventually curb the expansion of bank credit very substantially.

Nonbank investors.—The credit policies of recent months also had restrictive effects in the case of nonbank lenders. Perhaps the major effect is discernible in the case of new commitments. In the latter

part of 1950 and the early months of 1951, some lenders had been making new commitments in excess of the normal inflow of investable funds, on the premise that additional funds could be obtained through the sale of Government securities, if necessary to the Federal Reserve, at a largely predetermined scale of prices. The "accord" and the consequent reduction in market prices of long-term Government securities reduced the eagerness of many lenders to sign new commitments. The outstanding commitments of the life-insurance companies declined persistently for several months after the "accord." Here, as in the case of commercial banks, the record suggests that credit policies resulting in modest increases in interest rates can exercise a significant restraint upon lending policies in the aggregate. A highly restrictive credit policy, resulting in relatively large increases in interest rates, would place even greater handicaps in the way of maintaining lending operations through the sale of Government bonds.

Consumer saving.—Consumer saving is governed by a great many complex and largely inexplicable forces; certainly the level of interest rates is only one, and not the major, determinant of the volume of personal savings. However, although many arguments have been advanced to the contrary, it seems to me that credit policies which result in some increase in interest rates do contribute, to some extent, to an increase in savings by individuals. Over the short range, the increase in investment income does not appreciably stimulate higher savings. The increase in interest rates in the early part of 1951, however, came after a decade in which general credit policy had not been used at all significantly. Consequently, the public may have interpreted the more restrictive credit policy as evidence that the authorities were concerned about the problem of inflation and were willing to undertake a positive program to cope with it. This feeling, in turn, may have helped to check excessive consumer buying and spending. In this fashion, the change in credit policy early in 1951 probably contributed in some measure to the large increase in savings which occurred in the second quarter of the year.

Business outlays.—Business decisions with reference both to plant expansion and inventory accumulation are based upon views as to the future outlook for business activity and commodity prices. Thus a restrictive credit policy, which leads businessmen to become more skeptical concerning the continuation of an inflationary boom, may exercise a restraining influence upon business outlays for plants and inventories; this is likely to be more important than the deterrent posed by the increase in the cost of borrowed money, especially if the increase is of modest proportions. Furthermore, business spending is influenced by the availability of funds. To the extent that credit policies do contribute to more restrictive lending and investing policies on the part of commercial banks and institutional investors, they contribute toward holding down business spending.

The reduced availability of funds doubtless helped to slow down the rate of inventory accumulation in the third quarter of 1951, although the high levels of inventories, some decline in retail sales, and the changed price outlook were probably the most important factors. In the case of plant and equipment programs, the level of spending continues very high and 1951 is destined to be a peak year.

Such programs are not easily cut back. Furthermore, spending on plants related to the defense effort is increasing.

Lawrence S. Ritter (Michigan State College)

I tend to agree with those who are skeptical regarding the direct influence of relatively small changes in interest rates upon the expenditure decisions of most business firms (with respect to both plant extension and inventory policy) and consumers. On the other hand, the lending policies of commercial banks and relatively heavy institutional nonbank investors are probably quite sensitive to small interest rate changes and expected changes, and portfolio shifts of substantial amounts can well result from such changes. In turn, of course, these will tend to cause further changes. I am not sure what "relatively large changes" refers to in the sense of magnitude; I am sure that there is some interest rate so high, however, that if expected to continue business firms would take it into account as a significant factor, and that it does not have to go too high before it affects a substantial number of them.[1]

On the other hand, I think the indirect effects of even small changes in rates are substantial. Interest rate changes may, per se, exert slight effect upon the financial decisions of households and business firms, but credit policies resulting in such interest-rate changes may have substantial effect, i. e., through channels other than the changed rate of interest, channels which are only opened if a restrictive credit policy is pursued of the type that has usually also resulted in changed interest rates.

George B. Roberts (National City Bank of New York)

Credit policies resulting in changes in interest rates affect (*a*) lending policies of commercial banks by their impact on reserves and on security portfolios. Cheap money policies tend to expand bank reserves and make money more plentiful, thus tending to promote loan expansion. Conversely, firmer money policies tend to contract bank reserves and reduce credit availability, thus discouraging loan expansion.

Cheap money policies, with accompanying decline in interest rates, mean increased market profits and greater liquidity in bank bond accounts, creating conditions favorable to loan expansion. Conversely, firmer money policies and higher interest rates mean losses in bond accounts, reluctance on the part of banks to sell, with reduction in liquidity which discourages loan expansion.

(*b*) Lending policies of nonbank (institutional) investors, like those of commercial banks, are affected by increasing or decreasing the readiness with which investment assets can be converted into cash. During the period when the Federal Reserve was pegging the Government bond market, institutional investors could and did get funds for lending by selling their Governments to the Reserve banks. When the pegs were lowered, institutional bond portfolios became partially frozen, due to the reluctance of the institutions to sell and take losses.

(*c*) Consumer saving tends to be encouraged by offering more attractive interest rates.

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[1] I will confine myself to restrictive credit policies and interest rate increases, since inflation is the problem obviously under consideration.

(*d*) Business plant expenditure programs are affected by changes in the availability of credit, as described above. Also, a low long-term interest rate itself tends somewhat to encourage such expenditures, and a high rate to discourage them.

(*e*) Business inventory policy is affected—apart from the trade situation—mainly by changes in the availability of credit rather than the price.

Roland I. Robinson (Northwestern University)

Credit policy affects both the availability of credit and interest rates. While both factors can be restrictive, availability probably makes the greater difference. But since the results of the two cannot be separated, the following comments will comprehend both aspects of credit policy.

(*a*) The lending policies of commercial banks depend on the availability of cash and secondary reserves. Credit policy can limit the availability of cash reserves and reduce the liquidity of secondary reserve assets. Since short-term Treasury obligations are the prime secondary reserve assets, Treasury financing goes a long way toward determining bank liquidity. Since the war commercial banks have been surfeited with liquidity; credit policy has been hampered by an oversupply of short-term obligations.

(*b*) The lending policies of nonbank lenders are less directly affected, but they are influenced. Since these lenders are generally savings institutions, they can lend to the extent new savings flow to them without being limited by credit policy. But if they attempt to lend by selling from portfolio, this can be influenced by credit policy. The capital losses that may result from such sales are directly influential on their willingness to lend from this second source.

(*c*) Consumer saving is not influenced a great deal by credit restraint or interest rates. But savings institutions make better profits when rates are high; they are disposed to promote saving most vigorously at such times. And such promotion does seem not only to direct the flow of savings but to increase the total. Thus, savings are indirectly influenced by interest rates.

(*d*) Business plant-expansion programs are influenced by credit restraint to the extent they depend on borrowing. This has been the marginal part of such expansion in recent years, but it is still important. Firm credit restraint has the general effect of limiting capital outlays to the amount of current saving.

(*e*) Business inventory policy often depends on the availability of credit. In the later summer of 1951 quite a few concerns were pressed to reduce inventories by their bankers. Inflationary developments were halted in part by the credit restraint, mild though it was in general tone.

Quantitative estimates of the influence of credit restraint on spending do not give a complete picture. The amount of spending added by too free credit may not be big, but it can be the amount that turns the scales from reasonable prosperity to inflation. Credit restraint works best when it cuts spending enough to dampen hyperactive business but stops short of creating an unhealthy halt.

R. J. Saulnier (National Bureau of Economic Research Incorporated)

The effects of interest rate changes on the lending policies of commercial banks and other lending institutions, on the savings of con-

sumers and on plant and inventory expenditures of business concerns depend not only on the magnitude of the interest rate change in question but also upon general economic conditions at the time. There are so many possible combinations of circumstances which might prevail, and would affect the final outcome, that it would be an utterly impossible task to discuss the effect of interest rate changes in each of them. It may suffice, however, to discuss only the effects that tend to flow from an interest rate increase of, say, one-half of 1 percent or more in the prime borrowing rate under economic conditions such as those prevailing in 1950–51.

A tightening of money market conditions is reflected in two principal ways—in interest rate or money cost changes and in the supply of available credit. Both of these money market adjustments tend to be passed on from the point of first impact to all sections of the financial system in a series of impulses. But it goes without saying, I should think, that the force of the secondary and tertiary effects will depend in large part upon the degree of credit stringency that is produced in the first instance. The general character of the changes in money rate patterns and in credit availability which will occur is fairly clear. In the first place, the increase in the prime borrowing rate will be reflected soon thereafter in the rate charged for intermediate-term loans, and also in the maturities which will be offered by lenders on such credits. It is a fairly well-established practice in the central money markets to fix term-loan rates for the highest quality credits in a certain relation to the rediscount rate in effect at the time of the borrowing. Accordingly, an upward tendency in the rediscount rate will reflect itself shortly thereafter in term-loan rates, and subsequently in the rates quoted for other credits.

No less important is the effect of the tightening of credit conditions on the capacity and willingness of lenders to lend, and on the repayment terms which will be incorporated in loan contracts. The effect on credit availability that is traceable to a tightening of reserve positions is perhaps clear. This, too, tends to spread through the money sections of the financial system. One effect of this is that more rapid amortization of loans will be required, which imposes a higher rate of saving on business concerns. Further, the shortened maturities will tend to cause postponement, or abandonment, of business investment programs that seem feasible only on the basis of a longer repayment period.

It is a fairly well-established fact that this readjustment of credit-supply conditions will tend to occur first in the central money markets, and in connection with the larger loans. The rates charged on smaller loans, and particularly those charged by small banks in the smaller centers of population, are less immediately responsive to the impulses emanating from the central money markets, but they are by no means unaffected. Even to sketch in outline the manner in which these impulses are transmitted to smaller banks would require far more space than is available in this brief response. Briefly they are spread through the many thousands of correspondent and competitive relationships that exist among banks.

The question has also been asked how interest rate changes affect the policies of nonbank lending institutions. These play a part in the financial system of our country that is, I believe, grossly underrated;

for example, many thousands of small businesses are financed through the medium of commercial finance companies, factoring companies, and the like. To understand how these companies are affected by interest rate changes, it must be noted, first, that they are themselves heavy bank borrowers. Part of this borrowing is on a long-term basis; but another, and considerable, part is short term, and at all times a certain amount of it is being refunded. Furthermore, the great bulk of their borrowing originates in those centers in which credit conditions are first affected by credit stringency. Not only are the money costs of these companies increased, but additional funds may not be available if their borrowing is viewed as now excessive by reference to the new money-market conditions. This reaction is transmitted, of course, to the borrowers of finance companies through higher money costs and generally more stringent credit standards.

A word should also be said about the effect on money-market changes on the lending policies of life-insurance companies, illustrating another class of nonbank investors. The effect of higher interest rates on these institutions in 1950 and especially in 1951 was very direct; indeed, it approached the dramatic in the late winter of 1950–51. Naturally, insurance companies are constantly alert to the uses to which their funds are put. Having regard to both short-run and long-run considerations, life companies seek out the most attractive uses of their investable funds. During 1950 this means, in part, that they were disinvesting in securities of the Federal Government, which securities were absorbed in large part by the Federal Reserve banks, and channeling the funds so acquired, along with new money, into the mortgage market. In this way they helped finance the tremendous boom in residential building which carried housing starts during the year 1950 to around 1,500,000, the highest point in our history. While this financing was essential to the success of this tremendous building program, through which the postwar housing shortage was at least partially overcome, the sales of securities by the insurance companies, and their purchase by the Federal Reserve banks, had the effect of pumping additional reserves into the banking system.

With the change in money-market conditions which took place early in 1951, the attractiveness of this program was substantially altered, and insurance companies greatly reduced the flow of their funds into the mortgage market. Many companies had large outstanding commitments to absorb mortgages, and in some cases it was necessary for them actually to cease accepting new applications for loans until these had been taken up by the reduced flow of funds then available. In some cases the companies were forced to reduce the flow of their funds into mortgages because they had sold their Government bonds down to the point where further sales might have constituted an imprudent loss of liquidity, but the dominant factor was the change in the bond market.

There are a good many other nonbank investors in our financial system, but the above will perhaps suffice to illustrate the manner in which central money market impulses are transmitted from one type of institution to another and from lender or investor to the user of funds. But there is no intention to convey the thought that these impulses are transmitted instantaneously, for this is far from the case; they are, nonetheless, transmitted very quickly.

The effect of interest rate changes on consumer saving and on business investment programs is also a long and complex story. While this account cannot be given in full, there are a few facts concerning it that warrant special mention. Many types of consumer saving are doubtless affected little if at all by interest rate changes, but in certain other respects the consumer is very quickly affected. For example, if tightened money-market conditions require shorter maturities on consumer loans, the increased amortization requirements will force greater savings from individuals. The same is true of business concerns, which may be induced to retain a larger proportion of their incomes when it is found that funds drawn from external sources are available only on a more costly basis and on less attractive repayment conditions. If the interest rate increases are sufficient, they may lead to higher rates of returns on securities, and this, to added consumer savings or, in any event to a reallocation of savings.

The effect of interest rate changes on business-investment programs depends in part on how dependent the concerns are on outside funds for fulfilling their investment programs. A growing independence of business concerns from the banks is often alleged, but studies of the retention of income by corporations clearly show that this is not so and that in periods of high business activity very heavy reliance is placed on the acquisition of funds from outside markets. Business concerns customarily depend most on commercial banks for funds during the early stages of their investment programs. However, as an expansion continues and as credit tends to tighten, business concerns refund these shorter-term loans through long-term bond, preferred-stock, or common-stock financing. The incentive for doing this will be intensified, of course, by any tendency for interest rates to rise and by any sign that credit is becoming less available. Accordingly, an upward movement of bank rates will tend to induce increased flotations of securities; and, unless stock-market conditions are such that these added flotations can be readily absorbed, there will be a tendency for stock yields to rise. If yields rise, many companies will put aside their financing programs because of their unwillingness to float securities on what they regard as unattractive terms, with an obvious effect on real investment.

The effect of interest-rate changes on inventory holdings is very much more direct and immediate. These holdings are financed either out of the free working capital of the company or on short-term borrowed funds. Not only will a higher interest rate constitute a heavier drain on the income of a heavily indebted company, but stricter credit standards may also result in the forced liquidation of inventories, or at least in a slowing down of their further accumulation. Again, it would be an error to imply that interest-rate changes are transmitted immediately: they will first affect those inventory holdings or companies that are marginal in one respect or another. Not all investment expenditures of a concern will be equally affected: The over-all effect, however, will be restrictive, and great skill is required if the authorities are to avoid actually turning business downward where only a retardation of growth is called for.

Emerson P. Schmidt (*Chamber of Commerce of the United States*)

There has been a disposition among economists to view interest as such a small component of total costs that changes in interest rates have

little or no influence on borrowing, lending, or general economic activity.

This "economic agnosticism" is an economic heresy that has already done untold damage to European economies and, indeed, to the security of the western world. It generates actual or suppressed inflation and overestimates the demand for capital.

There are always marginal borrowers, and every borrower is marginal in part of his borrowings; otherwise, why would the borrower who is intramarginal not borrow twice as much or three times as much? Therefore every change in interest rate must be assumed to have some influence on the demand for funds, other things being equal.

A zero interest rate on a perpetual loan would, of course, be a full subsidy, the demand for which therefore obviously would be unlimited. If he could get it financed, a $3,000-a-year man might be able to afford to live in a $25,000 or $30,000 house if the interest rate were zero. Whenever the interest rate is forced below the market rate, demand for capital is stimulated.

There is an increasing realization among economists that a free money market is an integral part of a free society. While change in the interest rate is rarely if ever the only factor influencing the disposition to save and lend or borrow and invest, it is an integral part of our price mechanism. If the interest rates' function of helping to equilibrate the supply and demand for funds fails, then some other substitute governor must be found. This leads directly into the rationing by Government bureau or otherwise of investment funds. In the last analysis the economy is likely to be driven into over-all detailed planning. Instead of the price mechanism allocating resources, systems of priorities and end uses have to be set up. Instead of economic adjustment through a series of interrelated, small, relatively smoothly functioning changes, Government bureau decisions must be relied upon; and they work with disturbance and uncertainty. The economy is put into a strait-jacket and in time may cease to grow. Because of this stagnation, temptations are faced to put the economy under constant inflationary pressure to force growth and expansion.

Tipton R. Snavely (*University of Virginia*)

(*a*) The lending policies of commercial banks are not greatly affected by small changes in interest rates. This is true particularly of the smaller commercial banks, which make loans in relatively small amounts. Some of the very large banks probably scrutinize more carefully fractional changes in rates, especially when loans are made in large amounts and to large business firms.

This broad statement perhaps needs to be qualified in one respect. In the purchase of bonds, whether Government or industrial bonds, banks are responsive to the net returns. This assumes that due regard is given to the factors of safety or quality and to length of maturity.

All in all, however, the lending policies of commercial banks are affected much more by reserve requirements, controls over various types of loans, such as mortgages and loans on durable consumer goods, than by slight changes in interest rates.

Relatively large changes in interest rates are more significant in their effect on the lending policies of commercial banks. They have a direct motivating influence and indirectly make it possible to arrest

inflationary tendencies. In this connection I should like to refer to an opinion expressed by Mr. Per Jacobsson in the Quarterly Review of the Skandinaviska Banken for October 1951, page 87. He writes:

From general experience it can, however, be stated that an effective limitation of the volume of bank credit as a rule presupposes a certain increase in the level of current interest rates.

Mr. Jacobsson states further that since World War II European countries have found it necessary to raise long-term interest rates. The higher rates "have sufficed to insure equilibrium in the long-term markets without there being any injection of newly created money by the central banks of the countries concerned." He also emphasizes the importance of the long-term interest rate as a means of keeping an adequate balance between current savings and investment. * * *

Herbert Stein (Committee for Economic Development)

For convenience and brevity I shall discuss this question in terms of the effects of credit restrictions resulting in relatively small and relatively large increases in interest rates.

(*a*) Credit restrictions resulting in relatively small increases in interest rates are likely to have smaller effects upon lending, investing, and saving than credit restrictions resulting in relatively large increases in interest rates. The relation between the resulting interest rate effects and the resulting investing and savings effects is probably continuous. That is, it seems to me improbable that credit restrictions resulting in interest changes smaller than a certain critical size have zero effects on investing and saving, whereas credit restrictions resulting in interest changes larger than the critical size have great effects on investing and saving.

(*b*) How much effect on investing and saving goes with how much change in interest rates is impossible to say with any confidence. No one knows whether a credit restriction policy that would result in an increase of one-half point in interest rates would cut private expenditure (investment plus consumption) by $2 billion, $5 billion, or $10 billion a year. But to stop with saying this is to give a misleading view of the policy problem. In a situation where the alternatives to credit restriction are open inflation, suppressed inflation, or more taxes of the politically probable type, I believe that credit restriction is desirable even if it involves large increases of interest rates. It seems to me highly unlikely that the costs to the economy of credit restriction would be as great as the costs of any of the alternatives to credit restriction. Both the costs of restricting credit and the costs of not restricting credit are uncertain. This calls for a kind of watch-and-see policy. But we have watched and seen the policy of no credit restriction long enough and with sufficiently bad results to justify pushing on with a policy of credit restriction.

(*c*) Credit restriction will operate mainly, but not entirely, through its effects upon the lending policies of commercial banks and non-bank investors. In addition to affecting the lending policies of investing institutions, credit restriction will reduce the willingness of individuals and businesses to spend owned funds (as distinct from borrowed funds) by making the conversion of other assets into cash more expensive. Whether the credit restriction affects bank lending more than other lending depends in part upon the way in which the

credit restriction is brought about. If the credit restriction is brought about in the traditional way by open-market operations, there would be no clear distinction between the effects upon banks and the effects upon other lenders.

(*d*) I would expect the initial impact of credit restriction mainly upon investment expenditures, including not only plant expenditures and inventory expenditures but also expenditures for residential construction. I would expect the effects upon saving also to be significant; consumers' credit will be curtailed, and savings institutions will be induced to promote saving.

Alan R. Sweezy (California Institute of Technology)

Since it is difficult to get evidence that is in any way conclusive as to the effect of changes in interest rates, the most that can be claimed for answers to this question is that they are reasonable and that they do not conflict with what evidence there is. Application of these tests still leaves room for a good deal of difference of opinion.

I am inclined to think that small changes in interest rates would have little effect on any of the five items listed. This is particularly true of consumer saving and expenditure on business plant. The effect on inventory policy would also be negligible, I should think, unless the change were taken as a warning of other and more important changes in economic conditions. The same applies to the policies of both bank and nonbank lenders, with one possible exception: If rates are already very low, even a relatively small decline might considerably increase the disposition of lenders to hold cash; and, conversely, a slight rise would probably be sufficient to induce them to exchange money for high-grade securities.

The effect of relatively large changes in interest rates, on the other hand, might be considerable. Our experience with such changes in the past has been of two kinds:

(*a*) A sharp increase (and subsequent relapse) in periods of high prosperity such as 1892–93, 1907, 1920, 1928–29. (Some of these were also periods of price inflation, mild in most of the peacetime booms, violent in 1919–20; others, notably 1928–29, were marked by stable commodity prices.)

(*b*) The gradual fall of the whole structure of interest rates in the 1930's to what has so far been a permanently lower level.

Economists have generally assumed that the rise of interest rates in periods of expanding business activity was one of the major factors bringing the expansion to a halt. The rise of rates itself was generally reinforced by an increasingly restrictionist attitude on the part of lenders. Not, of course, that lenders objected to high rates as such, but rather that they were forced to assume a restrictionist attitude because of the growing scarcity of their resources relative to the demands of borrowers and also because experience taught them to be apprehensive about the future in a period of sharply rising rates. As interest rates went up, bond prices went down, and new financing through the issue of bonds became increasingly expensive and difficult. In some periods—1919–20 is a striking example—stock prices turned down several months before the peak of the boom had been reached, adding to the difficulty of financing programs of expenditure on plant and equipment. In 1928–29 financing through sale of stock remained easy and attractive right up to the break in the market in the fall of

1929, but bond yields and mortgage rates started to rise early in 1928 and are thought by many economists to have had a significantly depressing effect on construction.

Rising interest rates would also tend to curtail inventory accumulation both by making it more expensive for business concerns to carry large inventories and by making it difficult for some borrowers to get any accommodation at all.

Thus it seems clear that a relatively large and rapid rise in rates would tend to curtail investment and check any inflationary price rise that might be underway. Whether it would be possible to check an inflation in this way without producing a period of depression and unemployment is more doubtful. Also, the relative importance of the rise of interest rates in bringing past booms to an end remains a much-disputed question. A strong case can be made out that the temporary saturation of investment demand was more important than the rise of interest rates in 1929, 1893, 1873. And in 1920 it might be argued that the decisive factor was the change in price expectations and that the boom would have come to an end, though perhaps not quite so soon, even if interest rates had not gone up as they did. It is clearly impossible to go into these questions here. I cite them merely to illustrate the difficulty of drawing conclusions about the quantitative importance of interest rates from our past experience with economic fluctuations.

The fall of interest rates in the thirties to a new long-term level has had some consequences which I think can be made out fairly clearly in spite of the very disturbed and abnormal character of the period since then:

(*a*) Lenders, both banks and other institutions, have gone into new fields in their efforts to find outlets for their abundant funds.

(*b*) Investment, particularly in housing, seems to have been carried considerably further than it would have been at the higher level of rates of, say, the 1920's.

I am not in a position to say whether there has been any effect on inventory policy. As to consumer saving: one would expect a permanently lower level of rates to reduce the propensity to save somewhat. I have heard of individual cases of people dipping into principal because interest rates were too low to give them the income they were accustomed to. Whether this and other factors working in the same direction have been significant on a national scale would, however, be almost impossible to say. There have been too many other major changes in the conditions that affect the community's disposition to save: war, the accumulation of backlogs of demand and of liquid assets for the postwar period, inflation, the new level of tax rates, and the sudden shifts in anticipations in the last 18 months—to mention only the most prominent.

Lorie Tarshis (*Stanford University*)

Effects of credit policies resulting in relatively small and relatively large changes in interest rates, respectively, upon (c) consumer saving. Personal saving is so greatly affected by price expectations, existing financial obligations, holdings of liquid assets and their distribution, and so on, that I should not expect to find that even a large rise in interest rates would greatly affect it. This conclusion seems to be

especially applicable to present circumstances in view of the widespread expectation that prices will continue to climb.

(d) *Business plant expenditure programs.*—A small rise in interest rates would not discourage such expenditures enough to matter. A large rise might cut off some construction although with long-run anticipation as inflationary as I believe them to be, I doubt, that it would provide much relief. Also, I am not confident that the abandoned projects would be those which in the general interest we should be most eager to discourage.

The effect of capital losses upon business and consumer purchases would be in the right direction but short-lived. However, to create capital losses of this sort seems undesirable and unjust, especially since there are other more effective ways of checking inflation.

Rufus S. Tucker (General Motors Corp.)

Very small changes in interest rates on bank-eligible Government bonds may greatly affect the extent to which banks sell such bonds to the Federal Reserve in order to increase their lending ability. Larger but still moderate changes in the Federal Reserve rate of discounts would sometimes also help fight inflationary lending by banks. But even very large changes are not as effective as some other available measures of credit control, such as reserve requirements, margin requirements, and redefinition of the kind of paper which may be eligible for rediscount or accepted at full valuation as bank assets. I doubt that changes in interest rates would have much effect on nonbank investors or on consumer saving or on business inventory policy, since the availability of income for saving and the prospects of profit are much more important in determining decisions to save or invest.

Henry H. Villard (College of the City of New York)

Credit policies resulting in relatively small changes in interest rates may substantially reduce commercial bank lending and appreciably retard lending by nonbank investors (lenders), and therefore business borrowing for plant expenditure programs and for inventory accumulation, especially in the short run. On the other hand, small changes are not likely to influence consumer saving to any noticeable extent. The reason why changes in credit policy influence borrowing and lending without causing more than small changes in interest rates is that availability of loans can vary considerably before interest rates are greatly affected. Thus commercial banks typically turn down loans or investment banks, refuse to float new securities out of hand; they do not post a rate at which they stand ready to lend to, or float securities for, any creditworthy borrow.

Large changes in interest rates are likely to intensify restriction of lending and borrowing and may even somewhat increase consumer saving.

Edward F. Willett (Smith College)

I believe that credit policies resulting in small changes in interest rates are effective means of fighting inflation. They will probably not be a major factor, but the inflation threat is so serious that every possible means of coping with it should be utilized. I feel that large changes in rates sometimes have exactly the reverse effect of what might be desired; that is, the necessity for instituting a large change might be taken as indicative of a very serious situation and therefore

be conducive to action to avoid inflation, which might be in itself inflationary. I would suppose that changes of from one-quarter to one-half of 1 percent, at not too frequent intervals, would be more effective than a sudden change of 1 or 2 percent.

Kossuth M. Williamson (Wesleyan University)

(*a*) I believe that credit policies resulting in small increases of interest rates may have some, though perhaps not very much, restrictive effect on the lending policies of commercial banks. (1) A small increase of the interest rate may limit the availability of credit. Since commercial banks can increase their reserves by sale of securities which they hold, such banks can increase the potential credit expansion by this method. When a small rise of the interest rate occurs, the prices of Government securities will fall. This resulting capital loss in case of sales would tend to deter such sales and prevent an increase of bank reserves and of the volume of available credit which otherwise would take place. A fractional change of the interest can thus affect the lending policies of commercial banks by restricting debt monetization. (2) A fractional rise in the interest rate may also have psychological effects upon the lending policy of banks. An increase of the discount rate by the Federal Reserve banks may directly influence banks to be more restrictive or the rate change may dampen the expectations of bank lenders by leading them to think that inflation is going to be curtailed and the buoyancy of the economy reduced. Such a change of expectations on the part of bank lenders may cause them to be cautious and less liberal in extending loans.

When such a rise in interest rates reflects a cessation of bond price support by the Federal Reserve, it marks the beginning of a degree of flexibility of the interest rate which may allow the authorities to take other restrictive actions which may result in a small change of interest rate. These restrictive actions can reduce availability of credit, and such limitations of available credit which accompanies a small rise of the interest rate may be more restrictive of the lending done by banks than the increase to the borrower of the cost of investible funds.

The effects of a large change in the interest rate would be similar to those arising from a small change, but would be quantitatively more important.

John H. Wills (Northern Trust Co., Chicago)

(*a*) *The Lending Policies of Commercial Banks.*—It should be noted at the outset that central bank policy usually works without the public, or many individual bankers for that matter, understanding fully how it works. The reason is that the factors affecting the loans and deposits of a single bank may be quite different than for the banking system as a whole. When the central bank reduces its purchases of United States Government securities in the open market, it cuts down the creation of new bank deposits and reserves and, therefore, the multiple use of reserves by the banking system. The individual banker is influenced in ways to be specified herein, but he is also influenced in the management of his loans by his individual deposit experience and the needs of his customers. When in meeting these needs he has difficulty in selling securities except at higher yields and lower prices or, as an alternative, considers the advisability of borrowing from the

Federal Reserve Bank, then central bank action directly affects him, whether he has been influenced by other factors or not. The restrictive policy of the central bank has been working relentlessly all the time, cutting down the creation of new deposits and new loanable resources at its source. It is this effect on the supply of loanable funds, irrespective of what the reaction of the borrower or lender to changes in interest rates as such may be, that makes central bank policy a powerful instrument in controlling inflation.

Many factors influence the lending policies of commercial banks. One important factor is a change in interest rates. An upward change in interest rates, signifying as it does that central bank credit is less readily available, makes the banker more cautions. He is more cautious for one or more of several reasons: (1) When, as now, the banker's portfolio of United States Government, municipal and/or corporate securities declines in price as interest rates increase, the loss on the investment portfolio is a deterrent to risk-taking in loans and to the liquidation of securities in order to make loans; (2) a move toward higher money rates by the central banking authorities means to the average banker that prevailing business conditions are of the boom variety and may soon come to an end. The banker is, therefore, more careful of the quality and term of his loans, and the maturity of his investments; (3) higher interest receipts on earning assets, unless offset by rising expenditures or higher reserve requirements, improve the earnings position of the banker and allow him to be more selective in the assets he acquires, thus tending to reduce the volume of marginal-type loans.

A relatively small change in interest rates would affect the banker to some extent in each of the three ways listed above. Depending on the general environment and the uncertainties created, a relatively small change could have high leverage in affecting bank lending policies. A relatively large change in interest rates would reinforce and intensify these influences.

(*b*) *The Lending Policies of Nonbank Investors.*—Important nonbank investors, such as insurance companies and pension funds, usually invest funds promptly as received. Because of the scale of their operations and the prospect, in most funds, of steady growth year after year, and the necessity to earn assumed actuarial rates of interest, a policy of staggered maturities is widely followed, which means that by and large new funds are invested as they are received, in a rotating fashion. Changes in interest rates, and anticipations of future changes, may however affect the quality and the maturity of new investments. When, moreover, the volume of new investments has been exceeding the normal inflow of funds, necessitating the liquidation of investments already held, then the effect of higher interest rates on the marketability and the price at which sales of the latter could be made is a deterrent to further liquidation and thus affects the total volume of new investments. With these institutions, as with banks, higher money rates and generally tighter credit conditions increase selectivity and reduce the volume of marginal loans made.

(*c*) *Consumer Saving.*—Any statement of the effects of changes in interest rates on consumer saving is speculative, in the sense that economic statistics do not reveal clearly what the effects have been in the past. The answer to this question, therefore, involves a large element of judgment, which is always influenced by the predilections and

personal experience of the person expressing the judgment. It might be helpful to observe that the long-run effects of changes in interest rates on savings may be quite different from the short-run effects. In the short run, changes in incomes or in income expectations, in income tax rates, in the amount of deferred demands or the strength of anticipated shortages, as well as other influences affecting the decision of the individual to spend or save, may be more important than a change, either large or small, in interest rates. On the other hand, a small change in interest rates, particularly from the low levels now prevailing, might have a strong psychological effect in inducing people to save more. It is the writer's judgment that, over the longer run, individual savings will be larger if interest rates are higher than those prevailing in the past 20 years.

(*d*) *Business Plant Expenditure Programs.*—Decisions as to the scale and timing of business plant expenditure programs are influenced by a complex of factors. One of the factors influencing these decisions is undoubtedly judgment as to the business outlook. A move on the part of the monetary authority to tighten credit is an important element in the minds of businessmen in judging the future. Businessmen have a great deal of respect for the power of the Federal Reserve System to make money tight and to bring a boom to a halt. Like the bankers, businessmen interpret a tighter credit policy by the monetary authorities as a signal to become more cautious, and this affects their capital expenditure programs. Moreover, the supply of funds available to finance capital expenditures is reduced, particularly when restrictive action includes a reduction in purchases of Treasury issues by the central bank from institutional investors. The terms of loan agreements (covering rate, repayment schedule, and other financial conditions) are tightened, and this deters borrowers, or affects the size of the loan. Marginal borrowers find it harder to get funds, and marginal decisions by businessmen, whether to expand or not to expand, are affected. These changes at the margin are important. Undoubtedly, a large change in interest rates would reinforce or intensify these effects.

(*e*) *Business Inventory Policy.*—Caution engendered by a tighter monetary policy would also affect business inventory policy. Bank credit would be less readily available to finance the carrying of inventories. Here, again, a large increase in interest rates would reinforce a cautious attitude, because of the importance of the interest charge in carrying costs when the profit margin is low or when risks of inventory losses are high.

2. How important do you consider the expansion of credit to be in the totality of factors underlying the post-Korean inflationary boom? The postwar boom in 1945–48? How would you appraise the effectiveness of (*a*) general and (*b*) selective credit policy in coping with (i) a high level of private capital investment, (ii) a high level of consumer spending, (iii) large present or prospective Government expenditures, (iv) the wage-price-farm-support spiral?

Only a small minority of economists believed that expansion of credit was the principal cause of either the post-Korean or the 1945–48 booms. A substantial number stated, however, that an expansion of

credit was a necessary permissive factor and that neither boom could have occurred (or have been equally intense) in the absence of it. A minority of them stated that the credit measures which would have been necessary to avert either or both booms would have been more undesirable than the booms themselves and might have resulted in a substantially smaller volume of production and employment. Most of the economists considered the expansion of credit more important in the post-Korean boom than in the 1945–48 boom, pointing out that the latter boom involved principally the activation of money and expenditure of liquid assets which had been created during the war. A few replies, however, gave the reverse answer that credit expansion was more important in the 1945–48 period than during the post-Korean boom. Most of the answers expressed the belief that factors other than credit (such as postwar shortages, scare buying, etc.) were the primary causes of each boom.

The majority of answers considered general credit policy the most effective means of coping with a high level of private capital investment, and selective credit policy (i. e., regulation W) the most effective means of coping with a high level of consumer spending.

A number of answers pointed out that "coping" with large present or prospective Government expenditures might mean either (*a*) reducing these expenditures, or (*b*) making room for them by reducing private expenditures. Many of such replies stated that general credit policy was moderately effective in the latter sense and that no credit policy could be effective in the former sense and, even if it were, would not be the proper instrument for determining the level of Government expenditures in a democracy. A minority of replies expressed the opposite view that general credit policy could and should reduce Government expenditures by forcing the Government to subject itself to the "discipline of the market." Some answers said that no credit policy could cope with the wage-price-farm support spiral, while others stated that this spiral depended for its existence in large part on the sellers' markets and high-level employment created by easy credit policies.

Extracts from typical replies follow:

G. L. Bach (Carnegie Institute of Technology)

I believe the high liquidity of the economy and the ready availability of new credit were major factors in both the post-World War II and post-Korean inflationary booms. In both cases, Government fiscal policy was on the whole mildly anti-inflationary, so little direct blame for the inflationary pressure can be placed outside the private economy and the monetary system (except insofar as blame is placed on Government encouragement of individual wage and price increases). During the early post-World War II period, the economy was so liquid (in terms of money and Government securities) that it is doubtful whether the increase in private credit over the period was crucial to the inflationary boom. During the post-Korean boom, the increase in credit was relatively more important, I believe, as the level of liquidity had fallen considerably relative to the greatly increased level of income and employment.

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John A. Baker (National Farmers Union)

The post-Korean inflationary increases in prices resulted almost entirely from "scare" and prudential buying on the part of the public. Consumers and businessmen, remembering World War II, faced uncertainty whether the then relatively abundant goods would continue in abundant supply; certainly there was a distinct possibility that the Nation might be facing a long period of when production of many civilian goods would be stopped or greatly reduced. The prudent thing for a businessman or consumer to do in such circumstances is to accumulate whatever supply seemed appropriate to the circumstances including the borrowing of money to buy such supplies. In such circumstances, a buying psychology develops that probably goes beyond mere prudence.

To the extent that consumers and businessmen can make these purchases with already accumulated or newly acquired liquid assets, changes in credit policy would not affect the amount of buying. To the extent that credit is available, the amount of the increase in credit outstanding is a net increase in the funds available to be used for prudential and scare buying. Any particular credit expansion or credit shrinkage has but a limited and temporary effect. For example, suppose that average installment credit averaged 30 months duration; then suppose that no more installment credit is allowed. The main effects of this change in credit policy would be absorbed and completed within 30 months.

As a general rule it can be said that each dollar of consumer credit expansion has about the same inflationary effect that an added dollar of consumer expenditures would have. Each dollar of credit expansion going into plant expansion or capital investments has an immediate effect of about two to one but the longer run effect is less because of increased production afforded by plant expansion.

In view of this circumstance, a selective credit policy is a more desirable way of coping with a high level or private capital investment and with inflationary pressures than would a general credit restriction. General credit restrictions foreclose production-increasing capital investments and thereby freeze into being the low production that is itself one of the basic causes of inflationary pressures.

V. Lewis Bassie (University of Illinois)

Expansion of credit played a relatively minor role in the post-Korean boom. Most of the expansion in the money supply occurred before the end of 1946. The availability of funds no doubt facilitated the postwar boom of 1945–48 as well as the post-Korean boom. But the more fundamental way of looking at these booms is in terms of the objects of expenditure rather than the means of financing them. The accumulation of needs during the war period underlay the expansion of activity into 1948. The expansion of the military program and the induced scare buying were responsible for the inflationary upsurge after Korea. The military program is continuing upward, but we have gained a measure of stability as private buying receded. If consumers and business again step up their spending sharply, further inflation will occur, whether or not credit expands. There is, however, no threat of all-out inflation except as a result of all-out war.

James Washington Bell (*Northwestern University*)

Credit expansion was not, in my opinion, the dominating force underlying the post-Korean inflationary boom, but it was a conditioning factor and it contributed to the inflationary process. Since going off the gold standard, the stage is always set for inflationary movements. Under managed money, the policy has been to keep all bank assets liquid, and this in turn keeps credit easy. The concerted psychological urge to stock up with consumers' goods inventories and to start investment in plant expansion, housing, etc., before war restrictions could be put into effect found the financial system immediately available for providing effective demand for goods, services, and securities.

The postwar boom of 1945–48 was the result of pent-up forces which had been suppressed during the war. Basically, the monetization of the public debt provided excessive purchasing power which could find an outlet only after controls were lifted and civilian goods became available. Consecutive rounds of wage-rate increases were more than absorbed by higher prices. In the same manner, farm-support prices increased costs and entered into the wage-price farm-support spiral. A tighter credit policy might have contributed to the control of inflation and would not, in my opinion, have done any serious harm. Even a moderate restriction would have done some good. I do not share the view expressed by many economists entering this debate that a moderate credit policy would have no significant effect but that a drastic policy would have caused catastrophe. Both the reasoning and conclusions of these economists seem to me inconclusive and erroneous. (See question 1.)

General credit controls obviously cannot be made effective so long as Government debt is supported by the banking system at artificially low rates of interest. This situation is not of recent origin, nor is it a product of war financing alone. We have to go back to the devaluation of the dollar and the abandonment of the gold standard in 1933, with the subsequent deficit-financing, easy-money policy of the thirties and the forties to get at the basic cause of our present dilemma. Deficit financing at artificial low rates through credit inflation has so expanded and weakened our credit structure that we are afraid to use orthodox credit controls lest the market collapse. Hence we propose insulating certain sectors from the influence of market forces; e. g., segregating special secondary reserves consisting of United States obligations in the commercial banks. Parenthetically, it may here be observed how one control leads to another and still another. First we segregate the credit and monetary system from market forces by making money irredeemable; then we monetize the debt which we now propose to segregate in part to free it from the operation of market forces. No wonder some serious economists propose going back to the gold standard and the disciplinary influences of a free market.

General credit controls will not work effectively in the face of expansionist policies only. Interest rates should be allowed to find their own market level. The Federal budget should be balanced and debt monetization stopped. Either credit contraction must take place or production increased to new high levels; that is, we must grow into our inflated monetary structure, which means producing assets

for the time being without corresponding increase in debt. The alternative to this policy of checking inflation is the precarious risk of a credit collapse—a collapse, incidentally, which would probably be attributed to the failure of capitalism rather than to poor money management.

Selective controls involve supervision of the purposes for which bank credit may be extended. This supervision may be exercised by a Government department, a central bank, or by an especially constituted body—informally or in accordance with specific legislation.

These controls have had their origin during the cheap-money era, when a general rise in interest rates has been prevented (to minimize interest burden on the public debt) and when it was considered necessary or expedient to restrain or guide the use of credit by direct action.

Various countries have had experience with selective-credit controls—all of them, so far as I know, countries pursuing easy-money policies through credit inflation. Control of stock-exchange margins in the United States originating in the Securities and Exchange Act of 1934 was perhaps the first example of statutory controls, but during the war years statutory regulation of installment credit was introduced and in 1950 legal restrictions were put on residential real-estate construction credits. England, France, Sweden, the Netherlands, Canada, Australia, and New Zealand are among the countries resorting to forms of selective-credit controls during the war and postwar years, with Australia having perhaps the most detailed regulations. Experience in these countries as well as in our own are not conclusive. Differences in economic and political conditions, especially with respect to the banking structure and banking methods, would make problematic the conclusion that success or failure in one country would mean success or failure in another.

In general, I would consider selective-credit controls appropriate instrumentalities only in situations where significant imbalances have occurred and then only as temporary expedients, to be relaxed and suspended when the emergency subsides. I would favor informal arrangements rather than control on a statutory basis and supervision or administration of monetary controls through the Federal Reserve rather than by a Government department or a specially constituted body. If left in the hands of the Federal Reserve authorities, there would seem to be a better chance of sooner abandoning such selective controls in favor of a return to the instruments of quantitative controls and interest rates.

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William A. Berridge (Metropolitan Life Insurance Co.)

Highly important in both periods. For (i) and (ii), selective-credit control can be highly effectual if properly applied and administered. General credit control is also probably necessary for reinforcement, and to prevent evasion by the borrower in shopping around for the most lenient lender.

If category (iii) refers to restraint of Government expenditures, selective-credit controls should be applied to Government agency lending in the same manner as to private lending. If category (iii) refers to aid in financing Government expenditures, selective-credit control, reinforced with general credit control, results in more investment funds turning to Government operations because of curtailed investment outlets in other sectors of the economy.

For (iv), neither general nor selective credit controls are directly effectual, except perhaps as to selective credit controls in the area of commodity speculation. Most effectual means would be the removal of Government support programs.

Roy G. Blakey (University of California, Los Angeles)

Significant (but not most significant) in the post-Korean inflationary boom. Relatively more important in the 1945–48 inflation. General policies should be used to take care of all situations insofar as possible, if they would be effective. Selective policies should be used only for the special situations where they will work and supplement general policy. In the four cases mentioned perhaps (iv) presents most justification for special treatment, but in actual practice that has been abused. This danger of abuse should always be considered before adoption of a particular policy.

Raymond T. Bowman. Philip J. Bourque, Raymond T. Bye, H. LaRue Frain, Paul F. Gemmill, Amor Gosfield, Arleigh P. Hess, Jr., Almarin Phillips, Karl Scholz, Sidney Weintraub (University of Pennsylvania)

The importance of any factor, when many factors are involved, is difficult to assess until it is decided from what point of view to make the assessment. If we seek a cause in the sense of proximate cause, as in the starting of a fire, then credit expansion was not an important factor in either the post-Korean or 1945–48 period. By this we mean that the impulse which set off these booms was not an autonomous increase in the money and credit supply.

If, in assessing importance, we give considerable weight, as we do, to the conditions which make possible the inflation once it is impelled by other factors, then credit expansion was a very important factor in both of these booms. Furthermore, we believe that credit expansion was an important factor because we hold that policy actions in this sphere could have more adequately controlled the price rise.

The 1945–48 boom was supported by the credit expansion of the war years and an increase in velocity (i. e., greater turn-over of money and credit balances) which came after the end of the war.

The post-Korean boom was fed by an expansion of loans and deposits. In both cases the anticipation that credit would be easy, if required, was an important influence.

We do not believe that in these periods it would have been feasible, as a practical matter, to have completely prevented price-level increases. Pressures were too strong in the direction of a high level of expenditures, supported by a high level of current income receipts and the possession of large security resources considered as liquid by both individuals and business. Tighter general credit policies would have been possible, however, and these policies would have required, in our opinion, some fall in the price of Government securities and a rise in interest rates. Taxes should also have been higher and a larger decrease in public debt would have been necessary.

We believe that selective credit policies are effective anti-inflation measures only when the over-all credit policy sets fairly clear limits to expansion. They are, in our opinion, largely rationing devices and are ineffective unless the total level of credit is restrictive. This does not mean that we are opposed to selective credit policies. It merely

means that we believe selective credit policies by themselves are not enough.

Frederick A. Bradford (Lehigh University)

The expansion of credit has been only moderately important in the post-Korean boom to date. It may easily assume added importance as time goes on. It was of considerably more significance in the 1945–48 boom.

While selective credit controls may have some effectiveness in coping with a high level of consumer spending (including spending for housing), general credit control is much more effective with regard to the other three items mentioned. It also has the advantage of being entirely impersonal.

Martin Bronfenbrenner (University of Wisconsin)

A. *History.*—Credit expansion was the most important single causative factor in the post-Korean boom. While the Government was operating at a surplus, the banks more than offset it by credit expansion. If they had not done so, a certain amount of inflation would doubtless have occurred in any event through people's rush to spend their money, but the bulk of it would have been impossible. In the 1946–48 inflation, commercial bank expansion offset almost completely the deflationary effect of the Treasury surplus.

B. *Policy.*—Selective credit controls, which can be evaded easily, are probably effective only in the short run. On the other hand, I place general credit control in the forefront of any anti-inflationary policy, although it is not of great service in combating deflation. It makes no difference whether the inflation arises through consumption, investment, Government spending, or rising costs.

With special reference to part (iv) of the question, relating to the wage-price-farm-support spiral, I should like to call the committee's attention to the fact that this spiral only operates in periods of easy money, when consumer resistance to the resulting price increases need not be considered by pressure groups. Inflationary wage increases, for example, would mean shut-downs and unemployment in a tight-money environment. Few unions would be foolish enough to embark on them except in the effort to overthrow the tight-money policy itself.

Neil Carothers (Lehigh University)

The post-Korean boom was not a result of credit expansion. It was the result of increased industrial activity and anticipation of industrial activity. The credit expansion was necessary to carry the activity. The postwar boom of 1946–48 was primarily the result of the release of consumer savings. It was facilitated and intensified by deficit financing and by price and credit policies in relation to bonds. (i), (ii), (iii), (iv)—General credit control, voluntary by banks or forced by Government, can reduce all economic activity, including the four forms named. Selective credit controls, sensibly applied, can reduce undesirable forms of activity without impairing desirable activity. Coping with Government expenditures by credit controls is a contradiction in terms.

J. M. Clark (Columbia University)

As an enabling factor, credit expansion seems to have been very important in the post-Korea boom. Probably less so in 1945–48 for

the kinds of buying that were most actively causal at that time, as other sources of liquid funds, including those that fed consumer buying, were plentiful at that time.

(*a*) General limitations seem too undiscriminating to be very useful in restraining inflation at present, since expansion at points where bottlenecks need to be broken seems to be useful as an anti-inflationary measure; this applies to (i). General limitations might have some slight effect in increasing resistance to buying where prices are pushed up by the spiral mentioned under (iv).

(*b*) Selective limitations seem more appropriate, and are especially feasible for restricting consumer buying. The effect of increased Government buying seems to overlap the other headings.

George W. Coleman (*Mercantile Trust Co.*)

The postwar inflationary boom was caused by consumer expenditures to "catch up," to purchase new postwar models of durable consumers' goods, to buy houses, and to purchase other goods not available during the war. Business required capital to build new factories, to expand industrial plants to satisfy the increased demand of goods, and to purchase improved equipment. It is true that some credit was employed to finance this boom; but savings, both industrial and individual, were also employed. The monetary policies adopted by the Federal Reserve System facilitated the transfer of funds from investment in United States Government securities to investment in corporate securities. Credit expansion was primarily a result of the operation of these forces; in some measure it made the boom possible, but the expansion of credit did not cause the boom.

The post-Korean boom was similar. It was brought about primarily by fears that goods would be scarce in the ensuing war period. The expansion of credit probably contributed to the boom by enabling industries to accumulate large inventories and by allowing consumers to accumulate private inventories. Once again, it should be emphasized that the scare buying in anticipation of war was the most important factor.

The second general section of this question is difficult to answer because the terms used are not sufficiently specific. "Coping with" and "effective" are not clear concepts.

The funds to finance private capital investment are provided only in part by lending institutions; retained earnings and the sale of equity securities finance some private capital investment. Selective credit controls could be used to limit the extension of credit for this purpose but it must be pointed out that such control would be extraordinarily difficult to formulate and to administer.

Since consumer spending for nondurable goods and services is financed primarily from current income, it is difficult to see how selective-credit controls could be effective in regulating expenditures of this type. Of course, selective controls might limit the length of time which charge accounts could be outstanding but such controls would only supplement policies maintained by retail stores in their own interest. Selective credit controls regulating the terms under which durable consumers' goods are sold are more effective, but such controls would limit consumer spending for this purpose only to the extent to which consumer spending depended upon credit. If, as was the case after World War II, consumers had liquid assets with which

to purchase durable consumers' goods, selective-credit controls would not be so effective.

Selective-credit controls would have little direct effect upon Government expenditures either present or prospective. Such controls might, however, reduce the competition for resources by limiting the access of private borrowers to credit. In this way, the potential inflation might be reduced.

Inflation arises from either the "demand pull" effect upon prices or the "cost push" effect upon prices. To the extent to which general credit controls limited the expansion of credit, the effectiveness of these pressures might be reduced. Selective credit controls might reduce the "demand pull" effect of the wage-price spiral, and general credit controls could also contribute to the same result.

James C. Dolley (*University of Texas*)

The most important factors in the postwar business boom 1945 to 1948 were (1) shortage of goods available for consumer purchase and (2) an exceptionally high effective demand for goods resulting from accumulated savings, rising personal income, and the ready availability of credit. The same general statement would apply to the post-Korean war boom with the qualification that goods were in great abundance but that demand was stimulated abnormally by the fear of wartime shortages. Once again the ready availability of credit was a major factor in the inflationary effect.

General credit policy is far more effective than selective credit policy in coping with a high level of private capital investment. The same statement would apply to a generally high level of consumer spending with the qualification that certain lines of consumer spending can be disproportionately curtailed by selective credit controls.

Neither general credit policy nor selective credit policy can be expected of themselves to restrict Government expenditures. Such expenditures are based on political rather than economic considerations and whenever these two considerations conflict, the political aspect can be expected to be decisive.

General credit policy will be far more effective than selective credit policy in combating price inflation. Under normal conditions, a stable price level could be expected to result in wage stabilization. Under present conditions, however, it is reasonable to expect that labor leaders, with Government encouragement, would continue to demand and to get ever higher wage rates. As for the farm product price support program, that can never be justified economically except in a period of all-out war when every possible incentive must be provided for the maximum food production. Once the war emergency has ended, a continuation of the program represents little more than a simple concession to the political expediency of courting farmer votes with public funds. As long as political considerations govern wage rates and the prices of farm products, relatively little can be expected from either general or selective credit controls in restraining general price inflation.

Howard S. Ellis (*University of California*)

In the post-Korean inflationary boom, I would assign chief responsibility to credit expansion, though the wage-price-farm support spiral is a close second, and there is some evidence in the annual rate of turn-

over of deposits of an increased rate of spending money (old and new) on the average. Both the spiral and the rate of spending could have been much smaller themselves if credit expansion had been limited.

In the 1945–48 boom, the accumulated backlog of consumer and producer demand produced a large increase in rate of spending, though here again the wage-price-farm support spiral and the increase of credit, proceeding from Federal Reserve support of Government securities, were the chief factors.

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Clyde Olin Fisher (*Wesleyan University*)

Expansion of credit on the part of commercial banks, coupled with the emergence of a sellers' market induced by fears of scarcity, was the major factor in the post-Korean inflationary boom. This is apparent when it is realized that during this period the Federal Government enjoyed a cash surplus, itself a deflationary factor. The postwar boom of 1945—48 also was caused in substantial degree by an expansion of commercial-bank credit. A general credit policy is more effective as a check upon a high level of private capital investment and a high level of consumer spending, also the wage-price-farm support spiral, than is selective-credit policy. Nonetheless, in a transition period of maladjustment and uncertainty, selective-credit policy and direct control constitute a desirable supplement to the general-credit program.

Ralph C. Limber (*National Life Insurance Co.*)

In my opinion expansion of credit was an essential condition in the totality of factors underlying the post-Korean inflationary boom. Particularly in consumer credit and housing the ready availability of credit on the most favorable terms in history and with low down payments was very important to maintenance of a high level of sales. In business capital expenditures and inventory accumulation it may have been somewhat less important.

Postwar boom in 1945–48.—The postwar boom of 1945–48 was less dependent upon the ready availability of credit than the post-Korean boom. Nevertheless, even in the postwar boom expansion of credit was an important factor with bank loans, consumer credit, and nonfarm residential loans all showing substantial gains. It is probably true that deferred demand for civilian goods was so great, and the means of payment in the form of liquid savings in the hands of the public was so large, that a high level of business activity might have been maintained in the postwar years even with a more restrictive credit policy. It is doubtful, however, if the boom would have been so well sustained under such policy.

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Wesley Lindow (*Irving Trust Co., New York*)

The post-Korean inflationary boom, in my opinion, was caused by a variety of factors and I would place the "psychology of fear" as the No. 1 element. There was fear that raw material shortages would be severe and this led businessmen to seek to anticipate their needs far in advance. There was fear that there would be shortages of consumers' goods and this led to substantial panic buying in the stores. During the period of fear buying, which lasted about 7 months, prices rose sharply and particularly so in the case of raw materials of

international importance. Bank credit rose significantly also during this period and the rise contributed to inflationary pressures. It is my opinion, however, that a large part of the rise was desirable and essential in increasing production. The Federal Reserve index of industrial production increased more than 10 percent during the first 7 months of the Korean conflict. A substantial increase in bank credit was necessary to permit this increase in production. I think the psychology of fear was much more important in the post-Korean inflation than the increase in bank credit.

Fritz Machlup (Johns Hopkins University)

The Role of Credit Expansion in the Recent Inflation.—I am sure the committee has at its disposal all the statistical evidence showing the large rate of expansion of bank credit in the postwar boom in 1945–48 and again in the post-Korean inflationary boom. The data are most impressive, and I doubt that anyone can deny the leading role which bank-credit expansion played in the inflation during these years. From what was said in answer to question I, it should be obvious that credit policy could have helped reduce (i) the high level of private capital investment, and (ii) the high level of consumer spending. It probably could not have prevented or sharply reduced (iii) the high rate of Government expenditures for national defense or (iv) the expenditures arising out of our farm price-support program. On the other hand, it could have put a damper on the wage-price spiral because it was chiefly the high rate of effective demand swelled by increased expenditures by consumers and business that made businessmen yield with little resistance to the demands for higher wages and made trade-unions adamant in insisting on them.

Raymond F. Mikesell (University of Virginia)

I cannot believe that the $10 billion increase in bank loans has been a major factor in the post-Korean boom. A good part of the loans were undoubtedly related to the expansion of defense production and to increases in raw material prices which required larger funds for carrying inventories. The $15 billion expansion in bank loans which accompanied the postwar reconversion period, 1945–48, does not appear to be inordinately large considering the magnitude of the reconversion job. While the expansion of credit affected both monetary demand and the rate of expansion of civilian production, surely the major inflationary pressures must have come from the large liquid holdings and deferred demand of consumers and the large capital outlays required by the reconversion, most of which corporations supplied from internal sources.

In periods of adjustment from a wartime to a peacetime economy I would favor selective credit controls in the form of consumer and real-estate credit controls and controls on speculative credit. While general controls could certainly avoid a rise in prices if carried far enough, they are likely to slow down reconversion and cause unemployment. By 1948, however, I believe I would have favored a general tightening of credit conditions.

Hyman P. Minsky (Brown University)

To date, the post-Korean inflation has taken place with the Federal budget essentially balanced. The volume of demand deposits has

risen from 95 to 101 billions during the first year of the Korean war. Without this rise in demand deposits, I am convinced we would not have had as large a rise in prices as we have had. I also believe that the 1945–48 rise in prices had not fully absorbed the World War II increase in the money supply, so that the occurrence of a favorable event for business expectations, such as the outbreak of the Korean war, would have resulted in some rise in prices even if the money supply had not been increased.

The postwar inflation of 1945–48 was made possible by the extremely liquid position of private persons and business institutions due to the expansion of demand deposits during World War II. Price and wage controls during World War II succeeded in suppressing the effects of the monetary inflation which was the dominant way chosen to both finance the war and direct resources to war use. As soon as the price and wage controls were relaxed, the effect of the monetary inflation began to be felt.

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A general tightening of credit can mean that any rise in wages and farm prices will result in unemployment of labor and the growth of surpluses of farm products. The rise in unemployment and the forcing of farm prices down to the support level will effectively stop the wage-price spiral. You cannot have both an employment policy and a stable price policy in peacetime if monetary expansion is uncontrolled. Inflation has become so much more of a threat than unemployment, really mass unemployment such as we had in the thirties is impossible when Government expenditures are one-third the full employment of national income, that strong general credit controls can be used to prevent a rise in wages and farm prices. Selective credit controls cannot effectively halt the wage-price spiral; general credit controls can.

Henry Oliver (*Indiana University*)

Both the 1945–48 and the 1950–51 inflationary booms were largely financed by rises in velocity of money (including demand deposits). This rise in velocity was made possible, however, by the pre-1945 policies which gave the public a huge volume of money holdings and other liquid assets and depressed wartime velocity (chiefly through OPA). Credit expansion during the 1945–48 and 1950–51 periods themselves helped to accentuate the inflation but were not primarily responsible, especially during the former boom. Price rises were pushed higher on both occasions by wage demands resulting in part from the nature of the labor-union movement, and by agricultural price-support formulas. In the absence of the initial huge money base, however, wage policies and price supports would have pushed up prices only a fraction as far.

Since velocity increased sharply after the outbreak of the Korean war, much of the inflation potential existing in mid-1950 has already been realized, a fact which eases the problem for the future.

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Harold L. Reed (*Cornell University*)

Without giving figures I think the facts support the conclusion that, both in the post-Korean inflationary boom as well as in the boom of 1945–48, the credit volume did not expand paripassu with the increase in the gross national product. But easy credit prior to these

booms played a heavy part in that it left individuals and producing units in a strong liquidity position, so that the expansion of trade could be financed largely by drawing on idle balance and other liquid assets. The increase in the demand for credit in both the booms is indicated by the tendency of open-market interest rates to rise as also by the increase in the velocity of circulation of demand deposits outside New York City. It must also be kept in mind, lest we attempt to minimize the importance of the credit factor, that there is frequently a lag between an increase in the volume of trade and production and increase in the amount of bank credit that is provided.

In comparing general credit controls with selective credit control as I can only say that there isn't time to write a book. A general observation, however, has perhaps special applicability at the present time. Quantitative measures can be used to penalize the economy for advancing wages, other costs and prices, too rapidly. But the social cost of imposing such type of penalty might well be to prevent industry from operating at as high a capacity rate as otherwise would be possible. At the present time it is particularly necessary to control the creation of credit as fully as possible at the source. Selective controls are now needed to supplement general quantitative measures and to increase the efficacy of the latter.

Roy L. Reierson (*Bankers Trust Co., New York*)

My views as to the contribution of credit expansion to the postwar boom in 1945–48 and again to the boom following the outbreak of the Korean war may be summarized as follows: (1) In the postwar years, the expansion of credit was not a direct causal factor of inflation, although it contributed in some measure to the boom; (2) with the outbreak of the Korean war, some inflation was inevitable, and the expansion of credit accentuated the inflationary forces, although it again was not a major factor in the general picture; (3) however, the apparent inability or unwillingness of the authorities to undertake restrictive general credit policies probably contributed to a spirit of business optimism; and (4) in certain sectors of the economy, notably residential building, the easy availability of credit did indeed contribute directly and importantly to the boom. A brief discussion of each period may serve to explain these points of view.

Postwar boom 1945–48.—The postwar inflationary boom was based in large part upon the deferred demands built up during the war and the prewar depression years. Business after the war obviously had to replenish its depleted inventories and to modernize and expand its plant and equipment. In view of the severe housing shortage, a building boom was a foregone conclusion, as was a great boom in consumer durable goods. Spending was facilitated by the fact that business and the general public were able to draw upon large liquid assets built up as a result of the Government's deficit financing during World War II.

Government policy was another inflationary factor. The excessive liberalization of mortgage credit stimulated the residential building boom to undue proportions. One may well ask whether it might not have been in the best interests of our economy had a more restrictive real-estate credit policy helped to hold down the peaks and spread the high level of building activity over a longer period. The Government's buying policies for foreign relief pushed agricultural prices to

uneconomically high levels, and price supports operated against a correction. The Government's labor policies and the prevailing full employment facilitated repeated rounds of wage rises far above the long-term increase in productivity. The uneasy international situation, with its recurring war scares, was a further factor operating in the direction of higher prices.

During the postwar inflationary boom, in spite of the hurdles in the way of a restrictive general credit policy, the volume of outstanding Federal Reserve credit did not expand. Even during the period of large-scale support of Government bonds which began late in 1947, Federal Reserve credit increased only slightly, the money supply declined, and wholesale prices at the end of the tremendous support operation were only 3 percent higher than in November 1947, when support buying began.

Had the Federal Reserve been in position to follow a more restrictive general credit policy during the postwar period, the expansion of bank loans might have been restrained. However, there is no specific evidence of the significant use of bank credit for speculative purposes in this period. Certainly with regard to business inventories, where bank financing is predominant, the postwar increase overwhelmingly reflected the conversion of business to peacetime operations and the high levels of prices and economic activity; speculative inventory hoarding was minute.

Inflationary boom of 1950–51.—The outbreak of hostilities in Korea found the economy in an expanding phase, and the Korean war greatly accentuated the inflationary forces. It posed the threat of general world-wide conflagration; it guaranteed a substantial increase in armament outlays; it emphasized the short situation in many basic materials and raised doubts as to the continued availability of supplies; it brought memories of the shortages so recently experienced in World War II. Conversation immediately turned toward scarcities and inflation, and businessmen began to be troubled by the prospect of allocations and price controls. The inevitable result was a great wave of spending shared by all sectors of the economy.

A consumer-buying wave hit the country soon after the outbreak of the war, and reappeared around the end of the year with the unfavorable course of events in Korea. Business scrambled for materials and expanded its plant and equipment programs. Government stockpiling, which had been allowed to languish, was resumed with vigor and was pressed forward regardless of its effect on prices. Labor obtained another substantial round of wage increases and this in turn raised costs. Prices were marked up even in advance of costs as a protection against the widely heralded advent of price controls. Construction expanded and the production of civilian goods was pressed with the utmost vigor. The inevitable result was a sharp rise in commodity prices.

These factors were mirrored in a rapid expansion of private credit. Consumer credit spurted during the summer scare-buying wave and real-estate financing rose to record heights. Bank loans to business also increased rapidly and during the second half of 1950 showed the largest 6-month increase on record. Part of the increase in credit probably went into higher prices, but a large amount (especially in the case of bank loans) was used to support a rise in industrial pro-

duction. This, in turn, resulted in a rapid increase in business inventories which has been a factor in the easing of prices beginning about the second quarter of 1951.

Had the commercial banks not been able to meet the high demands for business credit in the latter part of 1950, some of the ensuing rise in output and inventories would probably not have materialized. The result might have been somewhat less of a scramble for goods at that time, but perhaps a smaller supply of many items and greater inflationary pressures in 1951. The decision of businessmen in the second half of 1950 to push the production of civilian goods while materials and manpower for that purpose were still available is one which appeared reasonable and proper under the existing circumstances. Assuredly it would have been better could some of the credit expansion in the second half of 1950 been avoided, but a large part of the increase in prices after the outbreak of the Korean war would most likely have taken place in any event.

Effectiveness of credit policies.—The effectiveness of general and selective credit controls depends upon the nature of the policies adopted and the skill and vigor with which they are pursued. These two policies should not be viewed as alternative but rather as complementary courses of action, each of which can make some contribution to the task of coping with inflation. And it should be recalled that the effectiveness of credit restraints in the private lending field is frequently offset and nullified by the continuing liberal lending policies of public agencies.

(i) *Private capital investment.*—General credit policies could help to moderate a capital investment boom by influencing financial and business opinion; by increasing the cost of capital to borrowers; by contributing to a more selective commitment program and investment policy on the part of institutional investors (as a result of added uncertainty about the future course of interest rates); and also by encouraging more careful operations on the part of securities underwriters.

An important sector of private capital investment that can be affected very materially through the use of selective credit controls is residential building. Increases in minimum down payments and shortening of maturities can dampen a housing boom very materially; contrariwise, liberalization in financing terms will usually stimulate activity. The crucial problem here is to obtain public and congressional support of moderately restrictive policies.

(ii) *Consumer spending.*—The great bulk of consumer purchases is not easily controlled by credit policies. In some sectors of the economy, however, notably in the case of automobiles and consumer durable goods, credit sales are an important factor in the market. Experience has shown that selective credit policy, assuming it to receive congressional and public support, can be reasonably effective in restraining the demand for such goods.

(iii) *Government spending.*—It is difficult to see how credit controls can be of much direct effect in coping with large Government expenditures. Unfortunately, budget policies are among the most important underlying inflationary forces, and it is all the more disconcerting that the budget apparently is out of control. Programs have been initiated which require recurring and increasing appropriations, while many

authorities in and out of the Congress agree that, in view of the already high levels of taxation, further sizable increases in tax rates are not feasible. Unless this situation can be remedied, the budget will become a chronic generator of inflationary pressures against which credit policy will be largely ineffective. Only if the budget position of the Treasury is favorable do credit policies have a fair chance of making some real anti-inflationary contribution. On balance, therefore, budget policy can make a greater contribution to the effectiveness of credit policy than vice versa.

(iv) *Wage-price-farm support spiral.*—The wage-price-farm support spiral is essentially a phenomenon which is not susceptible to control by credit policy; it reflects the concerted power of well-organized political pressure groups which is not likely to be affected by changes in credit conditions. In periods of inflation, it is argued that price support levels and wages must be advanced in order to protect the purchasing power of farmers and labor; in periods of falling prices, the argument is that price support and wage increases are required to maintain mass purchasing power. This wage-price-farm support spiral is one of the most powerful inflation-breeding forces in our political and economic system.

The wider application of escalator clauses in wage contracts, while essentially reflecting the greatly increased political power of labor unions, has been facilitated by the conditions of full employment that have prevailed in large measure during the past decade. Presumably, if it were possible to achieve some slack in the economy, the ability of organized labor to force annual wage increases at rates well in excess of any possible increases in productivity might be limited to some extent. Also, a more abundant supply situation in agricultural commodities might serve to focus attention upon some of the implications of the farm support policies now in effect or recently proposed.

However, the plain fact of the matter is that we, as a nation, have not yet learned how to live with conditions of full employment without having chronic inflation as a byproduct. Furthermore, in view of the difficulties of business forecasting, Government policy is likely to work in the direction of overemployment, rather than reasonably full employment; it is politically much more pleasant to have the margin of error on the side of economic hyperactivity. The role of credit policy in coping with these complex and underlying political trends is likely to prove modest. Credit policies may be able to make some contribution if they can help to take the edge off inflationary booms. But the real solution lies elsewhere.

Roland I. Robinson (Northwestern University)

In the post-Korean period, the expansion of commercial bank loans and the easy mortgage money terms based on earlier commitments undoubtedly were two of the leading stimulants of the boom. Other factors such as consumer hoarding and business capital outlays out of idle cash no doubt played a large role, but credit expansion was doubtless a sizable factor.

In the postwar boom in 1945–48, credit was not relatively as important as in the period after Korea. But even in this period the general ease of funds added to the inflationary problem. Nowhere was this more evident than in the mortgage money market. Govern-

mental mortgage guaranty and insurance and "Fanny May" purchase of mortgages were deeply responsible but private credit expansion also added to the spending stream. Insurance companies, mutual savings banks, and savings and loan associations all sold United States Governments at support prices and converted their portfolios to mortgages. The support policy "supported" inflation.

The effectiveness of selective instruments of credit control depend on the extent to which their controls are tolerated politically and publically. The legislative hobbling of both regulation X and W in the summer of 1951, suggests that public and political opinion will not support these controls except in periods of war or near war. Emphasis must then be on general measures of credit control.

General credit policy can limit a high level of private capital expenditures to the extent these expenditures are based on borrowing. In the periods of hyperactive business the proportion of capital outlays financed by borrowing and the sensitiveness of such expenditures to credit control rises.

Consumer spending is less sensitive to credit restraint because it is more closely geared to income flow or available cash balances. To the extent consumer spending is based on credit, it is undoubtedly trimmed more effectively by selective than by general credit measures. The range of effectiveness is determined more by political and public tolerance than by the direct mechanics of selective credit regulation.

Emerson P. Schmidt (Chamber of Commerce of the United States)

The expansion of commercial credit following the North Korean aggression was a primary factor in the inflationary boom. But probably of equal importance was the Government deficit spending in earlier years which brought into existence more than $200 billion of new liquid assets which became enormously activated after Korea. Velocity of money turn-over, along with the increase in private credit, can largely account for the inflationary boom.

General credit controls are preferable to selective credit controls. Selective credit controls, after all, are "direct controls" to a greater degree than general credit controls. They tell the citizen and the businessman how, and in what form, and to what degree funds shall be used. This amounts virtually to the same thing as Government ownership as concerns the quantity and direction of investment. In this respect, selective credit controls are at variance with the basic principle for which the United States of America is known throughout the world. Selective credit controls can be justified only if general credit controls are not permitted to function—which should not be the case.

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Bradford B. Smith (United States Steel Corp.)

Under an honest money policy there could not and would not have been (except to slight degrees, attributable to changes in the income-money velocity rate) a post-Korean inflationary boom, an inflationary postwar boom in 1945–48, an unduly high level of private capital investment, or unbalance in markets attributable to Government expenditures. (Government expenditures would be met out of taxes and, through borrowing, out of transfer of existing rather than inflationary creation of new deposits.)

Tipton R. Snavely (University of Virginia)

The expansion of credit has been important in the totality of factors underlying the post-Korean inflationary boom. Remembering the tight supply of goods which resulted from World War II, consumers rushed to buy durable-consumption goods, houses, and capital goods which were expected to become scarce during a prolonged war in Korea. The purchasing power, however, did not arise from borrowing alone. A substantial part of it came from the expenditure of past savings accounts and from the sale of Government bonds.

In the postwar boom in 1945–48, the expansion of credit was not the main factor in the inflationary boom. There was a large accumulation of funds in the hands of consumers which was used to satisfy the demand for consumers' goods. Corporations likewise had a substantial backlog in reserves which were used in the expansion of plant and equipment. While credit played an important role in the postwar years, it was by no means the most important element in the inflationary trend of that period.

Josef Solterer (Georgetown University)

Credit expansion significantly contributed to the post-Korean inflationary boom, especially to the price upsurge from November 1950 to February 1951. Over the whole period, bank loans (net) increased by $9.5 billion, demand deposits by $4.6 billion, and in February 1951 the rate of turn-over of demand deposits (except interbank and Government) was 14 percent higher than a year ago.

The increase in the supply of money was certainly not the primary cause of the inflation. But it was one of the prerequisites without which the sudden upsurge of consumer and business purchases could not have grown to such dimensions. Even if no additional credit had been put at the disposal of the economy, the two waves of scare buying and rushing into inventories would very likely have taken place; but the inflation would have been less pronounced.

The postwar boom of 1945–48 was also greatly enhanced by the expansion of credit. It seems impossible to imagine the inflationary process during this period independently of the 13.6 billion increase in the volume of demand deposits (from 69.1 billion in June 1945 to 82.7 billion in June 1948). Again, the credit expansion was a conditioning, not the initiating reason. The boom had its primary causes in the pent-up demand and in the extraordinary high liquidity of the economy at that time. It was precipitated by the premature scrapping of the wartime controls in 1945–46; it was given additional momentum by the credit expansion.

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The preceding is not meant to imply that a general credit policy can control a high level of private investment under all circumstances. History and theoretical analysis show the opposite to be true. In particular cases there may have developed such a large propensity to invest that a general credit policy, short of being disastrously restrictive, does not suffice; or it may be that the bulk of the investment stems from a rather sharply circumscribed field. In both cases a selective credit policy may be usefully employed for complementary action; it may even be indispensable. In 1950–51 the West German Bank Deutscher Laender had to fall back on selective measures, after its

harsh general credit policy had not succeeded in bringing the country back into international equilibrium.

The ultimate reason for such deficiency of general credit policy is the fact that the liquidity of a system does not depend only on monetary and credit measures.

Herbert Stein (Committee for Economic Development)

There were, of course, a great many factors underlying both the post-Korean inflation and the 1945–48 inflation. But in each case credit expansion was a factor of unique importance because it was a factor that could have been controlled by existing practical and appropriate instruments of policy. This was not true of most of the other factors that could be listed as explanations of the two postwar inflationary movements.

I believe that general credit policy can be effective in coping with (i) a high level of private capital investment, (ii) a high level of consumer spending, and (iii) large present or prospective Government expenditures. General credit policy can be effective in coping with any of these three situations in the sense of preventing any of them from having serious inflationary consequences. This does not necessarily mean that general credit restriction could be effective in cutting down the particular category of expenditure that happens to be unusually large or growing with unusual speed in any particular inflationary situation. For example, credit restriction could not reduce Federal expenditures. But credit restriction could be effective in coping with the potential inflationary consequences of rapidly rising Federal expenditures by cutting down private expenditures so that total expenditures (public and private) do not rise too rapidly. The three situations enumerated (high private investment, high private consumption, and large Government expenditures) constitute an inflationary problem requiring "coping with" only if they are part of an excessive total of expenditure. Credit policy can cope with the excessiveness of the total.

Whether general credit policy can cope with the wage-price-farm support spiral depends upon what the spiral is. If the spiral is merely the way in which an excess of demand works itself out into higher prices and wage rates, credit policy can cope with it by coping with the excess of demand. I believe the observed spiral of the past 6 years has been of this type. Conceivably, there could be a spiral in which wages and prices rise autonomously but only to the extent that the increases themselves generated an increase of demand and thus sustained the higher price level without substantial unemployment. Credit policy could cope with this kind of spiral by preventing demand from increasing. There is a third kind of spiral in which wages and prices rise despite the tendency of the rise to create increasing unemployment. If such a situation existed, credit control could not cope with it.

I do not see any limit to the potential effectiveness of general credit restriction. General credit restriction can reduce the supply of money without limit, to zero if necessary, and if one is prepared to reduce the supply of money without limit one can reduce the volume of monetary demand without limit. Of course, this does not mean that we should rely on credit restriction "alone" in an inflationary situation. The policy problem is to balance a number of instruments, of which

credit restriction is but one, each having its peculiar costs and advantages.

Selective credit controls, if they are not so comprehensive as to add up to general control, are effective only within limits; they cannot be pushed, like general credit control, indefinitely. I believe selective credit controls can have a significant net effect, but just how much is uncertain because restricting the extension of credit for particular uses tends to increase the availability of credit for other uses.

Alan R. Sweezy (*California Institute of Technology*)

It seems to me that credit expansion was a facilitating rather than an initiating factor in both the 1945–48 and post-Korean booms. In both cases any severe general credit restriction might have resulted in throwing the baby out with the bath water; i. e., in restricting desirable investment in plant and equipment and in new housing along with undesirable inventory accumulation and excessive expansion of consumer debt.

Selective credit controls are definitely preferable, to my mind, in coping with (ii) and (iii). I don't think credit control of any kind is the proper instrument for dealing with (iv), it could succeed only by producing unemployment and farm surpluses on a scale which would be undesirable at any time and intolerable in a war or mobilization economy. General credit restriction has usually been used in connection with (i) in peacetime; this does not rule out the possibility, however, that selective measures might be useful as a supplement to general restriction; if, e. g., measures to restrain inventory accumulation without curtailing needed types of construction could be devised. In a war or mobilization economy, direct controls over materials and over building take the place of selective credit controls.

Lorie Tarshis (*Stanford University*)

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(i) *High level of private capital investment.*—Higher interest rates would not efficiently discourage private investment so long as basic inflationary pressures remain substantially as they are now. So long as military procurement is carried on as though the budget is a blank check, and not at all a real budget which effectively controls expenditures, this method of attack looks hopeless.

Selective credit controls could do something more, although the ease of self-financing would permit many firms to expand without restraint. But, for any long emergency, I would use such selective controls sparingly, since not only are they relatively ineffective but also because they supplant the pricing mechanism instead of using it.

(ii) *A high level of consumer spending.*—Higher interest rates might do some good; but, because of the great inflationary pressures that would remain, I doubt whether they would contribute much. Even selective credit controls might do little, and that badly or unfairly, in view of the enormous block of liquid assets owned by consumers.

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Philip E. Taylor (*University of Connecticut*)

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* * * A policy of general credit restriction is probably essential to the successful control of any one of these tendencies. That is, selec-

tive control is not likely to be satisfactory unless used against a background of general credit restriction. But, given general credit restriction, it is obvious from recent experiences that restrictions on time purchases and similar selective limitations can produce results effectively.

