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REMARKS:

This is a redraft of Mr McCabe's testimony
by Mr. Thurston.

Mr. Carpenter said if Mr. Evans adjourns
the hearings for this afternoon as is
anticipated, the Board meeting will be
held this afternoon.

GOVERNOR ECCLES' OFFICE

Draft of Statement of the Chairman
Before the Joint Committee

Mr. Chairman and Members of the Joint Committee on the Economic Report:

I want to thank you for this opportunity to appear here today to testify on behalf of the Board of Governors of the Federal Reserve System in regard to the recommendations contained in the Economic Report of the President with respect to bank reserve requirements and regulation of consumer instalment credit. The Board of Governors unanimously favors both recommendations.

Inasmuch as I have just returned from an 8,000 mile trip on which I visited the offices of the System in Seattle, Portland, San Francisco, Los Angeles, El Paso, Dallas, and Houston, it may be of interest to this Committee if I preface what I have to say on credit policy by summarizing the impressions I brought back from this trip. My visits included many meetings with bankers, business, and professional men and representatives of agriculture in each area. I find that I get a feel of current and prospective developments from frank face-to-face discussions with informed men of widely different interests that cannot be secured in any other way. Since I took office less than a year ago I have visited ten Federal Reserve Banks and seven of their branches, primarily for this purpose.

Partly because of the shift in emphasis brought about by reappearance of conditions of a buyer's market, I found businessmen more alert and sensitive than on my previous trips to the major external influences -- international, legislative, and monetary -- which bear upon the activity,

profitability and soundness of the enterprises with which they are connected. For instance, most all of them, when commenting on business prospects, spoke about the dangers in the international situation, the implications of a Federal surplus or deficit, and the importance of credit and monetary policies. I found a very general opinion that we are in the midst of a levelling off adjustment and that the inflation probably had largely run its course. I found few who excluded the possibility of a renewal of inflation if expenditures for military and foreign aid, by local and State governments, and by industries and consumers were to increase.

I have found a widening realization that monetary authorities should be armed with adequate means at all times to deal with changing economic conditions and should be in a position to operate with a high degree of flexibility.

In his State of the Union Message, the President said:

"The Employment Act of 1946 pledges the Government to use all its resources to promote maximum employment, production, and purchasing power. This means that the Government is firmly committed to protect business and the people against the dangers of recession and against the evils of inflation. This means that the Government must adapt its plans and policies to meet changing circumstances."

In furtherance of this broad objective and as part of a comprehensive program, the President in his Economic Report to Congress proposed two specific credit measures. One would give the Board of Governors flexible authority to require all insured banks to hold supplemental reserves up to the limit of 10 per cent against demand

deposits and 4 per cent against time deposits in case strong inflationary pressures were to reappear. The other would continue regulation of consumer instalment credit, on the present flexible basis.

"On previous occasions," the President's Economic Report said, "I have recommended that adequate means be provided in order that the monetary authorities may at all times be in a position to carry out their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures."

Why do we think it necessary to ask Congress for these monetary and credit measures? If inflationary pressures have, in fact, subsided, what need is there for credit restraints?

The financial and other economic legacies of war have been described before this Committee by many witnesses. I shall not take your time to go over familiar ground but I should like to summarize briefly the situation, as we see it, which calls for these protective measures. War finance resulted in a huge and rapid expansion in the amount of liquid assets held by the public. This expansion represented the accumulation of savings made possible and necessary by the excess of wartime incomes over the supplies of goods and services available for purchase. The result, as shown in the chart, is that the total supply of money has expanded until it is more than three times pre-war levels. Today, physical volume of production of goods and services, so far as it can be measured, is about one-half larger than in the maximum pre-war year. As a consequence of an excessive money supply relative to production, we have already experienced a large degree of

inflation. Consumers' prices for all items as measured by the indexes of the Bureau of Labor Statistics rose by more than 70 per cent above pre-war and are still close to that peak. The existing and potential money supply could again generate very strong inflationary pressures.

