

MONETARY, CREDIT, AND FISCAL POLICIES

SATURDAY, DECEMBER 3, 1949

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY, CREDIT,
AND FISCAL POLICIES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met, pursuant to adjournment, at 10:05 a. m., in the caucus room, Senate Office Building, Senator Paul H. Douglas (chairman of the subcommittee) presiding.

Present: Senator Douglas (chairman of the subcommittee) and Representative Wolcott.

Also present: Dr. Grover W. Ensley, acting staff director, and Dr. Lester V. Chandler, economist to the subcommittee.

Senator DOUGLAS. Ladies and gentlemen, I think we should come to order.

We are happy to have Mr. McCabe with us. I have been studying at odd moments the 70-page printed statement that you submitted earlier, on pages 21 to 91 of the committee print on Monetary Credit and Fiscal Policies, and found it very interesting. And now I understand, with indefatigable and good work as always, you have prepared a further 28-page memorandum to read this morning of observations on the testimony to date. We will be very glad to have you proceed.

STATEMENT OF THOMAS B. McCABE, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; ACCOMPANIED BY WINFIELD W. RIEFLER, ASSISTANT TO THE CHAIRMAN; AND WOODLIEF THOMAS, ECONOMIC ADVISER TO THE BOARD OF GOVERNORS

Mr. McCABE. Senator Douglas, I would like to take this occasion to introduce to the committee Dr. Winfield Riefler, on my left, and Dr. Woodlief Thomas on my right.

Senator DOUGLAS. You are to be congratulated on the advisers that you have.

Mr. McCABE. Should I start, sir, with this statement?

Senator DOUGLAS. If you wish, yes, sir. Proceed in your own way.

Mr. McCABE. Now that the hearings before this subcommittee of the Joint Committee on the Economic Report are coming to a close, I wish to commend most enthusiastically the objective manner in which you have addressed yourselves to your important task. I am sure that the witnesses who have appeared before you all appreciate, as I do, the earnestness, impartiality, and diligence which you and your staff

have shown in your search for light on some of the most complex problems of our times. You have been concerned, not with any specific legislative proposal, but rather with the more fundamental questions of the principles which should guide future legislation. The report of this committee, composed as it is of members of both Houses who are well versed in money and banking, cannot fail to have great influence upon the direction of monetary, credit, and fiscal policies in the future.

The searching nature of the questionnaire sent out to qualified and interested individuals and the way in which you have brought out disinterested professional opinion have contributed to the sustained high level of discussion that has prevailed during the past 3 weeks of these hearings. The printed record with the testimony of men of broad experience from business, finance, and public life, together with the answers to the questionnaire, constitute a most important and constructive volume—one that will be a “must” in every library dealing with problems of money in the world today.

You are probing into a very delicate and very crucial problem. It is no exaggeration to say that nothing more vitally affects the welfare and destiny of this Nation than the integrity of its money and credit. The American dollar commands the highest confidence throughout the world. To maintain that confidence demands no less vigilance than liberty itself. The problems you have been exploring are at the base of that integrity and confidence. A free-enterprise economy cannot exist without appropriate central banking institutions to influence the availability and cost of credit. Unfortunately this point is not generally understood, and lack of background is not confined to the general public. The attitude of many business and financial leaders, and of some of our banking leaders and supervisory officials, whose devotion to the public welfare cannot be doubted, is explainable on no other grounds. Much of the diversity in the testimony before you reflects not so much basic disagreement as it does differences in appreciation of the importance of the problem.

I shall address myself directly to the role to be expected of central banking procedures in the functioning of the American economy. Central banking institutions have always been considered the necessary and essential complement of a free-enterprise economy. Money does not manage itself. Once commercial banking institutions holding demand deposits become important, central banking institutions must be organized to avert money panics and to mitigate booms and depressions. Although they have necessarily been given wide discretionary powers, they should in no sense be regarded as an invention of or an adjunct to a managed economy or an administered state. Instead, they are part and parcel of a free-enterprise economy, designed to maintain full and continuous use of its human and material resources. In modern terms this means that they are expected to help maintain a high and stable level of employment in a free-enterprise economy. They endeavor to do this by the prompt and flexible use of adequate discretionary authority over the cost and availability of money and credit. As in the case of the courts, they must be operated purely in the interests of the public, but at the same time they should be immune from political bias and control.

That is the traditional, the conservative, the classic position. It is the issue that was dealt with by Carter Glass, among others, when

the Federal Reserve System was established. Misunderstanding about it underlies much of the criticism of our actions. I cannot emphasize too strongly the difficulties we are placed under when many of the most vociferous supporters of free enterprise, businessmen and bankers and their organizations, criticize the possession and use by the Federal Reserve System of necessary authority over the cost and availability of credit as if the delegation of this authority to the System were characteristic of a managed economy or an administered state. It is exactly the opposite. Otherwise I would not have been considered for my present post. Nor would I have been disposed to hold it.

Our main problems today have arisen as an inevitable result of the huge volume of war financing. They raise anew the question, How should central-bank procedures be related to the fiscal function of the state? The traditional position was developed in a world where public expenditures constituted a low percentage of the national income; where budgets were expected to be balanced annually; where the public debt, though it might have seemed large at the time, was very low in comparison with anything we face today; and where, incidentally, the widespread use of credit by consumers had yet to take root. It is clear that this is very far from the situation which confronts us today. In this country public expenditures, including Federal, State, and local, are of a magnitude that approaches one-fourth of the gross national product. Since the war, our Federal public debt has been considerably in excess of our entire annual national income, even though the national income is at record peacetime levels. Public debt now far exceeds the total of all private debt. The variety of new considerations that have to be taken into account in the modern formulation of fiscal policy is indicated in the report of the economists at their conference on fiscal policies held at Princeton. Their report is included in the record of your committee.

It is clear that we can no longer expect the wise exercise of traditional central banking powers, unsupplemented by other public policies, to maintain high-level stability in a free-enterprise economy to the same extent as was thought possible a generation ago. The impact of other public policies on the whole economy has grown too large in the interval. Does this mean that an administered economy is inescapable and that we must frankly accept the habitual resort to widespread controls in the form of price fixing, allocations, rationing, *et cetera*, in order to maintain high-level stability? These are incompatible with all of our conceptions of a free-enterprise economy in peacetime. To this question the answer is unequivocally "No." We can and we must retain the dynamic stimulus of free-enterprise institutions. The course of postwar experience, both here and abroad, has demonstrated anew that these institutions need to be protected through the exercise of central banking functions affecting the cost and availability of credit. These are still powerful instruments in the promotion of high-level economic stability. They must operate, however, in close conjunction with appropriate fiscal, debt management, and other governmental policies. The Committee for Economic Development has submitted to you a most thoughtful document addressed directly to this problem. It deserves careful consideration.

When I joined the Board of Governors in the spring of 1948, the economy was still undergoing the trials of the postwar inflation.

Money and liquid assets resulting from war financing were in oversupply relative to available goods and services. This vastly expanded money supply was supplemented by an increasing volume of commercial credit and consumer credit. Total loans at all commercial banks increased by more than \$16,000,000,000 between the end of 1945 and the end of 1948. There was full employment, possibly over full employment; scarcities prevailed in the markets; our people were becoming restive under the impact of continuous increases in the cost of living; and the operation of the wage-price spiral that is characteristic of mounting inflation was everywhere in evidence. Inflation is a form of intoxication in which some groups gain at the expense of the rest of the population, particularly people of fixed incomes. Frequently it accentuates selfish interests. Many in these groups think that their financial progress has been due solely to personal merit. They are blind to the fact that the great impersonal forces of inflation greased the way. It was our unpopular task, together with the Treasury, to counteract these forces by monetary and fiscal measures under our respective or joint influences or control.

Let me enumerate the measures that were adopted and comment briefly on each. By far the most powerful measure of restraint was the use of surplus Treasury funds to retire bank-held debt, particularly Federal Reserve-held debt. The power of decision with respect to this measure lay wholly with the Treasury. I doubt whether the public in general appreciates how important this was and the credit that must be given Congress and the administration for making it possible during that period. There is no antidote to inflation equal to the development of a budget surplus and the use of that surplus to retire debt at the central bank. It was endorsed and, indeed, recommended by the Federal Reserve System.

The policy of restraint was also fortified by the campaign undertaken by the American Bankers Association to encourage voluntary restraint in the extension of credit. I have repeatedly commended this action in both public and private statements. This cooperation on the part of the commercial bankers exemplifies the fact that we can all pull together in this country to achieve public ends when leadership has understanding and conviction.

Another restraining measure was the reimposition of regulation W, establishing limits to the extension of installment credit to consumers. It was reinstated and administered by the Board of Governors of the Federal Reserve System when Congress granted a temporary authority in the summer of 1948. During the period of the lapse of this authority, the total volume of this credit outstanding increased by 2½ billion dollars.

Another measure, and one of the more controversial, was the decision of the Board of Governors, after receiving temporary authority from Congress, to increase reserve requirements of all member banks by 2 percent on demand deposits and 1½ percent on time deposits in the early autumn of 1948. The Treasury was informed of this decision and offered no objection.

During all of the period of strong inflationary pressures, there were related and highly controversial questions in regard to raising the cost of credit in the money markets. These involved, on the positive side, increases in discount rates made in 1946 and in 1948 by the Federal Reserve, the decisions by the Treasury in 1947 and 1948 to raise its

rates on new issues of certificates, and the accompanying restrictive actions in the open market by the Federal Reserve authorities to increase the rates at which Treasury bills and certificates were traded in the market. They involved, on the negative side, supporting actions in the open market by the Federal Reserve authorities to maintain the 2½-percent rate on the long-term Treasury bonds, after permitting prices of these bonds to decline from high premiums they had reached.

I would like the committee, in judging this controversial subject, to be in possession of the facts. It has been said that the Open Market Committee of the Federal Reserve System, which is charged by Congress with responsibility in these matters, did not wish to continue to support the 2½-percent level on long-term Treasury bonds but was induced to continue this policy by pressure from the Treasury. This is not true. There were widely varying shades of judgment, not only throughout the country and in the Congress but within the Federal Reserve System, on the wisest course of action to pursue. It was my view, stated at the time, that the System was obligated to maintain a market for Government securities and to assure orderly conditions in that market, not primarily because of an implied commitment to wartime investors that their savings would be protected nor to aid the Treasury in refunding maturing debt, but because of the widespread repercussions that would ensue throughout the economy if the vast holdings of the public debt were felt to be of unstable value.

Senator DOUGLAS. Mr. McCabe, I do not like to interrupt you, but sometimes I think it helps if questions are asked during the statement rather than waiting to the end when the continuity is somewhat broken.

I think the committee on the whole is quite well aware of the fact which you mention; namely, that any dispute which occurred between the Federal Reserve System and the Treasury in the years 1946 and 1947 was not on the support price of long-term securities or the 2½-percent interest rate, but rather on the question of yields and prices of short-term securities. And I would invite your attention to pages 37 and following of your statement in the committee print at the bottom of the page under "Elimination of bill-buying rate." [Reading:]

Federal Reserve authorities in 1945 and 1946 considered the discontinuance of the bill-buying rate of three-eighths of 1 percent and the repurchase option established early in the war. It was proposed that the rate on bills be permitted to approach the $\frac{1}{8}$ -percent rate on 1-year certificates, with support of the latter rate continued at that level. The purpose of these steps was to reduce the abnormal spread in the pattern of rates and to encourage banks to hold more bills.

While you were not a member of the Board during this period, is it not your understanding that in late 1945 and in 1946 and the first part of 1947 the Federal Reserve authorities did wish to have the interest rate on short-term securities raised?

Mr. McCABE. Yes.

Senator DOUGLAS. And to allow the prices of those securities, if necessary, to fall?

Mr. McCABE. That is right, sir.

Senator DOUGLAS. Now, then, you go on to say:

In 1947 the Treasury concurred in the discontinuance of the buying rate on bills and the repurchase option as a part of a program in which an increase was permitted also in the rate on certificates.