If the question requests an appraisal of the probable effectiveness now, under present conditions, I believe that there are practical obstacles to effectiveness of any type of credit control. The Congress has moderated selective restrictions because those restrictions have been effective. If the Congress wants inflation, then it will emasculate any control which begins to show stabilizing results. Likewise, if the Treasury refuses to accept the consequence of its own inflationary policies—i. e., higher yield rates and market values below par—then no general restrictive credit policy can be pursued.

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Henry H. Villard (College of the City of New York)

* * * * I believe that general credit policy can do much to cope with a high level of private capital investment, especially in the short run. On the other hand, selective credit controls, especially over installment sales, have a more direct effect on a high level of consumer spending, though general controls may also be effective if used drastically enough to cause increases in interest rates and, therefore, saving. Large present or prospective Government expenditures are best coped with by appropriate fiscal policy, though again general controls may help by cutting down competing private borrowing and perhaps also State and local expenditures. It is in connection with the wage-price-farm support spiral that general controls are likely to be least effective. If for any reason, including previous price increases, wages rise on the average by much more than a nickel an hour a year and if wage decreases are thought to be generally unacceptable, then permanent price increases are ultimately inevitable, and efforts to counteract the increases by credit policy will only lead to unemployment.

C. R. Whittlesey (University of Pennsylvania)

Previous expansion of credit, by contributing to the growth of circulating medium and other liquid assets, created latent inflationary pressures which were activated by other factors, thus producing the booms of 1945–48 and 1950–51. The expansion of credit which occurred while the booms were in progress facilitated the rise but was of secondary quantitative importance.

General credit policy would be relatively more effective in influencing private capital investment, and selective credit controls more effective in influencing consumer spending. Selective controls such as regulations W and X might also, however, have considerable indirect effect on private capital investment. In the face of large current or prospective Government expenditures, all methods of combating inflation should be available. Selective and general controls could be used to complement one another and to supplement other possible measures. I am not sure that there is a wage-price-farm support spiral in a chronic sense; but if there is, the same observation applies here as does to the problem of heavy governmental spending. A combination of policies is more powerful and more precise than policies used alone or without coordination.

John H. Wills (Northern Trust Co., Chicago)

The prospect of shortages of consumer goods and of the ability on the part of businessmen to carry out capital expenditure programs in certain fields, as well as the impact of the military program and the associated policy of expansion of productive capacity to provide guns and butter, all greatly stimulated spending out of existing resources and led many individuals and businessmen to borrow. If borrowing had not been as great, spending would not have been as large, and therefore the inflationary upthrust of prices would not have been as high. The subsequent problem of top-heavy inventories in many lines of merchandise and consequent slashing of retail prices to correct the situation would not have been as serious. The origin of the inflationary boom was the change in anticipations caused by the Korean war. But it is also true that the inflationary movement would not have been as intense if credit had not been so readily available at low rates.

In the postwar boom, the underlying factors were, among others, the deferred demands and huge liquid assets accumulated during the war, the relatively low private debt ratios resulting from liquidation of debt during the war, easy-money policies and bond price-support operations, and the continuance by the Federal Government of relatively heavy expenditures, farm-price support, foreign aid, and mortgage-insurance programs. The huge liquid assets were in turn the result of the kind of financing policy followed by the Federal Government during the war.

While the factors underlying high-level demands in the postwar boom and the post-Korean boom were different, a basic inflationary force common to both periods, besides easy money, was the wage-price spiral. The wage-price spiral and the easy-money policy were intertwined. The ability on the part of workers to obtain wage increases depended primarily on the prevailing high employment situation and on the ability of businessmen to pass on higher wage costs in higher prices. The ability to raise prices easily depended in turn on the widespread existence of sellers' markets, which were kept boiling not only by deferred and anticipatory demands and use of liquid assets but by large increases in consumer and mortgage debt (facilitated by FHA insurance and Veterans' guaranty programs) and business loans. The financing of both long- and short-term loans on the scale actually experienced was made possible by support purchases of billions of dollars of Federal securities by the Federal Reserve System and the Treasury. (The argument that at times purchases of long bonds by the Federal Reserve System were offset by sales of short-term securities, thus counteracting the immediate effect on reserve balances, overlooks the increase in liquidity status of sellers of the longer issues, and hence in their desire and ability to meet the demands of private borrowers.)

A difficult question of credit policy arises in connection with the wage-price spiral. In 1946 and repeatedly thereafter in the postwar period, the size of a wage increase was taken out of the area of collective bargaining and the play of economic forces and was, rather, determined by Government at a figure exceeding the contemporary gain in output per worker. The wage increase thus established in a key industry became the pattern elsewhere. The resulting higher

cost and price levels increased the financial requirements of business for working capital and for fixed-capital purposes. Some firms were able to finance these needs out of retained earnings and other internal sources of funds, but a growing number have had to borrow to meet these requirements. If borrowed money had not been so readily available, the operations of these firms would have been limited by the squeeze on their financial resources. This might have led to a curtailment of production and employment quite unrelated to other criteria of monetary control, though even then the squeeze would have had the advantage of moderating or avoiding the next turn to the wage-price spiral. The question of policy is that once Government has initiated a wage-price spiral, should the additional credit (money supply) necessary to finance the spiral be made available as a necessary consequence of the initial policy? Or, assuming that there is no hope of stopping the spiral in the manner in which it was started, should the objective of stopping the depreciation in the value of the dollar be considered of such paramount importance by the monetary authority (as by myself) that financial needs are squeezed and the next turn to the spiral thus moderated or avoided?

It has often been observed that, in reaping the paramount advantages of our economic and political freedoms, the American system has, and knowingly endures, certain minor ineffciencies and some cumbersomeness, compared with totalitarian systems. So it is with an appraisal of general credit policy as against selective credit policy. Selective credit controls may in certain areas operate somewhat more effectively than general credit controls, but at the cost of the substitution of governmental for private decisions and the new economic derangements to which such substitution leads. Because the overriding determinant of policy in our kind of basically free economy is to avoid the expansion of governmental controls over private economic and political decisions, and because general credit controls can be effective, I would prefer general credit policy to selective credit policy in each of the four areas named. More specifically: (i) A more restrictive general credit policy means that less credit would be available to finance private capital investment and the decision as to the needs that would and would not be met would be left to private borrowers and lenders, rather than to a "Capital Issues Committee" or Government agency. See also I (*d*) above. (ii) In an environment where a restrictive general credit policy is known to be operating, the financing of installment or other consumer credit would also become more difficult. Business managers, exercising their judgment of the risks involved, would determine the terms of consumer credit, and if events proved them too liberal or too strict, individual businesses would bear the consequences. (iii) Large present or prospective Government expenditures would not be as responsive as private spending to the credit outlook, though the influence even on Government spending of the availabiilty of financing only at higher rates deserves testing, if the sincere objective is to avoid a continuing depreciation in the buying power of the dollar. (iv) I have already commented on the influence of the availability of credit on the wage-price spiral. The farm-support element in the spiral would be influenced by the effectiveness of general credit policy on the wage-price spiral (which affects the parity computation) and by the reexamination of all Government spending programs that would result

if the financing problems of the Treasury became more serious because of a general restrictive credit policy.

To the argument that general credit controls do not differentiate between these situations, whereas selective controls would, the answer is that in peacetime private decisions, and not a Government regulatory agency, should determine the direction of the employment of resources, within the framework of an appropriate general credit policy.

3. What do you believe to be the appropriate roles of direct (e. g., price and wage) controls, selective credit controls, and a general tightening of credit as means of restraining inflation (*a*) when the Treasury is not expected to be a large borrower in the foreseeable future, (*b*) when a large volume of Treasury refunding operations will have to be effected in the foreseeable future, (*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future, (*d*) under conditions of total war?

Some answers stated that direct (e. g., price and wage) controls and selective credit controls were never appropriate, but that complete reliance should always be placed on a general tightening of credit—and, through it, on the price mechanism—as a means of restraining inflation, irrespective of attendant circumstances. In line with this approach, some answers stated that the condition of the Treasury as set forth in the various hypothetical conditions listed in the question was completely irrelevant.

The majority of replies, however, recognized a hierarchy of diminishing emphasis on general credit policy and increasing emphasis on direct controls as one passed from the situation visualized in condition (*a*) to that visualized in condition (*d*), with the emphasis on selective credit controls first rising and then falling as one progressed along the series. Perhaps the most common answer was that exclusive reliance should be placed on a general tightening of credit under conditions (*a*) and (*b*), a diminished reliance on a general tightening of credit, some reliance on selective credit control and some direct controls under (*c*), a heavy reliance on direct controls with small or moderate reliance on a tightening of credit and very little reliance on selective credit controls under (*d*). A substantial proportion, but still a minority, of economists believed that some reliance should be placed on direct controls under present conditions.

Extracts from typical replies follow:

E. E. Agger (Rutgers University)

(*a*) Chief reliance should be placed on credit controls when the Treasury is not expected to be a large borrower.

(*b*) General and selective credit controls should also suffice to take care of even large Treasury refunding operations. The chief inflationary effect of Treasury borrowing is exerted at the time of initial borrowing. In the refunding operations the effort should be to make unnecessary any further expansion of commercial bank credit.

(*c*) When the Treasury is a large net borrower the need for direct controls may emerge to the extent that, despite indirect controls and the best efforts to win individual and institutional subscriptions to Government security issues, reliance upon commercial bank credit expansion is unavoidable.

(*d*) Under total war a wide extension of direct controls including rationing is unavoidable.

V. Lewis Bassie (*University of Illinois*)

Direct controls should play an important role in stabilizing the economy in rearmament as well as in total war. Wage and price controls are about the last form of direct controls that should be used. Most of what needs to be done can be best accomplished by industrial-type controls, such as materials, production, and construction controls. General credit restrictions cannot provide a satisfactory substitute for such controls. Selective credit controls, such as consumer credit regulation, are relatively ineffective even in the areas selected, particularly when Congress limits their use as severely as at present. The question of whether the Treasury is borrowing is distinctly a secondary consideration. Attention should be focused on what needs to be done and what can best be sacrificed in order to get it done.

Murray R. Benedict (*University of California, Berkeley*)

* * * It is my view that, in times of severe inflationary pressure, all three types of restraint are needed, and should be used in conjunction. Except in unusual situations involving inflationary spiraling of prices, wages and costs, or cases where sudden increases in demand create large windfall gains without prospect of quick effects on output, I think direct controls should be avoided, if possible.

Jules I. Bogen (*New York University*)

When the Treasury is not expected to be a large borrower, but when defense spending brings ultrahigh employment and shortages in many materials, the inflation threat must be fought on every front. By combining direct controls, selective credit control, and general tightening of credit, it will not be necessary to rely unduly upon any one expedient, and the over-all result should be most favorable.

The need for carrying out a large volume of Treasury refunding does not require a change of policy, but does limit the extent to which interest rates should be allowed to rise to combat inflation. It lessens the freedom of action of the Federal Reserve authorities.

Where it appears the Treasury will be a large net borrower, freedom to allow interest rates to rise is further curtailed. Nevertheless, a moderate tightening of the market may continue to be desirable to check private expansion of credit.

Under conditions of total war, private credit expansion is unlikely, and facilitation of Treasury financing must become the one and primary objective of central bank policy.

Chelcie C. Bosland (*Brown University*)

As a means of controlling inflation, I would prefer a general tightening of credit; then selective credit controls, and, as a last resort, direct control over prices and wages. This would be true whether Government is or is not a large borrower. Inflation is much more costly to Government and to the economy as a whole than higher interest rates would be. In time of war, higher interest rates and selective credit controls may be inadequate to suppress inflation but they should be used for what they can accomplish even if direct controls over prices and wages (or other control measures) are also needed.

Frederick A. Bradford (Lehigh University)

Direct price and wage controls cannot be made effective except under conditions of total war, and not 100 percent effective then. They are a mere palliative at best and should be used only under the most extreme conditions. In wartime, a direct limitation on the production of certain types of consumer goods is more effective than selective controls. Under conditions (*a*), (*b*) and (*c*), a general tightening of credit is most desirable on the whole.

Elmer C. Bratt (Lehigh University)

(*a*) Rule out direct control, application of general or selective depends largely on conditions and relative importance of consumer credit and of speculation. (*b*) Essentially the same. (*c*) Should avoid direct control if at all possible because of its inefficiency, temporary nature of its effect. (*d*) Depends, but direct control may be necessary.

Cecil C. Carpenter (University of Kentucky)

I believe that trade, price, and wage controls should be used under conditions of total war. The same is true for credit control and allocation of supplies. Under the other conditions described in the question, I would not advocate use of any of the devices mentioned. I believe the Treasury should, in peacetime, be a general market borrower much like corporations and businesses.

J. M. Clark (Columbia University)

(*a*) If Government is doing little borrowing, direct controls are still needed if private capital expansion is large, since it can have equal general inflationary effect. If this stage of large private capital expansion is passed, direct controls may still be needed on a wide scale if "spirals" persist; but if they are effectively restrained by voluntary means, then direct controls may be limited to selective controls over special scarcities. In any case, selective credit controls are not alternatives to direct wage-price controls, but rather complementary, reducing excess demand to proportions that will not impose heavier strains than direct controls can successfully handle. Under "cold war" conditions, the power of direct controls to resist the pressure of excess demand is far less than in "hot war," so the need for strong backing by credit controls (and budget balancing) is much greater, especially, of course, if Government borrowing is large, or is expected to be large.

William E. Dunkman (University of Rochester)

(*a*) When the Treasury is not expected to be a large borrower in the foreseeable future, there is no need for any controls other than control of bank reserves.

(*b*) Same as (*a*).

(*c*) Same as (*a*).

(*d*) Under conditions of total war, it is necessary under the terrific economic impact to forego economic as well as other freedoms for the duration. It should be recognized that euphonius terms such as "Selective Credit Controls" and "Special Direct Inflation Controls" (e.g., price and wage), are simply terms describing an authoritarian economy, as contrasted with economic freedom in which prices

and wages are determined in markets where people are free to spend and produce, to compete for jobs and to move from industry to industry.

Howard S. Ellis (University of California, Berkeley)

Conditions (*a*) through (*d*) represent a progressive array of potential inflation or inflationary pressure. Selective credit controls have less and less efficacy, and the general tightening of credit becomes increasingly more necessary in the progression from (*a*) through (*d*). Any extensive use of direct controls should be made unnecessary by appropriate fiscal and monetary policies in all stages short of actual war.

Milton Friedman (University of Chicago)

In my view, direct controls and selective credit controls are inappropriate means of restraining inflation under any of the four conditions listed. These measures are ineffective in preventing inflation; they are inequitable in their impact on individuals; they produce distortion, inefficiency, and waste in the utilization of our resources; and they threaten the maintenance of our free institutions. In consequence, I would assign them no role at all as a means of restraining inflation.

General control over the quantity of money, which implies a general tightening of credit, should play a major role under all four conditions. It should be carried to the point at which inflation is prevented regardless of the effect on interest rates. This can be done if a reasonable fiscal policy is followed, that is, if the budget is either roughly balanced, or the deficit held to moderate size. If, for a given fiscal policy, such a monetary policy produces higher interest rates than seem desirable on other grounds, the appropriate remedy is to levy still higher taxes. The high interest rates do not justify direct controls or selective credit controls or inflation.

Nat Goldfinger (CIO Committee on Economic Policy)

Selective consumer credit controls, too, are an important factor in curbing inflation. Increasing the down payment and shortening the period of installment payments will tend to curtail consumer spending and stimulate personal savings. But the controls should be truly selective, aimed at curtailing inflationary pressures—in cases where goods are in short supply relative to effective demand—rather than aimed at depressing specific industries. Consumer credit controls should, therefore, be flexible enough to move up or down, depending on the degree of inflationary pressures. Consumer credit controls are inherently discriminatory against lower income groups. They should therefore be graduated, as in regulation X.

Consumer credit controls, without controls over business credit, will not curtail inflationary pressures, as was proved last winter. And both consumer and business credit controls should be flexible to permit a toughening or softening of controls, depending on the nature of inflationary pressures. Credit control policy, therefore, should not be spelled out in detailed legislation, but should rather permit for an area of flexibility.

Credit-control policy cannot properly be managed by the financial institutions themselves. The present policy—small rise in interest rates and a so-called program of self-restraint, supervised by the

financial community—is neither adequate nor realistic. It does not curb business-loan expansion, in my opinion, and it sets the basis for blackballing prospective borrowers on insufficient or discriminatory grounds.

Under conditions of sharp inflationary pressures—with Government expenditures greater than income such as in periods of partial mobilization or total war—monetary and fiscal measures, including tax and savings policies, will not be sufficient. Direct controls will be necessary.

In periods of mild inflationary pressures—or when pressures are starting, as in the summer of 1950—direct selective controls on the prices of basic raw materials should be instituted, in addition to indirect measures—increase output, credit control, taxes and a savings program. If such selective controls are insufficient—and inflationary pressures continue to mount—then, general direct price and wage controls should be instituted. Such controls should be based on the principle of equality of sacrifice and they should be part of a comprehensive program to stabilize the economy.

Since last winter, the CIO has urged the establishment of an over-all anti-inflation program, to include: (1) Increased output; (2) firm price controls; (3) rent control; (4) fair wage stabilization; (5) equitable taxes; (6) credit controls; (7) savings program.

We do not have such a program at present. As a result, we face the possibility of new inflationary pressures in 1952, without adequate protection of consumers or the economy itself. In addition, the current patchwork of controls is inequitable and it serves to undermine public morale and confidence.

Inflationary pressures cannot be curbed by single measures—such as interest rate changes or Government bond market manipulations—or by a patchwork of controls. Our complex economy is composed of interdependent areas, all of them intertwined in one imposing edifice. Control of one or two areas is neither adequate nor equitable. So long as inflationary pressures are permitted to develop and grow in some areas, those pressures will tend to affect the entire economy. What is called for is a comprehensive stabilization program, based on the principle of equality of sacrifice by all groups in the civilian population and adapted to meet the economic pressures of the time.

George H. Hildebrand (University of California, Los Angeles)

Save possibly for materials allocations, there should be no direct controls at this time. They deal only with the symptoms of inflation and not its causes; they foster the illusion of an unlimited supply of all goods; and they cannot command public cooperation save in a great war.

(*a*) The policy of credit control works easiest when the Government is not a large borrower.

(*b*) If refunding requirements are large, then the Government will have to pay a higher rate of interest. Why shouldn't it? Why should the whole public suffer inflation just so that the Treasury can enjoy an artificially depressed price for the money it borrows?

(*c*) This one is "loaded": it seems to mean that since public outlays must increase, increased borrowing follows automatically. Let Congress itself begin by recognizing that total output cannot satisfy all demands, and so (1) cut out nonessential and deferrable public spend-

ing, (2) raise taxes so that the public pays currently for what it gets. If excess reserves are cut down, then any Treasury borrowing must come out of the public and the public cannot finance it by borrowing from the banks. This would make the Treasury face reality too.

(*d*) In total war inflationary borrowing is probably unavoidable.

Allan B. Kline (*American Farm Bureau Federation*)

We believe that price and wage controls are totally inappropriate to the American economy except under conditions of total war when military needs are so great that it is clearly necessary to distribute civilian supplies on a per-capita basis. Price and wage controls disrupt production and distribution, waste manpower and create black markets. Even in a period of all-out war when patriotic feelings are at their highest, there are many serious disadvantages to such controls; however, they can be endured for a time when the public deems it is necessary to the successful termination of the war. An important consideration is the fact that in a period of all-out war, people can look forward to the termination of price and wage controls when victory is achieved. Our present situation is vastly different. We have embarked on a mobilization program of indefinite duration with the objective of avoiding a third world war. Since we must be prepared to continue this program indefinitely, the present emergency lacks the terminal facilities which are provided by the achievement of victory in a war. If we continue price and wage controls in the present mobilization period, we shall seriously reduce our ability to meet a real emergency should one arise some years from now.

Selective credit controls may appropriately be used to curb the demand for goods which are in short supply or which require labor and materials that are needed for defense uses. Measures designed to restrain the over-all expansion of credit are far more useful as a means of preventing inflation. To restrain the over-all expansion of credit under present conditions, we must achieve (1) a balanced Federal budget; and, (2) a sound management of the public debt. In view of the present size of the national debt, it is difficult to foresee a time when a large volume of Treasury refunding operations will not have to be effected in the foreseeable future. In the present situation every effort should be made to bring Government appropriations under control so that it will not become necessary for the Government to pay part of the bill with new money. In any case short of an all-out war, price and wage controls should not be used to conceal the inflation inherent in deficit financing.

Wesley Lindow (*Irving Trust Co., New York*)

In our modern economy, Government must use a great many of its powers and programs coordinately to obtain the desired economic effects appropriate to the business cycle. It is hard to say just how the various tools should be used but it is clear that inflationary tendencies must be fought with all suitable weapons at one time just as deflationary tendencies must be fought with suitable weapons at another time. Treasury financing and the management of the public debt constitute an important part of the economic scene today and we should neither ignore this nor exaggerate its place. Experience will help us to keep the various factors in perspective.

Fritz Machlup (*Johns Hopkins University*)

Direct Controls versus Credit Controls.—The use of direct controls over many years may undermine and eventually destroy the free-enterprise system. To the extent to which there is a choice between direct controls and credit controls, advocates of the free-enterprise system (if they know what they are doing) will fight the use of direct controls and favor the use of credit controls. I suspect that many who have voted for direct controls are not aware that every such vote is a vote against the free-enterprise system.

It is true, of course, that in emergencies the use of direct controls for brief periods may be unavoidable and that the comparative roles of credit controls and direct controls are different in the different situations outlined in the questions of the committee.

(*a*) "When the Treasury is not expected to be a large borrower in the foreseeable future," and any inflationary expenditures are thus merely those of businessmen and private consumers, credit controls can remove all inflationary pressures and direct controls are sheer stupidity—or measures of avowed advocates of authoritarianism.

(*b*) "When a large volume of Treasury refunding operations will have to be effected in the foreseeable future," one can understand that the Treasury will not like an increase in interest rates. The first question then is whether we can find ways and means of getting Treasury issues placed at low rates despite the increased interest rates required in an anti-inflationary credit policy. (This might be possible by the adoption of proposals such as the Eccles plan for secondary bank reserves.) If this should not be feasible, the second question is whether it is better to burden the Treasury with higher interest rates or burden the whole economy with the expensive machinery of direct price and allocation controls. In my opinion, the higher interest burden on the Treasury is the much smaller evil from the point of view of the Nation.

(*c*) "When it is expected that the Treasury will be a large net borrower during the foreseeable future," the alternatives are still the same as under (*b*). If new issues of the Treasury cannot be placed at preferred rates, it will still be much less costly in the long run for the Nation to pay more for the public debt than to put its economy into the shackles of direct economic controls. Higher interest rates along with higher tax rates can effectively reduce private demand for the resources needed for defense production. The use of direct controls for this purpose for long periods is economically wasteful, even apart from the serious danger which it involves for the survival of a free society.

(*d*) "Under conditions of total war" the introduction of some direct controls may be necessary. Total war may be defined as one in which at least half of the national income goes for military and defense expenditures. Under such circumstances some of the reallocations of productive resources which the Nation has to effect may have to be supported by direct controls. This, however, does not reduce the need for fiscal and monetary controls. Even in total war the chief burden of keeping down the rate of inflation should be on fiscal and monetary policy. That is to say, inflation should be combated first and foremost by reducing through high tax and interest rates the amounts of money that consumers and businessmen have available for their expenditures.

James A. Maxwell (Clark University)

Under conditions of total war direct controls have their clearest justification and effectiveness. Under the other three conditions which are specified I would regard general tightening of credit, plus some selective credit controls, as appropriate.

Gordon W. McKinley (Prudential Insurance Co. of America)

I have already indicated in the answer to question 2 that, during a period of business optimism, selective credit controls can be effective only if general credit controls are first put into operation. I grant that an orderly market for Government securities must be maintained, particularly during refunding operations and when the Treasury is making large new borrowings. The desire of the Treasury to borrow at low rates should not, however, be allowed to prevent the application of general credit controls. Under present conditions, it is impossible to have both low interest rates and stable prices. Since I believe that curbing inflation is more important than reducing the interest rate on Government securities, I advocate strong general credit controls as the major weapon against inflation. Selective credit controls should supplement the general controls, aiding in the allocation of scarce materials. In the event of total war, direct controls should be added to the general and selective controls.

Lloyd W. Mints (University of Chicago)

* * * I can see no place for selective credit controls, regardless of the position of the Treasury. They are ineffective in preventing inflation, and they may, at the very least, distort the price relationship among commodities.

I likewise can see no use for direct price and wage controls, again regardless of the position of the Treasury. Such controls, to be sure, may keep an index of the price level down while the controls are in effect; but if inflationary financing is resorted to (and there is no conceivable point to such controls if inflationary pressures are not present) the inflation will be in part concealed and in part postponed.

It will be concealed by the emergence of black markets, the deterioration of goods in quality and the outright disappearance of some commodities from the market. It will be postponed, insofar as the controls do keep the index down, to the period when the controls are removed, and this mere postponement is no solution to the problem. But there are also positive objections to direct controls. They seriously interfere with relative prices, they withdraw men for their enforcement from occupations in which these men could add to the output of the economy, and they place business enterprises in a strait-jacket which must considerably reduce the general efficiency of operation. For all these reasons the level of output will be reduced by direct price and wage controls.

Marcus Nadler (New York University)

Under present conditions, even though the Treasury may not be expected to be a large borrower in the foreseeable future, direct controls, selective credit controls, and general tightening of credit are necessary because of the inflationary forces generated by the rearmament program and the large capital expenditures by corporations in connection with the defense program. The rearmament

program of the present magnitude creates a demand for plant facilities, raw materials, machinery, equipment, and labor without at the same time producing commodities which enter the consumer stream. Moreover, wages are increasing, thus further raising the cost of doing business. Because the defense program is bound to lead to an increase in the disposable income of the people and a reduction in the supply of commodities available for sale the abovementioned controls are needed.

(*a*) So long, however, as the Treasury is not expected to be a large borrower a moderate degree of direct controls and selective controls would be sufficient. The present flexible open-market policy of the Reserve authorities is desirable because it makes availability of Reserve Bank credit more risky and because it reduces the supply of funds at the disposal of nonbank institutional investors that could be invested elsewhere. This results from their inability to sell Government securities.

(*b*) In case the Treasury is confronted with refunding operations the same conditions would prevail. The only difference it might make is that the open-market operations of the Reserve banks would have to be coordinated with the policy of the Treasury in order to make the refunding successful.

(*c*) If the Treasury is confronted with large net borrowing then the direct controls and the selective credit controls should be tightened. In this respect it may be stated that the Congress rendered a disservice to the country as a whole by relaxing regulation X and regulation W. The reduction in the spending power of the people caused by the higher tax rates recently enacted by Congress will be offset if the public avails itself of the increased borrowing permitted under the modified provisions of regulations W and X. Since the borrowing of the Treasury has to be successful the credit policies of the Reserve authorities will also have to be coordinated to the needs of the Treasury.

(*d*) Under conditions of total war all the resources of the country will have to be mobilized. This would include the financial resources of the country. All methods of control will have to be employed to assure the maintenance, as far as possible, of a sound economy and to provide the military forces with the necessary strength to win the war.

Harold L. Reed (*Cornell University*)

In brief language the Treasury's needs are an important consideration in the determination of the relative roles of quantitative and qualitative controls. Recently banks have been selling Government securities as a means of obtaining the funds for loan-granting. Even without further Treasury financing the Federal Reserve System may have to absorb a considerable volume of offerings if the Government bond market is not to become demoralized. If the support of the System is not tendered the bond market the danger emerges that yields on the marketable issues will rise to a point that will encourage the encashment of the nonmarketable E, F, and G bonds. Such redemptions make it the more necessary to rely upon offerings to the commercial banking system. This is one of the greatest of existing inflationary dangers.

This is one of the reasons why direct controls of wages and prices, as well as selective credit restraints, need to be invoked. Quantitative credit controls can't be invoked to do the whole job.

I addend a letter I wrote on "The Need for Direct Controls" that appeared in the Ithaca [New York] Journal on October 17, 1951.

THE NEED FOR DIRECT CONTROLS

More and more often as the debate over methods of controlling inflation proceeds we hear the statement that direct controls of wages and prices cannot subdue the fundamental forces operating upon prices and that, at best, they can only postpone effects. It is thus implied that controls have nothing to do with the volume of dollar purchasing power that is omitted and that their potency must eventually wear out. In other words, controls are labeled as pure palliatives and temporary expedients.

It is admitted by this writer that, if other forces of inflation are permitted to wax too strong, no type of controls our economy is capable of exercising may be adequate to arrest the march of inflation. It is just as strongly maintained, however, that controls may be essential to increase the effectiveness of other measures and that if properly and vigorously employed they may do far more than merely determine the timing of inflationary consequences.

Almost everyone agrees that our primary anti-inflation controls must be sought in the field of fiscal policy. We need heavy taxation, particularly of spendings, and we must supplement taxation by a vigorous drive to mop up savings for the benefit of the Treasury. It is also essential that nonnecessary governmental spending be cut to the bone. But under the conditions that exist, many of them very unfortunate indeed, hardly anyone expects that fiscal measures in and of themselves will be sufficiently potent. So we next give attention to monetary controls and credit restraints.

In estimating the effects of monetary restraints, however, we are immediately impressed by the great delicacy of the problem. In the first place, we cannot be sure that to carry monetary controls to the extent that would be required would not tend to demoralize the Government bond market and thereby make it impossible to effectuate a successful savings-bond drive unless the new bonds offered to savers carry a far higher rate than the old bonds. And if the new issues are made more attractive how can we prevent the cashing of the old?

Without giving figures these are significant facts of recent financial history: First, disposable personal income has been increasing tremendously with every likelihood that personal consumption expenditures out of this income shortly will become much greater. Second, banks have been obtaining funds to meet an enlarged loan demand, much of it originating in defense contracts, by selling marketable Treasury obligations. Third, the Federal Reserve banks have seen fit to buy quantities of Governments in order to prevent complete demoralization of the market. Fourth, such purchases have tended to expand the reserve positions of member banks and to contribute, therefore, toward credit expansion. Fifth, a serious drop in the prices of the marketable issues, or, to put it in reverse language, a rise in yields, would lessen the attractiveness of the nonmarketable E, F, and G bonds and thus compel greater reliance upon the sale of Treasury obli-

gations to the commercial banks, with all the inflationary consequences of this latter procedure.

No one knows how skillfully the Federal Reserve authorities can set a course that will steer through these manifold difficulties. But the above difficulties are by no means the most serious of those confronting adherents of monetary controls. The fact is that at a time when we must maintain full employment and maximize production labor is in a strong position to hike up wages and employers will be inclined to accept labor's demands if price increases are unrestrained. Certainly, in the absence of an effective anti-inflation program individual groups must be expected to use all their power to preserve their economic positions.

Without a system of direct controls, the monetary system, at such a juncture, may not be able to do much more than to refuse to provide the credit required to move goods at the heightened level of prices and costs. Theoretically, the money administration can tighten credit and thus penalize labor and enterprise for advancing costs and prices too rapidly, but only after the damage has been done and at the expense of inhibiting production and weakening the preparedness effort. So it does seem that we dare not now rely entirely upon normal processes of wage and price fixation and must depend upon direct controls to supplement the monetary and fiscal weapons. If such direct controls can be successfully administered, the demand for bank credit will be reduced at the source and the vexatiousness of the monetary problem lessened. So it seems highly superficial to aver that direct controls can do no more than merely soften the consequences of the creation of too much bank credit. Controls may prevent the origination of as much credit as otherwise would be required.

No believer in free enterprise can contemplate the vigorous use of direct controls with lightness of spirit. The writer likes controls perhaps far less than most such individuals. But unless we really want price inflation because we represent some special interest, we cannot conclude that the entire problem can safely be entrusted to the fiscal and monetary authorities. These authorities can't do the whole job and it is questionable whether they have the skill and courage to do even as much as might be possible.

Roland I. Robinson (Northwestern University)

In my opinion, the assumptions of conditions given in this question are not the criteria for deciding when direct control of prices and wages is appropriate. I doubt both the necessity of such direct control and would depend primarily on the vigorous use of monetary and fiscal policy. Even with allowance for the fact that between the legislative and executive branches of Government fiscal policy has been bungled recently and monetary policy has been used only mildly, they have a better chance of being tolerated. The direct controls are almost certain to be breached. Thus, direct controls seem inappropriate under almost all conditions short of (*d*). The selective credit controls have moderate applications under the present circumstances and would have even more in an urgent defense economy just short of war. In other words, the selective credit controls may be most effective when civilian capital outlays have not been wholly prohibited but when they should be discouraged greatly.

This leaves "a general tightening of credit as a means of restraining inflation" for consideration. Credit should be tightened whenever the important spending decisions being made in the free markets are tending to outrun current business and individual saving. The state of Treasury finances is not the proper criteria.

No central bank in a nation with a "vast public debt" can be unaware of treasury financing problems. But even though vast, the Treasury needs should not dominate the credit decisions. Credit based on monetary expansion can add the marginal spending that bulges prices; it should not be permitted. The form of credit restraint used might well aim at minimizing spending with the smallest possible interest-rate effects. But if interest rates must go up, then the price should be paid. It is a cheaper price than risking further additions to an already bloated money stock.

The only exception is total war. When the important spending decisions are no longer being made in free markets but by Congress, then credit restraint is proper only for sections of the private market not otherwise curbed. Easy credit may be unwise but positive tightness no longer is appropriate.

Edward C. Simmons (*Duke University*)

In my opinion there is no appropriate mix of these controls regardless of whether the condition is (*a*) or (*b*) or (*c*) or (*d*). Inflation cannot be avoided in the kind of economic system we have by utilizing the enumerated ingenious subterfuges—it can only be delayed. Taxation, via the personal income tax, must be used to the maximum to cover Government outlay, even to produce money-contracting surpluses under conditions of overfull employment. To the extent taxation cannot be made adequate to cover outlay, direct creation of money must be relied on, with all that entails. The distortion of relative prices that comes with inflation is less undesirable than the distortion which comes from price and other direct controls. Once we understand the fundamental issues, the problem will not be confused by the specious distinction of four cases such as the (*a*), (*b*), (*c*), and (*d*) of this question.

Josef Solterer (*Georgetown University*)

An alternative way of handling the inflationary problem in a total war has been suggested. Its gist is to replace price controls and rationing by consumer expenditure rationing (complemented by selective controls over consumption) and selective controls over business spending. The Treasury would finance the large budget deficit as much as possible by nonmarketable bonds to be put into the hands of consumers as well as of firms and banks. Direct control of consumer expenditure and business expenditure would be the kingpin of this system; selective and general credit policy would be ancillary.

We hold that such a system is superior to the "disequilibrium system" ("modified" or not "modified"), inasmuch as it would relieve the awkward pressure to which prices and allocations are exposed under the disequilibrium system. We do not go so far, however, as to believe that a policy of expenditure rationing could easily be perfected to a degree where it would provide for an over-all correspondence between effective demand and supply. It seems much more realistic not to expect more from it than a reduction—instead of a

complete elimination—of the inflationary pressure. But even the realization of this more modest goal would be a great achievement.

Herbert Stein (Committee for Economic Development)

I do not believe that direct controls (e. g., price and wage controls) should be used as a means of restraining inflation except under conditions of total war. The movements of particular prices and wage rates free of Government controls have so vital a function in the organization of our economy that they should not be interfered with except in cases of clear and strong necessity. Under conditions other than total war serious inflation can be prevented without use of direct controls. It is unnecessary, and therefore undesirable, to use direct controls except under conditions of total war.

I do not believe that selective credit controls should be used as a means of restraining inflation. When there is no clear national interest requiring the diversion of resources away from particular uses, but only a national interest requiring reduction of expenditures in general, to prevent inflation, a general instrument should be used, not a selective instrument. Use of selective credit controls as a measure for directing the flow of resources, comparable to allocations may sometimes be necessary. Their use for this purpose will have the incidental effect of restraining total expenditures and reducing total inflationary pressures.

The role of general credit restriction in all the conditions mentioned here is to serve as an element in an anti-inflation policy that is balanced among its parts and adequate in total. How much reliance to place upon general credit restriction within the total program will not depend primarily upon the debt position of the Treasury, but will depend mainly upon the size of the Federal budget, the probable duration of the source of the inflationary pressure and the efficacy of other measures—such as promotion of saving—in the particular situation.

Henry H. Villard (College of the City of New York)

Reversing the order, I believe that all the controls mentioned would be needed under conditions of total war. The second possibility—that the Treasury will be a large net borrower during the foreseeable future—premises an inadequate fiscal policy. Given this premise, as expenditures and the time "foreseen" approach the magnitude and length of a major war, use of all controls mentioned becomes increasingly desirable. But as the size of probable expenditures become smaller and especially as the probable duration becomes longer, the case increases for eliminating direct controls. Apart from war I personally "foresee" a cold conflict with Russia that may last for decades. Use of direct controls for even a single decade, I fear, will slow down our economic progress, which must be maintained for ultimate victory. Yet once direct controls have been relied on sufficiently to cause substantial idle balances to accumulate, they cannot be easily eliminated. It is to be prepared for the possibility that the struggle will be a long one that I favor much reliance on credit policy starting at once, even though it is still possible that the struggle may not be of long duration.

The shorter the average life of Government securities, the less the burden of an increase in interest rates falls on the holders of such se-

curities (as a result of decreases in bond prices) and the more the burden falls on the Treasury (as a result of having to pay more interest as securities are refunded). At present it is widely accepted that the burden of change should not be allowed to fall to any appreciable extent on bondholders; to prevent any burden falling on them is in fact frequently advanced as a reason for not allowing interest rates to change. As I believe that credit policy should be pursued even if substantial interest changes result, I do not regard large refunding operations as necessarily adverse; for such operations involve shifting the burden to the Treasury relatively rapidly, and therefore eliminate pressures to maintain interest rates to prevent hurting bondholders. Hence such operations should facilitate, rather than impede, use of credit policy. But even where the Treasury is not expected to be a large borrower, I would favor reliance on monetary (and fiscal) policy rather than direct controls. In both cases selective controls have a real, but relatively minor, role to play.

Ray B. Westerfield (*Yale University*)

There is no appropriate role for direct (wage, price) controls, or for selective credit controls, under any of the four suggested conditions of the economy. These controls are not compatible with the free enterprise economy; they belong to the Fascist or Communist systems, where management of the economy by the government is employed. Under the free enterprise system free markets and pricing will afford what control is needed, within "the general tightening of credit" which deals with the whole economy and does not try to allocate, foster, or depress, or otherwise exercise discriminatory pressure within the economy. * * *

Edward F. Willett (*Smith College*)

The threat of inflation is so serious that I would feel it desirable to make use of all types of controls—direct, selective, and general—as a means of restraining inflation under any circumstances. These controls, for obvious reasons, are more likely to be adopted when the Treasury is not expected to be a large borrower. Generally speaking, conditions of total war are so exceptional that much more rigid controls should probably be utilized than would be acceptable in time of peace.

Donald B. Woodward (*Mutual Life Insurance Co. of New York*)

Inflation is a major, persistent rise in the general price level, resulting from a condition in which claims for goods and services considerably exceed the total production of goods and services valued at existing prices. The most practical and equitable instrument that has been devised for the allocation of economic resources among conflicting claims is the market place. Here, if it is permitted to function, an equilibrium between demand and supply works itself out over time through the free interchange between buyers and sellers. The best method to try to restrain inflation would be that method making maximum use of this self-adjusting procedure, the imperfections of which are negligible compared with the gross brutalities of inflation.

Of the three types of controls mentioned by this question, a general tightening of credit makes maximum use of the market place. In general tightening of credit, all seekers for funds are on an equal basis in competition for a restricted amount of available credit, which

would be impersonally rationed among them, much more equitably and much less erratically than when done by some combination of authority and inflation. And general credit control is the only one of the three types mentioned by the question which deals directly with the most important single factor underlying inflation: the expansion of the money supply, which is the mechanism whereby an excessive volume of demand for goods and services tends to be made effective.

Selective credit controls, on the other hand, impair the free working of the forces of demand and supply by authoritarian exclusion or limitation of one or more segments of the economy from the market. They do not deal with the total volume of money, which is the most significant factor underlying inflation. They substitute authority for economic democracy, they entail value judgments by authority instead of impersonal adjudication of claims through the market place, they are wasteful of manpower, they erode public morals, they add burdens to an already overburdened judiciary, and their rigidity obstructs the essential continuous adjustment and readjustment of the economy. They serve more to postpone inflation, and they thus aggravate economic instability, inflation and deflation, instead of promoting that stability which is declared to be an object of national policy by the Employment Act of 1946.

Direct controls also stop the working of the market place. In more extreme form than selective credit controls, they substitute authority for economic democracy, they entail value judgments by authority instead of impersonal adjudication of claims through the market place, they are wasteful of manpower, they erode public morals, they add burdens to an already overburdened judiciary, their rigidity obstructs the essential continuous adjustment and readjustment of the economv. they serve to postpone inflation and they thus aggravate economic instability, inflation and deflation, instead of promoting stability. And they do not deal with the most important underlying factor in inflation.

The use of controls should therefore be extended no further than general credit control except under the most extreme and compelling conditions.

Therefore, a general tightening of credit is the only appropriate instrument "(*a*) when the Treasury is not expected to be a large borrower in the foreseeable future" or "(*b*) when a large volume of Treasury refunding operations will have to be effected in the foreseeable future." Under (*b*) the Treasury should go into the market like other claimants and bid for funds on a basis of equality.

Condition "(*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future," implicitly assumes large net borrowings by the Treasury are necessary in peacetime. I am unwilling to make that assumption except under certain extreme conditions of unemployment of economic resources. Government borrowing has been the major force in that most important single factor underlying the appalling inflation of the past decade: the expansion of the money supply. In view of the great economic, social and international harm which has resulted, the Government clearly has a solemn obligation to minimize expenses to the utmost extent, that will not impair the genuine requirements of national defense (and these should be kept under constant re-

view as Senator O'Mahoney has emphasized) and to live within its income. That sizable economies are possible has been made clear by former President Hoover and his associates in the Hoover Commission, Senator Paul Douglas of Illinois, former Under Secretary of the Treasury, Roswell Magill, the Committee on Federal Tax Policy, and others. (Mr. Magill's address in Toronto on October 11, 1951, is especially striking.) A condition where there is large net Treasury borrowing in peacetime, therefore, should not exist.

If, nevertheless, the Treasury is a large net borrower in peacetime, under conditions of full employment, the appropriate instrument is a general tightening of credit. Large Treasury borrowing in full employment means that credit will have to be rationed elsewhere, and it is preferable that this rationing be done by the market place rather than by the imposition of authority through selective credit controls with their defects as outlined above. And I can see no reason whatever why the existence of large Treasury borrowing should suggest the use of direct controls with all their defects. (There are, perhaps, conditions in which the objects of large public expenditure which are involved in large Treasury peacetime borrowing in full employment might warrant selective and/or direct controls but these are considerations of materials priorities, etc., and not of the restraint of inflation, which is the subject of this question.)

Finally, under conditions of total war, when the economy is strained to the utmost to provide the necessary armaments, manpower, etc., for the war effort, the overriding requirements of self-preservation necessitate use of whatever means will contribute to victory and to existence after the war. Probably all three methods mentioned by the question are required.

4. Do you believe that it would be (*a*) desirable and (*b*) possible to insulate public debt securities in whole or in part from the impact of restrictive credit policies designed primarily to discourage the growth of private debt? Do you have any concrete suggestions for action in this regard?

A majority of economists did not believe that it would be desirable to insulate public debt securities from the impact of restrictive credit policies. The commonest reasons for this were that it would interfere with the fluidity of the credit market and, therefore, with the effective functioning of the price system. Some of these answers thought that insulation of the Government securities market was bad because it would interfere with subjecting Government expenditures to the "discipline of the market." More answers, however, appeared to accept the determination of the level of Government expenditures by political processes as desirable and based their opposition to insulation on other grounds. A large proportion of those holding that insulation would be undesirable considered it possible, at least in part, but deplored the devices which they believed necessary to achieve it.

A substantial minority (about a third) of total replies believed that a substantial degree of insulation would be both desirable and possible and could be accomplished without impairing the operation of the price system. Believing that the total volume of Government expenditures was not properly a matter for determination by the money market, most of this group held that the cost of carrying the debt and

the value of Government securities should be no more responsive to policies designed to restrain private credit expansion than was necessary to achieve the objectives of those policies. Many of these answers expressed the view that a considerable amount of insulation was necessary in order to bring restrictive credit policies into the range of political practicability and favored it for this reason, although they might have opposed it otherwise.

Few believed that a complete insulation of Government securities would be possible. Among the devices referred to in order to secure a partial insulation were the requirement of secondary reserves for banks to be held in the form of Government securities, the issuance of nonmarketable securities, the holding of Government securities by the Government's own trust funds and the Federal Reserve banks, the use of selective credit controls, the establishment of loan ceilings for individual banks, and the compulsory sale of Government securities to individuals (under wartime conditions). A number of replies referred favorably to Professor Viner's proposal that reserve requirements of banks be based on classes of assets (rather than of liabilities) and to Professor Bronfenbrenner's proposal for a limitation on bank loans based on their ratio to deposits. Some replies referred to the 100 percent reserve system (for demand deposits) as desirable both in itself and as a way of securing partial insulation.

Extracts from typical replies follow:

Rollin F. Bennett (New York Life Insurance Co.)

It has been suggested that some method might be devised for achieving two objectives at the same time: (1) To maintain a comparatively high cost of private credit for the sake of restraining inflation; and (2) meanwhile to maintain a low yield on Government bonds in order to minimize the burden of debt service on the taxpayer.

In my opinion there is no practical way of reconciling these two objectives, and the first of them is far more important than the second. I therefore have no suggestion for insulating public debt securities from conditions in the market for private debt.

* * * * * * *

William A. Berridge (Metropolitan Life Insurance Co.)

(*a*) Not desirable in ordinary circumstances nor in most circumstances short of all-out war. In general, Government financing should operate in the climate of the market. This is not to say that no moderate actions should be taken to maintain a reasonably orderly market.

(*b*) It is possible to insulate public debt securities for a limited period, as was demonstrated during World War II. It is doubtful if it can be done indefinitely without highly undesirable effects upon the credit structure, such as the extremely easy availability of credit in the postwar period.

Chelcie C. Bosland (Brown University)

I am not sure that it would be desirable to insulate public debt securities from the impact of restrictive credit policies. It would create obvious loopholes in the credit structure, and not subject Govenment projects to any of the tests of the market place. It would make choices as between the public and private branches of the economy less rationed. Of course if it concerns *war expenditures* only this difficulty might not arise, but that is a special case.

Within limits, it would be *possible* to insulate public debt securities from private debt restrictions. Differential taxation and tax exemption might have some effect, but substantial insulation would come mainly by devices for compulsory purchases or holding of Government bonds, such as forced savings for individuals, forced purchases by business concerns, special security reserves for banks, insurance companies, and other financial institutions. Where forced savings are used as a partial substitute for a supplement to taxation, such a program might be desirable as it applied particularly to individuals. However, special reserve requirements for banks and financial institutions seem to be a means to force one group of savers or investors to accept a lower rate of return on Government securities than is available to those who can purchase higher-yield securities directly. I therefore doubt its desirability, unless it can be shown that the groups that are harmed have been given some compensating advantage by Government or, as in the case of commercial banks, it is necessary to restrict the creation of new reserves by the sale of Government securities to the Federal Reserve banks.

Martin Bronfenbrenner (*University of Wisconsin*)

It is both possible and desirable to insulate public securities to a considerable extent, but not completely, from the impact of restrictive credit policies. As means to bring this about I should suggest the "secondary-reserve" proposal associated with the name of ex-Chairman Eccles of the Federal Reserve Board, and likewise quantitative (ceiling) limitations on other types of lending. Fuller discussion of these points may be found in my paper "Inflation Control Through the Loan Ratio." * * *

J. M. Clark (*Columbia University*)

The use of special bank reserves invested in public debt has been suggested.

John C. Clendenin (*University of California, Los Angeles*)

It would be possible by statute, by such devices as (*a*) requiring bank and life-insurance companies to hold Governments; (*b*) requiring pension-fund investments in Governments as a condition precedent to tax deductibility of pension-fund payments by employers; (*c*) requiring personal bond investments to obtain a preferential income-tax rate; (*d*) selling added social-security income (deferred) to the public for cash, etc.

Such devices as this are obviously selfish manipulation by Government. To the extent that they succeed, they evade the normal cost of money, subsidize Government extravagance, and draw from the supply of savings without overbidding private users who also seek capital. I could justify them in wartime or in extreme emergency.

Roy L. Garis (*University of Southern California*)

This is the heart of the inflationary problem. The ability to monetize the debt is like pouring oil onto a fire. Instead of trying to borrow at abnormally and artificially low interest rates in the hope of minimizing the service charges on the public debt, the United States Treasury should refinance the public debt, perhaps on a perpetual basis as the British do, at interest rates high enough to induce the public to buy and hold the bonds. Why should the Federal Government

try to borrow money at the present abnormally low rates which have been forced upon the public by the Federal Government when this is a basic cause of the inflation that has reduced the purchasing power of the dollar by twice the interest earned on the bonds since 1940? Who can be expected to buy Government bonds or securities at 1 to 3 percent when the dollar has lost about half its value since 1940? The losses to United States bond owners after World War I were less than half the losses suffered by owners of World War II bonds in loss of purchasing power. This inflation has cost the American people a thousand times what the United States Treasury has saved on the service charges on the public debt by its erroneous policy of forcing on the public the existing abnormally and artificially low interest rates. In the words of Senator Everett Dirksen, of Illinois, September 25, 1951, "planners and controllers have developed an inflation engine which they can no longer control."

If Congress will return to fundamentals, I believe that the entire public debt can be refinanced in a short period of time on a 3½ to 4 percent basis that will induce the public to invest in and hold such securities. It is an elementary fact that the only dependable way to solve the problem of the Federal debt is to create the economic and political conditions under which private investment in Government securities can be made with security and confidence.

I do not think it is the duty or responsibility of the Federal Reserve banks to support the United States Government bond market. If the Treasury followed sound and proper policies, such would not be necessary.

R. A. Gordon (*University of California, Berkeley*)

It seems to me both desirable and possible to insulate Government securities in part from the impact of restrictive credit policies. Several suggestions have been widely discussed. In particular, I favor secondary reserve requirements for commercial banks and stimulating the purchase and retention of savings bonds through the issuance of a purchasing-power savings bond.

Burton C. Hallowell (*Wesleyan University*)

(*a*) Wholly or partially insulating the Government debt from the impact of restrictive credit policies designed to discourage the growth of private debt can be supported either on the grounds that it is a desirable end in itself or on the grounds that it frees the authorities, so that a more effective utilization of general credit policy can be made. The case for insulating the debt as an end in itself does not appear convincing to me. Whether the debt should be insulated to free general credit policy depends on one's estimate of the importance of this inhibition in the present formulation of credit policy by the authorities. I suspect it is of considerable importance. If we must assume that better timed and more effective credit policies will result in practice only from wholly or partially insulating the debt, I should be disposed to support insulation as desirable.

(*b*) I have no new concrete suggestions to make in this respect. Two proposals recently made appear worthy of more intensive examination, that outlined by Prof. Jacob Viner, of Princeton, in the New York Times of April 16, 1951, and the loan ratio plan proposed by M. Bronfenbrenner in the October 1951 Journal of Political Economy.

Seymour E. Harris (Harvard University)

It is both desirable and possible to insulate public debt securities in whole or in part from the impact of restrictive credit policies. There has been a spate of suggestions along these lines. In fact, the Government security market today receives special consideration; e. g., through the issue of securities to Government trust funds or corporations of about $35 billion of 15 percent outstanding; through the pressure on banks to hold P. S. not only as a result of liquidity requirements but also as a result of other pressures from Washington.

The advantage of impounding public securities in banks (and also vis-à-vis nonbanking lenders to some extent) would be that restrictive monetary policy might be enlisted with less resistance and less damage. Under these conditions, the banks, etc., would be provided with a return on Government securities related to the expense of handling the debt and perhaps related to the cost of services provided by banks to the public. Actually, it would be preferable that the banks charge for services on the basis of costs; and that the banks also charge the Government on the basis of costs. The Treasury would determine the amount of securities to be held as reserves by the banks on the basis of the general monetary situation. Once the resulting expansion of deposits becomes too large, the Treasury would sell securities to the public, tailoring rates of interest to the requirements of the market. Any resulting rise would be offset in whole or in part by the reduced rates on securities held by financial institutions. Banks should in fact be compensated for costs but should not make large profits in the process of buying securities and taking over the Government prerogative of manufacturing money.

Should the Treasury require banks and possibly other financial institutions to hold designated amounts of securities, then the experience of 1945–51 would not be repeated though some shifts to private financing might have been justified.

In these 6 years, financial institutions other than Reserve banks reduced their holdings of Federal securities from $117 to $86 billion, or from 50 to 40 percent of issues held by the public. The holdings of commercial banks declined by $26 billion, or almost one-third, and of insurance companies by $5.7 billion, or one-quarter. Particularly in the first year of the Korean war was the desertion of the Government security market by financial institutions particularly troublesome. Commercial banks disposed net of $7.1 billion, or 11 percent of the June 1950 investments. The result, of course, was embarrassment to the Treasury, and expansion of $4½ billion of holdings by the Reserve banks, and a general inflationary pressure which might have been averted in part had the financial institutions not had virtually complete freedom to dispose of public securities in response to the lure of more profitable investments in industry.

Philip G. Hudson (University of Arizona)

I believe it would be desirable, but I know of no concrete proposal to achieve this purpose.

O. B. Jesness (University of Minnesota)

The purpose of credit restrictions in a situation such as the present is that of reducing inflationary pressures. Public borrowing is as inflationary as private borrowing and the purpose of the restrictions will be defeated if public borrowing is exempted from the restrictions.

Allan B. Kline (American Farm Bureau Federation)

It is totally impossible.

Wesley Lindow (Irving Trust Co., New York)

I believe that it is desirable to work toward further insulation or separation of public-debt securities from private debt. The use of nonmarketable securities has contributed to this end and more can be done to develop specially tailored securities of this type. Selective credit controls operate in this direction also, and should be carefully studied for possible refinements. Various suggestions have also been made to tighten up bank reserve requirements so that the Federal Reserve would not have to cope with the problem of so large a floating supply of secondary reserves in bank hands. These proposals include: (*a*) the secondary reserve requirement proposal, (*b*) the asset classes reserve proposal, and (*c*) the loan expansion reserve proposal—various loan limitation devices like the loan ratio plan have also been suggested. I shall not take the time to describe these here since I assume that they will be fully covered in some of the more extensive questionnaires sent out by the committee. Undoubtedly, there are advantages and disadvantages to each of these ideas and I realize, of course, that there is an infinite variety of adaptations of these plans. I would like to suggest that extremely careful study be made of these ideas to avoid the possibility of miscalculation. We know far too little about the repercussions of credit restraint and interest rate movements, as well as many other aspects of modern economic affairs, to rush into a major change in central bank methods. It is far better to rely on steady evolution in central banking, which would be more consistent with the history of central banking over the years.

Harris Loewy (Bankers Life Co.)

I do not believe that it would be desirable to insulate public-debt securities in whole or in part from impact of restrictive credit policies designed primarily to discourage the growth of private debt. During the past 7 years this policy has resulted in debt monetization and inflation.

Fritz Machlup (Johns Hopkins University)

Preferred Treatment for Public Debt.—As was indicated in the previous question, I believe it is desirable and possible to insulate public debt securities from the impact of anti-inflationary credit policies. Some such plans as modification of reserve requirements to the effect that commercial banks must keep a secondary reserve in the form of Government securities may serve this purpose.

C. Ward Macy and E. C. Robbins (University of Oregon)

Under present conditions we believe it both (*a*) desirable and (*b*) possible to insulate public debt securities in part from the impact of policies designed to discourage the growth in private debt. Assuming that the Treasury is to be accommodated in its desire to maintain low interest rates on Government debt securities, it is at the same time desirable to free the Federal Reserve System so that its open-market operations may effectively aid in restricting credit. The most practical concrete suggestion we have is to establish a required secondary reserve for all commercial banks in the form of public securities. This might be extended to insurance companies. A general movement

of public debt securities to the form of perpetual bonds might make this proposal much less desirable.

Raymond F. Mikesell (*University of Virginia*)

I think that for temporary periods such a course would be desirable and possible. I suggest a system of reserve requirements based upon the type of assets held by banks. Reserve requirements for Government bonds could be maintained at the lowest levels, while reserves required against loans not related to defense or essential civilian production could be as high as 100 percent.

Lloyd W. Mints (*University of Chicago*)

It is not possible to insulate public-debt securities from the impact of restrictive-credit policies; nor would it be desirable were it possible.

Margaret G. Myers (*Vassar College*)

It is not desirable to insulate public-debt securities from the rest of the market. From the point of view of controlling inflation, as well as from the point of view of encouraging a pay-as-you-go policy of war financing, it is important to have Government borrowing subject to the test of the market.

The only way by which it is possible to insulate public debt from the market is to force it into the hands of such financial institutions as Government agencies can control: commercial banks primarily, and possibly savings banks and insurance companies. This is a distortion of their function, especially in the case of the commercial banks. If it seems to become necessary from a political point of view because of the difficulty of increasing taxes sufficiently to balance the budget, the whole economic structure will be endangered. We have weathered one such period of war financing but cannot be sure that another can be successfully gone through.

Lawrence S. Ritter (*Michigan State College*)

I do not believe that it would be desirable to insulate public-debt securities in whole from the impact of restrictive-credit policies. This would necessarily involve a severe hardship upon many for which there is little justification. I do believe, however, in view of the size and importance of Treasury refunding operations as well as for other reasons, that such insulation is desirable in part.

In the past decade we have in effect pursued a policy of complete insulation by the simple device of abandoning restrictive-credit policies. Our aim should be to achieve an orderly but not inflexible Government-security market which is compatible with restrictive policies. To that end I would suggest that the Treasury issue securities at rates more acceptable to the market and that support prices be experimentally lowered to slightly below par. Events centering about March 1951 indicate that flexibility can successfully be introduced and that it is possible to withdraw a rigid support program without disastrous results. These measures should be combined with the adoption of some type of reserve plan involving Government securities. Both the Viner plan of differential reserves against various assets and the various secondary reserve plans requiring the holding of Government securities equal to a stated percentage of deposits should be given full consideration. The latter would seem to me to be the more useful.

I would also recommend that, to the extent that they cannot be financed by borrowing from the public, further inflation period deficits, if substantial, should be financed in good part by borrowing from the Federal Reserve or printing currency rather than borrowing from the commercial banks. Combined with this should be the imposition of 100-percent reserves against deposits coming into existence as of a certain date.

George B. Roberts (National City Bank of New York)

It would be possible to accomplish (*b*) in part by applying the totalitarian principle of compulsion to holders of Government securities. It would not, however, (*a*) be desirable.

So far as insulating the interest charge on the public debt from the impact of restrictive credit policies, about the only feasible avenue in this direction would be by funding as much of the debt as possible for long periods. This, of course, would not protect the price of such securities.

Roland I. Robinson (Northwestern University)

It would certainly be desirable and, I think, possible to insulate a large part of the public debt from the direct impact of market-price quotations. I should not think it possible or even desirable to do so for the entire public debt. The market serves several useful purposes, including (*a*) giving individual banks a place in which to adjust their reserve positions, (*b*) giving individual investment institutions a means to adjust their portfolios to meet changed conditions, (*c*) offering an open market in which Federal Reserve credit policy can be given expression, and (*d*) giving a general guide as to the balance between current saving and investment decisions. Insulation of a sizable fraction of the public debt would not conflict with the existence of a market which would serve the above purposes.

Insulation can be by voluntary or mandatory means. If mandatory, such as bank secondary reserve plans, there should be compelling reasons for such an action. Such requirements are not fully consistent with the philosophy of a free economy, though some special circumstances may justify this use.

If the insulation is voluntary, then some bait must be offered investors. Either they must be given direct liquidity or special advantages. Most of the plans so far proposed are those incorporating certain special advantages, such as purchasing power guaranty, annuity rights, and the like. Since most of these suggestions are already spelled out and will be put before the committee, they will not be discussed further here.

In my opinion the most fruitful area for experimentation would be in the securities sold havings institutions. It was the sale of marketable securities acquired during the war by these institutions in the postwar period that made support policy so difficult. Perhaps securities which were not only nonmarketable but also noncashable except to meet deposit, share account, or reserve account drains would be appropriate could be devised.

Earl R. Rolph (University of California, Berkeley)

It is possible to insulate a part of the public debt from a restrictive monetary policy. If legal reserve requirements of member and nonmember banks were increased, accompanied by an offsetting buying of

Government securities by the Reserve banks, the prices of Governments would be prevented from falling and therefore be insulated. Various "fruit salad" types of reserve requirements might also be used to the same effect. Such action would, in my opinion, be desirable in the current setting. But it is not possible to insulate all Government securities from a restrictive monetary policy.

Emerson P. Schmidt (Chamber of Commerce of the United States)

It would be a major blunder to insulate public-debt securities in whole or in part from the impact of credit policies designed to prevent private deficit spending. Such insulation would be a hard-to-resist temptation to go deeper and deeper into governmental deficit financing and the creation of more and more liquid assets which would plague the Federal Reserve System and the Treasury and, indeed, the American people in years to come.

In order that Government policies do not put the whole economy under inflationary pressures, it is important that the Government, along with other borrowers, compete for loanable funds on the open market.

Louis Shere (Indiana University)

It would be desirable, and under certain conditions may become necessary, to insulate public-debt securities in whole or in part from the impact of restrictive credit policies designed primarily to discourage the growth of private debt. Also, it is possible to do so. Some suggested plans to accomplish these ends are desirable, others not.

Among the desirable suggestions are:

(*a*) A plan to require secondary reserves of banks in the form of Federal securities. The interest rate on such securities can be made as low as is necessary to provide the banks with a reasonable level of earnings, while a restrictive credit policy is pursued in the general credit market. I believe that this plan should be implemented and put into effect now to be used if, as, when, and to the extent needed.

(*b*) Compulsory lending of individuals: At some point it becomes difficult to tax or to borrow from the income areas where the most effective impact on expenditures and hence on inflation can be made. I suggest that beyond perhaps another 10 to 20 billion dollars of taxes the resistance to more taxation in the low and lower middle-income groups will become sufficiently effective to defeat an adequate tax program to curb inflation. Hence, if, say, a $15 billion tax program is attempted early in 1952, $5 billion should be in the form of taxes refundable, in decreasing percentages of the total, at retirement. The refundable taxes might be handled in the same way as old-age and survivors insurance payroll taxes with appropriate adjustment of the benefits to the individual accounts. Pressures to increase these benefits as a result of past inflation can be anticipated to be greater if this plan is not followed and similar pressures for added private pension plans, as wage adjustments will also be greater if this plan is not enacted. It is preferable to put some of the anti-inflationary taxes in a form that would avoid building into the fiscal structure and the wage structure elements which create problems of inflexibility after the emergency.

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There is also a strong case in equity for the suggestion. First, because, to fight inflation, less progressive taxes than comport with acceptable standards of tax justice must be employed to be effective; and this must be done in a situation where the distribution of the benefits from the expenditures is less favorable to the low income groups relatively than an equivalent amount of expenditures under truly peacetime conditions.

It is not a sufficient argument against the suggestion to argue that compulsory lending is not the same as compulsory saving because the requirements of compulsory lending can be met by switching assets instead of refraining from expenditure, and that it is the latter which is important for inflation control. The same argument can be made against higher taxes and the savings-bond program, yet nobody would argue that higher taxes and placing more Government securities in the hands of the lower income groups are not effective anti-inflationary devices.

Also, it is not a sufficient argument to point to the disappointing results of compulsory lending experiments during World War II both here and abroad. These plans were beaten by their built-in defects when conceived. The principal defect was in the attempted timing of the refund to fill an income trough that didn't develop, or in putting a near impossible political burden upon the Government's discretionary powers to make the appropriate determination of when the refunds might best be made to attune with economic requirements. To the beneficiaries, economic requirements under inflationary conditions seem entirely different than they do to the Government. The handling of the refunds as an integral part of old-age and survivors insurance benefits would do away with these vexing administrative problems associated with refundable taxes.

Under foreseeable conditions I would not resort to compulsory lending for (*b*) and (*c*); namely, corporations and financial institutions other than banks.

Under the compulsory lending of individuals, the Government securities, instead of entering the general market, would in effect be placed as an investment of the old-age and survivors insurance trust fund. This much of public-debt securities would be insulated from general market conditions which might be managed to discourage private debt. The aggregate amount that should be so placed would depend upon desirable levels of old-age and survivors insurance benefits and their adjustment for loss of purchasing power on account of the inflation that has developed and doubtless will continue to develop as a result of the defense effort. Further, it would not be an undesirable result if old-age and survivors insurance trust funds were thus built up beyond the amounts indicated with a view to ultimate reduction of the scheduled increase on payroll taxes over and above such reductions as might prove to be feasible on account of the upward shift in wage levels incident to inflation.

Also, consideration might be given to the building of a supplementary reserve for unemployment compensation at the Federal level. Nobody can foresee the future economic instabilities which might be building up incident to the current defense effort. Here is another potential outlet for Federal securities insulated from the impact of restricted credit policies.

Among the undesirable suggestions are those that in effect would price Government securities in ways prejudicial to the lower income groups by comparison with the higher income groups. The arch offender is tax exemption, but the discount bond that varies the interest rate with prejudice to short-period retention is not altogether free from this defect.

The proposal for tax exemption is currently being put in the guise of an offset to income that is otherwise taxable instead of in the form of issuing tax-exempt securities. It amounts to offering progressively higher yields for the securities as the income scale is mounted. It would require desperate conditions indeed to warrant resorting to such discrimination in the pricing of Federal credit.

The discount bond with prejudice for early cashing is by no means as offensive as the tax-exempt bond, but it is offensive nevertheless because, as a practical matter, it can be expected that the lower the income of the bondholder, the more likely is he to suffer from the differential pricing implied in the interest rate schedule. Force of financial circumstances rather than the bondholder's disposition to cooperate with his government's financial policies may be the critically important determinant of how long the bonds can be retained. The flexibility in the differential pricing inherent in existing and proposed discount bonds gives the holder an out in case of emergency by comparison with compulsory lending assuming no escape provisions. Such comparison assumes that suitable escape provisions cannot be built into a compulsory lending plan or that it cannot be devised to exclude those most likely to encounter hardships by reason of existing savings commitments, an assumption which is not necessarily so.

It is clear from the foregoing that I recommend against all proposals that are designed to pin down large segments of the public debt by extending the area of the existing type of discount bonds which differentiate the interest or pricing according to the period of retention.

I recommend also against all forms of tax exemption.

Herbert Stein (Committee for Economic Development)

I believe it would be possible but not desirable to insulate public-debt securities in whole or in part from the impact of restrictive credit policies. The existence of a large, widely held, widely acceptable and freely transferable public debt makes an important contribution to the efficiency and fluidity of capital markets. For example, suppose the public saves and wants to hold its savings in the form of claims against life-insurance companies. At the same time the strongest demand for credit is for the kind of loans typically made by commercial banks. Through the medium of the public debt the public's savings invested in life insurance can be made available for bank loans. The insurance companies can buy Government bonds while the commercial banks sell Government bonds and use the proceeds to make loans. I am not aware of any device for insulating Government securities from the effects of credit restriction which does not at the same time tend to insulate, in greater or less degree, one part of the capital market from another. Since I believe that insulating Government securities from the effects of credit restriction is not an ob-

jective of great importance, while the fluidity of capital flows is highly important, I do not regard insulation as desirable.

Henry H. Villard (College of the City of New York)

I believe that it is possible and probably desirable (unless the time required for the institutional changes is used to excuse failure to use monetary policy in the interim) to insulate those Government securities held by the banking system from the impact of restrictive credit policies. By far the neatest scheme to achieve this end would be substantial increases in reserve requirements accompanied by offsetting open-market operations, with the Federal Reserve being given the power to pay interest on reserve balances in an amount equal to the present earnings of the additional securities it acquires. The effect would be that most present bank-held debt would end up in the Federal Reserve so that any increase in interest payments would be recaptured by the Treasury but the banking system would not lose any of its present earnings.

Ray B. Westerfield (Yale University)

I believe public securities should be subject to the same test of the market place as private securities. It is not desirable to insulate public-debt securities in whole or part from the impact of restrictive credit policies. Any such insulation achieved would be of no net benefit to the public; on the contrary, it would be damaging, although quite illusory, particularly in the short run.

5. To what extent do you believe that the demand for Government and other high-grade, fixed-interest-bearing securities by nonbank investors is influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

The majority view appeared to be that the effect of the current level of interest rates on the demand for Government and other high-grade, fixed-interest-bearing securities taken as a whole by nonbank investors was relatively small. Many replies qualified this by saying that a higher level of interest rates would divert funds from equities into high-grade, fixed-interest-bearing securities, while a few economists connected with financial institutions said that the increased amount of promotion which such institutions could undertake if their gross earnings were higher would divert an important amount of funds now held in cash indirectly (i. e., through the medium of the institutions) into high-grade, fixed-interest-bearing securities and would also divert some funds, which would otherwise have gone into consumer expenditures, into savings.

Expectations with respect to changes in interest rates were generally held to have only a small effect on the aggregate demand for high-grade, fixed-interest-bearing securities but a great effect on preferences for short-term versus long-term securities within such media. A number of replies qualified this by stating that, provided only that long-term interest rates were higher than short-term ones, financial institutions having long-term actuarial interest requirements (as life-insurance companies) would, for the most part, continue to purchase the highest yielding high-grade, long-term securities available, with little reference to their expectations concerning rate changes.

The other factor most often mentioned as affecting the demand for high-grade securities was the expectation of higher living costs. This expectation, it was said, diverted investment from high-grade securities into equities and "real values" (especially housing). A number of replies stated or implied that, insofar as higher current interest rates changed expectations with respect to the future level of living costs, they could be considered as themselves influencing the current demand for high-grade securities.

Extracts from typical replies follow:

V. Lewis Bassie (*University of Illinois*)

The general level of interest rates has little effect on the demand for securities. However, artificially maintained rate differentials may have important effects on competing types of securities. Also, when changes in rates are expected, fairly rapid shifts may take place for a time; but, after adjustment to the new level, the general structure of holdings will probably not be much different.

James Washington Bell (*Northwestern University*)

Nonbank investors are not greatly attracted by the current low level of interest rates for high-grade, fixed-interest-bearing securities. They are influenced more by expectations of higher rates and by fear of continued erosion of the purchasing power of the dollar. Evidence is provided by their preference for short-term commitments and their frantic search for hedges against inflation. With current income at present high levels, savings are correspondingly large, and one would expect heavy demands for Government and other bonds. However, yields in corporate issues are edging upward, and conversion privileges are often necessary to induce investment, and the market for Government is sluggish despite sales efforts and the Treasury drive. The heavy supply of investment funds is finding competitive outlets in housing, real estate, durable consumer goods, and the stock market. The market for Governments and other fixed-interest-bearing securities would be immensely stimulated and stabilized, in my opinion, if our dollar were made redeemable in gold. A multiple-commodity standard would serve the same purpose and would be desirable if the administration of conversion of the dollar into such commodities were feasible.

Jules I. Bogen (*New York University*)

Demand for fixed-interest securities by nonbank investors is determined mainly by the inflow of funds. It is not usual for them to keep large amounts of funds uninvested or invested in short-term securities. They are greatly influenced by relative yields on the several types of investments they buy, and such relative yields in turn reflect supply conditions. Thus, the great expansion of mortgage borrowing after 1946 provided an ample supply of such investments at yields sufficiently larger than offered by Government securities to bring large-scale switches from Governments into corporates. This would have occurred regardless of the level of interest rates in all probability, since it was motivated by yield differentials to a large extent. It is possible, of course, that some companies would have been less eager to make this switch if the Government yield would have been 3 percent instead of 2½ percent for long-term bonds. But, where the

mortgage yield was sufficiently high, there would have been pressure to switch, nevertheless. This was so particularly since mortgage loans with FHA insurance and VA guaranties made the mortgage investment comparable in quality with the Government obligation.

Howard S. Ellis (University of California, Berkeley)

(*a*) The demand for Government securities relative to other high-grade, fixed-interest securities is fairly sensitive to differentials in effective yield rates between the two categories. This may be less marked for certain categories of small private investors, but it is quite marked, as recent history has shown, for the investment portfolios of nonfinancial corporations and for life-insurance companies. (*b*) Expectations as to future interest rates are among the main determinants of current interest rates. Thus a widespread conviction on the part of the public that the Government will consistently follow a tight money policy in the future will tend to raise present rates, increase holdings of cash and short-term securities, and thus reduce current spending, including the demand for mortgages and other long-term private debt. (*c*) The credit-rationing effect of tight money policy may equal or exceed the effect of higher interest rates. A tightening of commercial bank credit will be paralleled by tighter credit in other markets; new flotations and refunding issues of fixed-interest securities will not be as large in the lower grades of commercial bonds as before. This automatically transfers substantial sectors of investor demand to Government securities, even if interest rates were unchanged.

Walter W. Haines (New York University)

(*a*) The demand for high-grade bonds is not significantly affected by the general level of interest rates, taken as a whole. That is, if all interest rates were to double, there would probably be only a small increase in bonds bought. The demand, however, is undoubtedly influenced by the relative rates of interest between high-grade bonds and other securities, such that if the rate of these bonds rose while other rates remained stationary, there would probably be a shift of money into high-grade bonds, out of other types.

(*b*) Expectations of changes in interest rates are probably more important than the current level of rates, both with regard to the structure of rates as a whole and also with regard to relative changes within that structure. If the interest rate is expected to rise generally, there will be a tendency to sell now and hold liquid cash ready for investment after the rise has occurred. On the other hand, if it is expected that high-grade bonds will continue to carry the same interest, but other interest rates will rise in the future, there will be a tendency to move into high-grade bonds now, in the anticipation of shifting back after the change has occurred.

(*c*) Certainly other factors than interest play an important part in the demand for Government and other high-grade bonds. Lack of other safe investments, a belief in a general fall in security values (in which case high grades will fall less than low grades), patriotic motives in the case of Government bonds, the relative attractiveness of real assets (such as a new factory) as opposed to monetary investment—all these and more may have an important effect on demand.

Philip G. Hudson (University of Arizona)

(*a*) I think that higher interest rates on Government securities would attract more nonbank investors.

(*b*) I believe that the possibility of higher interest rates in the future may be hurting the sale of Government securities to nonbank investors, but

(*c*) I feel that the possibility of loss of real income through further inflation is a much greater factor to be overcome in the marketing of United States bonds.

Fritz Machlup (Johns Hopkins University)

The Demand for Government Securities.—The demand for Government securities on the part of nonbank investors is greatly influenced by the current level of interest rates as well as by expectations with respect to changes in interest rates. The demand for Government bonds is very elastic. If the yield of Government securities is more attractive, such securities will be a favored substitute for other assets. Moreover, if the yield is high, the likelihood of a subsequent fall in security prices is small and investors will be less apprehensive of the possibility of capital losses. A security yielding 3 percent can easily fall in price because everybody remembers that yields can go much higher. If the yield, however, is increased, the holding of Government securities may, despite a momentary shock to large holders, become very attractive to those who look for appreciation of their investment as well as to those who look for income.

James A. Maxwell (Clark University)

At present I suspect that the most influential single factor is the expectation of a rising price level. But I think that the demand of nonbank investors is influenced somewhat by the level of interest rates, and I would like the Treasury to put this proposition to the test of the market.

Lloyd W. Mints (University of Chicago)

The demand of lenders, bankers, and others for Government and other high-grade securities is undoubtedly influenced by the rate of interest on these as compared with other possible outlets for their funds; but I doubt that the absolute level of interest rates generally is a significant influence. Expectations of changes in interest rates might conceivably have some influence, although even here such expectations will be associated with expectations concerning the level of output, and it is this latter set of expectations that will exercise the major influence.

T. Bruce Robb (William Jewell College)

(*a*) Undoubtedly the current level of interest rates on high-grade fixed-interest-bearing securities is causing many investors to purchase common stocks where rates of return are much more attractive. However, recent buying of common stocks has also been influenced by the inflation specter as many people have tried to get out of fixed-interest-bearing securities whose principal is paid in a given number of dollars.

(*b*) We doubt that expectations with respect to changes in interest rates are greatly affecting the direction of flow of investment funds. The public has come to believe that interest rates, something like those

obtaining in recent years, are here to stay and people are placing their funds in conformity with that conviction.

(c) In addition to the low current level of interest rates, the fear of additional inflation is the most important factor in the lack of demand for Government and other high-grade fixed-interest-bearing securities by nonbank investors.

Emerson P. Schmidt (*Chamber of Commerce of the United States*)

The United States Treasury in its savings-bond campaign puts strong emphasis on interest accruals as inducement to buy. Evidently, the Treasury regards interest earnings as a factor in the sale and purchase of these bonds. To argue that a little higher rate would not reduce redemptions and would not increase sales is not only contrary to the implications of official pronouncements of the United States Treasury but is a species of "economic atheism" which will continue to encourage the monetization of the debt. Just because the interest earnings are not the only factor influencing saving and because the complex patterns of factors governing saving are hard to analyze, is not reason for ignoring the role of interest as a price in our price-mechanism-dominated economy.

Louis Shere (*Indiana University*)

I do not believe that the demand for Government securities by nonbank investors is influenced appreciably by either the current or expected change in interest rates. In general, the financial institutions place their funds as they receive them on the best terms available with due regard to liquidity requirements and the distribution of risk in their portfolios. They strive for optimum income results within narrow limitations as regards the main factors, and hence are always somewhat affected by interest rates, but ordinarily this is not the primary factor. Moreover, the uncertainties as regards changes in interest rates render it impracticable for them to hold out funds in anticipation of change. The liabilities of some financial institutions are such, however, as to require a minimum return, and if this minimum is approached, spelling the prospect of insolvency, sharp shifts in portfolio may result. This is not the same as to say that the demand for Government securities is elastic in relation to interest rate variations.

