ANTI-INFLATION PROGRAM AS RECOMMENDED IN THE PRESIDENT'S MESSAGE OF NOVEMBER 17, 1947

TUESDAY, NOVEMBER 25, 1947

Congress of the United States,
Joint Committee on the Ecomonic Report,
Washington, D. C.

The committee met at 10:10 a. m., pursuant to adjournment in room 318, Senate Office Building, Senator Robert A. Taft, chairman, presiding.

Present: Senators Taft (chairman), Flanders, O'Mahoney, Sparkman, and Representatives Rich, Hart, and Huber.

Senators Ecton, Baldwin, Kem, and Representatives Poulson and Horan.

Also present: Charles O. Hardy, staff director; Fred E. Berquist, assistant staff director; and John W. Lehman, clerk.

The Chairman. The committee will come to order.

We have this morning, Mr. Marriner Eccles, the Chairman of the Board of Governors of the Federal Reserve System, who will deal in particular, as I understand it, with the President's first point in the message, to restore consumer-credit controls and to restrain the creation of inflationary bank credit.

You may proceed, Mr. Eccles.

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

Mr. Eccles. Mr. Chairman and members of the committee, I do not, in coming before this committee today, speak for the Federal Reserve bank presidents or the Federal Reserve System, as a whole. I speak for the Federal Reserve Board of which I am the Chairman; this Board, being an independent body and an agent of the Congress, required to report to Congress annually or oftener as the occasion may require.

I did not attempt to negotiate clearance of the statement I have with the Reserve bank presidents. Time did not permit. I did not attempt to negotiate it as an administration statement.

The Chairman. Mr. Eccles, in that connection, may I ask whether the administration is going to present any other remarks on this proposal that we enact legislative action to restrain the creation of inflationary bank credit, or will you be the only one?

Mr. Eccles. I really could not say, Senator Taft, whether Mr. Snyder or others may discuss that question. I am not prepared to say.

If I may then read the statement without interruption, and then discuss it later, I would appreciate it. It is rather a long statement because this subject is considerably involved.

You have requested me to testify, I take it, as to what might be done in the monetary and credit field to deal with inflationary forces, which have already gone so far as to cause very serious maladjustments within the economy. Correction is overdue. The longer it is postponed, the more severe will be the inevitable reaction.

I am sure this committee recognizes that a great many factors and forces contributed to the inflationary problem, and that there is no easy, simple, or single remedy.

We are already in the advanced stages of this disease. It is no longer a question of preventing it, but of moderating so far as possible its ultimate ravages.

At best, monetary and credit policy can have only a supplemental influence in any effective treatment of either inflation or deflation. In considering what can be done so far as monetary and credit action is concerned, it is necessary to make a correct diagnosis of the multiple causes of the situation with which we are now confronted.

What is inflation? It is the condition which exists when effective demand exceeds the over-all supply of goods and services. Potential over-all demand always exceeds supply. What is lacking in deflation is effective demand.

We are witnessing effective demand today when individuals and businesses, together with State and local governments, as well as the Federal Government, generally have money which they are trying to spend, bidding for an insufficient supply of goods and services.

This effective purchasing power is composed of past savings, current income, or future credit. The savings were largely accumulated during the war years in the form of currency, bank deposits, and Government securities.

At the end of 1946, individuals and businesses held about $223,000,000,000 of such liquid savings, or more than three times the prewar total.

Similarly, current national income is at an all-time high level. It is running at a rate of $200,000,000,000 a year, or about two and a half times the total for 1940, the highest year prior to the war.

It is due to a record high agricultural income, high wages of organized labor, and other workers, but not all of them, and to the unprecedented business profits.

This is augmented by a readily available supply of excessively easy credit for consumers' goods of all kinds, for housing, for short- and long-term business loans, for State and municipal expenditures, and for foreign credits and grants. The notable exception is loans to buy listed stocks, which are sharply restricted by the Board's margin requirements.

In the face of these large and expanding demands, production is practically at capacity and further growth will necessarily be slow.

