TO AMEND THE FEDERAL RESERVE ACT

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY
HOUSE OF REPRESENTATIVES

SEVENTY-SEVENTH CONGRESS

SECOND SESSION

ON

H. R. 7158

A BILL TO AMEND THE FEDERAL
RESERVE ACT

JUNE 17, 19, 1942

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TO AMEND THE FEDERAL RESERVE ACT

WEDNESDAY, JUNE 17, 1942

House of Representatives,
Committee on Banking and Currency,
Washington, D. C.

The committee met, at 10:50 a. m., pursuant to notice, for consideration of H. R. 7158, Hon. Henry B. Steagall, chairman, presiding.

(H. R. 7158 is as follows:)

[H. R. 7158, 77th Cong., 2d sess.]

A BILL To amend the Federal Reserve Act

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (a) of section 12A of the Federal Reserve Act, as amended (U. S. C., title 12, sec. 263), is amended by striking out the second and third sentences thereof and substituting the following: "Such representatives shall be presidents or first vice presidents of Federal Reserve banks and, beginning with the election for the term commencing March 1, 1943, shall be elected annually as follows: One by the board of directors of the Federal Reserve Bank of New York; one by the boards of directors of the Federal Reserve Banks of Boston, Philadelphia, and Richmond; one by the boards of directors of the Federal Reserve Banks of Cleveland and Chicago; one by the boards of directors of the Federal Reserve Banks of Atlanta, Dallas, and Saint Louis; and one by the boards of directors of the Federal Reserve Banks of Minneapolis, Kansas City, and San Francisco. In such elections each board of directors shall have one vote; and the details of such elections may be governed by regulations prescribed by the committee, which may be amended from time to time. An alternate to serve in the absence of each such representative shall likewise be a president or first vice president of a Federal Reserve bank and shall be elected annually in the same manner."

Sec. 2. The sixth paragraph of section 19 of the Federal Reserve Act, as amended (U. S. C., title 12, sec. 462b), is amended to read as follows:

"Notwithstanding the other provisions of this section, the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, may by regulation change their requirements as to reserves to be maintained against demand or time deposits or both (1) by member banks in central reserve cities or (2) by member banks in reserve cities or (3) by member banks not in reserve or central reserve cities or (4) by all member banks; but the amount of the reserves required to be maintained by any such member bank as a result of any such change shall not be less than the amount of the reserves required by law to be maintained by such bank on the date of enactment of the Banking Act of 1935 nor more than twice such amount."

Sec. 3. The ninth paragraph of section 19 of the Federal Reserve Act, as amended (U. S. C., title 12, sec. 464), is amended by striking out the proviso thereof, so that the paragraph will read as follows:

"The required balance carried by a member bank with a Federal Reserve bank may, under the regulations and subject to such penalties as may be prescribed by the Board of Governors of the Federal Reserve System, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities."

The CHAIRMAN. The committee will come to order. We have called the meeting this morning to consider H. R. 7158, and we have invited Governor Eccles, to come down and meet with us and discuss this bill, and I am going to ask him to proceed now, and the committee members may interrogate him later. You may present any statement you have and the committee will reserve their questions until you have completed it, Governor.

Mr. ECCLES. I have a brief statement, Mr. Chairman, of explanation of the proposed amendments, and I believe it desirable to have that statement put in the record.

The CHAIRMAN. That will be done.

Mr. ECCLES. And I think, possibly, the shortest way to explain these three amendments would be to read that statement.

The CHAIRMAN. We will be glad to have you do so, Governor.

Mr. ECCLES. Section 1. Federal Open Market Committee: The Federal Open Market Committee consists of seven members of the Board of Governors of the Federal Reserve System and five representatives of the 12 Federal Reserve banks, and the proposed amendment would regroup the Federal Reserve banks for the purpose of electing their five representatives on the Committee. The principal change which would be effected by the proposed regrouping is to provide that a representative of the Federal Reserve Bank of New York be a member of the committee at all times. The regrouping would also provide for one representative to be selected by the Boston, Philadelphia, and Richmond Reserve banks; one by the Cleveland and Chicago Reserve banks; one by the Atlanta, Dallas, and St. Louis Reserve banks; and one by the Minneapolis, Kansas City, and San Francisco Reserve banks.

Under the present statute a representative is elected by the Boston and New York Reserve banks. As this has worked out in practice, the Federal Reserve Bank of Boston has not had its president or other representative serve as a member of the committee but only as an alternate to the president of the New York bank, who has served continuously. This situation has been unsatisfactory, and the directors of the Boston and New York Reserve banks have agreed that remedial legislation is necessary. As indicated below, it is desirable in the public interest that a representative of the Federal Reserve Bank of New York be on the committee at all times. At the same time, the Federal Reserve Bank of Boston should have the opportunity for its president to serve from time to time as a member of the committee, as do the presidents of the other Reserve banks.

The Federal Reserve Bank of New York occupies a unique position with respect to the Federal Reserve System, the Treasury, and the banking system of the country. Its resources total approximately 40 percent of the aggregate of the 12 Federal Reserve banks. It is located at the money market and at the principal market for Government securities; its operations as fiscal agent of the United States and its transactions with foreign governments, foreign central banks and bankers, as well as its operations in foreign exchange, are in far greater volume than those of any other Federal Reserve bank. It is clearly in the public interest that the Federal Open Market Committee be given at all times the benefit of counsel of the Reserve bank possessed of this sort of experience and in current touch with such affairs.

It may be suggested that the advice of the Federal Reserve Bank of New York would be available even if it were not represented on the Federal Open Market Committee. Admittedly, regardless of the composition of the committee, the Treasury in discharging its responsibility respecting the Goverment securities market would still wish to confer with the Federal Reserve Bank of New York. Thus as a practical matter the New York bank would be inevitably drawn into discussions regarding Government financing as well as open-market operations. But advice obtained unofficially is a different matter from full-fledged participation in the committee's work. Sound policy dictates that participation by the New York banks be through its representative on the Federal Open Market Committee rather than on a voluntary or unofficial basis.

Although it is clear from the hearings and debates that Congress intended the Reserve banks to be represented on the Federal Open Market Committee by their presidents, this was not specified in the act, and efforts have been made to elect officers of commercial banks. Hence it is proposed to specify in the law that the Reserve banks must be represented by their presidents or first vice presidents and that the details of their election may be governed by regulations prescribed by the committee.

Section 2. Reserve requirements: Section 2 of the bill would amend section 19 of the Federal Reserve Act so as to authorize the Board of Governors of the Federal Reserve System to change the reserve requirements of member banks in central Reserve cities, within the limitations of the present law, without necessarily making a change in the Reserve requirements of member banks in Reserve cities.

Under the present law the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, may change the requirements as to the maintenance of reserves against deposits by member banks in Reserve and central Reserve cities or by member banks located elsewhere. It does not have authority to change the Reserve requirements of member banks in central Reserve cities without at the same time changing those of member banks in Reserve cities. No change in Reserve requirements may be made if the result is to decrease the requirements of a member bank below the amount specified in the statute or to increase them to more than twice that amount. At present Reserve requirements of all member banks are at the maximum to which they can be raised under the law.

Because of the recent increases in the amounts of Federal taxes, it is probable that there will be a heavy withdrawal of deposits from banks throughout the country in order to meet tax liabilities at or around the quarterly dates on which Federal tax payments are due. In order to meet these withdrawals many banks will find it necessary to draw upon their balances with their correspondent banks, and these in turn upon their balances with banks in central Reserve cities, particularly New York. The excess reserves of member banks located in New York City have been ranging from $630,000,000 to $1,212,000,000 since January 1, 1942, and this amount may not be sufficient to meet the withdrawal of deposits from these banks which may be expected at tax payment periods. If this situation should arise, the banks in New York City may find it necessary to sell United

States obligations in considerable amounts. Such action might have a depressing effect upon the Government security market at a time when this would be contrary to the public interest.

In order to avoid such a contingency it may be desirable to reduce Reserve requirements of member banks in central Reserve cities. It may not be advisable at the same time, however, to reduce the requirements of member banks in Reserve cities and, accordingly, in order to provide the necessary flexibility to meet the situation, it is felt that the Board of Governors should be empowered to change the Reserve requirements of member banks in central Reserve cities without at the same time changing the reserve requirements of other member banks.

Section 3. Making loans and paying dividends while reserves are deficient: Section 3 of the bill would amend section 19 of the Federal Reserve Act by repealing the provision which prohibits member banks of the Federal Reserve System from making new loans or paying dividends while their reserves are deficient, retaining in the law, however, the power of the Board of Governors of the Federal Reserve System to prescribe penalties for deficiencies in reserves.

One of the difficulties leading to the enactment of the Federal Reserve Act was the fact that bank reserves were unavailable in times of stress and one of the reforms incorporated in the Federal Reserve Act was a provision permitting reserves to be checked against and withdrawn for the purpose of meeting existing liabilities, subject to regulations and penalties to be prescribed by the Reserve Board.

The addition of a proviso prohibiting the making of new loans and the payment of dividends while reserves are deficient is not consistent with the purpose of this provision. On the basis of this proviso, a recent decision of the United States District Court for the Southern District of New York held a bank director personally liable for losses sustained on loans made by the bank while its reserves were deficient. Although this is in conflict with an earlier decision of a circuit court of appeals in another circuit, it creates a fear of personal liability which may prevent banks from availing themselves of the privilege of utilizing their reserves in times of need.

If the proviso were repealed, the Reserve Board would still retain the power to prescribe penalties for deficiencies in reserves and this would be a sufficient deterrent for willful neglect of reserve requirements. The Board's present regulations prescribe a penalty in the form of an interest charge amounting to 2 percent more than the Federal Reserve bank discount rate, so that it is cheaper for a member bank to borrow from the Reserve bank in order to maintain its reserves than it is to become deficient in its reserves and pay the penalty.

Owing to the fact that large tax collections and the flotation of large amounts of Government securities during the present emergency may cause wide fluctuations in available reserves, especially in the money centers, it is particularly important during the emergency period to avoid any stringency in the money market resulting from the rigid and unnecessary prohibition upon making loans while reserves are deficient.

I might supplement that statement by saying in connection with section 2 referring to reserve requirements, the Banking Act of 1935, as passed by the House, and as reported out of this committee provided for the changing of reserve requirements, as requested in this amendment. The Senate changed or refused to accept that proposal. I think the banks, particularly the banking group of New York, were opposed to giving the Board power to increase or decrease the reserve requirements of the central Reserve banks, which are only those banks in New York and Chicago. They were concerned more at the time about increasing the reserve requirements, and they did not want the Board to have the power to increase their reserve requirements without having to increase the reserve requirements of the banks of all of the other Reserve cities. The provision asked for then was right, and it should have been passed. It is, however, much more necessary today than it was at that particular time. Forty to fifty percent of the excess reserves of the banking system were in New York during the period while excess reserves were increasing so rapidly, due largely to gold imports, and to a somewhat lesser extent due to silver purchases. Those excess reserves were reflected more in New York than in any other part of the country. It would have been desirable at that time to have been able to increase the reserve requirements in New York where the excess reserves were in such abundance. Today the opposite is true. With the gold imports practically stopped, and the Government through the defense war-program borrowing so heavily from the financial centers, and disbursing the funds throughout the country, the effect has been to pull down the excess reserves in New York much more rapidly than those in the rest of the country. So that the excess reserves in New York are running around 20 percent of the excess reserves of the country, instead of from 40 to 50 percent, and it seemed to us very desirable that the Board have the power to reduce the requirements, and likewise to increase them at some later date when it may be necessary in the central Reserve cities separate from having to take action on the Reserve banks in the rest of the country. It is a particularly necessary power at this time in connection with these huge financial transactions that take place over tax periods and likewise that is taking place each month now in increasing amounts due to the necessity for the Treasury to raise very large amounts of money.

This is one desirable improvement we feel that can be made at this time. I want to call your attention to the fact that this was provided for in the Banking Act of 1935 by this committee, so that if you pass it now you would merely be passing what you have passed before.

The CHAIRMAN. And we wanted it at that time for a purpose directly opposite to that which is desired now?

Mr. ECCLES. That is it exactly, the excess was piling up through not going into the rest of the country.

Mr. FORD. What you are seeking to accomplish is a more flexible system which will be applicable to those centers where excess reserves are most likely to increase in critical periods?

Mr. ECCLES. We feel that inasmuch as the statute provides three different percentages of Reserve requirements for the country banks, for the Reserve city banks and the central Reserve city banks, recognizing the three classes and the three different Reserve requirements, that so long as that provision is in the statute that the Board should have the power to change the Reserve requirements either upward or downward for the three different classes of banks. Of course, there is a limitation to that, as you know. That provision is that you can only double the statutory Reserve requirements. We cannot reduce the Reserve requirements below the statutory provision, nor could we increase them more than double the statutory provision, but within that limitation we should be able, it seems to me, to increase or decrease the Reserve requirements by classes of banks, that is, by those three classes of banks.

The CHAIRMAN. You mean you should have the power to increase or decrease it in order to meet the necessities of the situation in relation to each class of banks?

Mr. ECCLES. That is right.

Mr. FORD. Your Federal Reserve System is a good deal like an irrigation system, is it not? For instance, here is a series of reservoirs. If there were 10 reservoirs to supply water to a great area, you would want to let the water out of one reservoir into another to let it flow to the point where it was needed at any time it was necessary, would you not?

Mr. ECCLES. That is right. Of course, even this is a rather rough general approach to the problem, but it is a necessary supplement to that of open-market operation. I feel as to the decreased reserve requirements, we will say, for the country as a whole, when the situation at the present time is largely a money center deficiency, that the deficiency is more likely to develop there than it is in the country as a whole.

Now, there is another matter, I would like to say something in connection with section 3, making loans and paying dividends while reserves are deficient. The Board regulation provides that the banks in what we call the country banks, those in the country classification, can average their reserves over a 2-week period. In other words, they may be deficient for 3 or 4 or 5 days, or in excess for the rest of the period, but so long as the average reserve over a 2-week period meets the Reserve requirement there is no penalty, there is no deficiency. We likewise provide that the banks in the central Reserve cities and the Reserve cities can average their reserves on a weekly basis. That is desirable particularly when there are such large financial transactions as there are taking place today.

For instance, I was told by one New York banker that their reserves will fluctuate more than $50,000,000 a day. That is the sum that they have got to carry in order not to be deficient on any one day. They have got to carry more excess reserves than they would desire to carry. They would be perfectly willing to use their reserves and invest them in Government bills or our securities, but they do not want to take the chance of being deficient on any one day. That is because of this decision that I referred to, a decision recently by the United States district court holding the director of a bank liable for loans that were made upon a day when the reserve of the bank was deficient. I know that is true of all of the New York banks, that they will not permit their reserves to run too close, because they do not want to be deficient on any one day. It is inconsistent to give the Board the power to regulate, to issue regulations as the statute does. The Board regulations permit them to figure their reserves on a weekly basis, and only if they are deficient on a weekly basis are they penalized by a charge. It is expensive for them to run deficient. So, they would not run deficient on a weekly basis, but they pay no attention to that regulation. They are looking at this court decision which says that you cannot be deficient on any one day without the directors being liable for any losses sustained or any loans made on that day, and the directors are likewise liable for any dividend having been paid on that day.

Now, a large bank doing business cannot stop on particular days and say we cannot make a loan today, we cannot do business today, in effect, because our reserves may be deficient, or are deficient today. This makes no difference when the excess reserves were very large, when the financial transactions were much smaller than they are at the present time. As long as a bank had very large excess reserve they were not concerned whether they averaged them by the day or the week, because they had excess reserves all the time. Today when their reserves begin to run closer, and their volume of transactions, largely through Government operations, fluctuate as greatly as they do, they are hesitating to use their reserves, and we feel that this provision of the statute which appears to be in conflict with the other provision giving the Board power to regulate should be repealed. Although this decision which has been rendered by the court has not been taken up by the circuit court or the Supreme Court, and it may be some years before you do get a final decision, in the interim we think this situation which now exists should be rectified.

The CHAIRMAN. I should like to ask one question right there, Governor. I am not familiar with the decision to which you referred, and I do not know anything about it, but I imagine that the decision, if I understand you, would have been made irrespective of any regulation imposed by the Board as to the averaging of excess reserves? It was made without regard to that regulation of the Board?

Mr. ECCLES. That is right.

The CHAIRMAN. That order of the Board obtains now and permits them to average on a weekly basis?

Mr. ECCLES. That is right.

The CHAIRMAN. In that connection this question occurs to me, Governor: Will what you are attempting to do by this bill change that law? In other words the court holds now that the action of an officer in making a loan when the reserves are depleted or below the requirements, creates a personal liability against the officer, would not the courts hold the same way after we have changed the law as provided in this bill, leaving the matter entirely to regulation by the Board, that is, provided the action was contrary to the requirements specified in the regulations of the Board?

Mr. ECCLES. Well, if Congress would repeal this proviso which prohibit the making of new loans and the payment of dividends while reserves are deficient, then that would not be inconsistent.

The CHAIRMAN. What I am wondering is whether the court would undertake to attach personal liability against an officer who made a

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loan contrary to a rule or regulation of the Board, the same as it would under the law.

Mr. ECCLES. I suppose it would not. But the Board has issued a regulation that the country banks can figure their reserves on a 2-week basis because they are removed from the Reserve banks, and from the branch banks, and they have much more of a float, and they have to get their currency in and ship it out, and it is not as convenient for them. Therefore, we have permitted the country banks as a practical matter to average their reserves on a 2-week period. Now, with respect to the central Reserve cities and the Reserve cities, they are permitted to average their reserves on a weekly basis. I do not believe that a court could hold a director liable if this provision was taken out of the staute which provides that the payment of dividends and the making of loans are prohibited. In other words, you have a specific provision in the statute on that.

The CHAIRMAN. You think that the ruling of the court rests upon a provision carried in existing law which would be removed by the enactment of the present bill?

Mr. ECCLES. The Reserve bank counsel and our counsel have so advised us about it.

Mr. SACKS. That does not say based upon that, in view of the action of Congress that we speak now for all future action. They would have to take the law and interpret it in accordance with the intent of Congress.

Mr. ECCLES. Yes, I think so. I think there would be no question about it. As it is now there is a conflict, that is the decision of the court referred to, the decision of the United States District Court for the Southern District of New York.

The CHAIRMAN. What is the style of that case?

Mr. ECCLES. I cannot cite it, I can give you the information later. This is in conflict with an earlier decision of a circuit court of appeals of another circuit. So, you see even the courts have not agreed on it but it is a thing that at the moment we feel should be clarified, and it is necessary to have a clarifying amendment because of the reserve situation in the money market.

Mr. LYNCH. But if you repeal that paragraph that you refer to, then you have nothing at all whereby you hold the directors liable if they violate the 2-week provision that you suggest.

Mr. ECCLES. That is right.

Mr. LYNCH. Then they are absolutely free to violate the regulations without any penalty being imposed on them by the court.

Mr. ECCLES. No; because the Board regulations provide a penalty in the form of interest charges. So, it becomes much cheaper to borrow from the Federal Reserve than it is to pay the penalty.

Mr. LYNCH. At the same time, it relieves the directors of personal liability for their wrongful act.

Mr. ECCLES. No; there is nothing wrongful about it. The whole purpose of a reserve is not to have a bank close and have 20 percent or 30 percent of the money tied up and not used. The purpose of the reserve is to use it in times of necessity, and it is perfectly inconsistent to penalize a director for using the reserve at the time the reserve is necessary. What purpose is there of having a reserve here if in a difficult situation over a period you cannot use the reserve?

Mr. SACKS. Would he not still be liable if he violated your 2-week regulation or week regulation?

Mr. ECCLES. No; I do not think they would be liable at all, because the only provision which says they are liable we propose to repeal.

Mr. LYNCH. My point is this, the court held that if the directors made a loan on any particular day when their reserves were not in accordance with the regulations then they would be held personally responsible, is that correct?

Mr. ECCLES. Yes, sir; that is right.