Outside the area of financial institutions I suspect that there is even less response of investment in Government securities to changes in interest rate. Here Government securities are held not primarily for income, but for liquidity, whether it be in anticipation of tax, inventory, or other requirement. * * *

Bradford B. Smith (*United States Steel Corp.*)

At the present time I judge that the principal factor influencing (adversely) the demand for Government and other high-grade bonds (other than short-term) is doubt about the future value of the dollar.

James B. Trant (*Louisiana State University*)

It appears to me that the demand for Government and other high-grade, fixed-interest-bearing securities by nonbank investors is influenced by (a) the current level of interest rates. This is illustrated by the shift to common stock not only by individual investors but even in the trust field. The demand for such securities is greatly influenced

by (*b*) expectation with respect to changes in interest rates, (*c*) the importance of other factors would depend upon a variety of other circumstances which makes it difficult to discuss at this point.

Rufus S. Tucker (*General Motors Corp.*)

I believe that current interest rates have little effect on the demand for Government securities and such effect as they have is based not on their actual height but on a comparison with savings deposits or other bonds or mortgages. More important factors are the desire for liquidity on the positive side and the fear of inflation on the negative. The demand for other high-grade bonds is also more affected by the fear of inflation or the presence or absence of attractive equity investments.

C. R. Whittlesey (*University of Pennsylvania*)

Nonbank investors, such as insurance companies, will lend at any rate once they become accustomed to it or are convinced that a rise will not occur soon enough to compensate them for waiting. That is inherent in the nature of their business; they are continually in receipt of a heavy net inflow of funds and simply cannot refrain from investing for any significant period of time. The principal determinants of investment policy at any one time are the spread among rates (pattern of rates) and expectations with respect to changes in the level and pattern of rates rather than the absolute level of rates.

6. Discuss the merits and demerits of the proposal for the issuance of a bond, the value of which would be guaranteed in terms of purchasing power.

A large majority of economists were opposed to the issuance of a purchasing-power bond.

Three arguments were advanced in favor of the issuance of such a bond. The two commonest arguments were (1) that the issuance of such a bond was only fair in order to give the small saver a safe refuge for his savings, and (2) that it would make an important contribution to the fight against inflation by increasing the current level of liquid savings. Some economists thought that the issuance of a purchasing-power bond would be a restraining influence on future Government finance, although a larger number of replies thought that it would have the reverse effect. Some economists who favored the issuance of a purchasing-power bond believed that it should be done initially only on a small experimental scale.

The principal arguments advanced by those opposed to the issuance of a purchasing-power bond were (1) the issuance of such a bond, by lulling small savers into a sense of security, might diminish existing fiscal restraints on Government; (2) it would reduce the inherent resistance of the economic system to inflation by adding another "escalator clause" to those already in existence and would constitute in effect an official recognition that future inflation was likely; (3) it might precipitate a financial crisis by causing holders of existing life-insurance policies, savings deposits, etc., to become dissatisfied with them and seek to exchange them into guaranteed purchasing-power obligations; (4) the determination of the index measuring the price at which the bonds would be repaid would present technical difficulties and—no matter how decided—would result in popular dissatisfaction; (5) such

bonds, to be fair, should be adjusted for increases as well as for reductions in the purchasing power of the dollar, but this would result in much popular dissatisfaction and would probably be politically impracticable, and, finally, (6) the issuance of such bonds would be an irresponsible act on the part of the Government, as there could be no assurance that the obligation represented by them could be met at all times.

Some replies compared purchasing-power bonds with the old gold-clause bonds, some drawing the conclusion that their issuance would be equally ill-advised and others the opposite conclusion; that the correct solution for the whole problem was to return to a gold-coin standard.

Extracts from typical replies follow:

E. Sherman Adams (New York University)

The only good argument for issuing a purchasing-power bond would be that it might be done in such a way as to persuade large numbers of people to spend less and save more to such an extent that an important contribution would be made toward combating inflation. Restrictions on purchases of these bonds would have to be devised to prevent much diversion of either past savings or regular current savings from other forms into the new bonds. This would mean that the bonds could be purchased only in comparatively small amounts per individual, presumably on payroll-deduction plans or similar basis.

Unless these restrictions are very carefully designed and safeguarded, much harm might be done to other forms of savings. Moreover, the new bonds might not increase current savings appreciably.

The argument is sometimes advanced that investors in savings bonds are entitled to special immunities against the hazards of inflation. When a grass fire threatens to burn down a school, the job of the firemen is to put out the fire, not to pick out three or four children to take for a ride on the fire truck. The entire community should be protected against the destructive flames of inflation, but this should be accomplished by sound public policies which will check the blaze, not by conferring special immunities on special groups. To the extent that such immunities are granted, the less is the resistance to inflationary policies and the greater the suffering of those individuals who do not enjoy special immunity.

G. L. Bach (Carnegie Institute of Technology)

The essence of such a security would be its redeemability, when due, in terms of an amount of dollars representing a stable amount of purchasing power rather than in terms of the number of dollars originally paid for the security. Interest payments might or might not carry the purchasing-power adjustment feature. The basic idea might be incorporated in any type of security—marketable or nonmarketable, redeemable at the holder's option or nonredeemable before maturity, coupon-bearing or with interest accumulated to maturity. Any type of price index could be used to compute the purchasing-power adjustment; most discussion seems to have been in terms of using a standard index of prices paid by middle- or lower-income consumers on major components in their standards of living.

My answer to the question assumes that the bonds would be of at least 10 years' maturity, would be redeemable by the holder with the

purchasing-power adjustment only at maturity (though earlier redemption might be permitted with some penalty), would cumulate interest as in the present series E bonds with interest also purchasing-power-guaranteed, would carry an interest rate substantially lower than the present series E bonds in compensation for the special purchasing-power protection, and would use a Consumers' Price Index for purchasing-power corrections. These particular characteristics are assumed merely to provide a more concrete basis for my answer to the question.

The main possible advantages of such securities would appear to be the following:

(1) In an inflationary period like the past few years, such securities would probably be attractive to many investors. They might thus be able to draw funds into the Treasury that would otherwise be spent to increase inflationary pressures. Thus they might be an especially anti-inflationary type of issue.

There is no direct evidence as to how attractive such bonds would be—this would depend especially on the public's expectation concerning the future trend of prices over the life of the bonds and on the public's understanding of the new feature. Such bonds might be especially attractive to individual savers, especially those in the middle and lower income groups who most need to invest their savings in conservative, nonspeculative assets and who are relatively inexpert in protecting themselves against cyclical instability through more traditional investments available to larger investors. For such individuals, hesitant to engage in security or other speculation, a general anticipation of rising prices places a premium on current spending of income as against saving. This spending helps produce an even stronger inflationary pressure. Availability of guaranteed purchasing power bonds would render investment in Government securities more attractive in such periods; less potential savings would go into durable consumers goods, housing, and other such real assets.

In addition to providing an incentive for increased saving out of current income, such securities might absorb idle cash balances. Holding cash becomes increasingly unattractive as inflation progresses and further price rises are expected; absorption of idle cash by guaranteed purchasing power bonds might prevent the spending of such accumulated cash on real assets and thus mitigate inflationary pressures.

Whatever the actual quantitative effect, the availability of such securities should help induce individual and institutional savers to behave in a way conducive to greater economic stability.

(2) Guaranteed purchasing power bonds would fulfill a real investment need for lower and middle income individual savers and for certain types of institutions that seek primarily security of capital in terms of purchasing power with only secondary emphasis on yield. Examples are persons wanting to provide for old age, future schooling for children, and unforeseen future contingencies. Neither cash, nor existing types of securities, nor commodities or real estate really fulfills the investment needs of such small savers, who in total comprise a substantial part of our total population. Insofar as the Government should seek to meet the investment needs of particular groups, purchasing power bonds might meet a real need for some groups of savers. More broadly, it is my belief that the Government has a moral respon-

sibility to preserve the real value of the Nation's monetary unit. I believe it should and can fulfill this responsibility. Since there is much uncertainty on the matter, the Government can at least make available the limited protection of constant purchasing power bonds to those savers who are unable to protect their savings in the ways open to larger investors.

(3) Awareness of the potential increase in the Government's dollar liability on purchasing power bonds if inflation occurs might make more vivid to the public, the Congress, and the executive branch the need to avoid inflation, and hence help impell more vigorous steps against the inflation.

The main disadvantages of such securities appear to be:

(1) Such bonds would in effect establish an unlimited contingent liability for the Government. With a large volume of such bonds outstanding, serious inflation could mean an enormous increase in Government's debt liability. This liability could only be met by taxes imposed by the Congress or by additional borrowing by the Treasury. Neither is an alternative to be viewed with equanimity. A substantial offset to this potential liability would exist, however. In an inflationary period incomes would rise, providing both an enlarged tax base which would automatically provide increased tax revenues and larger money savings on which new borrowings might draw.

(2) Tying wages and particular prices to changes in the cost of living has already become fairly common in our economy. There are real advantages to such arrangements. But there is also a great danger that the spread of such arrangements may make continued inflation almost automatic once it starts. With a large volume of purchasing power bonds outstanding, the incentive of those bondholders to worry about aggressive inflation control measures might be substantially lessened (contrary to argument (3) above). Moreover, Treasury issuance of purchasing power bonds might be construed as Government admission that inflation is inevitable.

(3) Experimentation with radically new types of securities involves important risks. It is essential to maintain public confidence in the credit of the United States. Thus, new issues that may generally be felt to be "newfangled" or fiscally unsound should be experimented with at first only on a limited scale, designed to provide maximum information on the usefulness of the security issued and to permit an early conclusion of the experiment if it proves unsatisfactory. This consideration is thus an important one as to how purchasing-power bonds should be tried, but hardly a crucial argument against their experimental use.

(4) Opponents of the security have sometimes argued (*a*) that it would endanger the present holding of a great mass of the outstanding debt, because present holders would all want to shift into the new security; (*b*) that it would endanger our financial institutions such as insurance companies, since savers would want to buy the new bonds rather than saving through the traditional channels which are not protected against price level fluctuations; and (*c*) nobody would really want to buy the new purchasing power bonds. Obviously, the positions are incompatible, though they have been expressed by the same persons. As indicated above, evidence on the bonds' salability is mixed; something would depend on the interest rate used, and more

on the exact type of security and the sales program followed. But the fears (*a*) and (*b*) can easily be protected against by beginning to experiment on a limited scale. If fear (*c*) is correct, at worst the experiment will have turned out to involve substantial administrative time and expense, a possibility that is usually present with any new venture.

In my judgment, the potential advantages of purchasing-power bonds for at least limited use overweigh the potential disadvantages. I would suggest experimental use, with purchases limited to individuals and trust funds and to a relatively small amount per buyer per year at the outset. Such securities appear especially attractive for use in connection with retirement annuities or other retirement plans, and consideration might be given to combining them with Government or privately sold retirement insurance.

Murray R. Benedict (*University of California, Berkeley*)

This idea has a superficial attractiveness and appeals to one's desire for fairness to investors. In my opinion, however, it is a dangerous approach to the problem. If applied to bond values it would logically also be applied to private debts, wage rates, rents, prices, and so on, and thus would contribute to instability and would speed up inflation to an extent that it might well get entirely out of hand.

W. A. Berridge (*Metropolitan Life Insurance Co.*)

The superficial merits of such a scheme—the obvious appeal to the investor, and the attraction of funds to the Government—are the very factors which make it dangerous for the Government and for the economy as a whole. Such an unpredictable and open-ended commitment is clearly unsound fiscal policy and could all too readily lead to abrogation of the commitment, or to insolvency. The scheme would automatically add fuel to the inflation fire in a period of rising prices, by its vicious circle of rising prices and increasing dollar payments. Such an offer on some Government bonds would unfairly and dangerously discriminate, and make less attractive other Federal bonds, non-Federal bonds, private bonds, mortgages, insurance policies, and savings accounts, and would even tend, in inflationary periods like the present, to promote frantic selling of unfavored securities. It is obviously impossible for private institutions, lacking power to socialize risk through taxation, to guarantee purchasing power. Such a Government guaranty on its bonds would (as its lending proponent concedes) tempt people to demand socialization of life insurance and savings so that the Government could similarly guarantee those obligations.

Ralph H. Blodgett (*University of Florida*)

The issuance of bonds the value of which would be guaranteed in terms of purchasing power is one thing about which I am enthusiastic. I understand that bond sales are not going too well at present and I am not surprised. How silly it is to advertise that the Government will return $4 for $3 when everyone knows, usually through sad experience, that the $4, when received, are likely to buy only what used to be $2 worth of real goods.

If the Government would guarantee the purchasing power of the principal of its bonds by paying off with a variable number of dollars—

(*a*) Bonds would be purchased in tremendous volume by people seeking some measure of security in an uncertain and unstable world.

(*b*) This borrowing would be noninflationary, since people would gladly buy the bonds out of current income which might otherwise be spent on consumption.

(*c*) Fewer bonds would have to be sold by the Government to the banks, and sales to the banks are inflationary since they are paid for by creating demand deposits in favor of the Government.

(*d*) Interest rates on Government bonds would not have to be raised. People would buy bonds even at low interest rates if they were given security as to the purchasing power of their principal.

(*e*) Buyers might put up with unfavorable conditions of other sorts. To get security of principal, people might buy bonds, for example, which could not be redeemed at all for, say, 10 years.

I don't know of many disadvantages in connection with the proposal, but—

(*a*) If inflation continued and prices kept on rising, it would cost the Government a lot of money sometime to redeem the bonds with a number of dollars that would have the promised purchasing power. However, the effect of having large volumes of such bonds outstanding might have a sobering influence on the Government and keep it from promoting inflation as much as it has in the past.

(*b*) Sales of such bonds might be restrained by the fact that people might not trust the Government to make good on its promise. I doubt that you gentlemen realize the extent to which the Federal Government is distrusted by many people. Remember the gold clause that used to appear in Government bonds? If you don't want to guarantee the purchasing power of principal, why not promise once more to let people, who want to do so, redeem their bonds in gold? Not many people would ask for gold if they knew they could get it.

Jules I. Bogen (New York University)

Issuance of a bond guaranteed in terms of purchasing power would lessen public resistance to inflation policies, impose an uncertain future obligation on the Treasury to pay interest and principal, attract a wholesale shift of savings from existing institutions and securities into the new Treasury obligations. It would further undermine confidence in the willingness of the Government to avoid inflation and to promote reasonable stability of the dollar's purchasing power.

The only merit is to step up sales of savings bonds, but this is of dubious value. From the viewpoint of the economy, savings that flow into financial institutions can lessen inflationary pressure from consumers just like savings that are used to buy savings bonds from the Treasury. This would be so especially if the savings institutions will invest new savings in Government securities along with other commitments.

Raymond T. Bowman, Philip J. Bourque, Raymond T. Bye, H. LaRue Frain, Paul F. Gemmill, Amor Gosfield, Arleigh P. Hess, Jr., Almarin Phillips, Karl Scholz, Sidney Weintraub (University of Pennsylvania)

We view with considerable favor the idea of issuing a Government bond with a repayment at maturity based on changes in the cost of

living. We believe, however, that the following conditions must be recognized. The issuance of such a bond cannot be a primary action to counteract inflation, but can only be viewed as an auxiliary action which would make some of the other necessary actions easier. Furthermore, we do not believe that "escalator principles," and this is one, should be encouraged generally.

We do agree, however, that Government E bonds (or bonds of this type) might advantageously be issued with a promise to pay at maturity in terms of the changed value of the dollar as measured by an index of consumer prices. The promise should be to pay the face of the bond or the corrected face, whichever is higher. The total quantity of bonds which each individual could hold should be limited, and they should only be available to individuals. All other conditions applying to current E bonds should also hold.

The advantages we see stem largely from the increased saving (not spending) this kind of bond would induce from individuals. We think it might materially increase the volume of Government debt, current and prospective, that would be held by individuals. Continued holding of the bonds should be voluntary, but there would tend to be some automatic corrective to excessive withdrawals. Withdrawals and the spending of the proceeds would tend to push up the consumer price index, and therefore make it more attractive to hold bonds. We wish to stress the limited character of this type of bond, and to emphasize the need to stop inflation and not merely to inflate everything by some escalator provision.

Neil Carothers (*Lehigh University*)

The issuance of a Government bond with a guaranty of purchasing power is wholly impracticable. (1) In the event of a large decline in the price level the holders would be bitterly resentful. (2) In the event of a very large inflationary rise in prices it would completely disorganize the Government's handling of outstanding debt. (3) It would cause a disastrous decline in the value of bonds now outstanding. (4) It would be a confession that the present Government has no plans for controlling inflation.

J. M. Clark (*Columbia University*)

Bonds, the principal of which is repayable in constant purchasing power, would partially, but only partially, protect the investor against inflation, and might substantially reduce resistance to investment in Government bonds. They would give Government a moderate incentive to increased resistance to inflation (less than if interest were also paid in constant purchasing power) and might slightly reduce popular fear of, and resistance to, inflation. If inflation came, they would increase the principal of the public debt at refunding time. This prospect, being not immediate, might have relatively little current effect in strengthening resistance to inflation.

John C. Clendenin (*University of California, Los Angeles*)

A purchasing-power bond would have a great reception, for there is now no investment available which combines freedom from the credit risk with freedom from the equally severe purchasing-power risk. Such a bond should probably be a low-yield, nontransferable savings bond, redeemable only after 90 days' notice, and limited as to annual purchase amount.

However, it would need a very careful sales presentation, for its very existence implies a weakness in savings bank, ordinary bond, and life insurance investments.

The social need for a purchasing-power bond as a long-term savings and retirement-consumption device is very great.

To me, there is no speculation by the Government implied here. The Government promises to return what it borrows, in real terms.

George T. Conklin, Jr. (*Guardian Life Insurance Company of America*)

The issuance of the purchasing power bond would be an unfortunate event; far from helping solve the inflationary problem, it would magnify the problem greatly over the long term. The superficial merit of the proposal is that it would ease the iniquities of inflation for the individual who places his faith in the Government by investing in E bonds. However, what it really amounts to is an admission by the Government that they have defrauded past purchasers of E bonds by inadequate fiscal, monetary, and credit policies of the past which have resulted in inflation; that they are apt to pursue these policies again, but will protect the purchasers of E bonds against their effects.

Such an issue would obviously put other forms of savings at a competitive disadvantage and would eventually require them to adopt a similar policy. This would continue to spread throughout our economy, until we had no fixed incomes eventually.

The purpose obviously is to get rid of the iniquities of inflation by wishing them upon everybody rather than upon the saving class, alone. But unfortunately, you cannot escape the effects of inflation this way. By tying everything to prices you would create a price spiral that would make the wage-price spiral look anemic by comparison. Essentially everything would be chasing everything else with no hope of catching it. It would be like chasing the rainbow. All this conceivably would not do great harm were it not for psychology.

Why is there so much pressure for a purchasing-power bond? Examine the argument of Slichter who has been one of its earliest proponents. His whole argument stems about one thesis, namely, that the long-term trend in prices is surely steadily inflationary. The grave danger of tying all claims and assets to prices is that once the public feels that it is inevitable that the price trend is upward, it will tend to flee from money, and once this process starts with everything keyed to prices, you will not have the long-term creeping inflation predicted or assumed in the first place; you will have a galloping inflation that will destroy the currency as has so often happened in monetary history.

The only way to avoid the iniquities and harmful consequences of inflation is to avoid inflation; and the only method to avoid inflation in a nontotalitarian economy is to adopt courageous and sound monetary, fiscal, and general credit policies.

James C. Dolley (*University of Texas*)

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The prime argument against the authorization of such a Government bond, of course, is simply that the Government, in an emergency, would not live up to the terms of the contract. In such a situation, the Federal Government could be expected to modify the terms of the contract, as was done in the gold clause cases in 1934. That clause

was placed in literally thousands of private and public bond contracts for the precise purpose of protecting the lender against depreciation in the purchase power of the dollar. Despite this fact, when it suited political needs to do so, the clause was abrogated. It is reasonable to believe that history will repeat itself, so why delude another generation of bond buyers?

Fred R. Fairchild (Yale University)

Referring to your paragraph 6, I think there is much to be said for a Government bond guaranty in terms of purchasing power. However, the release of the money market from Government restrictions, and proper adjustment of the interest rate on Government obligations, which I have already recommended, would very largely remove the necessity of this device.

Milton Friedman (University of Chicago)

I strongly favor the issuance of a purchasing-power bond on two grounds: (*a*) It would provide a means for lower- and middle-income groups to protect their capital against the ravages of inflation. This group has almost no effective means of doing so now. It seems to me equitable and socially desirable that they should. (*b*) It would permit the Treasury to sell bonds without engaging in advertising and promotion that at best is highly misleading at worst, close to being downright immoral. The Treasury urges people to buy bonds as a means of securing their future. Is the implicit promise one that it can make in good faith, in light of the past experience of purchasers of such bonds who have seen their purchasing power eaten away by price rises? If it can be, there is no cost involved in making the promise explicit by adding a purchasing-power guaranty. If it cannot be, it seems to me intolerable that an agency of the public deliberately mislead the public.

The issuance of purchasing-power bonds might increase voluntary savings because they would be more attractive than existing means of investing savings open to the general public, but I regard this as a minor advantage compared with the two just stated. An additional minor advantage is that it might make the Treasury place greater emphasis on the important problem of preventing inflation and less emphasis on the unimportant problem of keeping nominal interest payments low.

The major disadvantage urged against purchasing-power bonds is that, like escalator contracts in general, they will make any inflation that occurs proceed more rapidly than otherwise because an additional class is protected against its ravages. It is not clear to me that this is a disadvantage; it may indeed be an advantage.

R. A. Gordon (University of California, Berkeley)

I favor this proposal, the merits of which seem to me strongly to outweigh the disadvantages.

George H. Hildebrand (University of California, Los Angeles)

I believe the purchasing-power bond has considerable merit in equity. Why should savers be expected to take losses of inflation when all other effective groups gain protections and see to it that inflation continues? Great nations have been ruined by inflation, for inflation destroys the reasons for saving, and with a decline of saving

plant wastage is not made up and capital growth is checked. This impairs the standard of living in the long run. We must face the long run.

Richard W. Lindholm (Michigan State College)

To be a success in 1951, a savings bond program must reflect the economic experience of the Nation as accurately as did the savings bond program inaugurated in 1935 and greatly expanded during the World War II period. During the postwar period, the outstanding economic experience of the Nation has been continuing inflation; and to meet investor's needs successfully after a period of inflation, as did the World War II savings bond after a period of deflation, a savings bond must assure a constant purchasing power.

Fritz Machlup (Johns Hopkins University)

Purchasing Power Bonds.—The question of bonds guaranteed in terms of purchasing power would never have arisen if the Government had pursued an anti-inflationary monetary policy. Now that we have had inflation for several years, I believe that the issuance of such bonds should be seriously considered. Indeed, we may regard this as a question of ethics as much as of economics. For it is immoral for a government to inveigle its people into buying its securities not secured against deterioration in purchasing power while that government at the same time pursues a policy which must of necessity result in reducing the real value of its money and of its money debts. To advise people to buy bonds while we know that those who do not buy them will be relatively better off, is not far from fraudulent. Those who are perpetrating this deception may be under the delusion that price controls will protect the bondholders. No price controls, however, have ever succeeded in doing this in the long run. Hence, if we wish people to put their savings into Government bonds, we should pursue the strictest anti-inflationary fiscal and monetary policies or we should promise the buyers of bonds that they will not suffer from inflationary policies of the Government.

James W. Martin (University of Kentucky)

The failure of Congress to regulate the value of money in the interest of the Government's own creditors during the past few years seriously impairs the public borrowing power in certain particular directions. One way around this would be a bond of constant purchasing power. Against such an instrument there seems to me to be two classes of important arguments: (*a*) Some people would not accept the guarantee as consequential in view of the Government's repudiation of the gold clause in earlier bonds; (*b*) there would be a problem of defining constant purchasing power.

A. Wilfred May (Commercial and Financial Chronicle)

(It would seem that your wording of the question implies a one-way guaranty, not a two-way adjustment. But even in the event of the later interpretation, I am opposed). I strongly oppose the proposal for the issuance of a Government bond carrying a guaranty of its value in terfs of purchasing power. Such a provision would contravene both public policy and the just equity of this credit-debtor relationship.

The Government's extension of such privilege, akin to a one-way gold clause, to a single fixed-interest investing medium would discriminate against individuals holding all other fixed-interest investments, such as: the 17 billions residing in our savings institutions, including mutual savings bank deposits; and the 240 billions in private life insurance policies. It is true that the ineligibility of institutional buyers would insure a continuation of corporate bond financing, but it would not obviate such discrimination.

The institutions owing these huge sums directly to millions of private citizens assuredly would be drastically undermined by the competition from a purchasing-power guaranty (particularly in view of the exaggeration of its attractiveness during the current "new era" of inflation consciousness). Because of legal restrictions and the nature of their operations, they cannot protect themselves against the threat of a rising price level by a major shift of their assets from money obligations into equities. And to the extent that they would be able to dispose of their fixed-interest securities and buy inflation-hedging common stocks, they would be abetting flight from the dollar and rendering even more difficult the Government's over-all financing problem.

"Escalator service" for bondholders would give still another group a "stake" in inflation, adding to the already too large part of the community which thus loses interest in removing its causes.

The guaranty proposal rests importantly on the concept of "wrong" involved in selling savings bonds because of the dollar-depreciation element. This assumes that changes in purchasing power constitute a one-way street. Let it be remembered that although the price level has risen appreciably over the very long term, there have been many intervals during which the holder of obligations payable in a fixed number of dollars has benefited from their increased purchasing power.

After the First World War the buyer of a 10-year bond in 1920 would have gained 17 percent at its 1930 maturity date, the 1921 buyer 27 percent, and all succeeding buyers through 1931 would have profited in varying amounts through dollar appreciation. When this occurs the bond buyer is enviously referred to as "bloated," not "defrauded."

Such purchasing-power appreciation intervals have likewise occurred even in the European money-depreciation countries.

In lieu of concentrating exclusive attention on the E bond's shortcomings and need for additional protection, let its great existing advantages be cited to the public. In addition to the unquestioned faith of dollar principal and interest, the yield—3.3 percent annually or 2.9 percent on the basis of compounding semiannually over the 10-year period—materially exceeds the return from even inferior fixed-interest obligations. Perhaps the greatest advantage to the savings bondholder is the continuing money-back option, making the bonds the equivalent of interest-bearing currency.

Through this call feature, a privilege unprecedented in world finance, the holder retains the constant choice of changing his investment from long term to short term, and at definitely guaranteed prices.

The recent removal of the Reserve system's pegs on the open-market bonds with the introduction of the host of imponderables surrounding their market pricing, further highlights the clearly stated, reliable and continuing cash-in privilege of the savings bonds.

Emphasis on these real, practical investment advantages, instead of harping on the dollar-depreciation potential, would truly constitute a constructive service to the lay saver as well as effective furtherance of the Government's savings-bond program.

Raymond F. Mikesell (*University of Virginia*)

I would personally find such a bond very attractive. However, I doubt if the average investor whose saving habits must be influenced if such a proposal is to have a significant effect in reducing inflationary pressures, would be sufficiently attracted to make a real difference. It might be attempted on a small experimental scale. But the average American still has the money illusion and God help us if he should ever lose it.

Hyman P. Minsky (*Brown University*)

A bond whose value is fixed in purchasing power would have no effect upon the money market if inflation or deflation were not in prospect. During World War II, the country was depression-minded; the dominant belief was that following the war there might be a short boom but it would soon be followed by a lengthy depression. Under these conditions a guaranteed purchasing power bond could not have been sold unless it carried a large yield.

Today, fiscal irresponsibility on the part of the Congress is taken for granted. The expectation is that inflation will take place. A hedge against inflation would be bought. A guaranteed purchasing power bond would find a market. I will try to analyze two different types of issues: One, a series E bond type, the other, an unlimited all investors type bond.

Assume an issue of series E type bonds, limited to a few thousand dollars a year per person. Given the prospects of inflation undiminished, such a bond would have a yield of 5 or 6 percent greater than its face yield (e. g. a 2-percent bond would, with present inflation prospects, be equivalent to at least a 7- or 8-percent yield). Any person holding redeemable Government bonds such as the series E bonds would, with present inflation prospects, cash these bonds in for the new bonds. Any person holding other assets would try to sell them. This would continue until such time as the market price of non-price-level issues fell to such an extent that their yield would be equal to the expected yield on the purchasing power parity bonds. This would mean a large rise in the yield, on all private securities and on nonprice level Governments if they were to be sold to private persons in competition with the purchasing power parity bond. This rise in the private security yields could cut down private business investment programs. To that extent the effect of the purchasing power bond would be deflationary (to the extent that it represents a rise from 2.5 percent to 7 percent in the yield on Government debt). * * *

General conclusions: A purchasing power bond will do nothing, as far as inflation control is concerned, that the elimination of bank creation of money and the resultant rise of the interest rates could not accomplish. I, of course, ignored the equity of "protecting" savers against inflation in a society where workers and farmers are "protected" against inflation. Such a spreading of protection would have two results: (*a*) It would add another segment to the population that really doesn't mind inflation; (*b*) it would prevent, or make more

difficult, the achievement of the allocational effects of inflation. Both of the above effects would be in the direction of more inflation; and (c) would mean that if the shift in the use of resources that the inflation is implementing is in the direction of Government demand, the Government would have to use even more direct controls than it is now using.

James J. O'Leary (Life Insurance Association of America)

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The merits of such a bond usually put forward are as follows: With the purchasing power of the dollar subject to fluctuation, and particularly subject to decline, the argument is made on grounds of fairness to bondholders for the issuance of a bond payable in constant purchasing power. It is argued that, just as labor has succeeded in preserving the purchasing power of wages through escalator clauses, and the farmer has protected his purchasing power through a system of parity prices, the investor in Government bonds should be protected against price fluctuations through the issuance of a bond payable in constant purchasing power. Aside from considerations of fairness, it is argued that such a bond would undoubtedly have the merit of stimulating the sale of Government securities at a time in which the need for a large volume of personal saving is great.

The demerits of the proposal are clear and compelling. First, the issuance of a Government bond, the value of which was guaranteed in terms of purchasing power, would place other forms of fixed-interest investment at a decided disadvantage and would jeopardize the continued existence of such other forms of investment. For example, corporate bonds, savings accounts, and life insurance policies would also have to be placed on a guaranteed purchasing power basis if they were to compete with the proposed type of Government bond. It will be argued that such forms of investment could be changed over to a constant purchasing power basis. It is difficult to see how this could be done, but even if it were possible with the issuance of new corporate bonds or on new savings accounts or new life insurance policies, it would certainly be impossible in the case of transactions which had been entered into in the past. There would be raised, therefore, the serious problem of fairness to savers who already had their savings programs in effect. Moreover, it appears inevitable that the adoption of a constant purchasing power Government bond would lead to a disastrous collapse in the value of outstanding investment media.

Secondly, this proposal would saddle the Government with an unknown future obligation which would be against all the tenets of sound finance.

Thirdly, the proposal for the issuance of a purchasing power bond suggests the argument which was made recently by a correspondent of the London Economist to the effect that secular inflation is inevitable and that all forms of income should be tied to the rising cost of living. The assumption which is made is that any rise in the general price level will be a gradual one. However, if Government bonds were placed on a constant purchasing power basis, and other investment media and other sources of income were placed on a similar basis, then the general existence of escalator clauses throughout the economy would intensify and make more certain the prospect of further

inflation. Under these circumstances, instead of a "creeping inflation," the country would inevitably move in the direction of a "galloping inflation."

Finally, the adoption of a Government bond guaranteed in terms of purchasing power would be a body blow to the will of the American people to resist inflation.

Unfortunately, it can be argued that because of forces which have already been built into our economy, inflationary pressures will remain persistent. In spite of this, the hard but proper course for the Nation is to adopt and pursue adequate measures of fiscal, public debt management, and credit policy to combat inflationary forces as vigorously as possible. It would be disastrous to issue a Government bond the value of which would be guaranteed in purchasing power.

Henry Oliver (Indiana University)

A guaranteed-purchasing-power bond would cause shifts from other types of investments into such bonds. To the extent that there was a shift away from insurance and bank deposits, the net increase in Government bond sales would probably be negligible, since the financial institutions involved would probably respond by themselves reducing their volume of Government takings. Availability of purchasing-power bonds would reduce the incentive to investment in stocks and in "real" capital, however, and to that extent would decrease inflationary pressures. Housing and expensive consumer durables are two of the areas which would be affected. The anti-inflationary effects of purchasing-power bonds in these areas would of course depend in large part upon the extent to which other controls restricted demand for housing and durables.

A second argument for purchasing-power bonds concerns equity to small savers, who usually do not have the opportunities of large savers to ride upstream with inflation. There seems to be on balance a case for purchasing-power bonds made available to lower-income groups, but not to higher-income groups. I do not care to recommend details of administration.

The bonds should be nontransferrable and noncashable before maturity. It would probably be desirable to tie maturity to some old-age payments scheme, in order to limit inflationary impact of the bonds' maturing.

Harold L. Reed (Cornell University)

* * * something could be accomplished in the general direction of mobilizing savings by issuing a bond with accretions of value more adequately adjusted to the current interest rate pattern. But I fear that to go further and adjust accretions to compensate for changes in the dollar's purchasing power would tend to increase authority's tendency to take inflation for granted. Any such policy would tend to magnify the burden imposed upon holders of other fixed-income securities who are in no position to be protected. The only real solution to the problem is to avoid inflation.

Earl R. Rolph (University of California, Berkeley)

I am a strong advocate of the issuance of Government securities which are guaranteed as to purchasing power. There is a great need in this country for a security which the average investor could buy and use to protect himself from losses in real terms. A beginning

could be made by the issuance of annuities redeemable only upon the owner reaching a certain age, with the payment adjusted for any change in the price level. Once the idea became understood, I think there would be a large demand for this type of asset, which would at the same time reduce demands for goods and services, and not merely reshuffle the types of money and securities held. The purchasing power type of Government security is about the only hope for success in inducing individuals to hold substantial additional amounts of Government obligations. It would also help people solve their social-security problem.

Emerson P. Schmidt (*Chamber of Commerce of the United States*)

To issue a Government bond with the value guaranteed in terms of purchasing power is defeatist and might in time be interpreted by the American people as overt capitulation to perpetual inflation. If the Government issued such a bond, quickly railroads, public utilities, and other borrowers would have to follow suit. Life insurance companies would inevitably be pressured into issuing annuity and other policies on the same basis. Such a program would undoubtedly, if partly successful in the initial stages, negate and destroy public resistance to inflation. It would be "built in" inflation and would in turn encourage more and more deficit financing.

Bradford B. Smith (*United States Steel Corp.*)

Under an honest money policy there would be no occasion to contemplate issuance of a bond, the value of which would be guaranteed in terms of purchasing power. Such guaranties would be tenable only on the hypothesis that the dollar over time spans would not be exchangeable for about the same amount of goods and services. Issuance of such a bond would be confession by the Government itself that the American dollar was untrustworthy.

Harold M. Somers (*University of Buffalo*)

[Letter written by Professor Somers to the editor of the New York Times and published therein December 29, 1950; submitted by Professor Somers to the subcommittee.]

Prof. Sumner Slichter has made the important suggestion that all incomes have a cost-of-living escalator clause attached to them. Since this suggestion has received widespread comment it is worth while to consider seriously the major difficulties that would be encountered if such a plan were put into effect.

(1) Psychologically, as the New York Times has suggested, the inclusion of an escalator clause in Government bonds would represent a defeatist attitude. It would mean that we are reconciling ourselves to inflation. This is not, in itself, a major objection to Professor Slichter's plan. A similar defeatist attitude is taken every time a law is passed—provisions are included in case the law is not obeyed. For instance, when price ceilings were imposed during the Second World War provisions were made for punishment in case of violation. It may be doubted, therefore, that the inclusion of an escalator clause in Government bonds would have any unusual influence of a purely psychological sort.

(2) It must be granted that the inclusion of a cost-of-living provision in Government bonds will attract large sums of money into

those bonds. But this does not mean that the magnitude of the counterinflationary effect may be gaged by the magnitude of bond purchases. Undoubtedly a large portion of the funds will come from bank balances or will be diverted from the purchase of corporation securities. Government bonds will become more attractive relative to other assets. In very few cases will people actually curtail their consumption in order to buy the Government bonds. Many inflation hedges now exist and people who want to curtail their consumption in order to acquire inflation-hedged assets can do so. The mere availability of a new type of inflation hedge, such as Professor Slichter's bonds, is not likely to curtail consumption materially.

Even if some curtailment of consumption takes place as a result of the availability of these bonds the possible inflationary effect of the escalator clause must be considered. The growth in value of the bonds through the cost-of-living provision may in itself encourage consumer expenditures even before the bonds are cashed. And when the bonds are cashed—which may take place under inflationary conditions if the war is a long one—there is very likely to be an impetus to consumer expenditures resulting from the swollen redemption value.

(3) Politically, the inclusion of an escalator clause in all forms of income gives everyone a stake in inflation. If everyone has a stake in inflation what chance is there of enacting or enforcing any counterinflationary measures? Even at the present time, when there are so many millions of people who are vulnerable to inflation, it is very difficult to get adequate control measures through Congress. If all forms of income, both earned and property income, are hedged against inflation, it is hard to see where the support for anti-inflation measures will come from.

It is one thing to have a million workers with a cost-of-living provision as part of a collective-bargaining agreement which is designed to insure industrial peace for a 5-year period; it is quite another matter to have the entire population protected against, hence indifferent to, a run-away inflation. It is true that equity would be achieved; but a run-away inflation, whether equitably distributed or not, would disrupt the economy and disorganize the war effort. Too much of our energy would be devoted to chasing and adjusting prices rather than producing goods and services.

Walter E. Spahr (New York University)

The Government should not issue a bond, bearing a guaranteed purchasing power. The value of Government securities, like the value of other securities and objects, should be determined in free markets. The only proper values known in the economic world are the values obtained objectively—that is, in free markets. Dictated values are the values specified by the dictator; they involve favors for some and penalties for others.

If the Government wishes to be assured of as good a market for its securities as it has any proper right to expect in a free market, the best thing it could do would be to make our currency redeemable in gold at the statutory rate of $35 per fine ounce. A lesson on this point can be found in what happened to the Government bond market when specie payments were resumed in 1879. The demands for Government securities, domestically and from abroad, were so great that the Treasury staff was unable to keep up with orders.

Prices of existing securities rose, and the Treasury was able to sell new securities at lower rates than prevailed in 1878.

Philip E. Taylor (*University of Connecticut*)

Presumably such a bond would be offered only to individuals. Whatever merit the scheme would have would lie in the provision of constant purchasing power for those who own them.

The demerits of the plan, however, far outweigh its merits, in my opinion.

(*a*) If instituted now, after considerable inflation, those whose situation is now worst in the income-distribution pattern would be in poor position to avail themselves of it, because of inadequate savings. And it would place on the escalator capitalwise those who are already on the escalator wagewise and profitwise.

(*b*) Issue of such a bond would make the escalator system even more general than it now is. What is needed is fewer, not more escalators. The more generally escalators are built into the economy, the fewer are the brakes upon inflation. For inflation can be checked from within only when demand weakens as goods are priced out of the reach of a larger and larger number of buyers. Escalators, if true escalators, do not permit the redistribution of wealth and income which can check further inflation. Thus, inflation becomes continuous, unless some external control becomes effective. If external controls were effective, escalators would be unnecessary, while escalators, by compounding inflationary pressures, make effective external controls more difficult.

Edward F. Willett (*Smith College*)

I do not feel qualified to discuss this question in detail. Obviously, the issuance of a bond, the value of which would be guaranteed in terms of purchasing power, would be extraordinarily attractive to investors. Many of them would probably be willing to buy such a bond with an interest rate approaching zero. The major demerit that I can see to the suggestion is that the Government might find itself involved in serious difficulties in carrying out the terms of the bond issue; in other words, paying the additional sums of money that might be required to meet the terms of such a bond issue might in itself be a major factor in promoting a still greater degree of inflation, thus resulting in a serious vicious circle of the inflationary spiral. One of the additional major merits of the proposal would be that it might compel the Government to take serious steps continuously in the future to prevent inflation.

Donald B. Woodward (*Mutual Life Insurance Co. of New York*)

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The proponents of the issue by the United States Government of a bond guaranteed as to purchasing power suggest that such a bond would (*a*) result in greater saving, which greater saving would help to curtail inflation, or (*b*) that it would result in greater nonbank purchase or holding of Government securities and thus lessen monetization of the public debt, with consequent diminution in inflationary pressures, or (*c*) that it would provide some protection to smaller and less well-informed savers.

The demerits of the idea are very large, and they overwhelm any possible merits.

A. The risk to the public credit entailed in this device is greater than should be taken. The international situation and its implications, as well as other factors, make the possibilities of marked further inflation considerable, and the more so because of public apathy about inflation (though there is considerable lip service to the opposite effect). Many of the major economic groups are already attached to one or another form of escalator provision; it is most highly formalized in certain labor contracts providing wage increases when the consumers' price index advances. If the public debt is now attached to an escalator provision as well, the threat to the stability of the currency will be further aggravated.

B. The device would make funds more freely available to finance governmental requirements or desires and would place the private business concerns of the country at a disadvantage. But it is the private business sector of the economy which is largely responsible for the industrial strength which constitutes the great power of the United States in world affairs and for the unprecedented output of goods and services per capita which makes the standard of living in this country unequaled by a wide margin. It would be unwise and undesirable public policy to discriminate further against that great source of national power and welfare.

C. The device would further discriminate against saving in any other form than purchase and holding of Government debt. This would follow a number of years in which public policy has placed emphasis on saving through the purchase of Government securities and payments of social-security taxes. This has at times gone to lengths of suggesting that saving through government is virtuous but that other forms of saving have considerably less merit. But in fact all forms of saving serve alike in curtailing inflation.

D. The device probably would make for economic instability over a period of time instead of the stability that is declared to be the national objective by the Employment Act of 1946. It would be a speculative instrument, into and out of which funds would flow as expectations changed. This would aggravate the problems of Treasury finance and of central banking, make for instability in financial markets, and probably increase the volatility of capital formation.

7. What types of securities do you believe should be the principal vehicles of Government borrowing (*a*) under present conditions, (*b*) in the event of the necessity for substantial net Government borrowing?

Securities covering practically the whole field of possible borrowing vehicles were recommended in one or another of the replies to this question.

A number of replies recommended that the entire debt be funded into marketable perpetual irredeemable consols at whatever interest rate was necessary to effect their sale and that all new borrowing should take place through this medium. Some of these replies either stated or implied that to the extent that an increased (or decreased) supply of money was desirable, borrowing by consols should be supplemented by borrowing from the banking system, or money obtained through the issuance of consols should be used to repay bank-held debt. The economists giving these replies were generally those who desired

to place exclusive reliance on the mechanism of the price system and opposed the use of direct controls even under conditions of extreme national emergency.

The main current of thought in the remainder of the answers, comprising the great majority, was that new borrowing should be concentrated on securities to be sold to nonbank investors. The majority preference was for increased emphasis on nonmarketable securities, although some expressed a desire for long-term marketable securities "not to be supported." Some said that a variety of forms and maturities of securities should be issued, "tailored" to the needs or preferences of different classes of investors. Many replies recommended more liberal terms for E bonds and higher interest rates generally. Some of those who had favored the issuance of a purchasing-power bond in the preceding question took occasion of this question to again recommend its issuance. A considerable number of replies said that in view of the present condition of the market it would be necessary to sell a substantial amount of short-term securities, in part to banks, in order to raise the necessary funds.

Replies in general failed to discriminate sharply between the two contingencies with respect to the amount of Government borrowing stated in the question. A considerable number of the economists replying to the questionnaire as a whole did not answer this question, stating that it involved more technical knowledge of the subject and a closer contact with the market than they believed they possessed.

Extracts from typical replies follow:

G. L. Bach (Carnegie Institute of Technology)

Since the Government is now borrowing substantial amounts net, conditions (*a*) and (*b*) are substantially identical.

This question can be answered only in the framework of general objectives to be sought in the management of the public debt. At present I would emphasize especially the following three objectives, though there are also other important objectives:

(*a*) Issue securities that will stimulate savings and channel savings into the Treasury so as to reduce private spending in the probably inflationary period ahead.

(*b*) Issue securities that will help insulate the outstanding public debt from the impact of anti-inflationary credit policies so the responsible authorities will feel freer to use credit policy aggressively against inflation.

(*c*) Issue securities that will recognize the varying types of needs of different segments of the investment market.

Combination of these three objectives seems to me to point toward substantial reliance on the following for the immediate future:

Long-term nonmarketable investment securities with limited prematurity redeemability.—The 1951 issue of 2¾ percent investment bonds represents a step in this direction. Experimentation with comparable types of issues should continue, to insulate as rapidly as possible the long-term investment part of the debt from the direct impact of restrictive credit policies by getting the securities firmly held in relatively nonliquid form. This step looks in the direction of making the long-term debt actually long term rather than in effect cashable on demand. It would be quite appropriate to pay a moderate interest premium to achieve this purpose.

Short-term bills and certificates to meet the needs of investors who definitely want highly liquid securities, either to protect against contingencies or to meet known cash needs in the near future. This step looks in the direction of satisfying the market's need for liquid instruments by selling frankly short-term, low interest rate securities. Such securities should, of course, be priced to carry yields appropriate to current market conditions. If money rates are tightened to check inflation or if they tighten without Government intervention, an appropriately higher rate on such securities is indicated.

Traditional long-term bonds—but only insofar as the special investment type securities listed above cannot be sold at moderate interest premiums, and only if the market and the Federal authorities understand that the price of such "traditional" securities will not be guaranteed against at least moderate market fluctuations. This looks in the direction of satisfying the market demand for traditional marketable long-term securities where necessary, but building recognition that such issues are not protected against at least moderate price fluctuations.

Beyond these issues, experimentation with the following should be considered:

Purchasing power bonds: These were discussed in the preceding question.

Government sale of retirement annuities, possibly as a supplement to the present social securities plan though on a voluntary basis. Combination of annuities with the purchasing power bond idea merits careful investigation.

James Washington Bell (Northwestern University)

We have a fairly good variety of marketable issues to serve most investors' needs and these types should be adequate under present conditions. Perhaps a 3-percent long-term bond, maturing, let us say, in 1975 or 1980, to correspond to some corporate bonds now outstanding, would be a feasible addition. Insurance companies and other financial institutions with substantial uninvested funds might find such a new issue a favorable outlet for their funds.

In the event of substantial amounts of new borrowing, it would probably not be feasible to offer high enough yields to induce the market to absorb them—at least not immediately. New high-rate bonds would cause depreciation in outstanding bonds bearing lower coupon rates. A gradual compromise position would seem possible. Three-percents mentioned above would be a step in the direction of recognizing competitive market rates.

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William A. Berridge (Metropolitan Life Insurance Co.)

A variety of marketables with maturities spread over a wide range, from short-to-long-term, with sufficient return to appeal to noncommercial bank investors. Not so much emphasis on short-terms as has been the case in the postwar period. This answer applies to both (*a*) and (*b*).

Frederick A. Bradford (Lehigh University)

It is my opinion that the bulk of the privately held Government debt should be refunded into consols, the price of which should be allowed to respond to market forces. With regard to (*b*), the Govern-

ment should see to it that it does not have to become a substantial borrower of additional funds. If it does, the form taken by the securities issued will not make too much difference, although longer maturities than have been customary would seem desirable.

William E. Dunkman (University of Rochester)

Under all conditions, the Government should use vehicles of borrowing which are of long maturity and so designed as to remain in the hands of investors of saved income. The Government should give consideration to the issuance of annuities and perpetual bonds.

Milton Friedman (University of Chicago)

Under either condition cited, long-term marketable and nonredeemable securities should be the principal vehicles of Government borrowing. However, given the will to let credit conditions in general be determined solely by the objective of stability and to pay whatever interest rate is necessary to borrow under such circumstances, the type of security offered is not of major importance and may well be adjusted to the conditions of the market at the time.

Richard W. Lindholm (Michigan State College)

I believe the sale of purchasing power assured bonds should be the principal vehicle of Government borrowing under present conditions.

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Wesley Lindow (Irving Trust Co., New York)

The Government should use a wide variety of securities under all conditions in order to best manage the debt. Nonmarketable securities have an important place in helping to insulate the debt, and probably can be used to an even greater extent to broaden debt ownership. Marketable securities should be used in the proper proportion to meet the needs of the money and investment markets; and to facilitate open-market operations.

C. Ward Macy and E. C. Robbins (University of Oregon)

Under present conditions, we believe that a move toward perpetual bonds is desirable. A large refunding problem puts pressure on the Treasury to insist on low interest rates, regardless of the effect on the rest of the economy. With a large public debt, the only way to reduce the refunding problem is to have long-term bonds. Perpetual bonds handle the problem once and for all.

A complementary approach to the public-debt problem is to attempt to get the bonds into hands where they will remain, and thus not compete on the market with new issues. A compulsory secondary reserve in special Government securities for all commercial banks, and possibly insurance companies, would appear worth a trial.

James W. Martin (University of Kentucky)

It seems to me the Treasury has wisely adapted the form of securities to the current market situation. The job is one requiring a staff of bond experts—not one on which a general policy can wisely be defined in advance. This observation applies not only under current conditions but doubly so under war conditions. Of course it should be continued with, if necessary, enlargement of Treasury authority. For example, I assume without special investigation that the Treasury now lacks authority to issue bonds of constant purchasing power.

If Congress believes such bonds should be authorized, it should accord authority without taking away existing authorizations.

James A. Maxwell (Clark University)

While I do not like my conclusion, I believe that the principal vehicles should be issues with maturities of 5 years or less.

Hyman P. Minsky (Brown University)

Government borrowing should always take place by means of the longest possible type securities: Ideally a security in perpetuity. This, of course, eliminates, practically speaking, refinancing problems.

Lloyd W. Mints (University of Chicago)

Except for short-term borrowing to compensate for lack of evenness of the flow of tax revenues to the Government all governmental borrowing should be with instruments that run in perpetuity (the British consols). This should be the method of borrowing in all circumstances (with the exception noted in the preceding sentence, and even this is not essential). Fixed maturity governmental obligations are so highly regarded by investors that they serve to some uncertain extent to take the place of money in "cash" balances, thus releasing the actual cash to be used in expanding the aggregate demand of the community for goods and services. In other words, their issuance may to some extent have the same inflationary influence as an issuance of actual money, and the shorter the maturity the greater this degree of "moneyness." However, it is problematical how great this inflationary influence from governmental securities is. I suspect that in fact it is not great, and therefore I do not attach major importance to this matter. Nevertheless, so far as there is a basis for a preference, it is for consols.

Marcus Nadler (New York University)

Under present conditions the Treasury will need very little new money and therefore no material change in the present types of securities need be made. In event of the necessity for substantial net Government borrowing, the E, F, and G bonds should be made more attractive in order to induce larger purchases. The Treasury should give some thought to issuing a nonmarketable security which would be more attractive to institutional investors than the present 2¾-percent obligation.

Roy L. Reierson (Bankers Trust Co., New York)

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Marketable versus nonmarketable securities.—A flexible, dynamic policy of debt management requires the substantial use of marketable, in preference to nonmarketable, securities for Treasury financing. We need a much more careful analysis of the full implications of the recent trend toward the use of nonmarketable securities for institutional investors, and of the effect of this trend upon the future effectiveness of the use of credit policy. Nonmarketable securities have been advocated on the ground that their use reduces the problems of the monetary authorities arising out of the sale of holdings of Government securities by investment institutions in a period of high capital investment. This thinking reflects adherence to the philosophy of an inflexible pattern of interest rates. The use of nonmarketable securities

may transfer some problems from the Federal Reserve System to the Treasury, but does not dispose of them.

The basic problem, in an inflationary period of high capital investment, is that many investors naturally and quite understandably wish to increase their investment returns by substituting corporate and private obligations for Government securities. This unloading is not prevented through the use of nonmarketable securities; investors can turn their holdings in for cash or for relatively short-term Treasury obligations, as the case may be, provided they are willing to take the capital loss involved. One big defect of nonmarketable securities is that the amount of discouragement to this process, represented by the loss in capital values, is predetermined and inflexible. The plain fact of the matter is that no one can forecast for years ahead what levels of redemption values would be most appropriate. This depends on whether it will be desirable in any given year to have a large or small volume of redemptions by holders; and this in turn depends upon the accuracy of long-range forecasts of general economic conditions in the midst of world-wide imponderables. Furthermore, in the case of many nonmarketable issues, the amount of capital loss entailed by redemption prior to maturity varies from year to year, increasing for a period and then declining as the securities approach their maturity, thus complicating still further the problem of appraising the volume of redemptions prior to maturity. In contrast, the discouragement to sales of marketable securities by present holders can be varied from time to time in accordance with changing conditions, and on the basis of the accumulating evidence as to the effects of any given level of market prices upon the desires of present investors to reduce their holdings.

Even in the area in which their use is presumed to have the greatest advantage, namely, easing the problems of the monetary authorities, the use of nonmarketable obligations has practical defects. The problems arising out of unloading by present investors are not solved; it is only their incidence that is changed, and that only in part. The redemption of nonmarketable issues places the Treasury under the obligation to provide funds for their redemption. If the Treasury is so fortunate as to be operating with a cash surplus, this may impose no real problem. But, under these conditions, the Treasury would have funds which could be used to offset the acquisition of marketable Government securities by the Federal Reserve banks. Thus, the nonmarketable securities have no practical advantage. If the Treasury is running a cash deficit, the redemption of large amounts of nonmarketable obligations will add to the financing problems of the Treasury, increase the likelihood of financing through the banking system, and complicate the task of implementing an effective restrictive credit policy. These problems are likely to prove no less serious than those resulting, under similar budget conditions, from the purchase of marketable Treasury obligations by the Federal Reserve banks.

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George B. Roberts (National City Bank of New York)

The Treasury should tailor its offerings to meet prevailing requirements of the market, and with a view to broadening and enlarging the market especially among nonbank investors. The test of a truly

successful offering is that it can be put over without special intervention by the Reserve banks. Also applying to either (*a*) or (*b*), there is an evident necessity to offer a new and more attractive savings-bond type of obligation.

Roland I. Robinson (Northwestern University)

In the selection of securities for Treasury financing the overriding consideration must always be the taste of the market. The Treasury must offer what will sell. But at almost any time short of panic or financial disorganization, a wide variety of securities will sell; the issue of policy then is to pick the securities that are appropriate for the circumstances then prevailing. When inflation is the dominant threat, financing should be done with securities that are as remote from the monetary system and as unavailable to it as is possible. When deflation is the prevailing problem then securities which encourage monetary expansion are appropriate. It is assumed in both parts of the following answer, inflation is the dominant problem; thus minimizing monetary expansion will be assumed to be the goal.

While the current official forecasts of Treasury receipts and expenditures indicate a deficit, a modification of these estimates to put them on a cash basis and also to correct for the usual underestimation of receipts suggest that a relatively small deficit is likely. The Treasury financing problem, therefore, is more that of refunding than that of raising new money. The goals at present should be to tap individual saving. Recently the E bond has lost favor; it is not selling well and is being redeemed rather heavily. Something new is needed. Within the compass of a short answer the specifications of such a new obligation cannot be drawn, but it should be generous and distinctly new; not just a trivial remodeling of the old E bond. A substantially higher rate may not be the proper answer; perhaps generosity should be reserved for other features such as convertibility into annuities. And the liquidity of the bond should be less than E bond; if its terms are generous enough this problem should be solvable.

Refunding in short-term form should be minimized. The Treasury should raise some long-term money. Unless private borrowers are to be denied access to the market, this means paying higher rates. This would be a cheap price for reducing the risk of having the public debt expand still further the already bloated monetary system.

If substantial net Government borrowing were necessary.—If the international situation should deteriorate further so that a larger deficit should become necessary, the rules of war finance then begin to apply. Under such circumstances the amount of private capital formation should be curbed by direct measures. The only kind allowed should be closely related to war-defense needs. Under these circumstances the market of securities could be much more rigidly controlled than now; institutional investors could be starved and corporate funds would tend to be idle. Under these circumstances, Treasury offerings should be of the "basket" sort: Something for each type of investor with funds. A generous yield might be used to sell long-term noncallable securities. Well-considered specifications for such securities would outrun available share but the general prescription is minimum liquidity.

Emerson P. Schmidt (Chamber of Commerce of the United States)

Every effort should be made by the Treasury to finance its debt on a long-term basis. While this itself must be a long-term process, movement in that direction should be started at once.

Undue reliance on short-term financing means that the Treasury is faced with large continuous refinancing problems. In order to be assured of successful financing it is likely to want the continuous artificial support of the Government bond market, thereby perpetuating inflation, excessive demand for capital and unwittingly weakening the basis for public confidence in Government bonds and other dollar instruments.

Tipton R. Snavely (University of Virginia)

It is my opinion that our present debt should be distributed between issues of moderate and long-term duration. It seems unlikely that a substantial amount of the Federal debt can be paid off in the near future (5 years). Refunding will be necessary. The rate of interest should not be held too far out of line with market conditions by artificial measures and controls. It is better in the long run for the Government to let the private economy take the lead in the establishment of lending conditions and money rates unless we are prepared to have the Government assume responsibility and control for the entire economy to an extent which seems to me undesirable at the present time. There should be a sufficient amount of short-term issues to enable the Treasury to liquidate as much of the debt at any time as surplus revenues may justify.

If substantial net Government borrowing becomes necessary, the issues should be duly distributed over short-, intermediate-, and long-term maturities. Discount and interest rate policies should not diverge too far from present and anticipated market rates.

Herbert Stein (Committee for Economic Development)

I believe the Government should use two principal kinds of securities in borrowing under present conditions and in the event of the necessity for substantial net Government borrowing arising out of the present rearmament program:

(*a*) A marketable, not-to-be-supported security of not less than 4 years maturity, in order to reduce the amount of refunding that has to be done during the hump period of the rearmament program. The maturities should be spaced out so that an equal and small proportion of the total debt comes due each year after, say, 1955.

(*b*) A nonmarketable small-denomination bond as an instrument for promoting saving. This should probably be essentially like the present E bond, but with a higher 10-year yield and a lower 3-, 4-, or 5-year yield.

Rufus S. Tucker (General Motors Corp.)

Annuity bonds might be useful as well as the other kinds suggested under my answer to question 4. If we were to go back on the gold standard, as I believe we should, gold bonds might be popular in spite of the repudiation of gold bonds in 1933.

C. R. Whittlesey (University of Pennsylvania)

Under present conditions the Government should rely chiefly on borrowing outside the banking system by more or less conventional

means. As far as possible it should adapt types of offerings to the apparent needs of lenders. To a limited extent and primarily to obtain familiarity with the technique, it should experiment with new types of securities designed to facilitate the insulation of the market and the Treasury from undesirable pressure. If it became necessary to borrow heavily, after every effort had been made to finance by taxation, it should make extensive use of securities of the types just mentioned. To the extent that it became necessary to borrow from commercial banks or the Federal Reserve, powers (such as increasing reserve requirements or otherwise) should be granted to the central bank to minimize the resulting inflationary potential.

Kossuth M. Williamson (Wesleyan University)

(*a*) Under present conditions or (*b*) in the event of the necessity for substantial net Government borrowing, I would favor a policy of sale of bonds to nonbank investors with the design of absorbing savings. I would favor for this purpose securities of the savings-bond type with higher yields than in the past. Consideration should also be given to the possibility of using nonredeemable and nonmarketable bonds of fairly long maturity and bearing a rate of interest sufficient to induce investment in such a security.

I should add, however, that, if by "substantial" is meant a very large amount of net Government borrowing, it will probably prove difficult even by these instruments to meet the borrowing requirements out of savings. This possibility serves to point up the policy of paying for war or preparation for war as far as possible by taxation, as the best safeguard against inflation. There does not seem to be any satisfactory and reliable substitute for adequate and appropriate tax policy in a total war or in a defense economy with heavy military requirements.

8. Under what conditions, if any, do you believe it would be desirable to resort to compulsory methods in the sale of Government securities to (*a*) banks, (*b*) other financial institutions, (*c*) other corporations, (*d*) individuals?

Many economists could see no circumstances under which compulsory methods of sale of Government securities would be desirable. Many, however, felt that compulsory sales might be used during total war when all other devices—principally taxation—fail to curb inflation.

A number of replies referred to the proposal that banks be required to maintain additional reserves to be held in the form of United States securities and said that they favored compulsory borrowing from banks to the extent of favoring this proposal. A few, however, felt very strongly that the Government should never subject commercial banks to compulsory lending.

The only other type of compulsory borrowing to secure substantial support was the compulsory sale of securities to individuals under wartime conditions through the mechanism of levying taxes refundable in the postwar period.

Extracts from typical replies follow:

E. Sherman Adams (New York University)

(*a*) It is difficult to conceive of any circumstances when there would be any excuse for compulsory sale of Government securities to

the banks. As was demonstrated during World War II, the banks will absorb almost any quantity of securities the Treasury wishes to sell them if they are provided with the necessary reserves.

(*b*) The purpose of compulsory sale of Government securities to insurance companies and savings banks would presumably be to tighten the availability of long-term credit. Better methods are available.

(*c*) I cannot think of any conditions which would justify compulsory sales of securities to other corporations.

(*d*) During wartime, careful consideration should be given to various types of forced savings plans, especially on a payroll deduction basis.

G. L. Bach (*Carnegie Institute of Technology*)

I question the wisdom of compulsory sales of Government securities. Such a procedure is clearly inappropriate except in times of national emergency. Even in emergency periods (primarily war or the imminent danger of war), the measure would probably do more harm than good.

In inflationary periods the real problem is to increase private saving in relation to private income. Compulsory lending to the Government has the great weakness that it is fairly easy to avoid by correspondingly reducing voluntary purchases of Government securities, so the individual's or business' total saving and total purchases of Governments is unchanged by the compulsory feature. This is certainly true when the compulsory lending plan is fairly small in relation to previous voluntary purchases of Governments.

Compulsory sale of Government securities is in effect refundable taxes. Compulsory lending offers some advantages over taxation. These advantages are primarily that compulsory lending (*a*) may have a less negative effect on production incentives, and (*b*) provides a ready mechanism for paying out Government funds to the public if depression develops after the borrowing period. But taxation is a stronger anti-inflation tool, since it reduces the public's current purchasing power without correspondingly building up the public's asset holdings as would be done under compulsory lending. Insofar as, politically, compulsory lending is a substitute for taxation, compulsory lending should probably be avoided as an inflation period device. As a practical matter, in such periods the prime problem seems to be that of inducing Congress to vote high enough taxes (either direct or refundable). If we could get high enough total taxes, compulsory lending might make some sense as part of the total, though we should recognize that the total tax take will need to be higher for any given anti-inflationary effect if it is partly in the form of compulsory lending. Compulsory lending makes little sense as a minor supplement to a large program of Treasury borrowing on a voluntary basis.

The banks and other financial institutions present a somewhat special case in this connection. There is much to be said for a supplementary bank reserve requirement that might be fulfilled by holding special types of Government securities. The main goal of such a requirement would be to restrain bank lending to private borrowers, but its effect would also be that in fact banks would be required to hold (not necessarily buy) a substantial volume of Government securities. There

would be some point in applying a similar requirement to other financial institutions if the requirement were applied to banks, though inclusion of nonbank lenders would mark a drastic change in the coverage of traditional general credit controls.

John A. Baker (*National Farmers Union*)

The correct answer to this question varies according to circumstances. There need be no forced savings at any time when the economy is operating at a level of less than practical full employment. Starting from a condition of full employment, any increase in Government expenditures plus any increases in private capital investment should be equaled or approximately equaled by an increase in total taxes levied according to the ability to pay principle. To the extent that we are unwilling or unable to raise taxes by that much, we should impose enforced savings, again on an ability to pay principle, to make up the deficit. Banks and corporations and other financial institutions as well as private individuals should be included in the forced savings system.

Rollin F. Bennett (*New York Life Insurance Co.*)

I would not consider it desirable for the Government to force corporations or individuals to hold prescribed portions of their assets in any specific form that they would not have chosen voluntarily. Nor can I imagine any circumstances that would justify use of coercion in "selling" Government securities.

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Chelcie C. Bosland (*Brown University*)

Compulsory sales of securities to individuals might be used in lieu of taxation sufficient to eliminate excess consumer purchasing power. Compulsory purchases by banks or other financial institutions would seem to have little merit, since this would not combat inflation. Compulsory sales to other corporations would probably be too crude a weapon to stop business spending. Since it is obviously necessary to permit a high volume of business investment for defense purposes, impossibly selective means would have to be employed. Perhaps business investment could be controlled better by allocations, priorities, and inventory regulation than by compulsory bond purchases.

Frederick A. Bradford (*Lehigh University*)

Under no circumstances other than total war and then only as a last resort.

Elmer C. Bratt (*Lehigh University*)

(*a*) Under certain tragic war conditions; (*b*), (*c*), and (*d*) when more desirable methods of channeling savings are unattainable..

Martin Bronfenbrenner (*University of Wisconsin*)

A. *Banks.*—As suggested in my reply to question 4, above, I am in favor of a secondary or bond-reserve proposal of the type suggested by Mr. Eccles as a permanent feature of Federal credit policy.

B. *All other institutions and individuals.*—Not having the power to create money, nonbanking institutions and individuals need not have that power restrained by compulsory bond purchases. "Forced loans" and compulsory bond purchases are distinctly inferior to higher

taxes, credit controls, rationing, or allocations. I should support them, however, as alternatives to price and wage controls.

Stahrl Edmunds (*Northwestern National Life Insurance Co.*)

I can think of no circumstances under which it would be desirable for the Government to resort to the compulsory sale of securities. I believe it would be better to raise the tax rates and get it over with. Forced savings have all the compulsory disadvantages of taxes plus the difficulties of (1) refunding or repayment in the future, (2) the substantial inequities which can result from transfer of income which takes place through interest payments, and (3) the inequity to investors through the changes in purchasing power.

Fred R. Fairchild (*Yale University*)

I would say most emphatically that there should be no resort to compulsory sale of Government securities to anybody, either corporations or individuals.

Wesley Lindow (*Irving Trust Co., New York*)

Presumably this question refers primarily to the use of the tax mechanism with provision for tax rebates at a later date. I think it would be unwise to adopt compulsory borrowing of this type, except possibly under conditions of total war in which fiscal requirements had become very severe. Even then, rebatable taxes may have serious difficulties, such as (*a*) impeding the passage of additional ordinary kinds of taxation which might be needed, (*b*) interfering with voluntary sales programs of securities, and (*c*) raising serious postwar problems when the rebates would have to be paid. It should be noted that new methods of reserve requirements may also be considered as compulsory methods to help place or immobilize the public debt. These are discussed in the answer to question 4.

Raymond F. Mikesell (*University of Virginia*)

I would not favor compulsory sale of Government securities at any time. If in time of war it becomes necessary to reduce lending in any direction it should be done by selective controls. If it becomes necessary to reduce the general level of consumer spending, beyond what can be accomplished by taxation, I should favor expenditure rationing or a form of compulsory saving which left to the individual saver the form which his saving would take.

Margaret G. Myers (*Vassar College*)

(*a*) It is never desirable to resort to compulsory methods in selling Government securities. If in an extreme emergency this is considered to be the lesser of two evils, the commercial banks should be the last resort; if they are to perform their economic function they should not have disproportionate amounts of long-term assets, and should be free to adjust their portfolios.

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James J. O'Leary (*Life Insurance Association of America*)

I do not believe it would ever be desirable to resort to compulsory methods in the sale of Government securities whether it be to banks, other financial institutions, other corporations, or individuals. Compulsion is repugnant to our system of economic freedom. The history of Government financing in World War II demonstrates that even

in a great emergency the Government can meet its financing needs without resort to direct compulsion. Indirect compulsion will exist in any event in the cutback of private investment and hence in the private demand for capital funds. Moreover, savings are dammed up by scarcities of consumer goods and by rationing, and are easily tapped. This indirect compulsion is sufficient and compulsory methods in the sale of Government securities or with respect to the retention of such securities should never be adopted. Under all circumstances, the best interests of the country indicate that the Treasury should go into the capital market and meet market terms.

Roy L. Reierson (*Bankers Trust Co., New York, N. Y.*)

In principle, the use of compulsion in selling Government securities would serve notice that the obligations of the United States Government are not sufficiently sound and attractive to invite their purchase and retention in comparison with other investment media. Such an admission of failure in managing the public debt would reflect upon the standing of all Government securities in the investment market. No system of compulsory purchases of Government securities should be considered, for the following reasons:

(1) Such methods would require a comprehensive system of regulation, control, and regimentation of financial institutions, business, and individuals. They would constitute a substantial step in the destruction of the system of private enterprise and of our system of political democracy.

(2) Compulsory purchases of Government securities would provide undesirable and unnecessary encouragement to lavish, irresponsible, and inflationary fiscal policies and would remove any incentive to develop and apply anti-inflationary policies in the field of debt management.

Even in the case of all-out war, grave questions arise as to the desirability of such a plan. Our experiences in World War II suggest that compulsory purchases of Government securities are not required in the case of banks and financial institutions and in the case of other corporations and individuals probably would make no significant contribution to coping with the grave inflationary situation we would then face.

Commercial banks.—So far as the commercial banks are concerned, a system of compulsory purchases was not required in World War II, nor is it likely that it would be necessary in the event of another all-out conflict. The basic problem of war finance is to limit, not encourage, the acquisition of Government securities by commercial banks. To the extent that the banks must be relied upon as residual buyers, their ability to buy can be maintained through management of the money market, the techniques of which are highly developed and the effectiveness of which was so well established in World War II.

Other financial institutions.—World War II experience also demonstrates that other financial institutions will buy Government securities to the extent of their available funds without compulsion. In a war, new security issues in the non-Government sector of the economy would be limited by direct controls over building, construction, plant and equipment, business inventories, and other uses of funds. With the reduction in private demand, funds of financial corporations would flow naturally and without compulsion into Government secu-

rities to the extent that they become available. Should the intent be to require that these institutions purchase Government securities in excess of their normal inflow of investable funds, they would be forced to finance the excess through borrowing, presumably from the banks. This would be no better than financing these amounts through larger sales to commercial banks in the first instance.

Nonfinancial corporations.—In the case of nonfinancial corporations, the basic economic goal, in addition to achieving the maximum of production, is to discourage the unnecessary accumulation of inventories and the construction of plant and equipment which is not required for the war effort. These activities could be effectively limited only through the use of comprehensive direct controls. If reasonably adequate returns are provided, corporate treasurers will be quite willing to invest excess funds in Government securities without compulsion. If excess funds are kept in the form of idle bank deposits, this would not contribute to inflationary pressures so long as the funds are not spent. A system of compulsory purchase of Government securities would require some adequate and effective standard for determining the amount of idle funds which could be so invested without impairing needed working capital and forcing increased borrowing from the banks. This would be a very difficult administrative task; nothing would be achieved by establishing requirements so high as to reduce production or increase bank lending.

Individuals.—In the case of individuals, the economic-financial problem during the war would be to induce greater savings and less spending on scarce goods. During World War II, as a result of the patriotic appeal coupled with rationing and the virtual cessation of the production of many consumer-durable goods, the volume of individual savings increased markedly, and purchases of Government obligations rose correspondingly on a voluntary basis. A system of compulsory purchases would involve, as in the case of nonfinancial corporations, very complex and difficult problems in establishing equitable bench marks for determining the amounts each individual would be required to purchase. The task of policing such a requirement would be extremely burdensome. Furthermore, there is the danger that such a requirement would have deleterious effects upon national morale and upon the willingness of the public to support the war effort. In combination these difficulties and undesirable effects would probably swing the scales against the introduction of a system of compulsory purchases, although the issues are probably harder to evaluate here than in the instances discussed above.

Postemergency considerations.—The advocates of compulsory purchases of Government securities also argue that this proposal could be used to reduce inflationary pressures in the postwar period by requiring investors to hold their securities until the initial postwar boom was over and until economic conditions required that some stimulation be given to the economy. As a practical matter, this would probably require the use during the war period of nonmarketable securities without specified maturity dates or redemption values. Such a step would be regarded by many people as a form of confiscation and would probably meet with widespread public opposition.

This postwar argument appears to have some validity only on the assumption that public policy in the postwar years would be wise and

strong enough to defer the redemption or encashment of these securities until economic conditions made such action desirable. This is not likely to be the case, at least not if our experience in the recent postwar years provides any useful clue to public policy following another conflict. The prospect of even the slightest downturn in employment and business activity in the postwar period would be used to support demands for the immediate cashing of these securities. Public policy is seldom determined on the basis of calm and judicious appraisal of economic conditions. Any number of pressure groups would actively press for premature redemption, long before the inflationary potential in the economy was exhausted. Finally, the cashing of large amounts of these bonds in the immediate postwar period would subject the Treasury to substantial cash drains at a time when the budget situation might not be at all satisfactory. The resulting cash deficiencies of the Treasury might well serve to rekindle the inflationary fires and defeat the objectives of this proposal. Consequently, reliance upon compulsory purchases of Government debt in an emergency would in all likelihood either necessitate the continuation of compulsion and other harsh controls indefinitely or create even larger and more complex problems for future years.

George B. Roberts (National City Bank of New York)

It is difficult to conceive of any situation under which it would be desirable to compel purchase of Government securities. To do so would tend to destroy the free market and is an admission of failure of the public credit.

Louis Shere (Indiana University)

The public debt must be placed to finance an emergency. Part of this can be done by compulsory lending, but most of it must be done by making it possible for the banks to absorb it. This means large reserves and relatively easy money conditions. It is idle to expect that the job can be done by enticing nonbank investors to lend enough, even if enticed by very high interest rates, and at the same time to argue that higher taxes would be impossible. The kind of borrowing that would be required to be noninflationary is essentially like the kind of taxes needed to have the maximum deflationary impact. Voluntary borrowing of the type needed is harder to attain in desired volume than compulsory taxes or compulsory lending.

Rufus S. Tucker (General Motors Corp.)

Banks might well be required to hold reserves consisting of Government bonds. Other corporations and individuals might be required to buy bonds in lieu of paying higher taxes, and the redemption of such bonds in limited amounts at regular intervals after the emergency is over would help in taking up the slack in demand and business activity that would naturally result from a cessation of emergency expenditures.

Henry H. Villard (College of the City of New York)

Compulsory sale of Government securities generally amounts, in my judgment, to refundable taxes. There may be cases in which refundable taxes are useful: a portion of a very high excess-profits tax or a part of heavy income taxes on those in the lowest income brackets are possible examples. But generally, if the Government is prepared

to force funds to be given up temporarily, I believe that they might as well reduce the postwar debt problem by forcing the funds to be given up permanently.

The only major exception that I can now think of to the proposition just stated involves the banking system. For a variant of the scheme suggested in answer to question 4 above involves requiring banks to hold certain types of Government securities. I would not object to compulsion in this case, though I consider the scheme I proposed much superior.

C. R. Whittlesey (*University of Pennsylvania*)

I find it difficult to conceive of a situation where it would be necessary to resort to compulsion to induce banks or other financial institutions to lend to the Government, notwithstanding compulsory methods in the First World War. In a situation comparable with World War II, forced lending by individuals and possibly by nonfinancial corporations might become desirable.

Donald B. Woodward (*Mutual Life Insurance Co. of New York*)

Compulsory sale of Government securities by any method or to any part of the economy should not be resorted to nor even considered under any conditions short of full-scale war with a major power, and then only in the very gravest emergency. (Whether a really valid case can be made for such action even then is dubious in my opinion.)

Both the military power of this country and the standard of living of its citizens depend upon the production system of this country. A system of compulsory Government loans in peacetime would curtail the access of that system to the credit which it may desperately need, and subject it to yet another burden in addition to the heavy tax burden it already is carrying. Such action could hardly have the result of improving the country's ability to prepare to defend itself nor of improving the ability of its citizens to increase their standard of living.

The fundamental essence of military strength and economic welfare is production per worker: a country whose workers produce most per head will have more goods and services per head to devote to defense, to consumption, and to preparation for the future. If production per head is sufficiently large, a country with a smaller population can exceed in power a country with a larger population. It is in output per head that the United States excels all the world, and it is the result of high output per head that the citizens of this country have the highest standard of living ever achieved and at the same greater military power than any other country, even including those with larger populations.

The most essential constituent of high output per head is superior and plentiful tools and equipment per worker. Personal skill and intelligence, and large national resources are important, but workers of whatever intelligence and skill could do little with their bare hands however many Mesabi Ranges and sections of rich Iowa lands they possessed.

A very vital part of the reason that America abounds in superior tools is that Americans have been free to accumulate capital, to use it in the most advantageous manner they could find, and to compete with each other to the utmost—all within limits only of decency and

with regard for financial safety of other people's money. The process has entailed an elaborate structure of markets and institutions for its operation, and the four groups to which this question refers are the major parts.

Arbitrary authoritative preemption of savings and institutional assets by compulsion to lend to the Government would gravely disable the whole process. I can think of no single action that this country could impose upon itself that would have more adverse effect.

APPENDIX TO CHAPTER X

QUESTIONS ADDRESSED TO ECONOMISTS

1. What are your views of the effects of credit policies resulting in relatively small and relatively large changes in interest rates, respectively, upon (*a*) the lending policies of commercial banks, (*b*) the lending policies of nonbank investors, (*c*) consumer saving, (*d*) business plant expenditure programs, (*e*) business inventory policy?

2. How important do you consider the expansion of credit to be in the totality of factors underlying the post-Korean inflationary boom? The postwar boom in 1945–48? How would you appraise the effectiveness of (*a*) general and (*b*) selective credit policy in coping with (i) a high level of private capital investment, (ii) a high level of consumer spending, (iii) large present or prospective Government expenditures, (iv) the wage-price-farm support spiral?

3. What do you believe to be the appropriate roles of direct (e. g., price and wage) controls, selective credit controls, and a general tightening of credit as means of restraining inflation (*a*) when the Treasury is not expected to be a large borrower in the foreseeable future, (*b*) when a large volume of Treasury refunding operations will have to be effected in the forseeable future, (*c*) when it is expected that the Treasury will be a large net borrower during the foreseeable future (*d*) under conditions of total war?

