THE ROLE OF COMMERCIAL BANKS IN WARTIME 1183

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Mr. Kenton R. Cravens, Vice-President, Mercantile Commerce Bank and Trust Company, St. Louis, Missouri, was born at Salina, Kansas, on 7 June 1904. After graduating from the University of Kansas he engaged in credit analysis with a large firm operating in the East and Middle West. He joined the Cleveland Trust Company as vice-president in 1938. In 1943 he became vice-president of the Mercantile-Commerce Bank and Trust Company, St. Louis, Missouri, in charge of the Banking Loan Division, and became a director of this organization in January 1946. In 1941 he was called to Washington as a consultant to the Federal Reserve Board with respect to selective credit controls and the promulgation of Regulation "W." In the early part of 1942 he was again called to Washington to be administrator of the War Loans Committee in connection with the formulation and administration of the Regulation "V" loan program for war production contractors. He is a past president of the Bankers' Association for Consumer Credit, and past chairman of the Consumer Credit Council, and the Subcommittee on Taxation of the American Bankers Association. He is presently Chairman of the Credit Policy Commission of the American Bankers Association.

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COLONEL WILLIAMS: I feel sure you have been impressed with the tremendous burden that a wartime economy places on the Federal Government and its many agencies, but we are apt to forget the roles that certain commercial banks play in wartime. Our speaker this morning will discuss "The Role of Commercial Banks in Wartime." Mr. Cravens is highly qualified to speak on this subject. In addition to being vice-president of the Mercantile Commerce Bank and Trust Company in St. Louis, during the war he held several key posts here in credit control positions, in war loans--in fact he was chief of the War Loans Committee. Mr. Cravens, it is a real pleasure to welcome you back here this morning.

MR. CRAVENS: Colonel Williams, members of the college: I have to start that way because I have great difficulty in thinking of you as students or pupils. But I do appreciate this invitation to again address you as a representative of American banking. I use "you" figuratively and not literally because I hope it is a different group. I have to cover a little bit of the same ground as I did last year. I have decided to follow my notes rather closely today in order to give more time for questions, because if I talk off the cuff, I am liable to ramble around here until twelve fifteen, and then there will be no questions.

Today I have taken the liberty of changing my assigned subject from "The Role of Commercial Banks in Wartime Lending" to "The Role of Banks in Two Wars--Actual and Potential." To lose either of the wars I refer to would be equally disastrous. The actual war I refer to is, of course, the war against inflation, and the potential war is the grave threat of armed communism. While banking has an equally important role in both, I am reversing the order today by taking the potential before the actual.

The banking industry believes that plans for financing a great military machine must be based on two major premises. First, that if the United States avoids or wins the war, but finances it in such a way that the integrity of the debt, the value of money, and the basis of our credit structure were destroyed, then this country would in effect lose the war after all, in spite of saving the lives of young men, or in spite of a military victory. Such a victory, coupled with economic and financial defeat or disaster, is a Pyrrhic victory. Second, that regardless of what the total cost of financing our defense or another war may be, a military victory does not necessarily mean that economic and financial defeat and collapse are inevitable.

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The basic requirements of the program we have embarked upon and of total war are men and money, and money is the banker's role. Private chartered banking must provide money; that is, war credit and other financial services, in four major areas, without repudiation or affecting the integrity of the credit structure. These are:

1. We must directly finance the Treasury of the United States to the extent we are unable to distribute the debt to private investors.

2. We must finance the production of war materiel except where it is more feasible for the Government to do so directly. Those exceptions, of course, should be kept to a minimum, but they are valid exceptions—atomic energy program and other similar programs.

3. We must finance civilian production, including the production of food and other agricultural commodities needed for both military and civilian uses.

4. We must provide those other indispensable financial services for the military, the Government, and the civilian population.

A brief review of our experiences in World War II will be helpful and will apply with somewhat equal force, whether or not we are building up our military power or are in actual war. Assuming that in either event the period will be a long one, our previous financial and industrial experiences will most certainly be helpful. Reference to them, however, does not mean, in the least, that we would be committing the blunder of "planning for the last war." We must look to the future with an eye on the past. There is, of course, no way to forecast the over-all cost of this gigantic program we have embarked upon, nor the cost of another war.

We do know, however, that during World War II the Government's expenditures amounted to 398 billion dollars, 44 percent of which was obtained from taxes, and 56 percent was raised through borrowings from banks and from private investors, such as individuals, insurance companies, and trust funds. At the suggestion of the president of the American Bankers Association, the Secretary of the Treasury deemed it advisable that the American Bankers Association form a committee, whose membership he personally approved, to serve in an advisory and consultative capacity to him and his staff. Such a committee was formed and counseled the Secretary as to the placement and management of the growing national debt.