I believe that action was in July of 1947.

Mr. McCABE. Yes.

Senator DOUGLAS. So that after the lapse of about a year and a half the Treasury agreed to the policy which the Reserve System had been advocating since at least the beginning of 1946?

Mr. McCABE. Yes. There was strong pressure on the part of the Federal Reserve at that time to get that rate up.

Senator DOUGLAS. And I think it may have been that to which Mr. Eccles referred in the memorandum that he submitted yesterday (see pp. 222-225); that Treasury action in some of these matters had been—I do not know whether he used this phrase—"too little and too late," but certainly too late.

Mr. McCABE. I believe Mr. Sproul used that phrase.

Senator DOUGLAS. Of course, it is a familiar wartime expression.

Mr. McCABE. Yes.

Senator DOUGLAS. You were not then a member of the Board and not responsible for any actions taken?

Mr. McCABE. I was chairman then of the Federal Reserve Bank of Philadelphia and had been for 10 years. So I was vitally interested in the problem at that time.

Senator DOUGLAS. Did you concur in the general opinion of the Federal Reserve authorities that the rate on short-time securities should have been raised at that time?

Mr. McCABE. Yes.

Senator DOUGLAS. For what reasons?

Mr. McCABE. We were just coming into the postwar period, and the evidences then were that we were entering an inflationary period. This was an instrument of Federal Reserve control that we felt should be applied to check the inflationary influence we felt was developing.

Senator DOUGLAS. Was it your feeling, if the interest rate on short-time governments were allowed to rise, that the interest rate on loans to private borrowers would also rise?

Mr. McCABE. You see, the whole credit structure is closely related to the Government-bond market and very sensitive to the Government-bond market. So, if there is a rise in Government bonds, there is a stiffening of rates throughout the whole credit structure.

Senator DOUGLAS. Stiffening, you mean, is the euphonious term for an increase?

Mr. McCABE. Increase; yes.

Senator DOUGLAS. The way in which reality can be muffled in Washington with soft words is really quite amazing.

You thought, therefore, that this would check undue private borrowing?

Mr. McCABE. It would help.

Senator DOUGLAS. But you did not put the policy into effect?

Mr. McCABE. The Federal Reserve was attempting to persuade the Treasury that that was the proper course to pursue.

Senator DOUGLAS. Did you have the legal powers to put it into effect even though the Treasury did not concur?

Mr. McCABE. The Federal Reserve, through its open-market operations, could upset the proposed policy of the Treasury.

Senator DOUGLAS. But you did not exercise your legal power because you wished to "cooperate" with the Treasury?

Mr. McCABE. At that time, we were emerging from a war period into a postwar period, and we had this colossal public debt. And at that time I was not Chairman of the Board. I would assume that its position was that it did not want to do anything that would upset—

Senator DOUGLAS. Were you a member of the Open Market Committee at that time yourself, Mr. McCabe?

Mr. McCABE. No. The Open Market Committee is comprised of members of the Board of Governors and five presidents of Federal Reserve banks.

Senator DOUGLAS. I wondered if perhaps it was your turn at that time to be a member.

Mr. McCABE. No; I was—

Senator DOUGLAS. I see, you were chairman of the Board of Directors in Philadelphia and not president?

Mr. McCABE. That is right.

Senator DOUGLAS. I see.

Mr. McCABE. Then I think you have to take into consideration the fact that during that time we had a debt-retirement program that was exerting considerable influence. And you see from the standpoint of the Federal Reserve and the execution of its functions, Senator, whenever you create surpluses in the Treasury you make our job very much easier.

Senator DOUGLAS. Oh, I think the policy of debt retirement in 1946, 1947, and the first part of 1948 was a most excellent one.

I wish my colleague from Michigan were here so that he might hear the comment that I am about to make. I only wish that it might have been continued by the Eightieth Congress and we had not had the tax reduction which gave us a deficit. I wish they might have continued in their good works. But that is another issue.

What I am trying to get back to is this fact that for a year and a half the Federal Reserve Board on the monetary and credit side wanted the rates on short-terms to increase in order that the general interest structure would advance and private borrowings might be diminished and, therefore, inflation checked, but that you cooperated with the Treasury in yielding your point of view, or the System cooperated with the Treasury. And I wondered under those terms what is the definition of the verb "to cooperate"? Does it mean to acquiesce?

Mr. McCABE. Senator, I think you ought to weigh in that period, as I say, this debt-retirement program. The Treasury very vigorously was pushing that program.

Senator DOUGLAS. But the retirement was being conducted out of surpluses of receipts over expenditures?

Mr. McCABE. That is right.

Senator DOUGLAS. I do not see how it is involved with the maintenance of a low rate on short-term issues.

Mr. McCABE. That was very effective, the point I am making.

Senator DOUGLAS. You mean that the Treasury felt this was sufficient? The Treasury felt that a reduction program was sufficient; that fiscal policy would be adequate to check inflation, and that you did not need added monetary and credit controls?

Mr. McCABE. Since I did not participate in those discussions at that time, I can only surmise.

Senator DOUGLAS. Here is the difficulty that we legislators labor under: We work to untangle a jigsaw puzzle and we generally find that the question directly addressed to the Government official is for a period in which he did not serve, or over an area for which he does not feel responsible, so that the Government official with perfectly good grace can say, "Well, it is impossible for me to answer."

And the poor frustrated legislator goes around in a merry-go-round hunting for the pea underneath the walnut and never finds it, and merely finds one administrative official after another telling him to look somewhere else.

Mr. McCABE. I thoroughly appreciate that; and I am in full sympathy with your problem.

Senator DOUGLAS. I do not know who was right in this period, very frankly, but I wanted to probe a little more deeply into the practical meaning of this verb "to cooperate." I notice that not only the Secretary of the Treasury refers to this verb but you do also. Favorite overcoat expressions which are sometimes used to cover up charming ambiguity of meaning are "to cooperate" and "to coordinate."

Excuse me.

Mr. McCABE. I cover some of the points you have made, Senator, a little later on in my statement.

Senator DOUGLAS. Will you proceed?

Mr. McCABE. In any case, the decision taken and executed was the decision of the Open Market Committee. It represented their combined best judgment, and I was convinced then, as I am now, in retrospect, that they were right. They were concerned with the huge size of the Federal debt and with its pervasive influence throughout the financial structure.

Senator DOUGLAS. You are still talking about long-term securities?

Mr. McCABE. Yes.

In view of the pervasive holdings of these securities, of the continued unsettlement that prevailed in the immediate circumstances of the postwar inflation, and of the fact that it had not yet been demonstrated that the great bulk of these securities was solidly held and that the floating supply had been absorbed, the adoption of a support level below par was a risk which the committee was not prepared to underwrite.

Our most controversial action during this period was to raise the reserve requirements of member banks. This decision was related to, but by no means conditioned solely on, the reluctance of the Treasury to increase short-term rates on bills and certificates as early as was recommended by the Open Market Committee. I propose, therefore, to discuss these two situations together. I have stated above that rightly or wrongly it was the decision of the Open Market Committee on its own responsibility not to risk a lowering of the support level on long-term Treasury bonds.

This decision in itself meant, of course, that funds paid out by the Reserve banks in support of the long-term bond market added to the bank reserves available for credit expansion. It meant that the System must depend mainly, for whatever restraining influence could

be exerted, either on increasing short-term rates or on increasing reserve requirements, or both. Either or both of these actions, restraining in themselves, were bound to be partly negatived to the extent that support of the long-term market resulted in furnishing reserves to the banks.

I think it is true that the reluctance of the Treasury to move as rapidly as the Open Market Committee recommended reinforced the disposition of the Board of Governors to make use of the power to raise reserve requirements. I doubt, however, whether the Board, under the circumstances then prevailing, would have refrained from the use of the power to raise reserve requirements even if the Treasury had agreed earlier to an increase in rates on short-term bills and certificates. It is difficult to be categorical about this point because it involves an interpretation of what official reactions would have been in a hypothetical situation.

There are some who felt that neither of these restraining moves would be effective because they would tend to be offset by the funds that would necessarily be put out in support of the long-term bond market. There are others, particularly among the member banks, who felt that the increase in short-term rates on bills and certificates would be effective but that the increase in reserve requirements would be completely offset by support purchases of bonds. We can now look back and give definite answers to some of these considerations that were highly conjectural at the time. It is a matter of record that the combination of these moves did actually exert a net restraint; that short-term money rates did firm; that loan expansion did stop, and that this situation prevailed until the Federal Reserve reversed its policies when the inflation abated.

Senator DOUGLAS. That is from July 1947 on?

Mr. McCABE. That is primarily in the latter part of 1948.

I do not personally subscribe to the view held by some that this actual result reflected solely the increases in rates on short-term bills and certificates supported by the voluntary campaign of the American Bankers Association to restrict credit advances to essential productive credits. Personally, I believe it also reflected the increase in reserve requirements, for one reason because this increase diminished the liquidity of the member banks. In retrospect, however, I would also say that my reluctance to resort to changes in reserve requirements as a method of dealing with an inflationary situation has been increased, not diminished, by the experience.

As everyone knows, that particular episode in our economic history, the hang-over of postwar inflation, had come to an end by early 1949. We can now look back on the postwar period as a whole, consequently, with some perspective and some of the advantages of hindsight. It is my personal evaluation that this country, all things considered, came through that period of trial amazingly well, better than any other major country and with less social and economic distortion. The amount of inflation that actually occurred was less than there was reason to fear. By this, I do not mean in any sense that no mistakes were made, or that the inflation and distortions we have suffered were unavoidable. Some inflation was inevitable, probably a considerable inflation, but it could undoubtedly have been held within narrower

limits. Nevertheless, taking all the complexities and perplexities of the problem into consideration and also the necessary coordination of millions of individual wills, I feel that it will be the verdict of history that our combination of democracy and free enterprise which we enjoy in this country gave a good account of itself during this period.

The monetary and credit measures which we adopted played no small part in that over-all result. Let me cite two specific instances. One of our controversial actions was the decision to reimpose restrictions on the extension of installment credit to consumers. When we reissued regulation W in the autumn of 1948, the automobile industry was producing cars to the full extent permitted by the availability of materials. This production was insufficient to meet the demand, however, with the result that so-called used cars commanded bonuses or premiums of as much as \$500 or more in the gray market.

Senator DOUGLAS. May I interrupt a minute on a semantic question?

When you use the term "gray market," does that mean a market that is not quite as dirty as a black market?

Mr. McCABE. It is in between, sir.

It was part of our objective to defer some of this excess demand until materials became more freely available, that is, to a period when the demand so deferred would sustain employment and buttress high-level stability rather than augment the inflation and the wage-price spiral. I think the record shows that these expectations were on the whole borne out by the subsequent course of events. Of course, many factors played on the scene, and subsequent events cannot be explained in terms of any one factor alone. Nevertheless, it remains true that the premium in the gray market for automobiles disappeared shortly after the reissuance of our regulation, that we were able in March of 1949 to relax the regulation, and that the automobile industry since that time has been a bulwark to employment during the transition period of inventory readjustment that has prevailed in 1949. With materials more freely available, the automobile industry has been able to set new high records in production and sales at a time when this production was most effective and most needed as a contribution to high-level stability.

My second illustration is from the field of mortgage financing in its relationship to home-building activity. You are all aware of the spiraling costs of housing construction during the postwar period when what seemed like an almost unlimited demand for shelter impinged on the limited resources of the home-building industry. You are also aware of the turn-down in new housing starts that occurred in the autumn of 1948, the subsequent reduction in costs of new homes by 5 to 10 percent, and the renewed and sustained home-building activity at new record levels that made itself felt during the past summer. Performance of the home-building industry was a powerful factor in the maintenance of employment at high levels and without renewed inflation of costs during this past year. It is my personal judgment that monetary and credit factors played a significant role in these developments. The slowing up of new starts that made itself evident in the autumn and winter of 1948 was not unrelated to the decreased availability of credit at that time. The subsequent upsurge of activity during this summer was related in part to the effect on

mortgage financing of our moves to ease credit during the spring of 1949, as well as to other actions by Government to ease mortgage credits.