4. Do you believe that it would be (*a*) desirable and (*b*) possible to insulate public debt securities in whole or in part from the impact of restrictive credit policies designed primarily to discourage the growth of private debt? Do you have any concrete suggestions for action in this regard?

5. To what extent do you believe that the demand for Government and other high-grade, fixed-interest-bearing securities by nonbank investors is influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

6. Discuss the merits and demerits of the proposal for the issuance of a bond, the value of which would be guaranteed in terms of purchasing power.

7. What types of securities do you believe should be the principal vehicles of Government borrowing (*a*) under present conditions, (*b*) in the event of the necessity for substantial net Government borrowing?

8. Under what conditions, if any, do you believe it would be desirable to resort to compulsory methods in the sale of Government securities to (*a*) banks, (*b*) other financial institutions, (*c*) other corporations, (*d*) individuals?

The above questionnaire was sent to about 300 economists, comprising a broad sample of those interested in financial and related questions, employed by universities, firms engaged in financial business, and various types of associations. Questionnaires were not sent to economists connected with the Federal Government except in one or two cases where they were especially requested. Replies were received from the following 111 economists. (There were 100 separate replies—some of the replies being signed by more than one person.)

Abbott, Charles C., Harvard University.
Adams, E. Sherman, New York University.
Agger, E. E., Rutgers University.
Babson, Roger W., Babson's Reports, Inc.
Bach, George L., Carnegie Institute of Technology.
Baker, John A., National Farmers Union.
Bassie, V. Lewis, University of Illinois.
Bell, James W., Northwestern University.
Benedict, Murray R., University of California, Berkeley.
Bennett, Rollin, New York Life Insurance Co.
Berridge, William A., Metropolitan Life Insurance Co.
Blakey, Roy G., University of California, Los Angeles.
Blodgett, Ralph H., University of Florida.
Bogen, Jules I., New York University.
Bosland, Chelcie C., Brown University.
Bourque, Philip J., University of Pennsylvania.
Bowen, Howard R., University of Illinois.
Bowman, Raymond T., University of Pennsylvania.
Bradford, Frederick A., Lehigh University.
Bratt, Elmer C., Lehigh University.
Bronfenbrenner, Martin, University of Wisconsin.
Bye, Raymond T., University of Pennsylvania.
Carothers, Neil, Lehigh University.
Carpenter, Cecil C., University of Kentucky.
Clark, J. M., Columbia University.
Clendenin, John C., University of California, Los Angeles.
Coleman, George W., Mercantile Trust Co., St. Louis, Mo.
Conklin, George T., Jr., The Guardian Life Insurance Co. of America.
Dolley, James C., University of Texas.
Dunkman, William E., University of Rochester.
Edmunds, Stahrl, Northwestern National Life Insurance Co.
Ellis, Howard S., University of California, Berkeley.
Fairchild, Fred R., Yale University.
Fisher, Clyde Olin, Wesleyan University.
Frain, H. LaRue, University of Pennsylvania.
Friedman, Milton, University of Chicago.
Garis, Roy L., University of Southern California.
Gemmill, Paul F., University of Pennsylvania.
Goldenweiser, E. A., Princeton University.
Goldfinger, Nat, Congress of Industrial Organizations.
Gordon, R. A., University of California, Berkeley.
Gosfield, Amor, University of Pennsylvania.
Haines, Walter Wells, New York University.
Hallowell, Burton C., Wesleyan University.
Hansen, Alvin H., Harvard University.
Harris, Seymour E., Harvard University.
Hess, Arleigh P., Jr., University of Pennsylvania.
Hildebrand, George H., University of California, Los Angeles.
Hudson, Philip G., University of Arizona.
Jesness, O. B., University of Minnesota.
Kline, Allan B., American Farm Bureau Federation.
Kurihara, Kenneth K., Rutgers University.
Limber, Ralph C., National Life Insurance Co., Montpelier, Vt.
Lindholm, Richard W., Michigan State College.
Lindow, Wesley, Irving Trust Co.
Loewy, Harris, Bankers Life Co., Des Moines, Iowa.
McKinley, Gordon W., The Prudential Insurance Co. of America.

McMillan, S. Sterling, Western Reserve University.
Machlup, Fritz, Johns Hopkins University.
Macy, C. Ward, University of Oregon.
Mark, Shelley M., Office of Price Stabilization, Honolulu, T. H.
Martin, James W., University of Kentucky.
Maxwell, James A., Clark University.
May, A. Wilfred, William B. Dana Co., New York, N. Y.
Mikesell, Raymond F., University of Virginia.
Minsky, Hyman, Brown University.
Mints, Lloyd W., University of Chicago.
Murad, Anatol, Rutgers University.
Myers, Margaret G. (Mrs. B. H. Beckhart), Vassar College.
Nadler, Marcus, New York University.
O'Leary, James J., Life Insurance Association of America.
Oliver, Henry M., Indiana University.
Phillips, Almarin, University of Pennsylvania.
Reed, Harold L., Cornell University.
Reierson, Roy L., Bankers Trust Co.
Ritter Lawrence S., Michigan State College.
Robb, T. Bruce, William Jewell College.
Robbins, Edwin C., University of Oregon.
Roberts, George B., National City Bank.
Robinson, Roland I., Northwestern University.
Rolph, Earl R., University of California, Berkeley.
Saulnier, Raymond J., National Bureau of Economic Research.
Schmidt, Emerson P., Chamber of Commerce of the United States.
Scholz, Karl, University of Pennsylvania.
Shere, Louis, Indiana University.
Shields, Murray, Bank of Manhattan Co.
Simmons, Edward C., Duke University.
Simmons, Frederick L., Guaranty Trust Co.
Smith, Bradford B., United States Steel Corp.
Snavely, Tipton T., University of Virginia.
Solterer, Josef, Georgetown University.
Somers, Harold M., University of Buffalo.
Spahr, Walter E., New York University.
Stein, Herbert, Committee for Economic Development.
Sweezy, Alan R., California Institute of Technology.
Tarshis, Lorie, Stanford University.
Taylor, Philip E., University of Connecticut.
Trant, James B., Louisiana State University.
Tucker, Rufus S., General Motors Corp.
Turner, Robert C., Indiana University.
Villard, Henry H., The College of the City of New York.
Weintraub, Sidney, University of Pennsylvania.
Westerfield, Ray Bert, Yale University.
Whittlesey, C. R., University of Pennsylvania.
Wiegand, G. C., University of Mississippi.
Willett, Edward F., Smith College.
Williamson, Kossuth M., Wesleyan University.
Wills, John H., Northern Trust Co., Chicago.
Woodward, Donald B., The Mutual Life Insurance Co. of New York.
Yntema, T. O., Ford Motor Co.
Zimmerman, Gerald L., Duquesne University.

CHAPTER XI

REPLIES BY BANKERS

1. Have the lending policies of your bank changed since July 1950? If so, what has been the general character of the change? Specifically, what change has occurred in your lending policies with respect to: (*a*) Regular commercial customers, (*b*) occasional commercial borrowers, (*c*) real-estate loans, (*d*) consumer loans?

A majority of the bankers replying stated that they had changed their policies since July 1950, but nearly half stated that they had not. The distinction between these replies is more apparent than real, however, as it depends principally on the interpretation given to the term "policy." In general, the bankers indicated that their loans had increased substantially since the middle of 1950, and that they were exercising a more careful scrutiny of applications in order to hold the increase down. Some considered this more careful scrutiny to represent a change in policy, while others felt that it represented merely a working-out of the logical implications of their preexisting policies in a changed environment. Some indicated that the more careful scrutiny was especially intensive in the case of occasional borrowers, while others (particularly the largest banks) stated that it applied equally to regular customers and occasional borrowers. A number indicated that customers' inventory policies were a subject of special scrutiny. Some stated that their policy with respect to real estate loans and/or consumer loans had been tightened more than that with respect to commercial loans, and some that they had ceased making new real estate loans altogether.

The extracts from typical replies, which follow, show the diversity of answers. (Some of these replies give the reasons for policy changes; as far as possible, however, such reasons are presented in connection with the answers to question 3.)

Chester G. Abbott (*First Portland National Bank*, *Portland*, *Maine*)

Yes. We have given careful consideration to all loan applications to determine what inflationary effect the granting of credit might have and also to what extent the loan would either benefit defense production programs or the maintenance of essential civilian needs.

(*a*) and (*b*) Applications from both regular and occasional borrowers are considered alike in the light of the above policies, however the normal requirements of our regular customers are much more readily understood as we have the benefit of past experience with them to guide us.

(*c*) We have made no change in our policy regarding real estate loans.

(*d*) We have given much greater emphasis to the type of consumer loans to small businesses for the financing of equipment and incidental

machinery and by the same token reduced the emphasis on the financing of consumers goods such as automobiles and household appliances.

C. W. Bailey (First National Bank, Clarksville, Tenn.)

We have followed a rather uniform course in the handling of loans during the period from July 1950 to the present time. In fact, we have not changed our policy other than giving a more careful scrutiny of all applications. We can very definitely say that we have not declined but few loans and that we have had but few applications which we did not see fit to accept.

Julian B. Baird (First National Bank, St. Paul, Minn.)

Over a period of many years it has been the basic policy of this bank to be more cautious and selective in its lending in periods of very active business and to liberalize its lending policies in periods of recession. The events following the outbreak of the Korean war in 1950 created a situation which to us seemed to call for restraint in lending and we have endeavored to act accordingly.

(a) The requests for credit from regular commercial customers were scrutinized more closely and we attempted to discourage inventory speculation on the part of our customers. Since the credit restraint program came into operation, all loans have been scrutinized for compliance with those restrictions.

(b) We have applied the same standards to occasional commercial borrowers who have been our customers, but have given less consideration to loan applications from other than our regular customers.

(c) We discontinued the purchase of FHA loans originated and serviced by others and confined our real estate loan activities to taking care of our local customers, having regard to the restrictions of regulation W and compliance with the spirit of the credit restraint program.

(d) As the field of consumer loans came under definitive regulation, we felt that that sufficed for this field of lending but we did take steps to temper the tone of our advertising for consumer loans.

Anderson Borthwick (First National Trust & Savings Bank, San Diego, Calif.)

Our lending policies have not changed since July 1950. We have analyzed all credit requests, keeping uppermost in mind our obligation to do all we can to conform with the voluntary credit control. Regular commercial customers' loans have declined since July 1950; occasional commercial borrowers have increased slightly; real-estate loans up to June 1951 increased, largely because San Diego population has grown due to increase in defense industry work force and permanent Navy residents, but have leveled off since June because of building and credit restrictions; consumer loans have diminished because of lower number of installment sales of consumer goods.

Lloyd D. Brace (First National Bank, Boston, Mass.)

Since July 1950 we do not feel that there has been any fundamental change in our lending policies or philosophy as regards our sincere effort to extend credit to our customers who are borrowing for legitimate business purposes. However, our actual lending activities in practice have been subject to some modifications and changes due both to the substantial increase in demand for accommodation and to the

impact of regulations X and W and the voluntary credit restraint program. Our comments regarding specific classes of loans are as follows:

(*a*) No fundamental change of policy as regards regular commercial customers.

(*b*) A lessened interest in seeking the new or occasional commercial borrower except as such immediate relationship holds promise of a continuing long-range relationship.

(*c*) Our real-estate loans today are higher than those actually held in July 1950, but only because of commitments which had been made at that former date. In the more recent past our policy has been to continue to make real-estate loans but at a slower rate both because of regulation X and because of our increased activity in commercial loans.

(*d*) No fundamental change of policy with regard to consumer loans except to comply with regulation W.

Milton Brown (Mercantile National Bank, Dallas, Tex.)

Yes. Our policies have become more selective, both in respect to credit quality and the effect of the proposed loan upon the national economy. (*a*) and (*b*) Loan applications are investigated as to whether or not the applicant is planning to unduly enlarge the nature of his operations, or unduly expand the volume of his usual business. (*c*) None. In making appraisals on real estate mortgage loans any recent increase in the market value of real estate is disregarded, which is in accordance with customary procedure. (*d*) Somewhat greater care is observed in screening the credit risk.

Harry C. Carr (First National Bank, Philadelphia, Pa.)

There has been little, if any, change in the lending policies of this bank since July 1950 in any of the categories specified in your question, excepting that, whereas for several years this bank has used every precaution to avoid the making of loans which would contribute to unwise inflation, it has been even more careful in complying with the principles of the voluntary credit restraint committee instituted in the spring of this year; and secondly, that with respect to consumer loans this bank has continued to follow carefully the stipulations and principles of regulations W and X.

Ernest Clayton (Industrial Trust Co., Providence, R. I.)

Yes, the lending policies of the Industrial Trust Co. have changed since July 1950. If any one word might be used to describe the general character of the change in our policy it would be "caution." But the word "caution" may be misleading because the many and different factors involved make it almost impossible to use any one word categorically. Rather it would seem that more than ever, consideration has been given to our obligation to our customers and to the purpose for which the proceeds of the loan are to be used. Defense, defense-related, and essential civilian activities carrying the top priority. We have wholeheartedly subscribed to the principles embodied in the voluntary credit restraint program, and have endeavored to so screen all loan applications to assure maximum compliance.

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S. Sloan Colt (Bankers Trust Co., New York, N. Y.)

We believe that we should always be prepared to meet changing economic conditions with appropriate changes in our lending policies. For instance, during the late months of 1947 when there occurred a period of rapidly rising prices and strong inflationary pressures, we concluded that as a part of our then current lending policies we should give primary emphasis to the making of productive loans, i.e., those which expedite the production and distribution of goods. Similarly, when we came to review and revise our lending policies after July 1950, we again shifted our emphasis to productive loans. We started, and have since continued, to reapply the same standards as we had in 1947.

(*a*) We feel that our regular commercial customers are entitled to look to us for the financing of their legitimate requirements. The fact that an applicant for a nonproductive loan happens to be a customer of long standing does not, in our opinion, justify making the loan. In this connection the voluntary credit restraint program has been of real value to the banks by establishing, in broad terms, standards for identifying the types of lending which are undesirable under present conditions.

(*b*) In applying our lending policies, we treat occasional commercial borrowers on the same basis as more frequent borrowers. The activity and importance of our relationship with the borrower is more likely to be reflected in such matters as terms, rates, size of the commitment, etc., than in the basic decision on whether or not credit will be extended.

(*c*) Real estate loans are not a major factor in our activities.

(*d*) Our policy on consumer loans has been altered in keeping with the terms of regulation W.

Sidney B. Congdon (National City Bank, Cleveland, Ohio)

The lending policies of our bank have become more restrictive since July 1950.

As to (*a*), regular commercial customers, our loans were restricted in the early part of the period to avoid inflationary lending in accordance with our own ideas of what was proper policy under those circumstances, and in observance of the pronouncements of the American Bankers Association, the Comptroller of the Currency and the Federal Reserve authorities on that subject. This change in lending policy was applied more precisely upon the adoption of the voluntary credit restraint program. We have declined a considerable number of loans to regular commercial customers for the sole reason that we believed them to be inflationary in character, and because in our opinion they did not conform to the requirements for permissive credits under the voluntary credit restraint program.

As to (*b*), occasional commercial borrowers, we have ceased the practice theretofore carried on by our bank of purchasing short-term commercial paper of noncustomers. We also have ceased the practice of seeking or making collateral loans to noncustomers, and have restricted collateral loans made to customers to those which are in conformity with the voluntary credit restraint program.

As to (*c*), real estate loans, we have observed the provisions of regulation X and the principles of the voluntary credit restraint

program, and have been less inclined to make large real estate loans on rental property.

As to (*d*), consumer loans made for our own account, there has been no material change in policy except as a result of the voluntary credit restraint program and regulation W.

We have been disinclined to increase existing lines of credit to finance companies or to make new loaning arrangements for finance companies not theretofore our customers.

Walter E. Cosgriff (Continental National Bank & Trust Co., Salt Lake City, Utah)

We have not changed the lending policy of this bank in any wise since July 1950, having pursued more or less the same policies for a considerable period before that time.

Ben DuBois (First State Bank, Sauk Centre, Minn.)

There has been no marked change in our bank's lending policies since July 1950 with the exception that we have tried to avoid loans which from their general nature are unusually inflationary and, of course, we have complied with regulations X and W.

Percy J. Ebbott (Chase National Bank, New York, N. Y.)

Yes, the lending policies of the Chase National Bank have changed since July 1950. In general, these changes in policy have involved deliberate attention to the following considerations: (1) inflationary impact, (2) credit needs of the defense program, and (3) credit risk under extraordinary economic conditions. Also, over-all lending policy has been made more restrictive because of the tighter money market conditions which prevailed and the restraining influence of Federal Reserve credit policies.

With respect to (*a*) and (*b*), the policy in the extension of credit to regular, as opposed to occasional business borrowers, has remained unchanged. Lending rates to both classes have been increased.

In respect to (*c*) and (*d*) the bank's policies have not changed materially. The volume of such loans is a small component of total loans, and the bank's policies have always been conservative. In the specific case of (*d*) the bank has reviewed on several occasions its program and revised its promotional activities in the light of regulation W and the policy bulletins of the Voluntary Credit Restraint Committee.

H. P. Fleming (First National Bank & Trust Co., Macon, Ga.)

(*a*) Policies not changed. (*b*) If these borrowers have carried good accounts with us, no change. If account not too satisfactory, we have been more strict in our lending policy. (*c*) Have tightened up somewhat on real estate construction loans, partly because of regulation X, but primarily because mortgage money has been tighter. (*d*) No change except to follow changes in regulation W.

Robert V. Fleming (Riggs National Bank, Washington, D. C.)

Since July 1950, with the general pressure and demand for loans of all kinds following the outbreak of war in Korea, there has been a more careful screening of all applications for credit to see that they are for productive rather than speculative purposes. Since the establishment of the voluntary credit restraint program, my institu-

tion has carefully observed the principles laid down in that program. (*a*) Applications for credit from regular commercial customers such as are received in the normal course of business generally would not be of the type that could be characterized as requiring as careful screening because these loans are mainly to merchants and other suppliers to take care of the needs of the community; nevertheless, these loans have been carefully scrutinized to see that there has been no undue accumulation of inventory above the normal needs and as usually carried by the borrower. This classification would also include loans strictly for defense purposes.

(*b*) As for occasional commercial borrowers the test of the voluntary credit restraint program has been applied, but we have had little occasion to criticize these infrequent requests because the community we serve is a nonindustrial area.

(*c*) As for real estate loans, we have carefully followed the provisions of regulation X. Although the demand for real estate loans in this area has been heavy, applications have been carefully screened as to terms and GI real estate loans have been granted under the tests we have applied since GI loans first were authorized. Due to the volume of applications, it has been necessary for us to exercise prudent judgment in granting such loans. If our customers' applications meet the provisions of regulation X, the banking laws, regulations of the Veterans' Administration, and our own tests as to GI loans, I know of no customer whose application has been declined.

(*d*) With regard to consumer loans, we do not maintain a consumer loan department and there is not much volume of consumer loans applied for. We do maintain an automobile loan department where our terms are in accordance with the provisions of regulation W.

Loring L. Gelbach (*Central National Bank of Cleveland*, *Cleveland*, *Ohio*)

Since July 1950 the lending policies of this bank have been reviewed and all necessary steps have been taken to conform with the credit policies advocated by the committee on voluntary credit restraint. In addition, the lending policies applicable to consumer credits and mortgage loans have been reviewed to make certain that they comply with Regulations W and X and all revisions thereto.

Included in the above program was a comprehensive review of all loans as to purpose of loan, provisions for repayment, and possible future loan requirements. To assist in the sound extension of credit, loans were graded as to the soundness of purpose, such as contribution to the rearmament effort and maintenance of a sound economy, as contrasted with inflationary loans of a nonessential or of a nonpressing nature.

The above changes in policy applied uniformly to both (*a*) regular commercial customers and (*b*) the occasional commercial borrower. (*c*) No change in real estate loan policy was made other than to limit the aggregate amount of loans to be accepted to the customary monthly totals existing prior to any serious tightening in the mortgage market. This was accomplished by restricting the granting of new mortgages to customers of the bank. The terms of the mortgage-loan agreements were at all times made to conform to the regulations promulgated by the Federal Reserve Banks. (*d*) The policy of extending consumer loans to worthy customers was continued; however, the terms sur-

rounding the granting of such loans were modified from time to time to conform with changes in the regulations governing such loans. No limit on the aggregate amount of consumer credit was found necessary as the regulations carried within themselves all the restrictive features necessary to control the demand for this type of credit.

Other changes in lending policy relate to increase in interest rates, amortization payments, and increased margin requirements on collateral loans.

L. M. Giannini (Bank of America National Trust and Savings Association, San Francisco, Calif.)

The lending policies of this bank have not been changed since July 1950, except to the extent required by full conformity with the voluntary credit restraint program.

R. M. Hanes (Wachovia Bank & Trust Co., Winston-Salem, N. C.)

Yes.

(*a*) For regular commercial customers we have urged shorter terms and have screened applications to avoid speculative accumulation of inventory and loans for other than essential production, distribution, and crop-movement purposes. Repayment agreements have been more rigidly enforced with the result that our loans outstanding are now less than they were a year ago.

(*b*) Same as in (*a*).

(*c*) Real-estate loans have been confined almost entirely to military and defense-housing projects. On the few conventional loans made, terms have been shortened and regulation X has been adhered to.

(*d*) The bulk of our consumer loans are for the financing of automobiles. We have complied with regulation W, and have been more selective in credit risks and the make of car financed.

W. L. Hemingway (Mercantile Trust Co., St. Louis, Mo.)

There have been a number of changes in the lending policies of this bank since July 1950. In the first place, interest rates have risen. The increase in interest rates was, in part, the result of restrictive monetary policies adopted by the Federal Reserve System and, in part, the result of the increased demand for credit to borrowers. In the second place, there has been a tendency to extend credit to finance industrial and commercial enterprises more willingly than to extend credit to other types of borrowers. Third, there has been a tendency to avoid making term-loans under present circumstances. Fourth, the voluntary credit restraint program has influenced us to make credit available to finance the production and distribution of essential goods and services while denying it to finance speculative activities as well as unnecessary capital expenditures. Fifth, loans to commercial borrowers have been scrutinized more carefully. The spectacular movements in prices and the uncertainty concerning the future of business activity have caused lending officers to exercise caution in making loans. Finally, as a result of the rapid expansion in bank loans, many banks are beginning to believe that the amount of money they have at risk is approaching a maximum in relation to their invested capital. Consequently, many bankers are considering the adoption of more restrictive lending policies. The lending policies of this bank have been influenced directly and indirectly by this development.

Our loans to consumers have conformed to regulation W. Real-estate loans have been affected by regulation X, as well as by an unwillingness to extend loans on real estate when commercial and industrial borrowers are seeking credit. The credit requirements of all deserving commercial borrowers have been satisfied, except when they violated governmental regulations, or were in conflict with the objective of the voluntary credit restraint program.

W. S. Hildreth (Peoples National Bank, Charlottesville, Va.)

(*a*) Regular commercial customers? None.

(*b*) Occasional commercial borrowers? None, except available funds limited at times by increased reserve requirements.

(*c*) Real estate loans? No change, except those limited by regulation X.

(*d*) Consumer loans? No change except those necessitated by regulation W.

James K. Lochead (American Trust Co., San Francisco, Calif.)

Since July 1950, we have undertaken to informally classify the needs of our customers and have permitted the loans to those in essential lines to expand by some contraction of loans in less essential fields and restricted term loans for business expansion unless in an industry related to the defense effort.

(*a*) and (*b*). We have made no differentiation in lending to regular borrowers as against occasional borrowers, feeling that any depositor is entitled to look to us for proper banking accommodation. We have in very few cases, however, accepted new customers on a borrowing basis from other banks on account of the heavy demand for loans from those to whom we felt our principal lending obligation.

(*c*) Our polices have not changed, but the laws enacted by Congress and the action of the Treasury Department in switching the ineligible 2½-percent Government bonds into 2¾-percent nonmarketable bonds (which froze $8½ billion of potential mortgage funds of insurance companies and mutual savings banks) have had a profound effect on our real-estate lending pattern. (See answer No. 3.)

(*d*) No change has occurred in our consumer lending policy except as compliance with regulation W required.

Charles J. Lyon (Society for Savings, Hartford, Conn.)

The lending activities of this bank are confined largely to real-estate loans. Since July 1950 there has not been any material change in our lending policy.

Since July 1950 the scrutiny of individual loans has been of a basically different character than that prevailing prior to July 1950. Since July 1950 each loan has been carefully screened for the purpose and realistic effect that the loan might have on the inflationary spiral which we appeared to be entering. In advance of regulation X we carefully reviewed each application to determine in our own minds whether the transaction was basically inflationary or whether it was basically a sound home purchase by the individual. The comparatively few loans which we make on commercial properties receive the same attention. While we feel that in certain cases the voluntary credit restraint program has worked an unfair hardship in individual instances, we have, nevertheless, lived up to the principles in every loan.

F. F. McGee (First National Bank, Cody, Wyo.)

Our lending policies have not materially changed since July 1950. We continue to make regular commercial loans to carry on the usual business of the community, and also occasional commercial loans to borrowers if used for legitimate purpose and if for a reasonably short period of time. For the past 2 years we have made very few real-estate loans, as we believe a commercial bank of our size should not tie its funds up in real-estate loans of any considerable volume or for other than a reasonable short period of time. Our policy is to accept consumer loans complying with the regulations, mostly through dealers. Since this class of loans are gradually repaid, we believe it is good business to accommodate those who do not have ready cash with which to purchase consumer goods and who are able to liquidate the loan on a monthly basis.

R. E. McNeill, Jr. (Hanover Bank, New York, N. Y.)

There has been no material change in lending policy since July 1950 with the exception of a complete screening of all loans as to purpose in order to comply with the spirit and letter of voluntary credit restraint. Loans to regular commercial customers and occasional commercial borrowers have expanded because of defense needs, the higher level of business activity, and, of course, higher prices. Real-estate mortgage loans have expanded, but these are largely relatively short term construction loans and amount to less than 1 percent of total assets. We do not make typical consumer loans.

Elmer B. Milliman (Central Trust Co., Rochester, N. Y.)

(*a*) While we still take care of the seasonal demands of our regular customers, we discourage loans used to increase inventories or to finance the construction or acquisition of new fixed assets where these are not used for defense purposes.

(*b*) Our rates are appreciably higher, and we insist upon the maintenance of adequate depository balances by our borrowers. We are not particularly interested in occasional commercial borrowings unless they are by our present depositors who are willing to pay the going rates.

(*c*) Whereas prior to 1950 we were actively looking for new mortgages, we now refer most applications for mortgages to savings banks or insurance companies. Occasionally we do make a loan on commercial or residential property for an especially important customer of the bank but only where we believe such a loan has no inflationary implications.

(*d*) Due to the increase in loans in the latter part of 1950, we curtailed the advertising program of our small-loan department. As 1951 progressed, however, the volume of our small loans fell off so substantially that we now have resumed advertising on a modified scale.

W. A. Mitchell (Central Trust Co., Cincinnati, Ohio)

The demand for loans from this bank by our customers has increased measurably since July 1950, due principally to the high activity of business in this area, increased raw-material and labor costs, and somewhat larger physical inventories. Cincinnati is a leading center of the machine-tool industry, and there has been a substantial growth in employment in this branch as well as in new defense plants estab-

lished here by national companies such as the General Electric Co. and the Ford Motor Co. This has resulted in substantial building activity, principally in small homes, and a demand for mortgage loans to finance their sale. The loans of this bank have increased during this period about 50 percent.

The lending policies of this bank have always been conservative and have continued so. I am a member of the Fourth District Voluntary Credit Restraint Committee, and our loans have been granted as far as possible in adherence with the objectives of that program.

With respect to subheadings of question 1: (*a*) We have endeavored to fulfill the legitimate requirements of our regular commercial customers. (*b*) The same is true in connection with occasional commercial borrowers. (*c*) We endeavor to restrict our mortgage activities to the financing of small houses erected by our customers in the building business. In many cases we have initiated the original mortgage and passed it over to long-term lenders such as life-insurance companies. We have observed, of course, the restrictions of the Ohio State Banking Act and of regulation X. (*d*) We operate with 12 offices located in Hamilton County and have a consumer loan department which services loans which are initiated at the branches. Our total volume in this division has not increased measurably since July 1950, although there was substantial activity in the fall of 1950. We adhere rigidly, of course, to the Federal Reserve requirements in respect to consumer loans.

S. C. Pidgeon (Bankers Trust Co., Des Moines, Iowa)

The general lending policies of our bank have changed since July 1950 only to the extent of complying with regulations imposed since then and the voluntary credit control policy, with which we have endeavored to comply, inasmuch as we have been heartily in accord with it.

(*a*) We have endeavored to take care of the reasonable demands of our regular commercial customers, which we believe is one of our definite obligations. It has always been our practice to keep ourselves in position to take care of these legitimate demands, and the period under discussion has been no exception.

(*b*) The occasional commercial borrower gets the same sort of treatment, provided he is a customer of our institution, as the so-called regular customer. However, if he has no business dealings with our bank, it is our practice to decline the loan application.

(*c*) Real-estate loans have been made in accord with the regulations prescribed, and we probably have been somewhat more critical of the borrower's ability to pay and slightly more conservative in our appraisals.

(*d*) Consumer loans: Our policy has not changed except that we have at all times endeavored to operate within the requirements of regulation W.

Frederic A. Potts (Philadelphia National Bank, Philadelphia, Pa.)

The Philadelphia National Bank has always maintained a conservative loan policy. However, following the adoption of the voluntary credit restraint program in March 1951, a project which we heartily favored because it is voluntary and because we approved of its objectives, an even more critical examination of loan requests was

established for the purpose of assuring that lending operations were in strict conformance with the spirit of the Voluntary Credit Restraint Committee's regulatory recommendations.

(*a*) There were very few instances where a change in policy was necessary in respect to our regular commercial customers.

(*b*) We were approached occasionally by other commercial borrowers for loans which we considered of an inflationary nature and which were therefore declined. However, the great majority of requests from these borrowers were represented by added cash requirements for such purposes as taxes, increased costs of raw materials, higher wage scales, and also some temporary loans for plant expansion.

(*c*) Our real-estate loans are for the most part limited to extension of credit during the construction period, with permanent financing already arranged with responsible institutions. As the purpose of the housing project and area served thereby has always been carefully examined, little change was necessary in our policy.

(*d*) Our volume of direct consumer loans is small. We have been extremely conservative in our extension of credit of this type, and therefore regulation W had relatively small effect on our normal policies. We considered the establishment of these restrictions both constructive and desirable.

R. F. Reader (First National Bank, East St. Louis, Ill.)

In July 1950 we found it necessary to put into effect a more restrictive credit policy for the reason that we were having a heavy demand for all types of loans from both customers and noncustomers. The general character of the change was that we discontinued making loans to noncustomers.

(*a*) Regular commercial customers have been requested to confine inventory purchases to normal requirements as indicated by 1949 and 1950 purchases.

(*b*) Occasional commercial borrowers who are noncustomers, were referred to banks with which they are doing business.

(*c*) Real-estate loans were made to our customers only, and loans were made only on properties in good physical condition.

(*d*) Consumer loans are made in limited amounts in strict conformity with regulation W.

Frank A. Rees (Bank of California, San Francisco, Calif.)

(*a*) No consequential change.

(*b*) We are somewhat more selective in choosing among occasional or transient borrowers.

(*c*) Until the last 2 years this bank has made very few real-estate loans. Beginning in the early part of 1950, we commenced a cautious and conservative program of building up a volume of selected real-estate loans, primarily on residential properties.

(*d*) No change of consequence. We make relatively few consumer loans directly, the bank's traditional policy having been to prefer loans to the large finance companies who specialize in this class of business.

John T. Rohr (Toledo Trust Co., Toledo, Ohio)

The lending policies of our bank have undergone no change since July 1950 with respect to (*a*) regular commercial customers and (*b*) occasional commercial borrowers, other than to satisfy ourselves that

the loans are for useful and constructive purposes and do not interfere with the defense production program.

What changes have occurred in our policies relative to (*c*) real-estate loans and (*d*) consumer loans have been only to conform with regulation X and regulation W, with more emphasis placed on conservative appraisals.

J. B. Root (Harter Bank & Trust Co., Canton, Ohio)

Lending policies of this bank have been changed, though slightly, since July 1950, largely by the impact of the restrictive regulations and other actions of the Federal Reserve System, but partly by the business outlook.

(*a*) We still endeavor to take care of our commercial customers' needs within the limits of the restrictive measures.

(*b*) We are not encouraging other than depositors to apply for loans.

(*c*) Our real-estate loans have been cut back substantially.

(*d*) We have not changed policy regarding consumer installment loans except to conform to the restrictions of regulation W.

James E. Shelton (Security-First National Bank, Los Angeles, Calif.)

The normal policy of the bank has been to analyze loan applications from the standpoint of the soundness of the credit, the terms of the loan, and the business relations with the applicant. The change since July 1, 1950, has been in the consideration given to the use to be made of the proceeds of the loan. Applications which were otherwise satisfactory, and where the proceeds were to be used for productive purposes in support of the defense program or the maintenance of the essential domestic economy, were approved. Where in our opinion proposed loans were not for such purposes, they were declined. This applies to all types of loans.

J. C. Thomson (Northwest Bancorporation, Minneapolis, Minn.)

The lending policies since July 1950 have been influenced by the inflationary situation and by the voluntary credit control program, as well as Regulations X and W. Outside of these factors, there has not been a general change in the lending policies of our affiliates. They have, to some extent, increased their real-estate loans for the purpose of more profitably employing time deposits. Total loans have increased materially to meet legitimate requirements of their customers which, in turn, are influenced by the inflationary situation and business conditions. Our affiliates have endeavored to meet requirements of their customers consistent with maintaining sound banking policies, cooperating with the Government in voluntary credit control and in other programs looking toward the control of inflation.

L. A. Tobie (Meriden Savings Bank, Meriden, Conn.)

Our interest is in real-estate loans exclusively.

We felt that the regulations affecting real-estate financing that were in effect prior to July 1950 were too liberal, and we welcomed the changes incorporated in regulation X and the related regulations affecting VA and FHA loans. We were disappointed that these regulations were modified by legislation in the autumn of 1951, as it is

our feeling that those regulations could have been retained without limiting new construction unduly.

The application of regulation X and the related VA regulation tended to bring our competition up to our level of quality in 1950, and we were able to sell lower-yielding loans to other lenders, since we had attained a position closely approximating our legal and policy limit of investment in mortgage loans.

It appears that the modification of regulation X and the related VA regulation has brought into the real-estate market—and so created a demand for mortgage financing—a considerable group of prospective buyers who are ill-equipped for the financial responsibility of home ownership.

We are currently faced with lending problems which require an internal policy which applies restraint beyond that of the recently relaxed credit regulations. The situation is more acute—almost alarming—with respect to VA loans than any other types.

R. H. West (*Irving Trust Co., New York, N. Y.*)

Since 1950 the lending policies of our bank have been changed, and since the inauguration of the voluntary credit-restraint program requests for all loans have been carefully screened to the end that we comply with the guiding principles of the program.

With regard to the subsidiary and specific questions asked, our replies are as follows:

(*a*) *Regular commercial customers.*—Term loans are not now solicited, but are considered when requested, and there is evidence of the need for such loans.

(*b*) *Occasional commercial borrowers.*—No change.

(*c*) *Real-estate loans.*—Solicitation has been discontinued; emphasis is being put on reduction in volume, and we have fully complied with regulation X.

(*d*) *Consumer loans.*—Most of our business in this field is of a "wholesale" nature; that is, purchasing consumers' paper from other originators. At this time we are not taking on any new "wholesale" accounts.

Joseph C. Williams (*Commerce Trust Co., Kansas City, Mo.*)

Our lending policies have changed since July 1950. We have become more critical of inventory loans and anything of a general speculative character, and we have attempted to conform to the voluntary credit-restraint program. At the same time, we have made an effort to cooperate on defense loans; have set up several sizable V-loans, and are particularly attentive to loans that bear on the production of materials for the war effort.

(*a*) Our regular commercial customers have been handled as usual, having in mind the above general rules. Lines of credit have been renewed; and in some cases, due to increased unit costs, we have increased lines of credit.

(*b*) Occasional commercial borrowers have been accommodated in the light of their needs and with due regard to inflationary pressures.

(*c*) We have attempted to stay away from speculative real-estate loans, but have facilitated defense-housing loans and proper new construction, working within the limits of regulation X.

(*d*) Consumer loans have been handled within the framework of a revised regulation W.

Frederic E. Worden (National Bank of Auburn, Auburn, N. Y.)

It is very difficult to state that in actual operations there has been any change in the lending policies of this bank since July 1950.

(*a*) With respect to regular commercial customers, we found that we had a number of accounts that had not borrowed for a number of years. Due first to the rise in prices and second to the scare buying which occurred during the fall of 1950, we were requested and did make loans which we had not previously been requested to make for a long period of time.

(*b*) We saw no change in our relations with occasional commercial borrowers.

(*c*) We have restricted and screened more carefully real-estate loans.

(*d*) We comply with regulation W in respect to consumer loans.

Earl S. Wright (Marble Savings Bank, Rutland, Vt.)

Yes. The lending policies of our bank have changed since July 1950 to comply with regulations W and X. We believe this change has been beneficial to the banks and also to our customers, especially in regard to real-estate loans.

2. Have the investment policies of your bank changed since July 1950? Discuss the change in terms of: (*a*) Purchase of municipal securities, (*b*) purchase of corporate securities, (*c*) management of your Government security portfolio.

A considerable number of the bankers stated that they had increased their purchases of municipal securities, generally giving tax reasons for this action. Little change was indicated in the field of corporate securities—many of the bankers indicating that they held few or none of these securities. The great majority of bankers stated that they had shortened the average maturity of their Government-security portfolios. Some of them stated that one reason for this was to increase their liquidity in anticipation of further loan demand; others gave interest-rate reasons. (See question 3.) A considerable number indicated that they were confining new investments to Treasury bills.

Extracts from typical replies follow:

Anderson Borthwick (First National Trust & Savings Bank, San Diego, Calif.)

Investment policies of our bank have not changed since July 1950. We have liquidated municipal and corporate securities to offset increase in loans. We have increased our holdings in short-term Government obligations and cash, in view of an increase in deposits.

Lloyd D. Brace (First National Bank, Boston, Mass.)

There has been no radical shift in our investment policy since July 1950 except gradual tendency to shorten maturities. This has been due to two factors:

(1) Chiefly a desire to increase liquidity and to decrease market risk during a period of loan expansion.

(2) The greater increase in short-term rates as compared with long-term rates and the impact of increased taxes have tended to flatten the yield curve to provide what we believe to be inadequate compensation for maturity extension.

Our comments regarding specific investment classifications are as follows:

(*a*) Policy of some increased purchase of municipal securities because of our belief that they are relatively more attractive in the light of increased taxation, and especially in the light of excess-profits taxation.

(*b*) No change of policy with regard to the purchase of corporate securities as we buy practically none.

(*c*) The policy as regards the management of our Government-security portfolio has been described in the general remarks comprising the first section of our answer to question 2.

Milton Brown (Mercantile National Bank, Dallas, Tex.)

Yes. (*a*) No substantial change. (*b*) No change. (*c*) Generally a policy was adopted looking toward the shortening of the maturity of the account. This was accomplished in our case largely through reinvestment of maturing Governments in 90-day Treasury bills and the investment of newly accruing funds in such bills.

Walter E. Cosgriff (Continental National Bank & Trust Co., Salt Lake City, Utah)

The investment policy has varied very slightly in the direction of shorter-term obligations but this trend has been so minor as to be practically nonexistent. About the same balance as formerly exists between municipal and Government obligations.

Ben DuBois (First State Bank, Sauk Centre, Minn.)

Our investment policy has undergone no change since July 1950.

H. P. Fleming (First National Bank & Trust Co., Macon, Ga.)

(*a*) Recently we have decided to increase our percentage of municipal securities to help us with excess profits. (*b*) Have purchased no corporate securities in many years. (*c*) We have always confined our Government portfolio to those maturing in not over 5 years except for small amounts. Recently, as we have increased our holdings of municipal bonds, we are shortening still further the big majority of our Government bonds. The only exception to this is that we are buying some of the longer-term Federal housing bonds.

Robert V. Fleming (Riggs National Bank, Washington, D. C.)

There has been no marked change in our investment policy since July 1950. Due to the nature of our deposit structure, having many accounts of banking institutions, other large corporations, foreign governments and missions, it has been necessary for us always to maintain a very liquid position to meet the fluctuations which take place in our deposit structure. While our portfolio is lower now than it was in 1950, this has been occasioned by the increased demand for loans from regular commercial customers whose needs are legitimate and to the demand for loans for defense purposes. To illustrate, our portfolio of Government securities has an average maturity of about 3¾ years and slightly less than 2 percent have a maturity of over 10 years.

(*a*) In recent months we have increased our purchases in the municipal classification but only in a moderate amount, for the purpose of investment yield, and those purchased have been a short maturity.

(*b*) We do not maintain many corporate securities in our portfolio, true corporates representing slightly over 1 percent of our total portfolio. Other than the Governments, the other securities in our portfolio are of quasi-governmental instrumentalities, and of short maturities.

(*c*) We have always maintained an investment position in the management of our portfolio rather than a trading position in regard to both Government and other securities. Our general policy is to carry Governments on our books at par, and in such few instances where securities are carried at a premium, the premium is amortized rapidly within the regulations of the Office of the Comptroller of the Currency.

L. M. Giannini (*Bank of America National Trust and Savings Association, San Francisco, Calif.*)

There has been no fundamental change in our investment policy since July 1950.

R. M. Hanes (*Wachovia Bank & Trust Co., Winston-Salem, N. C.*)

Yes.

(*a*) Only sufficient State and municipal securities have been purchased to replace the maturity or call of tax-free securities.

(*b*) No corporate securities purchased since July 1950.

(*c*) Very little purchasing done in Government securities with the exception of short-term bills and certificates of indebtedness.

W. S. Hildreth (*Peoples National Bank, Charlottesville, Va.*)

(*a*) We have had a slight increase in the proportion of municipal securities.

(*b*) We have liquidated all corporate securities holdings which for many years have been small.

(*c*) We have shortened the maturity schedule on our Government security portfolio.

3. Discuss the factors which contributed to the changes in your policies described in the two preceding questions, and your evaluation of the relative importance of each factor. Please give consideration to the following: (*a*) Increases in short-term interest rates, (*b*) declines in prices of long-term Government bonds, (*c*) increases in reserve requirements around the turn of the year, (*d*) moral suasion (including the voluntary credit restraint program), (*e*) changes in prices and in the business outlook.

The factor rated most influential in the largest number of replies susceptible to specific tabulation was the voluntary credit restraint program. Most bankers stated that they approved of this program and that they were complying with it fully. Many stated, however, that their lending policies were sufficiently conservative so that their loans all fell within the range of the voluntary credit restraint program in any event. (In some such cases there may have been a failure to realize the potential differences in criteria for the evaluation of loans on the basis of their individual soundness as compared with that of their conformity to the voluntary credit restraint program.)

The factor rated next most important in the replies subject to tabu-

lation was that referred to in the question as "(*e*) changes in prices and in the business outlook." Some bankers emphasized in this connection that increased prices and the possibly overextended positions of their customers made them more conservative in credit extension, while others emphasized that the increased price level in itself required a larger amount of lending to transact the same volume of business. Some pointed to the increased volume of their own loans as a reason for conservatism.

Increases in short-term interest rates were generally rated as more important in banking policy than the declines in the prices of long-term Government bonds. Interest rate changes were particularly important in investment policy—many bankers pointing out that higher short-term interest rates made it more easily possible (i. e., less costly in terms of earnings) to concentrate their Government security portfolio in short-term securities. The effects of interest rate changes on lending policies were less than their effects on investment policies. Some bankers said that higher short-term interest rates had caused some loss in deposits, some of the larger depositors prefering to hold the securities themselves.

All bankers stated that they were conforming to regulations X and W. The majority of them stated, however, that the requirements of these regulations were no stricter than they considered conservative banking and that they had been enforcing these standards in any event. On the whole it appeared that they considered these regulations somewhat less influential in bringing about policy changes than the factors mentioned above.

Only a minority of the replies considered the increases in reserve requirements around the turn of the year as important. Most bankers who referred to these increases said that they met them by selling short-term Government securities.

Increases in tax rates and the (newly enacted) taxation of mutual savings banks, although not included in the specific factors named in the question, were cited by a large number of bankers as influential in their loan and investment policies, particularly in the increased purchase of State and municipal bonds and of partially tax-exempt United States securities. Another factor not referred to in the question which was often mentioned as important was the diminishing ratio of capital to risk assets brought about by the loan expansion during the postwar period and particularly since Korea.

Extracts from typical replies follow:

C. W. Bailey (*First National Bank, Clarksville, Tenn.*)

We have not been influenced to any great extent by the factors mentioned in this paragraph of your inquiry for the reason that we maintain uniform rates at all times, do not own any long-term Government bonds, maintain surplus reserves at all times, try to operate our bank in keeping with the policies of the voluntary credit restraint program; and the business outlook in our area has been a very good one, even up to the present time.

Julian B. Baird (*First National Bank, St. Paul, Minn.*)

The changed policies described in 1 and 2 above were the resultant of many factors, all connected with a rapidly expanding economy and inflationary pressures.

(*a*) The increase in short-term interest rates made it unnecessary to seek outside investments to maintain earnings, but more than that the increased short rates signalized to bankers, as well as to the business community in general, that lending was becoming more restrictive.

(*b*) As our holdings of long-term Government securities were relatively small, the decline in price had little direct effect on us. The decline did have a significant effect on the psychology of the financial community similar to the effect of the rise in short-term interest rates.

(*c*) The increase in reserve requirements operated to force some banks, including our own, to sell Government securities if they were to take care of their customers' legitimate borrowing needs.

(*d*) The voluntary credit restraint program has without question made a significant contribution in bringing both lenders and borrowers to a recognition of their public responsibilities in connection with the creation and proper use of credit in an inflationary period. Since the inauguration of the voluntary credit restraint program, this bank has declined loans to the aggregate amount of $7,172,700 (about 5 percent of total loans on our books), all of which loans were creditworthy and would have been made were it not for the program.

(*e*) Rising prices naturally created a further demand for loans to carry higher-priced inventories, much of which demand was legitimate and had to be met by the banks. Such rising prices and the abnormally high level of business activity were regarded as signals for caution and reasonable restraint.

Lloyd D. Brace (First National Bank, Boston, Mass.)

(*a*) I do not look upon increases in short-term rates as the cause of any change in our policy. Instead, those increases were themselves primarily the result of increased demand for loans. I have already stated that this increased loan demand, rather than the increase in short-term rates, was the chief factor impelling us to shorten our maturities to some degree.

(*b*) Declines in the prices of long-term Government bonds had had little or no effect on our policies, chiefly because we did not wish to increase long-term holdings at a time of heavy loan demand and partly because the rise in long-term rates was not as great as the rise in short-term rates, with the result of creating a flat and, to us, uninteresting yield curve.

(*c*) Increases in reserve requirements around the turn of the year simply transferred earning power from us to the Federal Reserve banks and necessitated the replacing of short-term securities which we had to sell with other short-term securities (at the expense of somewhat longer term securities) in order to maintain our liquidity.

(*d*) Moral suasion has had no effect in changing our basic policies except that our sympathy with the objectives of the voluntary credit restraint program has naturally made us more than ever desirous of eliminating inflationary loans.

(*e*) Changes in prices and a high degree of business activity provided the foundation for the increased loan demand which we have already described as the chief factor affecting our policies during the period in question.

W. Randolph Burgess (*National City Bank, New York, N. Y.*)

The rising of the economic tide—evidenced in higher prices, larger inventories, greater demand for funds, rising interest rates—suggests caution to the banker who knows from experience that such periods breed trouble. Another consideration is the effect of higher taxes upon corporate liquidity and ability to repay indebtedness. In addition, the credit tightening action by the Reserve System and the voluntary credit restraint program have been specific reasons for greater caution.

As to the points (*a*) to (*e*), the following comments may be made:

(*a*) The level of rates is less important than the direction and the adverse reactions on investment values (point (*b*)) and on deposits. The increases in yields on short-term Governments have greatly broadened the market for such obligations, especially among corporations. Their purchases have had a marked effect of retarding deposit growth.

(*b*) Declines in intermediate and longer term Government securities tended to freeze the part of the investment portfolio that could only be sold at a loss and thus cut down loanable resources.

(*c*) Increases in reserve requirements diminished the lending power of some banks; most took care of it easily by selling Government securities, but lost earnings.

(*d*) The voluntary credit restraint program not only has resulted in denials of credit for disapproved purposes but also has had a general restraining influence on both borrower and lender.

(*e*) Covered above.

S. Sloan Colt (*Bankers Trust Co., New York, N. Y.*)

The most important single factor in the changes which have occurred in our lending and investment policies was undoubtedly the realization that the outbreak of war in Korea would set in motion a new trend of developments. It was evident that the banks would be called upon to finance a very rapid increase in production. Higher prices, especially for imported raw materials, immediately increased the working-capital requirements of business. It was also evident that the defense program would generate inflationary pressures. Sound lending policy under these circumstances indicated raising standards of creditworthiness and scrutinizing carefully the purpose of the borrowing.

(*a*) Increases in short-term interest rates have been important during the period since mid-1950. A rise in rates is the most effective means of giving emphasis to a major change in the credit situation. The higher rate serves notice on borrowers and lenders alike that the situation calls for tighter lending policies.

(*b*) In our case, declines in prices of long-term Government bonds were not a significant factor. The firming in interest rates for long-term financing was as important as short-term interest rates, however, in indicating the altered situation in the supply and demand of funds.

(*c*) The increases in reserve requirements which were announced on December 29, 1950, did not affect our lending policies, nor did they prompt changes in our investment policies. Since at that time the Federal Reserve was actively supporting the market for short-term Government securities, higher reserve requirements involved simply

the transfer of this type of earning asset from the commercial banks to the Federal Reserve banks.

(*d*) In our opinion, the voluntary credit restraint program has made a very real contribution. In providing information and guidance, the regional and national committees have served a very useful purpose. Of special significance has been the fact that for the first time the commercial banks have been joined by other financial institutions and by investment bankers in making a comprehensive and cooperative effort to channel funds where they will make the maximum contribution to the defense program and to efforts to restrain inflationary pressures.

(*e*) Changes in prices and in the business outlook have had their usual influence on our lending and investing policies. In times of rising prices and expanding activity, we are especially careful to see that sound credit standards are maintained and that this atmosphere does not lead to loose lending policies. Similarly, in our investment account we have emphasized the liquidity and quality of our securities.

Walter E. Cosgriff (Continental National Bank & Trust Co., Salt Lake City, Utah)

We have always maintained that an individual or corporation which has been a regular customer of the bank for a reasonable period of time has a preemptive right to obtain a loan providing their proposition is sound. This would be so regardless of the voluntary credit restraint program or the particular borrowing ratio of the bank involved. The only question concerning us is what attitude to take regarding applicants for loans who have not previously been customers of the bank.

Up to about June 30, 1949, we accepted these applications from anyone who filed them. Since that time we have gradually changed to a policy of limiting loans to people who previously have been customers of the bank in some capacity, but this program was in full effect in June of 1950.

Generally speaking, interest rates are charged commensurate with the general money market and the work and risk involved in the making of a particular loan. The voluntary credit restraint program has generally been applied by us only insofar as new borrowers were concerned.

Percy J. Ebbott (Chase National Bank, New York, N. Y.)

Changes in the bank's loan policies, outlined in the answer to question 1, were influenced principally by (1) commodity price movements and general business conditions, (2) increases in short-term interest rates initiated by the Federal Reserve System, (3) increases in reserve requirements, (4) moral suasion, and (5) direct credit controls. Declines in prices of long-term, marketable Government bonds, on the other hand, exerted no direct influence upon loan policies, since none of these bonds was held by the bank and it was not dependent upon their sale as a source of funds to finance loan expansion.

After July 1950 the credit demands of business borrowers increased in order to finance larger inventories and accounts receivable at rising prices. The bank responded to these demands when credit factors were satisfactory. Beginning in late summer of 1950, the bank adopted

a more restrictive attitude in the light of changes in money market conditions and in the availability and cost of funds to finance borrowers' demands. Eventually the bank found it necessary to raise its lending rates in response to changes in short-term rates initiated by the Federal Reserve System.

The voluntary credit restraint program inaugurated in March 1951 reinforced the loan policy earlier adopted. In response to this program the bank withheld credit from those borrowers whose requests were obviously inflationary and not in conformance with the criteria of essentiality.

The regulatory increases in reserve requirements at the turn of the year had their direct impact upon the bank's investments (discussed below). However, insofar as this measure impaired the earning power of the bank, it placed the bank under pressure to expand earning assets.

The influence of direct credit controls was confined to real estate and consumer credit in the manner described in the answer to question 1.

Changes in the bank's investment policies, outlined in the answer to question 2 were influenced principally by (1) expansion of the bank's loans, (2) the impact of corporate-income and excess-profits taxes upon the profitability of various types of securities, (3) increases in reserve requirements caused by expansion of the bank's deposits and by the regulatory action around the turn of the year, and (4) increases in short-term interest rates. The decline in market prices for long-term Government bonds exercised only a minor influence upon investment policies, since the bank held none of the issues affected. Commodity price movements as such exerted no direct influence upon the short-run management of the investment portfolio. However, price movements, and the general business outlook, did exert an indirect influence by reason of their impact upon the actual and anticipated volume of loans. The bank's investment policies, of course, were at all times responsive to moral suasion; e. g., the bank refrained from committing itself to invest in the special revenue bonds offered in May 1951 by the State of West Virginia.

Expansion of the bank's loans after July 1950 necessitated that some other assets be liquidated in order to obtain loanable funds. In the final analysis this need was measured by the additional reserves required against the deposit expansion that resulted from the loans made by this and other banks. Short-term Government securities—e. g., Treasury bills, certificates of indebtedness, etc.—were used for these purposes because the bank's holdings of corporate securities were already small and because municipal securities enjoyed tax-exemption privileges which would have made their sale more costly—in terms of the sacrifice of income—than the sale of fully taxable, short-term Government securities.

The bank pursued a policy throughout the period of switching from fully taxable Government obligations into fully tax-exempt municipal securities and into partially tax-exempt Government bonds. These switches were motivated by corporate-income and excess-profits taxes which made the after-tax yields obtainable from municipal and partially tax-exempt Government securities high relative to the yields obtainable from fully taxable Government securities. By the same token, these provisions of the tax laws discouraged the bank from investing

in long-term taxable Treasury bonds in order to improve the average rate of return from the investment portfolio. The increases in short-term interest rates that transpired during the period also discouraged the bank from purchasing long-term Treasury bonds.

Regulatory increases in reserve requirements caused the bank to liquidate short-term Government securities in order to obtain reserve funds. The cost of obtaining reserves for these purposes, as well as for offsetting the enlarged deposits that resulted from the afore-mentioned loan expansion, was increased considerably by the rise in short-term interest rates. This added cost derives from the fact that required reserves yield no income and involve a sacrifice of income that otherwise could have been realized.

Charles T. Fisher, Jr., (*National Bank, Detroit, Mich.*)

Aside from the regulations X and W and the voluntary credit-restraint program, which we have carefully adhered to, the factors which influenced the changes in our lending and investment policies were (1) the increase demand for loans, which not only presented the opportunity to be more selective but which also required us to be more selective, in order to be able to provide for the present and prospective requirements of our customers and community without an excessive expansion in our loan account in relation to our capital funds; and (2) the increase in short-term interest rates, which removed some of the pressure to improve gross income by obtaining more high-yielding loans and investments. An increase in gross income was particularly needed in view of rising expenses and higher tax rates. Our consideration of these factors was made in the light of our multiple responsibilities to the bank's depositors and borrowing customers, the community, and the stockholders.

We have no doubt that there would have been much greater expansion in loans if short-term interest rates had not been raised, long-term Government bonds had not declined, reserve requirements had not been increased, and regulations X and W and the voluntary credit-restraint program had not been in effect. We also believe that price rises would have been greater and that the business outlook would have been more inflationary, leading to further increases in bank loans, if the foregoing monetary and control steps had not been taken.

H. P. Fleming (*First National Bank & Trust Co., Macon, Ga.*)

(*a*) The increase in short-term interest rates has made it easier for us to keep our Government portfolio short-term. (*b*) The decline in long-term Government bonds also made it much safer for us to stay close to shore. (*c*) No comment. (*d*) We have tried to abide by the principles of voluntary credit-restraint program and believe the over-all effect of this program good. (*e*) Inflationary pressure has made us more cautious, not only in our bond portfolio but also in our lending policies.

Robert V. Fleming (*Riggs National Bank, Washington, D. C.*)

(*a*) The increase in the short-term interest rate and the general demand for loans have caused an upward tendency in the rates charged.

(*b*) Declines in the prices of long-term Government bonds did not materially affect us, as our portfolio has an average maturity of 3¾ years, and our policy of carrying governments on our books at par or amortizing over a short period the premium on the few holdings car-

ried at a premium have not resulted in too great an effect upon our portfolio.

(*c*) Increases in reserve requirements were, of course, a factor in stiffening rates charged for loans, as we had less money to lend.

(*d*) I feel that the voluntary credit-restraint program has been well organized and is being carried out effectively. As this program covers not only banking institutions but insurance companies and investment bankers and is under the guidance of the Federal Reserve System, it is more encompassing and effective than the voluntary program undertaken by the bankers of this country in 1948 (which program had the approval of the President of the United States and the Secretary of the Treasury), as it covers such a wider field of lending. I feel sure that many borrowers who might seek credit for speculative purposes have been deterred because of their awareness of the current voluntary credit-restraint program. While it is impossible to estimate in dollar volume the total of loans which might have been applied for had this program not been in effect, I am quite sure that the total throughout the country is substantial. I feel that the success of the program does not necessarily rest upon the total level of loans because of the price level, as it takes more money to do business now than it did under a lower price level. Furthermore, as the defense program becomes intensified, loans for defense purposes will unquestionably exceed the decline in nondefense loans. In my judgment, therefore, the test is the purpose for which a loan is granted.

(*e*) With respect to changes in prices and in the business outlook, as outlined above, we are following the policies resulting from our long experience and training in the banking business, such as carefully watching inventory, earnings after taxes, and the capabilities of management, all of which are so necessary in evaluating the soundness of credit requests.

R. M. Hanes (Wachovia Bank & Trust Co., Winston-Salem, N. C.)

(*a*) So far as loans are concerned, the increase in short-term interest rates has had very little effect on volume, as we have endeavored to limit loans to essential productive purposes and loans essential to the distribution of merchandise and the movement of crops. Insofar as funds were available for investment, the change in short-term rates made it advisable to purchase short issues rather than medium or longer term.

(*b*) Decline in prices of long-term Government bonds has had no effect on loan policies. The decline made it advisable to confine purchases to short issues in view of the increased return on them.

(*c*) Increase in reserve requirements around the turn of the year led to greater selectivity and an endeavor to hold credit to the minimum amount essential to carry on the borrower's business. It reduced amounts which might have been invested in bonds and required some selling.

(*d*) The voluntary credit-restraint program has been followed closely and has had a material effect in eliminating nonessential loans. No effect on investment policy.

(*e*) Increased prices have required larger credits to do the same unit volume of business. The peak to which prices have moved has met severe consumer resistance, with result that our textile and furniture plants are short of orders and are operating only part time.

This in turn has led to some slow credits and to caution in the making of loans in these fields, as well as our investment policies.

Lynn T. Hannahs (*First National Bank, Kenosha, Wis.*)

I believe that our loaning policy was influenced by all of the items listed under (*a*), (*b*), (*c*), (*d*), and (*e*). However, it is my opinion that abandonment of the par support of Government bonds and notes, thereby increasing the short-term interest rates, had more to do with the tightening of bank credit than any other thing, as banks in general hesitated to take a loss on their Government securities in order to raise cash to take care of the increasing demand for credit.

Comer J. Kimball (*First National Bank, Miami, Fla.*)

Each of the factors listed contributed to more cautious investment and lending policies. Principal factor in reaching this decision was recognition that during a period in which the Federal Reserve through its Open Market Committee operations was pursuing a policy of deliberately forcing higher interest rates with resultant lower prices for Government securities could lead only to uncertainty and confusion. Staying as close to shore as possible during such a period was deemed advisable.

James K. Lochead (*American Trust Co., San Francisco, Calif.*)

(*a*) Increases in short-term interest rates were notice to the public that money was tightening and had a tendency to make borrowers recast their plans in that light.

(*b*) The decline in the prices of long-term Government bonds has had no material influence on our policy, since we have never had any substantial holding of long-term bonds. However, the firming in long-term interest rates has naturally been a further notice to our borrowers of the tightening of credit.

(*c*) Increases in reserve requirements also were most effective, as notice to the public of the tightening of credit and had a similar influence to increasing the short-term interest rates.

(*d*) The voluntary credit-restraint program has been very effective, particularly in reducing loans for investment purposes, carrying speculative inventories, and financing longer inventory positions anticipating price rises.

(*e*) Changes in prices and the inflationary business outlook have created tremendous pressures on us for loans to buy everything, both for inflation hedges and business expansion. With the help of the voluntary credit-restraint program we have been able to control these demands quite satisfactorily, but rising prices and business activity have forced our customers properly entitled to consideration to ask for larger loans than heretofore and, in many cases, to become borrowers for the first time in several years.

* * * * * * *

The Treasury Department's issuance of 2¾ percent bonds and the withdrawal of market support by the Federal Reserve System changed the level of all bond yields and likewise mortgage returns by approximately one-fourth of 1 percent. However, the VA rate was not moved up to correspond with other governmental action. Hence the open market has been willing to pay only about 95 percent of par for veteran loans.

We have been forced to deny many requests for both FHA and VA financing because of lack of a proper secondary market, which in turn is due to unrealistically low rates on FHA and VA loans.

T. R. Murphy (First National Bank, Zanesville, Ohio)

Government regulation is largely responsible for all changes we have made in policy.

S. C. Pidgeon (Bankers Trust Co., Des Moines, Iowa)

The factors referred to have little bearing upon the general operations of our bank.

(*a*). The increase in short term interest rates has had little or no effect on our general operations.

(*b*) Decline in long-time Governments was not a material factor in that we have not been a purchaser of long-term Governments for several years, having confined our portfolio to short-term Governments which would in all probability have been bought regardless of rate.

(*c*) Increase in reserve requirements around the turn of the year affected us very little except that it was necessary for us to liquidate sufficient short-term Governments to meet the higher requirements. So far as we know, it did not curtail any loans to our legitimate borrowers.

(*d*) The voluntary credit control program has caused some change in our loan policies inasmuch as we have endeavored to cooperate in every way with the program. There have been a number of loans that have been declined by reason of their failure to qualify. However, we know of no case where we have lost worth-while business by reason of same.

(*e*) Price changes and general business outlook have been and are present at all times in the consideration of the extension of credit.

Thos. E. Prescott (Bank of Passaic and Trust Co., Passaic, N. J.)

The increase in short-term interest rates helps the big city banks because the bulk of their deposits is in demand rather than time deposits. It affords, however, very little help to the vast majority of country banks. (*b*) The decline in prices of long-term Government bonds has frozen the portfolios of most country banks and weakened their confidence in the Government bond market; furthermore, it has not checked the inflationary spiral. The policies of banks in the main are not the cause of this present inflation; Government spending is. (*c*) The increase in reserve requirements around the turn of the year as a move to check inflation means that the reserve requirements over and above what is necessary to carry ordinary business amounts to confiscation of the assets of the bank without compensation. It makes it more difficult for them to earn a living. (*d*) Reasonably applied, moral suasion is better than regimentation. Unfortunately it is quite apparent, from their actions in the past, that those directing the application of suasion consider themselves omniscient.

R. F. Reader (First National Bank, East St. Louis, Ill.)

(*a*) Increase in short-term interest rates has enabled us to operate our bank at a profit without substantially increasing our loans.

(*b*) Decline in prices of long-term Government bonds was the natural result of abandoning par support and increasing short-term interest rates.

(*c*) While we do not believe in excessive reserve requirements, we believe the increase around the turn of the year did discourage unnecessary loans and was justified in order to relieve some inflationary pressure.

(*d*) We are heartily in favor of the voluntary restraint credit program and will make every effort to do our part.

(*e*) Change in prices has resulted largely from increases in wages which continue to spiral upward. The continual increase in wages has made it impossible for many people on a fixed salary to acquire the things they actually need, and is a factor we must consider in extending credit.

J. F. Ringland (*Northwestern National Bank, Minneapolis, Minn.*)

Some of the factors that have influenced our policies discussed in the answers under 1 and 2 have been indicated in those answers. The inflationary trends of the economy were indications that care should be used in extending the greater amount of credit requested. Steps taken during the period under discussion by the Federal Reserve System tended toward a tightening of credit. Policies adopted under the voluntary credit restraint program had their influence upon our loaning operations. (*a*) Increases in short-term interest rates have not been an important fact in our loaning or investment policies. We would have wished to take care of the reasonable borrowing requirements of our customers whether or not rates had risen and the handling of our bond portfolio, as indicated above, was limited by our plan to adhere to the general investment policies we have heretofore followed. No doubt the increase in rates added to the attractiveness of loans and of short-term Governments as earning assets. (*b*) Decline in price of long-term Governments has had little effect upon the investment of our funds because we have been a holder of long-term Government bonds only to a very limited extent. We have felt that we have not been in a position to buy such securities during the period and we have not been unduly disturbed by the decline in price in Government securities. We early decided after the break in the Government bond market last spring that we would take care of the reasonable requirements of our customers even were this to result in the selling of Government securities at a loss. No doubt, however, the decline in bond prices was a factor in tightening credit. (*c*) Increase in reserve requirements early in 1951 did not affect our lending policies nor did it make a change in our over-all investment policy. The higher reserve requirements were in effect met through the sale of short-term Governments. As the Federal was supporting this market, the net result was that we and other banks reduced our earning assets and the Federal Reserve banks increased theirs. This action by the Federal, however, probably had a psychological effect toward the tightening of credit. (*d*) The moral suasion of the voluntary credit restraint program has had a definite influence upon our loaning policies. Not only have we declined loans because of it but we have discouraged borrowers or prospective borrowers from extending their operations in the light of the program's goal. (*e*) Changes in prices and business outlook have had their influence too. We have been concerned, as have many bankers, with the higher inventories in the hands of business and with other risks of an inflationary period. As always in

times of rising prices and expanding activity, the banker must exercise more care when a greater amount of credit is requested.

J. B. Root (Harter Bank & Trust Co., Canton, Ohio)

We would list the factors leading to the above changes in the following order:

(*a*) Decline in long-term Government prices with attendant drying up of market for mortgages.

(*b*) Increase in short-term Government yields which left us (and doubtless most others) "frozen in" with losses even in the shortest Governments.

(*c*) Changes in prices and business outlook.

(*d*) Voluntary credit restraint program.

(*e*) Increase in reserve requirements with loss of earning assets.

Estil Vance (Fort Worth National Bank, Fort Worth, Tex.)

(*a*) The increase in short-term rates had no effect on our investment nor on our loan policy. There has been very little change in our lines of credit outstanding during the past year. Those changes that have taken place are not the result of an increase in the short-term rate.

(*b*) The decline in the price of long-term Government bonds had very little effect on us, inasmuch as we have maintained a short position in securities.

(*c*) The increase in reserve requirements around the turn of the year necessitated our selling some of our Government securities; however, we have been able to meet this increase in reserve without curtailing the normal credit required for our customers.

(*d*) We have adhered closely to the policies outlined in the voluntary credit restraint program. It is our opinion, however, with few exceptions, requests for credit from our regular commercial borrowers have been based on their ordinary and normal requirements. It is for this reason we stated there had been no change of any consequence in loans to our regular commercial customers, inasmuch as they were allowable loans under the credit restraint program.

We have received applications for loans from occasional commercial borrowers, which we felt would be in violation of the credit restraint program. These applications have received our serious consideration, they have been presented in some cases to the State committee for decision, and in each instance where we felt there was the least color of violation of the credit restraint program, applications have been declined.

(*e*) The change in price and business outlook has, in our opinion, affected applications for loans to a greater extent than it has our extension of credit because of these facts. There have been lines in which sales have decreased; and, as a result, inventory has been reduced, resulting in a decrease of loan demand. On other lines, a weakness of the price structure has caused some businesses to operate on a more or less hand-to-mouth basis; however, the restraint was exercised by the individual business and not so much by the refusal of the bank to extend credit because of the change in price or business outlook.

R. H. West (Irving Trust Co., New York, N. Y.)

Changes in our lending policies since July 1950 have been due primarily to our desire to cooperate in the effort to stem inflationary

less than 10 percent of those present were in favor of removing all controls from the Government bond market and letting it take its own course; only one vote was cast in favor of a permanent peg of Government bonds at par under any and all conditions; and the balance of the votes cast divided about equally between those who felt that the policy of debt management which the authorities have pursued in recent months has been about right, and those who believed that orderly markets should be maintained but that a somewhat greater degree of flexibility might be permitted.

Certainly it is fair to say that there was considerable difference of opinion on this matter up until the beginning of the Korean war when recognition of the inflationary potential operated to crystallize views in our bank, and we believe in the banking business generally toward a freer Government bond market. It was obvious that a firm "peg" was depriving the Board of Governors of the Federal Reserve System and the Open Market Committee of the use of an effective tool in attempting to ameliorate the growing inflation by use of the monetary mechanism.

W. Randolph Burgess (National City Bank, New York, N. Y.)

We believe that the par support of long-term Government bonds should have been abandoned in 1946 or 1947 when inflation became generally recognized as a serious problem, and war financing had been completed. The pegging was inflationary.

R. R. Calkins (American National Bank, St. Joseph, Mo.)

Yes; and it is our opinion the time was well selected.

Alfred J. Casazza and Associates (Committee on Government Securities and the Public Debt, National Association of Mutual Savings Banks, New York)

We endorse the existing money managers. We believe in money management. In practically all countries, and over very many years, credit control has been accepted as a necessary and important part of any banking system. This is particularly true where the currency is not redeemable in gold and where there are thousands of commercial banks operating imaginatively for the benefit of local needs.

It is a denial of terms to consider money management as a one-way operation—constantly to increase the supply without limitation. We speak of some men in New England as "havin' all traces and no breechin'." They are not considered completely trustworthy. A timely check is obviously necessary on occasion.

The savings banks have felt the restrictions of the par support abandonment as much as any other business group. Not only did they become immediately subject to a price penalty in exchanging Government bonds for alternate investments, but also their quoted market value surplus showed an immediate reduction below book figures. Both of these resultants were unpleasant particularly to the type of individuals represented in savings bank management and on their trustee boards. However, in the face of the above, this committee remains unanimous that the withdrawal of par support to the longer Government bonds was justified. This committee is not of a mind to go into details as to whether the below-par prices were too high or too low, nor whether the action should have been undertaken early or late. Rather this committee wishes primarily to record itself that despite the adverse effect on savings bank balance sheets and income potentials, the removal of par support is accepted as in the best interest of the

economy in which this group has a large stake. In that sense the move is believed to have been in the best interest of the savings banks themselves.

If the decision to withdraw the above-par peg had been made by a group or board not solely responsible to exercise its judgment in the field of credit, if such a group or board had not been free to exercise the long-term view to the best of their professional abilities, then confidence in their action would have been impaired. Bitterness among savings bankers might well have replaced the trust and support which is the attitude of this committee. For certainly the short-range effects of the Reserve Board action on savings banking was adverse. Under the existing circumstances, this committee is willing and ready to dry its tears and to refuse to "crybaby."

George S. Eccles (First Security Bank of Utah, N. A., Ogden, Utah)

Believe that in view of the fact there was no previous abandonment of part support of long-term Government bonds, that the action taken in March 1951 was very desirable. However, I feel that a more appropriate time would have been June 1950 when bank credit started its tremendous expansion. This earlier action would have had great retarding influence on the expansion of credit both through the banks and the insurance companies and would have acted as a brake on the tremendous inflationary pressure which resulted in the rapid credit expansion which took place following the outbreak of the Korean war.

Changing of reserve requirements to the maximum permitted under the law by the Federal Reserve was not sufficient to meet this problem—neither was the inauguration of regulation W and regulation X, but if the abandonment of par support on Government's which resulted in increased short-term as well as long-term interest rates had also been applied, I feel the program would have had great beneficial results and the inflationary pressure could have been better controlled, and the price level would not have reached the height that it did by March of this year when the par support was abandoned and we would be operating on a lower price level than we now have.

Robert V. Fleming (Riggs National Bank, Washington, D. C.)

* * * In my judgment, in a time of all-out war the policy of pegged prices of Governments had to be maintained, but in a partially peace and partially defense economy, and without a Pearl Harbor to shock people into a consciousness of the need for an all-out patriotic effort, so necessary in a democracy, it is very difficult to see how the inflationary pressures could have been retarded unless par support had been dropped and an orderly market arrived at under the accord between the Treasury and the Federal Reserve System.

It must be recognized that the Treasury has the responsibility to meet the financial needs of the Government and to provide funds as appropriated and approved by the Congress in the Federal budget, as well as to handle the refundings and to manage the Federal debt. In evaluating the problem then existing it should be remembered that the Treasury must always endeavor to hold down so far as possible the cost of debt service as this is one of the larger items in our budget of expenses and even without a change in interest rates the cost of debt service will continue to increase. I believe the accord could have

been reached much sooner if it had not been for the tensions that developed and the dramatization of the problem in the columns of the press with respect to the divergent viewpoints prevailing at that time which now appear to be only history.

L. M. Giannini (*Bank of America National Trust and Savings Association, San Francisco, Calif.*)

We believe that it would have been wise to abandon the par support of Government bonds when evidence of inflationary tendencies became apparent in the early postwar period. The timing of the abandonment of par support in March of 1951 was inappropriate.

R. M. Hanes (*Wachovia Bank & Trust Co., Winston-Salem, N. C.*)

Yes; because a completely free market where securities reflect intrinsic values and the general level of interest rates is highly desirable. This, in our opinion, could have been done better at some earlier date before strain began to be evident in the economy.

H. Hiter Harris (*First and Merchants National Bank, Richmond, Va.*)

I believe that the abandonment of the par support of long-term Government bonds in March 1951 was a wise move in the best interests of our national welfare. I feel that all fixed pegs should have been eliminated after the end of World War II and an orderly market maintained by the Federal Reserve Open Market Committee.

W. L. Hemingway (*Mercantile Trust Co., St. Louis, Mo.*)

The support of the United States Government bond market by the Federal Reserve System during the war was probably necessary. There might be some argument about the particular interest rate pattern which was supported, but little objection can be raised to the advisability of supporting the United States Government bond market when wages, prices, production, and employment were subject to regulation and control.

Serious doubt can, however, be raised about the merit of continuing to support United States Government long-term securities at par long after the end of the war. The maintenance of a "pegged" market at artificially low rates facilitated the transfer of funds from United States Government securities to other more remunerative investments. It was unwise in the face of a growing demand for credit to continue to support the United States Government bond market and to interfere with the normal operation of the free market.

United States Government securities were supported at par for some time after the war because there were understandable fears that a decline in the price of long-term United States Government bonds below par would lead to the presentation for redemption of a large amount of United States savings bonds. It is worth noting that, when the long-term bonds did fall below par, no insuperable problem was presented.

The Federal Reserve System should have attempted to abandon the policy of supporting the long-term United States Government bonds at the same time that other wartime controls were abandoned. The end of the war should have been the signal for a rapid return to a free market for United States Government securities.

C. Johnston Huddleston (Wabeek State Bank, Detroit, Mich.)

It is our opinion that the abandonment of the par support in long-term Governments in March 1951 was timely. We have no opinion as to wisdom of any other time or under any other conditions.

J. B. Jessup (Equitable Trust Co., Wilmington, Del.)

We believe that it was wise to abandon par support of long-term Governments. However, hindsight makes us believe it would have been wiser to do so earlier; perhaps in the fall of 1949 when the Federal resumed support of the bond market in large volume.

Comer J. Kimball (First National Bank, Miami, Fla.)

Consider abandonment of par support on long Governments in March 1951 most unwise. Feel policy of fixed price support unwise and should never have been adopted in the first place. Feel that abandonment of policy after a period of deliberately forcing prices downward and after assurances of the Secretary of the Treasury that a long-term 2½ percent rate was going to be maintained caused great disillusionment and loss of confidence in those charged with fiscal affairs in our Government. Think announcement of change in policy should have been made during a period when free-market prices were well above par coupled with statement that Federal Reserve would continue policy of maintaining orderly market, either up or down.

William L. Kleitz (Guaranty Trust Co., New York, N. Y.)

I believe that it was wise to abandon the par support of long-term Government bonds in March 1951. Replying to the other four subdivisions of question No. 4, I believe that Government bonds should never have been supported at any arbitrary level.

Frank D. Lawrence (American National Bank, Portsmouth, Va.)

Answering question 4, I believe it was unwise to abandon the par support of long-term Government bonds. When a person lends money to our Government, I think he has a right to expect to get his money back when he needs it. I do not believe we should ever have permitted our Government bonds to go up and down as they have in the past. The market price of all Government bonds should be stable—they should all bear the same rate of interest. * * *

Wm. A. McDonnell (First National Bank, St. Louis, Mo.)

The abandonment of par support for long-term Government bonds was, in our opinion, long overdue when it did take place. Fundamentally, we have always considered any artificial price-fixing as basically unsound and one that merely led to putting off inevitable and necessary economic and financial readjustments. In our opinion, a continuation of par support for long-term Government bonds after the end of the war was unsound. * * *

E. R. Manning (First National Bank, Southampton, N. Y.)

* * * naturally we did not think it was wise to abandon par support of the long-term Government bonds, and believe that some plan or policy should be adopted by the Secretary of the Treasury and the Federal Reserve System so that our Government bonds would never sell below par.