Inevitably the debt increased from about 50 billion dollars before the war to a peak of 275 billion dollars at the close of the war. Incidentally, this committee is still active and continues to meet periodically with the Secretary of the Treasury. Another major activity of the banks was to sell and distribute United States War Savings bonds to the public through their facilities. As a result more than 50 billion dollars of United States War Savings bonds were held by the public, which is approximately 20 percent of the national debt. It is estimated that banks sold or acted as distributing agencies for 80 percent of this total.

In addition to the Government's great need for credit, the producers of war materiel required enormous amounts of credit. They will likewise require enormous amounts as our defense program gains momentum, and, of course, astronomical amounts in case of another total war. The total war production loans and commitments made by the banks during the war exceeded 20 billion dollars. Most of this was without government guarantee of the borrower's credit. As a matter of fact, for the entire war and postwar period, less than one-half of the banks' loans to war industries were the "V," "VT," or "T" government guaranteed loans.

Before I cover the ability of banks to perform as of this date, and the status of the wartime financing programs, let me review other banking services in war. Briefly, the other indispensable services for the military, the Government, and the civilian population are:

1. Assisting the Government in locating and freezing enemy funds in this country that are intended for espionage, sabotage, and other subversive activities.

2. Cooperating with Federal authorities in the regulation of consumer and real estate credit.

3. Providing financial assistance in the construction of defense housing.

4. Providing branch banking facilities for Army, Navy, and Air Force bases and encampments, and check-cashing services for families of men in the armed forces receiving dependency allotments.

5. Providing coupon accounting and clearing services for the Government as an essential part of the rationing system it may establish—one of the biggest headaches we took on.

6. Maintaining war loan accounts for the United States Treasury and serving as its tax depositories.

7. Providing trust services for men and women who are called to serve in the armed forces.

Now, as to the banks' ability to provide this credit, please keep in mind that there are more than 15,000 banks in the private chartered banking system. Banks are at their near peak in their holdings of liquid assets, government securities which can be converted into lendable reserves. Their total cash and government securities exceed 109 billion dollars, or almost two-thirds of their total assets. Of course, far less than this amount would be required for financing purely war industries and civilian needs. No allocation of this amount is necessary for direct financing for the Government's needs because it should be avoided at all cost.

Equally as important as the tremendous resources of the banking system is their "know-how" of war production finance. In World War II the banking system gained experience of inestimable value to war producers, the armed forces, and the Nation. Moreover, we have already reactivated the essential parts of our World War II program for financing defense contractors through the passage of the Defense Production Act of 1950. The Regulation "V" program is even now operating much on the same basis as before. While as yet we have no Defense Plant Corporation, the act provided broad lending powers for the Reconstruction Finance Corporation with the approval of the National Security Resources Board for financing defense contractors' facilities over long periods of time. Some two billion dollars has been provided for this purpose.

As a further inducement for the expansion of facilities, the new tax bill contains an improved five-year accelerated depreciation provision. Then, too, the Regulation "V" program has been broadened to cover, if deemed desirable, the guaranteeing of facility term loans. Yes, the banking system has the resources, the "know-how," and the emergency vehicles to do this defense financing job.

Now turning to the actual--the war against inflation--I think it properly should be included in any discussion before such a group as this because historically wars have been notorious breeders of great inflations. My dictionary definition of inflation is: "Disproportionate and relatively sharp and sudden increase in the quantity of money or credit, or both, relative to the amount of exchange business." * * * "In accordance with the law of the quantity theory of money, inflation always produces a rise in the price level."

During wartime, or any period of tremendous outlays for defense, the aggregate national income of our people rises precipitously and this, less that portion drained off by taxes, becomes a part of a tremendous spending stream at a time when civilian goods are in short supply. Moreover, our Government has found it impossible, or inexpedient, to finance the cost of defense and war entirely through taxation and must, therefore, resort to borrowing.

The unwillingness on the part of our Government to reduce our debt during relatively prosperous peacetime and the inflationary high national income bring into focus one of the most critical aspects of our present situation. This is the sharp contrast between economic policies of the United States and Russia during the years since World War II with respect to domestic and international affairs. The United States has poured a substantial part of its wealth overseas, and at the same time has increased its outlays for "welfare" purposes and a stimulation of consumer income and expenditures at home. I am told that the cost of television sets alone in the year 1950 would have built a radar network completely around continental United States, and that the raw materials that went into these sets would have been sufficient for this program.