Mr. LYNCH. Now, you propose to repeal that section of the law, and at the same time you propose that instead of having a regulation governing the reserves for any one day that they average it over 2 weeks or 1 week.

Mr. ECCLES. Yes.

Mr. LYNCH. Assuming that during that one week they do not keep up their reserves in accordance with the regulations, or assume that for several weeks they do not keep up their reserves, but during that time, in spite of the fact that they are paying a penalty of interest to you, there is no sanction placed on the directors for their acts.

Mr. ECCLES. There is no prohibition against it, you take the prohibition out. There is no provision at all that says they can or cannot. If it was a case of dereliction of duties, or something that was a willful act, I suppose if a bank finally closed, and it was found that the directors were parties to deception or fraud or mismanagement, which is not involved in this at all, then that certainly would not exempt them, but if the bank was operated in good faith, and operated in the interest of its depositors during this period when it was deficient I certainly would not feel that merely because it was deficient in reserves and paid a penalty because of that that the directors would be liable if you took this provision out.

Mr. LYNCH. If the bank continues, although it violates the regulations——

Mr. ECCLES. It does not violate them.

Mr. LYNCH. Well, assume it does continue, assume the bank violates the regulations and still continues in business, you do not think that any punishment should be meted out to the directors for their violation, but if the bank fails, then they should be punished?

Mr. ECCLES. No, I did not say that at all.

Mr. LYNCH. That is what I deduced from your original statement.

Mr. ECCLES. That is not what I said at all. All I am trying to point out here is that if you take this out of the statute it relieves the directors, and properly so, of the liability in case loans are made on any day when the reserve is deficient. Otherwise, if you do not do that, then the bank should provide not only the reserves called for by the statute and by the Board's regulations, but to be sure that they won't be deficient on any one day, they would carry reserves substantially in excess of the statutory requirement, but as a practical matter it does not make sense. It interferes with their flexible, practical operation. I am not a lawyer. The staff of our counsel have gone into it, and they have checked it with the counsel of the Reserve bank and the counsel of private banks, and everyone feels that this amendment should eliminate any liability that would otherwise be incurred by the directors in connection with the reserve deficiency.

Mr. LYNCH. Yes; I agree that it eliminates any liability on their part.

Mr. FORD. Let me ask you just a simple question, Governor. Would, for instance, the purchase of Government bonds on a day when the banks' reserves were deficient incur a penalty? That is a loan, is it not?

Mr. ECCLES. I would not think you would be concerned about the purchase of Government bonds on any day, because the Government is not likely to default.

Mr. FORD. Yes; you can go back and get the money all right, but, nevertheless, they are making a loan to the United States Government on a given day when their reserves are deficient. Why would not that apply?

Mr. ECCLES. The only danger to a director is in case of a loss on a loan made on that day. He is personally liable for the loss incurred.

Mr. FORD. Was there a loss incurred in this particular instance of which you speak?

Mr. ECCLES. Oh, yes! the loans were made when this bank was deficient in its reserves, losses were incurred, the bank went broke, and the directors were held liable.

Mr. FORD. It is all involved in the safety of the loan?

Mr. ECCLES. That is right, but the effect it has on any board of directors of a bank is that they give instructions to the management of the bank to make no loans on any day when the reserves are deficient.

The CHAIRMAN. That decision would mean that the officers who made that loan would be underwriting it.

Mr. ECCLES. Because of that the directors of the bank give instructions to the management to not let the reserves become deficient, sell your governments or keep these excess reserves there, keep your money there so that you do not go deficient. So, that is what they do.

Mr. LYNCH. Is not that what they are supposed to do?

Mr. ECCLES. No, that is not what they are supposed to do. If it is, why did the Congress give the Board the right to make regulations about these reserves? For years and years until this decision came out they have averaged their reserves. The country banks have always averaged their reserves over a 2-week period.

Mr. LYNCH. The repeal of this paragraph would mean this, that the responsibility is transferred, or possibly the penalty is transferred from the directors who might be personally liable to the banks which would have to pay an interest penalty, is not that it, for a violation of the regulation?

Mr. ECCLES. That is right. They pay the penalty, and as a practical matter the banks never run a deficiency, or very seldom, on a weekly basis. You would find on a weekly basis that there would not be any penalty. The country banks do not run a deficiency and pay a penalty. They stay within the regulation, and they average it now on a weekly basis, but you either ought to repeal the provision giving the

Board the power to regulate it, and let the statute stand, making it perfectly clear that no bank should let its reserve be deficient on any single day, either do that and repeal any power of the Board to regulate, or you should repeal the provision that we ask to be repealed and let the regulations stand, and they would be effective.

Mr. SPENCE. Do you think you have the power now to average reserve requirements over a period?

Mr. ECCLES. Yes.

Mr. SPENCE. You think that the law gives you that power now, do you not?

Mr. ECCLES. Well, the law does two things. The law says you can regulate, and we have regulated for a good many years. The country banks have figured their reserves on a 2-week basis, and if we try to put it on a daily basis they would raise the dickens about it.

Mr. SPENCE. Did the court in its decision pass upon your authority to regulate the reserve requirements?

Mr. ECCLES. No.

Mr. SPENCE. They did not pass on your authority to regulate at all?

Mr. ECCLES. No, sir.

Mr. SPENCE. You do not know whether you have that power or not, do you?

Mr. ECCLES. We think that there is no question about it. We think the Congress has given us that power, and we think we have got the power, but the power is not effective in the face of another provision of the statute which says that the directors are personally liable for any loans made when the reserves are deficient.

Mr. SPENCE. Was your authority ever plead in that case that you had the power in those cases to average it over a period, and, therefore, that they had not violated the law because of that?

Mr. ECCLES. I have not read the decision.

Mr. SPENCE. So, you do not know whether they passed on your authority or not.

Mr. WILLIAMS. Where is your authority set forth in the law, Governor?

Mr. ECCLES. It is in section 19, the sixth paragraph.

Mr. WILLIAMS. I refer to the power which this Board has to place a penalty upon them for a deficiency of reserves.

Mr. ECCLES. Yes.

Mr. WILLIAMS. Where is that?

Mr. ECCLES. It is in section 19, paragraph 6 of the Federal Reserve Act.

Mr. SPENCE. That is the law as it now stands with the exception of the proviso.

Mr. WILLIAMS. Do you have the law in front of you, Governor?

Mr. ECCLES. Yes.

Mr. WILLIAMS. I would like to have it read into the record.

Mr. ECCLES. I can read the proviso.

Mr. WILLIAMS. I am talking about your authority to place a penalty on a deficiency of reserves.

The CHAIRMAN. The power of the Federal Reserve Board to regulate reserves and provide penalties for deficiencies.

Mr. WILLIAMS. Yes, to provide penalties in case there is a deficiency in reserves.

Mr. ECCLES. Section 19, paragraph 6 reads:

Notwithstanding the other provisions of this section, the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, in order to prevent injurious credit expansion or contraction, may by regulation change the requirements as to reserves to be maintained against demand or time deposits or both by member banks in Reserve and central Reserve cities or by member banks not in Reserve or central Reserve cities or by all member banks; but the amount of the reserves required to be maintained by any such member bank as a result of any such change shall not be less than the amount of the reserve required by law to be maintained by such bank on the date of enactment of the Banking Act of 1935 nor more than twice such amount.

Mr. WILLIAMS. No; that is not what I am talking about. Now, that is all right so far. Now, suppose they do violate that, you say you have the power to penalize them?

Mr. ECCLES. I think our power to penalize them is only the power to charge a penalty rate against the deficiency. I do not understand that we have any power to do other than to say for the amount that you are deficient during this period you shall pay a penalty rate, a rate that is higher than the rate at which you could borrow from the Federal Reserve bank.

Mr. WILLIAMS. But that is, in my judgment, a very doubtful implied power from what you read there.

Mr. ECCLES. Here it is in section 9 [reads]:

The required balance carried by a member bank with a Federal Reserve bank may, under the regulations and subject to such penalties as may be prescribed by the Board of Governors of the Federal Reserve System, be checked against and withdrawn by such member bank for the purpose of meeting existing liabilities: *Provided, however,* That no bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by the law is fully restored.

Mr. WILLIAMS. That is paragraph 9, section 19?

Mr. CLAYTON. Yes, sir.

Mr. WILLIAMS. You think that is your authority?

Mr. ECCLES. There has never been, as far as I know, any question raised as to the authority.

Mr. WILLIAMS. I was just trying to locate where it was, and to get it in the record.

The CHAIRMAN. There has never been any question about the effectiveness of these orders until this new suggestion came in by way of a court decision that creates confusion and doubt in the minds of the banks?

Mr. ECCLES. That is right.

The CHAIRMAN. And all you want to do under this bill is to continue what has been done heretofore and what has been accepted by everybody except for this one decision that rules otherwise?

Mr. ECCLES. If it had not been for this recent court decision we would not have thought anything about making this amendment, but this court decision now has stopped every New York bank. They will not do any business on the weekly provision; they run on a daily basis, and they won't go deficient on any day because of this court decision.

Mr. MONRONEY. But were not these directors personally liable if their average deposits for the week were below the average required, personally liable for the loan made at that time?

Mr. ECCLES. I do not think at that time our regulations let them figure on an average basis of a week. I think the court has construed this provision of the law which says that you shall not be deficient in reserve requirements, and the court has felt that this provision of the statute that is passed by Congress apparently supersedes the power of the Board to regulate and, therefore, they have paid no attention to the regulations. So, you have a conflict here, and as I have stated, you either ought to make it perfectly clear that they have got to figure the reserves every day and the Board has no power to regulate, or you ought to make it perfectly clear that the regulations of the Board would stand.

Mr. MONRONEY. But in actual practice this prohibition against making loans or declaring dividends when the reserves are deficient certainly means something in the law. Was it construed that the directors ever had personal liability under this?

Mr. ECCLES. I do not quite get your question.

Mr. MONRONEY. I am referring to this prohibition against making loans or declaring dividends when the reserves were deficient, whether on a weekly basis or a two-weekly basis average, or whether on the daily basis, was that ever construed to mean individual liability of the bank directors?

Mr. ECCLES. I could not say. I think this is the only case that has arisen, and what I know of this case is that a director was sued, and the case went to the court, and this director was held personally liable in the amount of the loss of some loans that were made while the reserves of the bank were deficient. I do not know whether the reserves were deficient one day or more than one day, but the decision was based upon the loss made on loans while the reserve was deficient, irrespective of whether it was a day or a week. It was a question of the loans made during the period when the reserves were deficient, and losses were incurred on those loans.

Mr. SPENCE. Were your orders with reference to average reserve requirements over a period in effect at the time these loans were made?

Mr. ECCLES. I do not think they were.

Mr. CLAYTON. No, sir; I do not think so. It was a recent decision.

Mr. ECCLES. I would have to check as to the date when our regulations went into effect and also as to the date of the decision. I won't be sure. I would not be sure as to what regulations we had in effect at the time of this deficiency. All I know about it is that our lawyers who are thoroughly familiar with the case and the lawyers in the New York bank said this matter has been taken up with the New York banking people, and with our lawyers by most of the New York banks. All of the New York banks have asked in the light of this decision that this be repealed. Otherwise our regulation which now permits them to average their reserves on a weekly basis will be ineffective. They said they will pay no attention at all to our regulations. Their lawyers have advised them not to do so, and unless this is repealed they will not let their reserves become deficient. They will sell government bonds, or do whatever is necessary to keep their reserves up every day. In order to keep them up of sufficient amount one banker told me last week he would have to maintain $100,000,000 more than was actually required in order to be perfectly sure that he would not be deficient on any day.

Mr. GAMBLE. Might it not hurt the standing of the bank, Governor, if it had to admit it could not make a loan if it was deficient in its reserve?

Mr. ECCLES. The point is a bank would not be deficient. It would run with enough excess reserve so that it would not permit itself to become deficient on any day.

Miss SUMNER. He means that it might cause a run on the bank.

Mr. ECCLES. Nobody would know that it was deficient on any one day.

Mr. GAMBLE. I know, but they would have to give a good reason for turning the loan down.

Mr. ECCLES. They would turn the loan down, or possibly they would defer it. They would defer it until they could sell securities. Of course, if they are deficient they will sell their governments. That is easy, and they sell them right now. They would either do that or come into the Federal Reserve and possibly borrow, but it is perfectly impracticable for a bank to figure reserves on such a small period as a day at a time.

Miss SUMNER. I want to know if you are thinking of raising the excess reserve requirements for the small banks in rural communities?

Mr. ECCLES. We have no power to do so.

Miss SUMNER. That is, if this bill is passed.

Mr. ECCLES. This bill has nothing to do with that. This bill gives us no power to do that.

Mr. PATMAN. Referring to the Federal Open Market Committee, the present committee is composed of 12 members, 7 from the Board and 5 from the Federal Reserve banks?

Mr. ECCLES. That is right.

Mr. PATMAN. The Board, however, is lacking one of being the whole 7?

Mr. ECCLES. That is right.

Mr. PATMAN. With this change in the present Board you will still have 12?

Mr. ECCLES. We would have 11 if we have any vacancy.

Mr. PATMAN. You would still authorize 12?

Mr. ECCLES. Yes.

Mr. PATMAN. How would the five be changed? Will this change the bank members?

Mr. ECCLES. No; it will still leave five bank members.

Mr. PATMAN. It would still leave five bank members, but there is a different way of selection.

Mr. ECCLES. That is right. It is a different grouping. You see, the present grouping provides for New York, Cleveland, Philadelphia, Chicago, and St. Louis. There are six of the banks, and they elect three of the five members on the committee, and then of the western banks, San Francisco, Kansas City, and Minneapolis, one; and Richmond and Atlanta, one. Now we are proposing a regrouping.

Mr. PATMAN. And the regrouping is outlined in the bill itself?

Mr. ECCLES. Yes; that is right.

Mr. PATMAN. What are the powers of the Federal Open Market Committee, Governor Eccles?

Mr. ECCLES. Would you like to have the statute read on it?

Mr. PATMAN. I know the statute is rather specific, but in practice how often do you meet?

Mr. ECCLES. I think we are required to meet not less than four times a year.

Mr. PATMAN. Do you meet more frequently than that, usually?

Mr. ECCLES. Yes; I think we have during the last year or two. What we have had to do, in order to facilitate the operation of it is, we have had an executive committee composed of three of the members of the Board and two of the banks, and we meet much more often, in fact, in our operations.

Mr. PATMAN. To carry out the administration of the whole group?

Mr. ECCLES. That is right, of the whole group, and they delegate certain authority to the executive committee with limitations. They always give you authority up to a certain limit to buy or sell securities, and that authority has to be renewed or extended from time to time to meet the situation. Now, we have had several emergency meetings of the Federal Open Market Committee. We had such a meeting in 1939 just before the European war started, and we had one right after Pearl Harbor. There have been several instances where we have had to get them in quickly. Now, however, the executive committee is sitting almost in constant session, almost a week at a time.

Mr. PATMAN. What is your policy with reference to the price for Government bonds? Suppose there should be a tendency for Government bonds to go below par, do you have any definite policy not to let them go below par?

Mr. ECCLES. No, sir; we do not feel that there is anything necessarily sacred in par, because when you talk about par you have got some bonds selling as high as 110 or 112, and you have other Government bonds selling practically at par. In other words, at different times, bonds have been issued with different maturities and different interest rates, and there are certain bonds now outstanding that are partially tax exempt, bonds that were issued prior to the bill prohibiting issuing them.

Mr. PATMAN. Is it not a fact that you did send out letters to the banks which made the statement that the Federal Open Market Committee was ready to buy all bonds at par?

Mr. ECCLES. No, sir; not buy, we adopted a policy, each bank did, that would loan par on them.

Mr. PATMAN. That would loan par on Government securities?

Mr. ECCLES. Yes, sir.

Mr. PATMAN. Do you charge the interest rate that is effective in that particular Federal Reserve district?

Mr. ECCLES. One percent.

Mr. PATMAN. One percent.

Mr. ECCLES. Yes.

Mr. PATMAN. Have you ever told all the banks that you stand ready to make loans at par at a 1-percent-interest rate?

Mr. ECCLES. Each Federal Reserve bank has done that.

Mr. PATMAN. Each Federal Reserve bank has done that?

Mr. ECCLES. Yes; we did: Just recently the Federal Open Market Committee instructed each Federal Reserve bank, as its agent, to offer to purchase Treasury bills at the rate of three-eights, and those bills are now being pretty widely distributed and sold throughout the country. The Treasury is offering each week $300,000,000 of bills.

Mr. PATMAN. At what rate?

Mr. ECCLES. It is a bid price, but the very fact that we offer to take them at three-eights puts a ceiling on the rate.

Mr. PATMAN. That puts a floor on it, does it not?

Mr. ECCLES. No; it puts a ceiling on the rate. It does not put a floor on it. Competition for buying those bills has kept your ceiling below three-eighths.

Mr. PATMAN. If they can buy them for one-eighth, they can turn them right in for three-eighths and make a profit of two-eighths?

Mr. ECCLES. They buy them on the basis of three-eighths yield. If they buy them on the basis of one-eighth, the yield on them is two-eighths.

Mr. PATMAN. Regarding the excess reserves, you will not have any more power if this law is changed like you propose than you would have under the existing law, except you can break them up into groups?

Mr. ECCLES. Into three instead of two.

Mr. PATMAN. Into three groups instead of two groups?

Mr. ECCLES. Yes, sir.

Mr. PATMAN. And that is in order to take care of the situation which you explained a moment ago?

Mr. ECCLES. That is right.

Mr. PATMAN. What are the excess reserves on the money market at the present time?

Mr. ECCLES. They are running around two billion five hundred million.

Mr. PATMAN. How much could they buy in Government bonds if they were to use the excess reserve to the limit?

Mr. ECCLES. About $12,000,000,000.

Mr. PATMAN. $12,000,000,000?

Mr. ECCLES. Yes, sir; that is, assuming that the deposit structure and the present structure does not change.

Mr. PATMAN. It would be about $12,000,000,000?

Mr. ECCLES. Yes; you see, the Federal Reserve requirement is about 20 percent.

Mr. PATMAN. Yes, sir.

Mr. ECCLES. For the country it is 14, and for the central Reserve cities it is 20, and for the Reserve cities it is 26, so that we figure on about a 20-percent Reserve requirement, so that on the basis of $2,500,-000,000, if that were all fully utilized on the factional Reserve basis, I would estimate that they could buy about $12,000,000,000 worth of governments, that is, if it were utilized fully and completely through the entire Reserve, all the banks.

Mr. PATMAN. Suppose today they bought those $12,000,000,000 of bonds, what would they have back of those bonds to support them in addition to what they have now? In other words, what increased assets would the bank have except Government bonds?

Mr. ECCLES. They would have the Government bonds themselves, which would be an asset, and they would have a liability, however, in the form of a deposit.

Mr. PATMAN. That is right.

Mr. ECCLES. So that they would be in pretty tough shape if they had that deposit liability without the assets.

Mr. PATMAN. Governor, in regard to the excess reserves, it is not contemplated that you expect to change these reserves so that the larger banks can buy more Government bonds? You do not have that in mind now?

Mr. ECCLES. Well, it is not done, I would say, for that purpose, primarily or specifically. If we wanted to enable the banks to buy a lot of bonds we could.

Mr. PATMAN. By lowering the reserve requirements?

Mr. ECCLES. By lowering the reserve requirements, yes; or we could step up and buy a lot of bonds directly by Fed itself, and put more reserves in by open-market purchases. What we would like to see done is more of the Government bonds placed outside of the banks, and we would like to see an expansion of the bank-deposits structure go up as slowly as possible. We feel that there is an element of danger in a too-rapid growth or in too large an expansion of deposit currency.

Mr. PATMAN. I agree with you that the bonds should be sold outside of the banks, and I think we should encourage selling the bonds outside of the banks.