W. A. Mitchell (Central Trust Co., Cincinnati, Ohio)

There has never been any doubt in my mind, particularly since 1941, that it is essential for the Treasury Department and the Federal Reserve banks to pay very careful attention to the market for Government bonds. The very large amounts outstanding made it imperative that the economic effects of untoward movements on banks and, indeed, the whole financial fabric should be carefully studied. This of course involves strong support for the market when necessary. I never have been in favor of a pegged price, whether at par or at any other point. A pegged price usually leads to a false sense of security by purchasers, banks and otherwise, and indeed an invitation to speculators to work against the peg. I would have favored strong and adequate support without a peg in 1941 for the above reasons. On the other hand, I doubt whether commercial borrowers are restrained drastically from obtaining bank loans by a fractional change in interest rates, and I fear that drastic changes now would interfere immeasurably with the banking structure and the whole economy. On balance, I feel that the removal of the pegs has been accomplished by the authorities in a very skillful fashion.

F. W. Murray Jr. (National Bank of Orange County, Goshen, N. Y.)

We consider the abandonment of the parity support of long-term Government bonds of March 1951 absolutely justified and furthermore believe that the Federal Reserve should keep its hands off the market even if it does decline. This action should have taken place shortly after the close of the war in 1945.

Thos. E. Prescott (Bank of Passaic & Trust Co., Passaic, N. J.)

Would any business deem it wise deliberately to destroy the confidence of the public in its securities when it may at any time have to enter the market and borrow huge sums of money from the very people and institutions that have no trust or confidence in those who issued the securities? Why were the bonds supported in the first place? The so-called Mellon 3's (U. S. Government 3's of 1955) would have never sold down in the low 90's if they had received only a modicum of support.

J. F. Ringland (Northwestern National Bank, Minneapolis, Minn.)

While we recognize the wish of the Treasury Department to refinance the Government debt and to obtain new funds at low cost, we believe it was wise to abandon par support of long-term Government bonds in March 1951. With a debt as large as our Government's, it is imperative for the central bank to maintain an orderly market but we believe supply and demand should in the main determine interest rates. Probably it would have been wise to abandon par support of long-term Government bonds earlier. In retrospect, it seems that this could have been done any time after it became evident in 1946 that we were not to have an immediate postwar depression, provided a time was chosen when the Government market was strong.

Thomas J. Robertson (First National Bank of South Carolina, Columbia, S. C.)

Yes. If the Federal Reserve System could maintain all obligations of the Federal Government at par (and I question whether it could

without destroying the value of the dollar) there would be no necessity of having any maturity for any part of the Federal debt.

John J. Rowe (*Fifth Third Union Trust Co., Cincinnati, Ohio*)

I believe that the Federal Reserve banks should buy bonds for the best advantage of the shareholders of the Federal Reserve banks; that they should not, in the first place, have accepted a par support of the long-term Government market, and that their purchasing of Government bonds should follow the same policy which their member banks adopt, namely, which issues are for the best interests of the bank, bearing in mind not having a larger market risk than their net worth can afford. As to whether I favored the abandonment, or would have preferred that it had been done earlier, my own firm conviction is that it should never have been started in the first place. My own conviction is that governments have to go to the open market when borrowing money, and should not consider themselves completely above the competitive system which applies to business.

James E. Shelton (*Security-First National Bank, Los Angeles, Calif.*)

The pegging of Government securities at artificial prices is not basically sound. Having embarked on such a policy for a considerable period of time, the question of just when it should have been discontinued is difficult if not impossible to answer. It would appear that the proper time to have discontinued the practice would have been shortly after the termination of the hostilities in World War II when the heavy war financing was completed.

Albert C. Simmonds, Jr. (*Bank of New York and Fifth Avenue Bank, New York*)

We believe it was a wise decision in March 1951 to permit Government bonds to drop below par. While the timing of the decision is not easy to appraise, in retrospect it appears that it ought to have been taken earlier, perhaps as soon as practicable after the termination of the controls necessary to the war economy. Fortunately, in this instance, the abandonment of par support was effected with great skill and no serious shock to banking and investment circles occurred. While we feel that extreme rigidity of the support level should be avoided, we nevertheless realize the necessity for maintaining orderliness in the Government bond market under all conditions.

Burr S. Swezey (*Lafayette National Bank, Lafayette, Ind.*)

I believe it was wise to abandon the par support of long-term Government bonds in March 1951. In fact, I believe it would have been wise to have abandoned the par support as far back as 1947. I believe our economy is better served by having flexible interest rates.

J. C. Thomson (*Northwest Bancorporation, Minneapolis, Minn.*)

I believe it was wise to abandon the par support of long-term Government bonds in March 1951. In my judgment this should have been done earlier, as soon as the inflationary pressures resulting from the Korean incident became evident.

Estil Vance (*Fort Worth National Bank, Fort Worth, Tex.*)

We are in accord with principle of abandoning par support for Government bonds. It might be admitted that during the war period it was necessary that the Treasury maintain artifically low rates in

order to finance the huge military program which was necessary; however, had the Treasury not maintained support prices after the war, there would have been, in our opinion, far less inflation in this country than we have today. There was, in our opinion, absolutely no excuse for the Federal Government's maintaining the artifically low interest rates after the war.

On the other hand, after maintaining the support prices for a number of years, the abandonment of par support in March of 1951 was rather poorly timed. There are numerous investors who have been led to believe the Government would always support long-term bonds at par. The entire attitude regarding governmental credit changed when these securities were permitted to sell below their par value. The public in general realizes more than ever that governmental rates have been artificially low because of par support and future prices of Government securities are dependent upon the attitude of the Treasury Department rather than a market appraisal of the correct rate.

G. Van Haaften (American National Bank, Kalamazoo, Mich.)

Yes, it was wise to abandon the par support of long-term Government bonds. However, we feel that it should have been done about a year earlier, as this would have helped to slow down the inflationary tendency that came with the Korean situation.

R. H. West (Irving Trust Co., New York, N. Y.)

We believe it was wise to abandon the par support of long-term Government bonds in March 1951. We would have preferred to see the support ended at the earliest feasible date and during the period of support we would have liked to have seen more flexibility. Without more study and facts we cannot be more specific. We say this because we recognize the immense problem that confronted our monetary authorities with the vast increase in national debt incident to the conduct of an all-out war and the resulting problems of debt management that confronted us immediately thereafter.

G. C. Weyland (American Bank & Trust Co., Racine, Wis.)

Since the Federal Reserve has been supporting the Government bond market and seem to have some moral obligation to continue doing so, we do not believe it was wise to abandon such support. This action weakened the confidence in Governments, including prospective purchasers of savings bonds. With the Federal debt as high as it is, it would seem that low interest rates and Federal support will be necessary.

Frederic E. Worden (National Bank of Auburn, Auburn, N. Y.)

It is our opinion that it was wise to abandon the par support of Government bonds in March 1951. We believe that it would have been wise to have adopted this policy in December of 1950 and regret that the difficulties between the Treasury and the Open Market Committee did not permit this earlier action. If earlier action had been taken, the restraint on the extension of credit would have been less harsh, especially with respect to real-estate mortgage financing. We believe it also would have been more beneficial in putting the brakes on the inflationary pressures with respect to later demands to finance increased inventories caused by increased prices and scare buying.

5. What do you consider to be the principal functions of bank reserve requirements? Do you believe that nonmember banks should be required to hold the same reserves as member banks of the Federal Reserve System?

Many bankers believed that the only valid function of bank reserve requirements was the protection of depositors and the provision of liquidity for individual banks. A larger number, however, also recognized the function of bank reserve requirements as an instrument of credit control. More than half of all bankers replying believed that nonmember banks should be required to hold the same reserves as member banks. Such replies were principally from member banks. The number of nonmember banks replying was too small for significant generalization.

Competitive fairness and the uniform application of credit-control rules were the reasons most frequently given for desiring uniform reserve requirements. There was not a close relationship—although one might have been expected—between bankers who recognized the credit-control function of reserves and those who believed that nonmember banks should be required to hold the same reserves as members. Some bankers who believed in the credit-control function of reserves but opposed their uniform application stated that they recognized that their position might appear inconsistent, but said that they felt that the urgency of maintaining the dual banking system, which they considered threatened, was more important than formal consistency in this respect. Others, who favored the change, saw no threat to the dual banking system. Some opponents called attention to the fact that only about 15 percent of all deposits are held in member banks, and concluded that the argument for uniform reserves was not important quantitatively. Others stated that the possibility of banks withdrawing from membership in order to secure lower reserve requirements furnished what they believed to be a salutary check on the power of the Board of Governors to increase reserve requirements unreasonably.

Extracts from typical replies follow:

H. M. Arthur (Arthur State Bank, Union, S. C.)

The main purpose of bank reserve requirements should be that they be adequate enough to at all times take care of unexpected drops in normal deposits and to protect both the stockholders and the depositors. I very definitely and most emphatically do not believe that nonmember banks should be required to hold the same reserves as member banks of the Federal Reserve System. Why should they keep such reserves when they receive no benefits from the System? It is an invasion of States' rights to attempt to force nonmember banks to keep such reserves when they are already regulated under the dual system. After all, these banks only have 13 percent of the total deposits of the Nation, and any such attempt to control this small segment of the economy by arbitrary legislation could have little effect on the economy. Most nonmember banks today receive very valuable services from their correspondent banks and keep their reserves with these correspondents. Probably, in the majority of instances, these reserves are even greater than those now required by the Federal Reserve. There is another very important factor in this connection. If small

banks were required to keep a specified reserve with the System, and at the same time maintain their balances with the correspondent banks, such a reduction in their available resources for loans and investments would in many instances place these banks in a position where they would probably suffer a loss. And it would certainly reduce their income to a point where it would be difficult to increase their capital account, which is, after all, the main strength and safety of all banks today.

Julian B. Baird (*First National Bank, St. Paul, Minn.*)

Whatever may be the history of required reserves, it seems obvious that, under present conditions, unless a bank goes into liquidation, its legally required cash reserves cannot be used to meet unusual demands, although such might appear to be their purpose. It seems clear, therefore, that the real purpose of such reserves is as a part of the mechanism to regulate the supply of money created by bank credit. Theoretically, all banks, member and nonmember, should be required to hold the same reserves. Nevertheless, we believe it would be unwise for Congress to attempt to enact legislation to this effect. It might not destroy our dual banking system but it would tend to weaken it. The dual system provides checks and balances, which experience has demonstrated are so necessary in our type of representative government. If a member bank is not in accord with the policies and directives of the Federal Reserve System, it always has the privilege of withdrawing from the System, and this fact offers some assurance that the Board of Governors will not abuse its powers. The total resources of nonmember banks are not sufficiently large to seriously negative the effect of Federal Reserve action.

Lloyd D. Brace (*First National Bank, Boston, Mass.*)

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* * * Reserve requirements can properly be used as one of a series of instruments for credit control, and in that connection modest and infrequent changes in such rate are probably justified. However, since such reserves represent primarily illiquid and completely nonearning assets, the level of such reserves should at no time be so high as unduly to impair the reasonable earning power of the banking system.

It is difficult for me to answer categorically and without reservation the second part of question 5. This is primarily because I recognize the injustice and the competitive advantage or disadvantage of having nonmember banks not holding the same reserves as member banks.

On balance, however, I do not favor rigid insistence on equal reserves for both classes of banks for two primary reasons.

In the first place, the imposition by Congress of such reserve requirements on nonmember banks would go a long way to threaten the existence of the dual banking system, in which I am a believer.

Secondly, there is a distinct danger that Congress or the Reserve banks, or both, might at some time impose a level of reserve requirements (if they could be imposed on all banks) higher than is really needed or justifiable and certainly higher than is warranted in the light of the earnings penalty. The fact that a member bank can

change to a nonmember status and thereby perhaps escape the burden of unjustifiable reserve requirements is an element of protection which I would not care to see lost.

W. Randolph Burgess (National City Bank, New York, N. Y.)

The principal functions of reserve requirements are to maintain at the Federal Reserve banks funds for clearance of financial settlements across the country, to expedite currency movements associated with seasonal or emergency needs, and to influence the deposit volume. It is reasonable in theory to say that the same reserve requirements that are applied to member banks should be demanded of nonmember banks. As a practical matter, the apparent discrimination is of minor importance because the nonmember banks have such small resources and many State requirements are kept in line with those of member banks. The fact that some banks and many other financial institutions are outside the direct control of the national authorities is a wholesome safeguard against unreasonable and arbitrary action. In the final analysis, all lending institutions, whether or not they have legal requirements, need to have cash reserves proportioned to their operations, and are responsive to the amount of money the Federal Reserve banks put out in the market through open-market operations or discounts.

Walter E. Cosgriff (Continental National Bank & Trust Co., Salt Lake City, Utah)

The principal function of bank reserve requirements is to insure that bank depositors will be paid on demand. The reserves of nonmember banks should be up to the State authorities involved and/or the Federal Deposit Insurance Corporation.

H. D. Crosby (First National Bank & Trust Co., Fargo, N. Dak.)

Reserve requirements of banks are well known for performing an important function. Nonmember banks should never be required to hold the same reserves as member banks. There is no need for this innovation.

George S. Eccles (First Security Bank of Utah, N. A., Ogden, Utah)

I believe the principal functions of bank reserve requirements are to control the volume of credit both through the quantitative restriction which it automatically puts upon the bank and the restriction brought about by increase in interest rates due to increase in reserve requirements. In an inflationary period reserve restrictions should be fully applied, and in a deflationary period reserve restrictions should be liberalized.

I feel that, in order for the principal functions of bank reserve requirements to be obtained, all banks, whether members or nonmembers, should be subject to the same reserve restrictions.

Loring L. Gelbach (Central National Bank of Cleveland, Cleveland, Ohio)

Reserve requirements are necessary as a safety factor for the protection of deposits. In wartimes, increases in reserve requirements are necessary if the Treasury must resort to the banks to finance its deficit. Increase in reserve requirements removes the inflationary threat inherent in large amounts of excess bank reserves. As an in-

strument of credit control it is unsatisfactory. It not only affects the amount of reserves of the banks, but it definitely restricts in a harsh and abrupt manner the ability of banks to make loans.

In a period of increasing reserve requirements, the banks are placed in the embarrassing position of having to discriminate as between worthy borrowers or of fanning the inflation fires through the replenishing of their reserves by borrowing from the Federal Reserve or by liquidating Government securities to the Federal Reserves. (In the event the market for Government securities were not pegged, their sale would bring about a somewhat higher yield or interest rate. A worthy result, but why go through the hocus-pocus of upsetting the entire banking structure when direct action to increase interest rates will produce the same result?) Changes in reserve requirements do not encourage or discourage requests for loan accommodations at their source such as higher interest rates do. It is an indirect, negative approach to credit control and as such is not in the best interest of sound banking. Any credit-control restriction that attempts to control bank credit by limiting the aggregate amount of loans the banks may profitably make is definitely discriminatory in its application and therefore is not compatible with democratic principles of equal treatment to all worthy borrowers.

Uniformity of reserve requirements as between member and nonmember banks of the Federal Reserve System encroaches upon the rights of the States to determine their own reserves. It is a further centralization of power over credit in the Federal Reserve System. The adoption of a uniform reserve regulation is not based on any need to strengthen the financial condition of nonmember banks. Removal of any discrimination as between member and nonmember banks is not a factor in need of correction. Membership in the Federal Reserve carries many advantages not available to nonmember banks. Since membership in the System is voluntary for State banks, any thought of discrimination is beside the point.

Apparently, a uniform reserve law is adopted to facilitate the use of reserve requirements as an instrument of credit control. Since this method of control is incompatible with sound money or in the preservation of a sound, independent banking system, its adoption would not be in the best interest of society.

R. M. Hanes (Wachovia Bank & Trust Co., Winston-Salem, N. C.)

The essential function of reserve requirements is the protection of the depositors of banks and, secondarily, they control the volume of credit. Yes, assuming that reserve requirements are fairly and soundly established, we believe nonmember banks should be required to carry the same reserves as member banks of the Federal Reserve System.

H. Hiter Harris (First & Merchants National Bank, Richmond, Va.)

In my opinion, the principal functions of bank reserve requirements are to provide a safe depository for reserve funds which will enable the banks to be in a position to meet any unusual withdrawals; to provide the Federal Reserve System with operating funds; and to afford to the System, through its power to change bank reserve requirements, a basis for the control of credit. I believe that nonmember banks should be required to hold the same reserves as member banks of the Federal

Reserve System. These reserves, however, should not be held in the Federal Reserve banks.

William S. Hobbins (American Exchange Bank, Madison, Wis.)

I believe in the dual banking system, and any attempt to regulate all banks in Washington by a control of reserves abolishes the dual system. If half the system is in control of the Central Government, that is plenty. If a mistake of judgment is made by the governing body in Washington, the repercussions over the whole country will not be as widespread if they do not control all the banks. A regulation laid down for a country as large as ours and as diversified as ours fits our situation about as well as requiring all women to wear size 18 dress.

J. B. Jessup (Equitable Trust Co., Wilmington, Del.)

We consider the principal function of bank reserve requirements to be the provision of liquid funds to meet current and emergency needs of depositors and to take care of seasonal borrowing requirements of customers. As to nonmember bank reserves, we feel that the amount of reserves and the method of calculating such reserves should be left to the various States. We feel that the dual banking system and the private-enterprise system might be endangered by the Federal Government requiring nonmember State banks to follow the practice and policy of the member banks. We take this position even though we feel that we are at a competitive disadvantage in being forced to maintain our reserves with the Federal Reserve System instead of being allowed to count cash in vault and balances with correspondent banks as part of our reserves.

Homer J. Livingston (First National Bank, Chicago, Ill.)

I believe that the primary function of bank reserve requirements is to afford a means by which the central banking authorities may either expand or contract bank credit, as the public interest indicates. I believe that the original conception of reserves as primarily an assurance of the ability of a bank to meet its obligations to depositors is now a somewhat less important function than the function of controlling the quantum of bank credit, in view of changes in the law which permit borrowing by member banks from the Reserve banks on sound assets. Nevertheless, since the central banking authorities invariably decrease reserve requirements in times of inordinately heavy deposit withdrawal, the reserve-requirement mechanism continues as an important element in enabling the member banks to meet their obligations to their depositors in times of stress. I do not believe that nonmember banks should be required to hold the same reserves as member banks of the Federal Reserve System.

William A. McDonnell (First National Bank, St. Louis, Mo.)

Basically, bank-reserve requirements are for the purpose of enabling banks to meet their demand liabilities as they are presented. Nonmember banks should not necessarily be required to hold the same reserves as member banks. Their requirements should be based upon their needs in relation to size, location, and the State banking regulations under which they operate. I do not think that banks which are not members of the Federal Reserve System should be under its supervision.

W. A. Mitchell (Central Trust Co., Cincinnati, Ohio)

I believe that in the early beginnings of the Federal Reserve System reserves were required in order to provide deposits and thereby earning power for the new institutions. The word "reserve" is a misnomer because, in fact, the required deposits are not available to banks except in diminishing degree as bank deposits decline or in the event of liquidation. As the technique of our central banking system developed, it became evident to the managers that required reserves, so-called, represented a very potent control instrument; and, indeed, it is a very powerful and sensitive weapon which must be used with great intelligence and skill because of its effects upon the whole economy of our country. In my opinion there have been a number of instances when a change in reserve requirements was made too little and too late, and others when an increase was made in requirements at a moment when business was lagging through the natural courses of the economy and the increase aggravated an already difficult situation. In my opinion the Board of Governors of the System is too far removed from the hurly-burly of business and obtains its information from statistics that very often do not then represent the current business situation.

The operating costs of the Federal Reserve System, while large, are relatively small compared with the vast earning power generated by the required reserves invested principally in Government securities, with the result that the United States Treasury has benefited materially from those earnings. Commercial bank earnings, on the other hand, have not been sufficient after the payment of heavy corporate taxes to attract an adequate amount of newly subscribed capital to fortify the banking structure as deposits and loans increase. I think it would be very difficult to legislate relief from taxation to a special group such as commercial banks, but I do strongly feel that the time has come when careful consideration should be given to the payment of interest by the Federal Reserve banks on deposits of required reserves. An interest rate of one-half of 1 percent on such deposits would do much to correct this unfair situation. The rate could be adjusted according to the earning power of the Federal Reserve System. In 1950 the payment at one-half of 1 percent per annum would have amounted to less than one-half of the profits transferred to the United States Treasury. Indeed, the result would not be too prejudicial to the United States Treasury because a substantial portion of the resultant increased earnings of the commercial banks would be recaptured in taxes.

With regard to the reserves of nonmember banks: In many States required reserves of nonmember banks are almost as heavy as the reserves required by the Federal Reserve System. I believe that it would be beneficial if all commercial banks in the United States were members of the Federal Reserve System, but it is not in keeping with our Bill of Rights that nonmembers should be forced to join, and indeed it is perhaps politically impossible. If the above suggestion regarding the payment of interest on required reserves was followed, I feel sure that many nonmembers would find it to their advantage to join the Reserve System.

E. C. Sammons (United States National Bank, Portland, Oreg.)

A principal function of bank reserve requirements is to provide monetary control, though they also create working balances for central banks. We could also assign a third function, which is to replace the liquidity reserves formerly maintained by the banks themselves. As to whether nonmember banks in the Federal Reserve System should be required to maintain the same reserves as member banks, my answer is "No," although I realize that double standards are rarely defensible. Nonmember banks have access to the full investment field, and it could be argued, therefore, that they should not be spared the requirement of maintaining reserves equal to those of member banks. In any event, the net result would not be considerable for the reason that deposits held in nonmember banks are relatively small in volume.

James E. Shelton (Security-First National Bank, Los Angeles, Calif.)

The principal function of bank reserve requirements is to provide in the central banking system a fund sufficient to permit the orderly movement of funds in connection with normal banking requirements. It has been proved that this requires a reserve equal only to a small proportion of deposits. When reserves are increased for the purpose of attaining so-called economic, social, or political objectives, such action is fraught with danger to the independence of the banking system. It may well have adverse economic and social consequences as well.

Nonmember banks now under the regulation of the several States should not be subjected to Federal jurisdiction which would require them to assume the burdens without the benefits of member banks.

Albert C. Simmonds, Jr. (Bank of New York and Fifth Avenue Bank, New York)

While in earlier days of banking in this country cash reserves were required as a measure of security for depositors, the present-day function is largely that of providing a mechanism for controlling the volume of deposits, and consequently the volume of loans and investments, in the banking system.

We believe that uniformity in reserve requirements among all lending institutions is more desirable today than it was a generation ago, and that the present regional basis for reserve requirements is entirely outworn. Reserves should be related to the several categories of deposits, with minimum, if any, regional consideration. Inasmuch as the purpose of reserves is to control the volume of credit, it is obvious that such control would be more effective if nonmember banks were required by the various State banking authorities to hold the same reserves as member banks.

Howard J. Stoddard (Michigan National Bank, Lansing, Mich.)

The present function of reserve requirements is to insure a certain amount of liquidity. The second function is also an indirect method of controlling credit within certain limitations, and thus when wisely used is also a most desirable monetary tool. We most emphatically believe that nonmember banks should be required to hold the same reserve as member banks.

Henry R. Sutphen, Jr. (American Savings Bank, New York, N. Y.)

The reserve requirements provide a major device for regulating the volume of bank credit by increasing or decreasing the funds which

most commercial banks must hold idle. Mutual savings banks should not be required to maintain reserves as they do not create credit but it would be logical that all commercial banks be on the same reserve basis.

Burr S. Swezey (Lafayette National Bank, Lafayette, Ind.)

The principal functions of bank reserve requirements are to regulate the supply, availability, and cost of money.

I do not believe that nonmember banks should be required to hold the same reserves as member banks of the Federal Reserve System. I am a strong believer in the dual banking system and I believe this requirement would be looked upon as a step tending to destroy the same. If some plan could be worked out whereby the board of governors of the Federal Reserve bank and the supervisory authorities of the several States could work in closer cooperation with regard to reserves, it might prove helpful.

J. C. Thomson (Northwest Bancorporation, Minneapolis, Minn.)

Bank reserves, in addition to providing liquidity, enable the Federal Reserve Board, through the control of volume of such reserves, to exercise control of the aggregate volume of money and credit. In principle, it would seem advisable to have all commercial banks hold the same reserve as member banks, and there is a matter of equity involved as between member and nonmember banks. However, the matter is not of great practical importance because approximately 85 percent of resources of all insured commercial banks are contained in Federal Reserve System members. The relatively small practical gain to be obtained by control of all insured banks' reserves and the political problems involved in relation to State supervisory authorities would seem to make the matter of minor importance. Undoubtedly, more uniform results as to reserve requirements could be obtained through greater cooperation between Federal Reserve authorities and other Federal and State bank supervising agencies.

Raymond H. Trott (Rhode Island Hospital Trust Co., Providence, R. I.)

We consider the principal function of bank reserve requirements to be the maintenance of a strong banking system and a sound national economy. We believe that changes in reserve requirements should be made with the view to minimizing the cyclical swings in industrial production and trade and to curb inflation on the one hand and prevent deflation on the other. Obviously, over-all policy must be made by the Federal Reserve Board, and the wishes of the individual banks should of course be completely ignored in this matter. We strongly believe that nonmember banks should be required to hold the same reserves as member banks of the Federal Reserve System.

Estil Vance (Fort Worth National Bank, Fort Worth, Tex.)

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We are of the definite opinion that all nonmember banks should be required to carry the same reserve as member banks of the Reserve System. As we assume that the primary function of the reserve is for the protection of the depositors, this seems certainly to be a correct procedure. It also would seem that if changes in the reserve requirements were to be used during periods of inflation and depression, all bank reserves should be controlled.

G. Van Haaften (American National Bank, Kalamazoo, Mich.)

It has always been our opinion that the principal function of bank reserve requirements has been that in relation to the flexibility of credit expansion. In the circumstances, it would appear that nonmember banks should be required to hold the same proportion of reserves as member banks of the Federal Reserve System.

R. H. West (Irving Trust Co., New York, N. Y.)

In our opinion the principal functions of bank reserve requirements are: (*a*) To provide a substantial measure of safety for depositors. (*b*) To influence the volume of credit extended by banks in the interest of the Nation as a whole.

In order to make more effective the policies of the Federal monetary authorities, we believe it would be desirable for nonmember banks to be subject in effect to the same reserve requirements as banks which are members of the Federal Reserve System. If possible this should be accomplished with the cooperation of the various State authorities concerned.

G. C. Weyland (American Bank & Trust Co., Racine, Wis.)

It seems only fair that nonmember banks should hold the same reserve as member banks but it is a difficult question as we believe the dual system should be preserved.

6. Comment on the proposal (advanced in the Wilson report and in several annual reports of the Board of Governors of the Federal Reserve System) that banks be required to hold reserves additional to those now required, such reserves to be held at the option of the bank in specified classes of United States securities.

The great majority of bankers opposed this proposal. Some stated that if additional required reserves were necessary, they should be in the traditional form. On the other hand, a considerable number stated that requirements should not be increased but that the proposal should be applied to a portion of existing required reserves. A large number stated that they did not understand the proposal and did not care to comment.

The opposition to the proposal was based principally on the grounds that (1) it constituted an undue invasion of the right of banks to manage their assets, and (2) it might be used as a means for insuring the quasi-compulsory purchase and holding of Government securities by banks in order to finance future deficits. A number of bankers pointed out that Government securities comprising part of a required reserve could not be liquidated to meet a deposit decline and so would not be true secondary reserves. Many stated that it was only good banking to carry an adequate Government security portfolio and did not require compulsion. There was little mention of either the credit control advantages of the plan (see the Annual Reports of the Board of Governors of the Federal Reserve System for 1945, 1946, and 1947), or of the objection often offered in technical quarters based on the widely varying amounts of Government securities (in proportion to deposits) now held by banks and the consequent uneven incidence of a uniform additional reserve requirement of the type proposed.

Extracts from typical replies follow:

Lloyd D. Brace (First National Bank, Boston, Mass.)

I am strongly opposed to the proposals most commonly advanced that banks be required to hold reserves additional to those now required, perhaps at the option of the bank in specified classes of United States securities. My reasons are as follows:

(1) Present reserve requirements, in my judgment are, if anything, on the high side.

(2) These proposals represent, in my judgment, not an attempt really to strengthen the banking system but to usurp the management function by telling bank managements what form a susbtantial part of the bank's assets shall represent.

(3) Except to the extent of decreased reserve requirements in the event of deposit withdrawals, such additional reserves would represent further illiquid assets added to those already tied up in cash at the Reserve banks.

(4) These proposals would result in a further decrease in the already strained earning situation of the banking system.

W. Randolph Burgess (National City Bank, New York, N. Y.)

We see no merit in the proposal to require banks to hold secondary reserves in specified classes of Government securities. If the Federal Reserve banks are willing to restrict their extensions of credit by the tried methods of the discount rate and open-market operations, there is no need for further authority over bank reserves.

The record on changes in reserve requirements as a method of credit control is not impressive. The best case for using this instrument was in the thirties, after the dollar devaluation, when the Federal Reserve's Government security portfolio was too small to counteract the ensuing gold inflow. But reserve requirements are rough and crude, and credit in a highly developed industrial nation is a delicate piece of machinery. Even the 1936–37 reserve requirements dealt the bond market such a blow that the authorities had to come to the rescue. And every upward change in reserve requirements since then has been accompanied by pegging operations in the Government security market, substantially canceling off the effectiveness of the action.

The proposal to permit banks to invest additional required reserves in specified classes of Government securities would relieve banks of some loss in earning power, though on this matter they would be entirely at the mercy of the Secretary of the Treasury with a guaranteed market, he could pay as little as he pleased. Meanwhile, the presumption is that pegging would be continued and lenders other than banks would be free from restraint, thus permitting further credit inflation through the Federal Reserve and other financial institutions, but discriminating against small businesses without credit facilities other than banks.

What the scheme comes out to, in the final analysis, is a roundabout way of forcing banks to buy Government securities at low rates and making easier Government spending and deficit financing. It presumes, incorrectly, that banking is an excessively profitable line of activity, that the national credit has sunk to a very low estate requiring compulsory holding of its securities, and that the United States is too poor to pay going rates of interest in the market.

R. R. Calkins (American National Bank, St. Joseph, Mo.)

We do not believe that increased reserves should be required under present conditions.

John Carlander (State Bank of Faribault, Faribault, Minn.)

In our judgment, required reserves should be held in cash and no imposition should be made as to further reserves to be held in form of United States securities. The proposed theory with respect to reserves will curtail freedom of operation and too much Government control.

Ernest Clayton (Industrial Trust Co., Providence, R. I.)

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The power of the Federal Reserve to raise or lower reserve requirements is of more importance in the control of credit than the actual top limits of reserves which might be established. If present limits of cash reserve requirements were increased by law, bank earnings throughout the country would obviously be more sharply reduced than if increased reserves were allowed to be held in Government securities providing some income. Higher cash reserve requirements would force banks which wished to maintain current earnings to increase sharply their loaning rates, which would result, theoretically at least, in a sharp restriction of loans. Thus the proposition that any increase in reserve requirements may, at the bank's option, be held in income-producing Government securities, rather than in cash, appears a more subtle and gradual method of combating inflation, than would a mandatory increase in cash reserves.

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Reginald T. Cole (Brockton National Bank, Brockton, Mass.)

Without specifically referring to the Wilson report or the annual reports of the Governors of the Federal Reserve System, we believe that there is merit in requiring additional reserves to be held in certain specified classes of United States securities at such time and under such conditions as the Board of Governors of the Federal Reserve System shall designate. When I was commissioner of banking in the State of Vermont, I suggested and the legislature approved an amendment to the banking statute of that State giving the commissioner of banking, with the approval of the banking advisory board, the right to increase the reserves of State chartered banks by as much as 100 percent, providing that no part of the increase had to be in cash balances and under that statute the State of Vermont and United States Government securities were acceptable as reserves.

George S. Eccles (First Security Bank of Utah, N. A., Ogden, Utah)

I feel that up to this time it has not been necessary that banks be required to hold reserves in addition to those now required (as advanced in the Wilson report and in several annual reports of the Board of Governors of the Federal Reserve System)—such new reserves to be invested in certain classes of United States securities. However, if the voluntary credit restraint program does not curtail credit expansion and if curtailment is not had as the result of various credit regulations such as X and W, together with the present increase in short-term money rate, then in order to stop the inflationary

pressure it may be desirable to inaugurate a so-called secondary reserve program which would permit banks to carry this additional reserve in either cash (due from banks) or short-term Government securities. The difficulty which I see in this program would be that it does not take into consideration the present loan condition of the individual bank, and in some areas where banks are heavily loaned it would practically preclude the banks from making any further credit expansion and would possibly work a hardship on the area which these banks serve, while in other areas where banks may be underloaned, the secondary reserve would have practically no effect on the banks in that territory. It appears to me that this secondary-reserve program should be the last resort and that all other means which I have mentioned should be given a full opportunity to be tested. It may be that rather than trying to curtail the inflationary pressure by credit only that further restrictions such as tightening building restrictions—restrictions on the use of strategic materials—restrictions on expenditures that can possibly be delayed by local governmental units as well as the National Government should be enacted, and it may be necessary to inaugurate more stringent price and wage controls and possibly a certain amount of rationing.

Robert V. Fleming (Riggs National Bank, Washington, D. C.)

I am definitely opposed to the proposal that banks be required to hold additional reserves above those now required at the option of the bank in specified classes of United States securities. This would bring about grave inequities and unfairness in the banking system and the ability of the banks to adequately and properly serve the needs of their communities, as well as to fulfill the function of their charters, would be very much restricted. I believe the continuation of the voluntary credit restraint programs, as long as our defense program is in effect and we have inflationary pressures, provides a much more elastic and effective method of controlling the volume of credit. We must recognize, again, that if a peace were negotiated we could have a rapid change in our economic structure and I doubt that any body possesses the wisdom to impose such additional reserves or reduce them at the appropriate time. Furthermore, it would have the effect of freezing a portion of the existing debt in the banking system when the Treasury Department has been working to reduce the holdings of Government securities in banks as they mature and place them in the hands of non-commercial-bank investors. The more Government securities held in the banking system, the more the money supply is increased; that condition does not exist where the debt is held by non-commercial-bank investors.

L. M. Giannini (Bank of America National Trust and Savings Association, San Francisco, Calif.)

This proposal, if adopted as a major feature of monetary policy, would put the commercial banking system in a partial strait-jacket as a means of attempting to counteract the effect of past actions which have been taken with respect to fiscal and monetary policy and debt management. The proposal ignores the great variation in the credit needs of different communities or sections of the country. If applied only to member banks it would tend greatly to discourage membership in the Federal Reserve System.

The proposal would lend encouragement to the idea that a continuous expansion of the money supply by way of budget deficits would not be inflationary if bank loans could be kept from expanding by a progressive freeze of a portion of the portfolio of the banking system in investments in Government securities. Actually it would serve primarily to transfer lending activities away from the commercial banking system to insurance companies and other nonbank lenders whose investment policies were not similarly regulated.

Reserves required of member banks in excess of the amount needed to provide a degree of absolute liquidity for the banking system should be so handled that they would represent earning assets for the member banks. Earnings on such reserves should bear an appropriate relationship to the earnings of the Reserve banks on such assets and to the net returns of member banks on other earnings assets.

P. C. Hays (State Bank of Poplar Bluff, Poplar Bluff, Mo.)

We approve some kind of a "secondary" reserve in addition to primary reserve requirements that would allow those secondary reserves "to earn their keep."

W. L. Hemingway (Mercantile Trust Co., St. Louis, Mo.)

Before any such proposal is opposed or endorsed, the objectives to be attained should be carefully considered. If the purpose is to reduce the multiple by which bank credit can be expanded, then it would be ineffective (except for the unlikely possibility that Government securities are so scarce that the holding of cash assets is the only practical alternative). The "special reserve" plan would require only that a specified portion of any amount by which credit was expanded be invested in Government securities, and since the banks are already large holders of Government securities they would simply earmark certain ones as reserve. The result would be that what is now a free secondary reserve would become frozen and would not be available in case of need in an emergency.

If the objective is to insure a market for Government securities, the "certificate reserve" plan might not achieve its results. It would, however, compel the banks to hold Government securities or cash.

R. J. Hofmann (American National Bank, Cheyenne, Wyo.)

This would simply be a matter of forcing banks to buy additional Governments. Believe that the banks have done an outstanding job on Governments and will continue to do so without being forced.

N. Baxter Johnson (Chemical Bank & Trust Co., New York, N. Y.)

We do not believe that reserve requirements should be manipulated for the control of credit, or to restrict bank earnings. There is no justification for superimposing upon present requirements, additional reserves to be invested in a special class of United States securities. While the Treasury would be assisted in financing deficits, two harmful conditions would result:

(1) Bank earnings, which are already too restricted for sound growth, would be further penalized and additional bank capital, which is needed in many cases, would not be attracted.

(2) If reserve requirements were imposed at higher and higher levels, the banks would eventually become depositories for the Government debt, thereby gradually eliminating the functions

for which they were originally established. All private credit extension would rest in the hands of a Government instrumentality. Individual judgment in the exercise of free enterprise would be eliminated and bureaucratic decision would be substituted.

Comer J. Kimball (First National Bank, Miami, Fla.)

Would favor in principle special reserves if fairly set up and administrated. Care should be taken not to unduly penalize those banks with conservative loan policies and those with low ratios of loans to deposits.

Frank D. Lawrence (American National Bank, Portsmouth, Va.)

Answering question 6, if this comes about it will be like throwing oil on the fire—it would only make it worse.

James K. Lochead (American Trust Co., San Francisco, Calif.)

Whether the Board of Governors should have the power to raise reserve requirements beyond present maximum allowable percentages is one question. The proposal to invest increases in Government securities is merely clouding the issue. It would serve in no way to help in the control of inflation as the banking system as a whole already holds Governments far in excess of any amount of increased reserves so far suggested.

W. A. Mitchell (Central Trust Co., Cincinnati, Ohio)

This proposal contains some of the features of the suggestion made in answer to No. 5 above that interest should be paid on required reserves, but it would apply only to specified additional reserves. I believe that the matter should be handled in a straightforward way, with the full consciousness of the very delicate mechanism involved in a change of reserve requirements. The potential for good or evil involved in a change in reserve requirements should not be sugar-coated by the temptation of a modest return to banks through the investment of additional reserves in specified securities.

Earl R. Muir (Louisville Trust Co., Louisville, Ky.)

It seems to me that this question and the answers to it are tied to question 5 and its answers. Both the requirement that nonmember banks carry reserves with the Federal Reserve System and the requirement that banks hold reserves in addition to those now required in some form of Government securities or other investment, suggest a desire on the part of some to control the banking resources of the country through governmental agencies. I believe that any absolute control over the bank reserves of all of the banks in the Nation can result only in wrecking our whole economic system. If we keep in mind the primary purpose of bank reserves—namely, that of providing liquidity—then we must conclude that present reserves are adequate, if not excessive. There have been no losses of bank deposits since 1944.

T. R. Murphy (First National Bank, Zanesville, Ohio)

We feel that the requiring of additional reserves of specified classes of United States securities is asinine and is an indirect move to support Government bond prices.

Frederic A. Potts (Philadelphia National Bank, Philadelphia, Pa.)

Unless economic conditions deteriorate substantially, we would not favor the establishment of a secondary reserve requirement. Such a plan might well tend to lend itself to abuse (*a*) in tending to freeze short-term (or other) Treasury securities in the banking system, and (*b*) in possibly leading to the arbitrary imposition of artificially low interest rates for Government securities eligible for secondary reserves, which might be at variance with the going rates for other short-term paper. Furthermore, the technical changes that are proposed in the calculation of requirements might cause inequities, and undue penalties on certain banks, that are totally unrelated to the problems of credit control.

It is our opinion other more recognized and tested controls are available to accomplish the desired effect on the supply of money and credit through the member banks. These would include qualitative controls such as regulations U, W, and X, as well as voluntary action on loan restraint, in addition to the rediscount rate and open-market operations.

Frank P. Powers (Kanabec State Bank, Mora, Minn.)

In a country banking area such as we have here, which is strictly agricultural, I do not believe it is necessary to hold reserves additional to those now required.

Thos. E. Prescott (Bank of Passaic & Trust Co., Passaic, N. J.)

If additional reserves are required, they should be a form of short-term Government securities that would give the banks some income on assets that are frozen by the Federal Reserve bank.

J. F. Ringland (Northwestern National Bank, Minneapolis, Minn.)

We believe that banks should not be required to carry additional reserves in selected classes of United States Government securities. Under this plan, we would probably be required (unless we were to have idle funds) to buy and hold nonmarketable securities whose rates would be established by the fiat of Government and not by the normal processes of the market. Not only would we regret the higher and we think unnecessarily higher reserve requirements but we do not like this method of selling Government securities. We believe that in a system of free enterprise the value of securities should be determined by the market—not by Government dictate. Disposing of Government obligations in this manner is too easy a way of utilizing the banking system as a source of financing huge Government deficits. Such a program could result in banks being used as the tools of the Treasury to take care of its credit requirements and could greatly restrict banks in making use of their funds in proper loans to business and agriculture. At the same time, this plan does not limit the extension of credit through the Reserve System, other governmental agencies, and financial institutions such as the insurance companies, savings banks, and the like.

J. B. Root (Harter Bank & Trust Co., Canton, Ohio)

We are not favorable to additional reserves in Governments, for we believe management should be free to supply what credit its community needs. Banks will still hold sizable amounts in Governments—of the type and maturity which their management shall choose. We

believe the Federal Government should borrow its money in competition with all other borrowers and so be under similar restraint.

John J. Rowe (*Fifth Third Union Trust Co., Cincinnati, Ohio*)

It seems to me that to require banks to hold additional reserves is nothing more or less than a bald plan to, by police action, require more holdings of Government bonds than they themselves wish to hold.

E. C. Sammons (*United States National Bank, Portland, Oreg.*)

In the absence of some grave emergency, there would be no real need to increase reserve requirements. They are high enough. But if they should be increased, that increase should not be invested in a special type of Government security created for the purpose. In a sense, such a security and such a program would amount to semicompulsory bond buying, and the maintenance of reserves was never intended to be tied up with any concept of Treasury replenishment through the sale of bonds.

George J. Schaller (*Citizens First National Bank, Storm Lake, Iowa*)

Possibly an additional 10-percent reserve in short-term Government securities to present required reserves—when and if asked by Federal Reserve Board.

William B. Schiltges (*Fletcher Trust Co., Indianapolis, Ind.*)

I am opposed to the proposal that banks be required to hold reserves additional to those now required. Such a provision is not necessary for the maintenance of sound banking. In the absence of that necessity, it is an undue regimentation of the industry.

George J. Sokel (*Home National Bank & Trust Co., Meriden, Conn.*)

If, as, and when it is deemed absolutely necessary to increase reserves above those now required for the purposes as defined in our answer to question 5, we believe that it would be desirable to have such additional reserves, at the option of the bank, in the form of specified classes of United States securities.

Harold P. Splain (*Savings Bank of Danbury, Danbury, Conn.*)

I do not think that it is wise to require that banks hold Government bonds as additional reserves. This seems to me like a fictitious form of reserve and might easily be used as a means of loading the banks with Government debt. It seems to me that such a proposition is a departure from the theory of bank reserves which has been in use and represents a venture into a field which, if enlarged, could easily make the banks merely subsidiaries of the Treasury.

William E. Stone (*First National Bank, Peoria, Ill.*)

This might have a tendency to make speculative banks a little more liquid and probably will have a good effect.

F. W. Thomas (*First National Bank of Omaha, Nebr.*)

No. We believe banks are sufficiently supervised and regulated without additional technical curbs. However, if or when increased reserves are imposed the earnings on such increases should accrue to the contributing bank, the reason being that the bank should not be penalized or fined merely because the national business situation periodically gets a kink in its back.

Raymond H. Trott (Rhode Island Hospital Trust Co., Providence, R. I.)

We hold no very firm opinions either way on the question of whether banks should be required to hold additional reserves, at their option, in certain classifications of United States securities. We can conceive of undesirable consequences of such a proposal, but on the other hand, under conditions when very large reserves seem called for (to fight inflation for example) it might be better to have some of these reserves bringing in income than to have them held in sterile cash.

R. H. West (Irving Trust Co., New York, N. Y.)

Since the huge growth in the Federal debt various proposals have been made to tighten up bank reserves. These include: The idea of requiring secondary reserves in United States Government securities; the shifting of reserve requirements from deposit liabilities to classes of assets; new cash reserves against loan expansion, etc.

It is easy to understand why these proposals have been advanced. Traditional measures of central banking run into some difficulty with such a large Federal debt as we now have. However, there is a strong element of doubt as to the wisdom of extending reserve requirements for the purchase of credit control. It is entirely possible that changes might do more harm than good. For these reasons we believe that a great deal of study should be given this subject before any action is taken.

In considering any changes in bank reserve requirements we would like to add that basing reserve requirements on three classes of banks, namely, Central Reserve cities, Reserve cities, and country banks, is, in our opinion, outmoded. The changes which have taken place in the various geographical sections of our country have been so marked that this system is no longer sound or equitable.

7. Do you believe that the coverage of Federal deposit insurance should be extended to include all deposits in insured banks? Why, or why not?

The great majority of bankers replying did not believe that the coverage of Federal deposit insurance should be extended. A few were opposed to deposit insurance altogether, but most were satisfied with it as it stands at present (i. e., limited to $10,000 per account).

The commonest reason offered by those in favor of extension of Federal deposit insurance was that the deposit insurance assessment base includes all deposits and that the bankers should "get what they are paying for." Other bankers made the same point but concluded that the basis of assessment should be changed to insured deposits only. In general, however, there was relatively little dissatisfaction with the assessment base. Some bankers favored extension, saying that complete insurance could be obtained now by distribution of deposits among banks, while others offered this as an argument in favor of the present system.

The commonest arguments against extension were that it would encourage laxity in banking practice, that the cost would be too high, and that the Federal Deposit Insurance Corporation would be unable to meet the larger liability. Many bankers also expressed the view that the present coverage of deposit insurance amply served the

purpose of allaying apprehension on the part of the mass of depositors and of preventing bank runs; the large depositors, they said, can take care of themselves. There was no reference by either opponents or proponents to (previously published) studies indicating that the loss of large deposits has been more important as a prelude to bank failures than mass withdrawals by small depositors. The view was also commonly expressed that the extension of insurance would inevitably result in a greater degree of control of bank management by supervisory authorities.

Only a small proportion of the replies referred to the policy followed by the Federal Deposit Insurance Corporation in recent years of financing the merger of insolvent banks into solvent banks—by which practice insurance is in effect extended to all deposits. The majority who did comment on this considered that the practice rendered statutory extension unnecessary but others felt that the practice should be universalized by statutory extension.

Extracts from typical replies follow:

Henry C. Alexander (J. P. Morgan & Co., New York, N. Y.)

I do not favor extending the coverage of Federal deposit insurance to include all deposits in insured banks. I consider that the larger depositors are perfectly well able to look after themselves and to make sure that the banks with which they make deposits are solvent and well managed. I think the cost of insuring all depositors would be prohibitive, and that there is no feeling by large depositors that such insurance is necessary. I think it would be a bad influence on management and bank depositors to have full insurance, and that it is a healthy thing for banks to know they have to keep themselves solvent, and for bank customers to know that they should scrutinize their banks carefully.

Harold V. Amberg (First National Bank, Chicago, Ill.)

* * * * * * *

In my opinion, the only justification for the recent increase in FDIC coverage to $10,000 was that $10,000 may now be deemed to be the equivalent of the former $5,000. Any further increase in the coverage would put a frightening potential liability on all solvent banks and the Government. Incidentally, the Senate Committee on Banking and Currency, when it recently approved the increase of the coverage to $10,000, recommended that "No further increase in the maximum insurable account be made in the future." In this connection, it should be remembered that the FDIC was not designed to perpetuate an unsound banking structure and the anesthetizing of a depositor's scrutiny of the soundness of his bank, through such an illusory 100 percent coverage of his deposit, would indeed be unfortunate. Moreover, any additional increase in coverage potentially involves additional assessments on the banks, which would deprive them of funds otherwise available to build up their own capital and reserves and also create pressures on them to lend unsoundly for the sake of compensating earnings—all in the wrong direction if we are to maintain an adequate structure of sound and competitive commercial banks.

Julian B. Baird (First National Bank, St. Paul, Minn.)

The coverage of Federal deposit insurance should not be extended to include all deposits in insured banks. Such a course is totally unnecessary, as the present insurance up to $10,000 covers the vast majority of small depositors and the social responsibility of the Government does not extend to attempting to protect large depositors who should be able to protect themselves. It is highly desirable that bank managements feel a compulsion to conduct their institutions in such manner as to command the respect of the informed public and at least in some degree this compulsion would be removed if all banks were made equally safe for the depositor through insurance protection. Furthermore, the FDIC already has the power, if it wishes to exercise it, to extend aid to weak banks, which operates to protect all depositors. The point is that this action should remain discretionary.

Keehn W. Berry (Whitney National Bank, New Orleans, La.)

I am definitely not in favor of the coverage of all deposits by a Federal deposit insurance. I doubt the soundness of the original conception of deposit insurance. I have not had a single customer beyond the present insurance limits voice a demand for insurance of his deposits. I am sure there is no such demand. An extension of deposit insurance certainly will not add anything to the soundness of bank management. It may very well bring a rapid deterioration in bank management. The further guaranty of bank deposits, followed by a full guaranty of loans will lead us to very early socialization of the banking picture.

W. Randolph Burgess (National City Bank, New York, N. Y.)

We do not believe that the FDIC coverage should be broadened to all deposits. To insure all deposits would be to assume an obligation that might be too heavy to fulfill, and the protection the small depositor now has would be placed in jeopardy. As it is, the FDIC has the option to buy assets of a suspended bank and afford protection to all deposits. It it best to keep this on an optional basis.

The depositor with more than $10,000 should have the intelligence to pick out a safe bank and avoid any real possibility of loss. A bank's management, moreover, should always have a definite incentive to conduct its affairs in such a way as to command respect and trust and thus to gain deposits.

C. R. Dewey (Grace National Bank, New York, N. Y.)

In practice it seems to us that the application of a limitation on the amount of deposits covered by Federal deposit insurance has more or less been disregarded. This, we assume, is because experience has shown that it is necessary to take over the entire assets of an institution or arrange for their taking over by another bank, and to pay out all deposits regardless of the size limitation in order to avoid the disastrous losses which result from forced liquidation of bank assets. If this were to continue to be the practice, it seems to us that the question of whether the limitation should be $5,000, $10,000, or 100 percent is more or less academic. However, it is conceivable that a situation might arise in the future where bank troubles would be so widespread and asset shrinkage so extensive that no surviving bank in the locality could be found sufficiently large or strong to do the taking over of a

distressed bank. If such a situation should arise, it might be very essential that the FDIC should have a limitation beyond which it is not committed. Hence, we are inclined to favor maintenance of the present size limitation.

George S. Eccles (First Security Bank of Utah, N. A., Ogden, Utah)

No.

I think the $10,000 limitation now placed on FDIC insurance is ample and even though it has been the practice in the past for the Federal Deposit Insurance Corporation to pay some depositors 100 cents on the dollar in liquidating banks, I do not think that as a general practice this should be followed. Of course, there is some danger in not insuring all deposits. This has a tendency to work against the smaller banks of the interior in favor of the larger money-center banks, but still I feel that the smaller banks should be operated on a sufficiently conservative basis which would justify the larger corporations, which do business in that territory, carrying more than a $10,000 deposit with them. I realize that at the time of the depression in the early 1930's there was a tendency for large corporation accounts to flee from the interior banks to the larger banks in the money centers which works a hardship on the banks in the interior, but even with this adverse situation I do not believe that bank deposits should be 100 percent insured. It has been our feeling that the principal purpose of deposit insurance is best explained by the statement of the American Bankers Association in 1941 to the Senate Committee on Banking and Currency as follows:

> Deposit insurance was instituted, not so much as a deposit guaranty plan, but rather as an aid in reviving and sustaining the confidence of depositors in their banks. By insuring the deposits of the mass of individual depositors, it aimed to minimize the danger of panic among depositors during periods of economic unsettlement.

The latest figures available for our subsidiary banks show that 98.43 percent of all of our accounts are 100 percent insured and that 59.28 percent of our total deposits are insured.

P. M. Eliot (Farmers Savings & Trust Co., Mansfield, Ohio)

I believe that deposit insurance should cover all deposits in insured banks because any loss sustained by partial insurance of deposits will affect the stability of all banks. Only by insuring deposits 100 percent can we continue to maintain the confidence that the public has now in the banking system.

Ostrom Enders (Hartford National Bank & Trust Co., Hartford, Conn.)

We believe that the extension of such coverage to include all deposits in insured banks is unrealistic in the first instance in view of existing cash reserve requirements against such deposits. Secondly, we consider such an extension of coverage prohibitive in cost. Thirdly, 100 percent coverage might well encourage lax banking practices. Fourthly, such coverage would require practical control of all banking functions by the FDIC. We believe the present coverage is already too high and tends to shift the responsibilities of management to the guaranteeing agency.

Charles T. Fisher, Jr. (*National Bank of Detroit, Detroit, Mich.*)

I do not believe that the coverage of Federal deposit insurance should be extended to include all deposits in insured banks. The opinion of this institution on the subject of Federal deposit insurance was publicly stated at the first annual meeting of stockholders of the National Bank of Detroit on January 9, 1934, as follows:

> While there may be merit in the temporary plan for the insurance of small depositors, I must take this occasion to protest against the application of the permanent plan. It places upon all solvent and conservatively managed banks an unlimited liability for the mistakes and ill-conceived liberality of other banks, a liability which, had it been effective over the past decade, would have absorbed a substantial portion of the profits of every bank so participating in every year, and in many years would have trenched heavily upon their capital funds. I earnestly hope that the permanent plan may never become effective in its present form.

In my judgment the principles on which this statement was made still prevail.

Robert V. Fleming (*Riggs National Bank, Washington, D. C.*)

I do not believe it is desirable or necessary to extend the coverage of Federal deposit insurance to include all deposits in insured banks. To begin with, the potential liability of the Federal Deposit Insurance Corporation would be materially increased and for the benefit of depositors of the type that are familiar with the condition of the banks in which their accounts are carried. Under the insurance limit of $10,000 provided by existing law, a very large percentage of the deposits in the banking system are now fully covered, it being my understanding something like 98.4 percent are fully insured. Where banks have gotten into difficulty and their capital has become impaired, the Federal Deposit Insurance Corporation has exercised its power to purchase the doubtful assets and bring about a merger or consolidation with a solvent bank, thereby reducing the cost to the Federal Deposit Insurance Corporation while making possible a more orderly and better liquidation of the doubtful assets without the hysteria, attendant costs, and losses of receivership.

L. M. Giannini (*Bank of America, San Francisco, Calif.*)

Federal deposit insurance should not be extended to specifically include all deposits of insured banks.

While an established limit on FDIC insurance coverage at present exists, the practical effect so far has been a guaranty for all deposits of an insured bank, as demonstrated by the few bank failures since the inception of the FDIC. However, the establishment of a lawful limit should have a desired psychological effect on both the public and the banker. Records indicate that previous operating plans that specifically guaranteed all or substantially all of the deposit liability of banks covered by the plan created a false sense of security. This was not conducive to good bank management or to the exercise of care on the part of the public in choosing well-managed banks as depositaries for their funds. The banks that offered the greatest favors were the ones that received most of the public support, regardless of the fact that the unsound policies of management of some of these institutions were setting the stage for bank failures. Hence the present policy of establishing a reasonable limit of insurance coverage is a wise one; and the existing $10,000 limit (the equivalent of the former $5,000 limit of less inflationary times) appears to be adequate.

R. M. Hanes (Wachovia Bank & Trust Co., Winston-Salem, N. C.)

No. Such procedure would inevitably wreck the Federal Deposit Insurance Corporation and would be a severe penalty on well-managed banks. There would be no differentiation between banks, as one inefficiently, dishonestly, and badly managed would be as sound, so far as the public is concerned, as the bank which is well, honestly, and conservatively managed. Such a procedure would inevitably lead to Government banking. Therefore, we are completely opposed to the present procedures of the Federal Deposit Insurance Corporation in assuming all the liabilities of closed banks.

William L. Kleitz (Guaranty Trust Co., New York, N. Y.)

I do not believe the coverage of Federal deposit insurance should be extended to include all deposits in insured banks, because I am opposed to the theory and philosophy of Government insurance of any bank deposits.

Homer J. Livingston (First National Bank, Chicago, Ill.)

I do not believe that the coverage of Federal deposit insurance should be extended to include all deposits in insured banks. Such full coverage would cause large depositors to become indifferent to the relative quality of bank management, which would inevitably lead to a general lowering in the quality of the management of the banks.

J. H. McCoy (City National Bank & Trust Co., Columbus, Ohio)

I do not think that the insurance of the Federal Deposit Insurance Corporation should be increased above the $10,000 limit, but I do believe that in many cases it is far better for the Corporation to step in and buy assets, which will enable all depositors to be paid in full, as they have done in many cases, than to stick strictly to the $10,000 limit, because I believe they will save money for the Corporation in many instances and it will save many times more money to the local community.

Alexander C. Nagle (First National Bank, New York, N. Y.)

I do not recommend that Federal deposit insurance be increased. Its purpose was to permit the individual depositor to know that his money was safe. The recent increase in coverage to $10,000 results in protection for about 98 percent of all depositors in insured banks. The purpose is therefore adequately served. Bank earnings have been heavily burdened for many years to build up the reserve of the FDIC and only recently has the annual cost been reduced. In view of the unattractive earnings which banks make on their capital this is no time to add a heavy cost item to provide insurance for which there is neither need nor demand.

The substantial annual premium paid by the First National Bank procures insurance for less than 3 percent of our deposits. It is in reality a heavy tax. There is no relation between the premium and the coverage, or between the premium and the risk, in our case and in that of many other banks. We are severely penalized to furnish a subsidy for banks lacking adequate capital or good management or both.

Claude F. Pack (Home State Bank, Kansas City, Kans.)

While assessments by the Federal Deposit Insurance Corporation have always been computed upon the total deposits of insured banks, we believe that the present limitation of $10,000 Federal deposit insurance to each depositor is probably a wise provision. The principal purpose of the Federal Deposit Insurance Corporation is to strengthen confidence in the chartered banking system of the Nation by protecting the funds of the masses on deposit in the insured banks. This purpose has been well achieved without insuring all bank deposits, and any departure might quickly result in increased assessments for the benefit of larger depositors, who are actually fewer in number and who generally have opportunity to exercise discretion as to where their money is deposited. With the present tax levels and other rapidly mounting operating costs, banks cannot increase such items as FDIC deposit insurance premiums.

F. S. Rodger (Bank of Sheboygan, Sheboygan, Wis.)

We do not believe that Federal deposit insurance should be extended to include all deposits in insured banks. It is our belief that the FDIC was put into being primarily for two reasons: (*a*) To protect depositors, and particularly the one of modest means, and (*b*) to prevent runs on banks by panic-stricken depositors. It appears to us that both of those purposes are being admirably accomplished under the present amount of $10,000 per depositor.

John J. Rowe (Fifth Third Union Trust Co., Cincinnati, Ohio)

I do not believe in the Federal deposit insurance plan in the first place. I do not think the Government belongs in the insurance business. I am strongly opposed not only to the insurance at all, but I am certainly opposed to any increase in its field.

Albert Rowell (National Bank of Commerce, El Dorado, Ark.)

No. In time of panic the FDIC will be unable to pay depositors now insured.

J. C. Spencer (First National Bank, Erie, Pa.)

I do not think the coverage of Federal deposit insurance should include all deposits. This country should stand on its own feet and not depend on the Government for everything. Also, in time of stress, as in 1933, the Federal deposit insurance might not be able to meet such demands.

Charles H. Stewart (Portland Trust & Savings Bank, Portland, Oreg.)

Inasmuch as all deposits are assessed by the Federal Deposit Insurance Corporation, it would seem only just that they all be protected. This, however, we do not believe to be important, as the class of depositors who in the past have started runs on banks usually come within the $10,000 limitation.

J. C. Thomson (Northwest Bancorporation, Minneapolis, Minn.)

From the standpoint of public interest, I believe that the present protection is sufficient and certainly covers those who lack the facilities for judging a bank's condition. Recent policies of the Federal Deposit Insurance Corporation have resulted in practical elimination of bank failures and the resulting adverse effect on the community.

It does not seem to be necessary to guarantee all the deposits to maintain depositor confidence in the commercial banking system. I do not regard this provision as necessary for the carrying out of the policies of the Federal Deposit Insurance Corporation, nor do I feel that the extra expense involved to the banks would be warranted.

Raymond H. Trott (Rhode Island Hospital Trust Co., Providence, R. I.)

We do not believe that the coverage of Federal deposit insurance should be extended to include all deposits in insured banks. We feel that deposit insurance is designed to protect the small depositor, the man in the street, who in the past has brought about panics by withdrawing his funds in times of uncertainty. It is our understanding that at present a very large percentage of depositors are fully protected. This seems enough to prevent panicky runs in the future; and, in our opinion, no good purpose would be served by incurring the additional cost that would be necessary to extend the coverage to total deposits.

Estil Vance (Fort Worth National Bank, Fort Worth, Tex.)

In our opinion Federal deposit insurance assessment should be based only on the deposits that are insured. At this time we are paying on our total deposits, whereas insurance extends for only $10,000, and we feel that the assessment should be reduced to cover only deposits up to $10,000. We are of the definite opinion that insurance should not extend to all deposits.

Max von Schrader (Union Bank & Trust Co., Ottumwa, Iowa)

Definitely not. I do not believe in the principle of Federal deposit insurance, although I realize that after 1932 it was a necessary evil. It used to be that a well-managed and amply capitalized bank could attract business. Now all most depositors look for is the FDIC sign. This, of course, is all right from the depositor's standpoint, and I suppose they should have some protection from the results of poor banking. However, I believe insurance up to $5,000 was sufficient protection, and I certainly do not believe it should be increased above $10,000.

R. H. West (Irving Trust Co., New York, N. Y.)

Under the present Federal deposit insurance program, premiums are charged on practically all deposits, whereas insurance is extended only up to $10,000 for any one account. In our opinion it is inequitable to charge premiums on deposits above the amount insured. We believe that premiums should be paid only on the aggregate amount of insured deposits or, contrariwise, that deposit insurance should be extended to cover all deposits.

It might also be desirable to alter the premium formula so that some allowance is given for the capital position of a bank in relation to its deposits, or that the asset position be taken into consideration; that is, excluding cash and Government securities from the base for the calculation of premiums.

Looking ahead, premium rates should be generally lowered. In the final analysis Federal Government fiscal and monetary policies are vastly more important to the soundness of the FDIC than the volume of insurance premiums charged the banks.

W. M. Willy (Security Bank & Trust Co., Madison, S. Dak.)

In my opinion, Federal deposit insurance should cover all deposits. The whole should be protected as well as the part.

8. To what extent do you believe that bank examination and supervision should be used as instruments for furthering the objective of economic stability?

Most bankers interpreted this question as implying a substantial extension in the scope of examination and supervision and the great majority of them opposed it as an infringement on the prerogatives of bank management. Most replies expressed the opinion that the purposes of bank examination and supervision should be limited to seeing that individual banks were solvent, competently managed, and conducting their business in accordance with law. Some of them added that this itself was a significant contribution to economic stability. It is possible that the bulk of the answers would have been less intransigent if the question had been more moderately interpreted. This appears to be indicated by several of the answers extracted below.

Extracts from typical replies follow:

Henry C. Alexander (J. P. Morgan & Co., New York, N. Y.)

I think that bank examination and supervision should be used as instruments for furthering the objective of economic stability only to the extent of helping to keep banking institutions sound and solvent by making fair and objective appraisals of their assets, liabilities, and standards; that they should be used to discourage the making of bad and speculative loans; and that they should not be used in a depression period, like 1931 to 1933, to mark down good assets to panic prices.

V. J. Alexander (Union Planters National Bank & Trust Co., Memphis, Tenn.)

The purpose of bank examination and supervision is to see that the condition of banks is such as to make their funds available to their depositors on demand. To attempt to direct economic trends through that medium would give to the examining authorities a power entirely inconsistent with our historical form of government.

Keehn W. Berry (Whitney National Bank, New Orleans, La.)

Bank examination and supervision definitely should not be used as an instrument for the control of credit predicated upon the supervisor's idea of what will contribute to economic stability. Any effort to vest in supervisory authorities or to use their supervision to control bank policy to contribute to economic stability will very quickly put complete control of the banking system in the hands of a Government bureau.

Anderson Borthwick (First National Trust & Savings Bank, San Diego, Calif.)

Almost without exception the bank examiners who have reviewed our bank have been sound in their analysis and judgment and, if followed in spirit, their recommendations and criticisms can be of great constructive force to the economy as a whole.

Thomas C. Boushall (Bank of Virginia, Richmond, Va.)

Supervision of banks should be limited to sound operation. To do otherwise is to all but nationalize the banking system—a number one step in total socialization and a fulfillment of a Marxian concept. It (used as an instrument, etc.) can only be advocated by a convinced totalitarian, of the bureaucratic intelligence level, seeking to go beyond the limits of any so far observed geniuses able to operate such controls correctly.

A. E. Bradshaw (National Bank of Tulsa, Tulsa, Okla.)

In my opinion bank examination and supervision should not be used as instruments for furthering the objective of economic stability. I feel that bank examination and supervision should be limited to insuring adherence to the laws and the solvency of the banks. With all due respect to the bank examining authorities (Federal, Federal Reserve, and State) I do not feel that they should encroach on the managerial function by dictating or attempting to dictate lending and investment policies, even though in so doing they may, in their opinion, be furthering the objective of economic stability.

Milton Brown (Mercantile National Bank, Dallas, Tex.)

To a very limited extent only. It would be helpful if bank examiners and supervisors adopted more stringent policies and restrictive credit standards during periods of high employment and business activity, while on the other hand, relaxing such standards during periods of subnormal employment and business activity. The problem of applying such a policy arises from the difficulty of currently recognizing the stage of employment and business with respect to the business cycle, and further, because bank examiners and supervisors are likely to be swayed by the same factors as influence bankers themselves.

W. Randolph Burgess (National City Bank, New York, N. Y.)

Bank examination and supervision should be carried out at all times so as to insure that bank operations are prudently and soundly conducted. In time of crisis or panic it is necessary for the supervisory authorities to avoid pressing for unnecessary liquidation of inventories or investments on prostrate markets. This lesson should have been learned in 1931–32. But no one is wise enough as to the great movements of business to be able to vary examination policies from time to time in an attempt to influence the business cycle.

John Carlander (State Bank of Faribault, Faribault, Minn.)

Supervisory agencies can be very helpful for furthering the objective of economic stability providing they receive the wholehearted support from all Federal agencies. There should be no restrictions imposed on banks generally that do not apply to all Government and other lending agencies.

S. Sloan Colt (Bankers Trust Co., New York, N. Y.)

Bank examination and supervision are designed to protect the depositor against the risks of unwise or improper conduct of banking activities. Emphasis should remain primarily on appraising the quality of bank assets and the standards being applied in the individual bank's lending and investing activities. Part of an effective job of examination and supervision is, of course, to take into account the

general economic conditions which prevail at the time of the examination.

George W. Crawford (First National Bank, Chester, Pa.)

We believe that bank examination and supervision should have as its primary objective an appraisal of the solvency and liquidity of banks. Examination should also determine whether or not banks are being managed efficiently and conservatively. Examinations should not become an instrument of policy for achieving economic stability. We believe that required reserve, deposit insurance, and bank examination should be instruments for the protection of the depositors' money. Any attempt on the part of the Government to use these as instruments of policy might relegate the depositors' interest to a secondary posiion.

H. D. Crosby (First National Bank & Trust Co., Fargo, N. Dak.)

Bank examination and supervision should be carefully exercised and changed from time to time to conform to the economic situation then prevailing.

Percy J. Ebbott (Chase National Bank, New York, N. Y.)

Apparently question 8 was meant to evoke comment with respect to the suggestions that have sometimes been made that supervisory standards be varied for the purpose of business cycle control.

Examination and supervision should not be regarded as a substitute for, or as a technique of, monetary and credit control. Bank examination is concerned with the soundness of individual banking institutions and their activities within the broad framework of national monetary and credit policy. However, stabilization of the business cycle should not be the basic concern of bank examination. To attempt to use it for this purpose would involve a radical departure from the normal and historical procedures by which the performances of individual banks are judged. Frequent changes in the standards by which bank assets are evaluated and by which credit risks are differentiated are not administratively feasible, and would have undesirable consequences upon the management of individual banks. The responsibility for business cycle stabilization should lie primarily in the field of monetary and fiscal policy.

George S. Eccles (First Security Bank of Utah, N. A., Ogden, Utah)

I believe that bank examinations should be primarily conducted for the purpose of checking the solvency of banks and directing management into sound banking practices. I do feel there is merit to some of the changes made in examinations, whereby paper formerly classified as "Slow" is now classified as "No. 1 Classification" which does not necessarily mean that it is criticized paper, but that it is paper which should be given attention and close supervision. Also I think the change in the appraisal of the Government bond portfolios of banks was a good thing, with governments now being appraised at cost or par, whichever is lower. I feel that the general examination policy can have some influence on the banking fraternity. For example: During periods of inflation bank examiners should be extremely careful in reviewing credits that may become problems at the least downtrend in general business conditions and I think during periods such as we experienced in 1933–34 that examiners should be

careful so as not to cause a condition which would not result in liquidation of credits, but might only result in further pressure on the downward side of the economy.

Robert V. Fleming, (Riggs National Bank, Washington, D. C.)

I believe that bank examination and supervision should be used strictly for the evaluation of a bank's assets, the capabilities of its management and the safety and efficiency of systems employed in its operations. To use bank examinations to further the objective of economic stability would mean that in times of depression examining policies would be lenient or lax in order to stimulate extensions of credit; the doubtful assets of a bank would not be improved in such a type of examination, and in my opinion, in the long run could result only in aggravating difficulties that might exist in a bank whose doubtful assets were excessive.

L. M. Giannini (Bank of America National Trust and Savings Association, San Francisco, Calif.)

Furthering the objective of economic stability should not be a primary consideration of the examining and supervisory authorities in the handling of their normal examination and supervisory functions which are designed to maintain the solvency of the banks and assure the safety of the loans and investments included in the assets.

T. Allen Glenn, Jr. (Peoples National Bank, Norristown, Pa.)

In my opinion, it would be highly impractical to use bank examinations and bank supervisory agencies as instruments for furthering the objective of economic stability. In the first place, the examination policies and the physical examination of individual banks tend to lag behind changes in business conditions. To attempt to use examining forces as an instrument for furthering the objectives of economic stability would be somewhat like locking the barn door after the horse has been stolen. Bank examinations have traditionally been concerned with the quality of the assets of the bank and not with the economic effects obtained as a result of those credits being disbursed. In my opinion it would be exceedingly difficult to coordinate policies that will be, at the same time, applicable in the different sections of our Nation and among the different industries and businesses found therein. To me, such a proposal is highly impractical.

George H. Jackson (First National Bank, Spokane, Wash.)

I feel that bank examination and supervision should have as its main objective the appraisal and confirmation of the financial position of a bank from the standpoint of safety to its depositors and service to its community through the extension of credit. If it does this I feel it is furthering the objective of economic stability to the extent that it should.

N. Baxter Johnson (Chemical Bank & Trust Co., New York, N. Y.)

Bank examination and supervision are not related to economic stability except insofar as the soundness of banks is maintained. To use these devices to control credit and otherwise affect the general economy, would render useless the entire private banking system.

William L. Kleitz (Guaranty Trust Co., New York, N. Y.)

I do not believe that bank examination and supervision should be used in any degree for furthering the objective of economic stability. I believe that bank examination and supervision should be used solely to assure the soundness of the institutions being examined or supervised, and their compliance with appropriate statutes and regulations.

Homer J. Livingston (First National Bank, Chicago, Ill.)

Not at all.

James K. Lochead (American Trust Co., San Francisco, Calif.)

Bank examination and supervision should have only one objective: The protection of depositors first, and stockholders second. Any attempt to tie these activities to economic planning and control would divert attention from the purpose for which they were created—namely, to see that banks are sound assetwise, and are being operated honestly and in conformity with the law. Determination of bank policy within the framework of the law is the responsibility of each individual bank's management.

H. Raymond Makuen (Goshen Savings Bank, Goshen, N. Y.)

Bank examination and supervision is very important. It completes the triangle between the examiners, the bank, and the public. If the examination is made with the thought of economic stabilization in mind, we believe all three parties would benefit.

William R. K. Mitchell (Provident Trust Co., Philadelphia, Pa.)

Bank examination and supervision should be extended no further from their traditional functions than to ascertain compliance with specific qualitative credit regulations such as W, U, and X. Moreover, such regulations should be issued only in times of undisputed national emergencies. It would not be possible to recruit a staff of examiners qualified by training and proven experience to pass judgment on the economic impact of individual credits in an objective and uniform manner. The few good men who might be obtained would undoubtedly soon find more attractive opportunities in other fields. The grant of broad discretionary powers to supervisors and examiners lacking the necessary qualifications would be a catastrophe.

Earl R. Muir (Louisville Trust Co., Louisville, Ky.)

I believe that bank examination and supervision should be used to see that bank operations are legally and soundly conducted. I believe that any attempts to use examination or other supervisory authority to restrict the extension of credit, qualitatively or quantitatively, where the loans are sound, is unwise. I think that serious harm has been done to the economy of the country in time past by undue pressure being exerted by examiners on bankers to liquidate loans and investments when market and economic conditions were such as to indicate that liquidation was untimely.

W. B. Pollard (National Bank of Commerce, Memphis, Tenn.)

We believe that the functions of bank examination and bank supervision are separate and distinct. Examination should direct itself to the appraisal of assets of a banking institution and an assessment of management capabilities. Supervision should direct itself toward

regulation of credit extension by appropriate curbs in good times and appropriate relaxation in bad times.

G. W. Reese (*Citizens & Peoples National Bank, Pensacola, Fla.*)

I am strongly opposed to the thought "that bank examination and supervision should be used as instruments for furthering the objective of economic stability." This can only have the effect of stifling the independence and the individuality of our banking system. Political considerations and expediency would tend at once to throttle the ability of business to operate under the free-enterprise system. This country has grown and prospered under the theory that men and businesses were to invest their own capital, take their own risks, and derive what profits they might from their efforts. We can only lose the initiative that made this country great if we adopt the policy of restricting the business life to what the planners in Government think desirable. Such a move means complete socialism or control by the state under whatever guise it may choose to call itself.

Thomas J. Robertson (*First National Bank of South Carolina, Columbia, S. C.*)

Bank examinations and supervision are now contributing to economic stability by encouraging adequate banking services, by denial of charters where there would be undue risk of failures, and by enforcement of laws relating to solvency.

John J. Rowe (*Fifth Third Union Trust Co., Cincinnati, Ohio*)

It seems to me that bank examination should be for the one and single purpose of seeing that the bank examined is amply liquid, able to meet its obligations, and to avoid any form of dishonesty whatsoever. The suggestion that examination could further the objective of economic stability seems to me nothing in the world but a police state.

P. J. Schirber (*First James River National Bank, Jamestown, N. Dak.*)

We believe that bank examination and supervision can, and should, play an important part in furthering the objectives of economic stability.

Lewis A. Shea (*First National Bank & Trust Co., Bridgeport, Conn.*)

If the examinations made by the various supervisory agencies could be made on the high basis of the national-bank examination, and the examiner was a seasoned man with proper background, who could review the loaning and investment policies of the bank, and make recommendations, if necessary, to further the objectives of economic stability.

Clay W. Stafford (*Ames Trust & Savings Bank, Ames, Iowa*)

We believe it would be the objective of bank examination and supervisory authorities to make constructive suggestions to banks in furthering the objective of economic stability. We would not, however, favor giving these supervisory authorities power which they do not now have and which power we believe is sufficient to enable them to insist upon sound bank management.

William E. Stone (First National Bank, Peoria, Ill.)

Bank examining from my experience has had a good influence and could be expanded. It seems to me the examiners are inclined to be a little less strict in the past few years. A little more pressure now may save trouble later.

F. W. Thomas (First National Bank of Omaha, Nebr.)

Bank examination supervision should not be used as an instrument for furthering the objective of economic stability. Banks should be required at all times to operate within the law and under reasonable regulations which do not involve coercion. History demonstrates that banking generally has cooperated in all movements for national welfare.

J. C. Thomson (Northwest Bancorporation, Minneapolis, Minn.)

Bank examinations, based on our experience, should be confined to determining the bank's solvency, compliance with legal requirements, and conformance with sound banking principles on date of examination, in the light of conditions at that time. I believe that it is impossible to formulate and transmit to examiners in the field an accurate appraisal of business and economic conditions as of a given date, in time to be effective in aiding the examiner. Over-all policy determination would lessen the emphasis on evaluation of differences in local conditions and the individual ability of bank management and their customers. There is a danger that the use suggested might result in recommendations based on political considerations. It seems to me that any probable advantages are outweighed by the difficulties and the dangers involved.

Raymond H. Trott (Rhode Island Hospital Trust Co., Providence, R. I.)

We do not think that bank examination and supervision should be used as instruments for furthering the objective of economic stability. This would be usurping the major functions of the Federal Reserve Board and encroaching upon the policy and management functions of bank officers in acting for the best interests of all concerned. The job of trying to maintain economic stability is altogether too important to be spread among different governmental bureaus. The Federal Reserve Board was set up some 37 years ago for that purpose, and we think it would be a mistake to make any changes. Bank examination and supervision should, in our judgment, be restricted to determining the soundness of a bank's assets and the honesty of its administration.

Carl W. Ullman (Dollar Savings & Trust Co., Youngstown, Ohio)

None. We believe that bank examination and supervision should not be permitted to exercise qualitative control of credit and they should have no quantitative control of credit other than that now existing or that may exist under traditional means. We believe such vast and far-reaching powers should be retained by elective officials and not rest in or be delegated to appointed officials.