On the other hand, Russia has drawn upon the wealth of occupied and satellite countries to strengthen itself internally and at the same time has cut down the standard of living of the Russian people. For example, Russia has stripped Manchuria of most of its industrial equipment. It drains coal and agricultural products from eastern occupied Germany. Russia has dismantled eastern European factories and shipped their equipment to Russia. It draws on the agricultural resources of much of Austria and the Balkan States. Russia has also established what in effect amounts to consumer rationing. It has allowed the prices of consumer goods to soar to almost prohibitive levels for a large part of the population and has levied retail taxes as high as 60 percent on salt and 70 percent on textiles. On the other hand, Russia has rigidly held down the price of producer goods—these, of course, are bought by the State. In other words, Russia is maintaining its large standing armies and its industrial output for war, which accounts for 62 percent of the budget, at the expense of conquered peoples and of its own workers and citizens. The United States, however, has done just the opposite. The United States has exported its wealth to foreign countries and at the same time is attempting to practice "welfare statism." To pay for all this, it is not only placing a terrific burden on capital and business industry—its chief productive resources and its first line of defense--but it is also creating the most favorable climate for disastrous inflation.

You might properly ask, "Are we of the military expected to concern ourselves with such domestic issues as inflation, and, if so, is rampant inflation as great a potential threat as armed communism?" My answer to you is most assuredly "yes," since inflation can destroy the very things we are fighting for. Many of you here today remember when you could buy a 50 billion-mark postage stamp in Germany in 1923. A graphic illustration in a milder form is the case of the French pensioner, who prior to World War II received 1,000 francs—roughly equivalent to $200. This same pensioner today receives 96,000 francs with a purchasing power of roughly $180.

Many people have thought this could not happen here, but over the last ten years the United States has experienced the fifth major inflation in its history, and like the others, this one originated from war and the methods of war financing. The total money supply in this country is now in excess of 173 billion dollars, contrasted with less than 70 billion dollars at midyear 1940. Our physical volume of industrial production over the same span of years has shown nowhere near this tremendous increase. This lag in industrial production as compared with the money supply is responsible for the wholesale price index advancing substantially over 100 percent, and the cost of living index to very nearly 100 percent. To lose the war against inflation would obviate the need for this very institution you are attending, or the preparedness you are getting for the heavy responsibilities of your military assignments. As a matter of fact, item a, paragraph 1 of the Mission of the Industrial College of the Armed Forces, "Conducting a course of study in all phases of our national economy and interrelating the economic factors with political, military, and psychological factors" squarely puts this problem in your laps.

The extent of the battle against inflation today might properly be described as purely a skirmish. The ineffectual means we are using can only result in failure. They do, however, fall in four general areas and could be made most effectual. These are: fiscal and monetary measures, credit controls, direct controls, and production.

The most effective fiscal measure would be to reduce nonmilitary expenditures. The nonmilitary budget has swollen on the basis of fiscal 1951 budget proposals submitted to Congress last January to 23.3 billion dollars--the highest level of our history. We have never spent anything equivalent to this amount in any single year. The comparable figure for 1948 was 17.6 billion dollars, yet the Nation prospered. This tremendous nonmilitary budget is, in part, occasioned by "Social Welfare, Health, and Security," "Education and General Research," and "Housing and Community Development"--all havens of growing rash socialistic enterprises. The balance is occasioned by public works, farm subsidies, and the foreign aid program. Specifically, without affecting the standard of living we have known heretofore in the least, we could chop off some seven billion dollars. If our military budget reaches 75 to 100 billion dollars, which it well might, then we should tighten our belts and chop off considerably more than double this amount.

Increased taxes come next in importance of effective fiscal measures to combat inflation. We have made two commendable steps in this direction, but still have a long way to go to drain off a sufficient amount of the national income to come anywhere near balancing our budget or to balance purchasing power with the supply of civilian goods.

The final fiscal measure I wish to mention, but most important, is the method of covering the budget deficits, which most assuredly will result from any heavy defense program or all-out war. The Government's debt resulting from this deficit must be kept out of the banking system and channeled into the hands of the public and institutional investors. No doubt the Secretary of the Treasury adequately covered this in his address to you. This is the only fiscal and monetary measure that brings in directly the banking system. I can assure you that the banks of the Nation are ready and willing to carry out any program of the Treasury that will properly distribute the debt outside the banking system.