So much for the postwar inflationary situation from which we have now emerged, and the lessons that the experience has brought to us. I wish to turn now to the current position of the Federal Reserve System in its policy operations in the money markets.

That position was announced by the Open Market Committee on June 28 of this year. I will quote that announcement in full so that you all may be familiar with it:

The Federal Open Market Committee, after consultation with the Treasury, announced today that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture it will be the policy of the committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve banks with primary regard to the general business and credit situation. The policy of maintaining orderly conditions in the Government security market, and the confidence of investors in Government bonds will be continued. Under present conditions the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased.

I regard the announcement as a significant milestone because it reflected the joint judgment of the Treasury and of the Federal Open Market Committee that the postwar economic and financial situation had evolved to a point where open-market operations could safely be permitted to play a more orthodox role in our policies. Such operations will, of course, continue to be affected by concern for the stability of the Federal debt and its repercussions upon the entire debt structure. The public debt is now a dominant part of the financial structure. No one informed on money market operations expects that open-market policies will ignore this fact. The public debt, however, huge as it still is, has become sufficiently settled in the hands of stable holders to permit open-market policy to be formulated on a more flexible basis than formerly. I regard June 28, 1949, as a most important date. It signified removal of the strait-jacket in which monetary policy had been operating for nearly a decade; that is, since the beginning of the war.

The record that I have cited illustrates how we have been compelled to operate under utterly new conditions, unprecedented in modern times. What is their significance with respect to fiscal policies, to the relationships required between central banking authorities and fiscal authorities, and to the adequacy of traditional central banking powers? These questions are implicit in your inquiry. They demand the attention of thoughtful men everywhere. Unless we find the solution to these problems, our way of life, which is the way of the free world, will be in jeopardy. Having spent 33 years of my life as a private enterpriser, I want above all to avoid anything that either weakens our economy or puts the fiscal structure of our Government in peril.

I approach these problems with a feeling of humility which I am sure you and many of the thoughtful men who have appeared before you share. It is this feeling that makes me so sympathetic to the study which you are conducting. Out of all of the discussions, we can, perhaps, achieve better understanding for our future guidance.

I would be less than frank if I left you with the impression that the new position which was initiated on June 28 had ended the need for coordination between debt management and money-market policies. That need will, of course, continue. Many suggestions have been advanced in the answers to your questionnaire and in the testimony, suggesting formal procedures to assure a result that is in the long-run public interest of our democracy. Personally I am skeptical of the value of formalized procedures in a situation of this kind. The truth is that our problems arise out of the different character of the very serious responsibilities that are borne by the Treasury on the one hand and the Federal Reserve System on the other. The record of history is clear, that the institutions charged with these responsibilities should be mutually independent of each other, for the subordination of either might lead to unfortunate results. This seems to me to imply that we must rely on the men who carry these respective responsibilities, on their good will, constructive vision, and spirit of cooperation. There is no danger that Treasury officials and Federal Reserve officials will lack personal contact. The nature of their duties insures and will continue to insure that they face these problems together. I took pains to point out in my answer to the questionnaire that a splendid degree of cooperation exists between the Treasury and the Federal Reserve.

RESERVE REQUIREMENTS

I propose now to clarify several specific, but not necessarily related, points where the record indicates confusion. First of these is the general problem of reserve requirements. Three relatively distinct types of problems that fall under this heading have been dealt with in the record, and I want to distinguish them and comment briefly on each.

1. *To what extent should the Federal Reserve authorities have the power to raise or lower reserve requirements and under what conditions should this instrument be used?*

I am somewhat embarrassed in answering this question. The Congress has not seen fit in the past to delegate as broad authority with respect to this instrument as it has with respect to other instruments. Only 6 months ago Congress refused extension of the temporary authority that then existed. I am hopeful that as a result of this committee's interest the subject might be reviewed in broad perspective in a study under authority of Congress.

The Board has heretofore proposed that additional authority be granted so that it would be in a position to absorb additional reserves that might be made available in excess of the current needs of the economy. It has been recognized, and so stated, that reserve requirements are not a flexible instrument; in other words that frequent "jiggling" of the requirements should be avoided. The principal possible sources of additional reserve funds are (1) inflow of gold, (2) return of currency from circulation, and (3) Federal Reserve purchases of Government securities.

It should be recognized that from a long-run standpoint basic adjustments in reserve requirements may be needed from time to time to allow for fundamental changes in the reserve structure. An inflow of gold of a billion dollars a year for 5 or 10 years, together with a

return flow of a moderate portion of the very large wartime increase of currency in circulation, could deplete the Federal Reserve banks' open-market portfolio below a reasonable operating level. It may also be essential at times for the Federal Reserve to purchase Government bonds in maintaining orderly markets for these securities. An increase in reserve requirements might be needed in order to immobilize any large amount of reserves created in this manner.

As I stated in my answer to your questionnaire, the Federal Reserve should have authority broad enough to meet its responsibilities under different situations. We have learned from experience that if we should again be confronted with the problem of dealing with a dangerous expansion of bank credit, flexible open market and discount policies would be more effective instruments than increasing reserve requirements.

2. Is the existing system of reserve requirements for member banks effective and equitable?

It is not necessary on this occasion for me to discuss at length existing methods of computing reserve requirements or why we believe a change in the methods is worthy of consideration. These matters are treated at some length in the answers which the Reserve bank presidents and I have submitted in answer to your questionnaire. The problem has been studied by various groups in the Federal Reserve System almost from the time of its organization and many proposals have been made for its solution.

We are convinced that the existing system should and can be greatly improved. We are not, however, committed to any particular proposal for change. Our staffs after years of study have worked out a method which is believed to be workable and equitable and may be the best that can be devised. It has already been presented informally to your committee.

Senator DOUGLAS. Is that a statement that was submitted about 2 years ago?

Mr. McCABE. That was the statement to the Joint Committee on the Economic Report about a year ago last summer.

Senator DOUGLAS. And as I remember it, it called for abolishing the present differentials based upon the nature and size of the city.

Mr. McCABE. It would base requirements on the nature of deposits rather than on geographical considerations.

Senator DOUGLAS. So that the same type of deposit would have the same reserve requirement irrespective of the city in which the bank was located?

Mr. McCABE. That is right.

The problem is a continuing one and inequities increase the longer it remains unsolved. It is my view that the problem should be studied by the appropriate committees of Congress, by banking groups, and others, as well as by the Federal Reserve. We will be prepared to present a definite recommendation at the appropriate time. If a national monetary commission is set up to study such questions, this would be one of the most important for it to consider.

3. *Should banks which are not members of the Federal Reserve System be required to maintain reserve requirements essentially the same as those required of member banks?*

I have discussed at some length, in the answers submitted to your questions, the difficult problem of the limitations that the existence of nonmember banks place on the effectiveness of Federal Reserve actions. The Reserve bank presidents, who are intimately concerned with this problem, have also given you their views and so have many others. Differences in reserve requirements are one of the most important aspects of the effect of nonmember banks on the Federal Reserve System.

Reserve requirements for State banks which are not members of the Federal Reserve System vary from no statutory requirements whatever in the State of Illinois, to requirements which, in percentages, are higher than those of member banks in a number of States. The essential difference between reserve requirements of member and nonmember banks, however, is not in percentages but in the composition of reserves. Even where the percentages of deposits required to be held as reserves are the same as, or higher than those for, member banks, the nonmember bank still has an important advantage. Nonmember banks can meet their reserve requirements through holdings of vault cash and balances with correspondent banks, while member banks can count only their balances with the Federal Reserve as required reserves, and in addition must hold for working purposes a certain amount of vault cash and balances with correspondents. Member banks not in reserve cities, the so-called country banks, as a group have recently been maintaining holdings of vault cash and balances with other banks amounting to about 15 percent of their gross demand deposits, in addition to balances with Federal Reserve banks of 12 percent against net demand deposits¹ and 5 percent against time deposits.

Senator DOUGLAS. May I interrupt there, Mr. McCabe?

Has your organization ever been able to find the percentage of cash as distinguished from balances with correspondents at nonmember banks?

Mr. McCABE. We have an estimate of that, sir.

Senator DOUGLAS. Would you submit that for the record?

Mr. McCABE. I anticipated that question because I thought you would be interested.

The ratio of cash to total deposit of insured nonmember banks, according to our estimate, is 2.6 percent.

I would be glad to submit these figures.

Senator DOUGLAS. So that virtually all the rest of their required reserve is in the form of deposits in correspondent banks?

Mr. McCABE. I think this table gives the picture.

¹ Net demand deposits are computed by deducting holdings of balances with correspondent banks and other cash items from gross demand deposits.

Ratios of cash assets to deposits of all insured commercial banks, by class of bank, June 30, 1949—Ratios to total deposits

	Member banks				Insured nonmember banks	
	Total	Central Reserve city banks		Reserve city banks		
		New York	Chicago			
Cash in vault.....	1.3	0.5	0.4	1.1	2.1	
Balances due from banks.....	4.4	.3	2.5	4.0	7.2	
Cash items in process of collection.....	5.1	9.3	5.8	5.9	1.9	
Subtotal.....	10.8	10.1	8.7	11.0	11.2	
Reserves with Federal Reserve banks.....	15.2	20.0	19.3	15.5	11.8	
Total, cash assets.....	26.0	30.1	28.0	26.5	23.0	

Senator DOUGLAS. We worked out that the weighted average of reserves in the Federal Reserve System of member banks amounted to a little less than 20 percent, probably around 19 percent. Now, if we could get the average of the State banks in the form of deposits in correspondent banks, we could then find the average total reserve of the nonmember banks.

Mr. McCABE. We have here the percentage ratios.

For insured nonmember banks the ratio of all cash assets to total deposits is an average of 17.9; 2.6 of that is in cash in vault; 14.7 is balance due from banks; and 0.6 is cash items in process of collection; making a total of 17.9.

Now the country banks of the Federal Reserve System have an average of 2.1 percent of total deposits in the form of cash in vault, 7.2 percent in balances with correspondent banks, 1.9 percent in cash items in process of collection, and 11.8 percent in reserve balances at the Federal Reserve banks, making a total of 23 percent.

The country banks are carrying a total of 23 percent in those items against 17.9 percent for the nonmember insured banks.

Senator DOUGLAS. Or about 5 percent more.

Mr. McCABE. About 5 percent more. Now if you take a Reserve city bank—because in this column of insured nonmember banks you have not only country banks but you have Reserve city banks—the total for the Reserve city member banks is 26.5; and the total for the central Reserve city banks, for instance, in Chicago, is 28 percent; and in New York it is 30.1 percent.

Senator DOUGLAS. Have you got a weighted average for the System as a whole?

Mr. McCABE. Yes; 26 percent for all member banks.

Senator DOUGLAS. As contrasted with approximately 18 percent for the nonmember banks?

Mr. McCABE. Seventeen and nine-tenths percent.

Senator DOUGLAS. Eighteen percent, or 8 percent more for the member banks than for the nonmembers.

Mr. McCABE. Yes.

Senator DOUGLAS. I have never seen those figures before.

Mr. McCABE. I think they are of crucial importance.

We have some very interesting figures here also, sir, on comparative earnings.

(The table is as follows:)

Earnings of insured banks by class of bank, 1948

[In millions of dollars]

	All in- sured banks	Member banks					Insured nonmem- ber banks
		All mem- ber banks	New York	Chicago	Reserve city	Country	
Earnings.....	3,404	2,828	476	120	1,058	1,174	576
Interest and dividends on U. S. Government secur- ties.....	1,008	855	154	44	294	363	154
Interest and discount on loans.....	1,600	1,308	182	46	524	555	292
All other.....	796	666	140	30	240	256	130
Expenses.....	2,164	1,795	284	75	681	755	369
Salaries and wages.....	1,044	876	166	36	330	345	160
All other.....	1,119	919	118	39	351	411	200
Net current earnings.....	1,240	1,033	192	45	377	419	207
Net losses and charge-offs and transfers to reserve accounts.....	219	179	14	5	71	89	41
Profits before income taxes.....	1,021	854	178	41	306	330	166
Income taxes.....	275	234	39	11	91	92	42
Net profits.....	745	621	139	30	215	238	125
Ratio of net current earnings to capital accounts.....	12.5	12.0	8.4	10.4	13.1	13.8	15.7
Ratio of net profits to capital accounts.....	7.5	7.2	6.1	6.9	7.4	7.8	9.4

Mr. WOLCOTT. Mr. Chairman.