G. Van Haaften (American National Bank, Kalamazoo, Mich.)

We have always appreciated receiving the opinions of national bank examiners who cover many well-managed banks, and have

weighed their suggestions as well as the guidance we receive from other supervisory authorities.

R. H. West (Irving Trust Co., New York, N. Y.)

In our opinion bank examiners should be limited to ascertaining the soundness of banks and the correctness of their statements of condition. On the other hand, banking supervision authorities should properly concern themselves with promoting economic stability. In making this last statement we have in mind such things as harshly rating risks in times of booming business and the showing of more leniency in times of depression.

Joseph C. Williams (Commerce Trust Co., Kansas City, Mo.)

This is an insidious question. In some instances there has been an attempt on the part of bank examiners in the various fields of bank examination to depart from the fundamental principles of bank examination and endeavor to enunciate policies that will further so-called economic stability. This is beyond the province of bank examination, and inevitably would result in a staff of bureaucratic managers who would, in my opinion, not be foresighted enough to gage correctly the business cycle or its timing. Let the bank examiners see that the managements of banks are made up of men of integrity and ability, and that the loans are prudently made and are backed up by assets and individuals who are worthy of credit. There is a growing tendency on the part of bank examination forces to dictate capital requirements and to make other managerial decisions for bank management which tendency does not seem to be within the framework of the present laws.

9. In your experience, have regulation X (real-estate loans) and regulation W (consumer loans) of the Board of Governors of the Federal Reserve System been successful in accomplishing their respective objectives? Have they been fair and equitable in administration?

Most bankers replying indicated that they believed regulations X and W had been reasonably successful in accomplishing their objectives. Regulation W was, in general, considered to be somewhat more effective than regulation X. There was some criticism both of the congressional relaxation of the regulations and of the failure, in the opinion of the bankers, of the Federal housing agencies to contract their operations in line with the contraction called for in the private economy. There was also some criticism of the way in which regulation X was put into effect, creating a vast backlog of nonregulation financing to be waded through before it could become effective.

Extracts from typical replies follow:

Hubbard G. Buckner (First National Bank, Louisville, Ky.)

I think that regulations X and W have undoubtedly restricted the extension of some credit. I find it hard to think that they have been of major value to the country as a whole, when our inflationary policies are pouring so many cheap dollars into the monetary system. This latter factor makes the question of the restriction of specialized loans, such as are covered by the two above restrictions, purely academic, but to the extent that they have had any influence, I think it

has been good. I have no knowledge of any unfairness in their administration.

D. L. Chamberlain (First National Bank & Trust Co., New Haven)

We believe that regulations X and W of the Board of Governors of the Federal Reserve System have not been successful in accomplishing their respective objectives so far as curbing inflation is concerned.

Too much emphasis has been laid on bank loans as the root of evil of the inflationary forces, whereas other factors in our economy exert a greater impact on the problem, such as unbalanced Federal budgets, deficit financing, Federal subsidies, and general Government extravagance.

We believe that the administrators of regulations X and W have endeavored to be fair and equitable.

Ernest Clayton (Industrial Trust Co., Providence, R. I.)

We believe regulation W has not accomplished its objective. This may be partially due to the slowness with which the regulation was applied and also because, apparently, sufficient cash was held by the public to meet down-payment requirements. Further, single payment loans and charge accounts are not covered by the present regulation.

Although regulation W was administered fairly by the Federal Reserve Board during World War II, we believe it could do a far better job now if it had a practical consumer credit banker on its Board.

It is apparent that regulation X has not had any marked affect on our mortgage business and, therefore, has not accomplished its objective insofar as Rhode Island is concerned. While the tempo of our mortgage lending has definitely declined, we have no evidence that this is due to regulation X. For this area there has been sufficient credit, materials, and manpower for residential construction. It is in this type of mortgage that we specialize.

While the Board has never before dealt with real estate credit, in our opinion they appear to be handling it in a most satisfactory manner.

Walter E. Cosgriff (Continental National Bank & Trust Co., Salt Lake City, Utah)

We are not very much in favor of regulations X and W as they would seem to place unwarranted burdens on poor people and small businesses. Big business is capable of obtaining whatever credit it needs from banks by a multitude of individual devices. When credit is contracted artificially it is the small operator who suffers rather than the large, which tends to benefit big business at the expense of small business. This situation could be elaborated on indefinitely.

Percy J. Ebbott (Chase National Bank, New York, N. Y.)

Regulations X and W appear to have been helpful in accomplishing the objectives of the Defense Production Act. These objectives include the curbing of the inflationary effect of easy credit terms and the conservation of materials needed for defense during the emergency period.

According to a joint release by the Board of Governors of the Federal Reserve System and the Housing and Home Finance Agency, October 10, 1950, the restrictions on residential real estate credit were

based on the objective of a one-third reduction in housing production in 1951, that is, to about 800,000 units. New housing starts for the entire year 1951 will exceed this target. However, this is attributable largely to the backlog of preregulation commitments. The Board's announcement on September 8, 1950, of the reinstitution of regulation W did not stipulate any specific target against which performance to date can be measured.

Both housing and consumer credit restrictions have played a significant role in curtailing extraordinary demand arising from excessively easy credit terms. However, it is impossible to measure the extent to which the reductions which have occurred in the output of housing and durable consumer goods were caused by credit restrictions and to what extent by other factors.

In our experience the administration of both regulations X and W has been fair and equitable. Close and continuous contact with lending banks by the local Federal Reserve bank has facilitated understanding and interpretation of the regulations and thereby contributed to fair and equitable enforcement.

Loring L. Gelbach (Central National Bank of Cleveland, Cleveland, Ohio)

Regulation X and Regulation W have been successful in accomplishing their respective objectives of curtailing further growth in the volume of consumer loans and real estate loans outstanding. As to fairness and equitableness, the regulations are arbitrary and discriminatory as to types and terms of loans and as to certain classes of consumers. (For example, loans to veterans at lower down-payments and interest rates than allowable to nonveterans is discriminatory against the individual of comparable credit risk who pays more.)

L. M. Giannini (Bank of America National Trust and Savings Association, San Francisco, Calif.)

Regulations W and X have had some restraining influence upon the volume of consumer and real estate credit. However there have been many other factors involved in the changes in the volume of these types of financing since these regulations became effective. As emergency measures they may have some merit if properly administered, but they should not be regarded as a necessary part of normal peacetime banking procedures.

Kelley Graham (First National Bank, Jersey City, N. J.)

Regulation X and regulation W were both adopted by the Board of Governors of the Federal Reserve System in the hope of reducing real estate and consumer credit lending activity. In our observation, each of them has been successful in accomplishing its objectives and has been fairly and equitably administered.

H. Hiter Harris (First & Merchants National Bank, Richmond, Va.)

I believe that both regulation X and regulation W have had more than reasonably expected success in accomplishing their respective objectives and in our experience the administration of these regulations has been both fair and equitable.

W. L. Hemingway (Mercantile Trust Co., St. Louis, Mo.)

Regulations W and X are two of the selective credit controls imposed to limit the expansion of bank credit, as well as the extension

of nonbank credit. They were adopted as emergency measures in order to cope with the difficulties arising from the national defense program and should not be continued on a permanent basis.

Regulation W has been relatively effective. The terms under which consumer credit loans are made are relatively short and, consequently, this regulation was effective in reducing the amount of credit employed to finance the purchase of durable consumers' goods until Congress liberalized the terms recently. The liberalization was followed almost immediately by an expansion in the volume of consumer credit outstanding.

Regulation X governing real estate credit has not been as effective as regulation W because a large volume of commitments was authorized and outstanding before the regulation actually was placed in force. Likewise, modifications have been made in order to provide housing in defense areas and to continue the policy of giving favorable treatment to veterans. The liberalizations of the terms of the regulation has resulted in an increase in the number of housing starts in the last several weeks.

Insofar as we are able to judge, the administration of these regulations has been fair and equitable.

W. S. Hildreth (Peoples National Bank, Charlottesville, Va.)

In your experience, have regulation X (real estate loans) and regulation W (consumer loans) of the Board of Governors of the Federal Reserve System been successful in accomplishing their respective objectives? Regulation X, partially; regulation W, yes.

Have they been fair and equitable in administration? Yes.

Henry Knepper (First Camden National Bank & Trust Co., Camden, N. J.)

As to the effects of the application of regulation X and regulation W as issued by the Board of Governors of the Federal Reserve System, it is our opinion that they have in the main been helpful and accomplished their objectives. In our case we have found that credit soundness is dictated by the provisions of these regulations. In our section we believe that the administration of these regulations has been splendidly handled in a fair and equitable manner in every way.

L. S. McCready (First National Bank, Eugene, Oreg.)

It is the writer's opinion that regulations W and X have been successful in accomplishing a fairly large percentage of the respective objectives. In our experience they have been fair and equitable in administration.

F. F. McGee (First National Bank, Cody, Wyo.)

We are not in favor of the Government telling the banks how to lend their funds; however, we do think regulations X and W have been helpful and we are perfectly willing to go along on the basis prescribed by them. They are not unreasonable and the down payment is small enough.

Elmer B. Milliman (Central Trust Co., Rochester, N. Y.)

Our experience has been that regulation X and regulation W have been reasonably successful in accomplishing their respective objectives. As far as we can see, both have been administered in a fair and equitable manner.

F. W. Murray, Jr. (*National Bank of Orange County, Goshen, N. Y.*)

We question very much whether regulation X and regulation W have been successful in accomplishing their respective objectives. The average country bank tries to follow the regulations, but usually has a bad time trying to interpret what they really mean.

Andre J. Perry (*First Fond du Lac National Bank, Fond du Lac, Wis.*)

From our experience the two regulations must be treated separately in answering this question.

(*a*) Regulation W has been eminently successful in accomplishing its objective.

(*b*) Regulation X has had little force or effect.

Within the regulations the administration has been fair and equitable in both cases; however, the exceptions permissible because of FHA and veteran type X loans have materially affected appraisals on conventional lending. The human element is permitted to have so much more latitude under regulation X than W, that X as a regulation is of no major significance.

Ralph W. Phillips (*Bay City Bank, Bay City, Mich.*)

Regulations W and X, we believe, have been fair and equitably administered, but have accomplished very little toward the over-all objectives.

Thos. E. Prescott (*Bank of Passaic & Trust Co., Passaic, N. J.*)

Regulation X might have some effect after the huge volume of loans that are not affected by it are worked off. As you know, the builders and contractors were tipped off and secured commitments that will last them for several years. Regulation W is a class regulation which works a hardship on buyers of the lower-priced automobiles and causes the ordinarily honest citizen to try to circumvent the regulation and thereby match the dishonesty of the Government.

A. E. Reid (*Old National Bank, Spokane, Wash.*)

In our opinion, regulations W and X have been fair and equitable in the administration, and as originally written were very successful in accomplishing their respective objectives. As they accomplished these objectives, however, pressures, congressional and otherwise, were brought to bear to such an extent that relaxing of terms and conditions were effected, and to this extent, a lessening of the desired objectives was made.

J. F. Ringland (*Northwestern National Bank, Minneapolis, Minn.*)

It is our feeling that regulation X and regulation W have been reasonably successful in accomplishing their objectives. Regulation X would have been more effective immediately had it not been for mortgage commitments made just prior to the effective date of the various provisions of the regulations and the companion restrictions on VA and FHA loans. It is our feeling that both regulations X and W have been administered in an entirely fair and equitable manner.

John J. Rowe (*Fifth Third Union Trust Co., Cincinnati, Ohio*)

Again, I feel strongly that both regulation X and regulation W should not have been put into effect, and that if we do believe in free

enterprise, we should avoid any concession whatsoever to being under directives from an "all wise" Government.

E. C. Sammons (United States National Bank, Portland, Oreg.)

Regulation W appears to be accomplishing what was intended, but in the case of regulation X, its effectiveness is limited by Government guaranties and insurance of real-estate credit. Both regulations were intended for an emergency, and since that emergency still exists, their retention seems proper, even necessary. There have been relaxations to meet changing conditions, and at the right time, they should be lifted entirely. Their usefulness is questionable beyond the emergency period.

James E. Shelton (Security-First National Bank, Los Angeles, Calif.)

A statement of just what their objectives were would have to be made before the question could be answered. They undoubtedly have prevented the making of some loans by some lenders. I am inclined to think that the working of the natural laws of supply and demand and price have had more weight in the cessation of scare buying than the governmental controls. Such controls never are and cannot be fair and equitable in their application to all people under all circumstances. They are always arbitrary interferences with the freedom of the individual and always work real hardships in many cases.

J. C. Thomson (Northwest Bancorporation, Minneapolis, Minn.)

Our affiliates appear to be satisfied with the administration of Regulation X and Regulation W. We believe these measures have been successful in accomplishing their objectives to the fullest extent possible. I saw no reason for Congress liberalizing Regulation W and I see some danger for the future if Congress acts in such matters, influenced by particular situations and political pressures, without fully considering the long-range effects of interfering with operation of credit controls by the Federal Reserve System and overriding the judgment of the Federal Reserve Board.

Bruce Townsend (City National Bank, Clinton, Iowa)

We are favorable to the terms of regulation X and regulation W, particularly the latter. Regulation X would have never been necessary had not the Congress given such liberal guaranties on GI real-estate loans. It is our feeling that real-estate values would never have run away on the upside, had the supporting credit necessary to such a boom, been determined and granted on the judgment of the private loaning agencies.

Estil Vance (Fort Worth National Bank, Fort Worth, Tex.)

The objective of regulation W, according to our interpretation, was to curtail installment buying. We do not feel that the regulation has accomplished this purpose. In our opinion, the public will adjust itself to the new terms of regulation W and over a period there will be no substantial reduction in installment credit.

The present terms of regulation W are fair and reasonable, and the regulation has assisted in eliminating many unsound practices which were developing in installment financing.

In our opinion, the Federal Reserve Board has administered this regulation fairly and equitably to all concerned. We think a good

example is the recent revision of the regulation extending automobile financing from 15 to 18 months, which we think is sound and at the same time is fair and equitable to the average automobile purchaser due to the fact that prices of automobiles are considerably higher than they were during the period the regulation was in force in previous years.

It is our opinion that regulation X has accomplished successfully its objective and has been fairly administered.

The booklet issued by the Federal Reserve Board, setting forth the provisions of the regulation, does not state its objective; however, we believe we can agree that this objective is to restrict the further expansion of real estate credit in connection with our country's defense program.

It is our opinion that this objective has been accomplished and that the regulation has been fairly administered according to its terms. We think it should be noted, however, that in our opinion and in the opinion of many others who have expressed themselves on the subject, banks, building and loan companies, and insurance companies in recent months have voluntarily restricted real estate credit beyond the requirements of regulation X.

In connection with the statement that regulation X has been fairly administered, we think it is not improper to say that the regulation, because of its inflexibility, contributed in working a great hardship on many builders as a result of the slow market for homes that has prevailed for the past 6 months in all price ranges from $7,500 and up. As you know, in September Congress relaxed the down-payment requirements on homes ranging in sales price up to $12,000, and that will, no doubt, give some relief to builders by making it possible for additional people to purchase homes. There is evidence, too, that insurance companies are coming back into the market for FHA loans.

Herbert J. Vogelsang (First National Bank, Buffalo, N. Y.)

We do not have an extensive mortgage portfolio. We believe that regulation W (consumer loans) has been helpful in maintaining a reasonable debt load for most individuals. Violators should be exposed. We hope the Federal Reserve will never again give notice that a few weeks hence it will impose restrictions. The chaotic conditions created by the announcement of the end of "no down payments" should never be repeated.

Earl S. Wright (Marble Savings Bank, Rutland, Vt.)

Yes. We believe that they have been very fair and equitable in their administration.

10. What do you consider to be the advantages and disadvantages of the ownership of the stock of the Federal Reserve banks by member banks? Do you believe that ownership by the United States Government would be more desirable?

The overwhelming majority of bankers were opposed to Government ownership of the stock of the Federal Reserve banks. Some of the objections were based on grounds implying that the Federal Reserve banks should be operated for profit in the same manner as private banking institutions, but most of them recognized the unique character of central banking operations. Some stated simply that Government

ownership of the stock of the Federal Reserve banks would represent a drift toward socialism.

Some replies stressed that Government ownership of the Reserve banks would make it more difficult to secure high-class personnel and maintain a close cooperation with the business community. However, the commonest objection to Government ownership was that it would make the banks more political in character. The exact shade of meaning attributed to this phrase was difficult to determine. In many cases it undoubtedly expressed a fear that partisan politics would enter into the management of the banks. In most cases, however, it seemed to be based on the view that Government as such, irrespective of party, has an inherent expansionist bias (due to an understandable desire for perpetual prosperity) and must be held in cheek by an independent monetary authority if a reasonable degree of price stability is to be achieved.

Extracts from typical replies follow:

Chester G. Abbott (First Portland National Bank, Portland, Maine)

It certainly is proper that the stock of Federal Reserve banks should be owned by the members who have a vital stake in the welfare of the banks and consequently should have the responsibilities as well as the benefits of the operations of the Federal Reserve System on sound bases. Under no circumstances whatever, should the Government own the stock of these banks.

In closing this rather long answer I would like to say that if we had Government ownership of the Federal Reserve banks, 100 percent insurance by the Federal Deposit Insurance Corporation, policy examinations by supervisory authorities, higher reserve requirements, and Treasury control of the Federal Reserve interest rates we would have a pretty completely socialized banking system and it would represent a surrender of the basis of our economy to those who would like to see complete socialization of all private enterprise.

Henry C. Alexander (J. P. Morgan & Co., New York, N. Y.)

I do think that it is advantageous that the stock of the Federal Reserve banks is owned by member banks. I do not think it should be owned by the United States Government. I think that a good measure of independence in the Reserve System is highly desirable. Our very Government is founded upon the principle of the division of powers between the legislative, the judicial, and the executive. The basic principle was to avoid the establishment of tyranny. By analogy it is highly desirable to retain in the banking system the greatest possible measure of independence of the Government. The Reserve banks will in the end always have to support the Government's credit, and should do so, not by pegging bond prices or interest rates, but by maintaining an orderly market, but it is of the greatest value to the preservation of sound money and sound fiscal and banking policies that the authorities of the Federal Reserve System are not the hired employees of the Treasury.

Julian B. Baird (First National Bank, St. Paul, Minn.)

The fact that member banks own the stock of the Federal Reserve banks gives them the right to vote for certain classes of directors of the regional banks. If the stock were not owned by the banks, regional interests, which the System of 12 regional banks was designed to serve, would receive less consideration.

If the banks did not own the stock of the Federal Reserve banks, it would no doubt be held by the Treasury and this would tend to strengthen the position of those who claim that the Federal Reserve System should be under the domination of the Treasury. We believe that the functions of the Federal Reserve System can best be discharged if it is free of domination by either the member banks on the one hand or Government on the other hand. Surely the record of European banks that have come under the complete domination of government should give us pause in going further in that direction.

Keehn W. Berry (Whitney National Bank, New Orleans, La.)

It seems to me that the influence of the Treasury over the Federal Reserve Board during the war emergency, and particularly during the postwar peace period, points up very definitely the need for every safeguard to the independence of our Federal Reserve System, as our central banking mechanism, from Government control. The ownership of the Federal Reserve banks by private banks was one of the safeguards put in the original act. Whether or not it is effective there is not the slightest excuse for taking that stock and putting it in the hands of the executive branch of the Government. For the sake of our over-all economy, any change made now in the Federal Reserve Act must be in the direction of adding more safeguards and assurances for the independence of our central banking authority as represented by the Federal Reserve System rather than detracting from that independence.

Thomas C. Boushall (Bank of Virginia, Richmond, Va.)

Total ownership of the Federal Reserve banks by the banks would be far more representative of our democratic system and free-enterprise economy. There is no excuse or reason for the Federal Government to own any part of the 12 banks—witness FDIC total funds supplied by bank contribution yet under Federal control. Federal Reserve can be likewise situated.

Lloyd D. Brace (First National Bank, Boston, Mass.)

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There are those who might argue that stock ownership would not impair the independence of the System, but with those I heartily disagree. Such Government ownership in my judgment would lead only too rapidly to domination of the System by the executive branch in general and by the Treasury Department in particular. The immediate interests of those two divisions of Government might at many times be at variance with the objectives of the Reserve System in carrying out the responsibility assigned to it for controlling the supply and availability of credit. In view of that fact I believe that the independence of the Reserve System should be as jealously guarded today as was intended when the System was created by Congress.

W. Randolph Burgess (National City Bank, New York, N. Y.)

We see no disadvantage in ownership of the Federal Reserve banks by the member banks. They have no control but ownership—and a voice in the election of six of the nine directors provide some inducement to voluntary affiliation with the Federal Reserve System by State-chartered banks. Rotation on the directorships by leaders of

banking, commerce, and industry leads to better public understanding of the problems and policies of the Federal Reserve which affect the economic welfare of almost every citizen. The directors, reciprocally, bring the Federal Reserve into limited personal contact with responsible people from all parts of the country and tend to make it less of either an ivory tower or a political football. The support of their directors (mostly nonbankers) has helped the Federal Reserve bank presidents who are members of the Federal Open Market Committee to take courage in opposing unsound principles.

Ownership by the United States Government would have the disadvantage of weakening or destroying the decentralized basis in Federal Reserve organization, uniquely suited to a country where jealousy of centralized money power has run so strong. Under Government ownership, the Secretary of the Treasury presumably would be custodian of the shares and if he adopted a proprietary attitude toward the Federal Reserve System its power of resistance to easy-money, inflationary policies could be lost.

Alfred J. Casazza and Associates (Committee on Government Securities and the Public Debt, National Association of Mutual Savings Banks, New York)

This committee does not favor transfer of the ownership of Federal Reserve bank stock from member banks to the United States Government. That there is an innate fear of political control must be admitted. That fear is solidly based on the belief that long-range planning by any political group must be tempered by the immediacy of political pressures. This is particularly true when the short-term effects of a long-range plan are not immediately palatable. Whatever the fact, the existence of such fear attitudes would tend to weaken the necessary confidence and support for action in the field of credit, if under direct political control.

Underlying the whole of question 10 is the need to reconcile the Full Employment Act as adopted by the Congress and the present only indirect influence of Congress and the Executive order over credit policies of the Federal Reserve Board. Let us meet this question head on. In the view of this committee the Full Employment Act might logically and by inference encourage the Congress to take complete and direct control of the entire economy, including, and particularly, all employers and employees. We hope and believe that such is far from their minds. The value to this country of a great body of independent thinking is too marked to be overlooked. It is the obvious bulwark against centralization.

Continued ownership of Federal Reserve stock by the member banks is directly within this line of reasoning. The large stockholder group, acting on the local Federal Reserve presidents and boards of directors and so on through to the Open Market Committee, brings to focus every local aspect to the top policy level. Here is a local information and opinion chain too valuable to destroy. Just as this country has fostered the independence of banking in local areas, so it should avoid centralizing control over Federal Reserve action.

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S. Sloan Colt (Bankers Trust Co., New York, N. Y.)

The present set-up of the Federal Reserve System permits the officials of various member banks, by rotation, to act as directors of

Federal Reserve banks and thereby become familiar with the policies and workings of the Federal Reserve System. At the same time, it permits the officers of the Federal Reserve banks to keep in closer touch with the problems and thinking of the member banks. The educational advantages are mutual. The directorate, composed of member bank officials and business leaders, serves to promote cooperation and understanding between Reserve banks, member banks, and the business community. The regional character of the banks is also maintained by this arrangement.

The control of central bank policy and not the ownership of the Federal Reserve banks is the real issue. We believe that the public interest will be served best if that control is exercised by an independent body, free of both political domination and banker domination.

Our opinion is that the present provisions for ownership of Federal Reserve bank stock have worked satisfactorily. The transfer of ownership to the United States Government would seriously increase the possibility of domination by political influences.

Sidney B. Congdon (National City Bank, Cleveland, Ohio)

I believe it is desirable that ownership of stock of the Federal Reserve banks remain in the member banks as at present. I would consider the ownership of such stock by the United States Government as wholly undesirable. It is true that even with the ownership of the stock of the Federal Reserve banks lodged in the member banks, member banks have very limited influence upon the policies and operations of the Federal Reserve banks, this by reason of the fact that the members of the Board of Governors of the Federal Reserve System are appointed by the President of the United States with the advice and consent of the Senate, and because of the control which the Board of Governors exercises over the policies and operations of the Federal Reserve banks. Nevertheless, the existing arrangement of ownership (subject to important limitations) by the member banks and joint representation in the Federal Reserve System of the member banks and the Federal Reserve Board produces, I believe, a thoroughly tried and workable basis for cooperation of privately owned business and Government, to the benefit of the Nation. * * *

Walter E. Cosgriff (Continental National Bank & Trust Co., Salt Lake City, Utah)

We believe the difference between the present ownership of the Federal Reserve bank and Government ownership is very largely theoretical since the banks have no control over the Federal Reserve System as matters stand now. It would seem, rather, to be a question of whether to pay 6 percent on the bank's present investment in Federal Reserve bank stock and this is so minor a matter that it could be decided either way.

George W. Crawford (First National Bank, Chester, Pa.)

Member bank ownership of Federal Reserve bank stock stimulates interest in the central bank, its operation and policies. Ownership creates a desire to acquire knowledge of the objectives of the central bank and to cooperate with their efforts to restrain or stimulate credit as well as other credit and monetary actions designed to stabilize the economy under varying national conditions. The opportunity to elect a director, and the usual 6-percent dividend are secondary advantages,

far outweighed by the member banks' many contacts with the System.

The member banks are well aware of the fact, as stockholders, that they do not control the Federal Reserve System. With this they are content with the protection of the act to the effect that the System will not be politically controlled. In the event that the member banks were required to sell their Federal Reserve bank stock to the Government, we are of the opinion that much of the foregoing would be altered, and such action would be a backward step. Interest in and effort to understand the policies and action of the System would be reduced; as would the opportunity to collaborate in regional problems. * * *

Percy J. Ebbott (Chase National Bank, New York, N. Y.)

Member bank ownership of the stock of the Federal Reserve banks is an inherent feature of central banking organization and operation in the United States. The Federal Reserve System was conceived as a regional organization adapted to suit the needs of a unit commercial banking structure consisting of many thousand separate banks, chartered under both State and Federal laws, and scattered throughout a large and widely diversified economy. The dual nature of the commercial banking structure made it desirable to provide for voluntary membership by State-chartered banks. The purchase of stock in the Federal Reserve banks is an essential condition of membership in a system in which both National and State banks are joined for their mutual advantage.

Ownership of stock in the Federal Reserve banks, a condition of membership, signifies a relationship to the Federal Reserve banks which is uniquely different from that which characterizes the ordinary stockholder in a private corporation. The amount of stock held by a member bank is fixed in relation to the member's own capital and surplus and cannot be transferred or assigned. Although the stock is entitled to a cumulative dividend at a fixed rate, it should be noted that the Federal Reserve banks are not operated for profit and that roughly 90 percent of their earnings over and above the allowable fixed dividend is paid to the United States Treasury.

The stockholding member banks all participate in the election of six of the nine directors of a Federal Reserve bank, only three of which are in fact bankers. In this manner member bank and public representation in the administration of the Reserve banks is assured. This representation constitutes a valuable point of contact between the commercial banks and the Reserve banks which has reciprocal advantages to both institutions; for example, as a line of communications for the exchange of information and advice on banking, credit, and general economic matters.

From the narrow standpoint of the individual member bank, the advantages or disadvantages of ownership of Federal Reserve stock embrace every aspect of membership. From the broader standpoint of the public interest, the advantages or disadvantages can be conceived only in terms of the kind of central banking organization and structure best suited to American needs and traditions. Member bank ownership of the stock of the Federal Reserve banks is a basic structural feature of a central banking system which was designed by Congress to be administered in the public interest, as a nonprofit institution, independent of political influence and free from reliance upon congressional appropriations.

Ownership of the Federal Reserve banks by the United States Government would serve no advantage either to the member banks or the public interest. On the contrary, it would surrender many if not all of the benefits which characterize an independent central banking system.

George S. Eccles (First Security Bank of Utah, N. A., Ogden, Utah)

I do not believe that ownership of stock of the Federal Reserve banks by member banks is so all-important, as the ownership of the stock by the banks does not result in control by the member banks. It does, however, give them representation and makes possible an independent central banking system. I feel that the independent operation of the Federal Reserve System from domination by either the Federal Government (through the Treasury Department), or by the member banks is the important thing. So long as the member banks are given a voice in the election of part of the directors, and the directors represent banking as well as commerce and industry from all the different parts of the country as at present through our regional Federal Reserve set-up, I believe that we will have a central banking system which is sound and able to function without domination or dictation from either the banking fraternity or the Government.

I feel very strongly that complete domination of our central banking system by the Government would be a grave mistake. Under such domination we would lose the restriction that an independent central banking system exercises on monetary policies and in addition it would nullify any brake which the Federal Reserve is now able to apply against easy money and inflationary policies on the part of the Government. This might result in the pursuance of a policy by the central bank which could easily result in unsound credit expansion with continuing inflation.

Ostrom Enders (Hartford National Bank & Trust Co., Hartford, Conn.)

Ownership of the stock of Federal Reserve banks by member banks is the basic strength of our central banking system. We believe very strongly that this ownership should be maintained.

The continued independence of this system must be a reality. The ability of a central banking system to resist the pressures of inflation or deflation that can be created by the Government itself is of vital importance.

The greatness of our Nation was achieved and is maintained by democratic capitalism. The Reserve System stands as a bulwark between political influence in Government and free enterprise, assuring in a large measure the continued existence of the system to which we owe our national well-being.

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Charles T. Fisher, Jr. (National Bank of Detroit, Detroit, Mich.)

We see no material advantages or disadvantages to the member banks in their ownership of the stock of the Federal Reserve banks. This is so because the member banks do not control the Federal Reserve banks. The important thing is that the Federal Reserve banks remain independent. We see no reason for the United States Government to own the Federal Reserve banks other than that such owner-

ship would be a step toward control and on this basis we oppose ownership by the Government.

H. P. Fleming (First National Bank & Trust Co., Macon, Ga.)

Under our present system I do not see that it makes much difference who owns the Federal Reserve banks, so long as they are controlled by Washington. The only practical benefit that I think the banks get from their ownership is the interest (or dividends) on the stocks they own.

L. M. Giannini (Bank of America National Trust and Savings Association, San Francisco, Calif.)

Ownership of the stock of the Federal Reserve banks by the member banks carries with it the right to elect some of the directors of these banks. This in turn is helpful in assuring that many of the services performed by the banks for member banks are handled in such a manner as to be most helpful to the member banks and the public. It is highly essential that the Federal Reserve System be kept free of governmental or political domination if it is to carry out its broad responsibilities for maintaining long-term economic stability and the soundness of the Federal Reserve member bank system. Participation of the member banks in the selection of directors of the Reserve banks and in the ownership of the stock of the banks contributes to the attainment of this objective.

Government ownership of the stock of the Reserve bank and complete Government domination of the activities of these banks would lend encouragement to those who would like to see an increasing encroachment of Government upon the activities of private enterprise in banking and other business.

It would be highly desirable for the Federal Reserve banks to have more influence in the determination of Federal Reserve policies than is inherent in the present system.

R. M. Hanes (Wachovia Bank & Trust Co., Winston-Salem, N. C.)

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Ownership by the United States Government would not be desirable. It would terminate the advantages of our Reserve System as we now know them. There would be a real tendency to use the Federal Reserve banks as a dumping place for all Government bond issues at rates fixed by the Government. It would be a step in the direction of complete Government control and the end of private banking, which would result in the socialization of credit.

W. L. Hemingway (Mercantile Trust Co., St. Louis, Mo.)

The stock of the Federal Reserve banks should not be owned by the Federal Government. The ownership and control of the central banking system should be completely divorced from the Government because Government officials might compel the central bank to adopt measures that are not desirable. Some reason can always be found for encouraging further expansion, and Government officials would probably not order the adoption of deflationary measures.

The ownership of the stock of the Federal Reserve banks by the member banks is desirable because it permits the private banking system to exercise some control over the central banking system.

Moreover, it insures that directors of the district banks will be selected from persons familiar with the needs and problems of the district.

An effort should be made to secure for the Board of Governors greater independence of action.

L. H. Ickler (Aberdeen National Bank, Aberdeen, S. Dak.)

I believe that stock ownership of the Federal Reserve banks by member banks is the best ownership possible for the best interests of all Americans, not only bankers. I do not believe in Government ownership of anything, and its ownership of the Federal Reserve banks would be a catastrophe of the first rank, as it would open the door for Government dominance of the money markets, where politics already has too much to say.

N. Baxter Johnson (Chemical Bank & Trust Co., New York, N. Y.)

There are no disadvantages in the ownership of the stock of the Federal Reserve banks by member banks, and there is no sound reason for transferring this ownership to the United States Government. The reserve system is already an instrumentality of Government, deriving its existence from legislative enactment. Ownership by the private banking system, provides two characteristics which are essential:

(1) The majority of the directing governors are selected by the member banks which insulates the system against complete governmental domination and, at the same time, under the classifications permitted by law, control by member banks is sufficiently diluted.

(2) The evils of central bank control are avoided and the Government's access to the funds of the system is healthily restrained which, otherwise, would not be the case. It seems to us that the greatest advantage from the present arrangement is that the system is insulated on the one side from political control, and on the other side from private domination.

Hugh C. Lane (Citizens & Southern National Bank of South Carolina, Charleston, S. C.)

Under the current Federal Reserve organization the member banks, though stockholders, have relatively little to say concerning the policies of the Federal Reserve System, these being established primarily by the Federal Reserve Board in Washington. However, since the member banks do elect the boards of the 12 Federal Reserve banks, their ideas are corollated for the use of the Federal Reserve Board in determining policy which does give private banking an opportunity to express its ideas and thus it is my feeling that the ownership of the Federal Reserve stock by the member banks should be continued.

Frank D. Lawrence (American National Bank, Portsmouth, Va.)

Answering question 10, if all banks were in the Federal Reserve System, I think it would be a good thing for the Government to own all stock of the Federal Reserve banks; but, since it is apparent to me there are many advantages to a bank not to be a member of the Federal Reserve rather than being a member, I think we member banks are entitled to the dividends we receive on our stock in the Federal Reserve banks as one advantage for being in the System: it is hard to make 6 percent elsewhere.

James K. Lochead (American Trust Co., San Francisco, Calif.)

Ownership of the stock of the Federal Reserve bank by member banks ties the vast majority of banking management into the over-all responsibility for banking participation in the maintenance of economic stability.

Government ownership would convert the Federal Reserve System into another Government bureau and deprive it to a large extent of the thinking and leadership of the most highly trained men in finance.

J. H. McCoy (City National Bank & Trust Co., Columbus, Ohio)

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I don't believe the Government should have any ownership of the Federal Reserve banks. They should be operated for the benefit of the banks, as originally intended by Carter Glass. Should the Government own the Federal Reserve banks and they be operated as a Government agency, that, in my opinion, would be the final step in socializing this country. When you put the control of credit in the hands of seven men in Washington, politically appointed, that would be the straw that breaks the camel's back.

The board of directors in each of the 12 Federal Reserve banks should have the authority to elect the officers, regulate the salaries of the officers and employees, without first getting consent or approval of the Board in Washington. These directors and officers in the 12 districts certainly are familiar with conditions in their territory, and they should be free to exercise their own judgment to a greater degree than they are at the present time.

E. R. Manning (First National Bank, Southampton, N. Y.)

We consider it to be advantageous to have ownership of stock in the Federal Reserve banks. We would suggest that the Federal Reserve banks cooperate more fully with the Secretary of the Treasury. After all, the Secretary of the Treasury has a terrific problem and responsibility in handling the huge debt and borrowings of our Federal Government, and we feel that the Federal Reserve banks should assist and cooperate most heartily with his problem. The Congress and Senate are the representatives of the people and run the Government, and the Secretary of the Treasury receives his orders from them. We don't like to read speeches by top brass bankers making charges that your congressional committee is seeking to "debauch" the Federal Reserve System and supporting the Federal Reserve Bank System against credit policies of the Secretary of the Treasury.

W. A. Mitchell (Central Trust Co., Cincinnati, Ohio)

I do not believe that the ownership of partially paid stock of the Federal Reserve banks by member banks represents any medium of control. The return is adequate on the investment, and in theory it reflects a genuine American philosophy of free enterprise. In theory the central bank should be free of Government control, but in practice its administration cannot be divorced from the broad needs of the Government. I see no advantage to ownership by the United States Government and a serious psychological disadvantage. I feel strongly that the theoretical independence should be maintained.

Peter Pauly (Deer Lodge Bank & Trust Co., Deer Lodge, Mont.)

I feel that it is advantageous that member banks own the stock of the Federal Reserve bank. It creates some earnings for the member bank, and it results in a keen interest in the proper operation of the Federal Reserve bank. Ownership of the stock of the Federal Reserve bank by the United States Government would tend to further centralize economic authority and power, and I am not in favor of such further centralization.

G. W. Reese (Citizens & Peoples National Bank, Pensacola, Fla.)

The stock ownership of the Federal Reserve System should remain as it is now in the banks. Ownership of the stock by the Government would be just one more step toward the complete domination by the party in power of the economic life of the country. Remember the platform of the Socialist Party that their program requires a governmental acquisition of the Federal Reserve banks. Under the present system the banks, through directors elected by them, and industry, through their representatives, do have a voice as directors of the board of various Federal Reserve banks. These representatives do have influence upon the policies of the Federal Reserve System, even though the Federal Reserve Board in Washington is dominated by appointees of the President. This is a safeguard and a vital one. A free and independent central bank and a bank system composed of more than 12,000 individual units with its contacts through its directors of over 100,000 individual and successful businessmen is the greatest protection this country can have in its economic life. The services of this widespread diversified talent should be preserved, for there is no possibility that one small group can be superior in its limited judgment.

J. F. Ringland (Northwestern National Bank, Minneapolis, Minn.)

It is our thought that ownership of stock of the Federal Reserve banks by the member banks has been beneficial both to the Reserve System and to the member banks. The System through those Reserve bank directors elected by the member banks has been brought closer to the business and banking problems of the country, and the banks have been brought into closer working relationships with the System. Ownership of stock has not determined central banking and monetary policies. The control of these policies is in the hands of the Federal Reserve Board and Open Market Committee, and membership on these is not related to stock ownership. We see no disadvantage in ownership of the Federal Reserve banks by the member banks, but we do see disadvantages in ownership by the United States Government. Government ownership might tend to bring the System under political control and make it more susceptible from time to time to easy-money inflationary policies of government. We believe the present ownership of the Federal Reserve banks should be maintained.

John J. Rowe (Fifth Third Union Trust Co., Cincinnati, Ohio)

I feel that, as owners of the stock of the Federal Reserve banks, member banks should have more to say in the administration and management of Federal Reserve banks, and particularly endeavor to see that the Federal Reserve banks build up a very much larger surplus and undivided profits account in order to guard against being called

upon by the banks to pay in more capital. The thought that the United States Government should take over the ownership of Federal Reserve banks seems to me an outrage to those who believe in private enterprise.

Walter A. Schlechte (Old National Bank, Evansville, Ind.)

I believe that ownership of the stock of the Federal Reserve banks by the United States Government would not be desirable. I cannot see that anything at all would be accomplished by the transfer of such ownership, and unless there are some extremely valid reasons put forth I would object to the transfer of any more authority or control to the Federal Government.

Clay W. Stafford (Ames Trust & Savings Bank, Ames, Iowa)

We feel that to us the main advantage in ownership of Federal Reserve bank stock makes us feel ourselves to be a part of the System, and we know that we look with much more favor upon it than we would if it were a Government-owned institution. So far as we are concerned, there are no disadvantages in ownership of this stock. We would say emphatically "No" to United States Government ownership.

J. C. Thomson (Northwest Bancorporation, Minneapolis, Minn.)

The ownership of stock of the Federal Reserve bank by member banks provides a basis for participation by banking and business interests at the local level in administration of the Federal Reserve banks. I believe the regional set-up is highly desirable, brings the administration of the system closer to local problems, serves as an educational medium in regard to the System's responsibilities and means of meeting them, and assures greater acceptance of the decisions and policy recommendations of the Federal Reserve System. I see no important advantages and would be opposed to the Federal Government ownership because of the obvious advantages in the present arrangement.

L. A. Tobie (Meriden Savings Bank, Meriden, Conn.)

Ownership of Federal Reserve banks should remain with the member banks; otherwise, their management and control would be centralized and subject to political and governmental manipulation which would inevitably work to the disadvantage of the whole economic structure of the country.

Raymond H. Trott (Rhode Island Hospital Trust Co., Providence, R. I.)

We believe the banking system should continue to be privately owned; that it would be contrary to democratic principles and to the economic way of life in this country to have it owned by the United States Government. The control of money and credit should be beyond the influence of partisan politics. We think history has demonstrated the fallacy of expecting political control of a country's banking system to be in the best long-term interests of its people.

Estil Vance (Fort Worth National Bank, Fort Worth, Tex.)

The Federal Reserve System was founded on the theory that the interest of the country would be best served by a system of decentralized regional banks. It is true that in the final analysis control of all

Federal Reserve banks rests in the Board of Governors; however, the primary purpose of the 12 separate Reserve banks was to give most effective assistance to the particular region in which the bank was located. If this purpose is to be achieved, a close liaison between the Federal Reserve banks and the commercial banks of the district must be maintained, and it would seem fundamental that this purpose could be best accomplished through ownership of the Reserve banks by the commercial banks. The closer the cooperation between the Reserve banks and the commercial banks, the more efficient is the service they can and will render the public in general.

If the Reserve banks were owned by the Federal Government, it would mean even a further control by the executive branch of the Government. We have always been of the opinion that the further our Federal Reserve System could be removed from political domination the better it could serve the country. To place the Reserve System under the complete control of the executive branch of the Federal Government in effect would make it an instrumentality of the political party currently in power, thereby completely eliminating the original purposes of the Federal Reserve banks and make ineffective any real assistance that they might lend to the commercial banking system of this country.

The Reserve banks are not perfect; there are many parts of the act that probably need some amendment, but the control of these banks by the executive branch of the Government is certainly contrary in every respect to the best interests of all the citizens in this country.

Max von Schrader (*Union Bank & Trust Co.*, *Ottumwa, Iowa*)

I believe that the ownership of stock in the Federal Reserve bank should continue in the member banks. The fact that some of the directors are elected by the member banks gives the Federal Reserve banks a "grass roots" contact, which I believe is vital in the consideration of the economic problems of their respective districts.

APPENDIX TO CHAPTER XI

Questions Addressed to Bankers

1. Have the lending policies of your bank changed since July 1950? If so, what has been the general character of the change? Specifically, what change has occurred in your lending policies with respect to (*a*) regular commercial customers, (*b*) occasional commercial borrowers, (*c*) real-estate loans, (*d*) consumer loans?

2. Have the investment policies of your bank changed since July 1950? Discuss the change in terms of (*a*) purchase of municipal securities, (*b*) purchase of corporate securities, (*c*) management of your Government-security portfolio.

3. Discuss the factors which contributed to the changes in your policies described in the two preceding questions, and your evaluation of the relative importance of each factor. Please give consideration to the following: (*a*) increases in short-term interest rates, (*b*) declines in prices of long-term Government bonds, (*c*) increases in reserve requirements around the turn of the year, (*d*) moral suasion (including

the Voluntary Credit-Restraint Program), (*e*) changes in prices and in the business outlook.

4. Do you believe that it was wise to abandon the par support of long-term Government bonds in March 1951? If not, would you have considered it wise at another time or under other conditions? When, or under what conditions? If you favored the abandonment, would you have preferred that it be done earlier? When?

5. What do you consider to be the principal functions of bank reserve requirements? Do you believe that nonmember banks should be required to hold the same reserves as member banks of the Federal Reserve System?

6. Comment on the proposal (advanced in the Wilson report and in several annual reports of the Board of Governors of the Federal Reserve System) that banks be required to hold reserves additional to those now required, such reserves to be held at the option of the bank in specified classes of United States securities.

7. Do you believe that the coverage of Federal deposit insurance should be extended to include all deposits in insured banks? Why, or why not?

8. To what extent do you believe that bank examination and supervision should be used as instruments for furthering the objective of economic stability?

9. In your experience, have regulation X (real-estate loans) and regulation W (consumer loans) of the Board of Governors of the Federal Reserve System been successful in accomplishing their respective objectives? Have they been fair and equitable in administration?

10. What do you consider to be the advantages and disadvantages of the ownership of the stock of the Federal Reserve banks by member banks? Do you believe that ownership by the United States Government would be more desirable?

The above questionnaire was sent to a sample of about 800 banks selected for the subcommittee by the American Bankers Association. The sample included large banks and small banks, city banks and country banks, commercial banks and mutual savings banks, member banks and nonmember banks scattered over the entire United States. The proportionate response, however, was higher for large banks than for small banks. The questionnaires in each case were addressed to the presidents of the banks included in the sample. In some cases officers other than the president replied on his behalf. In all such cases the name of the person actually replying is listed.

The large sample selected by the American Bankers Association was supplemented by a short list of selected members furnished by the Reserve City Bankers Association. Most of the persons on this list were officers of banks already included in the sample selected by the American Bankers Association. (Members of the American Bankers Association are banks; those of the Reserve City Bankers Association are individuals.) The response from the persons whose names were included in the list furnished by the Reserve City Bankers Association was almost complete.

In addition, questionnaires were sent to all banks—about a dozen in all—which requested them, although they had not been included in the original sample. A letter received from the members of the Committee on Government Securities and the Public Debt of the National Association of Mutual Savings Banks, answering certain of the questions for bankers, has been summarized and extracted as though it were from an individual bank.

Replies were received in all from the 218 persons listed below, representing (after allowing for duplications) 208 separate institutions.

Alabama:
  Anniston:
    Commercial National Bank, C. R. Bell
Arkansas:
  El Dorado:
    National Bank of Commerce, Albert Rowell
California:
  Eureka:
    Bank of Eureka, C. H. Palmtag
  Los Angeles:
    Security-First National Bank, James E. Sheldon
  Oakland:
    Oakland Bank of Commerce, A. S. Weaver
  San Diego:
    First National Trust & Savings Bank, Anderson Borthwick
  San Francisco:
    American Trust Co., James K. Lochead
    Bank of America, National Trust and Savings Association, L. M. Giannini
    Bank of California, National Association, Frank A. Rees
Colorado:
  Denver:
    Colorado National Bank, Harold Kountze
  Fort Collins:
    First National Bank, L. B. McBride
  Pueblo:
    First National Bank, W. R. Hoge
Connecticut:
  Bridgeport:
    First National Bank & Trust Co., Lewis A. Shea
  Danbury:
    Savings Bank of Danbury, H. P. Splain
  Greenwich:
    First National Bank, Ogden Bigelow
  Hartford:
    Hartford National Bank & Trust Co., Ostrom Enders
    Society for Savings, Charles J. Lyon
  Meriden:
    Home National Bank & Trust Co., George J. Sokel
    Meriden Savings Bank, L. A. Tobie
  New Haven:
    First National Bank & Trust Co., D. L. Chamberlain
  Norwalk:
    Merchants Bank & Trust Co., W. P. Clark
Delaware:
  Wilmington:
    Equitable Trust Co., J. B. Jessup
District of Columbia:
  Washington:
    Riggs National Bank, Robert V. Fleming

Florida:
- Miami:
  - First National Bank, Comer J. Kimball
- Pensacola:
  - Citizens & Peoples National Bank, G. W. Reese
- Tampa:
  - Exchange National Bank, Fred C. Billing

Georgia:
- Gainesville:
  - First National Bank, Roy C. Moore
- Macon:
  - First National Bank & Trust Co., H. P. Fleming

Idaho:
- Boise:
  - Idaho First National Bank, John A. Schoonover
- Twin Falls:
  - Fidelity National Bank, Guy H. Shearer

Illinois:
- Chicago:
  - First National Bank, H. J. Livingston, Harold W. Amberg[1]
- East St. Louis:
  - First National Bank, R. F. Reader
- Kankakee:
  - City National Bank, C. A. Mueller
- Peoria:
  - First National Bank, William E. Stone

Indiana:
- Evansville:
  - Old National Bank, Walter A. Schlechte
- Gary:
  - Gary National Bank, W. W. Gasser
- Indianapolis:
  - Fletcher Trust Co., William B. Schiltges
- Kokomo:
  - First National Bank, Donald B. Smith
- Lafayette:
  - Lafayette National Bank, Burr S. Swezey
- LaPorte:
  - First National Bank & Trust Co., James C. Smith

Iowa:
- Ames:
  - Ames Trust & Savings Bank, Clay W. Stafford
- Clinton:
  - City National Bank, Bruce Townsend
- Des Moines:
  - Bankers Trust Co., S. C. Pidgeon
- Ottumwa:
  - Union Bank & Trust Co., Max von Schrader
- Storm Lake:
  - Citizens First National Bank, George J. Schaller

Kansas:
- Garden City:
  - Fidelity State Bank, R. N. Downie
- Kansas City:
  - Home State Bank, C. F. Pack
- Mankato:
  - State Exchange Bank, Lewis H. Stafford

Kentucky:
- Louisville:
  - First National Bank, Hubbard G. Buckner
  - Louisville Trust Co., Earle R. Muir

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[1] Separate replies were received from Mr. Livingston and Mr. Amberg. Mr. Amberg was sent a separate questionnaire because his name was included in the list of names furnished the committee staff by the Reserve City Bankers Association as mentioned in the introductory note.

Louisiana:
- Alexandria:
  - Rapides Bank & Trust Co., James C. Bolton
- New Orleans:
  - Hibernia National Bank, Wallace M. Davis
  - Whitney National Bank, Keehn W. Berry

Maine:
- Bangor:
  - Bangor Savings Bank, Edgar M. Simpson
- Biddleford:
  - First National Bank, Arthur F. Maxwell
- Portland:
  - First Portland National Bank, Chester G. Abbott

Massachusetts:
- Boston:
  - First National Bank, Lloyd D. Brace
  - National Shawmut Bank, Walter S. Bucklin
  - Provident Institution for Savings, N. Preston Breed
- Brockton:
  - Brockton National Bank, Reginald T. Cole
- Lowell:
  - Union National Bank, Homer W. Bourgeois
- Worcester:
  - Guaranty Bank & Trust Co., Roland A. Erickson

Michigan:
- Ann Arbor:
  - Ann Arbor Bank, Rudolph A. Reichert
- Bay City:
  - Bay City Bank, Ralph W. Phillips
- Detroit:
  - National Bank of Detroit, Charles T. Fisher, Jr.
  - Wabeek State Bank of Detroit, C. Johnston Huddleston
- Flint:
  - Merchants and Mechanics Bank, Lloyd H. Drake
- Iron Mountain:
  - Commercial National Bank, B. F. Bambenek
- Kalamazoo:
  - American National Bank, G. Van Haaften
- Lansing:
  - American State Bank, Albert A. Elsesser
  - Michigan National Bank, Howard J. Stoddard

Minnesota:
- Faribault:
  - State Bank of Faribault, John Carlander
- Minneapolis:
  - Marquette National Bank, R. L. Stotesbery
  - Northwestern National Bank, J. F. Ringland
- Mora:
  - Kanabec State Bank, Frank P. Powers
- St. Paul:
  - First National Bank, Julian B. Baird
- Sauk Centre:
  - First State Bank, Ben DuBois

Mississippi:
- Hattiesburg:
  - First National Bank, L. Y. Foote

Missouri:
- Kansas City:
  - Commerce Trust Co., J. C. Williams
  - First National Bank, Stanley Power
- Poplar Bluff:
  - State Bank of Poplar Bluff, P. C. Hays
- St. Joseph:
  - American National Bank, R. R. Calkins
- St. Louis:
  - First National Bank, William A. McDonnell
  - Mercantile Trust Co., W. L. Hemingway

Montana:
- Deer Lodge:
  - Deer Lodge Bank & Trust Co., Peter Pauly

Nebraska:
- Grand Island:
  - Commercial National Bank, Edward Huwaldt
- Lincoln:
  - Continental National Bank, T. B. Strain

New Hampshire:
- Concord:
  - New Hampshire Savings Bank, Ernest P. Roberts

New Jersey:
- Atlantic City:
  - Boardwalk National Bank, William C. Boyer
- Camden:
  - First Camden National Bank & Trust Co., Henry Knepper
- Jersey City:
  - Commercial Trust Co., William J. Field
  - First National Bank, Kelley Graham
- Montclair:
  - First National Bank & Trust Co., A. W. Ballentine
  - Montclair Savings Bank, T. Philip Reitinger
- Moorestown:
  - Burlington County Trust Co., Jonathan W. Powell
- Newark:
  - National Newark & Essex Banking Co., Robert G. Cowan
- New Brunswick:
  - National Bank of New Jersey, Samuel L. Allen
- Passaic:
  - Bank of Passaic & Trust Co., Thos. E. Prescott
- Trenton:
  - Trenton Banking Co., Sydney G. Stevens

New Mexico:
- Albuquerque:
  - Albuquerque National Bank, Fred Luthy
  - Bank of New Mexico, R. E. Adams

New York:
- Albany:
  - Albany Savings Bank, James R. Davie
- Amsterdam:
  - Farmers National Bank, F. Raymond Goller
- Auburn:
  - National Bank of Auburn, Frederic E. Worden
- Buffalo:
  - First National Bank, Herbert J. Vogelsang
  - Manufacturers & Traders Trust Co., Burton L. Gale, Jr.
- Goshen:
  - Goshen Savings Bank, H. Raymond Makuen
  - National Bank of Orange County, F. W. Murray, Jr.
- Ithaca:
  - First National Bank, Paul W. Brainard
- New York City:
  - American Savings Bank, Henry R. Sutphen, Jr.
  - Bank for Savings in the City of New York, DeCoursey Fales
  - Bank of New York and Fifth Avenue Bank, Albert C. Simmonds, Jr.
  - Bankers Trust Co., S. Sloan Colt
  - Bowery Savings Bank, Harris A. Dunn
  - Chase National Bank, Percy J. Ebbott
  - Chemical Bank & Trust Co., N. Baxter Jackson
  - Dry Dock Savings Bank, James B. Stovell
  - First National Bank, Alexander C. Nagle
  - Grace National Bank, C. R. Dweey
  - Guaranty Trust Co., William L. Kleitz
  - Hanover Bank, Craig S. Bartlett
  - Irving Savings Bank, Robert A. Barnet
  - Irving Trust Co., R. H. West
  - J. P. Morgan & Co., Inc., Henry C. Alexander

New York—Continued
  New York City—Continued
    National Association of Mutual Savings Banks, Alfred J. Casazza, John H. Duerk, C. Lane Goss, Richard A. Holton, Charles J. Lyon, Clifford F. Martin, Alfred C. Middlebrook, John Ohlenbusch, A. Edward Scherr, Jr., Levi P. Smith, Frank W. Wrightson, J. Reed Morss
    National City Bank of New York, W. Randolph Burgess
    Savings Banks Trust Co., August Ihlefeld
  Rochester:
    Central Trust Co., Elmer B. Milliman
  Southampton:
    First National Bank, E. R. Manning
  Syracuse:
    First Trust & Deposit Co., Albert B. Merrill
North Carolina:
  Winston-Salem:
    Wachovia Bank & Trust Co., R. M. Hanes
North Dakota:
  Bismarck:
    First National Bank, E. D. Saltzman
  Jamestown:
    First James River National Bank, P. J. Schirber
Ohio:
  Canton:
    Harter Bank & Trust Co., J. Brenner Root
  Cincinnati:
    Central Trust Co., William A. Mitchell
    Fifth Third Union Trust Co., John J. Rowe
  Cleveland:
    National City Bank, Sidney B. Congdon
  Columbus:
    City National Bank & Trust Co., John H. McCoy
  Dayton:
    Merchants National Bank & Trust Co., A. C. Wolf
    Winters National Bank & Trust Co., W. H. J. Behm
  Mansfield:
    Farmers Savings & Trust Co., P. M. Eliot
  Toledo:
    Toledo Trust Co., John T. Rohr
  Youngstown:
    Dollar Savings & Trust Co., Carl W. Ullman
  Zanesville:
    First National Bank, T. R. Murphy
Oklahoma:
  Anadarko:
    First State Bank, N. J. Dikeman
  Tulsa:
    National Bank of Tulsa, A. E. Bradshaw
Oregon:
  Eugene:
    First National Bank, L. S. McCready
  Portland:
    Portland Trust & Savings Bank, Charles H. Stewart
    United States National Bank, E. C. Sammons
Pennsylvania:
  Chester:
    First National Bank, George W. Crawford
  Erie:
    First National Bank, J. C. Spencer
  Norristown:
    People's National Bank, T. Allen Glenn, Jr.
  Philadelphia:
    First National Bank, Harry C. Carr
    Philadelphia National Bank, Frederic A. Potts
    Provident Trust Co., William R. K. Mitchell
  Pittsburgh:
    Mellon National Bank & Trust Co., Lawrence N. Murray
    Peoples First National Bank & Trust Co., Robert C. Downie

Rhode Island:
  Providence:
    Industrial Trust Co., Ernest Clayton
    Plantations Bank of Rhode Island, Howard E. Gladding
    Rhode Island Hospital Trust Co., Raymond H. Trott
South Carolina:
  Charleston:
    Citizens & Southern National Bank of South Carolina, Hugh C. Lane
  Columbia:
    First National Bank of South Carolina, Thomas J. Robertson
  Darlington:
    Darlington County Bank & Trust So., Samuel Want
  Union:
    Arthur State Bank, H. M. Arthur
South Dakota:
  Aberdeen:
    Aberdeen National Bank, L. H. Ickler, Jr.
  Madison:
    Security Bank & Trust Co., W. M. Willy
  Vermillion:
    Citizens Bank, Ray G. Stevens
Tennessee:
  Clarksville:
    First National Bank, C. W. Bailey
  Memphis:
    National Bank of Commerce, W. B. Pollard
    Union Planters National Bank & Trust Co., V. J. Alexander
Texas:
  Beaumont:
    First National Bank, L. Paul Tullos
  Dallas:
    Mercantile National Bank, Milton F. Brown
  Fort Worth:
    Fort Worth National Bank, Estil Vance
Utah:
  Ogden:
    First Security Bank of Utah National Association, George S. Eccles.
  Salt Lake City:
    Continental National Bank & Trust Co., Walter E. Cosgriff
    Walker Bank & Trust Co., A. K. Carlson
Vermont:
  Brattleboro:
    Vermont Savings Bank, Paul H. Ballou
  Burlington:
    Merchants National Bank, C. E. Brigham
  Rutland:
    Marble Savings Bank, Earl S. Wright
Virginia:
  Charlottesville:
    Peoples National Bank, W. S. Hildreth
  Danville:
    First National Bank, James Bustart
  Portsmouth:
    American National Bank, Frank D. Lawrence
  Richmond:
    Bank of Virginia, Thomas C. Boushall
    First & Merchants National Bank, H. Hiter Harris
    State-Planters Bank & Trust Co., H. H. Augustine
  Roanoke:
    First National Exchange Bank, Edward H. Ould
Washington:
  Everett:
    First National Bank, W. M. Jenkins
  Pullman:
    First National Bank, F. C. Forrest
  Seattle:
    Seattle-First National Bank, Lawrence M. Arnold
    University National Bank, A. W. Hogue

Washington—Continued
- Spokane:
  - First National Bank, George H. Jackson
  - The Old National Bank, A. E. Reid

Wisconsin:
- Fond du Lac:
  - First Fond du Lac National Bank, Andre J. Perry
- Kenosha:
  - First National Bank, Lynn T. Hannahs
- La Crosse:
  - National Bank of La Crosse, George A. MacLachlan
- Madison:
  - American Exchange Bank, William S. Hobbins
  - First National Bank, J. H. Stephan
- Milwaukee:
  - Marshall & Isley Bank, A. S. Puelicher
- Oshkosh:
  - First National Bank, Leighton Hough
- Racine:
  - American Bank & Trust Co., G. C. Weyland
- Sheboygan:
  - Bank of Sheboygan, F. S. Rodger
- Superior:
  - First National Bank, J. L. Banks

Wyoming:
- Cheyenne:
  - American National Bank, R. J. Hofmann
  - Stockgrowers National Bank, F. W. Marble
- Cody:
  - First National Bank, F. F. McGee
- Kemmerer:
  - First National Bank, John A. Reed

CHAPTER XII

REPLIES BY LIFE-INSURANCE COMPANY EXECUTIVES[1]

General Basis of the Investment Policy of Life-Insurance Companies

The replies of most of the life-insurance company executives set forth the general basis of their investment policy. Because this underlies the answers to specific questions raised by the questionnaire, it would be helpful to consider it briefly before turning to the questions.

Practically all of the executives pointed out that as trustees of policy-holders' funds the primary objective of their investment policy is to earn the highest possible rate of return consistent with safety of principal. In this connection, it was noted in many replies that the higher the rate of return on investments the lower the net cost of life insurance to policyholders, and that the life-insurance business is highly competitive on a net cost basis. Most of the executives pointed out that, although their goal is to earn the highest possible return consistent with safety of principal, they are striving at least to earn a rate of return high enough to cover the average rate of return required by policy contracts.

Many of the replies indicated that an important objective of investment policy is to aid in meeting the capital requirements of our national economy as they develop. It was frequently pointed out that during the war life-insurance companies invested heavily in Government bonds to aid war financing. In the postwar period funds moved to meet the needs of the private sectors of the economy. Thus funds aided the reconversion of industry from war to peace time production and later contributed to the expansion of industrial capacity as an offset to inflation. As the postwar demand for housing facilities developed, life-insurance funds flowed to meet this need. After Korea life-insurance investments shifted to defense and defense-supporting production.

Still another basic element of life-insurance investment policy which was apparent in the various replies is that the companies strive to maintain what they regard as a proper balance in their portfolios as between the different classes of investment holdings. Most of the replies indicated that at the end of World War II Government bonds constituted much too large a proportion of life-insurance assets so that from the viewpoint of striving for proper portfolio balance most companies felt it necessary to dispose of Government bonds. Likewise, many of the companies indicated that by the end of 1950 they were reaching the limits of portfolio balance in their holdings of residential mortgage loans.

[1] The text of this chapter was prepared by Dr. James J. O'Leary, director of investment research, Life Insurance Association of America. The committee staff wishes to express its appreciation for this public service on Dr. O'Leary's part.

Finally, many of the executives indicated that life-insurance companies, by the very nature of their business, are long-term investors and that investments are made to obtain a continuing income and are normally held to maturity if the return is sufficiently attractive.

1. Describe the policy of your company with respect to changes in its portfolio of (*a*) United State Government securities, (*b*) State and municipal securities, (*c*) corporate securities, and (*d*) mortgages during the period from the end of the war to June 1950, and state in a general way the reasons for this policy.

Policy with respect to changes in portfolio of United States Government securities, period from end of the war to June 1950.—Most of the companies followed a policy of gradual and orderly reduction in their holdings of United States Government securities. The timing of disposal of Government securities did not follow any set pattern; some of the companies began disposing of Government securities in substantial amounts shortly after the war and by the beginning of 1950 had reduced their holdings of Governments to an amount which was regarded as satisfactory from the viewpoint of portfolio balance. Other companies did not begin to dispose of Governments until somewhat later in the postwar period and were still selling Governments by the spring of 1951. The replies also indicated that the amounts of Governments disposed of differed greatly as between companies, depending on how high Governments had become as a percentage of assets at the end of the war.

The reasons advanced for disposing of Government securities were as follows: (1) The relatively low yield on Government securities and the need to obtain the highest yield consistent with safety of principal in order to reduce the net cost of insurance to policyholders; (2) the desire to reduce holdings of Government securities to a proper proportion of assets from the viewpoint of a balanced portfolio; and (3) the desire to satisfy the needs for capital funds in private sectors of the economy for reconversion of business to peactime production, for industrial expansion, and for housing.

The replies of three executives differed somewhat from the general pattern indicated by the replies of the majority. One company executive stated that his company's policy during the period had been to keep about the same total amount invested in Government bonds as was true at the end of World War II. Another said that his company had not bought the long-term issues of Government securities during the war, but rather had purchased intermediate issues. He pointed out the danger of his company being caught with a very large maturity of the intermediate issues for which the Treasury was not likely to issue new bonds suited to the needs of the company. Accordingly, his company had sold the intermediate issues as soon after the war as suitable investments became available. Another executive reported that during the period in question his company had made no significant change in its portfolio of Governments because the yield differentials on corporate bonds and mortgages were regarded as unsatisfactory.

Policy with respect to changes in portfolio of State and municipal securities, end of war to June 1950.—Most companies replied that State and municipal securities represented a small item in their port-

folios and were not important in life-insurance investments because the tax-exempt feature of such securities caused the yields to be unattractive. Many companies reported that bonds in this category had been sold on net balance in order to realize profits which had developed. Those companies which reported net purchases of State and municipal securities indicated that they were usually special revenue bonds or Canadian bonds on which the yields were attractive.

One small company reported a substantial increase in State and municipal securities and indicated that the reason for this increase was a desire for diversification and to obtain the possible advantage of tax exemption.

Policy with respect to changes in portfolio of corporate securities, end of war to June 1950.—The general reply of most company executives was that the policy had been to increase their holdings of corporate securities substantially as opportunities developed. This was true usually both as to volume of holdings and percentage of assets. The reasons given for the increased emphasis on corporate securities were: (1) to obtain improved investment yields; and (2) to satisfy the demands of industry for capital funds needed in reconversion and expansion.

One company executive stated that there had been no change in policy during this period with respect to corporate securities because the yield differential on such securities was still unattractive. Another stated that during this period his company's policy was to keep corporate securities as a steady percentage of assets.

Policy with respect to mortgages, end of war to June 1950.—Nearly every executive reported a sizable increase in mortgage loans during this period. In most cases this increase was not only in dollar amount but also as a percentage of total assets. The reasons given for increased emphasis upon real-estate mortgage loans were: (1) the rate of return on mortgage loans was more attractive than on Government securities or even corporate securities; (2) real-estate mortgages were increased in order to improve portfolio balance—it was pointed out by many companies that as a result of the low volume of mortgages acquired by life-insurance companies during the 1930's and the war period real-estate mortgages had become an abnormally low percentage of assets by the end of World War II; (3) real-estate mortgage loans were acquired in large volume to aid in meeting the housing shortage which was apparent at the end of the war.

The following are a number of extracts from statements made by life company executives which illustrate the nature of the replies made to this question.

George T. Conklin, Jr., the Guardian Life Insurance Co. of America

United States Government Securities.—During the war years our holdings of United States Governments rose to disproportionately high levels. The yield on these Governments moreover was less than the interest required on our policy reserves. Consequently, as soon as it was feasible to do so, it was our policy to reduce our holdings of Governments and to invest in higher yielding forms of investments, corporate securities and mortgages. This accomplished two purposes—in the first place, it established a more balanced portfolio and a higher average yield and secondly, it helped to meet the tremendous demand for capital in the postwar years in business enterprise, and in

residential housing. This policy was feasible only because of the pegged price for Government bonds in the face of inflationary demands on the part of consumers and business.

Louis W. Dawson, the Mutual Life Insurance Co. of New York

The investment program of a life-insurance company is not an independent financial operation. It must always be related to the requirements of the company's insurance operations, and to the needs of its policyholders. The investment operations are therefore an integral part of the insurance operations; and this consideration always has an important bearing on the investment philosophy and financial policies of such a company.

In establishing its premium rates, and in setting up its so-called policy reserves, which the law requires it to hold for future payment of benefits, a company assumes that such reserves, when invested, will produce a certain net investment return. This investment income, compounded over a long period of years, contributes greatly to reducing what would otherwise be a much higher cost of life insurance protection. And, on participating policies, any excess of investment income over the amount required to maintain the reserves, can go back to policyholders in the form of dividends, which further reduce the net cost of their protection.

* * * * * * *

If investment incomes declines at a time when costs of operation are also rising (as has been the case in recent years) the trend to higher cost of protection is further aggravated. Dwindling investment income and higher operating costs have combined to offset the gains resulting from improved mortality trends. Consequently, policyholders are paying far more for protection than would otherwise be true.

Cost is an important consideration to the policyholder, and since there are more than 500 life companies competing for the public's business, every company finds it necessary to obtain a satisfactory investment income if it is to do a good job for its policyholders and maintain a satisfactory competitive position in the matter of net cost. Those that do not, tend to suffier a loss of business and public confidence.

For all these reasons, the investment managers of a life-insurance company are likely to feel that, subject only to such considerations as the welfare of the whole economy, their primary responsibility is to invest funds at the best available rates obtainable without incurring undue risk of loss. This is an obligation of which investment managers must never lose sight.

In pursuing this general investment policy, however, life companies, under normal circumstances, are very likely to be fulfilling the greatest economic and social needs for new capital. Capital generally tends to flow into those industries and territories where the need for it is greatest. This is because those are the areas where investment opportunity is greatest; and where rates are likely to be the best obtainable. Thus, a life-insurance company, in seeking the best rates, usually meets the most pressing needs for capital, and at the same time, does the best job for its policyholders.

Frederic W. Ecker, Metropolitan Life Insurance Co.

From the end of World War II to June 1950, the policy of this company with respect to changes in its portfolio of—

(*a*) United States Government securities, is a policy under which the support of the company is traditionally given to United States Government financing in such acute periods as during the course of World War II. With the conclusion of the war financing, practically 50 percent of this company's assets was invested in United States Government securities. When, however, the urgency for such investments had seemed less in relation to the support of those private fields for investment wherein the demands for long-term capital are found, this company has followed a policy of gradual reduction in holdings of Government securities so as to better serve the general economy of the country and at the same time improve earnings and thereby reduce the net cost of insurance to its policyholders.

George L. Harrison, New York Life Insurance Co.

The New York Life Insurance Co. is a mutual company. In investing policyholders' money it seeks to obtain a maximum long-term rate of return, consistent with the safety and stability necessary for the fulfillment of its contractual obligations.

In a mutual company, income in excess of expenses, current benefit payments, provision for reserve funds and contingencies is returned to policyholders in a form called dividends. Therefore, changes in the rate of interest earned on our invested assets are reflected in the net cost of insurance to the millions of American families that we serve. These changes are expressed either through an adjustment of premium rates, dividends, or both.

In channeling funds into appropriate investments the composition of our investment portfolio necessarily shifts from time to time. Historically, these shifts have taken many forms. When railway securities offered comparatively attractive investment opportunities, we emphasized rails. When real estate mortgages became comparatively attractive, we invested in mortgage loans. When public utilities offered similarly attractive investments, we invested in utilities. When postwar expansion of vital manufacturing facilities offered high-grade investment opportunities we made investments in these areas. To a limited but increasing extent we have invested in corporate stocks and housing developments. These changes were in recognition of favorable opportunities to buy and sell investments which is a primary responsibility of portfolio management.

* * * * * * *

Replacement of United States Government securities by other sound investments has accomplished one main purpose. We have secured for our policyholders a better rate of return and thus reduced the cost of their insurance. The average net rate of return has risen from 2.69 percent in 1946 to a current rate of 3.18 percent. At the same time, our postwar investments have helped to strengthen the American economy by financing construction of essential facilities held in abeyance during the war. Increased supplies of goods and services made possible by this expansion of the Nation's productive capacity made a notable contribution to the easing of postwar inflationary pressures.

F. W. Hubbell, Equitable Life Insurance Co. of Iowa

As to holdings of State, county and municipal bonds, there was little change during most of the post-war period. This company had pursued a policy during the war of substantially reducing its holdings of municipal bonds, due to the fact that the tax-exemption feature is worth considerably more to certain other types of investors than it is to life insurance companies.

Leland J. Kalmbach, Massachusetts Mutual Life Insurance Co.

Over the years, it has been the policy of the investing staff of the Massachusetts Mutual Life Insurance Co. to obtain the highest possible interest return on policyholders' funds consistent with safety of principal. This policy has, however, been tempered, during emergency periods, to support the Federal Government in its efforts to borrow the savings of the people to the extent necessary to meet its financial requirements.

Thomas I. Parkinson, the Equitable Life Assurance Society of the United States

In the period between the end of the war and June 1950, the Equitable's policy toward United States Government securities was based upon two principal considerations: First, that during the war the Equitable had bought the intermediate maturities rather than the long-term 2½'s, and second, the fact that during that period the Treasury refinanced all of its maturities with short-term, low-yield obligations not suited to life insurance investment needs. At the end of 1945 we found ourselves holding several $100 millions of Treasury securities maturing in the late forties and the early fifties. These had to be administered in such a way as to avoid being caught with a very large maturity for which the Treasury was not likely to offer a new bond suited to our needs. For example, the Equitable had $200 millions of Treasury notes which matured in March 1947 and which were paid off by the Treasury so that we found ourselves with what might have been an embarrassing amount of cash. As it happened, Gulf Oil came along a few weeks later and sold us $100 millions of its 2½ percent notes at par, with an average maturity of about 15 years. This served to emphasize the importance of administering our Government holdings so as to avoid any similar concentration of maturing bonds. Accordingly when suitable investments became available we sold intermediate bonds, for example, the 2's of 1952–54, of which we held a very large volume bought at par and which had a ready market at or above par.

Carrol M. Shanks, the Prudential Insurance Co. of America

During World War II, Prudential substantially increased its holdings of United States Treasury securities, partly in order to aid the Government in the financing of the war and partly in order to prepare for the anticipated heavy postwar demand for funds from housing and other industry. It was our express purpose to build up a group of Government securities which would be readily marketable after the war to provide funds for reinvestment. We, therefore, avoided concentration in the long term 2½'s and purchased practically the whole gamut of Government maturities. While our Government security holdings were growing, other investments of the company were either

remaining constant or declining, so that Government securities came to occupy a larger and larger position in our total assets. There was little opportunity during the war to make new mortgage loans, so that these loans declined both in number and amount and as a percentage of total assets. Our holdings of industrial securities also fell during the war years, reflecting the small volume of financing. Since municipals and partially tax-exempt Governments were selling at substantial premiums because of the tax-free feature of these securities, we sold most of our holdings of this type and put the entire proceeds back into fully taxable Governments of comparable maturities. By the end of World War II we had thus reduced our holdings of municipals, partially tax-free Governments, industrials, and real estate mortgages, and had substantially increased our holdings of various maturities of fully taxable Governments. As a result, Governments constituted an abnormally high percentage of total assets, and mortgages and corporate securities an abnormally low percentage. This asset distribution resulted in an exceedingly low rate of investment return. We could not have continued at this low rate of earning power without sharply increasing the cost of insurance to our more than 27 million policyholders.

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The year 1947 marked the beginning of our return to a more usual distribution of assets. As business activity quickened and industry expanded, we sold Government securities in order to furnish funds for the building of homes, plant, and equipment, and in order to increase production. Although all aspects of our investment program are of course related, it may be simpler to discuss changes in our security portfolio and changes in our mortgage portfolio separately. Over the period 1947–49, total security holdings of Prudential (Government and corporate securities) remained approximately constant. Within the security portfolio, however, there were important changes. Our holdings of industrials and utilities in each year rose, while Governments declined. Through this steady shift within our security portfolio, we were able, by the end of 1949, to increase our holdings of corporate securities from the low level to which they had fallen during the Second World War to approximately the same position relative to total assets as they had occupied in 1940. These funds invested in corporate securities went largely to aid industry in rebuilding and expanding plant and equipment. This expansion of productive facilities was of course of great value in increasing production and helping to curb inflation.

The most important change in our assets over the period 1947 through 1950 was the very rapid growth in our investment in real estate mortgages. As the building industry expanded to meet the tremendous backlog in housing demand, Prudential was able to furnish an unprecedented volume of funds for home financing. In the 3-year-period 1947 through 1949, real estate mortgages absorbed substantially all new investment funds available to the company. (As has previously been explained, total Government and corporate security holdings remained approximately constant during this period.) By 1950, investments in real estate mortgages were being made in such volume that, in addition to absorbing all new investment funds, there was need to divert some funds from the sale of Government securities to

mortgage loans. Up until that year it had been necessary to sell only enough Governments to furnish funds for our increased corporate security holdings, but during 1950 we sold Governments both in order to acquire corporate securities and in order to supplement new funds going into mortgages. This meant a rapid decline in our holdings of Government securities. As will be explained in the answer to question 2, it also meant that the postwar shift which we had planned in the distribution of our assets was moving rapidly toward completion.

In general, the reasons for our investment policy in the period from the end of World War II to June 1950, were as follows: (1) To aid in the financing of the Nation's housing and farm mortgage needs; (2) to help increase production through the financing of private industry's tremendous postwar expansion program; (3) to reestablish a more normal distribution of our assets; (4) to increase the yield on our investments as much as possible consistent with safety and with other requirements of a life insurance company.

John S. Thompson, The Mutual Benefit Life Insurance Co.

From 1946 onward, our general purpose was to sell Government securities and to invest in corporate securities and in mortgages in order to (1) secure the largest possible net rate of interest for the benefit of our policyholders, while at the same time maintaining the level of investment safety traditionally characteristic of well-managed life insurance companies; and (2) to diversify our investments as to both type and location. It is impossible to state what would be regarded as a normal percentage, for us, of Government bonds to total assets, but such percentage in peacetime should certainly be less than 50 percent (the percentage at December 31, 1946, was 47 percent, the largest in our history). As the yield on Government bonds is usually lower than on any other type of investment in our portfolio and as our life and annuity contracts rest on substantial and far-reaching commitments as to interest earnings, it was and is imperative that we assume the moderate risks inherent in high-grade non-Government securities and thereby secure a larger interest return.

Frazar B. Wilde, Connecticut General Life Insurance Co.

During the period from June 1945 to June 1950 there was no significant change in this company's portfolio of United States Government securities. Our investment in Governments was largely acquired during the war period and was considerably higher than we would regard as normal for a balanced portfolio, but because we were not impressed with the relative attractiveness of other securities no important sales in our Government account were made during the period. In fact, we owned more Governments on June 30, 1950, than on December 31, 1945.