In the area of credit controls, which are important weapons against inflation, private chartered banking plays a far more important role. I have mentioned to you that the money supply has reached a peak in excess of 173 billion dollars and bank credit has accounted for much of this increase. As a matter of fact, since 28 June 1950, in the commercial banking field, loans have increased some seven billion dollars and now stand at approximately 52 billion dollars. This increase is graphically illustrated by the reduction in the liquid assets of the Nation's banks. This constant reduction of the banks' holding of government securities and its subsequent conversion into loans is as follows:

All Banks in the United States

(Figures partly estimated except on call dates.)
(Amounts in millions of dollars)

Date	Loans	U.S. Government obligations	Cash	Total cash and governments
1949—Dec 31	49,544	78,433	36,522	114,955
1950—June 30	51,999	77,320	34,099	111,419
July 26	53,320	76,440	34,210	110,650
Aug 30	54,760	75,610	34,060	109,670
Sept 27	56,670	73,750	35,070	108,820
Oct 25	57,730	73,620	35,620	109,240

This tremendous increase in bank credit is greater than in any comparable period of time in our history.

Our central banking system, the Federal Reserve Board and the Federal Reserve Banks, have the chief responsibilities in exercising credit controls to combat inflation. It is my understanding that the Chairman of the Federal Reserve Board will speak to you tomorrow, and

I am sure he will fully cover these responsibilities and what the Board is doing to discharge them. As a background as to what private banking can do and is doing, I will enumerate the important steps the Federal Reserve Board has taken.

To date the Federal Reserve Board has placed most of its emphasis on a short-term rate policy by increasing the rediscount rate from 1.5 to 1.75 percent and through its open market operations, which has resulted in stabilizing the Government one-year rate at 1.5 percent. This has brought about an across-the-board increase in commercial loan interest rates, which has has a restraining influence in the use of credit. The strengthening of the government short-term rate has been a deterring factor in banks selling their short-term government securities into the Federal Reserve System. Through powers granted under the Defense Production Act of 1950, the Federal Reserve has sharply controlled consumer and real estate credit through Regulations "W" and "X". Just a week ago last Friday they announced increased reserve requirements effective during January. The resulting sterilization of in excess of two billion dollars will be a further restraining influence in the extension of bank credit.

Commercial banks share the responsibility in restraining credit and are fully cognizant of this responsibility. As early as last July, and periodically since then, the banks have been urged by the American Bankers Association and the various supervisory agencies to use caution in the extension of bank credit, to screen loans carefully. The response to all of these appeals has been gratifying. The banks and the Federal Reserve Board have one method of credit restraint which has not yet been fully examined or used, and which might forcefully supplement actions already taken or which may be taken by the monetary authorities. This method is found in Section 708 of the Defense Production Act of 1950, which authorizes the President to permit financing institutions to enter into voluntary agreements to restrain credit not needed for the defense effort. By Executive order the President has delegated to the Board of Governors his authority under this act. A meeting was held at the Federal Reserve Bank of New York on Tuesday, 19 December 1950, to explore the possibilities of this method. It was attended by representatives of the life insurance companies, of the investment bankers, and the commercial banks. A smaller working sub-committee is carrying on the work and it is hoped that in the very near future a tangible and effective program will be adopted and announced.

The thinking at the present time is that this type of program or agreement among banks, insurance companies, and investment bankers might possibly comprise the following:

1. A Statement of Principles would be adopted and all lenders would be asked to give voluntary compliance.

2. Regional Committees would be organized in each Federal Reserve district which would endorse the Statement of Principles, and be available for consultation by lenders for interpretation of principles.

3. Regional Committees and the National 708 Committee would receive statistical data, compiled by the Federal Reserve System, by districts and nationally, with respect to the trend of bank lending by categories, together with similar data with respect to lending by the insurance companies and investment bankers, all compiled in a way that will show the direction of credit use, with a view to the information being used for such amendments to the "principles" or program as may be warranted by results and changing conditions.

4. Lenders would be asked to keep records of individual loans as to purpose, in such form as to be available for future analysis.

It should be noted that the most inflationary credit is long-term credit. An effective screening of credit with maturities of one year and longer should make a substantial contribution to the anti-inflation program. It is my firm belief that if this program is consummated and effectively used, it will be the greatest single factor in the restraint of bank credit—far more so, in fact, than the Federal Reserve Board's increase of reserve requirements or the strengthening of the short-term rate. The commercial banks effectively did this job before on a voluntary basis and I am sure you can count on them to do it again.

I have included in the various means we have of combating inflation the matter of direct controls, solely to bring it up for discussion since in my opinion it does not deal with the basic cause of inflation. A great many people feel that inflation can be stopped merely by having the Federal Government fix a price on everything. Direct controls do nothing to remedy the excess of money over production. Direct controls deal only with the effect, which is rising prices, and delay the impact of a steadily mounting money supply on the price level. Under direct controls this dammed-up purchasing power will eventually break through—either in the form of black markets or sky-rocketing prices in a postrelease period. Moreover, price controls must be accompanied by wage controls, and they are almost impossible to effectively administer. Certainly, short of total war, the Government should have the courage to adopt adequate fiscal and credit measures against inflation and they should first be given a chance to prove themselves.