Mr. ECCLES. But the point is if you have too much reserves in the banks it has two effects. The pressure of excess reserves continues to force your rates down and in the process of forcing them down the banks will go out and bid up and buy bonds on the open market in order to keep up their necessary income. They have a minimum income requirement, and in an effort to try to keep that up they try to increase the volume of their holdings to offset the drop in the rate. If their excess reserves were kept at a high level it would put them under pressure to keep those reserves invested and you would find that more and more of the financing would go to the banks and less to the public, because the lower the rate, the less likely the public are going to be interested in buying. We find we have an example in this bill rate. When the bill rate was nothing, and it was, for a time, a very small fraction of 1 percent, there was no purchase of bills outside of the money market, outside of New York, and practically all of the bills were purchased in New York.

Corporations with surplus funds, individuals, foreign governments and municipalities bought no bills. Today with the rate just up to three-eighths, there are tens of millions of these bills being bought by corporations, country banks, and banks throughout the country are buying them, and that would not be true, and it was not true when that rate was below one-fourth.

Mr. PATMAN. I want to get that later on, but I want to ask you this now in order to get the information I desire: Let us suppose that the banks are called upon to buy $12,000,000,000 of Government bonds today. That consumes all of their excess reserves. If you wanted to increase their excess reserves in order to buy another $12,000,000,000 of Government bonds, how would you do that, through the Federal Open Market Committee?

Mr. ECCLES. We might decrease the reserve requirements.

Mr. PATMAN. How would you decrease them?

Mr. ECCLES. I think it runs between $5,000,000,000 and $6,000,000,000.

Mr. PATMAN. Between $5,000,000,000 and $6,000,000,000?

Mr. ECCLES. Yes; somewhere between five billion and six billion.

Mr. PATMAN. If it were decreased as you suggest, that would enable you to buy how many bonds?

Mr. ECCLES. If we decreased it to the full amount, then the reserve requirements are 10 percent instead of 20 percent, and you can buy about 10 to 1.

Mr KEAN. What does change it from 5 to 1 or 10 to 1? Would you explain that again?

Mr. ECCLES. As it is the requirements of the Federal Reserve Bank System of the country as a whole are about 20 percent. If we changed the reserve requirements to the full amount we could then say the reserve requirements are only 10 percent instead of 20 percent, and you can get about 10 to 1, and that would be about $50,000,000,000.

Mr. PATMAN. After you have already reduced the reserve requirements of the banks and have bought these $50,000,000,000 in bonds, if you need to buy still more, how would you handle the others? Suppose you wanted to call upon them to buy $25,000,000,000 more in bonds?

Mr. ECCLES. We could carry it on then, if it were necessary, by an open-market operation.

Mr. PATMAN. In other words, you buy a billion dollars' worth of bonds, what would be the effect of that billion dollars on the banks?

Mr. ECCLES. If they could get a billion dollars they could buy up about $10,000,000,000 in bonds.

Mr. PATMAN. Then if you need to sell another $10,000,000,000 worth of bonds, you could get another billion dollars from the bank?

Mr. ECCLES. Yes; but if you did that you would have inflation on your hands, if you got any higher.

Mr. DEWEY. We have been talking about the liability of directors in making loans, and I think that any bank directors that carried out a proceeding in buying bonds to that extent would not require any regulations they ought to be put in jail anyway.

Mr. PATMAN. I did not get that.

Mr. DEWEY. Any bank directors participating in buying Government bonds or other securities in any such quantities as you are mentioning thereby cutting down the reserves of the bank. I think that the liability is very clear and they should be punished for such acts.

The CHAIRMAN. They would be within the law.

Mr. PATMAN. We have to finance the war in some way.

Mr. DEWEY. I know; but the banks of the United States are not supposed to finance the war entirely.

Mr. PATMAN. Certainly they are. They are public institutions, and they have been given wonderful assistance by the Government, and they ought to render some public service; and if they cannot render it during the war, when should they render it?

Mr. DEWEY. Do not ruin the finances of the country by operations such as you have been mentioning. The Treasury Department and the Federal Reserve Board, working together, are finding other means of financing it rather than ruining all the banks by forcing them to purchase Government securities.

Mr. ECCLES. Of course, the banks have never been forced to. They buy Government securities of their own accord.

Mr. PATMAN. Why should they be?

Mr. ECCLES. There is not any question but what a very, very important part of the banks' income has been from the interest from Government securities, and the Federal Reserve System has been in a position to either create a climate favorable for credit expansion or to create one less favorable. Now in a depression period we felt, and I think everybody did, that a condition that was favorable to credit expansion was desirable. That was not going to create inflation; we recognized that, or at least, we tried to create a condition in the banking system that was favorable for the banks to expand credit. We reversed the action from 1932, 1933, 1934, 1935, and 1936. It was a condition favorable to expansion of credit. The banks were encouraged to loan, and the Government helped them to find outlets for some of their funds by having them take Government bonds, and the banks were so anxious to get Government bonds, and they bought them so freely, and the excess reserves were such in the banks that they gradually forced the rate of interest down on Government bonds from where they were to where they are now.

So it was the banks bidding for Government bonds because of the demand on the part of banks, because they were the principal underwriters of them, and the demand for Government bonds on the part of the banks was in excess of the supply to such an extent that you have the present interest rate.

Now, we feel that it is desirable to stabilize the interest-rate structure for the financing of the war period, so that the investors and the banks will know pretty largely upon what to depend. I do not feel that the war should be financed on increasingly higher interest rates, and I feel that the purchaser of a 2½-percent bond today should not find in a year from now that if he had waited he could have gotten 2¾ percent or 3 percent, and the bond which he bought today is selling at a discount.

I feel very strongly that the financing should be done on the basis of a stabilized rate structure

Mr. PATMAN. Mr. Chairman, I have a very important engagement at 12:30. Of course, I anticipated we would get through before that time, and I need something like 30 or 40 minutes more, and I wonder if it would be all right to ask Governor Eccles to come back at another time for further questioning, because I know there are other members who would like to ask him some questions this morning.

The CHAIRMAN. I am sure he would be glad to come back. Let me ask the Governor when it would suit him to come back again.

Mr. PATMAN. We have that oil hearing tomorrow, Mr. Chairman.

The CHAIRMAN. I have not set that for tomorrow, because I anticipated that we might not finish with this this morning.

Mr. ECCLES. I had another conference committee meeting set for 11 o'clock, when we meet informally to discuss capital issues, and that has been set in the main by the Secretary of the Treasury. If I could come up Friday, if it would be just as convenient for the committee, I would appreciate it.

The CHAIRMAN. We will let you come back Friday if it suits you better.

Mr. ECCLES. If tomorrow suits the committee better I will just have to pass up that conference tomorrow, but I would like to attend that conference if Friday suits the committee just as well.

The CHAIRMAN. You may suit yourself and, if Friday suits you better, we will hear you Friday.

Mr. KUNKEL. Governor Eccles, you referred to this court case, and I wonder if you could secure and place the opinion in the record, and also any comments that the attorneys care to make on it, and I should also like to ask the chairman and the members of the committee if that could go in at the start where you make reference to it in connection with this bill?

The CHAIRMAN. Yes. We will meet tomorrow morning on the other bill at 10:30, and will expect you to continue Friday at 10:30.

Mr. DEWEY. I cannot be here Friday, Mr. Chairman. I would like to ask if the Governor will bear with me for a while, as I would like to ask him a few questions now regarding reserves.

The CHAIRMAN. We would be glad to have you do so, Mr. Dewey.

Mr. DEWEY. I want to talk a little bit regarding discounting 16-day loans and reserve requirements. If a bank had a large amount of Government securities on hand and desired to increase its reserve it could make a 16-day loan; could it not?

Mr. ECCLES. It depends on what it is borrowing on. There are various types of loans.

Mr. DEWEY. Can you give us the types of loans?

Mr. ECCLES. I could not do that offhand. There has been practically no borrowing from the Federal Reserve System since I have been connected with it.

Mr. DEWEY. If we are going into any such purchase of securities by the banks as that mentioned by Mr. Patman there will be plenty of borrowing from the Federal Reserve banks by banks to take care of their requirements to avoid the sale of Government securities.

Mr. ECCLES. Mr. Patman was talking about the Reserve system providing banks with sufficient reserves so that the banks could do that without borrowing from the Reserve System, without selling existing securities, so that it would not be a case of borrowing from the banks at all.

Mr. DEWEY. Mr. Patman's idea was for the system to buy directly from the Treasury?

Mr. ECCLES. Mr. Patman's idea was to reduce the reserve requirements and the statutory requirement which would enable them with the present excess reserves, if the Federal Reserve should reduce the reserve requirements of all member banks by the amount that they have already authority to reduce them, that would give the banks more than $5,000,000,000 additional excess reserves, and if every bank used all the excess reserves that it had, that it then could buy approximately $50,000,000,000 worth of Governments.

Mr. DEWEY. Who, the banks?

Mr. ECCLES. Yes, the banks.

Mr. DEWEY. That is what I am talking about.

Mr. ECCLES. But they would not have to borrow any money from the Federal Reserve to do that.

Mr. DEWEY. Now, then, coming to the point where they have no excess reserves, or their deposit liability is increased in one way or the other, and that is the point I am coming to, and Mr. Patman came to it. He wanted them to buy more bonds, and I think he said this war would cost $200,000,000,000 or $300,000,000,000, and the banks would have to, according to him, purchase them which would create additional deposits in the banks and require additional reserves. In connection with that there is a point where they would have to start either rediscounting with the Federal Reserve System, or making loans from the Federal Reserve secured by these bonds?

Mr. ECCLES. No; the Federal Reserve would buy in the open market. If the Federal Reserve then bought a billion dollars of securities in the open market that would be new Treasury issues. The banks would still hold them, and the Federal Reserve would put into the banks another billion of excess reserves. If they used that billion they could buy five billion more of Governments, and you could keep the price up. For every billion of the Federal Reserve banks put in the open market operations, the private banks could buy five billion.

Mr. DEWEY. That comes pretty close to some other ideas I have heard.

Mr. ECCLES. I mean they could buy ten billion. I mean the Federal Reserve when it carries out an open market operation, that is, if it purchases Government securities in the open market it puts new money into the banks which creates idle deposits.

Mr. DEWEY. There are no excess reserves to use for this purpose.

Mr. ECCLES. Whenever the Federal Reserve System buys Government securities in the open market or buys them direct from the Treasury, either one, that is what it does——

Mr. DEWEY. What are you going to use to buy them with?

Mr. ECCLES. What is who going to use?

Mr. DEWEY. The Federal Reserve bank to make these purchases.

Mr. ECCLES. What do they always use?

Mr. DEWEY. You are going to create credit?

Mr. ECCLES. That is all we have ever done. That is the way the Federal Reserve System operates. The Federal Reserve System creates money. It is a bank of issue.

Mr. DEWEY. That would tend to run into wide open inflation, currency expansion. It is currency inflation running hand in hand with credit inflation, is not that right? That sort of procedure would be diametrically opposed to everything we have been trying to do with price control.

Mr. ECCLES. We all recognize, Mr. Dewey, that it is desirable to finance the war, so far as it is possible to do so by taxes, that is most desirable, and, secondly, by the sale of Government securities to other than banks, primarily to the people who would otherwise spend their money on consumers' goods, and that the creation of new money or the creation of additional money by the sale of Government securities to the banks is inflationary in one sense, that is, it is inflationary in the sense that it creates an increased amount of the means of payment without increasing the supply of goods available for purchase, and up to a point certainly everything should be done to avoid the expansion of bank credit. We have already got now over $50,000,000,000 of demand deposits and currency, and I feel that that amount of deposits and currency could support a substantial amount of Government financing without increasing the total amount of bank deposits. You can only accomplish that by getting the owners of those funds to invest them. The banks do not loan those funds.

The people and the corporations that own that money are the only ones that can invest that money, and if they would invest that, if they would buy Government bonds, and the Government then spends that money, it goes right back again and the recipients of the money then spend it again, thereby increasing the velocity and the turn-over. I would like to see the velocity of existing deposits increased in both velocity and use, and at the same time to avoid as much as possible the expansion of the volume.

I am not saying that we can avoid some expansion of the volume of deposits. I am not saying that some expansion of the volume of deposits possibly would be bad as long as the national income is growing. You naturally get a larger volume of deposits concurrent with a national income of $120,000,000,000—you get more than you did when the national income was $60,000,000,000 or $70,000,000,000, so that as far as the growth of deposits is concerned, certainly within the last year or two, I doubt if it has been any more rapid than the growth in the national income.

Now, we have reached the point in the growth of the national income, or we are getting there where further growth of the national income is not going to bring about further development in production, because you cannot increase the supply of goods much beyond what you are doing now, but up to this time the growth in national income has been a growth in total production. From now on the growth in national income as expressed in dollars would be brought about through a price increase and that, of course, would be undesirable.

Mr. DEWEY. Again, in line with this policy of selling the bonds to the public, you naturally are dealing very closely with the Treasury for such distribution. Are there any plans being set up other than the sale of these Victory—I forget what you call them?

Mr. ECCLES. You mean the E. F. G.'s?

Mr. DEWEY. Yes; the E. F. G.'s. Is there any effort to sell longer term securities to the public?

Mr. ECCLES. Those are pretty long term, the E. F. G.'s They are 12-year securities subject to an interest penalty if converted earlier. They bear 2½ percent if carried to maturity, but if cashed prior to maturity the return that the holder gets is in relationship to the period in which he held the securities.

Mr. DEWEY. You have some theory on some so-called tap issues of some securities.

Mr. ECCLES. Do you mean the nonnegotiable tap issues?

Mr. DEWEY. Would you say a word on that, please?

Mr. ECCLES. I would prefer not to discuss that, because it does not seem to me it is pertinent to this legislation. It seems to me it is somewhat aside from this legislation, but it is related to discussions had between the Reserve people and the Treasury, and I feel that unless a complete, general, broad, carefully prepared statement covering this whole question of finance is going to be given out publicly that for me to get into somewhat of a discussion of the thing may well be misunderstood. It is a matter that a great deal of thought, a great deal of time, and a great deal of consideration has been given to by the Open Market Committee and by the Board, by the Treasury people and the Reserve people have agreed on definite ideas on which we are all in full and complete agreement as to a complete program on this.

Mr. DEWEY. Would you go as far as saying, or I think you have stated, that you believe that this war can be fought on a 2½-percent basis.

Mr. ECCLES. I have felt that the long market could be stabilized to 2½ percent. I have said that quite a number of times, commencing back as long as over a year ago. One of the reasons was that the Treasury had a lot of securities out that were bearing 2½ percent. Those 2½-percent securities were selling at more than par before the war started, and even before there was any large amount of funds being spent for defense purposes. It meant to talk about a different rate than 2½ percent, it meant that the securities that were then out would all decline, and it meant that the holders of those securities would have some losses, may well have some losses, and it meant that there would be uncertainty as to how high the rate was going, if 2½ percent was not the ceiling, then what would be, and nothing could be more upsetting to the stability of a Government market than to be financing at increasing rates, meaning that every time securities were purchased you could be sure that at a later date you could purchase them on a more favorable basis, and then on those that you had already purchased you would have a loss on them. That is not the way to finance a war. We would have been better off—I think it would have been possibly easier—to finance the war, and I do not mean by that that it is difficult now, but if the rates had been higher and the securities lower so that as the financing went on the rates would gradually decline, and the securities would advance, that would be a most favorable inducement to the investor, feeling that what he was getting was a little better, and that the rate might be getting a little less. Of course, the rate is so low now on government securities that it would desirable to expect public corporations and those outside of the banks to invest funds in government securities at declining rates, so that we have felt, and it is has been pretty generally accepted by the financial community that the market for securities, which means the interest-rate structure, should be stabilized within pretty narrow limits, that we should maintain a pattern from the shortest rate to the longest rate, and not have that sort of gyration where you have got to raise billions of dollars every month. One thing more you must have is stability in the government-security market, and one of the proposals of this bill is to enable the Federal Reserve Board, that is, the Open Market Committee of the Board, to help to maintain stability in the security market.

Mr. WILLIAMS. I would like to ask you one question, Governor, about section 2 of the bill which amends the existing law. Under the present law if you wanted to change the rates or the reserve requirements on deposits in any one of the three classes of banks would you have to change it as to all of them in the same issue?

Mr. ECCLES. We would in two classes of them, but not in all three.

Mr. WILLIAMS. What two classes go together?

Mr. ECCLES. The central reserve cities, that is, New York and Chicago, and the reserve cities, in that we cannot change the central reserve cities without changing the reserve cities in exactly the same ratio. If we increase the reserve requirements in one we have to increase them in the other, or if we decrease the reserve requirements in one we have to decrease them in the other, but we could change the reserve requirements in those two classes of cities without changing the country bank classification.

Mr. WILLIAMS. But they would have to be changed in the same ratio?

Mr. ECCLES. Exactly.

Mr. WILLIAMS. This amendment is designed to permit a change in any of the three in the proportion you want to change them?

Mr. ECCLES. That is right, within the limitations of the statute.

Mr. WILLIAMS. Yes; that is right.

The CHAIRMAN. Thank you, Governor Eccles. The committee will meet tomorrow morning at 10:30.

(Thereupon, at 12:40 p. m., the committee adjourned until tomorrow, Thursday, June 18, 1942, at 10 a. m.)

TO AMEND THE FEDERAL RESERVE ACT

FRIDAY, JUNE 19, 1942

House of Representatives,
Committee on Banking and Currency,
Washington, D. C.

The committee met at 10:30 a. m., Hon. Henry B. Steagall (chairman) presiding.

The Chairman. Governor Eccles, we will be glad to have you resume your testimony on the bill, and Mr. Patman would like to interrogate you further at this time.

STATEMENT OF MARRINER S. ECCLES, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM—Resumed

Mr. Patman. Mr. Eccles, the day before yesterday I had gotten down to the point where, if we needed more money, one way to give the banks extra reserves to purchase Government bonds would be for the Open Market Committee to buy Government bonds in the open market, and I suggested if you bought for the Federal Reserve Bank one billion dollars' worth of bonds, that would automatically create a billion dollars of reserves in the banks and, after the reserves had been reduced 50 percent, the maximum, that would enable the banks to purchase $50,000,000,000 worth of bonds. Now, let us assume that has happened——

Mr. Eccles. Ten million dollars' worth, by the purchase of a billion dollars' worth of bonds in the market.

Mr. Patman. I got the two mixed up. The purchase of a billion dollars' worth of bonds in the market, after the excess reserves had been reduced, will enable the banks to buy 10 billion?

Mr. Eccles. That is right.

Mr. Patman. Where the 50 billion came in was if you would automatically reduce the reserves now, which you have a right to do, that would give them $5,000,000,000 of excess reserves which they could use to purchase $50,000,000,000 worth of bonds.

Mr. Eccles. That is right.

Mr. Patman. Now let us assume that we not increase the reserves in the banks, and you go in the open market and buy a billion dollars' worth of bonds: you buy them with Federal Reserve money, do you not?

Mr. Eccles. Well, we buy them with Federal Reserve credit.

Mr. Patman. I know; but suppose the banks call for the money, you issue Federal Reserve notes, do you not?

Mr. Eccles. What we do, if we purchase Government securities in the market, is we credit the account of the bank that turns them in. They usually come through the banks.

Mr. Patman. That is right.

Mr. ECCLES. Even though they may be individuals who are selling the securities; and we debit the bond purchase account, showing that the Federal Reserve has a liability to the banks to the extent of $1,000,000,000, which represents their reserves on the one hand, and that they own $1,000,000,000 of bonds in what we call the portfolio, on the other hand.

Mr. PATMAN. I know in practice that is exactly the way it is done, Mr. Eccles; but suppose the banks want the billion dollars in currency, you would pay it in the Federal Reserve notes, would you not?

Mr. ECCLES. That is right.

Mr. PATMAN. Those Federal Reserve notes, as we have often discussed, are obligations of the United States Government?

Mr. ECCLES. That is right.

Mr. PATMAN. Then you use those Government obligations to buy interest-bearing Government obligations and you place them with the Federal Reserve banks, 12 of them?

Mr. ECCLES. That is right.