Evidences of an approach to a more balanced economic situation have developed in recent months. Easing of inflationary pressures is indicated by marked declines in some individual prices, principally of commodities that had risen most sharply. The easing was brought about largely by the record volume of production of both agriculture and industry in the past year. Over-all consumers' incomes and holdings of liquid assets, nevertheless, have continued at high levels and are fairly widely distributed.

Expenditures by businesses for capital investment, by State and local governments, and by home owners and builders for new housing have continued large, although there has been some slackening in new housing starts. Resistance to high prices and some abatement in the urgency of demands have been evident in the case of housing and of many durable goods, now that the more pressing shortages have been overcome.

As for credit, the increase in bank loans, which had been very large in previous years, slackened considerably in the last quarter of 1948. Also there was an almost complete cessation of sales of Government bonds to the Federal Reserve System by nonbank investors to obtain funds for other uses, a factor that had previously been an important inflationary factor.

It is possible but it is by no means certain that postwar inflation has run its course and that additional restraints for anti-inflation purposes will not have to be applied. The task of monetary authorities, obliged to apply restraints, is neither pleasant nor popular. It would be fortunate for the country if the economy is approaching a period of stability.

Unfortunately no one can be sure that inflationary dangers are over rather than merely interrupted. We have had a number of readjustments since the end of the war. Each was hailed by some as the end of the postwar boom. Each was succeeded, in turn, by renewal of the inflationary spiral. It may be weeks, months, or even a year or two, before the forces of expansion are resumed in a form that may need restraint through monetary and credit channels.

Those of us who have what may be broadly termed central banking responsibilities are today in a critical position. Unlike that of last August, the outlook for the next several months is not clearly inflationary. The temptation is strong to assume that because inflation forces are for the moment quiescent they have been dissipated. This may prove to be a completely unwarranted and extremely dangerous assumption.

The needs for enlarged defense expenditures, particularly if they involve the purchase of materials in short supply and if they prevent the maintenance of a budgetary surplus, are a continuing force for inflation. If our resources are already fully employed, additions to

the goods and services devoted to defense must be diverted from those going into private consumption and investment. If private demands for goods and services are not correspondingly adjusted, then higher prices will result. Under such circumstances, it is important that governmental expenditures be fully covered by revenues so that not only the resources which it needs but the means of paying for them may be diverted to the Government.

Not only is the surplus or deficit in financial operations of the Government important, the economy is also affected by the cash surplus or deficit operations of the private sector. In a fully-employed capitalistic economy, business and other investment should be financed largely from current savings of the public. If, however, expenditures exceed current receipts -- which is possible if they are made from accumulations of past savings or from bank credit expansion -- then the result is likely to be inflationary, especially if production and employment are at capacity and cannot be expanded in accordance with the increase in expenditures.

In view of the general liquidity of the economy, one cannot be complacent about the possibility of renewed or continued "deficit" financing by businesses and individuals. We still have a tremendous potential for a further increase in deposits and reserves as well as a more rapid use of existing money. Commercial banks alone hold approximately 58 billion of marketable Government securities which they could at

will convert into reserves capable of supporting an enormous deposit expansion. Demand deposits are currently being used at the rate of about 20 times a year, which is about the same rate as in 1939. However, it is less than half as rapidly as deposits were being used in the late 'twenties. In other words, if money were to be used at the rate it was in the late 'twenties, current spending for all purposes would be over twice what it is today. We must be prepared at all times to cope with inflationary possibilities.

We are also still confronted with the necessity of balancing our several objectives. We want to maintain stability in the Government securities market. To accomplish this the Federal Reserve stands ready to buy such securities when there are no other buyers at established prices. I think the System's support of the Government securities market has been wise and necessary. I concur in the statement of the President in his Economic Report:

"Such stability in the Government bond market has been a most significant element in the smooth reconversion from a wartime economy to a civilian peacetime economy. It contributes to the underlying strength of the financial structure of the country."