Production, on the other hand, is a basic remedy of inflation. In peacetime, if it were possible to keep our production level with our money supply, we would have no inflation. In a wartime economy, however, it is obvious, to me at least, that we cannot continue anywhere near our present rate of production of civilian goods and maintain our present standard of living, and at the same time support an enlarged military machine. This means that we must, to a degree at least, rely heavily on the fiscal and credit measures. Most assuredly, however, we should do everything possible to build new productive facilities by private enterprise, to cultivate the development of technological improvements to increase productivity and to assist business in the expansion of its plant and equipment. I have great confidence in the ingenuity of American industry to make vast strides in increasing production as it always has done in the past.

To summarize, I would like to give you some of my specific suggestions today which may be of some value in winning both of these wars and I think they apply in most instances with equal force. They are:

1. The financial requirements of our Government should be supplied to the maximum extent possible by taxation.

2. To the extent that governmental deficits are necessary, this debt should be spread as widely as possible and under no circumstances should it be concentrated in the Federal Reserve or commercial banking systems where it is immediately monetized. Monetization of the debt means that purchasing power is increased, which only adds fuel to the fire of inflation.

3. The financial requirements of the Nation's productive machine should be met through substantially the same channels and methods that were employed in World War II. This means that adequate credit will be promptly available without superimposing direct government financing on top of the present credit structure.

4. We should immediately effect drastic reductions in our non-military expenditures and further reduce these unessential expenditures as our military needs increase.

5. It is paramount that you gentlemen treat both of these enemies alike and so indoctrinate the entire military personnel. Certainly those of our military establishment should not only be cognizant of the danger of winning one war and losing another, but also should be urged to so inform their families and loved ones of these dangers. The military establishment—civilian and military—so informed—so indoctrinated—would via their families back home bring

about an effective demand on Congress and on our Administration to inaugurate and carry out adequate fiscal and monetary measures to thwart this grave danger.

When our Nation is threatened by war, our people are more than ready to subordinate their normal activities, their judgment, their political sentiments—yes, even their thinking—to the military and its needs. Through such subordination, they can easily lose the significance of a well-managed civilian economy tuned to the needs of the military and, most important, can easily lose the significance of the grave dangers of inflation. It seems to me, therefore, that it is only fair to ask you and our other military leaders to share the responsibility of defending both hazards—the hazard of all-out war and the hazard of inflation.

I am honored to have had this occasion to address you. Probably there was never before a time in the history of our country when our people were as appreciative as they are now of the splendid services you gentlemen are performing, or of those you may be called upon to perform. Speaking for banking, we shall serve you and the Nation as we have in the past. Thank you.

QUESTION: Mr. Cravens, I am interested in a little bit of information on guaranteed loans. If we could assume that John Doe comes into your bank and says, "Mr. Cravens, I am doing a good deal of business and my working capital is a little low; I need $50,000 for 90 days." And you say, "John, that is O.K.," and you give it to him. Then he comes in 30 days later and says, "My business has grown terrifically. The Government has been giving me a lot of contracts and I must have some more money. I need about $100,000." Then you say, "Well, look, give me a statement as to exactly what you need and what it is to be used for and we will see what we can do." He brings that in and perhaps you say, "This is for fixed capital and that is a long-term loan. We wouldn't be able to deal with that, and on this other, for your working capital, you have gone just about as far on the credit side as we can give you. But if the Air Force or the Army will guarantee 50 percent of this $100,000 or $150,000 you need for working capital, then we can handle it." Could you elaborate a little bit on that? Do you direct him to go to the RFC for fixed capital, or how would you handle it?

MR. CRAVENS: We would handle it as follows: First of all, we urge the banks to take above-average risks under these conditions, particularly where there are contracts that are not too difficult to justify. That is, where it is not exactly a new item or where the costs are reasonably well-established.

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But to take your example and carry it on to where the credit requirements of that small producer are ballooned to the extent that his working capital and his capital that he has in the business to protect us is wholly inadequate, in that case we would make application for a V-loan under the present new V-loan setup--it is different from what it was the last time inasmuch as we now have seven guaranteeing agencies and then we had only three. Now we have, in addition to the armed forces--that is the Army, the Navy, and the Air Force--General Services, the Departments of Agriculture and Commerce, and so forth, so that the application which we would prepare would go from the local Fed--that is the Federal Reserve bank or its branches--into the Federal Reserve Board here and then it would be sent to the agency that controls that particular contractor's contracts. If representatives of that agency thought that the products the contractor was producing were essential, they would guarantee the amount of money up to 90 percent. The bank would be the one that would decide whether it wanted a 50, 60, 80, or 90 percent guarantee. The reason is that the higher the bank goes the greater the Government's participation in the interest paid. During World War II the Government made some 23 million dollars out of its fees after losses.