2. Describe the changes, if any, in your policy with respect to holdings of United States securities, corporate securities, and mortgages since June 1950. If your policy during this period has changed, evaluate roughly the relative importance of (*a*) changes in the relative attractiveness as investments of the different classes of securities, (*b*) changed Federal regulations with respect to mortgages, (*c*) moral suasion, directly or indirectly, by the Federal Reserve System (including the voluntary credit re-

straint program), (*d*) the emergence of potential capital losses on United States securities in your portfolio, and (*e*) other factors, in bringing about the change in policy.

Changes in policy with respect to holdings of United States Government securities since June 1950.—Most company executives replied that no change occurred in their general investment policy in the period from June 1950 to date. By this they meant that no change had occurred in the over-all policy outlined at the beginning of this summary. Several noted that June 1950 was not a significant date in the sense that it marked any change with respect to their policy of disposing of Government securities or emphasizing investment in corporate securities or mortgages. It was stated that if any change occurred it was in April of 1951 after the unpegging of Government securities prices.

Most of the executives reported that their companies had continued to dispose of Government securities in the period June 1950 to April 1951, and at least to the end of 1950. The reasons given were similar to those put forward for the disposal of Governments in the postwar period up to June of 1950, namely, (1) a more attractive rate of return could be obtained in outlets other than Government securities; and (2) Government securities were disposed of to meet the industrial expansion required under the defense program as well as the enormous demand for housing facilities.

Several companies pointed out that a heavy backlog of forward commitments to purchase mortgages required further disposal of Government securities in the last 6 months of 1950 and early 1951. Those companies which stopped selling Government securities prior to April 1951 did so primarily for the reason that they felt their holdings of Government securities had gotten down to the proper amount for portfolio balance and that their holdings of mortgages had also increased to the point of proper portfolio balance.

Many of the companies indicated that their policy with respect to Government securities had changed after the so-called accord between the Federal Reserve and the Treasury. Following this accord they indicated a reluctance to incur the capital losses which would have been involved in further sales of Government securities.

Several companies indicated no policy change with respect to the sale of longer-term Government securities even after April 1951. However, for these companies further disposal of Government securities was generally in much smaller amounts because of the Treasury exchange offering of 2¾'s, declining prices of Government securities, and the fact that the companies were more satisfied from the viewpoint of portfolio balance to hold their remaining Governments.

Changes in policy with respect to holdings of corporate securities since June 1950.—The general reply made to this question was that no change in policy had occurred in June of 1950. Most companies indicated that their policy was to buy corporate securities whenever the yields were attractive as compared with other investment outlets. Many companies reported that following the unpegging of Government securities prices in April 1951 corporate securities became much more attractive from the viewpoint of yield spreads.

Several of the companies pointed out that in this period, and particularly after the launching of the voluntary credit restraint pro-

gram, it has been their policy to screen corporate loans carefully in order to concentrate their corporate lending in defense and defense-supporting and otherwise essential categories.

Changes in policy with respect to holdings of mortgages since June 1950.—Here again most of the company executives replied that there had been no change in general policy with respect to mortgage acquisitions. However, a number of companies indicated that during the 6 months following June 1950 mortgage holdings began to reach the limits of proper portfolio balance so that the volume of new mortgage commitments was reduced.

Many of the companies reported a noticeable change in their policy with respect to real-estate mortgage loans after the unpegging of the Government securities market in April of 1951. Many companies replied that as a result of the unpegging they had shifted their emphasis to conventional mortgage loans in view of the fact that VA and FHA mortgages had become relatively unattractive because of frozen interest rates on such mortgages. Also, following the unpegging of Government securities prices, greater emphasis was placed upon investment in corporate securities because of relatively attractive yield differentials.

Most of the companies indicated that, following the adoption of the voluntary credit restraint program, their mortgage loans on existing properties were screened as to purpose and terms of regulation X were followed in making such loans.

Importance of changes in the relative attractiveness as investments of the different classes of securities.—All companies indicated the enormous importance of this factor in their investment policy. It was apparent from the replies that changing yield differentials are watched carefully and investment funds are shifted promptly in the direction of attractive yield differentials.

As pointed out earlier, after the unpegging of Government securities prices VA and FHA mortgages became less attractive than conventional mortgage loans for most companies because of the fixed interest rates on Government-insured or guaranteed loans. Moreover, after the unpegging of Government securities prices, corporate bonds became more attractive than mortgages.

Importance of changed Federal regulations with respect to mortgages.—All companies indicated compliance with Federal regulations with respect to mortgages. Several companies pointed out that the regulations reduced the supply of available mortgages. However, most companies replying to the question indicated that the regulations have not had any direct effect upon their investment policy because their lending terms were as strict or stricter than those prescribed by the regulations.

One company expressed the opinion that the regulations had been helpful in curtailing inflationary boom in the housing field. Another company indicated that the regulations have caused some curtailment of new mortgage commitments.

Importance of moral suasion, directly or indirectly, by the Federal Reserve System (including the voluntary credit restraint program).—In reply to this question, emphasis by all companies was on the voluntary credit restraint program. All companies indicated that they have cooperated fully with the program. They reported that they

have carefully scrutinized both mortgage loans and corporate loans in accordance with the program and most companies stated that the program has been effective in accomplishing the objective of channeling funds into defense and defense-supporting and otherwise productive and essential uses. The general view was that the program has been of real aid in combating inflation.

Several companies pointed out that they have frequently rejected loans as not in accord with the program. However, several companies noted that, despite general compliance with the program, it has had little effect on their investments because the supply of investment outlets which are in accord with the program has been adequate to meet their needs.

Importance of the emergence of potential capital losses on United States securities.—Replies to this question show different shades of opinion with respect to the importance of the emergence of potential capital losses on United States securities. Many of the company executives stated that the emergence of such losses either eliminated further disposals of Governments completely or reduced them substantially. Many of the company executives pointed out that the emergence of capital losses has been of tremendous importance in that it made it impossible for companies to continue with making forward investment commitments on the assumption that their holdings of Governments were the equivalent of cash and could be liquidated at known fixed prices. The result indicated was that life insurance companies were obliged to look to their current flow of cash to take care of commitments.

Several companies pointed out that prior to the emergence of capital losses on Government securities they had already stopped disposing of Government securities because they felt their holdings had been reduced sufficiently from the viewpoint of portfolio balance. However, these companies pointed out that, had they still been disposing of Government securities, the emergence of potential capital losses on sales would have been a strong deterrent to further selling.

A minority of the company executives replying stated that their companies had continued to sell Government securities in reduced amounts at a loss following the decline in Government securities prices. These sales had been in part for the purpose of meeting forward commitments entered into prior to the unpegging of Government securities prices. Sales have also been made to satisfy demands for corporate credit which were in accord with the voluntary credit restraint program. A few of the replies pointed out that Government securities can be disposed of at a loss providing the proceeds can be reinvested at rates sufficiently better to make up the capital losses in a relatively short period of time.

The following are a series of extracts from individual life insurance company executives' replies to the above question:

Sherwin C. Badger, New England Mutual Life Insurance Co.

The emergence of potential capital losses on United States securities in our portfolio has not been a factor in our policy decisions. We would have no hesitation in taking such losses in order to provide reinvestment funds. Our policy against selling Government bonds was dictated by broad national rather than immediate financial considerations.

W. C. Batchelder, the United States Life Insurance Co.

The acts of the Federal Reserve System in March and April of this year in withdrawing support of United States Governments has had a distinct bearing on the company's approach to investments. These may be summarized as follows:

1. The company is now much less willing to maintain a fully committed position than it has been at any time since revising its mortgage program. Further, although it invested nearly 50 percent of new mortgage moneys in FHA and VA mortgages, the real estate and mortgage committee of the board of directors only recently indicated a strong preference for conventional loans, since said commitee felt that the spread in yield between the insured and the conventional loan was too wide.

2. The company is no longer able to consider Governments as cash reserve. By the same token, the company's corporate bond portfolio does not have the same degree of liquidity because of potential market losses. Investment commitments, therefore, must be tailored to the actual flow of new cash.

George T. Conklin, Jr., the Guardian Life Insurance Co. of America

After the unpegging in Government bond prices in March following the unpegging of the market, we ceased to sell Governments for about 8 months. The principal reason for this cessation of selling was the fact that we had already sold heavily prior to the break in the market and had thus completely protected our commitment position with funds to spare for new commitments. Secondly, there was a natural reluctance to sell Governments in view of the loss involved. Thirdly, we held numerous corporate bond issues which we could still sell at a profit and reinvest at substantial yield improvement.

However, when cash became low once again and possible sales of corporates at little or no loss were largely exhausted, we resumed the sale of Governments where the yield spread was more than amply sufficient to amortize our loss.

Louis W. Dawson, the Mutual Life Insurance Co. of New York

In spite of the lower prices, the company continued to sell Governments even at a loss in order to have funds available to meet forward commitments, and to satisfy other legitimate demands for credit. The company's portfolio of long-term Government bonds then represented a much-reduced percentage of the company's entire portfolio and this, together with the depreciation in market value of such bonds, led to a slowing up of the company's investment program. From the time that Government bonds fell below par up to July 1, sales aggregated $54.5 millions. Between July 1 and the present date such sales have aggregated $7 millions. During this period the company purchased $81.5 millions of Treasury bills.

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The company has cooperated fully under the voluntary credit restraint program ever since that program was organized. All corporate loans have been carefully screened, and no loans have been made if they were classified as inflationary under the tests of the credit restraint program except to fulfill advance commitments, as provided for in the program.

Frederic W. Ecker, Metropolitan Life Insurance Co.

No change has taken place since June 1950 in the general policy described above. However, the unpegging of Government securities in the spring of 1951 had a most salutary effect on the whole credit structure. Prior to that time, life-insurance companies and other investors had available for investment not only their current income but also their entire portfolio of Government securities which could then be disposed of at relatively fixed prices. This added a tremendous potential source of funds in a period of strong inflationary pressures. The drop in market value of Government securities below par occasions an immediate direct charge against surplus in the case of any such sale, and such loss is bound to be a deterrent on the sale of Government securities. In addition, the voluntary credit restraint program referred to below has made for an even more careful scrutiny of all loans in the light of the objectives of the program.

The principal change during this period in the relative attractiveness as investments of the different classes of securities is due to the failure of the Veterans' Administration and the Federal Housing Administration to increase interest rates in line with the general increase which has taken place. As a consequence, this type of investment is relatively less attractive than formerly. It is our view that money is available from private sources for financing in this field, if interest rates were adjusted to meet the competitive market.

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The voluntary credit restraint program appears to us to be effective and a sound method of reducing inflationary forces in the present situation.

Edmund Fitzgerald, the Northwestern Mutual Life Insurance Co.

The moral suasion program of the Federal Reserve System and the voluntary credit restraint program have helped to channel funds to productive uses and to curtail unnecessary credit. This company has declined to make loans which have not met the criteria of these programs. We believe these informal measures have been most effective.

Since March 31, 1951, this company has not sold United States Government bonds in substantial volume and therefore the amount of investment losses so taken have been small. Potential losses in the sale of United States Governments has resulted in restricting commitments for new investments to amounts equal to investible funds from other sources.

George L. Harrison, New York Life Insurance Co.

Our investment operations since the outbreak of war in Korea have been influenced by prior commitments, changed economic conditions and the military situation. In corporate investments, emphasis has been given to those related to expansion of defense plants and other essential facilities requiring new capital. In making mortgage loans, we have screened applications from the point of view of essentiality and have restricted the size of loans in relation to appraised value of the properties, in accord with Federal regulations. At the present time our mortgage portfolio has nearly reached the proportion that we consider appropriate and corporate investments are becoming more attractive relative to mortgages. Our mortgage lending is tapering off in response to these conditions.

Thus our post-Korean investment operations represent a natural and logical application of the principles that have always guided us. Our actions are in accord with the voluntary credit restraint program, because we believe in it. They do not result from suasion, moral or otherwise. They are wholly in keeping with our basic investment principles, as described in response to question 1.

B. L. Holland, Phoenix Mutual Life Insurance Co.

Possible potential capital loss on United States securities reduced our sales of Government securities for the purpose of investing in higher yield corporates. It also reduced forward commitments.

F. W. Hubbell, Equitable Life Insurance Co. of Iowa

As pointed out above, we had discontinued the selling of Government bonds before they broke par, so the emergence of potential capital losses on such securities was not a factor in our policy decisions. However, had the unpegging of the Government market taken place at an earlier date, it would have been a serious deterrent to our selling of Government bonds.

Leland J. Kalmbach, Massachusetts Mutual Life Insurance Co.

* * * The fact that the United States Government bonds in our portfolio showed a loss in market value did not create a change in our policy, since we had not been selling United States Government bonds in this period except for a brief emergency period when a small volume was sold to meet mortgage loan commitments.

M. Albert Linton, Provident Mutual Life Insurance Co. of Philadelphia

Corporate securities and real-estate mortgages have continued to be increasingly attractive as investments in comparison with United States Government bonds. This category, of the five suggested ones, has been the most important in motivating a continuation of our pre-Korea investment policy. At the outbreak of Korean hostilities the Provident still held too large an investment in low-yielding Government securities relative to the rest of the industry. Consequently it is probable that we would have accelerated the replacement of those securities in defense-supporting investments, had it not been that the exchange offer of the United States Treasury with respect to Victory bonds resulted in our being more willing holders of Government securities.

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The possibility of future losses from the forced liquidation of United States Government bonds in an emergency has not been a cause for investment policy concern. Losses actually taken as the result of voluntary sale, have not caused concern because such losses will be recovered from the increased income derived from the replacing investments during the first two or three succeeding years.

A. J. McAndless, The Lincoln National Life Insurance Co.

It appears that in the current market, federally insured mortgages have not increased their yields as much as corporate securities. Consequently, we regard them as relatively unattractive for purchase. This change has occurred since March 1951, however, rather than dating from June 1950.

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Book losses on our United States Government securities in our portfolio have not proved particularly burdensome. As noted previously, we have never engaged in the practice of wholesale liquidation of United States Government securities in order to invest the proceeds in other investment opportunities. As a matter of fact, the change in yields on United States Government bonds has been much less than that on other bonds so that yieldwise a switch from Governments to other bonds has become more, and not less attractive, although capital losses to be taken on the sale have probably slowed down such switching.

Frank P. Samford, Liberty National Life Insurance Co.

* * * We exchanged our 2½-percent long term marketable Government bonds into the 2¾-percent longer term nonmarketable bonds with the thought that these bonds would be permanently held in our portfolio. It appears to us this exchange offer was extremely wise on the part of the Government in that it increased the yield to the insurance companies and enabled them to hold bonds which might otherwise have been sold.

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The emergence of potential capital losses on United States Government securities has had no effect on our policy because it had not been necessary for us to sell Government securities to meet any of our other commitments. However, had we been selling Government securities, there is no doubt in my mind but that the emergence of potential capital losses would have deterred us from making further sales.

Hollister V. Schenck, The Life Insurance Co. of Virginia

We adhere strictly to the voluntary credit restaint program, which definitely has affected the type of loans we consider, but we have found an adequate volume of loans which meet all requirements of the credit restraint program.

The potential capital losses on United States Government securities unquestionably deterred us from selling our holdings of long Governments. On the other hand, we feel that a certain proportion of our assets should always be invested in Governments, and for this reason, we would likely keep most of our long bonds.

John P. Sedgwick, State Mutual Life Assurance Co.

* * * In any such policy change, the change in relative investment values will be the major reason for change. Changed Federal regulation with respect to mortgages, direct or indirect moral suasion, the emergence of potential capital losses on portfolio securities, these and other factors may conceivably have some effect on the relative attractiveness of alternative investments, but these factors are not, in and of themselves, the compelling reasons for change in investment policy.

Carrol M. Shanks, The Prudential Insurance Co. of America

It has been explained in the answer to question 1 that, by the middle of 1950, a good deal of the shift which we had planned in the pattern of our assets had been completed. Looking ahead, we could see that if our mortgage loans continued to increase at the then current rate the time was not too far distant when we would arrive at a satisfactory relationship between mortgage loans, corporate securities,

and Government securities. Accordingly, a company decision was reached late in 1950 to exercise greater restriction on the flow of funds into real-estate loans. This increased selectivity was also motivated to some extent by the uncertainty as to the future of interest rates. In line with this policy, the volume of our new mortgage loans began to decline in January 1951, and continued to fall, with some minor interruptions, to September of this year. The smaller volume of our real-estate loans in 1951 has been principally due, therefore, to our decision late in 1950 to slow down the rate of growth of our mortgage loans since a more normal balance in our assets had been reestablished.

Prudential has continued in 1951 to increase its holdings of corporate securities at approximately the same rate as in 1950. Funds secured from the sale of Government securities in January and February of this year, coupled with the normal inflow of new investable funds, have proved sufficient to permit the increase in our corporate security and mortgage holdings. It has, therefore, been unnecessary to sell any large volume of Governments since the time of the removal of the pegs in March.

It is always difficult to evaluate the relative importance of different factors in bringing about a change in policy. It seems clear, however, that the most important single factor in our decision to slow the rate of growth of our mortgage loans was our conclusion, late in 1950, that we were approaching a satisfactory distribution of our assets. Regulation X has not as yet had an important effect in reducing the volume of real-estate loans closed and placed on the books of Prudential. It has taken a considerable amount of time to work off preregulation X commitments, so that we have disbursed a large volume of funds this year under commitments made in 1950. In addition, we had in any event made the decision to hold real-estate loan commitments considerably short of the demand for them. In other words, company policy has held total new mortgage loans at a figure below that which could legally have been made under regulation X. If company policy dictates a larger entry into the mortgage-loan field, regulation X may have an important future effect on our investing in loans on real estate.

Prudential has taken a leading part in the program for voluntary credit restraint. The president of the company aided in the initial establishment of the program, and is one of the four life insurance company members of the National Voluntary Credit Restraint Committeee. We have from the beginning complied with the spirit of the program and as a result have turned down many applications for loans which we might otherwise have favorably considered.

Because of the particular circumstances of our investment position in 1951, the removal of the pegs from the Government security market has not affected our policy with respect to Government securities. For a period of months prior to the March removal of the pegs, we had been ever mindful of our mounting forward commitment position in mortgages, and had from time to time increased our United States Treasury bill holdings. Accordingly, since February it has not been necessary for us to sell any appreciable amount of Government bonds.

It should be made clear, however, that our lack of dependence on the Government security market in recent months has been due to

our particular investment position. Ordinarily, we would be very much affected by an important change in the price of Government securities. The first consideration in our investment policy is the establishment of a sound and balanced distribution of assets. We are next interested in securing the maximum yield from our investments consistent with safety and with the national need for productive use of capital. Within the limits established by these considerations, there is wide leeway for a shift from one type of asset to another in response to yield differentials. Changes in the price of Government securities are, therefore, normally a most important factor in the periodic reappraisal of our investment policy.

R. G. Stagg, Northwestern National Life Insurance Co.

Except for $1,000,000 maturity value of United States Treasury bills which either matured or were sold and not replaced, no United States Treasury obligations were disposed of after April 30, 1951. This was due to our unwillingness to take the substantial capital losses which would have been involved. During June and July a total of $1,831,000 par value of municipal bonds and short-term equipment trust certificates, other corporates and Canadian governmental obligations were sold to provide funds for investment commitments ready for closing at that time. These sales produced a net profit.

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Moral suasion, including the voluntary credit restraint program, by the Federal Reserve System has not been an important factor in our investment operations. We have, of course, believed in the program and supported it in spirit and letter. However, our mortgage lending limits in relation to value are well within those fixed by regulation X and those prescribed by the voluntary credit restraint program. New corporate obligations which do meet the requirements of the program have been available in sufficient volume to take care of our investment needs.

E. B. Stevenson, Jr., the National Life & Accident Insurance Co., Tennessee:

The voluntary credit restraint program has definitely restricted certain types of loans that would have otherwise been made by us prior to the adoption of this program.

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Very few Government bonds have been sold by this company because of the fear of capital losses on these securities.

Frazar B. Wilde, Connecticut General Life Insurance Co.

In March 1951 the over-all policy of the Corporation abruptly changed. We tried to buy more securities, particularly corporates, and to reduce our new commitments in the mortgage area. We did try to hold some funds for our mortgage correspondents to make new commitments in addition to the heavy commitments already made. The reason we decided to shift to corporate securities was because the relative yield after the unpegging of Governments was much more attractive than that in the mortgage field.

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The voluntary credit restraint program has our full support and in our opinion is serving its intended purpose of helping to control

inflation. We believe it has helped to channel available investment funds into essential areas. In this sense it has had an impact upon our investment policy, but there continue to be plenty of securities and mortgages in which we can invest without contravening the program.

The capital loss which would have ensued had we sold Governments was a most important factor in influencing us not to sell them.

3. If the Treasury should have to engage in substantial net borrowing during the foreseeable future, what class or classes of securities do you believe it should offer to life insurance companies?

The consensus of life insurance executives on this question is as follows. Everyone agreed that the maturity of the bond should be long, ranging from 20 to 40 years, and many company executives indicated that the definite term of the bond is not important within that range. A large majority indicated that the bond should be fully marketable, although a few, as will be noted later, indicated that a nonmarketable bond would be acceptable as an alternative. Most replies did not specify a definite rate of return on the bond, but indicated that the interest rate must be competitive under the given market conditions existing at the time of issue. Most of the executives stated that the interest return should be at least high enough to cover the average rate of return required by policy contracts. Many replies emphasized that the interest return is an important factor reducing the net cost of life insurance to policyholders, and that because of the highly competitive nature of the life insurance business the interest rate is highly important to life companies.

Several replies specified that the bond offered to life insurance companies should be ineligible for purchase by commercial banks. Several company executives cited a minimum rate of return which the bond should pay without taking the position that it should be a competitive rate based on current market conditions. This minimum rate was usually set with an eye to the average rate of return required by policy contracts and ranged from 3 to 3¼ percent.

The replies of four company executives indicated that a nonmarketable bond would be a suitable alternative to a marketable bond. However, all four specified that the nonmarketable bond should be convertible into 5-year notes which would be marketable as in the case of the 2¾ percent bonds made available last spring in the exchange offering.

Finally, one company executive expressed a preference for a nonmarketable bond in order that the life insurance business might be given the highest possible yield.

The following are a number of extracts from the replies of company executives to this question.

Sherwin C. Badger, New England Mutual Life Insurance Co.

If the Treasury should engage in substantial net borrowing during the foreseeable future (under conditions other than all-out war), we believe the Treasury's primary objective should be to offer securities that are competitively attractive and that, therefore, would be retained by investors as long-term holdings. In the case of securities sold to life insurance companies, this means that the rate of interest should be

not less than the gross interest which most life insurance companies must earn to cover policy reserve requirements plus investment expense plus Federal income tax. Under present conditions, it is our opinion that such a rate on a new long-term Treasury bond should be in the vicinity of 3¼ percent. A lower rate, since it would not meet the true earnings requirements of most life companies, might well result in relatively small and reluctant purchases by life companies and in their resale whenever other more attractive investment opportunities became available.

In the event of all-out war, and under emergency conditions which would then be present, other considerations would be involved, as was the case during World War II.

We do not believe that the maturity of prospective Government bonds offered to life insurance companies is particularly important, since life companies are long-term investors and do not need the liquidity required by other types of investors, such as savings banks and commercial banks. We believe a long-term bond, even up to 50 and 100 years' maturity and which carried a satisfactory coupon, would prove more attractive than a shorter maturity with a lower coupon. We believe the bonds should be fully marketable and should be eligible for purchase by all types of investors, including commercial banks.

Morton Boyd, Commonwealth Life Insurance Co.

I would answer this complex question with what is perhaps an oversimplification. Unless the Treasury finds it to its own interests to offer to the life-insurance companies securities that are tailored to the needs of the companies, I do not think that for long the companies will buy and hold such securities. Obviously, with guaranteed rates upon policy reserves in our case averaging above 3 percent, we cannot welcome any opportunity to invest at less. Therefore, if we are to buy United States Government securities willingly, they must carry a living wage for us which must exceed 3 percent and which we think can be justified by projecting the maturity of such securities as far out as is required to give a yield proportionate to that afforded by lower rate and shorter term securities. As a matter of Treasury policy, we favor fully marketable, unpegged, and unrestricted issues.

George T. Conklin, Jr., the Guardian Life Insurance Co. of America

If unsound fiscal policy is followed and large deficits are incurred, then they should be financed by real savings rather than credit creation. To do this, it will be necessary to offer a realistic interest rate which would depend upon market conditions at the time. A long-term bond issue with a maturity of up to 40 years would be a satisfactory investment medium for life-insurance companies. An interest rate of 3 to 3¼ percent might be necessary for the success of such an issue without resort to credit creation.

Currently it would appear wise to continue to finance by short-term issues as much as possible and to issue long-term bonds when there is evidence of some accumulation of long-term funds.

Louis W. Dawson, the Mutual Life Insurance Co. of New York

We do not feel it is feasible for us to suggest definite terms and specifications that would help to make future Treasury offerings attractive to life-insurance companies. The suitability of such terms would depend entirely upon conditions at any given moment, and

upon the relative attractiveness of other types of investment available at the same time.

We do not believe that the Treasury should offer securities especially designed for life-insurance companies or for any other individual type of investor. Fundamentally, we think that the functioning of the market place is the best method for resolving all conflicting claims to available investment funds, and for the allocation of resources among investments of different sorts. The alternatives run to various kinds of special privilege, and involve decisions that are more imperfect and more dangerous than the combined judgment of the market. Therefore, we recommend that the Treasury offer such terms on its general financing as are necessary to raise the money needed, in a noninflationary manner. In short, we recommend that the Treasury go to the long-term market and bid, as other borrowers bid, for the funds it needs. If it bids a proper price, in terms of yield and specifications, it will obtain the money it needs.

Frederic W. Ecker, Metropolitan Life Insurance Co.

If the Treasury should have to engage in substantial net borrowing during the foreseeable future, the class or classes of securities offered could only be determined in the light of conditions at the time. However, it is our view that such issues should not be restricted as to sale by the holder, as marketability is one of the basic features giving United States Government securities their preeminent credit position. Because of the taxation and expenses referred to above, it is probable that the longer term issues bearing the higher interest rates would have more appeal for life insurance investment.

Edmund Fitzgerald, the Northwestern Mutual Life Insurance Co.

Life-insurance companies are interested in long-term investments at yields which are attractive in terms of their own contract obligations. It is our opinion new issues of United States Government bonds designed to be sold to life-insurance companies should have a term of from 30 to 35 years and carry interest rates that meet free market conditions.

The primary purpose of interest in a life-insurance contract is to reduce the cost of the protection to the policyholder. Life insurance is a competitive business on a cost basis, both within the institution and with other forms of savings. Investments to be offered to life-insurance companies must recognize this factor if they are to constitute long-term holdings of the companies.

George L. Harrison, New York Life Insurance Co.

Government securities designed to be offered to non-bank-investing institutions in general should yield a sufficient rate of interest to insure for them a permanent "home" in which they will earn their keep in competition with other sound investments. These securities should be either marketable or convertible into marketable notes, of, let us say, 5 years.

F. W. Hubbell, Equitable Life Insurance Co. of Iowa

If the Treasury should have to engage in substantial net borrowing during the foreseeable future, it is suggested that bonds offered to insurance companies should be marketable, noneligible bonds having a long maturity, such as 25 years. The interest rate would, of course,

have to be tailored to fit money market conditions at the time but should be sufficiently high to attract insurance company funds in competition with other types of investment.

M. Albert Linton, Provident Mutual Life Insurance Co. of Philadelphia

Life-insurance companies cannot be willing long-term investors in any class of either corporate or Government securities not compatible with their pattern of contractual policyholder obligations. This is another way of saying that life-insurance companies were unwilling to be continuing long-term lenders to the Government at a rate of 2½ percent when other sound investments became available at yields more compatible with their obligations to their policyholders.

It is our belief that the life-insurance companies will be willing to invest, and desirous of so doing, a reasonable proportion of their new funds in United States Government securities yielding, after Federal taxes, a return compatible with their requirements. Such securities could and should be fully marketable. Their permanent retention by the insurance companies would be assured so long as corporate yield differentials remain unchanged.

Ralph R. Lounsbury, Bankers National Life Insurance Co.

If the Treasury should have to engage in substantial deficit financing, it is my suggestion that the life-insurance companies be offered long-term bonds at a rate of at least 3 percent. With a 3-percent rate, I believe insurance companies will not only buy substantial amounts of Government bonds but will retain them. I think they will be retained because I cannot foresee a time when in a free market the Government will have to pay more than 3 percent for institutional money on a long-term basis.

Thomas I. Parkinson, the Equitable Life Assurance Society of the United States

With respect to the third paragraph of the committee's questions, we think that if and when the Treasury resorts to further "substantial net borrowing," it should offer long-term bonds at yields which will be attractive for life-insurance investment. In the interest of the stability of our economy and of the Treasury's future management of the existing debt and its future borrowing needs, we believe that there should be a cessation of short-term financing at extremely low interest rates through the commercial banks and a substitution therefor of long-term bonds at yields which will make nonbank investors, including the life-insurance companies, want to acquire and to hold such bonds to maturity.

Hollister V. Schenck, the Life Insurance Co. of Virginia

Life-insurance companies and other long-term investors should be offered a security sufficiently attractive to compete with other investments at the time of offering. They should mature from 25 to 30 years, be fully marketable and bear a rate which shows a return to the insurance companies at least equal to their reserve requirements (approximately 3 percent).

John P. Sedgwick, State Mutual Life Assurance Co.

As indicated in the preceding paragraphs, it is our conviction that life-insurance companies should be free to seek and take action on

relative investment values. It, therefore, follows that life-insurance companies as a group should not be offered bonds available only to them. They should be allowed to choose from among the Treasury issues which are freely marketable and not redeemable at the option of the holder.

In the long run the interest of the country will best be served if the Treasury finances Federal deficits by selling marketable obligations in the capital markets and sets terms upon these obligations which will face squarely the requirement of meeting the competition from corporate borrowers with respect to rate and maturity without artificial support. It is our conviction that for a number of years the Treasury has financed too great a proportion of its needs on a short-term basis on the strength of a strictly temporary saving in interest cost, a false economy which has contributed to a far more burdensome price inflation. A long-term funding of the Treasury debt is highly desirable and the life-insurance companies would participate if the offerings were on a competitive basis.

Carrol M. Shanks, the Prudential Insurance Co. of America

We do not believe that the Treasury should offer a class or classes of Government securities intended for purchase by life-insurance companies alone. We believe that the Government should offer a class of securities with a term of 20 years or longer and with an interest rate sufficiently high to compete with top-grade corporate obligations. It seems to us that such a security would be attractive to life-insurance companies as well as other institutional and individual investors.

Grant Torrance, Business Men's Assurance Co. of America

If the Treasury must engage in substantial net borrowing during the foreseeable future, we believe it should offer to life-insurance companies medium- and long-term wholly marketable issues whose yield is attractive in relation to that of other investments available to them, and is in line with that which they must earn in order to fulfill their obligations to the more than 70 million policy owners and their families.

Frazar B. Wilde, Connecticut General Life Insurance Co.

The answer to question No. 3 is that the Treasury should offer securities to life-insurance companies and other long-term investors which will be sufficiently attractive to them to compete with their other investment opportunities. This is a fundamental rule of the market place. It is impossible to be specific because market conditions at the time the money is wanted must determine the rate. The maturity normally can be long, meaning at least 25, perhaps as long as 35 years.

It must be observed that the obligations of life-insurance companies to their older policyholders create a very special reason why the companies must try to earn at least 3 percent net on investments. The over-all rate required by the companies is less, but there are millions of dollars of reserves requiring an interest rate of 3 percent or better.

APPENDIX TO CHAPTER XII

QUESTIONS ADDRESSED TO LIFE INSURANCE COMPANY EXECUTIVES

1. Describe the policy of your company with respect to changes in its portfolio of (*a*) United States Government securities, (*b*) State and municipal securities, (*c*) corporate securities, and (*d*) mortgages during the period from the end of the war to June 1950, and state in a general way the reasons for this policy.

2. Describe the changes, if any, in your policy with respect to holdings of United States securities, corporate securities, and mortgages since June 1950. If your policy during this period has changed, evaluate roughly the relative importance of (*a*) changes in the relative attractiveness as investments of the different classes of securities, (*b*) changed Federal regulations with respect to mortages, (*c*) moral suasion, directly or indirectly, by the Federal Reserve System (including the voluntary credit restraint program), (*d*) the emergence of potential capital losses on United States securities in your portfolio, and (*e*) other factors, in bringing about the change in policy.

3. If the Treasury should have to engage in substantial net borrowing during the foreseeable future, what class or classes of securities do you believe it should offer to life insurance companies?

The above questions were submitted to 42 life-insurance company executives. Replies were received from the following 38:

American United Life Insurance Co., Indianapolis, Ind., L. E. Crouch.
Bankers Life Co., Des Moines, Iowa, E. M. McConney.
Bankers National Life Insurance Co., Montclair, N. J., Ralph R. Lounsbury.
Business Men's Assurance Co. of America, Kansas City, Mo., Grant Torrance.
Columbian National Life Insurance Co., Boston, Mass., Julian D. Anthony.
Commonwealth Life Insurance Co., Louisville, Ky., Morton Boyd.
Connecticut General Life Insurance Co., Hartford, Conn., Frazar B. Wilde.
Connecticut Mutual Life Insurance Co., Hartford, Conn., Peter M. Fraser.
Equitable Life Assurance Society, New York, N. Y., Thomas I. Parkinson.
Equitable Life Insurance Co. of Iowa, Des Moines, F. W. Hubbell.
Fidelity Mutual Life Insurance Co., Philadelphia, Pa., E. A. Roberts.
Guardian Life Insurance Co. of America, New York, N. Y., George T. Conklin, Jr.
Home Life Insurance Co., New York, N. Y., George N. Emory.
Jefferson Standard Life Insurance Co., Greensboro, N. C., Howard Holderness.
John Hancock Mutual Life Insurance Co., Boston, Mass., H. S. Payson Rowe.
Liberty National Life Insurance Co., Birmingham, Ala., Frank P. Samford.
Life Insurance Co. of Virginia, Richmond, Hollister V. Schenck.
Lincoln National Life Insurance Co., Fort Wayne, Ind., A. J. McAndless.
Massachusetts Mutual Life Insurance Co., Springfield, Mass., Leland J. Kalmbach.
Metropolitan Life Insurance Co., New York, N. Y., Frederic W. Ecker.
Minnesota Mutual Life Insurance Co., St. Paul, T. A. Phillips.
Mutual Benefit Life Insurance Co., Newark, N. J., John S. Thompson.
Mutual Life Insurance Co. of New York, N. Y., Louis W. Dawson.
National Life and Accident Insurance Co., Nashville, Tenn., E. B. Stevenson.
National Life Insurance Co., Montpelier, Vt., Deane C. Davis.
New England Mutual Life Insurance Co., Boston, Mass., Sherwin C. Badger.
New York Life Insurance Co., New York, N. Y., George L. Harrison.
Northwestern Mutual Life Insurance Co., Milwaukee, Wis., Edmund Fitzgerald.
Northwestern National Life Insurance Co., Minneapolis, Minn., R. G. Stagg.

Occidental Life Insurance Co. of California, Los Angeles, H. W. Brower.
Penn Mutual Life Insurance Co., Philadelphia, Pa., Malcolm Adam.
Phoenix Mutual Life Insurance Co., Hartford, Conn., B. L. Holland.
Provident Mutual Life Insurance Co., Philadelphia, Pa., M. Albert Linton.
Prudential Insurance Co. of America, Newark, N. J., Carrol M. Shanks.
Reliance Life Insurance Co., Pittsburgh, Pa., George L. Langreth.
State Mutual Life Assurance Co., Worcester, Mass., John P. Sedgwick.
Union Central Life Insurance Co., Cincinnati, Ohio, John A. Lloyd.
United States Life Insurance Co., New York, N. Y., W. C. Batchelder.

CHAPTER XIII

REPLIES BY GOVERNMENT SECURITY DEALERS

1. What, in general terms, has been the response of your customers (in terms of buying, selling, and holding United States securities) to the various credit policy and debt management moves made by the Treasury and the Federal Reserve System since the outbreak of the war in Korea? Distinguish, if you desire, between successive phases.

The answers to this question—which calls for a narrative of the events in the United States security market during the past year and a half—cannot be adequately summarized. The "feel" of the confusion which prevailed in the market during the period of conflict between the Treasury and the Federal Reserve can be obtained only by reading several of the extracts presented below. In general, there was a great deal of selling (to the Federal Reserve) during the period of conflict and up to the abandonment of par support. Since that time selling has greatly diminished, but very little buying has appeared.

Extracts from typical replies follow:

Francis D. Bartow (*Bartow Leeds & Co.*)

In the first place the changes in credit policy since the outbreak of war in Korea brought up again the question in investors' minds as to whether Government bonds would be permitted to go below par and seek their own level or whether, in the face of inflation, the Federal Reserve System would take a firm stand and not permit quotations under the par level. There naturally developed two schools of thought on the question with strong adherents on both sides. Each school viewed the problem with greater and greater apprehension as the prices of the longer securities neared par.

The adherents of the school who believed in the integrity of par purchased long Governments at successively lower levels on the way down. As each week went by their most recent purchases looked high in comparison with the market. And so it was not surprising to see them stop buying. It, too was not surprising to see some of them change their views on the market, sell out at a loss and go into bills and certificates.

The adherents of the other school who believed in a free market and the possibility of below-par prices were fairly heavy sellers of bonds above par. They were not lulled into any feeling of security by the actions of the Open Market Committee; they saw the tremendous demands for capital and made themselves equal to the situation.

The response of our customers in terms of buying, selling, and holding Government securities in view of what occurred in the market was their admission that they were confused, disappointed, and very perplexed. A good many of our customers reiterated again and again

their belief during the open market purchase operations that at times there did not exist a market for these bonds. Their apprehensions and anxiety mounted as the days went by.

The controversy between the Federal Reserve Board and the Treasury served at this time only to heighten the confusion that already existed in the minds of our customers. The various statements that were made showed that even our Government officials had no solution to this very important question; in fact in the Treasury and in the Federal Reserve Board there was bitter disagreement over what was to be done. Newspapers commented upon it, columnists wrote about it, and it was freely discussed on the radio.

All of the publicity given to the controversy did not clarify any of the problems of our customers.

J. D. Gillespie (J. D. Gillespie & Son, Dallas, Tex.)

Practically no buying of long-term obligations. Many customers are keeping what they have, while very many will sell. This upset of the market began before Korea, in the latter part of 1949 when the Federal System and the Treasury locked horns on who would set the interest rate on certificates of indebtedness, and who would have the say as to what the Government would pay for money. After Korea the uncertainty in the market became worse culminating in the Federal permitting the long-term market to go under par.

John H. Grier (First National Bank of Chicago)

It is difficult to determine how much the motivation of our customers was influenced by events in the international and domestic field and apprehension of further inflation, and how much by actual credit policy and debt management moves made by the Treasury and the Federal Reserve System since the outbreak of the Korean war. Generally speaking, the first effect of removing pegged prices was to cause sales in anticipation of still higher interest yields and lower prices. Once prices had fallen, there was considerable reluctance on the part of some of our customers to sell, as it involved taking losses.

Alfred H. Hauser (Chemical Bank & Trust Co.)

The most significant of the credit and debt management moves was the abandonment of support of Government bonds. The principal response of our customers to this move was the realization that it is impossible to obtain a long-term interest rate on a short-term investment without market risk. There is now a distinct reluctance to buy Government bonds for temporary investment.

During the initial phases of the Korean war the psychological influences which induced scare buying also resulted in considerable selling of Treasury bonds by individuals who wished to buy goods or other securities which they believed to be a better hedge against inflation. Similarly, institutional investors were induced to sell long-term bonds in an attempt to avoid loss. Dropping of support levels in the early stages accentuated the desire to sell.

As the depreciation in Government holdings increased, institutional investors became more reluctant to take losses, and selling gradually diminished.

With the continuation of subpar prices there has been a tendency for holders to become accustomed to the loss and they become more

willing to sell, particularly when the rate of return can be substantially improved through the purchase of corporate securities or mortgages. Investors who are subject to income tax are also under less compulsion to hold their bonds because the potential loss is greatly reduced by the tax saving.

A. H. Kiendl (Guaranty Trust Co.)

Since the outbreak of the war in Korea, most of our customers have confined their transactions in United States Government securities largely to the adjustment of their individual money positions and requirements. Because of the accelerated demand for mortgage financing, consumer-credit loans, and commercial borrowings during the greater part of this period, there was a net liquidation of Government securities. However, our experience indicates that selling tended to diminish as prices declined. During the same period, our corporate customers built up substantially their holdings of short-term Government securities, particularly Treasury bills.

Aubrey G. Lanston (Aubrey G. Lanston & Co. Inc.)

[The following two paragraphs are extracted from Mr. Lanston's introductory remarks in response to his request that his general point of view be made clear.]

> A retrospective judgment of the methods and policies employed by the Treasury and the Federal Reserve relate largely to the quality of personal decisions made during an unusually difficult period. Differences in the quality of such judgments have no bearing on the fundamental question, namely, the allocation of authority, from a structural point of view, within the Government or with respect to the Federal Reserve System.
>
> The methods employed by the Federal Reserve during this trying period did turn an important instrument, namely, Federal open-market operations, into one that was highly personal. * * * Just as the Federal Reserve System should have its independence preserved from domination by the executive branch of the Government, private credit institutions and the market mechanism should be protected from personalized dealing by the Federal Reserve.

Events and the experiences of investors during the months prior to Korea were a major factor in determining their response to what followed. In the pre-Korean interval investors based their actions on a belief that the Treasury would prevail in the obviously growing dispute with the Federal. The Korean incident, as it then seemed, reassured investors that they were correct in their premise. The subsequent developments, therefore, should be related not only to the background of the early summer of 1950, but to the earlier period beginning in December 1949. We, therefore, believe it desirable to refer to this earlier period in our reply.

The year and 10 months involved (to October 31, 1951) divides itself into 10 successive phases, with significant differences dominating the

responses of investors to the events of each phase, and we have so divided our comments. The chronology of these phases is given below.

Phase:	Period
1	The first 6 months of 1950.
2	June 22–Aug. 16, 1950.
3	Aug. 17–Oct. 11, 1950.
4	Oct. 12–Dec. 13, 1950.
5	Dec. 14, 1950–Feb. 28, 1951.
6	Mar. 1–Apr. 4, 1951.
7	Apr. 5–July 3, 1951.
8	July 5–Sept. 19, 1951.
9	Sept. 20–Oct. 10, 1951.
10	Oct. 11–31, 1951.

Phase 1. The first 6 months of 1950.—As early as November 1949 there was some evidence that the Federal Reserve was attempting to influence the Treasury toward the use of higher interest rates in its financings. The terms set by the Treasury for its December-January refunding indicated that the Federal had made no progress.

In January 1950 the prices of Treasury securities, partly as a consequence of the terms set by the Treasury, reached a new peak in the upward movement of prices that had begun in June 1949. At this time, the Federal Reserve initiated two policies for its handling of the Treasury security market. It started to sell Treasury restricted bonds in volume and at declining prices. It also caused the prices of Treasury short-term securities to ease, by minute fractions, so that the Treasury's financing appeared to have been unsuited to prevailing market conditions.

The Federal Reserve sold restricted bonds until the price of the key issue had declined from 103⅞ in January 1950, to 101 when hostilities broke out in Korea. In so doing, the Federal would cause prices to drop slowly, by filling all buy inquiries shown to it, until the market had reached a point that the Federal knew was one at which many investors contemplated making substantial purchases. It then permitted prices to stabilize for periods of a week or more. This momentary stabilization reinstated investor confidence in the stability of the price level and inspired broader buying.

Shortly, however, the Federal would resume its pressure on prices until the market reached a lower level at which investors felt prices would be permitted to stabilize. Prices then were stabilized at such a point by the Federal. Confidence was reinstated, and just as surely dissipated later on by a resumption of Federal Reserve pressure on bond prices. This occurred four times before the price of key issues had been pushed down to 101.

In the short-term market the approach was the same, but the technique was slightly different. During the greater portion of the period involuntary factors affecting member bank reserve balances were negligible. This means that a large volume of selling by the Federal of restricted bonds forced banks to adjust their reserve position by selling Treasury securities. Moreover, commercial banks were anxious to acquire bank-eligible bonds for income as these were sold by nonbank investors. Such commercial bank purchases required additional sales of short-term issues. Therefore, in firming the yields of short-

term securities, the Federal needed to be only a reluctant buyer of the latter and drop its bids by minute fractions, to cause Treasury financing rates to appear unsuited to market conditions.

This technique also caused a new issue of medium-term 1⅜ percent notes to sell below par shortly after issuance, an event almost without precedent.

As a consequence of this firming of short-term rates, the February, March, and April Treasury financings took the form of 1¼ percent notes, an increase of one-eighth of 1 percent, with an initial term of 20 months, later reduced to 15 months for short-term paper.

The last financing announcement during the first half of 1950 was made on May 5 just as a recently issued 5-year note, bearing a coupon rate of 1½ percent, had been permitted to go below par by the Federal. The Treasury's announcement entailed an advance notice, the length of which was without precedent. Investors quickly gathered that, in this way, the Treasury was using its financing decisions to retard the firming of rates brought about by Federal Reserve open-market operations. This was taken by investors as a signal that the Treasury was still in the saddle.

In general, investors had been surprised at the manner and degree by which the Federal was fighting out its differences via the market. They had resented, for a long time, the low interest rate policy which they believed to be a permanent Treasury Department fetish. They admired the way in which both the Treasury and the Federal stuck to their guns, but they were getting tired of being "in the middle."

Investors were finding that they could not rely on their judgment of business conditions or their common sense to aid them in handling their day-to-day or long-run investment problems. The rules to which they had been accustomed, with respect to the Treasury vis-à-vis the Federal, were not being followed. Under the circumstances, most investors based their investment decisions on the belief that the Treasury ultimately would prevail.

Phase 2, June 22–August 16, 1950.—Our acceptance of the Korean challenge caused investors to conclude that the Treasury-Federal Reserve feud over the level of short- and long-term rates would come promptly to an end with the Treasury the winner. Most questions with respect to the future level of the 1-year rate were whether it would decline to 1⅛ percent or 1 percent.

The inflation atmosphere was actually a bullish item in investors' analyses of the outlook. They concluded that controls of various types would severely decrease the future availability of non-Treasury investment media, and a broad demand for restricted Treasury bonds came in from all parts of the country.

The Federal Reserve's technique now underwent a change. It no longer endeavored to depress the price of restricted bonds below the prevailing level of 101. This price stability, combined with other factors, greatly enlarged the demand of investors who were bold in their belief that they should buy bonds while the supply lasted. The Federal Reserve's holdings of restricted bonds was reaching a foreseeable end.

Investors resented, however, the tightening of certain other techniques. When prices were being forced down, the Federal Reserve asked few questions and rather generally met all buy inquiries. Now

that the price level apparently was not going to be pushed lower, recognized dealers were being forced or encouraged to identify the source of their buy inquiry, and other information pertaining to the business of the buyer. If, in the opinion of the officials in charge of Federal open-market transactions, the information furnished was satisfactory, it was then determined whether the order would be filled in its entirety, in part, or not at all, and whether such answers would be given immediately or after delays that, on many occasions, seemed unreasonable. Sometimes the decision would depend upon what recognized dealer had the order, that is, whether he was in "good standing" that particular day. Sometimes it depended upon the identity of the investor or of his agent, such as what member bank, what stock exchange firm, or what other dealer.

During this phase, involuntary factors influencing the reserve balances of member banks decreased these by nearly $600 million. All of this drain occurred during the first week of this phase, a period coincident with the refunding of the Treasury's July 1 maturity. These factors, combined with heavy sales by the Federal of long-term bonds during the entire period, were responsible for large Federal Reserve purchases of short-term Treasury securities.

It seemed likely to investors that nonbank institutions would continue to be buyers of Treasury securities and Federal Reserve holdings of restricted bonds were on the verge of exhaustion.

Phase 3. August 17–October 11, 1950.—The Federal Reserve's announcement of August 18 came as a complete surprise to investors. They were stunned by receiving, coincidentally, a Treasury financing announcement calling for no change in rate or term, for a refunding of unprecedented amount. The Board's approval of increases in the discount rates of the Reserve Banks made the entire situation incongruous.

The initial reaction of investors was mixed. Most of them admired the belated action of the Federal Reserve to reinstate its legislative independence. But the fact that both the Treasury and the Federal Reserve Board's announcements appeared simultaneously caused most investors to wonder how they could be reconciled.

When the Federal undertook to refund the Treasury's maturities from its portfolio, investors concluded that the upshot would be increases in short-term rates of about ¼ percent, and that long-term rates would be maintained. In fact various reports from Washington, shortly after the announcement, seemed to confirm that no change was contemplated in the long-term rate structure.

The combination of these impressions with the fact that the Treasury was offering only short-term notes, caused some investors to expect a rise in long-term bond prices. For several days bond prices rose.

Within a short space of time, however, the rate of mortgage manufacture and the increased demand for credit of all types caused investors to change their minds and they concluded that the availability of non-Treasury investments might exceed their available investible funds. Investors then were quick to recall that the dropping of the pegs in 1947 took place, of all times, on Christmas Eve. They also recalled the statements by the Federal Reserve officials, and rumors, that 2½-percent restricted bonds should not be supported at par.

In a nutshell the reaction of investors is well expressed in the words of a commercial banker several weeks later. "We have been in the habit," he said, "of maintaining a secondary reserve of X million dollars in Treasury securities of short and intermediate term. The way this thing (the market) was handled," he went on, "taught me very clearly that if I needed to raise funds from this reserve, in the near future, the only buyer might be the Federal Reserve and at what prices I don't know. Consequently, why should I sit and do nothing? I didn't. I sold the whole blooming portfolio, including short-term notes and bonds, and put the money in Treasury bills. Then, if I needed money to make a loan to a good customer I would have to sell only Treasury bills. If I find I can't sell them I can borrow from the Federal until various maturities come due. Then I will make repayment of my loans."

During this phase the Federal bought $1 billion of bank-eligible securities (notes were increased by $4 billion, while bills declined by $3 billion), and it bought $200 million restricted bonds. Actually, the Federal Reserve sold $200 million during the first 3 weeks of the phase and bought $400 million in the subsequent 5 weeks.

Involuntary factors reduced member bank reserve balances by $650 million during the 8 weeks. Federal Reserve holdings of Treasury securities increased by $1,200 million net. This not only offset the involuntary factors but increased member bank balances by more than $500 million. Thus, the open market refunding of the Treasury maturities permitted banks to meet a $216 million increase in reserve requirements and carry $275 million to excess reserves. This placed the banks in possession of almost $1 billion in excess reserves, and facilitated a further expansion in bank credit at a time when borrowers were anxious to make commitments because of the possibility of higher rates.

Phase 4. October 12–December 13, 1950.—After the initial impact of the Federal Reserve declaration of independence and the completion of a disjointed Treasury refunding, investors had time to review and reassess the situation. The concensus seemed to be that the Federal may have acted impulsively and many doubted that it had thought through on the problems to be faced.

Several questions were in the minds of investors. To what extent was the Federal prepared to increase further short-term yields? The longest term restricted bond was being supported at 100²⁶⁄₃₂. Would support hold at that price? Was it possible that par support was in real danger?

The familiar technique of the Federal was then brought into play. Treasury bills remained stable at a yield of about 1⅜ percent, and short term notes at a yield of slightly less than 1½ percent. Investors became reassured and were reconvinced that the 2½ percent rate was here to stay. A number purchased the longest bank-eligible 2½ percent bond at a premium of 104.

It had been presumed by Federal Reserve officials that the introduction of depreciation in commercial bank portfolios would act as a deterrent to the expansion of bank credit because banks would be reluctant to accept the losses entailed. This overlooked the fact that the corporate tax increases had been made effective and that such losses were deductible from a high corporate tax rate.

Nonbank lending institutions became substantial sellers as mortgages and other investments were committed for in increasing volume. In some instances it seemed desirable to management to sell long-term Treasury bonds as commitments were made and to reinvest in short-term securities. Commercial loans were climbing sharply.

Toward the end of the period, the Treasury had to refund $8 billion of maturing obligations. The offering took the form of a 1¾-percent note of 5-year term. This proved to be unsuited to the preferences or needs of many holders. Incidentally, on the morning of the Treasury announcement the support price for the longer Treasury restricted bond was dropped two-thirty-seconds after several weeks of precise stability. Investors asked whether this was another indication that the firming of rates was to continue. Four days later the price was dropped to 100²³⁄₃₂. Investors became jittery. Obviously, such minor changes in the price at which support was rendered to restricted bonds could have little bearing on the decision of an investor who had already made up his mind to sell. The psychological effect was to suggest to other investors that they do likewise, and it increased the reluctance of investors to accept the Treasury refunding offering, although Federal Reserve officials were now characterizing its terms as appropriate and attractive. This exchange was one of the most unsuccessful in Treasury history. Fifteen percent of the public's holdings were redeemed for cash and 35 percent were sold to the Federal Reserve.

During the 9 weeks, involuntary factors decreased member bank reserve balances by $347 million. During the better part of the period banks financed a $536 million increase in reserve requirements by drawing on excess reserves and momentarily increasing their borrowings. Many banks contemplated repayment by the sale or redemption of the Treasury maturities involved in this refunding.

By the end of the period, and as a partial consequence of the failure of this financing, Federal purchases proved to be in excess of $1 billion. Excess reserves of member banks advanced by $140 million to $1,100 million.

Phase 5. December 14, 1950–February 28, 1951.—Prior to the beginning of this period commercial banks had been expecting an increase in reserve requirements. This was announced late in December and just before the increases became effective, the Federal Reserve had to buy Treasury securities in volume. But, by this time, Federal purchases of restricted bonds were in large volume and the sales of short-term securities by commercial banks were less than they would have been under different conditions.

In January 1951 the Secretary of the Treasury, in a public speech, stated that the Treasury's refundings and new-money issues would be confined to those that would fit within the pattern of a 2½ percent long-term rate. This statement provoked a response by the president of the Federal Reserve Bank of New York that implied that the Secretary's statement had not met with full Federal Reserve approval.

The commitments of nonbank lending institutions were growing in size. Increased difficulty was being encountered as investors tried to sell Treasury bonds. Support was being confined increasingly to only the longer restricted issues. Larger institutions generally preferred not to make necessary sales of restricted bonds against support bids emanating from the Federal Reserve Bank of New York. Their sales

were made, as a rule, only as bids were available from other nonbank investors. Obviously, if "the outside buying" was to be absorbed in this manner, the volume of purchases to be made by the Federal was in no way diminished, but it was fairly clear that this was the way the Federal wished things done.

Most, if not all, of the support rendered the restricted-bond market during this phase was confined to the two longest bonds. Consequently, sales of the other eight issues were more difficult to arrange although their approaching eligibility for commercial banks and their shorter term caused them to sell at higher prices and lower yields than the two longest bonds. Because of the latter considerations a large number of sellers attempted to sell the unsupported, or less well supported, bonds. Since most nonbank investors were sellers on balance, therefore, the bids generated for these came largely from investors who, as a general practice, are willing to sell one issue and buy another when one is "high" in the market because of an unusual demand, and the other is "cheap" because insufficient bids are available. Naturally, the "high" issues became the two that were being the more freely supported, and the "cheap" issues were those that were supported less well, or not at all.

Gradually, the volume of offerings of "cheap" issues became greater than the willingness of investors to make bids via such exchanges. Consequently, price and yield relationships between the various issues became increasingly abnormal. Investors generally instinctively distrust a market with such characteristics and this condition, therefore, increased the investors' desires to sell.

Moreover, the Federal seemed to be an increasingly reluctant buyer. By January 1951, the support price for the longest restricted bond had dropped another one thirty-second to $100^{22}/_{32}$ and that of the next longest bond had dropped two thirty-seconds to $100^{21}/_{32}$. The Treasury was becoming an increasingly large buyer for its own accounts and funds. The impression was that Treasury buying was confined to the longest bond and the difference between the two prices signified that the Treasury wished the support prices to be stabilized and the Federal Reserve wanted them to continue to decline. Investors believed that if the differences between the two groups of officials were so marked that different support prices had to exist for two almost identical bonds the best thing to do was to sell. Throughout, the Federal Reserve was becoming more and more insistent on identifying the seller and the details of the seller's business. If the bonds being offered to the Federal were for the purpose of reinvesting in other Treasury securities such offerings generally were not accepted. On the other hand, if they were for the purpose of investing in mortgages, loans to business, and the like, the Federal would look more favorably on the transaction and base its decision on considerations such as those mentioned earlier.

This technique served, at times, to prevent some investors from having access to any market, since recognized dealers were also more or less under orders not to transact business in restricted bonds below the Federal's nominal bids or the prices it wished dealers to quote.

On the whole, the period was one in which conditions arising from the Treasury-Federal Reserve dispute were becoming more and more intolerable. This was recognized by practically every investor, and

it inspired sales of Treasury securities in excess of actual needs. Moreover, it was increasing the demand for capital and credit by businesses and individuals who wished protection against higher interest rates or a decreased availability of money.

For the period as a whole, involuntary factors were minor in their impact on member bank reserve balances. The increase of $2 billion in required reserves was largely the result of the increased reserve-requirement percentages. Member banks drew substantially on their excess reserves and also increased borrowings. The increase in borrowing was no longer related, of necessity, to bank needs. It originated frequently from considerations of excess-profits-tax liabilities.

Phase 6. March 1–April 4, 1951.—The announcement of a Treasury-Federal Reserve accord was received with general relief. The corollary exchange offering of a 2¾-percent bond was received with satisfaction, in spite of its hybrid character and complications. Some investors were critical of the decision to confine the offering to the two longer bonds. A number had sold these issues to acquire other restricted bonds for which no support had been rendered. They believed that such shifts in their holdings had been helpful to the market and reflected sound practices. They felt that, in so confining the exchange offering, the Treasury "let them down."

It was quite clear from the combination of announcements that the market would be deluged with sell orders. A decision to lower the support price of the longer bonds from 100²²⁄₃₂ to 100 seemed to be in the cards. To everyone's surprise the 100²²⁄₃₂ price was maintained for these bonds but other restricted issues remained largely without bids. Treasury and Federal Reserve officials had felt that the new offering would create a "rights value" for the bonds that were to be turned in, but it was impossible to create a premium for anything in the demoralized conditions that existed. At this crucial point, the fact that neither the Federal nor the Treasury seemed much concerned about the state of the market for the remaining $30 billion of restricted bonds was another shock. By and large, investors were interested only in bids.

On March 8 the support price on the two longer bonds was dropped from 100²²⁄₃₂ to par. At this point, support was rendered, momentarily, to all issues. The final vestige of investor confidence in par support then was destroyed as support for most issues proved to be only of the reluctant buyer type. Some investors could not get executions on their sell orders. It seemed senseless to add fuel to the fire by withdrawing par support at this juncture. Only a public statement by the Federal and the Treasury that support would be that of a willing buyer could stem the tide.

On March 13 par support was withdrawn. Prices of Treasury restricted bonds dropped sharply to 99. At this level the Federal evidenced a renewed buying interest that included six instead of two issues. Within a few days the press was regaled with stories of the free character of the Treasury security market and the noteworthy stability of prices that had ensued. These press reports were erroneous. The market was not free. Prices were stable because recognized dealers were forced by the Federal to quote nominal prices higher than those at which investors would gladly sell if they could make an actual sale. The Federal frequently required that the investor leave his bonds on order with a dealer. Even then, and when the amounts were of

moderate size, the investor might sell only a part, sometimes none, of his bonds. Thus, to some holders of a presumably highly liquid investment, Treasury securities, no market existed. Under the circumstances, the average investor's desire to hold his securities was weakened.

The nominal prices quoted by recognized dealers were the only ones printed in the press. They were carried daily by a leading financial news ticker service. The free market on many such occasions was lower in price than these quotations. To prevent such a market from functioning—that is, to discourage other Treasury security dealers from transacting business in Treasury restricted bonds at lower prices with investors—recognized dealers were requested to refrain from customary dealings with their brokers.

The Federal's tactics changed from day to day. On some days it would buy everything offered to it without regard to source, name, or story. On subsequent days it was difficult to effect sales, regardless of the details furnished as to the investor's needs. One could not predict from the policies of one day what the next day's policies might be. Few investors felt justified, therefore, in speculating on their ability to raise funds "tomorrow," and most of them sold when they found a bid.

During the space of the 5 weeks involved, involuntary forces reduced member bank reserves by almost $700 million. The Federal Reserve bought about $800 million of bonds over 5 years, and $200 million of shorter issues.

Treasury purchases during the month of March were almost $500 million.

As this phase came to a close, investors were asking whether any selling of Treasury securities was to be expected after the exchange books were closed. A popular view was that a number of investors had oversold and would scramble to buy if it became apparent that few bonds were available in the market.

Phase 7. April 5–July 3, 1951.—Treasury bonds were offered in substantial volume as other investments became available at higher rates of return. Prices of Treasury restricted bonds declined two points in about 2 weeks. They then were stabilized for a short while by Federal support before being permitted to decline once again.

The Voluntary Credit Restraint Committee was doing an outstanding job; but, as had been obvious throughout the dispute, a substantial volume of financing had to be met in connection with defense requirements and the desirable peacetime needs.

Finally, prices reached a sufficiently low level that a number of professional trustees found it to the advantage of their accounts to redeem series G bonds and to buy marketable securities, Treasury and other. Such a price level, therefore, threatened the stability of ownership of another large segment of Treasury debt.

Under the leadership of the new Chairman of the Board of Governors, a somewhat different outlook developed. It became known that Mr. Martin recognized the situation as it actually was. This led to rumors that the Federal Reserve might clear the market of such Treasury securities as nonbank lending institutions might have to sell to take up their forward commitments and to make desirable new ones. Investors who had oversold at higher prices began to reinvest in Treasury bonds.

The bottom of the market was reached during the second week of May. A prospective slackening in the demand for capital and credit contributed to the stability of Treasury security prices as it reduced the selling needs of lending institutions. No one could tell, however, whether this was to be the customary summer lull or a more permanent situation.

During the 13 weeks involuntary factors were negligible in their impact. Net purchases of Treasury securities by the Federal Reserve were only $63 million, but the Federal had bought over $500 million of restricted bonds. In this phase of the market, investors desired liquidity, and they bought short-term securities as they sold long-term restricted bonds.

Phase 8. July 5–September 19, 1951.—The steadying of Treasury bond prices brought in scattered investor demand, and this revealed to dealers that a number of sellers were no longer interested in bids. Some buying orders subsequently began to assert a measurable impact on prices. By Labor Day week the longest 2½ percent restricted bonds had rallied to 99 from a low of 96¾. Many lending institutions now began to wonder whether the future rate of mortgage manufacture and the demand from business for capital or credit would leave them with a surplus of investable funds by as early as mid-winter 1951–52. A number of investors were assuming, in an off-hand fashion, that any excess would be invested in long-term Treasury bonds.

Running parallel with the improvement in the prices of Treasury securities was an encouraging upturn in the savings deposits of the various types of banking institutions. Investors were vastly encouraged by the decrease in the depreciation shown in their investment accounts. Some wishfully expressed the thought that restricted bonds would sell at par by the year end. The Treasury's deficit was being financed through bill issues, most of which were being taken by business corporations.

Toward the end of this period the Treasury had to meet two small maturities—September 15 and October 1. The refunding issues were the same as those offered 3 months earlier, namely, 11 months' certificates bearing a coupon of 1⅞ percent. The attrition on one issue, originally offered as 20–24 year bonds, was surprisingly large. Although attributable largely to the type of holder, the size of the attrition was nevertheless disconcerting to some investors.

Entering the picture at this juncture was a new factor, namely, the probable taxation of mutual associations, such as savings banks and Federal savings and loan institutions. Such taxation seemed likely to decrease their desire to acquire additional Treasury bonds and to increase their willingness to sell present holdings at a loss.

Simultaneously, many investors began to believe that the availability of non-Treasury investment media would be quite large again. This presaged more sales of Treasury bonds. Congressional legislation loosening the restrictions over consumer and real-estate credit was a psychological factor that affected investor thinking on this score.

During the 11 weeks of this phase involuntary factors had reversed themselves in a substantial way, increasing member bank reserve balances by about $300 million. An increase in gold stock was the key factor.

The Federal Reserve increased its holdings of Government securities by $158 million, all of which was in bills and notes. The principal official support of the bond market came from Treasury trust and agency accounts, largely through exchanges of short-term partially exempt Treasury securities for restricted bonds.

The combination of Federal Reserve purchases of Treasury securities when involuntary factors were adding to member bank reserve balances together with an increase of $178 million in member bank borrowing increased reserve balances by $646 million. Of this increase $230 million was needed to meet increased reserve requirements and $416 million was carried to excess reserves to lift the total to more than $1 billion.

Phase 9. September 20–October 10, 1951.—This brief period is noteworthy because (1) the Federal Reserve System acquired a large amount of Treasury securities and (2) the action of the Treasury security markets suggested that the price improvement of the summer had been a secondary or technical adjustment. Private loan demand was increasing at both bank and nonbank institutions.

The Treasury faced the necessity of refunding $11 billion of notes due October 15 and November 1. Approximately two-thirds of the maturing issues were held by the Federal, and it seemed that this would be one of the least troublesome Treasury refundings to be undertaken in some time. The terms announced by the Treasury were essentially the same used a month earlier, that is, 1⅞ percent certificates, one of which was due in 11 months and the other in 11½ months.

Apparently, one consideration was given insufficient weight, namely, that the pending tax bill called for retroactive increases in taxes. Many corporations had not accrued their tax reserves from such a premise. Others had been accruing at the existing rather than the contemplated rates. Many corporations who held the maturing obligations, therefore, expressed a preference for Treasury bills instead of the new offerings that would mature almost a year hence. The high corporate tax rate and increasing excess profits tax liabilities further reduced the incentive of investors to accept the exchange. As a consequence, the Federal Reserve had to buy substantial amounts of the maturing and the new securities.

Money market requirements had an interestingly adverse effect as well. An usually tight situation had developed in the money and bill markets during the week of September 26, and Federal purchases of bills, certificates, and notes totaled $300 million. Such support now was deemed by investors to be evidence of potential weakness in the price structure of short-term securities, and this discouraged some exchanges.

During the subsequent 2 weeks, the Federal, therefore, had to acquire about $600 million of certificates and notes. Total purchases for the entire 3 weeks of this phase were more than $900 million.

Federal Reserve support of the Treasury bond market is more dramatic and provocative than support rendered in connection with Treasury short-term financings. For example, had the Federal Reserve bought anywhere near this amount of 2½ percent bonds, widespread discussion might have followed, but this large-scale support of short-term issues provoked only passing comment. But, this experience

seems to have confirmed the earlier expectancies of many investors, namely, that the availability of reserve credit could not be curbed effectively by either a creeping withdrawal of par support for long-term bonds or by fractional increases in short-term rates, or by a combination of both.

During the 3 weeks, the Fed's purchases of securities exceeded the loss from involuntary factors by $384 million, while reserve requirements increased by only $45 million. Member banks repaid $280 million of borrowings, but excess reserves rose slightly to a level of approximately $1,100 million.

Phase 10. October 11–31, 1951.—During the period Treasury bonds continued to drift lower, a trend that, at the time of this reply, has carried prices back to approximately their May lows.

The Treasury's offering of $1¼ billion of 144-day Treasury bills seemed well attuned to the investor demand at the moment. The provision that payment might be made by a credit to war loan accounts was partly responsible for the comparatively low rate at which the bills were awarded as was the excessive ease experienced by the money market as a consequence of the Federal's purchases of Treasury securities just mentioned. And, most corporations were catching up with the higher tax reserves called for by the 1951 legislation. This resulted in an increased demand for Treasury bills and a surprising preference for those due in 91 days or less. The yields of such bills moved sharply lower in the open market. The combination enabled the Federal Reserve to reduce its holdings of Treasury securities, primarily bills, by over $500 million.

Two opposing beliefs were arising with respect to the prospective demand for capital and credit. One belief was that we had seen the peak. The other was that (*a*) the liquidity position of business had deteriorated so much that a renewed demand for bank and long-term credits was in the offing, and (*b*) the ability of managements to bolster the per share earnings of their stockholders by increasing their debt ratio also forecast new demands.

Involuntary factors increased member bank reserve balances slightly. Required reserves increased by $161 million and borrowings by $107 million. Consequently, member banks drew upon their excess reserve balances by more than $500 million, to reduce these to $565 million.

It is of interest to note that from June 22, 1950, through July 3, 1951, involuntary factors decreased member bank reserve balances by $2,400 million. A decline in gold stock, that leveled out from the end of May through the end of August, and a more or less steady expansion in money in circulation, were the principal factors bringing this about.

It, therefore, was inevitable that member banks would seek to adjust their reserve position through the sale of Treasury securities. Net sales to nonbank lending institutions would have been impossible as these investors were net sellers. Net sales to businesses and the like would have had to be made to the extent of about five times the decrease caused by the involuntary factors. That is, businesses and the like would have had to buy $11 billion to $12 billion of Treasury securities from member banks.

The Treasury had a large cash surplus during the year. This was money derived largely from businesses, individuals, and the like but,

because of an eroding confidence in the stability of the Treasury security market, some portion of this cash surplus had to be used to redeem maturing Treasury debt held by nonbank investors. An additional sum was used by the Treasury in an attempt to support the prices of Treasury securities that commercial banks cannot acquire. Only a portion of the Treasury's cash surplus was available, therefore, to redeem bank-held Treasury debt.

Under the circumstances, and regardless of the feud, the Federal Reserve banks were compelled, therefore, to offset the drain on member bank balances resulting from involuntary factors by the purchase of Treasury securities. Otherwise, an increased redemption at maturity would have taken place. Whether such Federal Reserve purchases resulted from the support of long-term bond prices or from underwriting the success of Treasury financing is inconsequential in terms of the quantitative need of the member banks for reserves.

The efficacy of Federal Reserve policies and methods, therefore, was dependent upon the effectiveness with which it could use the interest rate mechanism. It seems that one must conclude that the Federal Reserve completely underestimated (1) the manner in which its moves would increase the desire of investors to get out of Treasury securities, (2) the inefficacy of losses on Treasury securities as a deterrent to their sale during a period of strong demand for capital and credit and high taxes, (3) the degree by which the origination of a small creeping increase in rates would invite—

(*a*) sales by most investor classes of all but the shortest-term Treasury securities,

(*b*) the acquisition of shortest-term issues with which future availability of funds could be assured, and

(*c*) an increase in the demand for capital and credit beyond actual current needs.

As matters developed, it is not surprising that net Federal Reserve purchases totaled roughly $5,300 million. After allowing for the increase in reserve-requirement percentages, this was less than $1,000 million more than the decrease in member bank reserve balances brought about by involuntary factors.

The Federal Reserve, if it were not prepared to make extensive and abrupt use of the interest rate mechanism, would have achieved a less inflationary result for the period reviewed had it placed greater emphasis on achieving maximum stability of debt ownership and less emphasis on other considerations.

Nevertheless, the controversy that has followed serves to bring the key issues to the fore. Because of this, the price paid may prove small in comparison with the ultimate strengthening of our defense economy.

R. A. Love (Chas. E. Quincey & Co.)

Since the outbreak of the war in Korea, institutional investors have been rather steady sellers of United States Government securities. Due to the increase in demand for loans, commercial banks have either sold Governments or let the securities run off at maturity, with the result that their holdings are now considerably less than they were previous to the war in Korea. Insurance companies and savings banks, due to their large forward commitments, were compelled to sell a large amount of their long-term ineligible bonds.

Since June there has been a considerable decrease in selling. It is generally felt that the necessity for further large-scale liquidation has been completed.

Robert C. Morris (*Bankers Trust Co.*)

The terms of the Treasury's exchange offerings in August and September 1950 were considered unattractive by most of our customers. As a consequence, they disposed of their holdings of maturing obligations in the open market and reinvested the proceeds in other short-term Treasury securities at higher yields. The Federal Reserve absorbed the offerings of maturing securities and at the same time was the principal source of supply of the alternative investments.

The failure of this Treasury refunding operation marked also the beginning of precautionary selling of long-term Treasury bonds by some life insurance companies and a gradual accumulation of short-term holdings. Selling by the savings institutions was also necessary to meet commitments for the large volume of real-estate mortgage financing which the Government had stimulated so aggressively with FHA and VA guaranties. Increased member bank reserve requirements in January 1951 brought about selling of short-term Governments by commercial banks with the Federal Reserve acting as the residual buyer. The market generally was under pressure and the stability which followed Secretary Snyder's policy speech of January 18, 1951, was only of a temporary nature.

The accord in March of this year between the Treasury and the Federal Reserve indicated to our clients a constructive change in the postwar pattern of credit and debt management. After a short period of liquidation by institutional holders, selling subsided gradually and became limited to the need for cash for other investments. A large number of our customers like the Treasury's offering of the 2¾ percent investment bonds series B of 1980/75 in exchange for the 2½ percent bonds of June and December 1972/67, some turning in all of their holdings. Others availed themselves of a favorable technical market situation to switch part of their longest 2½ percent bonds into shorter nonbank issues.

Subsequent refunding offerings by the Treasury, confined entirely to short-term securities, were realistic as to terms. Sentiment in the short-term market improved gradually. Presumably this assisted the recovery of the longer term market to some extent, but this improvement was not sustained because of the lack of substantial investor demand for long-term Treasury bonds.

Emil J. Pattberg, Jr. (*First Boston Corp.*)

The open-market operations of the Federal Reserve System, undertaken in conformance with its credit restrictive policies, had resulted in some tightening of the market for long-term Government obligations prior to the outbreak of the war in Korea. The System had been able to sell long-term bonds from week to week to insurance companies and other investors at gradually lower prices.

After Korea, a radically different situation prevailed. An active demand for loans developed and banks sold short-term securities to provide the funds required. With the increased demand for credit, the System permitted the heavy offerings of short-term securities to

force the market to a higher level of yields. As questions arose regarding the possible rate objectives of the System and the Treasury, uncertainty developed in the entire Government market. Other measures were adopted by the System to limit credit expansion and restrain inflationary trends.

Corporations, in response to the tightening of short-term credit, sought funds in the long-term market. This demand, together with heavy requests for mortgage loans, caused insurance companies, savings banks, and others to become substantial net sellers of long-term Governments to provide funds for higher-yielding investments. Sales of Governments continued at a substantial rate so that by the end of February 1951 insurance company and savings bank holdings of long-term Government securities had been reduced by about $2,700 million from the level at the end of June 1950.

The next major market development was precipitated in March 1951, by the outcome of the controversy between the Treasury and the the Federal Reserve System. The Open Market Committee found itself in the position of having to buy large amounts of bonds in order to support the market prices of ineligible issues at the pegged prices (about 100-21 for the 2½'s 1967-72) because of the steady and increasing selling from the sources mentioned above. When the market prices of ineligible issues were permitted to decline on March 8, 1951, to approximately par, the changed policy had a major effect upon investors who then became heavy sellers during the brief intermediate period of support at or near par. They became convinced that there would be a limit to the amount of support rendered at this point, and continued to liquidate large amounts of bonds to provide the funds which they believed would be needed to meet the heavy volume of commitments already made.

At the end of this short period of support near the par level, the Open Market Committee permitted the price of the ineligible 2½'s to decline to about a 3-point discount below par. This development affected the securities operations of the insurance companies and savings banks. Many of them became unwilling to sell long-term Government bonds at prices below 98, except when prior commitments made it unavoidable. There seems little doubt that the elimination of par support was decidedly effective in checking the steady selling of long-term Governments which had posed such a problem for the System.

Although the System was obliged to continue some support of the market as it descended into new low ground, the amount of buying required to maintain an orderly market diminished rapidly and the market finally stabilized at a level slightly under 97 for the 2½'s December 1967-72. A rebound then occurred, after which it became unnecessary for the System to absorb any significant amount of bonds. However, the market was kept orderly by occasional intervention when blocks of bonds were offered and other bids were not immediately available. Corporations absorbed a large amount of Treasury bills at the higher yields available from these securities.

The policy which permitted Government bonds to go below par was undoubtedly one of the major developments in the Government bond market since the early part of World War II. It would seem to have been successful in limiting the selling of Governments by investing institutions in order to obtain a higher rate of return on their funds.

In view of the great difference of opinion at that time as to whether such a move could or should be made, and of dire predictions by some as to the chaos which would result from any attempt to end the policy of par support, it appears clear that a great improvement in the climate of the Government bond market was affected without the accompanying dangers which had been so freely predicted.

On March 19, 1951, the Treasury offered holders of 2½'s June and December 1967–72 an exchange into 2¾ percent nonmarketable bonds due 1975–80. The offer resulted in exchanges amounting to $13,574,-000,000, transfering that amount of debt from the marketable to the nonmarketable category.

Since the middle of 1951, by which time a reasonable degree of stability in the Government bond market had been achieved, it has been unnecessary for the System to take a significantly active part in the long-term market. Although the tone of the market has not been favorable to any consistent upturn in prices, a moderate amount of buying power has been in evidence and the unwillingness of institutions to sell, as discussed above, has enabled the market to carry along on a reasonably even keel.

Wm. E. Pollock (Wm. E. Pollock & Co., Inc.)

Holders of Government bonds were disturbed emotionally but waited for actual developments.

Buying was curtailed immediately.

Confusion and selling developed in August because of the much publicized variance of opinion between the Federal Reserve bank and the Treasury pertaining to the short-term rate.

The assurance, by Messrs. Truman, Snyder, and McCabe, that the par level for the 2½ percent bonds would be maintained, caused some abatement of selling pressure on long-term bonds. The expectation was quite general that the above assurance would be substantiated.

Unfortunately, announcement of the 2¾ percent bonds came at the height of the so-called disagreement and while normally this action would have been on the constructive side, it was interpreted as a poor compromise and caused considerable apprehensive selling by all institutional investors who had commitments in long-term bonds against nearby requirements for cash funds.

Herbert N. Repp (Discount Corp.)

The response of our customers to the various credit-policy and debt-management moves made by the Treasury and Federal Reserve System since the outbreak of the war in Korea was as follows:

(1) Institutions increased their selling of intermediate and long-term bonds for the most part to provide cash to meet commitments for the purchase of higher yielding investments. If the cash so realized was not needed immediately, short-term securities maturing at appropriate intervals were purchased. Selling tended to dry up as the market extended its decline because investors were faced with the necessity of taking substantial losses to realize funds to make new investments.