Mr. PATMAN. And they would continue to receive interest on those Government obligations as long as they were outstanding?

Mr. ECCLES. That is right.

Mr. PATMAN. So the result is the Government's credit has been used and the Government has gotten nothing for the use of that credit; the Federal Reserve banks are using it free, are they not?

Mr. ECCLES. Well, the Government in effect, for all practical purposes, owns the Federal Reserve banks.

Mr. PATMAN. For all practical purposes?

Mr. ECCLES. Yes; because the Federal Reserve banks are not operating for profit. The Government can take from the Federal Reserve banks, at any time they choose to do so—and they have done it in the past—any earnings that the Federal Reserve may make. They took $140,000,000 from the Federal Reserve banks and used it to set up the capital for the Federal Deposit Insurance Corporation. If at any time the Federal Reserve's income, as a result of its purchase of Government securities, should enable it to accumulate large surpluses that the Congress felt it wanted to use, they could appropriate those surpluses for whatever purpose they wanted to.

Mr. PATMAN. I understand that, Mr. Eccles, and that it has been done in the past. The law used to provide that that surplus would overflow into the Treasury. Of course, that has been changed. But the point I am endeavoring to reach is this: To what point are you willing for the banks to go in buying Government bonds? All of the banks now have a total capitalization of about three and one-half billion of capital stock and three and one-half billion of surplus, and one billion of undivided profits. That is about $8,000,000,000 of capital structure. How far are you willing for these banks to go in buying Government securities? Are you willing for them to buy $100,000,000,000 worth, or $150,000,000,000 worth?

Mr. ECCLES. You are speaking of private banks?

Mr. PATMAN. Yes; I am speaking of private banks.

Mr. ECCLES. I would like to see the Government's deficit financed to the greatest possible extent out of the sale of its securities to the public outside of the banks.

Mr. PATMAN. I agree with you on that.

Mr. ECCLES. I would not feel that it would be necessary to sell to the banks anything like $100,000,000,000 of securities. I would feel, if anything like that amount of securities was sold to the banks, that we would have failed to distribute the securities to the public as they could and should be distributed, and we would have created an inflationary condition in the banking system.

Mr. PATMAN. That is not an answer, Mr. Eccles, to my question. I asked you the question how far you would be willing for the banks to go. I agree with you that we should sell bonds to the public, to those who have existing accounts and have transferable accounts, rather than the creation of new deposits. I thoroughly agree with you on that. But suppose we are unable to sell a sufficient amount of bonds—and we are selling only about a billion dollars' worth a month and spending two billion—and suppose we have to keep on selling securities to the banks, how far are you willing for them to go with their present capital structure?

Mr. ECCLES. I would not want to fix some specific amount, some ratio, at all. I recognize to the extent that the Congress is unwilling to levy an adequate tax system and to the extent that the Government does not devise securities that the public is willing to buy, then the difference must be made up through the selling of securities to the banking system, or through pursuing the course which you have suggested, which is equivalent to the issuance of currency.

Mr. PATMAN. Well, is not the selling of bonds to a bank, that creates a deposit by a bookkeeping transaction, equivalent to the issuance of currency?

Mr. ECCLES. No; there is a very great difference.

Mr. PATMAN. The credit in the bank has the equivalent of currency, has it not?

Mr. ECCLES. There is a very substantial difference. When you issue currency, when you create excess reserves, you drive down the rates. As you drive down the rates, you reduce the interest of the public in the purchase of the securities, and you increase the pressure for the banks to purchase and, of course, decrease the pressure for the public to purchase.

Mr. PATMAN. There is no pressure on the banks to purchase now, is there?

Mr. ECCLES. There would be pressure on them as the rates went down, because there would naturally be an effort to increase the volume—in other words, to offset the reduction in rates.

Mr. PATMAN. In other words, if instead of buying $1,000,000,000 worth of bonds from private banks, the Federal Reserve banks would create that credit themselves on the books, you say that would be more inflationary?

Mr. ECCLES. Yes.

Mr. PATMAN. More inflationary?

Mr. ECCLES. Yes.

Mr. PATMAN. Let us suppose you need $1,000,000,000 this morning, the Treasury does, and the Treasury gets that on a certificate of indebtedness from the Federal Reserve banks, without interest, and in that way creates $1,000,000,000.

Mr. ECCLES. That is right.

Mr. PATMAN. What is the difference in the actual creation of money or increasing the deposits in the amount needed, and in selling $1,000,-

000,000 worth of bonds to private banks and increasing their deposits by exactly $1,000,000,000?

Mr. ECCLES. There would be a very substantial difference.

Mr. PATMAN. What is the difference?

Mr. ECCLES. I will explain it to you.

Pursuing your suggested method of giving to the Federal Reserve banks a certificate for $1,000,000,000 and the Federal Reserve banks giving the Treasury credit for $1,000,000,000, that would be the equivalent to the Treasury issuing currency in the first instance. There would be no difference whatever in putting non-interest-bearing certificates into banks as you suggest, and merely printing a billion dollars of currency and depositing the currency with the Reserve banks to be disbursed by the Reserve banks as the currency needs of the public require the use of currency. That would be exactly the same, because when that credit of the Treasury in the Reserve banks of $1,000,000,000 is spent, that billion dollars goes out into circulation as the Treasury spends it and becomes a deposit in the banking system somewhere on the one side, and becomes an excess reserve on the other side. So that the banks are then in a position, with that billion dollars of reserves that has been put with them, to expand a multiple amount of credit and that billion dollars puts them immediately under pressure to loan money, or to buy securities. It creates a condition or climate that is favorable for the easiest kind of credit expansion.

The supply of an excess of reserve funds in the hands of the banking system would tend to drive down bill rates and other rates to the vanishing point and, as the rates drop, the banks attempt to offset their loss of income, in order to keep going, by buying a greater volume. That, of course, would tend to divert the securities into the banks and away from the public—the very thing we do not want to do. When the banks buy Government securities directly, they have, in lieu of the excess reserves, an asset in the form of Government securities and it actually diminishes the excess reserves of the banking system, because, as the banks buy Government securities, they increase the total deposits by that amount; and as the deposits increase, the reserve requirements increase. In other words, if the banks buy one billion of Government bonds, they create a billion of deposits and the reserve requirements go up 200 million. So that you actually reduce any excess reserves by the purchase by the banks of Government bonds; whereas, with your proposal, you increase the excess reserves. That is a fundamental difference.

Mr. PATMAN. But, Mr. Eccles, suppose you had the power to control the excess reserves—and you have the right to increase them; you could make it 25 percent, 50 percent, or 100 percent—then that would be a complete answer to what you said, would it not?

Mr. ECCLES. No; it does not answer it at all, for this reason——

Mr. PATMAN. You could wipe out the excess reserves you did not want.

Mr. ECCLES. That is right; but you would have to pay the banks for the service they rendered fully as much as the interest they get on Government bonds.

Mr. PATMAN. The banks are getting paid now; the people are paying now for the carrying of their accounts, and why should the people and the Government both pay?

Mr. ECCLES. Look at the earnings of the banks! Bank stocks are selling for 50 percent of their liquidating value today. Look at the whole banking picture: Can you say that the banks are excessive earners? Is there any line of business that is rendering a more useful service than the banking system, and getting less return?

Mr. PATMAN. I do not know about the returns——

Mr. ECCLES. I wrote you a letter here in March on this very subject that covered this whole field, and it seems to me this is more or less going around that same circle.

Mr. PATMAN. One thing is obvious, that the bank stockholders all have in all invested $8,000,000,000; that they have been permitted to put three times that much in Government securities on which they receive interest now. I do not object to that; I want to give the banks a fair return. I think the banks are a very necessary and highly desirable institution, and are rendering a wonderful service, but as long as the Government subsidizes the banks like it does—and three times the capital structure should be enough—I think if the Government can finance the war debt by not being compelled to pay interest on the remainder; it would be perfectly fair to the taxpayers that it be done.

Mr. ECCLES. Let me answer that by asking a question: Why is the interest a burden on the taxpayers, when the taxpayers get the interest?

Mr. PATMAN. What do you mean by "the taxpayers get the interest?" Do you mean to say that the holders of Government bonds are the principal taxpayers?

Mr. ECCLES. Pretty largely.

Mr. PATMAN. Of course, if they were all the same, your suggestion would be correct, but I do not think they are all the same.

Mr. ECCLES. No.

Mr. PATMAN. We have some very burdensome excise taxes.

Mr. ECCLES. Yes; but looking at the economy as a whole, they are the same. You might be interested to know that the insurance companies own a very large amount of Government bonds and of course, as I am sure you must know, the policyholders in the insurance companies number more than 60 million.

Mr. PATMAN. I am not objecting to the insurance companies buying Government bonds. They are exchanging deposits; they are not creating the money to buy them. But I have often heard you say that the banks create money and I notice in all of this advertising in the bond-sales campaign and the talks and speeches encouraging people to buy bonds and stamps, they make this statement, that "if the people do not buy bonds and stamps it will cause inflation, because the commercial banks will be required to buy these bonds and, if the commercial banks buy the bonds, they create the money, which automatically increases the demand deposits and causes inflation." Now, is that a correct statement, or not?

Mr. ECCLES. Well, commercial banks as a whole create money; but the individual bank in purchasing Government bonds or making the loan has the reserves with which to do it; because, when they set up the credit for a loan or for the Government bond which they purchase, they of course do not know how soon that credit may be drawn out; therefore, to them, they are investing funds that they have on hand.

Mr. PATMAN. But they remain in the banking system as a whole?

Mr. ECCLES. They remain in the banking system as a whole, as an increase in deposits.

Now I want to get back to this question of the insurance companies and others purchasing Government securities, that is, others outside of the banks.

Mr. PATMAN. There is no difference between us on that.

Mr. ECCLES. As I understand it, your proposal is that all institutions and individuals, with the exception of commercial banks, be permitted to purchase interest-bearing Government notes; that your proposal is merely to finance that portion of the Government's requirements through the Federal Reserve System, without interest, that it is impossible to finance by the sale of interest-bearing securities.

Mr. PATMAN. To the holders of existing accounts.

Mr. ECCLES. Yes.

Mr. PATMAN. That is right.

Mr. ECCLES. And you want to make up merely the differential.

Mr. PATMAN. That is right.

Mr. ECCLES. How do you prevent then the banks from going in the market and bidding for open-market securities—securities that are in the market?

Mr. PATMAN. Well, of course, I would hold them down to the amount of bonds that they had as of a certain definite period and let them exchange all they wanted to. They are getting about 400 or 500 million a year now in interest on bonds which they hold, which is enough to pay their employes expenses.

Mr. ECCLES. What you would do is to freeze the commercial banks—

Mr. PATMAN. Put a ceiling on the amount.

Mr. ECCLES. You would freeze the commercial banks' holdings of commercial securities and would not permit them to purchase any more Government securities.

Mr. PATMAN. In excess of a certain amount.

Mr. ECCLES. Yes.

Mr. PATMAN. They could sell and buy, but they could not go beyond that ceiling.

Mr. ECCLES. Of course your proposal is somewhat of a modification of a former proposal that was designed, as I recall, to finance the entire Government deficit through the issuance of non-interest-bearing certificates through the Federal Reserve System.

Mr. PATMAN. You are referring to bill H. R. 6391, I think, and it says specifically in there, Mr. Eccles, that they shall be allowed to hold that amount of bonds that they held at the end of 1941, December 31. I think you will find that specific provision in there.

Mr. ECCLES. The fundamental objection to your proposal, first, is the inflationary effect through the increase of the excess reserves on the part of the banking system. If that was met by increasing the reserve requirements by the amount of the excess reserves that were created in the banking system through purchase by the Federal Reserve banks of certificates, then, of course, the inflationary objection would be partly overcome; it would not be as inflationary. You get, then, to the point of what is the banking system worth to the community; should it be required to render an increasing amount of service without an increasing return?

As the Government increases its expenditures of funds, through the method you have indicated, you would greatly increase the deposits of the banking structure. That in itself, of course, would be inflationary, because there would be an increasing amount of deposits created as you propose. You would create deposits in exactly the same amount, but in a different manner, and you would get the inflationary effect through a great increase in the deposits—not through the banks loaning the money, but through the Federal Reserve actually creating the money instead of the individual banks creating the money. You would create the money, of course, in exactly the same amount that we, of course, increase the deposits of the banks, and increase the work of the banks in handling the increased volume of deposits.

The banks are up against this situation today: their costs of operation, labor costs, particularly, are increasing. The volume of their work is greatly increasing because of the volume of business activity in general and the volume of check transactions and particularly the work they are doing for the Government in connection with War Savings bonds and other Government securities, upon which they get no return. And along with that, through the curtailment of installment credit, they are rapidly losing the most remunerative loans.

Priorities has curtailed the construction of houses and, therefore, the mortgage loaning business of the F. H. A. which proved to be a very desirable type of business for the banks—they were by far the largest holders of F. H. A. mortgages—those loans will be on the decline and, as a matter of fact, loans in the aggregate are now on the decline and I look to see, over the next year or so, the volume of bank loans and investments, outside of Governments, diminishing. And unless the holdings of Governments increase to some extent, I do not know what the banks are going to do from an earning standpoint, unless they should put much heavier service charges on the public. The rank and file of the public who use the convenience and the services of the banks for keeping their books—because that is about the only books that the average person has—would be charged and would have to be charged more if the bank was unable to increase its loans and investments, its source of revenue, to offset the increased expense due to the increased volume of activity.

So that you get down to the perfectly practical problem here of having to pay in one way or another for the service which the banks render, and they certainly are not overpaid.

Mr. PATMAN. And you think it is easier to pay through interest on Government bonds?

Mr. ECCLES. I think that the whole principle of paying interest on debt is fundamental in the democratic capitalistic system.

Mr. PATMAN. Have you ever given consideration to saving the interest on the Government war debt?

Mr. ECCLES. To saving interest?

Mr. PATMAN. To not paying interest on the Government war debt? Have you ever tried to arrive at some plan that would be safe and logical to save interest on the war debt?

Mr. ECCLES. It does not save any, because the public gets the interest on the war debt.

Mr. PATMAN. But they are not the same people.

Mr. ECCLES. I started to point out to you how nearly the same they were. We seem to think that people are all debtors on the one side, and all creditors on the other. A great many people, in fact possibly the bulk of the people, are both debtors and creditors.

Mr. PATMAN. Well, we would not have any money unless we were in debt, would we?

Mr. ECCLES. That is correct. But the savings of the public in the mutual savings banks, the savings of the public in the savings deposits of the commercial banks, and those savings in those two types of institutions, which will run between 20 and 25 billion dollars, are invested, a very substantial part, in Government bonds and they represent the savings of tens of millions of our people. I think the holdings of Government securities by the insurance companies, as I recall, are around 8 billion or more and they represent something over 60 million policyholders. Government trust funds from its retirement systems of various kinds, Social Security trust funds—which, after all, belong to all the people—are invested in Government securities and there is over $8,000,000,000 of Government securities held there.

I do not recall what the commercial banks own; something like 20 billion of Government securities.

Mr. PATMAN. It is 24 billion, I think, now.

Mr. ECCLES. But their securities are the ones with the lower interest rate, because they own the shorter securities, the notes and the bills, which of course are low-interest-bearing securities.

Then there are the war savings bonds and stamps which now run five, six, or seven billion dollars in that field. And we all know that they are generally owned by the public.

So that when we think of interest on Government debt going to a comparatively few rich people, it seems to me we fool ourselves, because the interest on the Government debt——

Mr. PATMAN. But you are getting away from what I am talking about, Mr. Eccles. You see, I am in accord with you on the selling of bonds and stamps to people who have existing accounts, including individuals, corporations, life insurance companies, or any institution that has an existing account, because that is necessary to keep down inflation. But when this war is over, you know that these people who now hold bonds and stamps are going to be anxious to buy automobiles, refrigerators, and something they need in the form of essential civilian products and, in doing that, they are going to want their money.

Mr. ECCLES. Well, some of them will; some will want some of it. We hope they do.

Mr. PATMAN. Suppose we have $10,000,000,000 worth of holdings of these bonds wanting their money after the war is over, will you have the banks just to create that money like you are talking about and the Government pay interest on it, or will you finance it in some way whereby we save that interest rate?

Mr. ECCLES. You, of course, are assuming that everybody wants to convert into cash.

Mr. PATMAN. No; you are absolutely mistaken. I do not say that; I say a lot of people will, and I say assume, for the purpose of discussion, that $10,000,000,000 worth of them want their money, where are you going to get that money—have the banks create it and have the people forever pay interest on it?

Mr. ECCLES. No. As long as we maintain the national income at a high level and maintain full employment, there will be a terrific lot of savings, and people who want to sell their securities, or to convert them, will likely find a market for them in people who are still saving and who want to buy them. The insurance companies will still have a very large income currently to invest; the mutual savings will likely have a large income currently to invest.

So that I am not at all sure when the war is over, and I hope not, that the Government will have to be issuing a lot of further securities expanding the debt as they are at the present time; that the problem of employment would be met by the backlog of purchasing power that will be created in the field of housing and consumers' durable goods, and that the corporations and many individuals and institutions will still have funds to invest and likely will be able to provide a market for those who want to sell.

Mr. PATMAN. What do you expect the interest rate to be after the war?

Mr. ECCLES. I think the interest rate is largely a controlled factor; that is, the interest rate is pretty largely what the Federal Reserve and the Government make it.

Mr. PATMAN. Well, under existing policies supported by law, the Federal Reserve Board can really fix the interest rate, can it not?

Mr. ECCLES. No; we cannot fix it——

Mr. PATMAN. What I mean is you can control it.

Mr. ECCLES. The Federal Reserve can influence it within rather reasonable limits.

Miss SUMNER. Governor Eccles, I hope you include in your remarks relative to the need on the part of some citizens for Government bonds the fact that there are State laws which make it necessary and mandatory for trust estates and estates held by administrators and executors to invest in Government bonds and, in many cases, Government bonds are the only legal investment for those funds.

Mr. KUNKEL. I want to ask Mr. Eccles if he will insert the letter he wrote you (Mr. Patman) in the testimony.

Mr. PATMAN. Let him put it in at the end of his testimony.

Mr. KUNKEL. Yes.

Mr. PATMAN. Also the letter I wrote him and his reply to it.

(The letters requested are as follows:)

[Statement for the press for release in morning newspapers of Tuesday, March 25, 1941]

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, March 21, 1941.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D. C.

DEAR MR. PATMAN: From time to time my attention has been called to your frequent public utterances on the floor of the House and over the radio, culminating in your recent radio address as printed in the Congressional Record of March 17, 1941. You have long charged that the Federal Reserve System is under the domination of the private bankers of the country and more recently you have proposed that the Government finance its entire expenditures through the issue of new money and without the payment of interest. Since these questions are of increasing importance in these times, I feel that your statements should not remain unanswered lest the public be misled into supposing that the issue by the Government of interest-bearing bonds is unnecessary, extravagant, and wasteful, as you contend. Your propositions concern matters in which I have an especial interest and for the purposes of the record I am making this personal reply. While I have no reason to believe that the Board would differ with the substance of this letter, it has not been submitted to the other members and therefore does not necessarily represent their views.

Your plan as described in the Congressional Record is for the Government to finance its expenditures by issuing new money and avoiding the payment of interest. In this fashion you would have the Government meet not only its normal expenditures in excess of receipts but also the enormous defense expenditure now under way and in contemplation and ultimately the entire outstanding Federal debt.

The sovereign power of the Congress to authorize such a program is beyond question. What has to be determined, however, is whether it would be for the good of the country to embark on such a course. To my mind it would be disastrous. Plausible as your proposals may be made to appear, there is no escape from the truth that someone must pay for everything. If the Government could save the billion or more a year without causing any corresponding or greater losses to the country, no one could reasonably be opposed to your proposal. I am convinced, however, that the creation of the huge amount of new money contemplated by your plan could only lead to incalculable losses for the country as a whole.