At the same time we want to prevent the reserves supplied to banks by these support operations from becoming the basis for manifold expansion of deposits. We also need to absorb reserves made available from other sources, ~~not only~~ gold inflow. It would, of course, be possible to prevent expansion of reserves by failing to support Government securities in the market. The adverse consequences that

would result from abandoning the support policy on the one hand, or from failing in our responsibility to prevent excessive credit expansion, on the other hand, has led to the two recommendations designed to avoid either of these evils.

The heart of this problem is bank reserves. The workings of our entire economic system are reflected in bank reserves and in bank accounts. Let me emphasize again, as I have many times before, that I am not singling out bankers for criticism. Banking is a unique profession because deposits in banks are the largest part of our money supply. Banks play a vital role in many ways. As I have said previously "... this nation owes a debt of gratitude to commercial bankers generally for their service in the task of financing the war."

Monetary authorities are not pointing an accusing finger at the banker when they take steps to prevent newly-created reserves from becoming the basis for further deposit and bank credit expansion. If we are to exercise any effective restraint over the money supply and the credit situation, we must be concerned with changes in the volume of bank deposits, as well as to the nature and quality of bank assets.

Banks cannot expand credit and create deposits unless they have or can acquire reserves on which to expand. That is why actual and potential reserves are the center of attention for monetary authorities the world over.

The banking system today acquires reserves in three major ways: (1) imports of gold, (2) return of currency from circulation, and (3) purchases of Government bonds by the Federal Reserve Banks. If the

volume of deposits is to be held in check, additional reserves arising principally from these sources have to be absorbed or immobilized.

Monetary policy has been directed to this end. For example, during the year ending last October large amounts of reserves were supplied to banks as a result of Federal Reserve purchases of bonds, largely from nonbank investors. These purchases amounted to about 10 billion dollars. In addition, gold inflow and return of currency from circulation supplied banks with over 2 billion dollars of reserve funds.

These additional reserves were largely offset in the following ways:

First, during the early part of 1948 the large excess of cash receipts over expenditures by the Federal Government reduced privately-held deposits; and the transfer of these funds to the Reserve Banks absorbed reserves. The Treasury used these funds to retire public debt held by the Reserve Banks. Banks in turn maintained their reserve positions by selling Government securities to the Federal Reserve. The necessity to make these sales exerted some degree of restraint on banks.

Another important means of absorbing reserves was the sale of short-term Government securities by the Reserve Banks. Since the middle of 1947 interest rates on such securities have been allowed to rise somewhat from the very low levels that had been maintained during the war and early postwar period. Investors were encouraged by these higher rates to purchase and hold short-term issues. As a result of sales in the market and retirements by the Treasury, the Reserve Banks reduced their holdings of short-term securities by fully as much as they increased their holdings of bonds.

Still another means of dealing with the problem of reserves was to increase reserve requirements. Under authority of permanent law, the Board of Governors increased reserve requirements at central reserve city banks in New York and Chicago in February and again in June. Then, in the third quarter, when nonbank investors were selling bonds in large volume and the demand for bank credit was active, the Board used part of its newly acquired authority to increase reserve requirements for all member banks. Let me emphasize that we have not used our added authority merely because we were given it. We have used only a part of it, cautiously and with discretion, to meet a specific development.

Since no one can predict the future, we should be prepared for whatever may develop. We are now more poorly equipped to deal with the development of excessive or unsound credit demands than we have been for a long time. Of greatest importance in this connection is the cash position of the Treasury. A cash surplus of \$6 billion in 1947 and \$8 billion in 1948, used in the way I have described, was the largest single restraining force on the money supply. But at best the prospects for this calendar year, in view of our enlarged defense expenditures, are for a cash surplus of less than 2 billion dollars, which is more than accounted for by the excess of receipts in the first quarter, leaving a deficit for the rest of the year.