(2) Some commercial banks, to gain liquidity for the increasing demand for commercial loans, shortened their maturities. However, when the market declined to a level where substantial losses would result, this type of switching diminished.

(3) Corporations increased materially their buying of Treasury bills, certificates of indebtedness, and notes as higher yields on these short maturities became available.

Dominic W. Rich (D. W. Rich & Co., Inc.)

As the intention of the Federal Reserve Board to raise rates first became evident, investors of all classes shortened up or went to the side lines. When higher yields became available on certificates and bills, some important buying developed among nonbank investors especially. The longer notes which began to appear at the year end at first commanded considerable bank interest, but, as the clouds of disagreement deepened and the fear of counterinflationary measures grew, another shortening-up period occurred. The growing uncertainty concerning the price support of the long end of the list sharpened the anxiety of the long-term investors and stimulated the selling of the 2½'s "against the peg." With the announcement of the accord, selling soon subsided, due partly to the reluctance to take losses and partly to sharp improvement in yield. A comfortable feeling that the worst was over replaced the apprehension engendered by the long-continuing decline. In the short-term market the higher certificate rate prominently supported by the Open Market Committee in June took care of itself in July.

Girard L. Spencer (Salomon Bros. & Hutzler)

The general background is that both commercial banks and nonbank institutions had programs to sell Government securities. Such sales were accelerated by several moves of the monetary authorities.

These in chronological order were (1) the statement of the Federal Reserve Board in August 1950 that it would use all means at its disposal to restrain further expansion of bank credit; (2) the increase in reserve requirements announced in December 1950 to become effective early in 1951; (3) the strong and expressed opposition of several officials of the Federal Reserve System to the maintenance of the 2½-percent long-term rate and the fact that the Open Market Committee continued nevertheless to buy bonds above par; and (4) the announcement of the accord on future policy between the Treasury and the Federal Reserve System, coupled with the conversion offer made to the holders of the ineligible issues of 1972/67.

The offering of a 5-year 1¾-percent note as a refunding in November 1950, which the market assumed was approved by both groups of monetary authorities, and the statement by Secretary Snyder of the decision to maintain the 2½-percent rate in January 1951 temporarily slowed selling of all types of holders, but the need for funds to take up loan and mortgage commitments was basic, and general liquidation of Government issues soon was resumed.

It is probable that even as late as February 1951 relatively few investors anticipated the removal of par support for long 2½-percent Government issues. However, in view of their heavy commitments, the prospect of no early improvement in market prices for Treasury securities, and the open disagreement between the Treasury and the Federal Reserve System, many institutions decided that it was sound procedure to anticipate their future needs for funds by increasing their sales of long issues and holding the proceeds in very short maturities.

There has been less selling of long maturities since prices have fallen substantially below par. In the last several months most nonbank institutions have been able to finance outstanding commitments through other means, including sales of the short maturities acquired earlier.

Commercial banks in many instances have chosen to use the rediscount privilege rather than sell Governments when requiring additional reserves because of the advantages this procedure gives them by lessening their excess-profits-tax liability.

2. What has been the effect of the changes in credit policies since the outbreak of the war in Korea upon the preferences of your customers as between short-term, intermediate, and long-term United States securities? Distinguish between classes of customers.

All answers to this question agreed that the preferences of all classes of investors with the single exception of pension funds have shifted sharply toward shorter term securities since the outbreak of the war in Korea and especially since the accord. It is clear that until these preferences are changed it will be very difficult to sell any substantial amount of long-term United States securities.

Extracts from typical replies follow:

Francis D. Bartow (Bartow Leeds & Co.)

The effect of the changes in credit policies since the outbreak of the Korean war upon the preferences of our customers as between short- and long-term Government bonds points up the general desirability of the short issues. This has been particularly true of commercial banks, savings banks, and even life-insurance and fire and casualty companies. The various pension funds of the States and municipal governments appear to the best buyers of the long-term bonds in the months that have passed when the par level was broken.

M. G. Briggs (Briggs, Schaedle & Co., Inc.)

Almost without exception it has been the policy of all of our customers to get themselves into a more liquid position. This applies to insurance companies, savings banks, commercial banks, and others.

J. D. Gillespie (J. D. Gillespie & Son, Dallas, Tex.)

The result of the afore-mentioned change has resulted in practically killing the market for any except very short time paper, like bills or certificates of indebtedness. Furthermore, the savings-bond sales have been badly "crimped." While we urge small investors to buy all the savings bonds they can, we caution them not to except to carry them 10 years to maturity, but rather treat them as demand paper after 60 days.

John H. Grier (First National Bank of Chicago)

Again, it has been difficult to determine how much changes in credit policies since the outbreak of the war with Korea have had upon our customers and how much has been due to anxiety about the international and domestic situation and fear of further inflation. The demand since that time has been chiefly for short-term securities, and this is particularly true of our banking customers.

Alfred H. Hauser (Chemical Bank & Trust Co.)

Nearly all classes of investors now show a distinct preference for short-term issues. Commercial banks desire greater liquidity in their investments because of the increase which has taken place in the loan portfolio during the past year and because of uncertainty of the future trend of the market. Savings banks and insurance companies require liquidity in order to have funds readily available to take up future commitments in mortgages and private placements. Pension Funds put somewhat less emphasis on liquidity because of the fact that in most cases additional cash will be contributed to the fund and because the future commitments are smaller. Nevertheless, they have a relatively limited interest in long-term bonds.

Individual investors under present conditions have little interest in Government bonds of any kind.

A. H. Kiendl (Guaranty Trust Co.)

The changes in credit policies invoked since the outbreak of the Korean war have influenced our customers generally to manifest a preference for shorter-term securities. We have found that the lessened yield differential between shorts and longs has been the principal influence. As cited above, corporations have added substantially to their holdings of Treasury bills as a temporary investment for funds accumulated for tax purposes. Insurance companies and savings banks having mortgage and other commitments to meet have followed the practice of holding a larger-than-normal amount of short-term securities. On the other hand, we have found that, as prices declined, the banking system has been reluctant to liquidate intermediate- and longer-term bonds because of the losses involved in the sale. To a large extent this also has been true among the insurance companies and savings banks.

R. A. Love (Chas. E. Quincey & Co.)

The tendency of all classes of institutional customers, with the exception of certain pension funds, has been to prefer short-term United States Government securities. There is still great uncertainty as to the future trend of interest rates. Recently short-term issues have been in demand, whereas the long-term issues have been a drug on the market.

R. C. Morris (Bankers Trust Co.)

As yields increased, nonfinancial corporations have added to their holdings of short-term Government securities. These are now providing a reasonably good return on liquid funds which are being accumulated largely as a reserve for taxes. As mentioned above, institutional investors, particularly life-insurance companies, became more conscious of the desirability of liquidity when the failure of the Treasury refunding operations in August and September 1950 indicated that the heavy demand for funds inevitably would lead to higher interest rates. They stepped up their selling of long-term Treasury bonds and increased their holdings of short-term securities in order to prepare for the rising demand for long-term capital from other sources. While selling of long-term bonds continued after the March accord, it was largely confined to the need for funds for other investment commitments. Even though the decline in price was of moderate

proportions, the loss resulting from sales acted as an important deterrent to continued liquidation. Commercial banks generally have increased that portion of their Government holdings becoming due or callable within a year, reflecting the desire for greater flexibility in a period of rising demand for bank credit.

D. William O'Kolski (New York Hanseatic Corp.)

As the result of the authorities' credit policies, commercial banks, in general, proceeded to shorten the average maturity schedule of their Government portfolio and allowed a portion to run off. As the short-term rates moved up, it narrowed the differential between the short- and longer-term eligible bank bonds and resulted in the sales of the latter.

Savings banks and insurance companies sold their tap and other Governments to take up their commitments in mortgages and corporate bonds. In a number of instances they sold in anticipation of commitments and in the apprehension of what the authorities had in store for the market and eventualities.

As yields moved higher on short-term Governments, corporations, particularly those with large deposit balances, were enticed to place an increasing amount of their funds in these securities.

Emil J. Pattberg, Jr. (First Boston Corp.)

The major effect of changes in credit policies upon maturity preference since the outbreak of the Korean war has come since March 1951, when the support of Government bonds at par was discontinued. It has already been pointed out that financial institutions in general have become much less willing to sell Government bonds for the purpose of making other investments when such sales would involve substantial losses. This is true of commercial banks, as well as of insurance companies and savings banks to which most attention was directed in the preceding discussion. The realization that it might be impossible to sell medium or long term securities in the open market without taking losses has made commercial banks considerably more cautious about purchasing long-term securities. Therefore, banks have stressed liquidity and have purchased short term bonds, notes, certificates, and Treasury bills, rather than intermediate and long term bonds which might involve a risk.

At the same time, investors now realize they cannot hold long-term Governments without assuming all of the risks associated with long term investment. In particular, savings banks and insurance companies increased sharply their holdings of Treasury bills and short term securities. Thus, 319 life insurance companies held Governments due or callable within 1 year as of August 31, 1951, in the amount of $1,123,000,000. By adopting a policy of liquidity these institutions know that funds will be available without market risk as their short term securities mature. They also have assurance that, if liquidation is necessary before maturity, the active market in short-term Governments in all likelihood will enable them to sell substantial amounts of such securities at prices not too far from cost.

From the viewpoint of the Treasury, this situation currently limits the interest of savings banks and insurance companies in long term Governments. But when they finally take up the large volume of existing commitments, and again have a balance of new funds available for

investment, they may once more be interested in buying long-term Governments. To operate successfully, they will need to obtain a more liberal yield than is provided by short term maturities. At that time the Treasury will undoubtedly be able to make offerings of long-term securities.

Wm. E. Pollock (Wm. E. Pollock & Co., Inc.)

Buying in long term bonds was continued for a time by pension funds but diminished greatly by mid-February and has been rather a minor factor since. Other important investors, including some pension funds, restricted themselves almost entirely to the short-term category.

Herbert N. Repp (Discount Corp.)

The changes in credit policies since Korea have caused a marked preference for short-term maturities by nearly all classes of customers because of higher yields on shorter maturities and uncertainties in the longer market. Previously, many long-term securities were held by corporations and other investors against short-term commitments. With pegged prices this had been profitable.

Demand for intermediate Treasury securities diminished markedly because of the narrowing spread in yield, particularly after taxes, between short-term and intermediate issues. Few sellers choose to liquidate intermediate issues because of an unwillingness to realize losses. As a result, there has been little activity in this area of the market.

The principal types of customer which did not prefer short-term securities during this period were those pension and public funds which traditionally buy the best yielding long-term Governments available.

Girard L. Spencer (Salomon Bros. & Hutzler)

Except for public pension and other investment funds limited primarily to holding United States Government securities and needing the highest obtainable income immediately, practically all nonbank investors have preferred to limit their purchases of Government issues to the very short-term maturities. They have preferred to do so (1) because of their desire to avoid possible loss of principal, (2) because they have expected to hold the funds in Government securities for only a relatively short period, and (3) because they have assumed that official credit policies will result, for the time being at least, in further increases in long-term interest rates, and thus it would be to their advantage when possible to delay purchases of long maturities.

Commercial banks in general have also concentrated their holdings in short maturities. With loans continuing to expand they have seen little prospect of any official action which would ease money rates.

3. Do you believe that it was wise to abandon the par support of long-term Government bonds in March 1951? If not, would you have considered it wise at another time or under other conditions? When, or under what conditions? If you favored the abandonment, would you have preferred that it be done earlier? When?

While only one of the dealers replying believed in the par support of United States securities as a continuing procedure, the dealers as a class were highly critical of the timing and manner of its abandonment. A number made the point that, as a matter of sound procedure,

the abandonment should have taken place during a period of market strength rather than during one of market weakness. A number of earlier dates from 1946 to 1950 were named. Several also stated that the abondonment, following as it did closely upon statements to the contrary by the President and the Secretary of the Treasury, was highly confusing to the market (many persons had bought on the basis of these representations and were bitterly disappointed) and tended to lower the prestige of United States securities.

Extracts from typical replies follow:

Francis D. Bartow (Bartow Leeds & Co.)

In March 1951 when the par support of long-term Government bonds was abandoned our country was beset with very strong inflationary pressures. The inflation unfortunately, was fostered all along by the Open Market Committee purchases up to this month. If the support of Government bonds at par level were timed to take place at a much earlier date when the inflationary pressures were first detected, then, and at that time the support of the par level should have been abandoned.

Credit policy moves made by the Treasury and the Federal Reserve System since the end of World War II appear to be almost always too late when they are undertaken. Changes in credit policy take full effect only after a good deal of time has passed. It is difficult to correct the direction of our economy if it has progressed in that direction too far. But on the other hand it is surely possible to anticipate where we're going and take corrective steps through proper credit-policy moves before the wrong that must be corrected goes too far.

Thus in March 1951 par support was abandoned. The market should have been allowed to decline to par in the early autumn of 1950 with but a brief period of support. It then should have been allowed to settle in an orderly manner to whatever lower level it had to go below par. The Federal Reserve System it is believed, with proper anticipation could have maintained orderliness in the long-term Government bond market without making the great inflationary purchases that it ultimately did in the first 4 months of 1951.

J. D. Gillespie (J. D. Gillespie & Son, Dallas, Tex.)

I think that the abandonment of the support of the long bond market last March was a calamity of the worst order. It has undermined confidence in Government paper that it will take many years of intelligent management of the debt to bring back. It would never be wise to let the market go under par for obligations against which the Federal is issuing money at par.

John H. Grier (First National Bank of Chicago)

Yes. I would have favored the abandonment of pegged prices in 1948 or 1949.

Alfred H. Hauser (Chemical Bank & Trust Co.)

We believe it was wise to abandon par support in March of 1951. We feel that earlier action should have been taken when the peak financing of the Second War had passed and the Government enjoyed a fiscal surplus. Certainly such par support was inflationary and made more difficult the problem of controlling the upward spiral which was in evidence before July 1950.

A. H. Kiendl (*Guaranty Trust Co.*)

The abandonment of par support of long-term Government bonds in March 1951, in our opinion, was a constructive move. In the face of the rapidly rising inflationary pressures in the post-World War II era, we think flexibility in open-market policy should have been invoked at a much earlier date. In fact, we are generally opposed to a policy of supporting Government bond prices at any specific price level, under any conditions.

R. A. Love (*Chas. E. Quincey & Co.*)

In the early part of 1951, assurances had been given by the President and the Secretary of the Treasury that par support of long-term bonds would be maintained. It was unfortunate that such support should have been abandoned so soon after such assurances. With a debt of such magnitude, confidence in the stability of the market and of the economy as a whole is of great importance. It still remains to be seen to what extent confidence has been impaired.

It is my opinion that there should be no guarantee of par support of long-term Government bonds. They are a commodity which should be permitted to fluctuate in price as conditions change just the same as other commodities do. In retrospect, I believe announcement of the abandonment of par support should have been made in the fall of 1949, when prices of long-term bonds were appreciating in price and selling at a considerable premium. The Federal Reserve System at that time was selling bonds from its portfolio. Had this announcement been made then, it is doubtful that insurance companies and savings banks subsequently would have made such large forward commitments, which could be carried out only by the selling of long-term Government bonds.

Regulation X was imposed after such an interval of discussion that its effect was lost for a considerable period of time, by reason of forward commitments having been made in the belief that par support of long-term Government bonds would be maintained.

R. C. Morris (*Bankers Trust Co.*)

It is our opinion that it was wise and necessary to abandon fixed price supports for long-term Government bonds in March 1951. It is our belief that the withdrawal of support should have come at least 6 months sooner and perhaps as early as 1949. At that time there was substantial investment demand for long-term Government bonds, and a declaration of change of policy probably would not have had any serious adverse effect upon the price level. It is a fact that during the first half of 1950 the Federal Reserve banks were selling long-term bonds to reduce existing premiums and to effect a gradual pressure on bank reserves. After the outbreak of war in Korea, the whole economic situation changed abruptly. It was even more desirable to exercise the restraining influence on lending and investing activities which a decline in prices of Government bonds would have provided. Substantial buying by the Federal Reserve was necessary in any event to maintain an orderly market, but such purchases should have been made at declining prices as they were in March, April, and May 1951.

D. William O'Kolski (*New York Hanseatic Corp.*)

No. I do not believe it was wise to abandon par support in March 1951.

The high office of the President of the United States had been dragged into or entered the dispute of the Treasury versus the Federal Reserve System and had made its pronouncement. The President's office was flouted. It seemed an incredible event.

That par support should be abandoned was a necessary step, but it should have been done early in January 1951, when other messages to the Nation were presented (the annual message, budget message, the margin increases to brokers and banks, and the higher rates posted for prime commercial loans by banks).

Emil J. Pattberg, Jr. (First Boston Corp.)

The discussion of the previous questions has brought out the opinion that the abandonment of par support in March 1951 was a desirable policy. Conditions during the latter part of 1950 and 1951 demonstrated that the obligation to support the prices of Government securities at a fixed level was incompatible with the obligation of the System to exercise proper control of credit—its statutory obligation. Instead of being in a position to sell Government securities to tighten money and make credit less accessible, it found itself obliged to purchase substantial amounts of Government securities, sold to it at the will of the banks and others, with a complete reversal of the desired effect upon the money market. Moreover, this made access to additional credit at the option of the banks instead of the Federal Reserve System.

The only effective solution of this problem was a change of policy which would end the necessity of supporting the market for short and/or long Government obligations at a fixed level, and substitute a policy calling only for the maintenance of an orderly market at such fluctuating levels as would best serve the necessity of credit control at any moment.

It should be pointed out that a dual objective was accomplished when the long-term 2½-percent bonds were allowed to go below par. Not only have sellers been discouraged from selling by the losses they would have to take by selling at prices materially below cost, but also the Open Market Committee has been able to bring about a degree of uncertainty in the market level. Such uncertainty can only prevail when the level of the market is free to fluctuate and is not tied down to some fixed level of support. Fixed prices may have been important or necessary during the period of war financing, but they proved to be a serious handicap in the proper and effective functioning of credit restraint by the Federal Reserve System during an inflationary period.

In retrospect, it seems that it would have been better to have made the announcement that par support would no longer be rendered, at a time when the long-term Government market was at a higher level, and when some degree of institutional demand for long-term Governments was in evidence. However, in view of the heavy liquidation on balance of Government securities by insurance companies and savings banks in much of the postwar period, as more attractive investments in corporate bonds and mortgages became available, there were few times when the move could have been made without the danger that the market would promptly drop through the par level.

It is probable, however, that the System could not have reached an understanding with the Treasury permitting abandonment of par support until after the developments of 1949–51. It is probable that only the critical condition which appeared in the early part of 1951

could have brought all parties concerned to the realization that par support could no longer be rendered in the face of the inflationary conditions prevailing. The fact that so important a step was taken without demoralization of the market indicates it was not too late to act, even though it would have been preferable to have avoided the long period of support during 1948–51 in which so large a quantity of long-term bonds had to be absorbed by the Federal Reserve System.

Wm. E. Pollock (*Wm. E. Pollock & Co., Inc.*)

I was not in sympathy with the abandonment of par support in March 1951 but would have favored it at another time—either earlier or later—when the Government would not be operating under an emergency spending program.

Herbert N. Repp (*Discount Corp.*)

We believe that it was a wise policy to abandon the par support of long-term Government bonds in March 1951. The support program of late 1947 and early 1948 was perhaps defensible on the ground that many of the bonds sold in the war-loan drives, and particularly in the Victory-bond drive of 1945, had not been purchased by ultimate investors. Too early withdrawal of support might have precipitated disorderly market conditions.

We believe the Federal Reserve Open Market Committee's statement of June 28, 1949, created a favorable background for the adoption of flexible markets through the abandonment of the theory of par support.

Dominic W. Rich (*D. W. Rich & Co.*)

Support or pegs are regrettable at all times as the instruments of market management. Whenever employed in emergencies they should be abandoned immediately the crisis passes. This would indicate the spring of 1946 as the optimum date for removing the wartime strait-jacket. If that period had been missed, a second opportunity would have been the summer of 1949. Whenever attempted, the "pulling of pegs" should have been accompanied by a clear statement by the authorities that the maintenance of orderly markets was a permanent part of debt management, later backed up by action when the need arose. The gradual lowering of pegs after quasi-refusals to make them stand up always aggravated the pressure to sell. Whereas a resolute willingness to take all offerings would have discouraged the trader for the decline and stiffened the backbone of the timid investment manager.

Girard L. Spencer (*Salomon Bros. & Hutzler*)

With the abandonment of par support of long Government bonds now an accomplished fact and accepted as such by the large holders of these issues, any discussion of the wisdom or timing of this action must necessarily be academic. It is as such that this answer is submitted.

Dropping of the "pegs" in March 1951 now appears to have been the almost inevitable result of a long series of miscalculations and mistakes made by all national fiscal, economic, and political authorities. They not only failed to adopt measures promptly to check mounting inflationary pressures in 1950, but in some instances they even added to them through various actions and regulations. Had the types of controls and the restrictive measures recommended al-

most immediately after the outbreak of the Korean war by many experienced economists and financiers (such as Mr. Bernard Baruch) been adopted, a great part of the inflation problem of the ensuing months could have been avoided. The method of putting regulation X into operation not only permitted huge forward construction undertakings but actually encouraged them. This caused an enormous demand for mortgage financing. The official forecasts of shortages impelled business as well as individuals to pyramid their buying and to borrow heavily. Corporations advanced their plans for plant and equipment additions and their borrowings for the same reasons. Government agencies added their part to the increases in the prices of raw materials by their method and haste in stock-piling strategic materials. The excess-profits tax made it most advantageous for many corporations to borrow rather than to use their own accumulated earnings to finance expansion of both plant and inventory.

Because of the widely publicized talk of future restrictions that might limit their ability to invest outside of Government securities, most institutions controlling the bulk of the community's liquid savings considered it sound policy to extend their forward loan and mortgage commitments far beyond their immediately anticipated receipts. Since nearly every policy statement and official action led them to believe that they would be able to dispose of their long Governments to take up these commitments as they came due, they felt quite safe in making them. In fact, in a good many cases they believed that once curbs on private purchases of goods and on building construction were enforced they would not only replace but also would, of necessity, increase their total holdings of long governments.

It is true that this selling added to the credit base and the supply of money which was inflationary. But, in comparison to other inflationary forces operating in the economy, sales of long governments by nonbank institutions to the Federal Reserve System were of relatively minor importance.

It was the open disagreement between the Treasury and the Federal Reserve Board over the policy of debt management—which policy disagreement became more and more acrimonious in the first 2 months of 1951—that brought on the heavy avalanche of selling of noneligible bonds to the Federal and finally resulted in the "accord" and the abandonment of par support in March. It is highly questionable whether this move was of great importance in restraining inflation. Sales by nonbank investors were of only minor consequence when compared with the huge expansion of commercial-bank credit.

The abandoning of par support in March 1951 caused a serious disruption of capital markets and major losses in all branches of the investment-security underwriting and distributing industry. It almost completely halted the sales of series F and G bonds and greatly slowed sales of series E bonds, particularly in denominations of $100 or more. It persuaded many individuals to shift savings into speculative securities, or property or goods, because of fear of further depreciation of the value of fixed-income securities, which, in fact, may have added to some small extent to inflation rather than the reverse.

Any value this move may have had in restraining inflation was more than offset by its generally disruptive and disturbing consequences.

The timing of the abandonment of par support was particularly unfortunate.

This leads directly to the question of whether it might have been wiser to have taken this step at another time, but it might be more logical to ask first whether the policy of par support ever should have been adopted at all. In 1947, when the Federal Reserve System and the Treasury first began to support the long-term Government market on a large scale, very few, if any, large holders of these issues had any thought that their holdings were not subject to the market changes which might occur with changes in basic interest rates. It was the action of the Federal Reserve in the fall of 1947, culminating in the statement of its intentions on December 24, that first gave holders of ineligible bonds the idea that a price of par or higher would thereafter be maintained for these issues. Whether or not this was the best policy from the point of view of the postwar economy can be persuasively debated on both sides. It cannot be decided at this time and perhaps cannot be answered for several years.

Assuming for the purpose of further discussion that the policy of support adopted in 1947 was correct, there was no reason why it could not and should not have been discontinued in the summer of 1949 and a direct and definite official announcement then made to that effect. At that time the great need for expansion of productive capacities was over and there was no longer a question of a need to supply great amounts of capital quickly to private industry. The monetary authorities had in fact decided that the best interests of the economy required an easing of money rates, and they started to move in that direction in June of that year. Had a definite statement to the effect that the Federal Reserve System would not support long Government bonds at any given level been included in the announcement that bonds would no longer be supplied to the market except in the interest of maintaining an orderly market, the problem which arose in 1950 well might never have arisen. It is highly probable that there would not have been the huge overextension of commitments by nonbank institutions if they had been made unquestionably aware that the policy of par support no longer existed. In the summer of 1949 the market for long-term Government bonds was at a substantial premium, and abandoning of the policy of par support would have had no unfavorable effects.

In conclusion, it should be added that, now that the policy of par support for long Government bonds has been abandoned, it should not be revived unless circumstances arise which make it imperative, and even then the policy should be adopted only on the basis that it is a temporary measure. This should be made clear to all investors.

4. To what extent is the demand for long-term United States Government and other high-grade, fixed-interest-bearing securities by nonbank investors influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

The answers to this question place primary emphasis upon differences in interest rates rather than upon their absolute level. Institutional investors, it was said, tend to keep more or less fully invested, irrespective of the level of rates or of rate differentials, but direct their

flow of funds into the channel—such as United States securities, State and municipal securities, corporate securities, or mortgages—which seems to be currently most attractive. This process is limited, however, by many yardsticks—largely traditional—of the proper proportion of each type of security in a well-balanced portfolio. When they expect higher long-term interest rates, many investors seek the security of short-term obligations, although this tendency is more marked among banks than among nonbank investors. When interest rates are low and the yields of corporate stocks are relatively attractive, many funds are diverted into equities. This process is accelerated if there is a current fear of inflation.

Extracts from typical replies follow:

Francis D. Bartow (Bartow Leeds & Co.)

There is thought to exist by many nonbank investors a yield differential between long-term Government bonds and high-grade corporate securities where at one time it is desirable to buy governments and where, on the other hand, it is desirable to buy corporates. This differential or "spread" is rarely defined in terms of an exact figure because, as the years pass, many of the factors change.

The demand for capital today, most people will admit, is exceedingly great, and thus a lender receives a higher return than he did when the demand was much less. To the extent that such a lender may put his own price on his money and contract to lend it at that price, so to that extent he will not be a buyer of governments. Thus today most nonbank lenders are not tempted by the yields on Treasury bonds to be buyers; in fact, in many instances they are sellers because of the current wide spread between these bonds and the yield return on their own investments.

It might be properly concluded that nonbank investors will continue to stay out of the Government-bond market as long as great demand for private capital exists. When this demand perceptibly lessens, these investors will turn again to the Government market.

M. G. Briggs (Briggs, Schaedle & Co., Inc., New York, N. Y.)

At the current level of interest rates, there is practically no demand for long-term United States Government bonds. This is due to the fact that there are so many other obligations available at better yields. If interest rates were expected to rise, investors would probably sell United States Government securities in order to buy higher-yielding other obligations. When interest rates are falling, it means that the long-term investor is in funds and he is unable to invest satisfactorily in other securities than Government bonds, so that his funds tend to flow into long-term United States Government securities under these conditions.

J. D. Gillespie (J. D. Gillespie & Son, Dallas, Tex.)

When a person buys a long-term bond or security, while he may expect to keep it to maturity, nevertheless he wants to know that if, later on, he desires to sell the security he can do so at no more than a reasonable loss, based on his appraisal of a free market. He is satisfied with the rate at the time he buys, or, rather, feels that it is the best he can get.

There is now no free market. The market is ultimately in the minds of the 12 men who form the Board of Governors of the Fed-

eral System and Open Market Committee. They are the market. They can do anything they want with it, without recourse to any authority.

Naturally, investors have some hope of making profits on long-term paper just as do owners of other kinds of property. Consequently, they are willing to risk their judgment on a money market, but they can't be expected to commit very far ahead when they have to be mind readers.

John H. Grier (First National Bank of Chicago)

The demand for long-term United States governments and other high-grade fixed-interest-bearing securities is influenced in part by the current level of interest rates and to some extent by the expectation of changes in the interest rates, but most importantly by the viewpoint of sellers and purchasers as to whether inflation is going to continue and the purchasing power of the dollar is going to be stabilized or continue to decline.

Alfred H. Hauser (Chemical Bank & Trust Co.)

The current level of interest rates is not the prime factor in determining the over-all demand for long-term bonds. Those institutions which require specified rate of return will favor Government bonds over other issues if the yield is equal to or in excess of such fixed specification. Expectations with regard to the future trend are of greater importance. This is borne out by the experience in the past, when we have seen a preference for long-term bonds even though the available yield was less than that on short-term investments. This can be explained only by the fact that investors expected the short-term rate to soften, in which event they might have lost the opportunity to acquire long-term issues at attractive levels.

One of the most important factors is the rate of saving. This, in turn, is influenced by the attitude of savers toward inflation. Confidence in the dollar is a determining factor in the volume of funds seeking investment in high-grade bonds. National income and tax rates influence the amount available for saving, but thrift habits are also important, for some saving will go on regardless of economic conditions. The availability, relative yield, and market performance of securities other than Governments have a bearing on the demand for Government obligations.

A. H. Kiendl (Guaranty Trust Co.)

(*a*) The demand for long-term governments and other high-grade fixed-income securities by nonbank investors naturally is influenced by the level of interest rates existing at any one time. For example, we believe that the increasing popularity of equity securities has been a natural corollary of the low-interest-rate pattern that has existed in the postwar period, and that the recent trend toward liberalization of regulations governing purchase of equities for trust accounts and insurance companies in many States has been heavily influenced by the unsatisfactory return available from high-grade fixed-income securities.

(*b*) Except for the expectation of imminent change in interest rates, we doubt that investment in fixed-income-bearing securities is very much influenced by the ordinary slight changes in rates. Prin-

cipal purchasers of long-term obligations—namely, insurance companies, savings banks, trust and pension funds—usually, as a matter of policy, remain fully invested. In addition, most of them have little leeway in their income requirements to go in and out of the long-term, market; and, as a matter of policy, available funds as they accumulate are invested in long-term high-grade, fixed-income securities. During periods of low interest rates, however, preference is developed for higher-yielding assets such as mortgages and lower-quality assets in order to maintain income requirements.

(*c*) Covered by (*b*).

R. A. Love (*Chas. E. Quincey & Co.*)

It is my belief that interest rates play an unimportant role in the control of credit. Interest rates have been steadily increasing in other countries of the world, particularly on long-term obligations; but the inflationary spiral continues. In the late 1920's increasing rates were not a deterrent to speculation or other price increases.

The statement was made by the Federal Reserve System that their intent is not to raise interest rates but to prevent the increase in the money supply by their reluctance to purchase Government bonds. When the increase in the money supply is greater than the amount of goods produced, the value of money is depreciated while the price of goods goes up. However, rather than refuse to purchase Government bonds, with the consequent ineffectual rise in interest rates, it seems to me that more study should be given to the problem of selective controls and the immobilization or reduction of the effective supply of money and credit. Regulations W and X, in my opinion, accomplished far more in checking inflation than did the Federal Reserve's reluctance to purchase Government bonds. Unfortunately, Congress limited the power of the Federal Reserve System to exercise these controls. As a result, installment credit began to increase, even though interest rates had gone up in the meantime.

Further study should be made regarding other selective controls, such as asset reserves, secondary reserves, etc.

R. C. Morris (*Bankers Trust Co.*)

(*a*) The demand for such securities depends in large measure on the flow of savings to the principal investing institutions. The higher rates available afford them more income for use in the promotion of savings. As to nonfinancial corporations, the higher short-term yields have undoubtedly induced them to increase their investment of idle funds.

(*b*) The outlook for a change in interest rates and in the level of interest rates is sometimes a factor in restraining or accelerating long-term investments. However, insurance companies and most other long-term investors cannot afford to postpone for long the investment of available funds in the hope of a higher return because of constant substantial cash accumulations, and the requirements to earn contractual rates of interest.

(*c*) Spreads in yields and tax factors cause investors to favor one class of securities or another. Treasury bonds must compete in the open market with high-grade corporate bonds, mortgages, State and municipal bonds, and other investments in order to preserve flexibility in credit and debt management.

Emil J. Pattberg, Jr. (*First Boston Corp.*)

Current yield levels of other high-grade investments lead investing institutions to prefer them instead of lower yielding Governments. The yield differential in favor of other investments, combined with the accumulation of prior commitments, has virtually eliminated insurance company and savings bank interest in long-term Governments.

It does not appear that expectation of an important change in interest rates is exerting an important influence upon the demand for long-term high-grade investments. Although noncommercial bank investors have purchased a larger than normal volume of Treasury bills and other short-term Governments, such purchases are probably in anticipation of commitments which will become payable during the next 6 to 12 months. Under the circumstances, it is unlikely that these investors would be net buyers of long-term Government bonds in the near future. Their interest in such securities is not likely to appear for some months to come, after present commitments have been retired, and if new funds are then beginning to accumulate in excess of relatively attractive outlets afforded by other investments. At that time, expectations regarding the interest rate outlook are likely to be a much more important factor in their attitude toward short-term versus long-term issues.

Herbert N. Repp (*Discount Corp.*)

Considering long-term United States Government and other high-grade, fixed-interest-bearing securities as a whole, we believe that the level of interest rates current at any one time has only a moderate bearing on the aggregate demand by nonbank investors.[1]

Some nonbank investors refrain from buying long-term securities when the expectation exists that a favorable change in interest rates will take place in a relatively short time. Some make commitments to anticipate future income when they feel that interest rates will be lower in the foreseeable future. The majority, however, in our opinion, invest at the current rate as their funds become available.

In the over-all demand by institutions, "other factors" such as the amount and flow of funds seeking investment and the availability of competing investments are an important influence.

Girard L. Spencer (*Salomon Bros. & Hutzler*)

The demand for long-term Government securities and other high-grade fixed-income-bearing issues by nonbank investors is not influenced by the current level of interest rates. It is influenced by expectations of changes. If it is anticipated that rates will rise, buying of longer maturities will be delayed and if the reverse is forecast, purchases will be accelerated and the investment of anticipated future accruals of funds often will be made.

One factor which influences the demand for these types of securities is the relationship of the income they produce to the operating requirements of the investing institution. When the income equals or exceeds the investors' requirements, the tendency is to place larger percentages of funds in Government bonds and other high-grade

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[1] Within the market, certainly, the level of interest rates, as expresssed by the yield spreads between various types of high-grade securities, does have an important effect on the preference of both institutional and individual investors for each type.

issues than when yields obtainable from them do not cover operating expenses.

5. What types of securities do you believe should be the principal vehicles of United States Government borrowing (*a*) under present conditions, (*b*) in the event of the necessity for substantial net Government borrowing? Discuss both marketable and nonmarketable securities.

Few dealers thought that it would be possible to sell substantial amounts of long-term securities in the immediate future, and said that, for the time being, all financing (except for continuing sales of savings bonds) would have to take place through the sale of short-term securities. For the longer pull and in the event of the necessity for substantial net Government borrowing (with the probable corollary that alternative channels of investment would be blocked off), the opinion was generally expressed that an effort should be made to sell as many long-term securities as possible to nonbank investors. The dealers expressed a natural—but not unanimous—preference for marketable securities. Opinion was divided on the desirability of offering (marketable) bank-restricted securities, as opposed to offering securities available for holding by all classes of investors. The opinion was also expressed by some dealers that the terms of series E savings bonds should be liberalized.

Extracts from typical replies follow:

Francis D. Bartow (Bartow Leeds & Co.)

Under present conditions it would be difficult to find any sizable amounts of long-term money for the Government to borrow.

If the Treasury had of necessity to borrow currently it would find only short-term funds available and only in the commercial banking system. Such borrowing, one hopes, is to be avoided if possible.

In the event of the necessity for substantial net Government borrowing at the present time, resort to the commercial banks would be required.

On the other hand, with the credit controls that our Government possesses and with careful execution of some of them, a tempering of the demand for private capital could be brought about. Thus, in a managed economy these funds could be made available for Government use.

In the event the Treasury borrowed such money from nonbank investors, we feel strongly that it should be done with marketable securities. Such bonds should be ineligible for commercial bank ownership prior to 5 years before the call date, or if a fixed maturity, then prior to 5 years before such date.

If such a security were to be issued as a perpetual bond with no maturity, ownership by commercial banks should be expressly denied without qualification.

As to the whole question of marketable and nonmarketable securities, we have found the average professional investor prefers the former outspokenly. It is with reluctance that he buys the nonmarketable issues, and he likes to refer to such purchases as "taken" amounts. He feels that the nonmarketable Government bonds that might be tempting to buy should be priced in the category of an investment

"bargain." If he found that such yielded him a compelling rate over a comparable marketable bond, he might well become at times a vigorous buyer.

Thus a factor to consider in this question is the cost of borrowing; a nonmarketable Government bond might be a more costly security to sell in the required volume than a marketable bond. The flow of capital in its seeking of employment is aided by the quick negotiability of a marketable instrument; to a degree a nonmarketable instrument does not contribute to the easy flow of capital.

There are many forceful reasons which advocate the marketable type of investment security as against the nonmarketable one. The history of finance in this country shows that investors acting on their own free will preferred the free instrument and the marketable one. The step that our Government takes when it borrows and gives the lender its promise to pay that cannot be thrown on the market for sale is a sad commentary on our illustrious history.

J. D. Gillespie (*J. D. Gillespie & Son, Dallas, Tex.*)

The present various types of Goverenment issues are all right, except Treasury bills which should bear interest from date like other paper. The Government financing was going along smoothly until the Federal and Treasury got into the inevitable differences which always occurs when two bosses try to run one job.

I see no special merit in nonmarketable paper, when it is virtually payable on demand.

I think all paper except savings bonds should be marketable.

John H. Grier (*First National Bank of Chicago*)

To me (*a*) and (*b*) seem identical, since it is apparent at the present time that the Government will have to borrow substantial amounts of new money. The refunding of bonds held by the banks should be accomplished primarily by short-term obligations. New money and the refinancing of bonds held by insurance companies, etc., should be financed by long-term marketable obligations not eligible for bank investment even if these required a 2¾ or 3 percent rate.

Alfred H. Hauser (*Chemical Bank & Trust Co.*)

Long-term bonds cannot be sold to investors in large volume until measures are taken to restore confidence in the purchasing power of the dollar. It is highly desirable that the Government avoid borrowing from banks because of the resulting increase in the money supply. Under existing conditions, however, it appears that the Government will have to resort to borrowing from banks, except to the extent that it can sell short-term securities to those corporations who are accumulating funds for the payment of taxes in 1952. Consequently, any new offerings would be confined to short-term issue. In the event of the necessity for substantial Government borrowing, it would be important to design offerings for nonbank investors. These should be of long maturity. Their sale would be facilitated by cutting off other, competing outlets for institutional investment. "In the event of necessity for borrowing" carries the implication that economies on the one hand, and maximum taxes on the other, have been accomplished. In order to sell any large volume of debt to nonbank investors, it would be necessary for the Government to demonstrate its sincere effort to economize.

A. H. Kiendl (Guaranty Trust Co.)

(*a*) In our opinion, it is always desirable to place as many United States Government securities as possible outside the banking system. That objective is particularly desirable under present day heavy inflationary conditions and would be even more so in the event of the necessity for substantial net Government borrowing. Securities, primarily, should be designed to attract the large accumulation of funds in the hands of individuals and to encourage institutional investors to commit a larger portion of their funds to long-term Government securities.

Further, build-up of the already heavy short-term debt, in our opinion, should be avoided and, even to the extent that it is necessary to borrow through the banking system, an effort should be made to extend the maturities of the borrowings.

Our experience indicates that there is very little further appetite for nonmarketable securities. We consider it to be in the best interests of the Treasury and Federal Reserve Board to have a broad and active market in United States Government securities and that this objective tends to be defeated by diverting part of the debt to nonmarketable form.

(*b*) Covered by (*a*).

Aubrey G. Lanston (Aubrey G. Lanston & Co., Inc.)

Nonmarketable securities are undesirable media for Treasury financing except where these are designed for individuals, and are made available subject to relatively small maximum-purchase limitations.

A nonmarketable security must be offered on terms that will compare favorably with an existing background of interest rates, both as to level and trend. If the trend of rates is upward when the terms of a nonmarketable offering are set, these must be sufficiently favorable to discount the prospectively more favorable yields of marketable securities.

If existing rates are stable or the trend is toward lower rates, the nonmarketable security still must be favorable to the time the terms are set. These tend to become unnecessarily generous as market rates move lower.

The present types of nonmarketable securities, once offered, tend to cause them to be held in increasing amounts during periods of business depression, and in decreasing amounts during periods of boom. This is exactly the antithesis of the objective toward which debt management should aim. During periods of depression the need is to increase plant and equipment expansion, and consumer purchases. Thus, it becomes desirable to induce institutions and individuals to divest themselves of idle cash and "dead horse" securities, such as Treasury obligations. During periods of boom or prosperity, it becomes desirable to curtail or stabilize plant and equipment expansion and consumer purchases. Increased accumulations of cash and Treasury securities, by individuals and institutions, should be the aim of debt management.

During boom periods, the tendency within the economy is to over-expand plant and equipment and to spend rather than to save. In such periods the interest rate mechanism, if adequately used, is a persuasive influence that operates in the right direction. The adequacy of its use is important. It becomes necessary for rates to rise to such a punitive level, that in combination with other factors they will de-

crease substantial amounts of marginal business investment, and to become relatively so attractive as to encourage maximum investments in fixed income obligations, particularly Treasury securities, by individuals, financial institutions, and businesses.

Nonmarketable securities are also too inflexible to suit our needs. This is clearly demonstrated in the lack of changes in the terms offered by the savings bonds of various series. If, in periods of inflation, we endeavor to make such securities more attractive by increasing the rates of return offered by them, it would become more or less impossible to induce the investor to part with his holdings should business become recessionary or deeply depressed.

We believe, therefore, that nonmarketable securities should be discontinued except for individuals, that is, except for a modified series E type of bond, and these should be subject to small maximum-purchase limitations.

We suggest that the following provisions be incorporated in this type of bond. The maximum limitation for purchases might remain at $10,000 per annum. A guaranteed minimum interest rate should be provided, probably not to exceed 2 percent. Changing rates of interest would be paid on both current income and appreciation bonds and would be determined by fluctuations in the yields available on long-term Treasury bonds.

During the spring of 1949 such a bond might have paid interest at a rate of 2¾ percent, compared with the guaranteed minimum of 2 percent. In the spring of 1950, the applicable rate might have been 3 percent. Today, it might be 3½ percent. It would follow the trend of general market rates, which should be high in periods of inflation and low in periods of recession.

Restricted bonds, ones that cannot be generally purchased by commercial banks, are undesirable and should be discontinued. They serve to compartmentalize Treasury debt and to interfere with the fluidity of the market. If nonbank investors are net sellers on balance, commercial banks cannot acquire these bonds. Consequently, Federal Reserve or Treasury purchases are frequently necessary to the maintenance of orderly market conditions.

On occasions, nonbank institutions have been buyers of long-term Treasury bonds when commercial banks have been sellers. If other investor classes held the same kinds of bonds, commercial bank sales would flow to other nonbank investors.

In a period such as the present when the Government faces substantial net Government borrowing, its offerings should be confined to (*a*) a savings bond of the type described above, and (*b*) to issues of whatever type will meet the preferences of investors who have substantial amounts available for investment in this residual type of security. At the moment, this is confined to shortest-term securities.

Our suggestions are best developed by assuming the necessity to finance a Treasury deficit of $50 billion. In such event, the Government is bound to add to the spendable income of the country in excess of the availability of goods and services. Such a sum is also bound to be in excess of the investment demand that may be induced from other than banks. Therefore, the Government is bound to increase the supply of money. To insure that such an increase will be held to a minimum, it should widen the difference between money and

Treasury securities to the maximum, that is, it should use a high interest rate. It would be best to err, in the first instance, by making the rate too high rather than too low.

Further, since the difference between money and Treasury securities lies in the interest paid on the latter, it becomes relatively unimportant during such deficit financing, whether the securities offered are of short- or long-term character. In fact, during subsequent periods, when a divestment of Treasury securities may be expected, the problems would be decreased if the deficit were to have been financed largely, in the initial instance, by short-term securities.

Intermediate- and long-term bonds should be sold during the deficit period only as a bona fide investment demand appears. New offerings of such bonds should be made at a discount rather than at 100, but their yields should be commensurate with those existing in the market.

Obviously, if the Government is forced to incur large deficits of this order, long-run inflation can be avoided only as the Government later provides the Treasury with substantial cash surpluses.

At the present time, the lowest short-term rate that might conform to such a program, and to the potential inflation in the economy, might be 2½ or 3 percent for securities of 1-year term, with whatever yields this would bring about in the longer-term areas.

It obviously would be necessary to make some provisions to the effect that financial institutions could carry good-grade holdings of fixed income securities at amortized cost, and where necessary borrowings could be effected at these appraised values.

Such resort to the use of the interest rate mechanism would materially increase the cost of interest on the Treasury's debt, but it might preclude further increases in the costs of goods and services that the Government must purchase. The existence, during inflationary or large deficit financing periods, of high costs on borrowings, and of an increasing short-term debt might aid those in Government who believe in sound fiscal policy.

R. A. Love (Charles E. Quincey & Co.)

At present the type of borrowing must of necessity consist of short-term obligations. Insurance companies and savings banks have yet to complete their forward commitments. The new tax bill is being studied carefully to determine whether or not it will be more advantageous to purchase tax-exempt securities when funds are available. With the steady decrease in the purchasing power of the dollar, the individual seems more loath to buy long-term Government bonds. When funds are available the financing should consist of competitive long-term marketable bonds ineligible for purchase by commercial banks.

R. C. Morris (Bankers Trust Co.)

(*a*) An ample supply of short-term marketable securities is appropriate to provide for the Treasury's current cash needs and refunding operations. This would meet the present demand for this type of security on the part of corporations, banks, and other financial institutions. The terms of the new issues should be such, however, as to attract nonbank funds as much as possible in order to minimize the increase in the money supply in the presence of inflationary conditions.

(*b*) The types and terms of securities should be fixed in relation to general economic conditions. If these are of an inflationary nature, nonbank borrowing to the extent possible would be advisable. If the trend is deflationary, securities designed primarily for commercial bank ownership, leading to an increased money supply, would be appropriate.

Offerings of nonmarketable securities should be confined to savings bonds of the E, F, and G types, but present terms should be improved by means of higher interest rates and/or special tax advantages in order to increase their appeal. Such offerings should be made only to individuals and other small investors.

Marketable securities for all large investors are preferable to nonmarketables. They insure investment flexibility and reserve the initiative in credit and debt management to the monetary authorities. The fixed redemption scales and conversion features of outstanding nonmarketable bonds leave this initiative largely with the holders.

D. William O'Kolski (*New York Hanseatic Corp.*)

The current vehicles of United States Government borrowing are satisfactory for the present but postpone the offering of a suitable security to the nonbank class. If it is agreed that this class must be induced to invest and finance the Government deficit and not the banks, then one elementary way would be to offer a more attractive coupon for a suitable maturity.

When one thinks of the amount and extent of the inflation talk via our Government officials (the President, the Director of Defense Mobilization and his assistants, Eric Johnston and DiSalle), the Government's price policies on various commodities; plus radio, newspaper, and magazine stories; the decreasing purchasing power of our dollar and the future outlook, it is surprising to note that any savings are made in E bonds, savings banks, and insurance companies, especially when it can easily be noted that the difference in return to the investor between the fixed interest security and that of the dividend on our top quality equity securities is about doubled by investment in the latter. Of course, Government bonds and top-notch stocks are not the same in many ways and quality, but there is the problem of the diminishing annual return on one's savings.

Marketable and nonmarketable securities each have their place in our investor classes.

The marketable security appeals to what may be termed the professional investor class, savings bank, insurance companies, some pension and State funds. They feel that they can move about and in and out of them, arbitrage and use their specialized knowledge to increase the return of their Government investments. In addition, they probably feel less restraint by having marketable securities in their portfolio. They can also act with less delay as more attractive (interest-wise) corporate bonds and suitable mortgages present swapping opportunities. The latter type of fixed interest securities present quite a lure as the spread in coupons widens in its favor.

The nonmarketable security by now is fairly well known and appreciated by the individual investor, who knows at all times just how much money can be had by redeeming his security—a higher interest rate on the equivalent of an E savings bond, properly explained, should induce considerable additional investment in this type of se-

curity. Perhaps a pension bond with (fixed) monthly payment payable to the investor to be coupled with or added to one's social security benefit. Why not a very special tax benefit to accrue to the owner if held through to its scheduled maturity.

In the event of substantial net Government borrowing, a choice would be either to up the coupon to try to induce the nonbank investor, particularly the individual, to put current and additional future savings in Governments—a disinflationary form of investment.

According to present reports, insurance companies and savings banks have no large amount of funds available seeking employment. Such totals as are now available have been committed to the higher interest bearing corporation bonds, mortgages, and special deals. The insurance companies have already done a considerable amount of this kind of business.

This apparently leaves it up to the commercial banks to furnish the funds to cover the deficit. This will add to the inflationary forces but could be offset in part by various controls currently available for use by the Government to be imposed on the banks (Trading With Enemy Act).

If thought necessary and the Congress approved, other controls could be enacted, such as a special Government deposit and corresponding special Government securities to cover same, limiting the amount of the loans a bank may make in a ratio to the amount outstanding as of a certain date.

In the event of substantial net Government borrowing, a choice would be either—

(1) To up the coupon and try to induce the nonbank investor, particularly the individual, to put his present and additional savings in this form, an anti-inflationary security.

(2) Because there are no large amounts of funds in insurance companies and savings banks at present and whatever is available has been committed already to corporation bonds, mortgages, and special deals, it resolves itself to look to the commercial bank for this financing. This adds to inflation. This could be offset by controls on the commercial banks (Trading With Enemy Act or new regulations to be passed by our Congress).

Emil J. Pattberg, Jr. (First Boston Corp.)

We would expect that the Treasury will have to adapt the type of securities offered to the supply of funds available in the hands of investing institutions. Under present conditions, it would appear likely that the amount of cash financing required by the end of the fiscal year has been quite well completed (allowing for the offering of $1.25 billion long-term Treasury bills offered in November). It would seem that the choice of Treasury bills payable on tax dates was well attuned to the needs of the market, and to the fact that insurance companies and savings banks appear to have available no important amount of investable funds. If it should develop that the Treasury has a substantial cash surplus during the first half of the calendar year 1952, it would be easy for the Treasury to retire some of this newly created debt on the tax dates, or on the maturity of other bill issues.

If substantial net Government borrowing proves necessary at a later date, the Treasury will again be influenced by the type of funds

accumulated. Every effort should be made by the Treasury to curtail short-term debt and to offer longer-term securities to the extent that funds are available. For the balance of funds required, the Treasury would have to have recourse to sales of short-term securities.

In either event we believe that marketable securities should be offered. Marketable securities are preferred by institutional investors and may therefore be placed at a lower interest to the Treasury. At the same time, they provide the Open Market Committee with a greater degree of qualitative and quantitative control.

In addition, it is dangerous for the Treasury to insulate itself from the realism that the test of the market imposes. From this point of view, we believe that the Treasury should choose marketable obligations as the medium for financing in all operations, and that it should discontinue the issuance of nonmarketable securities except for the encouragement of savings by individuals through series E savings bonds.

The division of the market between eligible and noneligible Government securities has had an undesirable effect upon the breadth of the market. There is no longer any reason for a distinction between these two classes of securities. Open-market operations in the past would have been greatly facilitated if it had not existed. It is of major importance that the Federal Reserve System and the Treasury should have a broad and active open market. It is impossible to have this to a maximum degree unless all available financial resources are available to all segments of the market.

In the past, when the savings banks and insurance companies were net sellers of long-term securities, it would have been desirable to have permitted commercial banks to absorb these securities instead of the Federal Reserve System. The System then would have had additional control over credit expansion, as commercial bank portfolios would have been more sensitive to upward changes in interest rates. Banks would have been less willing to sell Government securities at a loss in order to make more attractive investments or loans.

Wm. E. Pollock (Wm. E. Pollock & Co., Inc.)

Under present emergency conditions and in this phase of substantial Government borrowing, I favor, most emphatically, short-term obligations only. When circumstances permit a reduction in governmental expenditures, I should favor a resumption of financing with medium and long-term bonds.

Other than savings bonds, such as the present series E, F, and G, I should favor the issuance of marketable securities only. Furthermore, such marketable securities should be eligible for purchase by all investors, including commercial banks. The present "bank ineligible" bonds, issued in the financial urgency of World War II, since have proved difficult to handle in our markets, whether in a rising or declining trend. They have required more attention by the Federal Reserve Board and the Treasury than the rest of the Government debt. Competing with corporate securities they have added to investment problems.

I believe strongly, that if ultimately there would be only one type of Government security, refinancing would be done at more advantageous rates, resulting in lower debt service costs. In addition, supervision of the entire Government market by the Federal Reserve Board would be simplified greatly.

Herbert N. Repp (Discount Corp.)

We believe that under present conditions the general objective of United States Treasury borrowing should be to offer securities attractive to nonbank investors and to use the banking system only as a residual buyer. There seems little prospect of early substantial demand for medium or long-term Government securities. For the time being the borrowing must be in the relatively short-term area that will attract primarily the funds of corporate investors.

The circumstances which would attend the necessity for substantial net Government borrowing would in all probability reduce the volume of offerings of competitive securities. Institutional and other investment funds, thus released, should be channeled into intermediate and long-term Government securities.

We believe it is better fiscal policy to offer marketable securities because:

(1) It is in the best interests of a free economy to preserve marketability. Federal Reserve open market operations to expand or contract the volume of credit can be effected only through marketable securities. Further, we believe that it is in the best interests of the economy for the Federal Reserve System to follow a policy of flexibility in its open-market operations. With this basic premise of flexibility, marketable securities cannot be sold at pegged prices, and any value to the authorities that nonmarketable securities formerly may have had, has now disappeared.

(2) It is in the best interests of the Treasury Department to preserve free markets through the issuance of marketable securities for other than individual investors.[1] The salient reasons for this are:

(*a*) Marketable securities give permanency to the Treasury's financing operations because it is through the issuance of marketable securities that its debt structure can best be approached from the point of view of long-range planning. The right to present for payment or to convert to a shorter issue at the holder's option places the initiative for determining the Treasury's maturity schedule with investors rather than with the Treasury.

(*b*) Marketable issues provide a barometer at all times which is an important asset to the Treasury in pointing up values and in the proper pricing of offerings. Nonmarketable issues do not. To compartmentalize the debt further into marketable and nonmarketable issues would destroy this index of the market by establishing scarcity values for free issues.

(*c*) Marketable securities, we believe, save the Treasury interest costs in debt service. Our experience has shown that institutional investors will take nonmarketable securities only at yields higher than those obtainable in the open market and even then only to a limited extent.

(*d*) Marketable securities can be used by the Treasury's trust accounts to supplement credit policies of the Federal Reserve Board.

(3) In addition, these further considerations bear important weight in favoring marketable securities:

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[1] Nonmarketability is an acceptable feature of savings bonds designed for individuals because small investors should not bear the brunt of credit and debt management moves made to counter economic trends.

(*a*) The market for long-term bonds should be developed in its broadest sense so that financing outside of the banking system will attract the greatest number of investors. We firmly believe that nonmarketable securities limit the development of this demand.

(*b*) United States Government securities, being the top credit of the country, should stand on their own and successfully compete with all other forms of investment. The issuance of nonmarketable securities, either redeemable at varying prices or exchangeable into other issues, implies that this prime credit cannot stand the interplay of forces in a free market and must be insulated to protect it.

Dominic W. Rich (D. W. Rich & Co., Inc.)

Under present conditions, i. e., a balanced budget to 5 billion in the red, cash can probably be most efficiently provided through the money market via discount bills and certificates of indebtedness. So long as the present nonbank demand absorbs these offerings small objection can be made to this flexible and cheap method of covering current cash needs. When larger needs arise the longer bond market should be approached. As a starter another nonmarketable 2¾ percent with note convertibility might be tried for the big money to be followed by a popular all-purpose bond, timed and couponed to appeal to the general public. Of this, insurance companies and savings banks might be allowed limited amounts. Commercial banks must find their sustenance in the 1-year market sweetened by the various outstanding issues as they become eligible.

Girard L. Spencer (Salomon Bros. & Hutzler)

(A) Under present conditions United States Government borrowings should be restricted to offerings of short maturities. To minimize the possible inflationary effects of deficit financing, the Treasury should borrow to the greatest degree possible from nonbank sources. At the present time this can best be done by sales to nonfinancial corporations. Only short maturities can be sold to them as they have only current funds to invest.

(B) Should substantial net borrowing become necessary, every effort should be made to obtain funds from all available nonbank sources, both individual and corporate. This will require the adoption of methods to encourage voluntarily or to force the savings in liquid form of a large percentage of the national personal income. This can be done either by restricting the goods available for consumer purchases or by offering to both individuals and nonbank corporate investors securities sufficiently attractive to attract additional savings to Government bonds. A combination of both might be desirable.

In the case of institutional investors the maximum response would be achieved by making offerings to them carrying a rate of return that will cover their over-all costs of operation.

Except for investment by individuals, where nonnegotiability is a protection and fixed redemption features are of real value, nonmarketable bonds no longer have any advantage when compared with marketable issues. The principal argument in favor of nonmarketable bonds in past years was that large investors would not redeem them at a discount in substantial amounts and that this would make the task of supporting long-term Government bonds easier for the

Federal Reserve System. Therefore, the increase in the credit base resulting from Federal Reserve purchases of bonds from nonbank investors would be lessened; and if on the other hand nonmarketable issues were redeemed it would make no difference whether the Treasury or the Federal Reserve supplied the funds. This, the principal argument in favor of nonmarketable bonds, or as they might better be described, "redeemable" bonds, may have had some validity before the par support for long-term marketable bonds was abandoned. It no longer has.

On the other hand, reasons for favoring a marketable bond are still valid. The holder does not have the privilege of turning in his bonds at any time at his option, which if he did, would certainly be when it would be most inopportune and most costly to the Treasury. In the case of marketable bonds, there is no obligation, actual or implied, that the monetary managers must support the market at any level, nor any obligation on the part of the Treasury to repurchase the bonds before maturity. Support at any given level for long Governments is no longer official policy.

Marketable bonds help provide the monetary authorities with flexibility in expanding as well as contracting the credit base when and if either action seems proper. They permit the Treasury to finance at changed levels of interest rates without concern that it will be required to redeem outstanding obligations if the general level of interest rates advances to the point where it might be advantageous to the holder to cash in nonmarketable bonds. Market quotations furnish a yardstick by which not only the investor but also the Treasury can judge the proper coupon rate for its offerings and the supply of long-term funds seeking investment. Traditionally, the American investor prefers marketable securities and is normally willing to accept the risks of loss as well as the chances of profit arising from market fluctuations.

If and when it is necessary or desirable for the Treasury to finance in the long-term market, it will get a larger and more willing reception from institutional investors with offerings of marketable bonds. With the elimination of the most potent argument for nonmarketable bonds which occurred when par support was abandoned, practically every factor indicates that marketable issues will better serve the purposes both of the Treasury and of almost all large nonbank investors. If substantial borrowing is to be done and the funds are to be raised to the greatest extent possible from nonbank sources, marketable issues of suitable maturity are the best medium.

APPENDIX TO CHAPTER XIII

Questions Addressed to Government Security Dealers

1. What, in general terms, has been the response of your customers (in terms of buying, selling, and holding United States securities) to the various credit policy and debt management moves made by the Treasury and the Federal Reserve System since the outbreak of the war in Korea? Distinguish, if you desire, between successive phases.

2. What has been the effect of the changes in credit policies since the outbreak of the war in Korea upon the preferences of your cus-

tomers as between short-term, intermediate, and long-term United States securities? Distinguish between classes of customers.

3. Do you believe that it was wise to abandon the par support of long-term Government bonds in March 1951? If not, would you have considered it wise at another time or under other conditions? When, or under what conditions? If you favored the abandonment, would you have preferred that it be done earlier? When?

4. To what extent is the demand for long-term United States Government and other high-grade, fixed-interest-bearing securities by nonbank investors influenced by (*a*) the current level of interest rates, (*b*) expectations with respect to changes in interest rates, (*c*) other factors?

5. What types of securities do you believe should be the principal vehicles of United States Government borrowing (*a*) under present conditions, (*b*) in the event of the necessity for substantial net Government borrowing? Discuss both marketable and nonmarketable securities.

The above questionnaire was sent to 20 Government security dealers. Replies were received from the following 16:

Bankers Trust Co., New York City, R. C. Morris
Bartow Leeds & Co., New York City, Francis D. Bartow
Briggs, Schaedle & Co., Inc., New York City, M. G. Briggs
Chemical Bank & Trust Co., New York City, Alfred H. Hauser
Discount Corp., New York City, Herbert N. Repp
First Boston Corp., New York City, Emil J. Pattberg, Jr.
First National Bank of Chicago, Chicago, Ill., John H. Grier
Harvey Fisk & Sons, New York City, Ralph W. Proctor
J. D. Gillespie & Son, Dallas, Tex., J. D. Gillespie
Guaranty Trust Co., New York City, A. H. Kiendl
Aubrey G. Lanston & Co., Inc., New York City, Aubrey G. Lanston
New York Hanseatic Corp., New York City, D. William O'Kolski
Wm. E. Pollock & Co., Inc., New York City, Wm. E. Pollock
Chas. E. Quincey & Co., New York City, R. A. Love
D. W. Rich & Co., Inc., New York City, Dominic W. Rich
Salomon Bros. & Hutzler, New York City, Girard L. Spencer

CHAPTER XIV

STATEMENT BY CONFERENCE OF UNIVERSITY ECONOMISTS SPONSORED BY THE NATIONAL PLANNING ASSOCIATION

The following statement entitled "Monetary Policy to Combat Inflation," prepared by a Conference of University Economists called by the National Planning Association at Princeton, New Jersey, October 12–14, 1951, was released to the press on January 21, 1952. It was submitted to the Subcommittee for its consideration and is here reprinted for the convenience of members of the Subcommittee and of the public generally. The "Foreword" by Mr. Sonne accompanied the original release by the National Planning Association.

MONETARY POLICY TO COMBAT INFLATION

FOREWORD

In 1949, the Congressional Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report requested the National Planning Association to call a meeting of prominent university economists to discuss fiscal and monetary policies and to develop an area of agreement on these important subjects. The conference decided to limit discussion at that time to fiscal policy and to take up monetary policy at a later date. The report of the economists on fiscal policy was presented to the Subcommittee on September 23, 1949, by two of the economists, Dr. Simeon Leland and Dr. Arthur Smithies, and by me.

Because of the current importance of effective monetary policies in checking inflation, NPA was urged by representatives of the university economists to call the second meeting in 1951 to consider what should be the basic elements of our monetary policy and how control of these policies should be exercised. The group assembling in October consisted of most of the economists attending the first meeting and, in addition, a number specializing in monetary policy. An effort was made to bring together those representing the major schools of economic opinion.

In securing agreement on such a complex and controversial subject by economists of divergent points of view, it has been necessary to limit the statement to broad principles. However, in cases where different points of view cannot be reconciled, NPA encourages the insertion of dissenting opinions in signed footnotes. Footnotes by some of the participating economists appear at the end of this statement.

It should be noted that in publishing the opinions of the economists signing this statement, NPA does not imply endorsement of these recommendations by the NPA Board of Trustees nor by NPA Committees. I have joined the other economists in signing the statement because I consider it a worthy document.

H. Christian Sonne,
Chairman, NPA Board of Trustees.

MONETARY POLICY TO COMBAT INFLATION

The program for strengthening America's defenses creates a serious danger of inflation which may be with us intermittently or continuously for some years. It is essential that we deal with this inflation problem more effectively than in recent years and in ways that will promote healthy growth of the econ-

omy. This will require a coordinated program of general financial measures adequate to prevent a significant excess of the total monetary demand for goods and services over the total supply, at stable prices. Such a program should include:

Adequate taxation
Economy in government expenditures
Effective control of credit
Proper handling of the government debt
Encouragement of private savings

In addition, there is general agreement among the members of this conference that the government should have power to allocate scarce materials. Most of us also believe that under some circumstances the prevention of inflation requires certain direct controls over wages and prices—either selective or comprehensive; a few of us believe that such controls are unnecessary. We all agree, however, that price and wage controls are, at best, a necessary evil and that a program to prevent inflation, whatever direct controls it may contain, will succeed only if it includes fiscal and monetary measures adequate to eliminate excess monetary demand.

Excess monetary demand can be reduced by taxation that reduces spending power; it can also be reduced by monetary measures that increase the cost or reduce the availability of credit and limit the supply of money. The more we tax, the less we need to rely on stringent monetary policy; the more stringent our monetary policy, the less taxation will be needed to prevent inflation. For example, a government surplus with an easy money policy or a government deficit with a tight money policy might each have the same effect on total inflationary pressure.

While inflation is not the only situation with which monetary policy may have to deal, the present statement deals neither with problems of deflation nor with those of all-out war, but concentrates on the use of monetary policy to meet an inflationary situation during the present defense period. Without implying that the present tax structure is adequate nor that still higher tax rates may not be required, our basic conclusion is that monetary policy should play a more active role in limiting inflation than it has played in the recent past.

Recommendations

The amount that individuals and businesses desire to spend is powerfully influenced both by the volume of credit that is available to them and by the volume of money and other liquid assets they already possess. Monetary policy covers the whole range of measures affecting these influences on spending, and the following recommendations are directed to monetary policy in this broad sense.

RECOMMENDATION I

The central contribution that monetary policy can make to the control of inflation is to control the reserve position of the banking system so as to restrict the supply of credit. The main specific technique for restricting the volume of bank reserves is the sale by the Federal Reserve authorities of securities in the open market, re-enforced by a rediscount policy that limits bank borrowing. The reserve position of banks can also be tightened by an increase in reserve requirements, but restrictive monetary policy need not wait for the new legislation this method would require.

In our judgment, the failure to utilize existing monetary powers adequately in the period since the war must bear a significant share of the responsibility for the inflation that we have experienced. In reaching this judgment, we have considered the repercussions of the exercise of such power on the economy in general and on the bond market in particular. It is our judgment that fuller use of existing Federal Reserve powers can make a major contribution to restraining inflationary pressures.

Footnote to Recommendation I

Lawrence H. Seltzer.—This recommendation contemplates action more violent than I consider necessary or advisable in the present circumstances. Barring a marked increase in the turnover of money, it is only necessary to limit further additions to member bank reserves to the amounts the economy can use without inflation, not to reduce them nor to increase cash reserve requirements. Among the evils from which we have not suffered during the past few years are unem-

ployment, low profits, falling prices, and a stagnant or declining level of output. Inflation is not necessary to avoid these evils, but violent deflation is pretty sure to produce them. Let us by all means strive to keep the expansion of credit within limits that avoid inflation, but let us also avoid violent deflation.

RECOMMENDATION II

Fuller use of existing Federal Reserve powers to counter inflationary pressures might on some occasions result in substantial declines in the prices of government securities or substantial rises in their yields. This result would not in itself justify giving up a policy of monetary restriction that is required for economic stabilization. It may, however, call for action from time to time to keep declines in security prices orderly. But we do not believe that Federal Reserve purchases of government securities to maintain orderly conditions need involve any net purchases over a significant period of time that would not have been required by general economic stabilization.

In addition, it may be desirable to temper the use of monetary restriction if circumstances arise in which the contribution of further restriction to economic stability would be too small to compensate for possibly undesirable consequences of the decline in the prices of government securities or the rise in their yields. Among such possibly undesirable consequences are capital losses for banks and other financial institutions; redistribution of income associated with a rise in interest payments; discouragement of saving as a result of fluctuations in government security prices; effects on the terms on which investors will purchase government and other securities; and changes in the willingness of business enterprises dependent on the security markets to make real investments.

It is difficult to predict in advance the extent to which monetary restriction will contribute to the prevention of inflation in any particular situation, or whether any accompanying decline in government security prices or rise in yields will produce seriously undesirable consequences. Hence, the policy of monetary restriction described in Recommendation I must be subject to continuous reappraisal.

Footnote to Recommendation II

Milton Friedman and Roland I. Robinson.—We do not concur in Recommendation II. "Orderly markets" has become a semantic cloak hiding the desire to resist all price declines. Moreover, the consequences of monetary action listed as "possibly undesirable" are mostly trivial, imaginary, or—where real—not undesirable.

If truly undesirable consequences should develop, the appropriate remedy would be higher taxes, which would make a lower level of interest rates consistent with avoiding inflation.

RECOMMENDATION III

The impact of restrictive monetary policy on the prices and yields of government securities can be moderated by a number of devices. While we have not studied such devices in detail, we believe that the following are sufficiently promising to justify serious examination with a view to possible adoption: (a) the imposition of reserve requirements by classes of bank assets instead of, or in addition to, present requirements against bank deposits, the level of requirements to be lower on government securities than on other assets; (b) the establishment of limits on the aggregate amount of loans and investments other than government securities that may be held by individual banks, the limits to be determined by objective and non-discriminatory rules such as reference to a base date, with provision for transfers of quotas among banks and for reasonable classification and adjustments to care for defense needs and remove inequities; (c) the imposition of requirements that banks hold secondary reserves in the form of government securities equal to a specified fraction of their assets or their deposits. If one or more of these devices were found suitable for adoption, the power to use it should be given to the Federal Reserve authorities. But consideration of these devices or of other measures included in subsequent recommendations should not be made an excuse or occasion for delay in the appropriate use of existing powers.

Footnotes to Recommendation III

Milton Friedman.—I dissent from this recommendation because the devices listed would reduce the efficiency of our private credit system by altering, in essentially arbitrary ways, relative yields on various classes of private loans and securities. I see no counterbalancing advantage.

Charles J. Hitch.—I must oppose as unnecessary, administratively undesirable, and inconsistent with the efficient operation of a free enterprise economy proposals like Recommendation III (b) which involve quota restrictions on the lending activities of individual banks.

RECOMMENDATION IV

The existing powers of the Federal Reserve authorities over the reserve position of banks should be strengthened by additional legislation (a) giving the Federal Reserve power to increase cash reserve requirements against deposits above the present maximum level and to impose a special reserve requirement against increases in deposits of individual banks after a stipulated date, with provision for reasonable classification and adjustment to care for defense needs and to remove inequities; and (b) making the reserve requirement for banks which are not members of the Federal Reserve System correspond to those of comparable member banks. These additional powers are desirable to improve the long-run effectiveness of the Federal Reserve System, but their absence should not excuse delay in the use of existing powers.

Footnotes to Recommendation IV

George L. Bach and Milton Friedman.—These powers are unnecessary. The Federal Reserve already has ample power to control the volume of money through open-market operations; its unwillingness to use existing powers will not be solved by giving it still more power.

Milton Friedman.—These powers are also undesirable—the first, because it is less flexible than open-market operations, the second, because its impact depends on the accidental position of the banks on the base date.

Herbert Stein.—The proposed measures should receive further examination and be adopted only if thorough study indicates their desirability.

RECOMMENDATION V

We make no attempt to offer detailed proposals on the specific types of securities to be issued by the Treasury. We do, however, recommend that a substantial part of the debt be in the form of securities which contain strong incentives for investors to hold them to maturity. As far as possible, the balance of the debt should be in the form of securities that will not give rise to frequent or persistent pressure for Federal Reserve support.

Footnote to Recommendation V

Roland I. Robinson.—If the last sentence of this recommendation is interpreted as adverse to the use of long-term marketable Treasury securities, I demur.

RECOMMENDATION VI

In a defense period, selective credit controls (such as those applying to consumer credit and housing credit) can assist in the diversion of particular resources from less essential activities to defense-related uses. These controls will also reduce somewhat the extent to which general monetary restrictions need be applied.

Footnote to Recommendation VI

Milton Friedman.—I disapprove of selective credit controls. Such controls, like other "direct" controls, are an inequitable and inefficient means of altering resource allocation. The "interest rate," despite admitted deficiencies, will do a far better job.

RECOMMENDATION VII

We endorse the following statement, made in January, 1950, by the Douglas Subcommittee on Monetary, Credit, and Fiscal Policies:

"* * * the restoration of free concertibility of our money into gold would be neither a reliable nor an effective guard against serious inflation. * * * There is no reason to believe that a requirement of redeemability into gold would promote wise monetary and credit policies; in fact, past experience indicates that it would at times endanger such policies. * * *"[1]

[1] Monetary, Credit, and Fiscal Policies, Report of the Subcommittee on Moneary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, 81st Cong., 2d sess., Document 129, p. 43.

RECOMMENDATION VIII

Increased saving can make a significant contribution to the restraint of inflationary pressure. Study should be given to the issuance of new types of securities that may encourage saving, such as bonds of constant purchasing power (which might be particularly appropriate for purchase by Social Security and pension funds), annuities in excess of those provided under the present Social Security program, and savings bonds offering strong inducements for retention to maturity by the original purchaser.

RECOMMENDATION IX

The policies of government lending and loan-guaranteeing agencies should be made consistent with other fiscal and monetary policies. These agencies exert a significant influence on the cost and availability of credit for major sectors of the economy, and their actions have frequently run counter to the needs of general economic stabilization. In making these recommendations, we are, of course, aware that other aspects of national policy besides general stabilization must be considered.

RECOMMENDATION X

Full and effective utilization of monetary powers requires coordination of the policies of the various government agencies whose actions affect the volume and availability of credit—especially the Treasury Department and the Federal Reserve System. We recommend, therefore, that steps be taken immediately to establish an effective coordinating mechanism to ensure that all agencies concerned with monetary problems follow consistent and mutually supporting economic policies.

Footnotes to Recommendation X

Lester V. Chandler.—While agreeing that better methods of integrating monetary, credit, and fiscal policies are desirable, I disapprove of this proposed method and feel that its full implications have not been adequately considered.

Roland I. Robinson.—In a democracy profound disagreement on policy is to be expected. I do not believe that recent policy disputes have created such a lack of reasonable cooperation at the operating level as to require administrative reorganization.

Signers of the statement

James W. Angell, Chairman, Department of Economics, Columbia University
George L. Bach, Head, Department of Economics, Carnegie Institute of Technology
Howard R. Bowen, Professor of Economics, University of Illinois
Lester V. Chandler, Professor of Economics, Princeton University
Howard S. Ellis, Professor of Economics, University of California
Milton Friedman, Professor of Economics, University of Chicago
Albert G. Hart, Professor of Economics, Columbia University
Charles J. Hitch, Chief of Economics Division, Rand Corporation
Simeon E. Leland, Professor of Economics and Dean, College of Liberal Arts, Northwestern University
Roland I. Robinson, Professor of Banking, Northwestern University
Paul A. Samuelson, Professor of Economics, Massachusetts Institute of Technology
Lawrence H. Seltzer, Professor of Economics, Wayne University
H. Christian Sonne, Chairman of the Board of Trustees, National Planning Association
Herbert Stein, Associate Director of Research, Committee for Economic Development
Henry H. Villard, Chairman, Department of Economics, The City College, (New York City)
Donald H. Wallace, Professor of Economics, Princeton University
Charles R. Whittlesey, Professor of Finance and Economics, University of Pennsylvania

Footnotes by signers to the Statement as a whole

Paul A. Samuelson and Charles R. Whittlesey.—This statement points in the right direction but exaggerates the potency of monetary policy relative to fiscal policy, selective credit policies, and other more direct controls. We also believe

that many of the policies mentioned should have further discussion, analysis, and observation before being applied even experimentally.

Footnotes by other economists who attended the meeting

The following economists whose footnotes appear below attended the conference, but did not sign the statement:

E. A. Goldenweiser, Princeton, N. J.
Alvin H. Hansen, Littauer Professor of Political Economy, Harvard University
Richard Musgrave, Professor of Economics, University of Michigan
Jacob Viner, Professor of Economics, Princeton University

E. A. Goldenweiser.—While I agree that vigorous monetary action is essential in an inflationary period, the statement includes so many propitiatory qualifications that the general position loses much of its force. Also there are many matters of detail and emphasis on which I differ. Consequently I am unable to sign.

Alvin H. Hansen.—The statement implies that monetary policy is more potent than it actually is. In particular, the third paragraph is far too sweeping in alleging perfect substitutability of monetary for fiscal policy to control inflation. We face inflationary pressures which cannot be controlled by monetary policy unaccompanied by tax increases except at the cost of serious repercussions on production.

Vigorous monetary policy should be undertaken only if its impact on government security prices is moderated by some of the devices advocated in Recommendation III. Hence, I disagree with the conclusion which places much responsibility for recent inflation on the monetary authorities. Expectations caused by Korea were bound to result in price increases; their prevention by monetary action alone would certainly have injured the economy.

Richard Musgrave.—Space does not permit me to state the qualifications, on a few major and several minor points, which would enable me to sign. I agree entirely that effective stabilization requires a supporting monetary policy, but I believe that the extent to which the Federal Reserve can or should apply general credit restriction (and the extent to which the disadvantages mentioned in the statement may be avoided) depends greatly on whether measures such as those listed in Recommendations III and V are taken. Also, selective controls, rather than help "somewhat," can do an important part of the job, thus reducing the range of necessary interference with Treasury operations. Finally, the issue is not whether *some* degree of credit restriction can check inflation (it obviously can), but *what* degree of restriction and rise in interest is now needed. Since we know little about this, or the magnitude of adverse effects, the whole is a matter of judgment. Considering the stakes, it is all important that activation of monetary policy be framed so as to minimize the risks involved.

Jacob Viner.—I am in agreement with the statement insofar as it stresses the importance of increased use of monetary policy to combat inflation. My unwillingness to sign it is due to my belief that the support here given to vigorous use of monetary policy is too weak and excessively qualified.

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