At the outset I think it necessary to dispose of some of your misconceptions on the subject of the banking system. First of all, the interest received by the commercial banks of the country on their Government bond holdings is not an unconscionable tribute, as one might imply from your discussion. The banking system of the country is an indispensable part of our capitalistic economy. Practically all the people make use of some banking service, either directly or indirectly. How would these people be affected by your proposal? If the revenue from Government bond holdings should be taken from the banks, they would seek some other source of revenue to replace it or reduce their disbursements. Obviously they could not raise their lending rates, since the huge amount of new money involved in your plan would drive interest rates even below their present low levels. The banks would be obliged to reduce still further the rate of interest paid on their savings accounts although the savers of the country are now receiving an excessively low rate of return. Beyond that, the banks would have to increase materially their service charges of various kinds, principally for checking accounts. These efforts to replace the revenue now derived from interest on Government securities would impose a new burden upon the people of the country substantially in the same amount as the interest now received by the banks on their Government bond holdings. There is this important difference, however, that the new burden upon savers and other individuals using banking services would fall most heavily upon the more numerous owners of small accounts whereas the burden of taxes collected by the Federal Government to pay interest on its bonds falls for the most part upon those with ability to pay.

Nor can it be truthfully said that banks make inordinate profits, and that they could operate on a sound basis with less income. During the 10-year period 1930–39 the average rate of net earnings on invested capital by member banks was 2 percent, which is less than a reasonable rate of return. It should be noted that these earnings relate only to banks which survived the great depression. A complete picture would show that during the period 1929–33 inclusive, 9,755 banks failed and their stockholders in nearly every instance lost their entire investment and in many cases paid assesments up to the par value of their stock. During the 5-year period 1935–39 the average rate of return was 6.1 percent, but this better showing was due in large part to the fact that during this period banks were realizing recoveries on losses charged off during the depression and profits on the sale of securities in a steadily rising bond market. Obviously, these are nonrecurring items, without which the earnings for this recent 5-year period would have been substantially lower.

That the banking business is not considered lucrative by the investing public is attested by the fact that during 1940 the average price of common stocks of 19 New York banks was about 55 percent of the corresponding prices in 1926, whereas public utilities stock prices averaged around 80 percent and industrials around 100 percent of the corresponding prices in 1926.

The effect of your proposals upon mutual savings banks, life-insurance companies, educational endowments and other institutional investors who hold Government bonds would be even worse because these institutions would have great difficulty in making up the loss of revenue. They would be compelled to reduce drastically their disbursements. Savings banks would have to reduce still further the rate of interest paid on their accounts, life-insurance companies would have to curtail dividends on outstanding policies and charge higher premiums for future policies, and educational endowments would be forced to decrease their support of schools and colleges.

One of your favorite complaints is that the Federal Reserve banks are owned by private bankers and that the Board of Governors in Washington as well as the Federal Reserve banks are operated in the interest of private bankers. These charges will not stand up under examination. The Board of Governors, the members of which are appointed by the President and confirmed by the Senate, is a public body. As to the Federal Reserve banks, you rest your case upon the slender point that the stock of the Federal Reserve banks is owned by the member banks. Congress specifically provided for this, as well as for the rate of dividend and Congress can change the nature of the stock and the rate of return at will. This so-called stock ownership, however, is more in the nature of an enforced subscription to the capital of the Federal Reserve banks than an ownership in the usual sense. The stock cannot be sold, transferred or hypothecated, nor can it be voted in accordance with the par value of the shares held. Thus the smallest member bank has an equal vote with the largest. Member banks have no right to participate in earnings above the statutory dividend, and upon liquidation any funds remaining after retirement of the stock revert to the Government. You greatly exaggerate the significance of this so-called stock ownership. At the current dividend rate of 6 percent, it involves the payment annually of approximately $8,000,000 to more than 6,000 member banks, and could be done away with altogether without important effects except to put an end to an illusion created by you and others in the minds of some people. At the same time, it is my view that the Federal Reserve System should be unequivocally a public instrumentality but the ownership of the stock of the Federal Reserve banks is not the determining factor.

Coming to the principal issues involved in your proposal to issue a constant stream of new money to finance the Government, the reasons why this would be contrary to the public interest may be summarized as follows: (1) Borrowing by the Government at interest, particularly the borrowing of money actually saved by consumers, rather than issuance of currency, is a necessary safeguard against inflation, particularly at this time, and (2) borrowing by the Government at interest is an essential part of the capitalist economy in which we live.

There are times when the money supply should be increased and times when it should not be. It is one of the tasks of the Federal Reserve System to see that the money supply is adjusted to current requirements of the economic situation. The System has powers to supply almost unlimited increases, but its powers to prevent harmful increases or to bring about needed decreases are now wholly inadequate.

The prevailing situation, which is likely to continue during the new few years, does not call for increases in the available supply of money. The amount of adjusted demand deposits and currency, which together constitute the supply of money owned by the public, already exceeds $42,000,000,000 or more than double the amount that existed in 1933 and some $15,000,000,000 more than was on hand at the peak of the boom period of the twenties. A large part of these deposits represents idle funds being held on demand for future investment. In addition, commercial banks of the country have over $6,000,000,000 of reserve funds in excess of their requirements and available as a basis for a multiple expansion of loans and investments and therefore of deposits. In fact, existing deposits, if utilized at the rate of turn-over that prevailed in the twenties, could support a tremendous boom without creation of an additional dollar of new money.

With prospects for improved business under the stimulus of the defense program, it is probable that individuals and institutional investors will find greater demands for their now idle lendable funds, and that these funds will be put to more active use. In the first place, idle funds will be lent to the Government for its defense expenditures, and this will unavoidably put them into active circulation. Then, as business improves, idle funds will be put to use by large and small business units raising new capital. Even beyond this, as prosperity grows, individuals themselves will put into circulation part of their accumulated cash savings by buying goods and services as one kind and another, the purchase of which they postponed in the past when they accumulated those cash savings. It is possible that this expansion of the use of existing funds may go so far that, added on to the present rate of turn-over of money and goods and services, it may exceed the productive capacity of our economic system. Such a condition is one of monetary inflation, characterized by attempts to buy things that cannot be bought, that is, by the bidding up of prices of goods, of equities, and of other property—in other words by the usual phenomena of general inflation.

One way of helping to avoid this development is for the Government to finance its expenditures by taxation and by borrowing existing funds. It is better that borrowing be done from the current savings of the public and from past savings now held as deposits of individuals, business corporations, insurance companies, and other fiduciary institutions, rather than from the idle reserve funds of the banking system. Borrowing from the latter results in a further increase in the supply of bank deposits. It amounts to financing with new money which would be dangerous if the supply of deposits were already actively in use and with production already nearing capacity levels. Yet your proposal would court this danger by bringing about an even greater increase in bank deposits. In order to carry out the growing defense program it may at some stage become desirable that borrowing be entirely from current savings—which will, however, need to be larger than now—so that for every dollar the Government spends the consuming public will have spent a dollar less. It may also be necessary to absorb a part of the banks' additional lending power by increasing their reserve requirements, as was indicated by the special report which the Federal Reserve System submitted to Congress on December 31, 1940. Your proposal, on the contrary, would increase manyfold the excess reserves of member banks, through the issuance of new money by the Federal Reserve banks for Government expenditures, and would add enormously to the banks' lending power.

Your plan is inconsistent with the nature of our capitalistic democracy. As our economic system works, a large part of the public saves a part of its income which is invested in homes or in plant, equipment, and the like, which supply current goods and services to others. Or they lend to the Government to meet its expenses in excess of tax receipts. Interest is the most common form of compensation that these individuals obtain for the use of their money. These savings are often not invested directly but are entrusted to insurance companies, banks, and other institutions, which do the lending. These institutions receive interest and in turn either pay interest or provide services to savers, as well as meet their operating costs.

Interest on debt—a large part of which is public debt—constitutes income of private individuals, of educational and charitable trusts, of insurance companies, and of banks. A certain part of it pays for the costs of the process of investment. Discontinuance of interest on the public debt, therefore, must be thought of not merely as so much saved the Government or the taxpayer, but also as so much income cut off from savers, trusts, institutions, and individuals that require the safest type of investment.

If there were some virtue in your ideas for Government financing, other countries might be expected to follow them. But the fact is that not even the dictator nations and none of the other powers have abandoned the payment of interest on Government issues. For all of the boasted efficacy of German financial management, the Nazi government has adhered to strict orthodoxy in paying interest rates, considerably higher than those prevailing in the United States, on its obligations and has sought with much success so far to avoid creating new money. Instead, by heavy and widely distributed taxation, the Nazi government has sought to finance its vast expenditures so far as possible out of existing funds and to avoid monetary inflation, possibly because the memory of the demoralization of the mark after the first World War is still so fresh in German memory.

Financing Government by issuing currency would have a double-barreled effect upon the interest income of the public. It would reduce the amount of interest received by savers, and it would increase the amount of money available for investment. As use for these funds was sought, interest rates on all types of debt would decline, until the bare costs of investment could not be met. In such circumstances, funds intended for investment would either remain uninvested or would, out of necessity, be used for the speculative purchase of existing consumption goods, physical property or equities of various kinds. This would intensify the inflation already generated by capacity production for the defense program if financed by new money. Such conditions would completely demoralize our economic system as now constituted. It would mean the end of capitalism and require the substitution of some other system in its place.

Very truly yours,

M. S. Eccles, *Chairman.*

[Copy]

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D. C., March 24, 1941.

HON. MARRINER S. ECCLES,
Chairman, Board of Governors, Federal Reserve System,
Washington, D. C.

DEAR MR. ECCLES: I have received your letter of March 21, 1941, and I expect to reply to it as soon as I have the time to do so. It is my belief that your views should be given to the public, and when I reply to your letter, I expect to insert it in the Congressional Record, along with my reply.

Before replying to it, and in order to get our definitions straight, I would like for you to answer the following questions:

1. Has the Federal Reserve Banking System refused to comply with certain laws which affect governmental institutions, including civil service, because the Board took the position that it is not a governmental institution?

2. Is it not a fact that the Open Market Committee has the greatest power and influence that can be exercised by any group in connection with the Federal Reserve Banking System? (If you disagree about this, please outline the tremendous powers that can be exercised by this committee and state wherein these powers are not as great as the powers possessed by any other committee or group in the System.)

3. Please give the names and addresses of the Open Market Committee and the institutions in which the members of this committee, who are not on the Board of Governors, are connected.

4. Please give the names and addresses of the advisory committee and the names of the companies and institutions the members of this committee are connected with.

5. I have asserted that the Federal Government can issue either interest-bearing bonds or money, or both bonds and money. Is this a correct statement or not?

6. I have also asserted that a Federal Reserve bank obtains money from the Federal Reserve agent for the cost of printing, which is approximately 30 cents per $1,000. If this statement is not true, please indicate wherein it is untrue.

7. I have also asserted that Federal Reserve notes that are paid into circulation by a Federal Reserve bank are not obligations of the Federal Reserve bank, but these notes state on their face: "United States Government promises to pay upon demand —— dollars." Am I correct in the statement that the money issued by the Federal Reserve banks are obligations of the Federal Government and not the Federal Reserve banks and is the same as a Government non-interest-bearing obligation?

8. I have stated that under our present system the Treasury can sell a thousand-dollar bond providing for an annual interest payment to a Texarkana, Tex., bank and that the Dallas Federal Reserve Bank could take the one thousand dollars' worth of Federal Reserve notes and buy these bonds from the Texarkana bank. That the Federal Reserve bank at Dallas could continue to hold the Government bonds until due and collect interest each year when payable from the Government; that this was, in effect, permitting a privately owned institution—the Dallas Federal Reserve Bank—to use the Government's credit free of charge to buy an interest-bearing obligation, which the Government must continue to pay interest on. Do you agree that this illustration is possible under our present system? If not, why not?

9. Do you agree with my statement that the private commercial banks have created by bookkeeping transactions almost $20,000,000,000 for the past few years for the purpose of acquiring United States Government interest-bearing obligations?

If you agree that the banks create this money, do you also agree that the Government could create it directly without having any more money in circulation than if the banks created it?

10. Do you also agree that the Federal Reserve Banking System creates money on the Government's credit without paying the Government anything therefor?

11. Do you agree further that the same security that is behind a United States Government bond is behind a Federal Reserve note, which is a Government non-interest-bearing obligation?

12. Do you believe that the Federal Reserve Banking System should be wholly owned and controlled by the United States Government through its duly appointed representatives?

13. Is it a fact that if a Board in charge of the Federal Reserve System is given the powers, which were recently requested in a special report, that dangerous inflation can be prevented, even though the Government uses its own credit by paying money into circulation instead of using the present system?

14. If in answer to the preceding interrogatory, you state that the powers would be insufficient under the circumstances, what additional powers could be granted by Congress that would absolutely control and prevent dangerous inflation?

15. I have often asserted that by the time the Federal Government pays a long-term bond, it will pay as much in interest as on the principal. Do you agree that this statement is correct? If not, give me your opinion.

16. Do you consider the title to the gold in the United States Government or in the Federal Reserve banks?

17. How much money could be created by the Federal Reserve Banking System under existing laws and regulations if used to the limit upon the gold certificates claimed by the Federal Reserve banks and United States Government bonds held by both the Federal Reserve banks and the member banks?

18. Is it true that the Board of Governors have agreed upon a policy to pursue that will cause an increase in interest rates generally?

19. Is it true or not true that you personally believe interest rates should be much higher?

20. Is it true or not true that you favor the Federal Government taxing the income of State and municipal securities for the purpose of causing an increase in interest rates generally?

21. Please state your answer to the following:

(*a*) All of the stock of the 12 Federal Reserve banks is owned by private commercial banks and not one penny of it is owned by the Government or the people.

(*b*) The Federal Reserve banks pay no taxes whatsoever to the Federal Government and only pay taxes on real estate to the States and political subdivisions in which they are located.

(*c*) Salaries are paid to individuals connected with the Federal Reserve Banking System up to $50,000 a year.

(*d*) Practically all of the income of the Federal Reserve banks is from Government bonds, which were purchased through the free use of the Government's credit.

(*e*) Although the original law required excess profits of the Federal Reserve banks to go into the Federal Treasury, at this time under existing law, the Federal Reserve banks do not pay anything into the Federal Treasury.

22. I would like to precede this question with an explanation. My proposal is for the Government to pay the private commercial banks the $138,000,000 that they have invested in stock in the Federal Reserve Banking System and for the Government to take over the System and operate it in the public interest. If Congress should enact such a law, do you agree that the Federal Reserve banks could accept from the Treasury non-interest-bearing obligations and give the Government credit upon the books of the Federal Reserve banks therefor, permit checks to be drawn upon the account by the Treasury and no more credit or money would be placed in circulation than if Government interest-bearing bonds had been issued and sold to the commercial banks?

23. Do you agree that if the Federal Reserve Banking System is owned by the Government, and expenditures are financed as proposed by me that there will be no more actual money printed than is printed under the present system?

24. Although the members of the Board of Governors are appointed by the President, is it a fact that their salaries are paid by the privately owned banks?

For your information, I am not advocating the issuance of any kind of new money and am not advocating abolishing the charging of private interest, except on United States Government obligations. Further, I am not proposing for the Government to issue money or credit with no expectation of it being paid. I agree that someone must pay for everything, and if the Government issues non-interest-bearing bonds under my proposal, they could be paid back 4 percent a year and the debt entirely liquidated in 25 years, whereas under your system, if 4-percent interest is paid each year for 25 years, the Government will still owe the principal of the debt.

When you have replied to these questions, and I hope you will see your way clear to do so at an early date, I shall be very glad to answer every question raised in your letter of March 21, 1941.

Yours sincerely,

WRIGHT PATMAN.

[Copy]

April 18, 1941.

Hon. Wright Patman,
House of Representatives,
Washington, D. C.

Dear Mr. Patman: Upon my return to Washington a short time ago I found yours of March 24 in which you acknowledged my letter of March 21 and advised that you expect to reply to it as soon as you have the time to do so. Meanwhile, in your letter of March 24 you ask me to furnish answers to a series of 24 questions which you propound.

From a perusal of your questions it is evident that they are not directed to the fundamental issue which I discussed in my letter of March 21; namely, the fallacy of your proposal to have the Government finance its expenditures without paying interest. This issue I considered of sufficient importance to justify my answering your proposal publicly. On the other hand, it would serve no useful purpose to embark upon a correspondence which subjects me to a catechism covering a variety of matters which run the whole gamut of the problems of money, banking, and public finance, but are scarcely relevant to the real issue. Again, many of your questions have the appearance of calling for factual answers, but such answers would not convey the correct meaning. For instance, your question 21 (*a*) asserts that all of the stock of the Federal Reserve banks is owned by private commercial banks and not 1 penny of it is owned by the Government or the people. While this is technically true, a mere statement of it is misleading, since this ownership is not of the character implied by the ordinary meaning of the term, particularly with reference to the matter of control. But, as I pointed out in my letter of March 21, "This so-called stock ownership, however, is more in the nature of an enforced subscription to the capital of the Federal Reserve banks than an ownership in the usual sense. The stock cannot be sold, transferred, or hypothecated, nor can it be voted in accordance with the par value of the shares held. Thus, the smallest member bank has an equal vote with the largest. Member banks have no right to participate in earnings above the statutory dividend, and upon liquidation any funds remaining after retirement of the stock revert to the Government. You greatly exaggerate the significance of this so-called stock ownership."

Again, many of your questions involve matters which are within the purview of the Wagner questionnaire and which cannot be adequately dealt with except in full and open discussion such as will presumably be had before the Senate Banking and Currency Committee. However, should this or any other committee of Congress wish me to discuss a series of questions as far reaching as those contained in your letter I should be glad to respond, as I have frequently done in the past. Such matters do not lend themselves to satisfactory discussion by correspondence.

In your questions 3 and 4 you ask for the names of the members of the Federal Open Market Committee and the Federal Advisory Council. The composition of these two boards is printed monthly in the Federal Reserve Bulletin, and in the April 1941 issue will be found on page 378. For your convenience a copy of this Bulletin is enclosed herewith.

Yours sincerely,

M. S. Eccles, *Chairman.*

Now, Mr. Eccles, in raising money to pay the debt, you know we have to have burdensome taxes. Are you in favor of a sales tax?

Mr. Eccles. I very strongly opposed a sales tax at this stage as being a regressive tax, bearing no relationship whatever to the ability of the taxpayers to pay.

I would favor a sales tax in preference to no tax, however.

I feel that taxes are very essential to reduce purchasing power, but the sales tax is the wrong way to get at it at this time, I believe.

I believe in first things first and I don't think that a sales tax should be enacted until other taxes are enacted.

I would not want to say that a sales tax may not be necessary. I think that if the war goes on long enough and we continue to spend the amounts that are contemplated, we possibly will need on top of all the other taxes we are able to get, some form of—I would like to put it this way—we may need some form of sales tax.

Of course you have now very substantial taxes that are called excise taxes and I favor the excise tax if applied in a nonregressive manner rather than a general sales tax.

Mr. PATMAN. Mr. Eccles, in obtaining this money from existing sources of supply, one of the ways is the way suggested by the gentlewoman from Illinois, Miss Sumner, but there are a lot of dormant accounts in this country. It has been estimated there are $100,000,000 in dormant accounts in banks and in even the banks that are members of the Federal Reserve System.

Don't you think that money should be used to buy Government bonds—I mean accounts that have been neglected for 10, 20, or 30 years?

Mr. ECCLES. I would think that those funds in the banks are being used. I mean the banks don't just earmark their dormant accounts and then set aside that money in the vaults—set aside in its vaults so much currency to meet the account. The funds are intermingled with all other funds and those funds are invested the same as any other funds.

Mr. PATMAN. For instance, there are a great many dormant trusts. There is one in Massachusetts for the relief of superannuated wool carders. The fact is there have been no wool carders in the last 150 years but the money is still accumulating in the banks.

Mr. ECCLES. Well, aren't those funds invested?

Mr. PATMAN. Yes; I presume they are. By the banks?

Mr. ECCLES. Yes.