About the percentages of guarantee now, they are not arbitrary. They say, "Take anything you want up to 90 percent, but anything above 90 has to be negotiated." There are not so many of them at the present time. The demand--maybe Chairman McCabe will give you more accurate information tomorrow--I think less than 200 applications have been made to date in the country and they have totaled less than 100 million and only some 35 million have been authorized.

We do have a factor today that we must cure by legislation before we can get any substantial amount of private financing for war contracts. That is a ruling on the part of the Comptroller General to the extent that the assignee under a contract is liable for recoupment of price revisions and other claims. Now we had some instances, one example, where a man borrowed $100,000 to perform a contract. He performed the contract, or at least part of it, the bank received the $100,000, retired the loan, canceled the note, and sent it to the contractor. The Government came along and revised the contract for one reason or another. Then the contractor was broke, so they made the bank dig up and pay the $100,000. We do have proposed legislation to correct this; all the services, the Bureau of the Budget, and most everybody else have agreed to it, and we hope that it will be passed shortly in the new session of Congress. Such legislation will relieve a good deal of pressure on V-loans and on RFC. The RFC has had numerous applications for that very reason.

As to facilities, we are in nowhere near as good shape as we were during World War II. We have the vehicles but we haven't clarified, at least at this moment, our position. The RFC has the allocations for facility loans, but it can't approve the items—that is a responsibility of the NSRB. The V-loan legislation has been expanded to cover facilities, but the Government hasn't taken any action in that direction as yet. There is no Defense Plant Corporation. That is one area that needs attention and needs it badly.

QUESTION: Mr. Cravens, during the course of your discussion, you stated that the commercial banks would be willing to do anything possible to prevent this inflationary trend during the coming years. I wonder if you would care to discuss the possibility of the commercial banks accepting nontransferable bonds from the Government and at the same time acceding to the regulation that they place reserve requirements against active deposits. Wouldn't that greatly cut down the credit trend?

MR. CRAVENS: It wouldn't cut it down in the least because I don't care what kind of securities we accept, we have put that much more credit into being. If you buy the bond, we haven't increased the credit outstanding; but regardless of what kind of security the Treasury would give us, we have increased credit percentages by that amount. So it doesn't make any difference whether we hold nontransferable or nonnegotiable bonds. The only thing the Government might be able to do--to follow through your suggestion--is to raise reserve requirements to 70, 80, or 100 percent, but as soon as you take all the funds out of the banks, you can't finance defense production.

QUESTION: Isn't it true that during the war the Federal Reserve did not require the commercial banks to maintain a reserve requirement against government deposits?

MR. CRAVENS: That was true. That is not true today, however. We do maintain them. That was true primarily for only 40 percent of the defense dollars and only until they were spent. Take the amount of such funds on deposit, figuring any reasonable reserve against them, it would affect the loanable reserve of the banks very little one way or the other.

QUESTION: Aren't these bonds also used to further inflate credit by being turned into the Federal Reserve banks for more credit?

MR. CRAVENS: The bonds have not been so used yet because there is no need for the banks to borrow at the present time. The Federal Reserve banks have sold bonds into the banking system of some five or six billion dollars during the last year. If they were nonnegotiable, nontransferable, the Federal Reserve still would have the power to loan rather than purchase. So even if the banks needed funds for financing defense, or other purposes, the fact that the bonds are nonnegotiable wouldn't affect their obtaining governments.

QUESTION: That is what I mean, the point beyond which the commercial banks couldn't issue credit.

MR. CRAVENS: In talking about the amount of reserve requirements, for instance, if you raise reserve requirements up to 70 or 80 percent, you will stifle the whole Nation because you won't have any credit. It might be that in New York, it wouldn't hurt but very little; in Houston, it might throw industry into a panic. It is an impossible thing to have across-the-board reserve requirements of such high percentages.

QUESTION: You mentioned the new term here--"guaranteed facility term loan," which you said is a new wrinkle. Would you care to explain a little bit more about it?

MR. CRAVENS: I just mentioned that. The new wrinkle is that in World War II when we inaugurated for the first time the V-loan program, it only covered working capital loans. The Defense Production Act of 1950 primarily authorizes agencies to guarantee working capital loans, but if they deem it advisable they can guarantee facility loans. The new Defense Plant Corporation took care of all new plants.