Senator DOUGLAS. Mr. Wolcott.

Mr. WOLCOTT. In following Mr. McCabe, I did not know whether he had given us the average reserves of nonmember banks which might be located in central Reserve cities and Reserve cities.

Mr. McCABE. We have not broken that down. This is the average of all nonmember insured banks.

Senator DOUGLAS. If you take the two systems as a whole, the contrast is between 18 percent and about 26 percent?

Mr. McCABE. That is right.

Mr. WOLCOTT. Excepting that the legal reserves in the Reserve city banks is 26 percent, and you say they are actually 31 percent. That builds up your average of member banks pretty high. I do not know whether we should compare that under those circumstances with the average reserves of the country banks that are not members.

Mr. McCABE. I do not know if you want to take the time right now to figure it out, but insured nonmember banks have cash assets of 17.9 percent of total deposits and country member banks, which are similar to insured nonmembers, carry cash assets amounting to 23 percent of total deposits. The legal reserve requirements today for central Reserve city banks is 22 percent; for Reserve city banks, 18; and for the country banks, 12.

Mr. WOLCOTT. Not 26?

Mr. McCABE. No; 22. We reduced it twice.

Mr. WOLCOTT. I guess I am speaking of legal limits. Your legal limit is 26?

Mr. McCABE. The legal limit is 26. You heard that 26 discussed at great length before your committee.

Mr. WOLCOTT. Yes; I had that 26 in mind.

Mr. McCABE. The practice of holding balances with correspondents is characteristic of our system of unit banks. In any inquiry of needed monetary and banking legislation, consideration should be given to the possibility of evolving a system of reserve requirements that would make allowance for holdings of vault cash and balances with other banks in such a way as to minimize the effect of differences between member and nonmember banks. In my answer to your questionnaire, I have submitted some alternatives that might be considered to deal with this problem.

THE PROBLEM OF A DIVIDED BANKING STRUCTURE

It has been intimated to the committee that we in the Federal Reserve are unduly alarmed by the problems presented by a divided banking structure since nonmember banks hold only 15 percent of the total commercial bank deposits in the country. I want to point out that this is an over-all figure and can be very misleading if not viewed on a geographical basis. The percentage of deposits varies between 4.5 percent and 62 percent from the lowest State to the highest.

Senator DOUGLAS. What State is the lowest and what State is the highest?

Mr. McCABE. New York is the lowest and Mississippi is the highest.

Correspondingly, the number of nonmember banks varies between 13 percent and 85 percent of all commercial banks. I need hardly point out to Members of Congress the actual influence of these 7,000 nonmember banks representing 50 percent of the banking constituency.

I emphasized strongly in my answer to your questionnaire my fundamental faith in the dual banking system. The great commercial expansion of this country was ventured under that system, and I would be the last to advocate any policy that supplants it. I also emphasized my great concern lest our dual banking system degenerate into a hopelessly divided banking structure, and I gave you what I consider some constructive alternatives to deal with it.

My primary aim is to consolidate the efforts of all forces concerned with our financial integrity to the greatest extent possible in order to have this country adequately armed, so far as our money mechanism can accomplish that, to prevent credit excesses in an upswing and to make Federal Reserve resources universally available to banks if they need help in stormy weather.

Our banking and credit economy consists of an incredibly complex structure of interlocked assets and liabilities. No bank can operate that cannot convert its assets quickly into cash when depositors' use of funds results in a drain. In periods of financial strain there is no alternative but recourse to the Reserve System. This recourse to funds is always available to a member bank, with full assurance that the Federal Reserve will be in a position to meet its requirements, whatever they may be. I would like to see this recourse open also to nonmember banks who carry their reserves in the Federal Reserve banks.

Senator DOUGLAS. May I raise a question there?

As long as the Federal Reserve System is willing to buy Government securities from the banks and give them Federal Reserve notes if necessary, in return, does that not mean there is virtually no danger of bank failure?

Mr. McCABE. I think the danger of bank failure has been greatly minimized over the last several years.

Senator DOUGLAS. And minimized not merely by the FDIC, but also minimized as long as the Open Market Committee will buy Government securities from the banks; is that not true?

Mr. McCABE. I was very much interested the other day in Mr. Harl's testimony before you, where he emphasized so strongly the importance of the maintenance of the support program on the long-term Government bonds. I think he made a very strong point of that in testimony before this committee.

I think it is a combination of many factors. The banks are more liquid today than they have ever been in their history. Of their total loans and investments, roughly 50 percent are in Government bonds.

Senator DOUGLAS. Excuse me for interjecting, but I am asking this question to clarify my own mind.

Government securities differ from the private securities in that in the case of private securities there is no market that banks as a whole can depend upon to operate at all times; but, as long as the Open Market Committee is willing to buy bonds from the member banks, you do provide a market at all times for Government securities. Therefore, you now provide a degree of liquidity which was not present when Government securities formed only a small proportion of the holdings of the banks and the overwhelming proportion of their holdings was in the form of securities which they were not able to liquidate at the same time, or if they tried to liquidate all at the same time would result in a disastrous fall of prices in those securities; is that not true?

Mr. McCABE. All the character of bank investments today is greatly improved over what it was 15, 20, 25 years ago. We never have had, Senator, a banking structure as strong as we have today.

Senator DOUGLAS. Here is the interesting thing. It has been made stronger, has it not, by the very existence of the public debt? That is a curious paradox.

Mr. McCABE. That is a curious paradox, but it is true.

Senator DOUGLAS. There used to be an old saying that public debts were private blessings. Is that true in the case of banks?

Mr. WOLCOTT. I assume your question was predicated upon the fact that we could monetize much of our debt to prevent the failure of banks. If there came a time in our economy where that was necessary, what would be the natural effect under the quantitative theory of money upon our economy if you monetized enough of the debt to support the banks?

Mr. McCABE. You are thinking that if overnight, using a hypothetical case, the Federal Reserve should purchase all of the Governments held—

Mr. WOLCOTT. Not all, but sufficient to prevent the banks from failing, if we take that means.

Mr. McCABE. You would have the potentialities then for a great credit expansion. It would depend on the circumstances at the time as to whether that credit expansion would take place, but you would certainly have the potentialities.

Senator DOUGLAS. In a period of depression that very fact would lend an element of stability to the situation?

Mr. McCABE. Unquestionably, as you supply reserves to the banks in a period of recession or depression or whatever you want to call it—

Senator DOUGLAS. "Inventory readjustment" seems to be the official phrase nowadays.

Mr. WOLCOTT. Is that not what we usually refer to as printing-press money? And do you advocate that in periods of depression we start the printing presses to offset the depression?

Mr. McCABE. Congressman Wolcott, as you well know, I am—

Mr. WOLCOTT. Perhaps I should not have asked you that question. I think it naturally follows that your answer would be "No," generally, but I think maybe, if I may offer the suggestion, a little of it might be all right and might prevent further depression, but you would not use that as the alternative to a depression.

Mr. McCABE. As you probably know, I think I am a rugged exponent of all the safeguards of our private-enterprise system and have an abhorrence of an unsound money. As long as I am in this position, I would fight with everything that is in me not to do anything that would break down the confidence of our people in our money.

Mr. WOLCOTT. I felt that was the kind of answer he would like to make to clarify the situation.

Senator DOUGLAS. The purpose of the Chairman of the Federal Reserve Board is the purpose of everyone. No one would break down the confidence in money.

Mr. McCABE. Objections raised against inclusion of all commercial banks in common protective action against inflationary excesses do not, of course, arise when we talk of making the resources of the Reserve System available to all banks, regardless of membership, when the going gets rough. Whether it is more vital to restrain a boom or cushion a depression, in either case I have felt that the Reserve System should be in a position to use all its influence.

I think this should dispel the fog that has spread over the question of whether nonmember banks should be on an equal footing with member banks so far as reserve requirements are concerned. This is no new subject. It is as old as the Federal Reserve Act itself. Carter Glass was by no means alone in insisting that logic and simple fairness called for universal membership. I can imagine no more vigorous a champion of States' rights than he was. In the early and mid-thirties, Congress specifically provided that all insured banks, at least, should be members of the Reserve System. True, that decision was subsequently reversed.

Senator DOUGLAS. Just a moment. When was it that Congress provided that all insured banks should be members?

Mr. McCABE. When the FDIC was first created.

Mr. THOMAS. In 1933.

Senator DOUGLAS. And when was it reversed?

Mr. McCABE. It was modified in 1935, and repealed in 1939.

Senator DOUGLAS. It was put into the law in 1933 and was repealed in 1939? Was it ever operative?

Mr. McCABE. It was supposed to become effective in 1936, but it never actually went into effect. A 1935 amendment excluded very small banks and extended the effective date to 1941, but this was repealed in 1939.

Senator DOUGLAS. There was no occasion for withdrawal?

Mr. McCABE. That was the intent of Congress at the time of the passage of the FDIC legislation.

Senator DOUGLAS. Then as the fear of break-down diminished—

Mr. McCABE. There was great pressure exerted throughout the country on that.

I mention this only to point out that there is nothing new or novel; there is no reaching for more and more power, when we bring to your attention the fact that nonmembership dilutes our ability to do our job—and that is all we are concerned with. Carter Glass put it in far stronger terms when he said it makes for competition in laxity.

As a businessman, I naturally dislike restrictive Government authority and centralization of power. Some of the fog that surrounds the subject of the role of monetary policy arises because of the erroneous belief that the Federal Reserve System seeks to play a far greater part than was intended and that it is reaching for more power. I have tried to bring out in this discussion, on the contrary, that the dilemma we faced until this year could not be resolved adequately because, in our considered judgment, we could not use the open-market powers—undoubtedly very great—which we already possessed without the likelihood of doing more economic harm than good.

The suggestion has recently been made to me by a very competent observer that one step forward might be taken through strengthening, in some appropriate and acceptable way, the relationships between the Reserve System and the supervisors of State banks. I have not thought this out completely, and I mention it only because this is one of many constructive thoughts that we are exploring to harmonize the policies of all supervisory authorities in attaining our common objective.

With your permission, I will introduce in the record a table which shows nonmembership by States, both as to deposits and numbers of banks. I would also like to introduce into the record excerpts from letters I have recently received from the presidents of the Federal Reserve Banks of Chicago, Minneapolis, and Kansas City, commenting on this subject.

Senator DOUGLAS. We will be very glad to have you do so.