Mr. PATMAN. Why shouldn't there be some way—why shouldn't the banking system suggest some way of handling these funds and segregating them and investing them in Government securities directly. There is an endowment providing for the ransom of American seamen held by barbary pirates on the North Coast of Africa.

There was another one established for the sufferers of an incurable fever caused by coal gas. There is another trust dated 1683 providing for the relief of seven aged Protestants in the County of Cork, Ireland. For the last 50 or 60 years the trustees have been unable to find seven Protestants of any kind in all the County of Cork.

There is a fund which has been established in St. Louis since 1851 for the assistance of aged and worthy distressed travelers passing through St. Louis to take up new land in the West.

According to the last report the fund had more than $1,000,000 surplus and there are no takers.

It just occurred to me those funds could certainly be utilized in the purchase of bonds and stamps; but as you suggest they are in banks and undoubtedly are being used now through the banking system as a whole.

Mr. ECCLES. Yes. I don't think they are in the form of what we call hoarded currency.

Mr. PATMAN. I read the report of the Federal Reserve Board and the report of the Comptroller of the Currency and I gained the impression that the number of banks is on the decline and the number of branch banks are on the increase. Is that the tendency or not?

Mr. ECCLES. I think there is very little increase in the number of branch banks. I don't recall the figures, but from 1933, I mean after the bank holiday, up to the present time, I would doubt if in the agregate there are any more banking offices now than there were at that time. But the increase, I am sure, is not an important factor, and it may be that there are actually less offices than there were at that time.

Mr. PATMAN. In the bill we passed here a few days ago, creating the Smaller War Plants Corporation, there was an amendment offered by the gentlewoman from Illinois, which was adopted and it is now a part of the law, providing that there should be no limitation on the amount of a loan to any person or corporation by any bank, providing, of course, that the loan is guaranteed by the Government or some agency of the Government.

Have you given consideration to that amendment, Mr. Eccles?

Mr. ECCLES. Are you referring to the technical aspects of it?

Mr. PATMAN. No; I am talking about—suppose a bank had a capital stock of $250,000, could they, under this amendment, negotiate a loan for say $5,000,000 if it is guaranteed by the Government or some agency of the Government?

Mr. ECCLES. It would take the limit off. There is no limit to the amount of Government bonds, for instance, that a bank can buy. Its only limit is its supply of funds.

Mr. PATMAN. You mean there is no limit now?

Mr. ECCLES. That is right.

Mr. PATMAN. This amendment did not cause that—it was already that way?

Mr. ECCLES. No; the difference is—there has been no question about direct obligations of governments. This was simply a case of recognizing the loans which were guaranteed as having the same status as a direct Government obligation.

For instance, what is spoken of as loans made by banks under the Regulation V, which regulation was written by the Federal Reserve Board in carrying out the provisions of an Executive order which provides that the Army, the Navy, and the Maritime Commission can guarantee loans made by banks for war-production purposes, the Reserve bank acting as the agents for the Army, Navy, and Maritime Commission.

A question was raised as to whether or not the bank could loan more than what is spoken of as its "legal limit" on a guaranty of that sort, and as I understand it this amendment was passed for the purpose of permitting banks to take off the restrictions that were imposed on banks as to ordinary loans.

Mr. PATMAN. There are two other points I want to cover and I will be through. One is on the reserve requirements last November being raised. Why did you raise the reserve requirements last year?

Mr. ECCLES. The excess at that time was around $7,000,000,000——

Mr. PATMAN. Was the objective to stiffen or increase interest rates?

Mr. ECCLES. The objective was to increase the short-term rates in part, and to stabilize rates and to try and induce more loans to be made outside of the banks. As long as the banks had the large excess reserves and the interest rates were falling——

Mr. PATMAN. Because there was too much competition with one another?

Mr. ECCLES. No, no, it wasn't that at all. As long as the banks were under pressure to be buying Government securities and large excess reserves put them under pressure to buy, there was a tendency to drive the rates down and the lower the rates would go the less likelihood there was of inducing the public to purchase Government securities.

The trend was in the direction of the banks buying and not the public and we were anxious to divert more of the purchasing to the public and have less in the banks, and it was felt that such a large excess reserve created an unstable money market situation.

Mr. PATMAN. Another point, Mr. Eccles, is that there are 197,000 taxing units in the Federal Government, and State governments, 48 State governments, 3,070 counties, and different school districts and road districts and levy districts and all kinds of political subdivision districts. Now, a number of these districts, and especially school districts, are dependent upon sources of revenue that are going to be greatly decreased because of eliminating the making and the sale of automobiles and restricting so greatly the use of gasoline, upon which there is a heavy tax and which is one of the principal sources of revenue for many of the school districts and school systems throughout the country.

Have you or your group given any consideration to the Government assuming any part of these obligations under the unusual circumstances caused by the war, in the national interest in helping out those school districts, for instance?

Mr. ECCLES. No, no, the Federal Reserve Board has not and I don't know of any other agency of government that has.

Mr. PATMAN. It has not?

Mr. ECCLES. Not that I know of.

Mr. PATMAN. In connection with the receipt and expenditures of the Federal Government, I believe that we will appropriate this year, by the time this Congress is over, about $150,000,000,000; will it not, Mr. Eccles? It has already gone over 100 billion.

Mr. ECCLES. I haven't kept track of the appropriations from day to day and that is what one would have to do to keep up with it.

Mr. PATMAN. I mean authorizations.

Mr. ECCLES. Yes.

Mr. PATMAN. Like the other day we appropriated 8½ billion dollars.

Mr. ECCLES. That is authorizations you are referring to?

Mr. PATMAN. Yes. Anyway they exceed $150,000,000,000?

Mr. ECCLES. Yes.

Mr. PATMAN. I had the amount of receipts added up of our Government from the time it was first organized in 1789 to the present time, and the total receipts to date are only 143-odd billion dollars, so that will be greatly in excess of what the Government has heretofore collected in all the 153 years of its existence. And, regarding the interest rates on Government bonds, the interest collected for the first 120 years of our country's existence, the average amount of interest paid was $20,000,000 a year.

From 1893 to 1917, it only averaged $33,000,000, but since 1917, the interest each year has been $801,000,000.

I bring this up for the purpose of showing that the interest paid on Government obligations had never been a problem up until after the first World War, and it never did become such a great burden until now when it looks like we are facing a $300,000,000,000 debt, and if we pay as much as 2½ percent interest there will be an interest burden of 7½ billion dollars, and if we have to pay that much and if people like yourself insist that we must do it, and you say we must pay interest, why, I don't see how we will ever pay this debt of 7½ billion in interest and then the running expenses of the Government.

It looks to me like it will be just almost unbearable.

Mr. ECCLES. Of course, I don't agree with you that the interest is the problem indicate, neither do I agree that there is any necessity for, any such size of debt. If we ever permit the debt to go to $300,000,000,000, it will be because the Congress has been unwilling to levy the kind of taxes that a war economy calls for.

It seems to me that we confuse ourselves a good deal with reference to what we call the "burden" of debt.

You have made some comparisons with former periods in our history. It seems to me that the economy today has greater wealth-producing power, than, of course, it has ever had before. The thing that is of importance is: what has the economy left over after paying the interest? Does the payment of interest to the Government in any way detract from our ability to produce and distribute wealth, or to produce and distribute goods?

It actually doesn't in any way interfere with the ability of our economy to produce and distribute goods and after all that is the wealth of the country.

Mr. PATMAN. But it will make a big difference to the taxpayers. Suppose you create $1,000,000,000 through the Federal Reserve and pay 2½ percent on that debt for the next 40 years, the debt will be paid, but if you create the money through a commercial bank and pay 2½ percent interest for 40 years, you still owe the debt at the end of those 40 years, so there is a big difference to the taxpayer.

Mr. ECCLES. If all debts were paid, you would have no money.

Mr. PATMAN. That is very true.

Mr. ECCLES. And it is impossible for an economy to save and invest without debt. That is the very basis of your capitalistic system and even in the communistic countries, Russia, for instance, they have recognized the need of debt and savings.

Mr. PATMAN. Not necessarily interest-bearing debt.

Mr. ECCLES. They have interest-bearing debts, however.

Mr. PATMAN. I say not necessarily interest-bearing debt. You can create money without interest-bearing debt.

Mr. ECCLES. The Russian Government sells an interest-bearing bond to its people and they likewise have an insurance system or mutual insurance systems of insurance, Government-owned, of course, that enable people to save through buying this insurance, as people in this country save to buy insurance, and unless you devise some system for completely eliminating savings, it seems to me that you cannot eliminate a system of debt, and as long as you have debt there must be interest on that debt.

Mr. PATMAN. Not necessarily to create money, Mr. Eccles, you don't say that, do you?

Mr. ECCLES. No, no; you can print money. I mean there is no problem at all about the United States Government being able to issue greenbacks to whatever extent it desires.

Mr. PATMAN. Well, the Federal Reserve Bank issues greenbacks every day, doesn't it?

Mr. ECCLES. No, no; the Federal Reserve Bank does not issue greenbacks to pay for the Government deficits at all.

Mr. PATMAN. Let us see if they do. Suppose you buy $1,000,000,000 worth of Government bonds, where do you get the money?

Mr. ECCLES. But it is the purpose for which you issued it.

Mr. PATMAN. I know. I am asking you where you get that one billion dollars? Where did you get it? You create it, don't you?

Mr. ECCLES. We are a bank of issue. That is a central bank. All central banks do that. The central banks of Russia and Germany do that.

Mr. PATMAN. And if that isn't printing press money, I would like to know what it is.

Mr. ECCLES. There has been no scheme devised for creating money in any other way.

Mr. PATMAN. Thank you very kindly, Mr. Eccles.

Mr. FORD. Mr. Eccles, I would like to ask you a question, if you don't mind. When a man goes to work for the Government, the Government pays him a salary, doesn't it, for his services; some plants produce some goods and they sell those goods to the Government, and the Government pays for it, don't they? When people loan money to the Government in lieu of their personal services, they are paid an interest rate for the use of that money, aren't they? What is the difference between that and paying a salary to the man that works for the Government?

Mr. PATMAN. I am going to object to that. I think it is right for the people to pay interest for money, but I object to letting the banks create the money out of nothing and then our people and Government pay interest on that.

Mr. FORD. No matter how much the bank creates there must be assets in the bank to cover that.

Mr. PATMAN. No; they haven't anything to cover it. They will have a capital of $8,000,000 and——

Mr. FORD. All right; that money is redeemable, but they have to have a structure behind it to get the money.

Could you buy $1,000,000,000 worth of bonds, could a bank buy $1,000,000 worth of bonds from the Government on a capitalization of say, one million or two million?

Mr. ECCLES. Well, a private bank certainly wouldn't buy $1,000,000,000 worth of bonds if it didn't have the one billion dollars worth of credit either in the Federal Reserve, correspondent banks, or in currency, or all three. It would have to have the funds with which to pay for those bonds when it bought those bonds.

Mr. FORD. Now, it is true that you buy $1,000,000 worth of Government bonds—when you do that you are simply crediting the United States Government on your books with a deposit of $1,000,000.

Mr. ECCLES. That is correct.

Mr. FORD. But you may have to pay that out tomorrow?

Mr. ECCLES. That is right. And, therefore, when that deposit is paid out you have got to have the funds with which to pay it or you would have to sell the bonds the minute the deposit was transferred in order to get the money to take care of the transfer, so that the individual bank, although it appears to create the money by putting on the asset side the bonds that it purchases and on the liability side, credit to the Government the amount of those bonds, yet the Government withdraws those deposits and that bank never knows whether an amount equal to those deposits is going to come back to it through Government expenditures.

Mr. FORD. What would happen, Mr. Eccles, if the $3,000,000,000 that the President is authorized to issue any time he pleases, what would happen if that were issued?

Mr. ECCLES. Which $3,000,000,000 do you refer to?

Mr. FORD. The one put on the agricultural bill some years ago.

Mr. ECCLES. Oh, that is known as the Thomas amendment.

Mr. FORD. Yes.

Mr. ECCLES. Well, as those funds were spent it would increase the deposits in the banks by three billion—increase the bank's total reserves by $3,000,000,000 and the Government interest-bearing debt would not increase at all.

Mr. FORD. Then you would probably be called upon to raise the reserve requirements in order to take care of that pressure, wouldn't you?

Mr. ECCLES. That is right, and the banks would have three billion more of deposits to look after and handle, but wouldn't have $3,000,000,000 worth of income-bearing loans or securities to pay them for the handling of the $3,000,000,000 deposits which were created.

Mr. FORD. If there was no interest on Government bonds, the only way banks could possibly handle them would be by making a charge for that service, isn't that right?

Mr. ECCLES. It would have to get something.

Mr. FORD. A direct charge?

Mr. ECCLES. That is right. The banks would have to get an income from some source to offset the increased work and service involved in handling the business, and the return on Government's is certainly not—doesn't pay any one excessively.

I was interested when John Maynard Keynes, the chief adviser, I suppose he is, to the British Treasury, and director of the Bank of England, was here recently—not recently, but when he was over here last fall, I think it was. I discussed with him the means that the British Government was using in their war financing and where the banks came into the picture.

He pointed out to me the type of financing that Britian was doing in order to sell as many of their securities as possible to the public and then whatever the deficit was or the difference they borrowed from the banks. They happen to have only four or five banks there with a great many branches and they would informally allocate the amount to be taken by each bank. They would say that they need so much money and those banks would just take what was required to meet the difference between the expenditure and what they were able to raise in taxes and in selling the bonds outside, and they were given a rate which was, as Keynes says, "a living rate."

They were given 1⅛ percent for a 90-day or 6-month bill, I am not sure which, but at least they were given 1⅛ percent, which was a rate that they had agreed upon with the banks as being a living rate for short-term paper.

Now, that is about three times as much as we pay for a similar maturity in this country. I just thought you might be interested in that.

Mr. FORD. We pay about three-eighth percent, don't we?

Mr. ECCLES. Three-eighths for 90-day paper. At the present rate the British pay 1⅛. Now, I am not certain whether that was for 90-day or 6-month paper.

"Well," I said to him, "Can't you get a less rate than that?"

"Well," he said, "of course we can, I suppose control or fix any rate that you want to by putting enough reserves into this picture so as to reduce the rate but," he says, "the banking system is performing a very necessary and useful service and we have determined that that is the minimum living rate for them," and he said, "that has just been arbitrarily agreed to as a living rate."

And, they decided that that was the best way to help pay the banks for their services.

Mr. FORD. What does their long-time paper bring?

Mr. ECCLES. Why, I wouldn't be sure. They don't have any. They are not putting out any paper for nearly as long a time as we are. As I recall it theirs is somewhere around two and three quarters for 10-year paper. I would not be certain of that, however. The rates in Britain are running at least a half of one percent more than the rates here.

Mr. FORD. I saw a statement in an article that I read that they were two or three points above the old consul rate.

Mr. ECCLES. Well, the rates average, I would say, on British paper, at least a half of 1 percent more than is being paid here.

The rates the Government is paying today are the lowest rates that have ever been paid; and mind you, that is in spite of the fact that they are not issuing any tax-exempt or partial tax-exempt securities; that the present fully taxable securities yield a lower current rate than their partially tax-exempt securities when they were originally sold.

Mr. FORD. Well, Mr. Eccles, I have been looking into this. Supposing we paid up our bonded indebtedness right now. That would relieve the Treasury of several billion dollars in interest, but in what position would the Government be when it became necessary to secure an income? What would happen? They would have to go out to find private investments to take up that, wouldn't they?

Mr. ECCLES. It is practically impossible today for the income of various forms of institutions, education and philanthropic; religious, as well as the various forms of trust funds to find an outlet for their income for those funds except in governments, and that is likewise true of insurance companies, mutual savings banks, and other institutions—all savers. The allocations and priorities have practically stopped private building of any kind except for war purposes and therefore most of that form of development or expansion is being financed by the Government, so that the Government is borrowing the money with which to finance that industrial construction and so about the only avenue or outlet for savings for capital accumulations of all kinds is through the purchase of governments.

Mr. FORD. As a matter of fact, however, we could finance the war with non-interest-bearing securities, but I am wondering what would happen when peace came. Has anybody figured that out?

Mr. PATMAN. It would be a lot easier than have the seven and a half billion-dollar annual interest burden.

Mr. FORD. I don't know whether it would or not. I am wondering. I am trying to figure it out. I am not criticizing your stand or anybody else's. I am simply asking for information.

Mr. ECCLES. Well, I think the difficulty of controlling inflation is sufficiently great without increasing that difficulty by financing the war through an expansion of currency such as has been suggested. That would only increase, to my way of thinking, greatly increase the problem of inflationary control.

Mr. PATMAN. There are ways of offsetting that, though, aren't there, Mr. Eccles?

Mr. ECCLES. Not to the extent that the funds are once created. You can offset the excess reserve effect of the multiple expansion by increasing reserve requirements by a sufficient amount to offset the increase in deposits so that you wouldn't get the multiple expansion that you otherwise would get, but you would get a huge expansion of deposits and you wouldn't save anything. You would have to pay the banks just as much in some other way. You would save nothing and you would be undertaking a completely new and untried procedure. It wouldn't save the economy as a whole a thing.

Mr. MONRONEY. Isn't the fundamental principle that $1,000,000,000 worth of Government bonds are worth $1,000,000,000 is because they have a productive working capacity, a capacity to produce interest on that $1,000,000,000? If they were dropped into the currency system without interest, they would become deadwood and merely represent a medium of exchange, but with interest-bearing power, they have a productive capacity which makes them worth the par value for which they are issued.

Mr. ECCLES. Well, of course, when they are issued for war purposes that is not true, because $1,000,000,000 of public debt when the proceeds are spent for bombers or tanks and ships that are sunk or shot down, they don't have any value. Their value disappears. As a matter of fact, there is no productive value even if they survive.

Mr. MONRONEY. What I mean is the bonds themselves have a productive value because of the fact that they work and make interest for the security holders.

Mr. ECCLES. Well, of course, the interest that is paid on the governments must be collected from the people, from the taxpayers as a whole, just as the interest when it is paid goes to the taxpayers as a whole. A sort of a bookkeeping entry is really what it amounts to. As long as the debt is financed internally, if we think of ourselves as one great family, and we are all paying the taxes to pay the interest and we are largely all receiving the interest when it is paid—maybe not directly but indirectly through our insurance, through our savings banks, through our educational institutions, through our hospitals, through innumerable ways, we are getting the interest that is paid.

Mr. MONRONEY. In answer to one of Mr. Patman's questions, you observed in the absence of an effective tax bill to finance the war, and also in the failure of the Government to make bonds attractive enough to draw private money, that the only other alternative was to put these bonds in the banks. From that would you preclude any consideration of any compulsory savings plan?

Mr. ECCLES. The Treasury has adopted a program of voluntary savings that the President in his seven-point program indicated was going to be tried out—the voluntary savings program. That plan is under way and I would prefer not to discuss the pros and cons of a voluntary savings plan and enforced savings plan when the voluntary savings plan has been decided upon at least for the present.

Mr. ROLPH. Mr. Eccles, what is the advantage of a bank being represented on the Open Market Committee? For instance, I have read of the situation in Boston. I notice that certain of the banks have two representatives. For instance, Cleveland and Chicago have one representative while another has three. What is the advantage of being on this open Market Committee?

Mr. ECCLES. Advantage to whom?

Mr. ROLPH. To the Federal Reserve bank itself and the branch banks. For instance, why is Boston so anxious to have a representative?

Mr. ECCLES. Well, they have felt that as long as the statute provides that the Federal Reserve bank should have five representatives on the Open Market Committee, and they were grouped with New York, that is was somewhat of a reflection upon them if every other bank took its turn in being represented except Boston.

Mr. ROLPH. Is that the way it works out?

Mr. ECCLES. Yes. They always rotate. For instance, in the west there are three banks in the western group—San Francisco, Minneapolis, and Kansas City.

Mr. ROLPH. And they take turns, is that right?