QUESTION: One of the indicators of inflation is the stock market, for instance, at the beginning of the last war, a drop in the value of stocks. Today we see rationing coming on, a conversion program which is cutting earnings of companies, and control of critical materials causes work stoppages, increasing wages. What is your explanation for the inflation occurring in the stock market today?

MR. CRAVENS: I won't agree that the stock market is anywhere near inflated to the extent that all other materials and commodities are in the country. I think probably the price of stocks compared to the price of cotton, or the price of coal, or the price of steel, or the price of materials is relatively cheap.

There is only one plausible explanation for anybody's buying common stocks and that is that they are scared to death of the dollar. We are buying them for trust funds, trying to save some little bit for widows and other beneficiaries. That is the answer. If you don't get any yield at all in the stock market, you will still have a bull market. People will not buy bonds. They won't take any fixed investment. They are scared to death, and they have a right to be scared to death. The dollar is now less than 50 percent of what it was ten years ago or so.

QUESTION: I would like to sort of brief our position and then I will ask you a question that you are not going to like. We who are in the military are especially dependent on the value of the dollar. We don't have the opportunity, as a rule, to stay in any one place long enough to put our money in anything to keep us from the inflation trend. Many of us are buying property to take care of it. Many of us feel that the reason inflation exists is because bankers have not lived up to their responsibilities in forcing price and resources to get together, getting the value of government bonds down to where they belong, and making the dollar scarce enough to increase its value. Why have bankers adopted such a position?

MR. CRAVENS: Well, I think maybe to some extent they haven't discharged their responsibility. Let me begin with that. But I don't think, even if they had tried very hard, they would be in a position any different from what they are now, except that they wouldn't be so welcome in the Secretary of the Treasury's office as they are.

QUESTION: Is that particularly desirable?

MR. CRAVENS: Well, since they are, under present policy, our supervisory agency and mean the life and death of the banking system, it is a fairly desirable thing. We just don't have the power to force a realistic attitude on the part of the Treasury. It comes about from having a lot of archaic assistants in the Department. They seem to think their one primary objective to do this job is to keep the cost to the Government down to a minimum. Every time they save three quarters or even a half they have cost the Government billions of dollars, and the cost goes higher while they do it. And we just can't sell any other idea. Do you know why we can't sell it? It is because it is political. The fault probably is more with the men in Congress than in the Secretary of the Treasury. It is tragic. It is tragic not only because to let those rates rise would be anti-inflationary, but it is tragic because we are not developing securities that the public will buy. They can't take the risks. They have contracts outstanding and they have to deliver 3 percent minimum. Those are contracts outstanding. They have to buy governments during time of war because there is no place else to put their money. They take a 2.5, 2.25 percent security because they haven't anything else. But what happens when they get a chance to get anything else? They sell them. John Doe bought a $75 bond which is going to mature next year or the year after. Well, 2.5 percent isn't very attractive or even 2.9 to John Doe under these conditions, because he has lost a good deal of the dollar he put in. If we could increase it, it might attract him. I think 3 or 3.5 percent might attract a lot of people, but you can't get a realistic position in a political, capitalistic system like we have. It is tragic. Somewhere along the line we will have to come to it. The bankers cannot control it. While we hold a large part of the debt, we cannot control or fix the rates. We have tried to work with the Federal Reserve Board to make some peace, and behind the scenes we have done a lot of good. You will notice the December issue came out with a five-year one and three-fourths. We did get a short-term rate up to one and a half. Everything is lovely for the minute. Did you ask Secretary Snyder about that?

QUESTION: No, because at the time I didn't fully appreciate what was going on. I have only recently developed that. Going into this a little more deeply, maybe an educational campaign is needed to get the American public to realize what is going on, make the American public understand that higher taxes are the hottest investment they can make right now.

MR. CRAVENS: The quickest way to get anybody to do something is for a banker to tell him not to do it. We are the poorest people in the world to tell the public to do anything. We are a little higher in their estimation than we were at the beginning of the Great White Father in 1933, but we are not too high. I still think, and you ought to think about exactly what I told you this morning, when you take a boy into the service for a 13-week period of indoctrination and training, teach him exactly through the problem and let him write letters back to the folks at home, telling them "I am going to go to Korea; you see to it that I get more than 50 cents for my dollar when I get home." Then you will get some pressure on Congress and that is good pressure, not from the banks. If we go up before Congress, they just laugh at us.

QUESTION: When Series E bonds were issued in 1935 I believe, they were called Baby Bonds, savings bonds, small type. They were tax exempt. Later on, they made them taxable. You are speaking about making bonds more attractive. Do you think people would invest more in these Series E bonds if they were still tax exempt?