(The material referred to above is as follows:

Commercial banks in the United States; percentage of nonmember banks, by States, June 30, 1949

State	Number of banks	Percent non-member	Percent total deposits held by non-member banks	State	Number of banks	Percent non-member	Percent total deposits held by non-member banks
Mississippi.....	203	84.7	62.0	Rhode Island.....	19	47.4	20.0
Georgia.....	391	83.5	28.9	Utah.....	55	43.6	16.5
South Carolina.....	150	78.0	32.5	California.....	204	43.6	8.5
North Carolina.....	226	76.1	45.4	Illinois.....	891	43.2	9.6
Iowa.....	663	75.5	48.1	Vermont.....	70	42.9	48.1
Tennessee.....	295	72.2	22.9	Connecticut.....	114	42.1	31.4
North Dakota.....	150	72.0	57.4	Oklahoma.....	337	41.9	14.0
Louisiana.....	161	71.4	23.0	Malta.....	64	40.6	31.4
Kentucky.....	385	70.9	37.6	West Virginia.....	179	40.2	23.0
Arkansas.....	230	70.9	32.1	Idaho.....	45	40.0	13.5
Wisconsin.....	551	70.2	31.0	Colorado.....	147	37.4	11.0
Missouri.....	590	69.9	21.6	Texas.....	893	36.6	11.1
Minnesota.....	682	69.6	26.9	Ohio.....	662	36.0	11.6
Nebraska.....	416	65.6	26.4	Virginia.....	314	35.0	19.3
Kansas.....	610	64.8	38.0	New Mexico.....	50	32.0	20.5
South Dakota.....	170	63.5	33.8	New Hampshire.....	75	30.7	32.3
Florida.....	190	61.6	23.0	Wyoming.....	55	25.5	10.3
Alabama.....	226	59.7	18.1	Nevada.....	8	25.0	8.4
Washington.....	122	56.6	7.9	Montana.....	111	21.3	13.3
Oregon.....	69	56.5	8.2	Pennsylvania.....	979	24.0	13.5
Delaware.....	39	56.4	33.7	Massachusetts.....	183	21.9	8.8
Arizona.....	11	54.5	16.5	District of Columbia.....	19	15.8	6.1
Maryland.....	163	52.8	26.2	New Jersey.....	331	15.3	12.5
Indiana.....	486	51.6	27.3	New York.....	648	12.8	4.5
Michigan.....	446	48.2	13.7				

COMMENTS OF RESERVE BANK PRESIDENTS ON NONMEMBER BANK PROBLEM

From H. G. Leedy, Federal Reserve Bank of Kansas City

It is sometimes said that the effectiveness of the Federal Reserve System is not reduced significantly by the presence of nonmember banks, as member banks hold 85 percent of all bank deposits in this country, leaving only 15 percent not directly subject to Federal Reserve influence. This statement greatly understates the problem.

Recently, one of our officers visited with a banker in a small town who is operating a national bank, and therefore a member bank. His competitor across the street is a State nonmember bank. The national banker indicated that there was serious question in his mind as to whether he should carry or could afford to carry the cost of being a member bank when he was trying to compete with an institution across the street that did not have to meet those particular costs. He not only thought that it was not fair and equitable, but he indicated serious doubt as to whether it was good judgment on his part to operate his bank as a member bank in that kind of competitive situation. This conversation is only one example of a host of similar conversations that we have had.

Repeatedly, we hear our member bankers raising serious question as to whether it is either equitable or good judgment for them to incur the additional dollar cost that is involved in being a member bank, and we hear nonmember banks commonly giving that increased cost as a reason for not joining the Federal Reserve System. Recently, a member bank withdrew from the Federal Reserve System, and in a letter to this bank made the following statement: "In this action we want to assure you that there is absolutely no ill feeling, as our association and business dealings have all been most pleasant, but it was thought that keeping such a large reserve with the Federal Reserve worked quite a hardship on us, and precluded our investing State and county funds in bonds, as we are required to keep the reserve with you on such deposits."

We also must recognize that part of the effectiveness of Federal Reserve credit action stems from the indication it gives of the viewpoint of the monetary authorities with respect to credit developments. An increase in member bank reserve requirements, for example, not only immobilizes part of a member bank's reserves but it also makes the member bank acutely conscious of the fact that the Federal Reserve officials think that credit expansion should be restrained. This in itself, I am convinced, tends to make member banks more selective in their extension of credit to customers. On the other hand, nonmember banks not only do not have that additional part of their reserves immobilized, but the Federal Reserve's expression of its attitude with respect to further credit expansion has little effect upon the nonmember banks' lending policy. In our Federal Reserve district, with 1,009 nonmember banks as compared with 759 member banks, this means that the lending policy of the vast majority of banks, and in some areas of the district nearly all banks, are affected little, if at all, by Federal Reserve credit actions.

From C. S. Young, Federal Reserve Bank of Chicago

Present capital requirements specify only capital stock and fail to take into consideration surplus and other accounts, which are part of the capital structure of a bank. In this way, a bank with a substantial and well-balanced capital structure may be ineligible for membership even though its capital structure is stronger than that of some bank that has the required amount of capital stock. A bank should have a reasonable amount of capital stock to be eligible for membership, but consideration should also be given to other capital accounts. Also, if a nonmember bank has a sound investment and lending policy and its management is capable, it should not be denied membership in the Federal Reserve System if the only reason involved is lack of capital sufficient for it to become a national bank.

No bank can insulate itself against the effects of System action by remaining out of the System, nor can it gain all of the benefits of membership without becoming a member.

The Chicago Federal Reserve District serves more member banks than any other district, and as of November 28, 1949, it had 1,006 members. Of the 14,000 banks in the United States, more than 2,500 are located in the Chicago district. Branch banks are operated in four of the five district States and 292 maintain branches. Of the commercial banks, 565 are national institutions, and 1,942 operate under State charter. Because of statutory requirements based on the population of the town or city they serve, 150 are denied the benefits of membership in the Federal Reserve System, and 222 cannot join or have had to withdraw from the System because they operate branches outside the city in which they are located and do not have the common capital stock required for membership under present statutes.

From John N. Peyton, Federal Reserve Bank of Minneapolis

It is a distressing fact that the Federal Reserve System which is the central banking system of the United States, serves directly less than half of the commercial banking institutions in the Nation. To be sure, the banks which are members of the Federal Reserve System hold the major part of the banking resources of the country, but the System cannot be said to be successful or fully effective under present conditions. In time of emergency, banks which are not members of the Federal Reserve System must rely on other commercial banks for credit, and it is probable that at such times these other commercial banks may be overextended and must rely, themselves, on the Federal Reserve System. This is exactly the situation which prevailed periodically before the Federal Reserve Act was passed, and the act was designed to cure this defect as one of its major objectives.

At the opposite extreme, in times of boom and speculative mania, the machinery set up by Congress through which the central banking system can restrain excessive creation of bank credit cannot be fully effective as long as thousands of banks can continue to operate as they please without feeling the restraints of such administrative actions as higher discount rates and higher reserve requirements.

LOANS TO BUSINESS

I wish particularly at this point to clarify my response in the questionnaire that dealt with the authority of the Federal Reserve banks

to extend direct loans to industry. The statement has been misunderstood by some to indicate that I requested new authority to compete with the lending authority of the Reconstruction Finance Corporation. The fact is that the Federal Reserve banks have long had authority under section 13b of the Federal Reserve Act to make direct loans to industry. I was seeking in my answer to avoid conflict between the lending activities of the Federal Reserve banks and those of the RFC. I specifically stated that if Congress did not wish to clarify the position I would prefer that our authority be repealed, and I wish to re-emphasize that statement because the Federal Reserve System should not be looking for new worlds to conquer. Furthermore, the very justifiable question can be raised as to the role of a central banking authority in the field of direct lending.

It is part of my basic philosophy to be wary of the growth of Government loan agencies that, in their competition with private lending institutions, weaken these institutions to the point where they no longer play a dynamic role in our economy. At the same time, I recognize that situations have arisen, and may arise again, particularly in periods of emergency, when the availability of public financing is essential to the survival of the economy. I recognize also that in the area of small business there may be financial needs at all times that justify direct Government attention and support. In my answer, I tried to deal with both of these needs.

The basic problem arises out of the nature of the credit relationship between borrower and lender that is appropriate to a private-enterprise economy. Though it may not so appear on the balance sheet, a business credit or business loan is not an isolated transaction that occurs once between a borrower and a lender and is terminated at the time of repayment. What a businessman needs, and what small-business men need above all else, is a credit connection, a recurrent source of loans to which he can turn periodically to finance his seasonal needs—

Senator DOUGLAS. Or, to use the phrase of the Bible, "an ever-present help in time of trouble"?

Mr. McCABE. Exactly—to tide him over emergencies, to advise him on plans for expansion and to help finance his growth. It is only very large concerns, with direct access to the central money markets, that can afford even to contemplate operations without an established recurrent source of financial accommodation. Most of our successful business enterprises, both large and small, are meticulous to cultivate and maintain customer relationships of long standing with commercial banks and other financial institutions, and vice versa.

It is this long-term nature of business-credit relationships that makes me fearful of Government lending activities. The danger is that such financial relationships, once established, tend by their very nature to be maintained, and that a growing sector of our private business economy may come to depend for its credit advances on the public credit.

The suggestions I advanced in my answer represented my best thought of how we in the Federal Reserve System might meet these conflicting objectives constructively, if the Congress placed our authority on a more effective basis. The advantages to the economy, should Congress do so, are that we are very close to banks and are

familiar with their operations, that we have adequate resources, and that we have an experienced personnel capable of giving considerate and constructive attention to unusual credit situations, particularly those that are closely associated with the legitimate financial needs of small business. It has been my observation that an important difficulty of small business, particularly of relatively new ventures, to secure financing is due to the fact that it has no established banking connection. It is my thought that if the Congress so directs, we in the Federal Reserve could play a constructive role by devoting ourselves to the establishment of sustained customer connections between small-business units and their local banks. Clearly, this would be more welcome to small business than the prospect of continued dependence on public lending agencies.

Frequently, these connections are not automatically established in the market place, because a typical small business with no regular banking connection represents an unusual credit risk that does not conform to traditional standards. In such cases, the application may be turned down by the local bank because it has not the facilities to make the investigation essential to establish whether or not the risk is bankable. It is these situations where the Federal Reserve banks could operate most effectively. With their trained personnel and facilities they are in a better position to investigate unusual credit situations than many small local banks. If they found such situations justified the extension of credit, they could make the loan, subject always to the safeguard that the local institution carried at least 10 percent of the risk.

Senator DOUGLAS. That the Federal Reserve bank would make the loan, and not merely insure the loan made by a local bank?

Mr. McCABE. My thought is here that the Federal Reserve under no circumstances would make the loan unless the local bank took 10-percent participation. The local bank could take any amount of the participation over 10 percent that it desired. Then I further stated that any time during the life of the loan the local bank could take over all of it or any part of it. That was in my suggestion.

They would always be prepared to sell back to the local bank any or all of their participation and we would consider their job well done when the borrower had acquired an established local banking connection and no longer repaired to the Federal Reserve bank for assistance.

I am aware that direct loans of a customer nature to industrial business units lie outside the main credit activities of central banking institutions. I would not expect that the dollar volume of such loans at the Reserve bank would ever be large. I would look on it as a pilot operation designed to establish regular customer relationships between local small businessmen and their local banks. I would judge its success not by the dollar volume of such loans outstanding at any one time but rather by the vitality that it gave to small business and to commercial banking.

If Congress were to request us to do a job like this, I can assure you that the Federal Reserve is organized to do it. As I indicated in my answer, I would want our existing authority liberalized and I would also want assurance that the law be amended so that we would not be in a competitive position with the Reconstruction Finance Corporation.

Senator DOUGLAS. As I understand your suggestion as it was developed in your reply to our questionnaire, the role of the Reconstruction Finance Corporation would then be the final defense, if you may use that phrase, and RFC would loan only after (a) the local bank had turned it down, and (b) the Federal Reserve had turned it down; so that the RFC in a sense would be the safety man in the banking back field.

Mr. McCABE. In the RFC there are certain types of loans that I feel it should always have authority, and be in a position, to make. That is, there are types of loans to certain public utilities and railroads, there are also types of loans in times of great emergency that the RFC should be in a position to make.

In other words, I am going back to the original intent of Congress in setting up the RFC. The RFC also, if there was a good reason that the Federal Reserve bank could not get a participation of 10 percent from the local bank in the loan, and therefore, the loan was going to be turned down, that they would have a last resort to the RFC.

ORGANIZATION OF THE SYSTEM

It is of course vital that the Board of Governors and the Open Market Committee be composed of men of the highest caliber. I wholeheartedly agree with the view, which has several times been expressed here, that the best assurance that the System will continue to be able to arrive at informed and disinterested judgment on all questions of monetary policy is a strong Board of Governors. Only a Board made up of men of the highest competence can discharge the heavy responsibilities for monetary policy entrusted to it. That is why I feel so strongly that it was a great mistake for the Congress under the recent executive pay legislation to alter the relationship between the salaries of Board members and those of the top executive officers of the Government, which was established when the Federal Reserve was founded. It is not the salary level as such so much as the implied disparagement and reduced status of the Board which will make it extremely difficult in the future to induce outstanding men to accept Board membership. The Board is also placed at a disadvantage in its relationship with other agencies.