Mr. ECCLES. Yes, they rotate each year. The statute provides that there shall be an election once a year and the Open Market Committee shall organize and elect a chairman and vice chairman and secretary and so forth, Boston has been the only bank that has never been represented on the Committee and it has been felt that the importance of New York was such that they should be on the Committee and Boston has continued to waive what was, they felt, their proper rights.

Mr. ROLPH. Then there is really no particular advantage to the bank of having a representative on the committee at any one time, is there, outside of New York itself? For instance, what advantage does Boston get by having an opportunity to get on the Committee?

Mr. ECCLES. No bank is supposed to get any advantage. The Open Market Committee is not designed to give any member any advantage. The purpose of the Open Market Committee is to render a public service in exercising its control over the money market in the public interest entirely.

I am sure that Boston or no other Federal Reserve bank wants or expects representation on the Committee for any other purpose.

Mr. ROLPH. I was just curious to find out about that.

Mr. SMITH. Mr. Chairman, may I ask a few questions?

The CHAIRMAN. Mr. Smith.

Mr. SMITH. Mr. Eccles, you propose to lower the reserve requirements, as I understand, under this bill of the central reserve city banks only, is that correct?

Mr. ECCLES. This bill gives to the Federal Reserve Board the power to change the reserve requirements.

Mr. SMITH. In those particular banks?

Mr. ECCLES. No; to change the reserve requirements of the central reserve city banks without being required to change the reserve requirements of the reserve city banks, which is the present requirement of the statute.

Mr. SMITH. Now, what percent of the total deposits in the commercial banks would be involved in the operation of that particular provision?

Mr. ECCLES. This does not affect in any way the commercial deposits of these banks.

Mr. SMITH. Well, you alter the reserve requirements of the central reserve city banks. I don't quite understand that would not involve at all the deposits.

Mr. ECCLES. What you want to know is what are the total deposits of the central reserve city banks?

Mr. SMITH. That is right.

Mr. ECCLES. In relation to the total deposits of the Reserve System?

Mr. SMITH. That is right.

Mr. ECCLES. I couldn't tell you.

Mr. SMITH. Is it a substantial amount?

Mr. ECCLES. About 35 percent.

Mr. SMITH. Maybe I misunderstood you then the other day when you spoke about the New York banks.

Mr. ECCLES. I said the resources, the assets of the New York Federal Reserve Bank, represented about 40 percent.

Mr. SMITH. Federal Reserve?

Mr. ECCLES. Of the resources of the Federal Reserve System.

Mr. SMITH. You state at the present time the average reserve requirement is about 20 percent, is that right?

Mr. ECCLES. That is right on demand deposits.

Mr. SMITH. Have you any idea, what the average would be under this bill? You must have in mind some figure at which you expect to fix reserve requirements, do you not?

Mr. ECCLES. If we reduced the reserve requirements in the central reserve cities to the present reserve requirements of the reserve cities, which this bill would permit us to do, it would increase the excess reserve by about one billion and a quarter. The reserve requirements of the central reserve cities are 6 percent on demand deposits, 6 percent on time deposits.

The reserve requirements of the reserve cities are 20 percent and the time deposit reserve requirement is the same for all banks, so that if the reserve requirements of the central reserve cities was reduced to the 20 percent, I mean a reduction of the reserve requirements from 26 percent to 20 percent, this would release about one billion and a quarter of reserves from required reserves to excess reserves.

Does that answer your question?

Mr. SMITH. Yes; that answers it. Now, the expansion of deposits—the possible expansion of deposit liabilities at the present time is about five times the reserve, is that correct?

Mr. ECCLES. That is right. That is the maximum possible expansion.

Mr. SMITH. And so the lowering of the reserve requirements in the particular banks referred to would increase to a certain amount the possible expansion?

Mr. ECCLES. That is right.

Mr. SMITH. The expansion possibilities of deposits?

Mr. ECCLES. That is right.

Mr. SMITH. You spoke, Mr. Eccles, about the Government devising securities that are attractive to the public, or you made a statement something to that effect. By that you mean issuing Government securities at a higher interest rate, do you not?

Mr. ECCLES. No, no. I would feel that to issue securities at a higher interest rate would be a mistake. It would immediately have the effect of outstanding securities dropping in price. It would shake the confidence of the public in Government securities. It would cause the public to wonder how far Government securities were going to drop and how high a rate the Government might pay.

I feel that the rate structure must be stabilized at around the present levels—that the present pattern of rates must be maintained.

Mr. SMITH. Just what did you mean then—I don't quite understand what you meant by that statement.

Mr. ECCLES. Well, for instance, your Defense Savings bonds are an attractive security. They have features that make them attractive. The yield on Defense Savings bonds, series E, have been designed to meet the requirements of the smaller investor, of the investor that has up to $3,750 a year to put into those securities. That is just typical.

Now, I wouldn't want to get into a discussion of my views as to other changes that might be made in other types of securities that might be designed to attract other types and forms of funds, but I can say that I did not have in mind the question of increasing interest rates.

Mr. SMITH. Mr. Eccles, as to the question of issuing interest-bearing Government securities as is being done at the present time to the banks, and on the other hand issuing non-interest-bearing securities directly to the Federal Reserve banks: The question has been raised here as to whether there is any difference between the two ways of financing. Isn't it a fact that the private bankers themselves, throughout the country, the whole banking fraternity, individually and collectively, are urging as much as possible the sale or disposition by the Government of its securities to private investors?

Mr. ECCLES. That is correct.

Mr. SMITH. Now, suppose instead of the Treasury issuing its securities as it does at the present time, it would issue non-interest-bearing obligations directly to the Federal Reserve banks, is it not a fact that we would be taking away one of the most powerful and effective influences for private financing that there is in the country?

Mr. ECCLES. I think so.

Mr. SMITH. So that there is a vast difference between the two systems or methods, or whatever you may wish to call them, of financing. You agree with that?

Mr. ECCLES. Yes, I agree.

Mr. SMITH. In other words, the psychology of financing these securities through the private banks, as is being done at the present time, tends toward sounder banking, sounder financing, and tends especially toward private control and private investment, whereas the financing as has been proposed, of Government interest-exempt securities directly to the Federal Reserve Bank, leads in the direction of irregular and unsound financing and toward political control of financing, is that not correct?

Mr. ECCLES. Well, I am not concerned about what we call "political control of financing," if you mean by that Government control, because that is what we have and I believed we should have Government control of financing. I think the Constitution has recognized that that is a power of the State and a power that the State should exercise, so I believe in public control of finances, but I believe the public control of finance should be exercised so as to preserve the debtor-creditor system and to maintain as far as it can possibly be done methods of financial stability in the economy.

Mr. SMITH. Let me put it this way then, Mr. Eccles. We are already near to fiat money, pure fiat money, and we would be nearer to pure fiat money if we issued these obligations interest free directly to the Federal Reserve banks than we are by financing under the present method. It is but a small step from issuing these securities to the Federal Reserve banks, interest free, to printing money outright.

Mr. ECCLES. Well, there is no really fundamental difference at all.

Mr. SMITH. Yes; there is still a fundamental difference there.

Mr. ECCLES. What is it?

Mr. SMITH. Well, after all your bond is a tax warrant—Of course, you may say the other is a tax warrant and if you do, why, to be sure, there is no fundamental difference.

Mr. ECCLES. If the Federal Reserve banks are required to purchase such non-interest-bearing certificates as the Treasury may require them to purchase, if, as and when it has a deficit to finance, then there is no difference between that and the Treasury issuing directly its currency and depositing the currency in the Federal Reserve bank to its credit—not a particle of difference.

Now, true if the certificates they deposit with the Federal Reserve bank had a definite maturity date and they must be paid at a certain maturity date, whereas if the currency was put out and there was no retirement of it called for, there would be that difference.

Mr. SMITH. That is right. Now, Mr. Eccles, there is one more fundamental consideration I believe we should recognize in connection with the kind of financing that the Government undertakes to raise its funds to carry on the war.

We suppose that there is still in the banking fraternity, individually and collectively, a conscientiousness of reserves. That was the fundamental principle which underlay the enactment of the Federal Reserve System. Is that not true as a matter of fact?

Mr. ECCLES. That is right.

Mr. SMITH. All right, when we think of reserves we think of gold, as the law provides that reserves shall consist of gold, or gold certificates, though "lawful money" may also be used as reserves against Federal Reserve deposits. Nevertheless we think, or hope, the banking fraternity is still thinking in terms of gold reserves, however enigmatic and illusory this thinking may be.

Now, I hope and I believe that private bankers throughout the country when they consider the advisability of financing these bonds by selling them directly to the public instead of putting them in the banks, have in mind the fact that reserve requirements still exist; and isn't it true that they feel the need of private financing because of that—the danger in other words, of excessive inflationary deposits in the banking system which means ultimately a lack of true gold reserves, isn't that true?

Mr. ECCLES. Well, it is difficult for me to say what the bankers might think of the thing. I think that some of them don't think of it at all and others may think of it as you indicate. I think, generally speaking, however, that the bankers are not concerned about the banks being required to buy so many Government securities that the gold reserve requirements will be jeopardized.

The gold reserve requirements are so small as compared with our supply of gold that the amount of bonds that the private banks could finance, thus increasing, of course, the amount of their required reserves with Federal Reserve, is so great that it is almost fantastic, so I think that the banks are merely concerned about the rapid growth of deposits as a result of their creating deposits through the purchase of government securities.

I think that it is true of some of them. As I say, I think a great many of them don't think very much about it, but I do think that the more thoughtful banker is concerned about the inflationary effect brought about through a rapid expansion of bank deposits through the purchase of government securities by the banking system.

Mr. SMITH. But you would say, Mr. Eccles, that it is the responsibility of the Federal Reserve banks and especially the Federal Reserve Board, to give consideration, due consideration, to that particular question.

Mr. ECCLES. That is right. I think that the Federal Reserve, the Open Market Committee, and the Board have some responsibility to exercise and use their influence to whatever extent they can, to avoid unnecessary inflationary development of the money system. We do have the responsibility of seeing to it that the war is financed and I think that the Government security market should be maintained upon a reasonably stable basis.

Along with that we have the duty, I think, to exercise our influence so far as possible, both in connection with our advice to the Treasury as well as with reference to public statements that we may make, that financing should be done so far as possible outside of the banks and whatever we can do to bring that about by advice or action, I think we ought to do.

Mr. SMITH. Well, the reason, Mr. Eccles, that I raised this question is because of deposit liability expansion possibilities. I have an estimate here from figures received from the Federal Reserve Board just yesterday, that present reserves would permit an expansion of deposits of about $187,000,000,000 and that is aside from any expansion of deposits that might result from silver——

Mr. ECCLES. You are basing that on the gold reserve?

Mr. SMITH. Alone.

Mr. ECCLES. On the present gold reserve?

Mr. SMITH. That is right. Now, the point is, we are talking about spending in this war an amount equal to the total value of our national wealth. I have heard figures up to $300,000,000,000. I don't know what it is going to cost. But certainly when we get up into figures that high or even 150 billion or 200 billion, the question of gold reserve becomes an exceedingly important matter, does it not?

Mr. ECCLES. I don't think so.

Mr. SMITH. Well, doesn't this ultimately hinge on the Gold Reserve Act of 1934, which specifically provides that all forms of currency shall be maintained at a parity with gold?

Mr. ECCLES. Congress can change the act as they did in 1934—the question of what the gold reserve is. That is an arbitrary matter left up to Congress. I mean there is nothing sacred about the present reserve requirements and statutory provisions. They have been changed before and they can be changed again.

Mr. SMITH. Then you think we can change the amount of reserves at will without affecting the value of securities?

Mr. ECCLES. Yes. I think the gold reserve has no relationship to the value of the securities. We could have a very great inflation and still maintain the present gold reserve and likewise have a very great deflation. We saw that when gold was selling at $20.67 an ounce, that the gold would buy very much less in goods, for instance, than in the bottom of the depression when gold was worth $35 an ounce, when it would buy almost twice as much in goods. So here is a situation where the price of gold went up and the price of goods went down.

There was a feeling that by increasing the price of gold, you recall, that the increase of the price of gold would be immediately reflected in increasing the price of goods. Well, of course, that we all know didn't work, so I say that the question of the gold reserve doesn't have any relationship to it.

Mr. SMITH. Stability of value——

Mr. ECCLES. No.

Mr. SMITH. Of the currency?

Mr. ECCLES. No.

Mr. SMITH. Either bank currency or circulating currency?

Mr. ECCLES. I don't think so.

Mr. SMITH. Mr. Eccles, what then is the fundamental principle of the Federal Reserve Banking Act?

Mr. ECCLES. Well, it isn't that.

Mr. SMITH. You would go on record—I don't believe you want to do that, go on record as saying the amount of gold reserve has no relation to the stability of the value of circulating currency or bank currency——I don't believe you want to do that.

Mr. ECCLES. That is right, yes, I do. I don't want to retract anything. I am perfectly willing to let that stand.

I have said that inflation is brought about by an increase in the means of payment in excess of the supply of goods—an increase in the means of payment in the hands of those that want to spend the money in excess of the supply of goods, and that if Congress appropriates the money, the Federal Reserve can't be expected to refuse to supply or do what is necessary to supply the funds that the Congress appropriates, and I am sure that the gold reserve would not be permitted to be a deterrent any more than the Reserve Act was permitted to be a deterrent at the time the Glass-Steagall bill was enacted in 1932 amending the Reserve Act so that the Reserve System could meet a situation that had been brought about by the loss of gold, the hoarding of gold and by the absence of commercial paper.

As you recall the original Federal Reserve Act provided a certain percentage of deposits and currency must be secured with gold and with eligible paper and when there wasn't the gold and the eligible paper to meet the requirements, why, Congress immediately changed the law so that the requirements could be met, and I say that the Congress would do that again if the emergency called for it, and, therefore, the gold reserve that you refer to isn't in itself the factor that is going to make the currency of the country stable in its purchasing power or in its value.

Mr. SMITH. Now, Mr. Eccles, I wish to be understood on one point that you brought up that the banks must find some means of financing the requirements of the Government. I agree with you in that completely. The point I am trying to get at is that we should devise—it is up to Congress to provide that means of financing which involves the least amount of danger and which promises the greatest amount of security to our people and to our Government.

We were discussing the two different ways of financing these securities, and I agree with you and I think that the country in general agrees, that these securities should be financed by selling them directly to the public, exchanging them for actual savings, money actually earned instead of depositing them in the banks.

Mr. ECCLES. That is right.

Mr. SMITH. And the point that I wish to bring up here is that after all there is a relationship, of course, you deny it, between the stability of value and the amount of gold reserves.

Mr. ECCLES. Stability of the value of goods, you mean, and services.

Mr. SMITH. Value of currency, what you call—what is commonly called purchasing power of currency, either in the form of bank currency or in the form of circulating currency.

Mr. ECCLES. I do deny that the amount of the gold reserve, the gold requirements have anything to do with the price level which means it has nothing to do with the value of the currency.

Mr. SMITH. Aren't you in effect saying there is no relation whatever of the gold in this country to our currency?

Mr. ECCLES. That is right.

Mr. SMITH. There is no relation whatever?

Mr. ECCLES. That is right.

Mr. SMITH. You then take the attitude we are completely off the gold standard?

Mr. ECCLES. Yes; completely.

Mr. SMITH. And that the clause in the Gold Reserve Act of 1934 which, if the committee will indulge me for just a moment, I would like to read because I would like to have it in the record.

I am trying to find the clause relating to the maintenance of the value of all forms of currency to the value of gold and I just don't happen to see it at the present time, but I will ask, Mr. Chairman, for permission to insert it in the record following this hearing.

The CHAIRMAN. That is all right, it is so ordered.

(The matter referred to by Mr. Smith is as follows:)

Section 6 of the Gold Reserve Act of 1934 reads in part as follows:

"Except to the extent permitted in regulations which may be issued hereunder by the Secretary of the Treasury with the approval of the President, no currency of the United States shall be redeemed in gold: *Provided, however*, That gold certificates owned by the Federal Reserve banks shall be redeemed at such times and in such amounts as, in the judgment of the Secretary of the Treasury, are necessary to maintain the equal purchasing power of every kind of currency of the United States."

In section 9 is to be observed another reference pertinent to the question of the relation between gold and circulating currencies. The same reads in part as follows:

"That the Secretary of the Treasury may sell the gold which is required to be maintained as a reserve or as security for currency issued by the United States, only to the extent necessary to maintain such currency at a parity with the gold dollar."

Certainly the language in each one of these provisions should leave no doubt that the law intended that gold should control and regulate all prices, assuming, of course, that gold certificates are representative of gold and nothing else.

It is true there is language in section 8 of the act here referred to which throws some doubt upon this interpretation. This provision grants to the Secretary of the Treasury, with the approval of the President, "authority to purchase gold in any amounts, at home or abroad" and so forth, then is added the following enigmatic language—

"* * * of law relating to the maintenance of parity, * * * to the contrary notwithstanding."

It would appear that this language could be so interpreted as to give the Secretary of the Treasury full power to sever gold completely from all forms of paper currency to suspend it completely as the standard unit of value and measure of exchange values, leaving prices and exchange values to find their levels to the arbitrary will of the supreme political authority.

Mr. SMITH. I am rather astonished at your statement here and I am more or less impelled to press the point somewhat. It makes no difference then, whether we have an ounce of gold as reserve or whether we have 700,000,000 ounces?

Mr. ECCLES. It has made no difference to Russia for 20 years; it has made no difference to Germany for a long while. Most of the countries of Europe have had to give up the idea of the gold reserve. Their currencies have gone into managed currencies. The British have made quite a number of changes with reference to their gold reserve requirements as they lost gold and as the requirements of the war financing increased they made changes to meet the situation.

I don't feel that our gold reserve, our gold stock has had any relation to the purchasing power of our currency.

Mr. SMITH. Did it operate that way in Germany and in Russia?

Mr. ECCLES. I don't believe it had any relationship.

Mr. SMITH. Well, now let us look and see. In Russia at one time the ruble was devalued 75 percent. Did that make a difference in the purchasing power of the rubles remaining in circulation after the devaluation?

Mr. ECCLES. But you devalue a currency in relation to gold without necessarily affecting its purchasing power.

Mr. SMITH. You don't mean to say that did not affect the purchasing power of the ruble?

Mr. ECCLES. I don't know—I am not familiar with the history of the Russian ruble. All I know is that the Russians have mined gold as a commodity to sell to the democracies and get goods that they wanted to get and that they haven't looked upon gold as a necessary item to support their currency.

Mr. SMITH. Mr. Eccles, what do you think they devalued the currency for except to effect——

Mr. ECCLES. The devaluation of a currency merely means you can increase the supply of your currency and you decrease its purchasing power.

Mr. SMITH. That is the point.

Mr. ECCLES. But the gold doesn't have anything to do with that. You take in this country, we have had a tremendous expansion of— we possibly have two or three times the volume of bank deposits in currency that we had in, we will take the time of the last war, and yet our price structure today is not any where near as high as it was at the time of the last war.

At the time of the bank holiday we had outstanding in currency the greatest volume of currency we had ever had outstanding and the lowest, possibly one of the lowest prices that we had had for a good long while.

Mr. SMITH. You mean just before the crash we had that amount of deposits. Deposits afterward dropped considerably, didn't they?

Mr. ECCLES. Yes; because some of the banks weren't opened and the deposits were frozen—they weren't made available after the bank holiday.

Mr. SMITH. That is all, Mr. Chairman.

Mr. FORD. I want to ask one more question.

The CHAIRMAN. Very well.

Mr. FORD. Mr. Eccles, do you think that if the savings bonds or savings stamp bonds we have out now that run for 12 years at 2½ percent, which we are selling at the rate of about $600,000,000 a month, or something like that, if there was a clause put in there saying that the person who held the bond for the full 12 years would get a bonus of one-half or 1 percent, do you think that would stimulate the sale of those bonds?

Mr. ECCLES. I did not quite understand your question.