MR. CRAVENS: That is a fine question. I am glad you brought it up. There are three phases of it I would like to discuss. First, we have the problem of 80 billion pieces of paper issued now--I guess more than that. As they mature, we have a tax problem because that 25 percent gain, that 25 dollars on every hundred-dollar bond, is subject to income tax. The Treasury economists, as you know, have really sort of tentatively agreed to go along with the program of temporarily at least putting forward the day when the tax is due. I think that is step one. That is a "must." We must. If we don't forego the tax, we must put it ahead until such time as cashed.

Step two is the type of tax. You have heard a lot of people suggest, "Let us not make it income tax, but tax it as capital gain." Personally I don't think that will do a bit of good because a 25 percent gain is probably not going to be much less. Right now it wouldn't be more than the big bulk of those holders pay, so that is not any real inducement. Maybe if taxes got up to 40 percent, there would be some inducement.

Step three, they ought to be tax exempt. Then you would have a real attraction for people to hold them. We have suggested to the Treasury that it keep the bonds, don't roll them over. It costs over five million dollars for new bonds, just to distribute them, just the motion, the mechanics of it. We suggested that the Treasury tell people to keep their bonds, they will accrue one percent every four months--of course they are demand paper--and they are tax free. If we would do that, people would not only hold their bonds but they would buy more. That would be from interest-bearing new blocks purchased per dollar. So answering your question specifically, it would be a great thing if we would make them tax free.

QUESTION: In the first question that was asked, you brought up the Defense Plant Corporation, RFC, and other government lending agencies. As I understand this inflation, if the RFC makes a loan direct or the Defense Plant Corporation, as they have in the past, makes a loan direct, that increases inflation. If the contractor comes into the bank and borrows the money out of the bank, that does not increase inflation.

MR. CRAVENS: No. No. If the RFC or any one of the government agencies, and that is the Government of the United States money, that money goes into the spending stream. The only inflationary aspect, other than the amount that went into the spending stream, is the source of funds. If the Treasury taxes them, then you have no inflation. You have taxed the amount out and put it back into the stream. It is an even balance. You have an absolutely even balance. You have a tax of a billion and you put back into the spending stream a billion.

If the Government, however, borrows that billion instead of acquiring it by taxation, then you have to see the character of the borrowing. If the Government borrows that amount from an individual, or insurance companies, or private investors, then there is a working balance, no inflation. Why? Because a billion was taken out of the spending stream and put back in. If the Government borrows the money from a commercial bank, then the spending stream has been increased by two billion; if it goes into the Federal Reserve, it goes up six times, or six billion. If the banks loan direct, rather than to finance the Government, they lend it, expenditures may go up one billion because we have created another billion dollars of purchasing power over and above what we started with. Does that answer your question?

QUESTION: In other words, any time the loan is made, unless it originates from taxation, it is inflationary.

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MR. CRAVENS: Every loan made known to man is inflationary.

QUESTION: Would you say something about the effects of a severe clamp-down on consumer and real estate loans?

MR. CRAVENS: Yes, I would like to. The present dilemma with respect to inflation is primarily due--I laid it all on the laps of war, but it is not all the war. It is also in a good many of the policies that our Government is following. One of these areas where the Government has violated sound principles to the worst extent has been in the field of real estate credit, sponsoring a tremendous extension of real estate credit through low equities--the biggest era of credit expansion we have known. We never could get any regulation of that. We got them to regulate everything else, but we couldn't get Congress to touch it. This time, we have the Regulation "X".

You might be interested in the mechanics of that regulation. The Federal Reserve is authorized under the Defense Production Act to regulate real estate money, mortgage credit of the conventional type. It is required also to regulate government guaranteed credit, but it can't regulate government guaranteed credit unless it gets the consent of the Federal Housing Administrator. He can't give it until he gets a ruling from the Veterans' Administration as to what advantage is given to veterans over and above John Doe. We finally got them together. That is why the regulation was late coming out. It cut down 500,000 housing starts.

In the field of consumer credit, Regulation "W" was for a 15-month limitation generally. That will probably cut out about 25 percent of the credit. That will take about 50 percent out of this market--in other words, about half the goods bought on time. That half is a mild reduction in purchasing power. It might have to be tightened. I think right now it ought to be let alone until we see what happens to it. Both these regulations are very, very effective.

COLONEL WILLIAMS: I know you all realize now why we looked with pleasure to Mr. Craven's lecture. On behalf of the staff, faculty, and student body, I thank you, sir, for coming down.

MR. CRAVENS: It was a real pleasure.

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