Senator DOUGLAS. May I interject here for a minute, and may I say that as a member of the Banking and Currency Committee, I was in favor of increasing the salaries of the members of the Board to \$22,500. When that issue, however, was on the floor of the Senate in connection with the executive pay bill, I thought I detected a very strong move from the private banks of the country to keep the salaries of the Federal Reserve Board down on the alleged ground that they should not exceed the salaries of the members of the Federal Deposit Insurance Corporation.

The thought occurred to me—it may be that I am of an excessively suspicious nature—that the private bankers were using the FDIC as an instrument whereby they might prevent this increase in salary to the members of the Federal Reserve Board.

I wondered, on the basis of your experience in public affairs, whether you could tell me if this suspicion of mine is justified or whether it was the unfounded conclusion of a nature which perhaps is unduly suspicious?

Mr. McCABE. I think, Senator, to be perfectly frank with you, there was great pressure put on the Congress at the time this was before the Congress by some groups of the banking fraternity to keep on an equal basis the salaries of the Board of Governors, the FDIC, and the Comptroller of the Currency.

It has been true since I have been in office—when issues arise quite frequently the representatives of the banking fraternity take the position that all should be on an equal footing, and sometimes like to play one of us against the other.

I was told that the amendment which was offered had a good chance of passing until the pressure became so great to equalize this.

Senator DOUGLAS. I think that is substantially true. From my observation so far as the Senate is concerned I have always been struck by the fact that there was a peculiar emotional affinity between various governmental agencies and various outside bodies, and at times it seemed to me as though the national banks had great emotional affinity for the Comptroller of the Currency, and that the State banks, particularly the nonmember State banks, had a great affinity for the Federal Deposit Insurance Corporation, and that the poor Federal Reserve System had very few friends in the banking fraternity.

I wonder if you feel as friendless as I, at times, thought you were.

Mr. McCABE. I would like to say this, however, Senator: That the Advisory Council to the Federal Reserve took a very strong position on this salary increase for the Federal Reserve, and there were a great many bankers throughout the country who felt just as strongly as I did about this. There were some of them who expressed themselves very strongly to me that they disliked this policy of trying to play one agency against another. I certainly do not want to take the position that I depreciate the positions of the directors of the FDIC or the position of that of Comptroller of the Currency. I think I would fail, however, in my duty if I did not bring forcibly to the attention of this committee and to other committees of the Congress my concern about this problem.

Senator DOUGLAS. The arguments of those who said that the salaries of members of the FDIC and the Comptroller of the Currency should be on a level with the Federal Reserve System were based primarily on the relative work performed by these bodies in connection with bank examinations as compared with the bank examination work of the Federal Reserve System.

Now, the bank examination work of the Federal Reserve System is relatively minor, is it not, compared with your other responsibilities?

Mr. McCABE. That is right, it is important but it is not as important as our policy-making function.

Senator DOUGLAS. Credit control?

Mr. McCABE. Yes; the policy-making function. I would like to say further that I have the very, very highest regard for the present incumbents of the offices in the FDIC and Comptroller of the Currency.

Continuing with my statement: The accusation has been made that the Board operates in an ivory tower, and that its decisions are surrounded by mystery—

Senator DOUGLAS. You do not operate in an ivory tower, but you do operate in a very handsome building.

Mr. McCABE. I think the most beautiful in the country.

This is very far from the fact. I doubt whether there is any institution, public or private, anywhere in the world whose operations are so fully disclosed to the public as those of the Federal Reserve System. In the Federal Reserve Bulletin, in the annual reports to Congress—which include all policy actions of the Board and of the Open Market Committee, together with the reasons therefor—in regularly issued reports of day-to-day operations, in frequent other publications both of the Board and of the Reserve banks, and in public discussions, the actions and activities of the entire System are displayed as in an open book.

Senator DOUGLAS. The difficulty many of us find is that the language in this open book is of such a nature that it is very difficult for us to tell what the words mean.

Mr. McCABE. Senator, as you and I work together more perhaps we can both get a better understanding of these words.

We occupy no ivory tower. We live in a goldfish bowl—

Senator DOUGLAS. Is this a description of the architecture of the Federal Reserve building again?

Mr. McCABE. This statement can cover many things, Senator.

The unique organization of the Federal Reserve enables the System to be extremely close to the pulse of the economy at all times. Before coming to decisions on all matters of policy, the Reserve Board has the inestimable advantage of being able to communicate with and obtain factual information, as well as opinions, from the 12 Federal Reserve banks and their 24 branches throughout the country, on whose boards are more than 250 directors, drawn not only from banking but from the widely diversified industrial, commercial, agricultural, and professional pursuits of the Nation. The directors, the officers, and staffs of the Reserve banks and the Board, the Federal Advisory Council, and the member banks comprise the Reserve System. The Board has constantly available current information, drawn from this great System to supplement the vast mass of factual and statistical data gathered through other governmental sources.

Moreover, the System sponsors special studies as occasion demands. In addition, we are always at pains to consult with representative businessmen, the small as well as the larger ones, with trade associations and, in fact, with all who are affected by System operations. We try to weigh carefully their views and to distinguish broad national considerations from those reflecting narrower interests.

The art of central banking is far from simple, nor is it one of the exact sciences. That is why, as I have stated, I feel that your committee is doing such a useful educational job in bringing these monetary, credit, and fiscal problems to the attention of the public, and grappling with these problems. You can help greatly by such conclusions and recommendations as you may put in your report to chart the future course of monetary and credit policy and enable it to play its full part toward achieving our goal of steady economic progress.

Senator DOUGLAS. Thank you very much, Mr. McCabe.

There is a very central question that I should like to ask, but before I do that, I think I should lay a basis for it in a statement of my own.

Article I, section 8, of the Constitution lays down the powers of Congress, and the second paragraph of section 8 states that Congress shall have the power "to borrow money on the credit of the United States."

And then paragraph 18, the so-called implied powers clause, states that Congress shall have the power to make all laws which shall be necessary and proper to carry into execution the foregoing powers.

So that the Constitution lodges in Congress the power to borrow money and to make all laws which are necessary and proper to carry into execution the borrowing of money.

Now, since the details of borrowing money cannot be fixed legislatively, Congress has in practice confided virtually all of these powers to the Secretary of the Treasury with not many restrictions imposed, except a total limit—

Mr. WOLCOTT. Which is very ineffective.

Senator DOUGLAS. Which my colleague says is ineffective, and which on occasion in the past has been increased.

Mr. WOLCOTT. May I explain that remark by saying that when the differential in the debt limit between the total debt and the bonded debt was removed we, of course, put ourselves in the position, being the legislative body that we are, of increasing the debt limit whenever appropriations were made by the Congress which would carry the debt over the legal debt limit; so that the existing debt limit as provided by Congress is just something to be talked about every time it comes up, and it has as little effect as any act we have ever passed, because we can amend that inferentially and indirectly any time we please by appropriating money over that amount.

Senator DOUGLAS. We have confided those powers pretty largely to the Secretary of the Treasury.

Now, paragraph 5 of section 8 gives to Congress the power, which I have quoted several times in these hearings, "to coin money" and "regulate the value thereof."

Now, since metallic money is a relatively unimportant part of our monetary system and since Federal Reserve notes and bank credit form the overwhelming portion of the medium of exchange—

Mr. McCABE. Bank deposits.

Senator DOUGLAS. Bank deposits, pardon me—in practice under the Federal Reserve Act we have confided most of our powers in those directions to the Federal Reserve System without much control exercised by Congress. We have, therefore, given to two administrative bodies these basic powers, and in the absence of further legislation by Congress, each has the legal power to proceed more or less independently of the other.

Now, since the Treasury is not lodged with the responsibility for legislating the value of money or maintaining a price level, let us say, and since its primary responsibility in this connection is the management of the debt, it seems to me that under those circumstances the Treasury would have an almost inevitable desire to reduce the interest charges upon the debt in order to reduce the total of governmental expenditures and to maintain the price of Government securities at not too far below par.

On the other hand, the Reserve System, being primarily charged with the regulation of the value of money in its broadest aspects, will have a natural tendency when prices are rising to try to check that rise in price and will, therefore, feel inclined to check that by the instruments which it has available.

One of those instruments is the method of open-market operations and its effect upon yields of Government securities and prices of Gov-

ernment securities. Therefore, irrespective of personalities, it would seem to me that in a period of inflation the Reserve System would have an inevitable tendency to want to increase interest rates as a means of checking further undue expansion of the volume of privately created purchasing power by the banks; but to do that would necessarily involve, in view of the fact that the Government debt is now so important, an increase in the interest charges which the Treasury and, therefore, the Government would have to pay, upon this public debt, and might involve—and, in fact, reciprocally would tend to involve—some reduction in the prices of Government securities in order to send the yields or true interest rate up.

It, therefore, seems to me that you have what I think Mr. Sproul described as an inevitable conflict, not necessarily an irrepressible conflict, but an inevitable conflict between these two purposes. There is no legal machinery at present provided to determine which of these policies will prevail. We might indeed have the two of them moving at cross-purposes.

Therefore, the two authorities fall back upon the magic words "co-operation" and "coordination," which have real meaning if they describe a genuine spiritual attitude on both sides, but the meaning of which is somewhat ambiguous, and the reality of which may at some times be lacking.

Suppose, for example, we were to move into a period of inflation after this "inventory readjustment" which is taking place, and you should wish to raise interest rates in order to repress the volume of private borrowings and, hence, inflation, but the Treasury should want to issue or refund Government securities at low rates of interest.

Here you are, twins, Siamese twins, but with no central coordinating nervous structure to dictate a uniform policy.

Do you see some possible dangers in that situation?

Mr. McCABE. Well, I could see very grave dangers if you had in the personnel of the Treasury and the Federal Reserve the type of people that just refuse to discuss these broad questions from the standpoint of the public interest. If we reached an impasse, Senator, I would think the first recourse would be to go to the President and have him arbitrate these differences in point of view.

Certainly, the Federal Reserve being a creature of the Congress and reporting to the Congress, should then make its appeal to the Congress to arbitrate the points of view.

As I see it, there are three steps: One is persuasion, the second is appeal to the President, the third is appeal to the Congress; that is, to meet this hypothetical situation that you advance.

Senator DOUGLAS. Would it be helpful if Congress were to give a definite directive of policy which both the Treasury and the Federal Reserve would follow, not merely on money and credit policy, on the one hand, and debt policy, upon the other hand, but for the two as an integrated whole?

Mr. McCABE. I have thought a great deal about that, as to the type of directive, if you want to call it that, which the Congress might issue. It might be in the form of a resolution or the Congress might more definitely define the areas of responsibility, or the Congress might even go so far as to say which body would be the body of final decision.

I would have great difficulty, however, in drafting the kind of directive that I think might be suitable.

So frequently I have seen specific directives proposed. By the time they emerged from the various committees of the Congress they often were very difficult to carry out.

I remember so well being Foreign Liquidation Commissioner, trying to operate under the old Surplus Property Act, which to my mind was a hodgepodge, just cluttered with compromises, almost unworkable. You will remember Congress set up a three-man commission and an unworkable act and then in a period of time realized they had to change that three-man commission to a one-man administrator to get action, and then had to clarify finally certain sections of the law.

Now, that would be one of my apprehensions in a directive.

Senator DOUGLAS. In other words, just as Members of Congress sometimes have doubts about the administrative machinery of the Government, the members of the administrative apparatus sometimes have doubts about Congress; is that correct?

Mr. McCABE. I think this—

Senator DOUGLAS. Members of Congress sometimes have doubts about themselves, I may say.

Mr. McCABE. I think this committee, as a result of these hearings, and knowing the backgrounds of the men, could propose a directive that might be effective; but when I think what might come out of the hopper in the final form I have to be realistic enough to say to you that I think your greatest insurance is in the character of the men that you have on the Board of the Federal Reserve and in the character of the Secretary of the Treasury.