No one can know how the volume of reserves will change in the future. We should be prepared to deal with the problems that would arise if reserves increase significantly. That is why we have come to request that you endorse enlargement of the authority of the Board of Governors to require banks to hold reserves.

Specifically, we ask for authority to require all insured banks to hold supplemental reserves in the form of balances at the Reserve Banks. These reserves would be in addition to requirements under existing law. We ask for authorization to require such supplemental reserves up to a maximum of 10 per cent against demand deposits and 4 per cent against time deposits.

It is vitally important that the requirements be made applicable to all insured banks, not only to member banks of the Federal Reserve System only. Banks now subject to Federal supervision and enjoying the protection of Federal insurance of their deposits comprise ___% of all commercial banks and hold ___% of all bank deposits.

It would be grossly inequitable to limit the authority to member banks alone. Member banks already carry higher effective reserves than nonmembers. It is unfair to have them bear the entire burden of actions in the monetary field undertaken in the public interest. For the first time in my years of association with the Federal Reserve System, I have found members becoming restive and the reason for this restiveness is the inequitable application of reserve requirements. Failure to include all insured banks would seriously impair the effectiveness of national monetary policy.

It is not suggested that the proposed supplemental reserve requirement is the perfect or final solution of the problem of arming the monetary authorities with adequate means of performing their primary function. It is to be hoped that possibly through another monetary study Congress will arrive at a still better long-range means of dealing with the question of bank reserves. The pending proposal, however, is a

necessary step in the right direction. Together with other powers now available, it would equip the central banking mechanism with authority to cope with over-expansion of the money supply in case that danger again threatens us.

In addition to the authority with respect to bank reserves, we urge you to extend consumer instalment credit legislation. Regulation W, as it is called, has helped to curtail unsound tendencies in the instalment credit area and to damp down somewhat expansion of this type of credit which in the past two years had been unduly rapid. I would like to say that the acceptance by the public and by the trade of the new regulation has been, on the whole, favorable. Of course, there have been complaints and criticisms. These have not been widespread, considering the large number of retailers, lenders, and consumers affected by the restraints.

Regulation W is a useful supplement to the System's available tools for restraining unsound credit conditions and inflationary credit expansion. Instalment credit has been subject to wide fluctuations in the past and has contributed to wide variations in consumer buying, especially of durable goods. We need to be in a position to temper the use of this type of credit at some times and to encourage its use at other times. It is a relatively small credit area but one of strategic importance and one that experience shows can be influenced by regulation in a way that will contribute to greater economic stability. It makes a real contribution, too, toward the "peace of mind" of the millions of household managers of the country, by helping to limit improvident credit spending and instalment debt that may be excessive in relation to current

living expenses and income. The value of this contribution is sometimes forgotten, but in the past the need for it has become painfully apparent when unemployment strikes or incomes decline.

The Board fully appreciates the problems that increased reserve requirements raise for banks that have to obtain the additional reserves by liquidating other assets. We appreciate the problems which consumer instalment credit regulation presents to retailers, as well as to sales finance companies, banks, and other credit-granting agencies. We earnestly hope that the need will not again arise for further restraints. We would only use such restraints because we felt it necessary to do so in order to protect the economy. We believe that they should be provided as a precaution and safeguard. We believe that in the world of today the United States, occupying as it does a place of world leadership, should be equipped, at all times, with modern, effective means of carrying out appropriate monetary policies, adapted to changing economic circumstances.

Most of my business life has been spent in private industry. I would be the last to want Government to have power and authority merely for the sake of having power and authority. In the complex and fluid monetary field, the timeliness of policy moves is of critical import. That is why we think that, in the interest of a stabilized, progressive, economy, it is essential that our monetary machinery be prepared, in advance, not after the event, to adapt itself to changing economic needs.

February 11, 1949.