Mr. FORD. If the present bonds had a clause in them; bonds that are selling at low prices—low-priced bonds—if there was a clause in the bond providing that if they held the bond for the full 12 years they would be given a bonus of one-half of 1 percent, which would mean they would get instead of 2½ percent over the 12-year period they would get a full 3-percent interest; don't you think that would loosen up a lot of money?

Mr. ECCLES. I don't think so. I don't think that the question of whether it is 2.92 or practically 3 percent, which they are getting now, makes any particular difference. I don't think an extra half percent would make any difference.

Mr. FORD. You don't think so?

Mr. ECCLES. No; I don't think so.

Mr. FORD. I was just wondering what your opinion is.

Mr. ECCLES. I don't think so. I think that 3 percent—a 3-percent return, or practically 3 percent compounded as at the present time, is a good return on capital.

Mr. FORD. I am thinking of the G series, which is a straight 2½ percent for 12 years, would be made more attractive if the purchasers were given a one-half of 1 percent bonus for holding that bond for the 12-year period.

Mr. ECCLES. Well, of course, the minute you do that you throw all the rest of your financing out of line. There is no reason why you should give series G 3 percent for 12 years and series F no increase. There would be no point in increasing series G and not increasing everything else proportionately.

Mr. FORD. I am thinking it might bring out a lot of money now that we are not getting.

Mr. ECCLES. Well, I feel that we have to keep the pattern of rates steady. The relationship has been established, and I don't believe right in the face of a rapidly increasing public debt you can begin to shift your pattern of rates that are established without greatly upsetting your market situation.

Mr. FORD. I am glad to have your opinion on that.

Mr. ECCLES. With reference to a question by Dr. Smith, a question that he asked me, maybe I should clear up this point, that theoretically and not practically, theoretically, so long as the statute provides that there shall be 40 percent of gold held in the Reserve system against the deposit liabilities——

Mr. SMITH. Thirty-five percent.

Mr. ECCLES. Thirty-five; and 40 percent held against the currency liability, there is, as I say, a theoretical limitation to the expansion of currency and bank deposits, but that expansion, it seems to me, is within the scope of our present gold reserve. The expansion can be so great that the devaluation that there would be and could be, a very great devaluation in the purchasing power of currency without any change whatever in the dollar value of gold. You could expand your currency and bank deposits, I think, as you indicated, up to 180-some-odd billion dollars. Such an expansion, such an amount could create a tremendous inflation and thus destroy the stability of the purchasing power of money, and that was what I was trying to make clear—that the gold itself for all practical purposes, had little or no value in stabilizing the purchasing power of our currency or our money; that if you got the kind of an inflation that you could get by maintaining the present gold reserve requirements, and that the situation was such that further expansion could not be carried out, and that Congress felt that it was necessary to have a further expansion, they would very readily change, no doubt, the gold reserve requirement just as they met a situation in 1932 by the passage of the Glass-Steagall Act to meet a situation that seemed to be called for at that time.

Mr. SMITH. Now, Mr. Eccles, I agree with you that the gold held in this country is unrelated or only remotely related to prices because it isn't circulating. It can't have the proper and normal relation to prices unless and until it is actually circulating.

There is another question I would like to ask you. You mentioned Russia and Germany as being instances where it has been shown there is no relation between gold and prices, in which, of course, I think you are wholly mistaken. But may I ask you this question: Do you have any historical evidence since the use of paper money, to show where any monetary authority believed there was no relation between gold and paper money, and have you any historical evidence where any legislative body in the world, up until let us say 1917 or 1918, went on that assumption in dealing with the question of gold as money?

Mr. ECCLES. Plenty has been written on the subject. The libraries, I am sure, are full of pamphlets and articles and books on every side of the question.

I haven't had the time to read them. I think they are living in the past and that we have got a new world that we are living in and we haven't any blueprints. I have been so devoted to the present problems that I haven't had a great deal of time to delve into the history of it.

Mr. SMITH. Well, John Law had that idea and they had it during the French Revolution and we had it in the colonies, but doesn't history tell us those ideas were given up?

Mr. ECCLES. Well, as I say, I am not a historical authority.

Mr. WILLIAMS. Mr. Eccles, would you mind me asking you a question with reference to this bill?

Mr. ECCLES. It would be quite refreshing.

Mr. WILLIAMS. Well, I want to ask for my own benefit and for the benefit of the record, what is meant by the expression "central Reserve cities"? What does that mean?

Mr. ECCLES. I couldn't say except the two cities, New York and Chicago, are at the present time classed as central Reserve cities.

The CHAIRMAN. They are fixed that way in the statute, aren't they?

Mr. ECCLES. The Board has the power to change the classification of cities, in other words.

Mr. WILLIAMS. The central Reserve cities under the regulations and rules of the Board are simply New York and Chicago.

Mr. ECCLES. That is right.

Mr. WILLIAMS. Now, what are Reserve cities? Let me ask you if that means simply the cities where the Reserve banks are located?

Mr. ECCLES. No.

Mr. WILLIAMS. What does it mean?

Mr. ECCLES. There are a great many cities where the Reserve banks are not located—I think there are about 108 cities.

We have discussed a good number of times the establishing of a formula by which you could decide which cities should be put in a Reserve classification and in what we term a "country banking" classification, cities which are not in either a Reserve city where a Reserve bank is located, or a branch of Reserve bank. I have felt they should possibly be all classified as "country"—"country bank" classification. However, the bankers in those cities have preferred to remain in the classification of Reserve cities and we haven't gone so far as to arbitrarily change the classifications.

There isn't any good reason why some of the cities which are called Reserve cities should be Reserve cities and other cities just as large and possibly even larger, should be in the class of country bank classification.

Mr. WILLIAMS. Well, what is the fundamental principle by which you determine a Reserve city?

Mr. ECCLES. Why, I have felt there is only one Reserve city and that is New York. That is the one central Reserve city, that is the point at which the surplus funds ultimately flow unless they go into the Reserve bank of the district.

A country bank will carry a balance in a Reserve city but the Reserve city carries its balance in excess of what it may have in the Reserve System in a central Reserve city, so that it may well be—let me put it this way, that New York is the only central Reserve city in fact. New York doesn't carry balances throughout the country. The country carries balances in New York and that is the distinction between a central Reserve city and a Reserve city. The Reserve cities are not likely to carry Reserve balances in country banks. The country banks carry their excesses in the Reserve cities; the Reserve cities in the central Reserve city.

Mr. WILLIAMS. Are all cities where they have banks that carry country balances considered Reserve cities?

Mr. ECCLES. No.

Mr. WILLIAMS. That is what I am trying to get straightened out. What is the dividing line between them?

Mr. ECCLES. We have none. There is nothing in the statute and there is no formula by which we can go. The banks that desired to be Reserve cities and have pretty largely continued as Reserve cities, are now as they were in the beginning.

We have discussed the advisability of reducing the Reserve cities or restricting Reserve cities to those points where there are Reserve banks or branches of Reserve banks.

Mr. WILLIAMS. But you have enlarged that field if you have over 100 of them now.

Mr. ECCLES. No; we have reduced the number. There are less Reserve cities that there was.

Mr. WILLIAMS. You have a great many more Reserve cities than you have Reserve banks and branches?

Mr. ECCLES. Yes; that is right; but there has always been substantially more.

Mr. WILLIAMS. I was wondering if there wasn't some kind of a principle by which you determined what a Reserve city was.

Mr. ECCLES. Governor McKee can probably answer that question for you.

Mr. MCKEE. Prior to the formation of the Federal Reserve System there was a correspondent bank relationship between banks through which banking functions were carried out. Without such a relationship banks could not function.

The National Banking Act provided for the recognition of balances of country banks carried in Reserve cities as part of their reserve required under the law at that time, and that built up these various points throughout the country in excess of where there are regional banks and Federal Reserve branches at that time, but the character of the business in those towns was in part bank deposits and they were recognized as Reserve cities and have continued as such.

As Governor Eccles said the amount has been materially reduced from back in those days and probably could be reviewed again, but that is how that Reserve city got its origin in my opinion.

Now, I am going back to the day when I was in the banking business and prior to the Federal Reserve Act, and I do know that we in Reserve cities got credit for carrying our balances as a national bank in a central Reserve city, and a small country national bank got credit for carrying their reserve with us.

Mr. SMITH. Mr. Chairman, Mr. Williams, I believe the point that you raised can be cleared if you go a little bit further with the National Bank Act in this little booklet put out by the Federal Reserve Board, which is called The History of Reserve Requirements for Banks in the United States. In this book appears the statement:

> The next important change in the National Bank Act came in the act of March 31, 1918, which gave the Comptroller of the Currency the authority to designate additional redemption cities.
>
> In this act for the first time the term "Reserve cities" was used to designate cities where banks might hold part of the reserve of banks located elsewhere.
>
> The act also introduced—

and this is the point, Mr. Williams—

> the act also introduced the term "central Reserve city," which was applied to New York City because it was permitted to hold part of the reserves of all banks, including those located in Reserve cities.

There is your distinction, if that is still being carried out.

Mr. WILLIAMS. The picture in my own mind now is that there are cities containing banks that are carrying reserves that are not considered Reserve cities, just as those that are in the Reserve city classification.

Mr. ECCLES. That is right. As Governor McKee has pointed out, before the time of the Federal Reserve Act country banks or banks in smaller cities carried their reserves with banks in the larger cities, and as the statute recognized those balances carried with those Reserve banks, that is balances carried with banks in what was designated as Reserve cities, were looked upon as legal reserve.

Now, of course, there has been a great shifting since that time. Some cities have become much more important and some less important.

The establishment of the Reserve banks and branches have likewise lessened the importance of the correspondent bank relationship, and we do not recognize a balance carried with any other bank as a part of their legal reserve for any bank that is a member of the Reserve System. All national banks, of course, are members and, of course, those State banks which are members, the only reserves which are recognized as a legal reserve, are the reserves that are carried with the Federal Reserve bank.

Now, there are a great many of the smaller banks, as you know, that are State nonmember banks and they still are permitted to carry their balances with banks in Reserve cities and be counted as their legal reserve requirements by their State laws, so there is a good deal of resistance on the part of banks in Reserve cities to have their cities classified as "country banks" because they have a certain amount of correspondent bank business from the nonmember State banks and they would likely lose that business if their classification was changed to "country banks" from Reserve city banks.

That is why the number of Reserve cities has been held stationary. It is due largely to the way it has grown up.

Mr. WILLIAMS. There is one other thing. The reserves are not as high, either?

Mr. ECCLES. The reserve requirements?

Mr. WILLIAMS. I mean legal requirements.

Mr. ECCLES. That is more of a factor now than it would have been for the past 6 or 7 years. During the past 6 or 7 years they all had such large excess reserves that it wasn't much of a factor. As the excess reserves begin to disappear that will be an inducement. However, a Reserve city should favor from that standpoint, being classified as a country bank city because its reserve requirements would be reduced. That would be in its favor.

Mr. WILLIAMS. It doesn't seem to me there is very much scientific basis for this reserve requirement when based upon whether or not a particular bank is in a Reserve city. In other words, there may be a bank classified as a "country bank" that may be much larger than another bank in a larger city.

Mr. ECCLES. That is correct.

Mr. WILLIAMS. And still the reserve requirements would be much lower.

Mr. ECCLES. That is correct, exactly. It is simply a question of what has been. Of course, the question of reserve requirements gets into the question of all banks of deposit being members. I mean we can get into a very extended discussion of this; and I agree with you that this whole question of reserve requirements is not very scientific and if the subject were not so controversial I certainly would like to see this whole subject of reserve requirements and bank membership and quite a number of other things that don't make very much sense, considered, but I don't believe now is the time to undertake any fundamental overhauling of the banking picture which could be done, I think, with value to the public.

The CHAIRMAN. It is my recollection that the law classified New York and Chicago as central Reserve cities and also made a list of Reserve cities.

I find in the Federal Reserve Act a provision that authorizes the Federal Reserve Board to add to the number of cities classified as Reserve and central cities, and there is a further provision which brings national bank associations under the requirements set forth in section 20 of the act. It is also provided that existing reserve and central reserve cities may be reclassified or terminated—terminate their designation as such.

It would seem that that law established central reserve and reserve cities.

Mr. ECCLES. That is right.

The CHAIRMAN. And the Federal Reserve Act allows and empowers the Board to classify or abolish them.

Mr. ECCLES. That is right. We recognize that we have that power, but have exercised it very little.

The CHAIRMAN. Off the record.

(Discussion off the record.)

The CHAIRMAN. Of course, the committee appreciates your attendance and your able discussion of this bill, Governor Eccles, and we wish to thank you.

Mr. ECCLES. At the hearing last Wednesday there were certain excerpts from the case of *Michelsen* v. *Penney*, and other citations that the chairman said he would accept for this record.

Mr. CHAIRMAN. That is true; and you may hand them to the reporter.

(The documents referred to are as follows:)

EXCERPTS FROM THE CASE OF MICHELSEN ET AL. *v.* PENNEY ET AL.

(D. C. S. D. N. Y., Oct. 6, 1941) 41 Fed. Supp. 603

NOTE.—The opinion in the above-entitled case is very long; contains a voluminous statement of facts regarding a number of claims involved in the case; and discusses at some length the qualifications and responsibilities of directors of national banks. The matter quoted below relates only to that part of the case dealing with the liability of a director for losses upon loans made while reserves are deficient.

The case is being appealed to the circuit court of appeals.

"Action by Hamilton Michelsen and others, individually and as assignees, and constituting depositors of the City National Bank in Miami, Miami, Florida, Depositors' Committee on behalf of themselves and all depositors of the City National Bank in Miami, Miami, Florida, against James Penney, sometimes known and referred to as J. C. Penney, and another to recover for losses allegedly sustained by reason of the named defendant's alleged negligence and failure to perform his duty as a director of the bank. On exceptions to findings and conclusions of a Special Master.

"Exceptions sustained in part and overruled in part" (p. 606).

* * * * * * *

"On reconsideration of the whole case, I am satisfied that what I have already said (on the subjects of 'casual relation' and 'statutory interpretation') makes plain why, on the particular facts involved in Reserve Deficiency Losses Nos. 6 and 7 herein, I do not consider myself bound by *Holman* v. *Cross*, 6 Cir., 1935, 75 F. 2d 909, or by *Allen* v. *Luke*, C. C. D. Mass. 1908, 163 F. 1018, to the extent that they point to a contrary conclusion" (p. 615).

* * * * * * *

"CLAIMS NOS. 6 AND 7

(Losses upon loans made during reserve deficiency)

"Net loss claimed $28,545.65.

"Penalties, $5,178.21.

[15, 16] "As to this claim, my difference with the Master is that, although Penney is not shown to have known personally of the reserve deficiencies, he should, upon the whole case, be held to be chargeable with such notice. Consequently, if by reason of this, liability rests upon him, it should be so declared. So far as the bank suffered losses as a result of loans made during the periods when there were deficiencies at the Federal Reserve Bank, I shall hold Penney to responsibility. The express command of the statute is that during a time of reserve deficiency—'* * * No bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by law is fully restored.' 12 U. S. C. A. § 464.

"This provision of law should be construed to mean precisely what it says. Its purpose is to require a bank that is deficient in reserves to restore the same as quickly as possible. Restoration will be neither expeditious nor certain if a bank be permitted to pay dividends and make interim loans. Furthermore, if the statute can be violated with impunity, and without personal liability to the directors who give assent thereto, enactment of the measure was an idle gesture. Losses resulting from loans made during the time that there was a deficiency in reserves are recoverable. A diligent director would have known of the deficiency and acted accordingly.

"[17] The law does contemplate that a bank's reserve may fall below the minimum that should at all times be on deposit. For such shortages as occur, a regulation of the Federal Reserve System provides its own penalties, and these in this case were paid. Penney should not be compelled to restore them. They were a part of the operating cost of the bank, and, in the absence of more proof than is here, as to which overdrafts were justifiable and which were not, I shall hold for defendant" (p. 628).

In the case of *Holman* v. *Cross* (C. C. A. 6th Circuit, 1935), 75 Fed. (2d) 909, the receiver of the First National Bank of Allegan, Michigan, brought suit against the directors to recover losses on loans on the ground that they were made in violation of various statutes, or negligently or improvidently. Among other things he sought to recover the amount of losses sustained on loans made while the reserves were deficient in violation of the proviso in section 19 of the Federal Reserve Act that "no bank shall at any time make new loans or shall pay any dividends unless and until the total balance required by law is fully restored." In support of this contention he relied upon a provision of section 2 of the Federal Reserve Act to the effect that in cases of noncompliance or violations of the provisions of the Federal Reserve Act "every director who participated in or assented to the same shall be held liable in his personal or individual capacity for all damages which said bank, its shareholders, or any other person shall have sustained *in consequence of such violation.*"

The court held that the losses on the loans made while the reserves were deficient were not "in consequence of" the violation of the Reserve Act and that therefore the directors were not personally liable. After discussing a number of cases holding that, even in the absence of words of limitation, the violation of a statutory duty may support liability only where the loss or injury results approximately from such violations, the court said:

"Finally, in this connection it is clear that the mandate of the statute here involved was intended not to protect member banks against loss, but to protect the Federal Reserve System in maintaining an adequate compulsory reserve to enable reserve banks to furnish an elastic currency and to afford means for rediscounting commercial paper. The injury intended to be prevented by the law alleged to have been violated, is not the injury here complained of. It follows that the court did not err in sustaining the exceptions of the defendant to the findings and conclusions of the master imposing upon them an individual liability for losses which resulted from loans made while the deposit with the Reserve Bank was impaired."

In the case of *Allen* v. *Luke* et al. (U. S. Circuit Court, District of Massachusetts, 1908), 163 Fed. 1018, the stockholders of a national bank brought suit against the directors to recover the amount of unpaid loans made while the bank's reserve was too low in violation of section 5191 of the Revised Statutes. The court refused to hold the directors liable on this ground and said:

"The object of Rev. St. § 5191 is to insure the constant presence of a cash reserve. If this were depleted below the statutory limit, the bank might suffer loss for want of cash on hand, and for such a loss, if one occurred, the defendents might be liable, although the loans made while the reserve was below the limit were paid at maturity. This provision of the statute was not intended to protect the bank against bad loans, and a loss arising from their nonpayment cannot fairly be said to be caused by the directors' violation of law. Moreover, the bill here goes no to allege that the statutory reserve was replenished after the bad loans were made, and before the bank went into the receiver's hands. In this respect the demurers are sustained.

SECTION 5191, REVISED STATUTES

"SEC. 5191. Every national banking association in either of the following cities: Albany, Baltimore, Boston, Cincinnati, Chicago, Cleveland, Detroit, Louisville, Milwaukee, New Orleans, New York, Philadelphia, Pittsburgh, Saint Louis, San Francisco, and Washington shall at all times have on hand, in lawful money of the United States, an amount equal to at least twenty-five per centum of the aggregate amount of its notes in circulation and its deposits; and every other association shall at all times have on hand, in lawful money of the United States, an amount equal to at least fifteen per centum of the aggregate amount of its notes in circulation, and of its deposit. Whenever the lawful money of any association in any of the cities named shall be below the amount of twenty-five per centum of its circulation and deposits, and whenever the lawful money of any other association shall be below fifteen per centum of its circulation and deposits, such association shall not increase its liabilities by making any new loans or discounts otherwise than by discounting or purchasing bills of exchange payable at sight, nor make any dividend of it profits until the required proportion, between the aggregate amount of its outstanding notes of circulation and deposits and its lawful money of the United States, has been restored. And the Comptroller of the Currency may notify any association, whose lawful-money reserve shall be below the amount above required to be kept on hand, to make good such reserve; and if such association shall fail for thirty days thereafter so to make good its reserve of lawful money, the Comptroller may, with the concurrence of the Secretary of the Treasury, appoint a receiver to wind up the business of the association, as provided in section fifty-two hundred and thirty-four."

The CHAIRMAN. The committee will stand adjourned until next Tuesday.

(Whereupon, at 1:15 p. m. the committee adjourned until Tuesday, June 23, 1942.)

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