Now, the Secretary of the Treasury has and should have considerations other than just the interest rate on the Government securities. I think that most of the Secretaries of the Treasury I have known have been conscious of the broader implications of their job. That is, they have to think of tax returns and, therefore, they must be conscious of the economy and the things that are good for that economy.

They have certain monetary powers also. They have to be conscious of those powers. The Secretary of the Treasury is also a member of the President's Cabinet, he is chief financial officer, and he should be influenced to a considerable extent by the philosophy of the President in maintaining a sound economy. So there are many broad considerations in the picture.

Now, on the side of the Federal Reserve, we feel that one of our primary considerations in regulating the supply, cost, and availability of money and credit is to study all facets of the economy. I think we are set up in such a fashion that we not only have one of the finest research staffs in the world, but in addition to that, through our 12 banks and 24 branches and 250 directors, we can almost overnight find out through these directors the current things that are taking place in the economy.

Quite often the data from a research staff may be a few weeks old by the time you get it, but overnight we can get the information from our banks and through our directors of what is taking place currently; and we try to put those two things together.

Therefore, when we sit down with the Secretary of the Treasury—and I would like to say for the benefit of this committee that we spend

hours, literally hours, in discussion of all phases of the problem—we try constantly to bring to his attention what is taking place as we see it. He has his own avenues of determining what is taking place in the economy.

To be absolutely realistic about it, I feel that for the immediate future the best solution I can see is for Congress to have sufficient confidence in the Treasury and in the Federal Reserve—confidence that they can coordinate—I have used the word “coordinate,” Senator, instead of your word “cooperate”—

Senator DOUGLAS. That is not my word.

Mr. McCABE. Coordinate their activities to attain the desired objective of the Congress and the public.

Now, this “struggle” that it has been intimated takes place between the Federal Reserve and the Treasury—it is not new today. There have been differences of opinion since the Federal Reserve was first created, and quite rightfully so.

Senator DOUGLAS. What I am trying to say is that those conflicts of opinion are inevitable and irrespective of personalities, because each body is lodged with a different duty.

Mr. McCABE. Yes; and you know from your study of the history of other countries—the relation of central banks to the Treasury—that there have always been differences between the central banks and the treasuries. It is quite normal that there should be that difference of opinion.

What I am groping for, and the committee also, I know, is how in the future we can unite the opinions of both. I must say that in my period down here I have found the Treasury anxious and always willing to listen, to consult, and to get our point of view. I have gone to great lengths to get their point of view. I do not envy you in deciding at the end of these hearings your responsibility in trying to determine how you would resolve this point that we have been discussing.

Senator DOUGLAS. You are a little afraid, however, that if Congress were to give you a specific directive, the cure might be worse than the disease?

Mr. McCABE. Yes; I have some apprehension of that.

And then, of course, after you issue a directive there is the interpretation.

Senator DOUGLAS. We generally find that whatever directive we issue, the administrative agency always interprets it in the fashion most favorable to itself, and that they always have attorneys who tell their boss that he should do precisely what the boss wants to do.

Mr. McCABE. Of course, Senator, you can never eliminate the human equation in this problem or in any problem irrespective of what the directive may be. I have had enough experience in my lifetime to know that the issuance of a directive is not the cure-all; that, unless you have the right man to carry out the spirit and intent of that directive, you still have not accomplished what you want.

Senator DOUGLAS. I have been rereading the statement of policy of the Full Employment Act, which is reprinted at the bottom of page 26 in the footnote in our committee print. As a matter of fact, you submitted it yourself.

Mr. McCABE. Yes.

Senator DOUGLAS. And you will notice that the primary declaration of policy is for the—

Federal Government to use all practicable means * * * to promote maximum employment, production, and purchasing power.

In other words, the declared objective is maximum employment, production, and purchasing power. There is no specific mention made in that declaration of policy to prevent undue inflation. Would it be helpful if that second standard were added to the promotion of maximum employment—

Mr. McCABE. You have maximum employment, production, and purchasing power. It does not say "full employment." It says "maximum employment," and I have a horror of making full employment your objective, because I think we have some experience—

Senator DOUGLAS. The act is guarded on that point. It does not say "full employment"; it says "maximum employment." But what I am getting at is this. As I remember the German hyperinflation of 1923 and 1924, everyone was employed. There was no unemployment in Germany; the industries of Germany were going at full speed, but the increase in prices was astronomical in nature.

Now, to merely have such a directive without prevention of inflation, it might be possible for someone to argue that the purposes of Congress were being fulfilled if you had everyone employed, even though the index of prices were to go up through the ceiling and soar toward the stratosphere.

Mr. McCABE. Dr. Thomas points out to me that they did not have maximum purchasing power there. They had maximum employment and production.

Senator DOUGLAS. What is purchasing power in the large but the total volume of production in the economy? Some people did not have purchasing power; the holders of fixed incomes did not have purchasing power, but the volume of purchasing power is the total volume of production, because, after all, the money mechanism, as every schoolboy should know, as Macaulay would say, is merely a means to facilitate the exchange of goods.

So, I wonder if you have a sufficient directive binding upon the Treasury and the Reserve System, perhaps upon the Reserve System, but binding on the Treasury to prevent inflation—

Mr. McCABE. I think it comes back largely, Senator, to the man who occupies the position of Secretary of the Treasury and, in the final analysis, to the President. If the President has the concept, which I feel is the concept of this committee, and if the Secretary of the Treasury has that concept, there is no difficulty in harmonizing the points of difference. Now, I fully appreciate what you are trying to do, and some of my very wise counselors tell me that it is possible to write such a directive. I would certainly explore those avenues. My own feeling is that the policy directive of the Employment Act of 1946, which is an act of Congress, is our guide until Congress rescinds it.

Senator DOUGLAS. Then there is no obligation upon the Reserve System to prevent inflation if inflation carries with it maximum employment, production, and purchasing power?

Mr. McCABE. I would follow the steps that I enumerated. If we should encounter another inflationary period like 1948, and if we

felt that the actions of the Treasury did not conform with the actions we thought were right, of course, we would have used all the persuasion and presented all the facts and brought to their attention as forcibly as we could all the arguments then in the absence of action. The next step would be to go to the President. If we still felt that we could not get the desired action, we could then only go to the Congress which created us and to whom we are responsible.

Senator DOUGLAS. But you would prefer to do this only if an emergency arose and in default of adjustment otherwise?

Mr. McCABE. That is right. Now, if you could clearly define in the directive you have in mind—which I assume you have in mind—and that directive was clear enough, I can see that it could serve a useful purpose. I want you to understand I am sympathetic to the purpose you have in mind in suggesting a directive.

Senator DOUGLAS. Would you and your staff take this under advisement? Would it be possible for you within a couple of weeks to give us an opinion in writing as to whether or not you think such a directive could profitably be given and, if so, what you suggest it should be?

Mr. McCABE. I have every desire to help this committee in every way.

Senator DOUGLAS. Some time we may have to deal with this issue.

Mr. McCABE. We will give it the very best thought we have; will be glad to collaborate with your staff, and see if we can formulate such a directive.

(The material referred to above will be supplied at a later date for the files of the committee.)

Senator DOUGLAS. Now, may I ask you to turn to your testimony, in which you quote the announcement of June 28.

Mr. McCABE. Yes.

Senator DOUGLAS. In which both the Treasury and the Reserve Board joined, and which you regarded as a happy evidence of cooperation and coordination existing between the two agencies.

Mr. McCABE. I brought that out with the force that I did, Senator, because that announcement was the result of days of discussion and was the unanimous expression of the Open Market Committee. That announcement was drafted and redrafted, and it was submitted to the Treasury.

Senator DOUGLAS. And it was acceptable to them?

Mr. McCABE. It was acceptable to them.

Senator DOUGLAS. Was not this issued at a time of either recession or inventory readjustment, June 28?

Mr. McCABE. That was the period in June following 6 months of experience of recession. We had experience working together in an inflationary period and in this period of recession. We had the experience also of operating together in coordinating our open-market operations with debt-management problems. This announcement was reached, as I said, by mutual agreement.

Senator DOUGLAS. This is my point: Did not that announcement or decision mean that at the time it was issued—namely, one of recession or inventory adjustment—that securities would not be sold and did it not, therefore, tend to keep down or to depress interest rates and, therefore, of course, would it not be acceptable to the Treasury? But does it follow that, because the Treasury agreed at this time that

the Treasury will go along with primary regard to the general business and credit situation in other periods?

If we were in a period of inflation and were to carry out this policy, it might mean—it would mean to the degree that the Federal Reserve Board exercised its powers—the sale of securities, a rise in the interest rate, and a fall in the prices of Government securities.

In other words, the instance of cooperation which you chose was one which was very happy from the Treasury point of view, when there was no conflict between the two purposes in a period of depression. But would this cooperation necessarily continue in a period of inflation?

Mr. McCABE. The acid test of relationships and even of partnerships, Senator, comes when you have to meet a critical situation in the future. I am going on the assumption that this was an agreement made by men of understanding and good will and that it means what it says.

Senator DOUGLAS. That is not a statement of policy for an indefinite period of time. I think it is somewhat indefinite in language; but certainly, whatever it means, it does not mean the two bodies are bound forever.

Mr. McCABE. To the Federal Reserve, it means flexibility.

Senator DOUGLAS. That in periods of inflation the interest rate will be increased and, if necessary, the prices of Government securities depressed?

Mr. McCABE. That the open-market operations will be flexible—

Senator DOUGLAS. Flexible both ways?

Mr. McCABE. And that we will conform to the economic situation with which we are confronted.

Senator DOUGLAS. You will have flexibility both ways?

Mr. McCABE. Both ways.

Senator DOUGLAS. Do you think the Treasury so understands it?

Mr. McCABE. That is my understanding. The Treasury understands this: That they have the final decision on fixing the rate on any refunding of Treasury obligations. We so recognize that they have this final decision and that when they announce a maturity—the refunding of a maturity—they determine the rate.

Senator DOUGLAS. The Government budget will be unbalanced this year by at least $5\frac{1}{2}$ billions and possibly more. I hope we will be able to avoid that for the fiscal year 1950-51.

In that connection, I think a tremendous amount of self-restraint is going to be needed by the Nation as a whole, as well as by Congress. But if that self-restraint should be lacking and we should have an appreciable Government deficit in a period of revival and prosperity, with prices rising, and the Treasury would then be forced to issue new securities and not merely refund old securities. If the Treasury should then insist upon low interest rates in order to prevent cash outlays by the Government for interest charges rising, but the Reserve System believed that interest rates should be increased in order to check expansion in the private sector, you would be in conflict; would you not?

Mr. McCABE. Yes, and I would say that we would go to extraordinary lengths to convince the Treasury of the point of view of the Open Market Committee. I assume that the experience we both had

in 1948 would serve us well in meeting such a future situation. That was the most inflationary period in my lifetime that we have had to face, and I think both of us learned a great deal from meeting the problems of that period.

Senator DOUGLAS. Do you think the checking of inflation in 1948 was primarily carried through by a rise in the general interest rate or by selective controls over consumer credit and raising of reserve requirements, and so forth?

Mr. McCABE. It was a combination of all factors. I think the actions of the Federal Reserve contributed materially. I think there were many other actions that also contributed. That is, I just cannot say that monetary and credit actions were alone responsible. I think that monetary and credit actions also contributed very materially in checking the recession that took place in the first 6 months of this year, because I think we demonstrated as a governmental agency our flexibility, and we were very quick to act on relaxing our various regulations—very quick to act.

I think that the record since the first of the year shows that as a governmental agency we have been unusually flexible. As a businessman, I have always had a perfect horror of governmental agencies that were inflexible. I think our record of flexibility since the first of the year speaks for itself.

Senator DOUGLAS. One of the advantages of a public hearing is that it permits the audience to ask questions of the witness, provided the members of the congressional committee acquiesce. I think it is an advantage of a democracy.

With the understanding that this is not a question which I myself ask, but it is merely a question in which I act as the imperfect vehicle through which an anonymous member of the audience asks this question, I shall read it, and you can make such reply as you may wish. I do not know whether this is true or not, but I merely read the question that has been passed up.

"Last week the Federal Reserve Board strongly requested the Treasury to withhold any announcement of refunding terms on the certificates maturing on January 1. The Board—so it is alleged—wanted to be free to let the market decline in order to establish a $1\frac{1}{4}$ percent interest rate, as opposed to the $1\frac{1}{8}$ present rate, if conditions made this advisable. Nevertheless—so runs this question from an anonymous member—the Treasury a month in advance announced that on January 1 certificates would be refunded for 1 year at $1\frac{1}{8}$ percent."

First I would like to ask if that is a correct statement of fact. No, I do not ask that—the anonymous questioner would probably like to know whether this is a correct statement of fact, and, if so, what comments you would like to make upon it.

Mr. McCABE. Senator, I think I have demonstrated my desire to be completely frank in these discussions, and I would like to continue to be frank. I question, however, if I should make any comment on this statement, because it involves a confidential relationship between the Open Market Committee and the Treasury, and I doubt if it is appropriate for me to comment on that in a public forum.

Senator DOUGLAS. Would you be willing to comment in an executive session?

Mr. McCABE. So far as the gentlemen of this committee are concerned, our records and our actions are an open book.

Senator DOUGLAS. Is it true, however, that you live, therefore, in a perfect goldfish bowl? I would say there was a state of low visibility in some respects.

Mr. McCABE. You know we report regularly to the Congress the policies of the Open Market Committee and the actions of the Board, and keep them informed. As far as I am personally concerned, I have no hesitancy in commenting on the statement. However, I have to realize that, even though I am up here as an individual, I have a responsibility under what I consider to be a confidential relationship between the Treasury and the Federal Reserve, and I would just question whether I should comment on a statement of this kind. Am I not right, sir?

Senator DOUGLAS. I am in some uncertainty as to whether you are right, but I know your motives are of the best. It is a very real problem. On the one hand, I think the Congress and, to some degree, the public are both entitled to know the issues which are at stake, and that in a democracy these proceedings should not be entirely confidential between the agencies of the public which transact them.

On the other hand, I am well aware of the difficulties which the Treasury may have in floating issues, and I am also well aware that there are sharp speculators, whom we certainly do not wish to aid. So I am in some uncertainty about the issue.

I would say this: That the least secrecy possible is the best.

Mr. McCABE. That is my viewpoint.

Senator DOUGLAS. And I think that the democracy will not permanently endure a situation in which these decisions are made quietly and then not reported to the people.

Now, those may be the reflections of an inexperienced Senator, but in my judgment these matters should not permanently be kept secret, and I say this not with any desire to raise personal issues or to pit one agency against another at all, but simply in the interest of sound policy.

Mr. McCABE. Senator, in this particular case this refunding has not taken place.

Senator DOUGLAS. But the terms have been announced.

Mr. McCABE. The terms have been announced. There is a question in my mind as to whether I would make any statement about a current transaction of this kind that might in any way embarrass the Treasury in its operations.

Senator DOUGLAS. Well, I appreciate your motives; I respect your character. Is money and credit so mysterious a thing, however, that its operations should be hidden from the light of day?

Mr. McCABE. None whatever. I do not see any. There is a question always in your current operations, the question of tipping your hand to those of the public, and the speculators who are always watching for a tip. In this particular case it is not so much a question of tipping hands as it is that I would not want to be placed in the position of doing anything to violate a confidence with the Secretary of the Treasury.

Senator DOUGLAS. But certainly in the long run these gentlemen's understanding should not supersede the right of the public and the duty of Congress to have information?

Mr. McCABE. I thoroughly appreciate that.

Senator DOUGLAS. Now, I have taken up a great deal of time and I appreciate your readiness to testify. If my colleague will permit me, there are a few questions I should like to ask about your recommendations on reserve requirements, particularly about making them uniform.

Mr. WOLCOTT. May I interrupt for a personal statement? I must leave and I regret it very much.

First, I want to thank you for your courtesy to me and I hope I have not made myself so obnoxious that I will not again sit in with you.

Senator DOUGLAS. You are always welcome.

Mr. WOLCOTT. I think I should want to express my appreciation to Mr. McCabe for the very splendid contribution he has made to our studies here this morning. I regret very much that circumstances are such that I am impelled to return to Michigan this afternoon.

Senator DOUGLAS. I feel, perhaps, Congressman Wolcott, that I should apologize to you for taking up so much time.

Mr. WOLCOTT. I did not have any questions to ask. I think Mr. McCabe has covered it very fully in answer to questions—all the questions that were in my mind and many that were not in my mind. It has been very helpful.

Mr. McCABE. Thank you, sir.

Senator DOUGLAS. I think I will be able to conclude in a few minutes.

I have tried to go into this question of whether it is necessary to have uniform reserve requirements for nonmember banks as well as for member banks with a number of witnesses, and there is a point upon which no tangible evidence, so far as I know, has yet been submitted, and it is this:

Have there been any cases in practice in which when the Reserve Board was considering an increase in reserve requirements there was then the threat, explicit or implied, on the part of member State banks that if this increase were to go into effect they would withdraw from the System?

The argument of the Reserve System thus far has been hypothetical in nature, that this might happen, that this has been, I believe in the case of Mr. Eccles, a restraining influence upon their minds; but the advocates of so-called dual system, when I pushed them on the question of that danger have continually challenged me to bring forth one case in which a State bank has either withdrawn or has threatened to withdraw because of the imposition of reserve requirements.

Mr. McCABE. I will just refer, if I may, to a communication from the president of our Federal Reserve bank in Kansas City:

Repeatedly we hear our member bankers raising serious question as to whether it is either equitable or good judgment for them to incur the additional dollar costs involved in being a member bank, and we hear nonmember banks commonly giving that increased cost as a reason for not joining the Federal Reserve System.

Recently a member bank withdrew from the Federal Reserve System and in a letter to this bank made the following statement:

"In this action we want to assure you that there is absolutely no ill feeling, as our association and business dealings have all been most pleasant, but it

was thought that keeping such a large reserve with the Federal Reserve worked quite a hardship on us and precluded our investing State and county funds in bonds, as we are required, to keep the reserve with you on such deposits."

I could cite other examples. I can state, not as an actual withdrawal, but in 1948, when we had made one of the increases in reserve requirements, the president of a bank in Winchester, Va., came up to see me. He represented a clearing association of some 20 banks.

He came into my office one day suddenly without appointment and asked if I would see him. I immediately saw him. He expressed to me his great concern, as a result of a discussion among their banks, that we would lose members if this continued. He felt so strongly that he made a special trip up to see me.

We went to lunch, and I spent a good part of the afternoon with him, going over the whole situation. After I had presented all phases of the problem to him and what I felt were obligations of banks in the System, he asked me if I would come down to Winchester and address his group, including all the directors of those banks. I made a special trip down there and spent the evening with these directors.

In that case, to my knowledge, we did not lose any members. But I cite that to show what the presidents of our Federal Reserve banks and the managers of our branches face when the members become restive under this condition.

Now, our records show, Senator, that the reason of reserves was given for withdrawal in three cases in 1947. We had one in 1948 that gave that as a reason, and we have had four in 1949 that have given that as a reason. That is, have specifically given reserves as a reason.

I think that it is a threat. I think it does have an influence on the Board in making its decisions on increasing reserve requirements. Certainly the presidents of our Federal Reserve banks and the managers of the branches impress upon us with great force the possible results in this respect of any action to increase reserve requirements.

Senator DOUGLAS. Now, in your proposal for uniformity of reserves between nonmember and member banks, would you extend to non-member banks the reserve requirements which are now applicable to member banks, or would you wait until the reserve requirements have been altered before making them applicable to nonmember banks?

Mr. McCABE. I would like to say that what we call our uniform requirement proposal has not been passed upon by the Board of Governors. The Washington staff has done a voluminous amount of work on this in collaboration with our field staffs. We have conferred with bankers and other groups about it, and we have presented it informally to your joint committee. We have tentatively drafted certain terms and conditions, and the highlights of those terms and conditions are these:

1. That the differentials in reserve requirements would not be based on geographical location of banks, as at present, but on type of deposits. Thus, the present designation of central Reserve cities and Reserve cities and the resulting differential in reserve requirements would be eliminated.

2. A relatively low percentage, as at present, would be prescribed for time deposits or savings deposits, a higher percentage for demand deposits other than interbank deposits, and a higher percentage for interbank deposits.

3. Vault cash would be counted as a part of required reserves.

Senator DOUGLAS. That would be a proposal which would make this more palatable to the nonmember banks?

Mr. McCABE. Well, it depends entirely when you say "more palatable." It would be, Senator, a question of each bank sitting down with a pad and pencil and figuring it out.

Senator DOUGLAS. This would apply to all banks?

Mr. McCABE. This would apply to all banks.

Senator DOUGLAS. My very able associate, Mr. Chandler, suggests that the issue there is how far they would be from the Federal Reserve bank, because if they were just around the corner from the Federal Reserve bank they do not have to carry much vault cash.

Mr. McCABE. All these are practical questions. It would be quite natural that every bank would sit down to figure out whether it would be better off, or whether the result will be the same or whether it would be worse off. So there are a great many practical considerations. We want to explore it further with banking groups, and we want them to get their pencils and paper out to figure the results of it, and then after we have explored it further with the banking group we would like to come back to the appropriate committee of Congress to discuss it.

Senator DOUGLAS. Probably it would be more acceptable to banks in the central Reserve cities, possibly a bit more in the Reserve cities than to the country banks, because the process of averaging would send the latter's reserve ratios up.

Mr. McCABE. On first blush, I think you probably would get more acceptance from the country member banks than you would perhaps from any other group. You might get some resistance from the correspondent banks in the Reserve cities and the central Reserve cities. If a higher rate applies on interbank deposits, you would get some resistance there.

Of course, you would get great resistance if you talked about making this applicable to all insured nonmember banks. That will come from the nonmember banks, of course.

Senator DOUGLAS. Would you make your graduation of reserve requirements on the basis of the type of deposit conditional upon establishing uniform requirements for nonmember banks as well as for member banks, or would you be willing to go ahead on this new type of reserve requirement for member banks alone?

Mr. McCABE. Personally, if I was assured, after conferences with the banker groups, I would accept it for member banks only if it was not possible to get the inclusion of the nonmember banks.

Senator DOUGLAS. Would you recommend an act of Congress to make any new provision that you introduced for member banks applicable to nonmember banks?

Mr. McCABE. You recall that in my answer to the questionnaire I submitted alternative proposals as to what I would recommend to the Congress. I said there that the ideal would be to have the same reserve requirement—not talking about uniform requirements necessarily but talking about all reserve requirements—apply to all insured banks. In that event the nonmember banks would have access to the credit facilities of the Federal Reserve.

Another proposal was made to me very strongly by a banker for whom I have great respect, and he made that second alternative proposal I wrote in my questionnaire: That the nonmember banks be allowed to carry their reserve with the correspondent banks. If that was done—and I think that might be a step in the direction—if that was done, then I think hooking up with that the uniform reserve proposal would be very desirable. In that event, I question, as I said in my answer, whether they should have access to the credit facilities of the Federal Reserve, if they did not keep their balances with the Federal Reserve—that is, the reserve balance.

Senator DOUGLAS. Well, thank you very much, Mr. McCabe. I am afraid we have kept you a long time and asked you many embarrassing questions.

Mr. McCABE. I will be glad to come back at any time, and I thank you for your courtesy.

Senator DOUGLAS. This concludes the hearings of the Subcommittee on Monetary, Credit, and Fiscal Policies. Several statements which have not yet been filed with the committee will be included in the printed hearings. (The statements appear on pp. 544-570.)

It is possible we may be able to arrange an executive session, not open to the press, of various leading officials of the Government.

(Whereupon, at 1 p. m., the hearings were concluded.)