The physical volume of output of manufactured goods and minerals in 1947 has averaged 186 percent of the 1935–39 average. Current output is about one-fifth below the wartime level, largely because of the reduction in weekly working hours.

Agricultural output in physical terms has continued for the past 3 years at record levels of about a third above the maximum of any prewar year.

This volume reflects general favorable weather, and further growth can hardly be expected. Construction of all kinds, including residential building, is close to any previous peacetime peak.

Expansion of building is now being retarded by shortages of essential labor and materials. Railroad transportation is limited by the shortages of railroad cars and other equipment. Employment is at very high levels with acute shortages in many fields and with a minimum of unemployment.

The source of the present inflation is war financing, and the enormous Federal deficits incurred in preparation for and prosecution of global war.

During the 6-year period, June 30, 1940, through June 30, 1946, the Government raised about $398,000,000,000, but only $176,000,000,000, or 44 percent, came from taxes. The remainder of 222 billions, or about 56 percent, was raised by borrowing. And of this total which was borrowed, approximately $90,000,000,000, or 23 percent of total needs, was raised by selling Government securities to the commercial banking system, including those purchased by the Federal Reserve banks.

As the Reserve Board stated in its 1945 annual report to Congress, it is important to bear in mind that borrowing from the banking system, whether by the Government or by others, creates an equivalent addition to the country's money supply.

To the extent that the Government did not finance its war program by taxation, it was obliged to borrow, and to the extent that it did not borrow from nonbank investors, it relied upon the banks, and thus created new supplies of money.

The Federal Reserve, by purchasing Government securities supplied the commercial banks with reserves needed as a basis for the increased money supply.

As a result, the country's money supply, as measured by privately held demand deposits and currency in circulation, increased more than two and one-half times, rising from less than $40,000,000,000 in June of 1940, to $106,000,000,000 at the end of June 1946.

In the same period, time or savings deposits nearly doubled. In addition, the general public, outside of banks, insurance companies, and Government agencies, accumulated or increased holdings of Government securities to $100,000,000,000, or nearly seven times as much as in June of 1940. These Government securities in the hands of the public are the equivalent of money because they are readily convertible into cash.

It should be strongly emphasized that the banking system was the instrument, and not the instigator, of this swollen money supply. The bankers performed a vital service in the financing of the war and, particularly, in the sale and distribution of savings bonds and of other Government securities.

If it were possible to finance a great war entirely by taxation there would, of course, be no increase in the public debt. Or if it were possible to do the financing by a combination of taxation and borrowing outside of the banking system, there would be no increase in the money supply.

In retrospect, we can see that we could have, and probably should have, taxed more and borrowed more from nonbank investors, and less from the banking system.

We are suffering the consequences today of an excessively swollen money supply which neither the bankers individually nor the Government authorities have adequate means at present of controlling.

In order to enable the banks to purchase Government securities essential to the financing of the war, the Federal Reserve System maintained easy money conditions and made Federal Reserve credit and reserves readily available to the banks.

The vast money supply thus created was held in check by an elaborate harness of controls consisting, among other things, of allocations of scarce materials, construction permits, price and wage ceilings, rationing, and the excess-profits tax.

When the harness of controls was prematurely removed and no effective substitute was devised to hold back the flood of effective demand, it was apparent, or at least it should have been apparent, that a sharp rise in prices was inevitable.

As a result, the economy was caught in a dangerous wage-price-profit-credit spiral, acutely intensified by short farm crops abroad, and reduced corn and cotton crops at home.

Critical conditions aboard, in part resulting from our rising prices impose upon us obligations which must be met even though they add to our inflationary difficulties.

It would be blindly and foolishly optimistic to believe that the spiral of inflation can continue through further general wage, price, and profit increases, and further over-all expansion of credit without ultimate serious deflation.

The longer the necessary readjustment is delayed, the longer it will take to reach a stable condition of employment and production.

The most serious maladjustments are evidenced by the increasing numbers of our people whose income do not keep pace with the rising cost of living. They are being priced out of the market for housing and many other things, and in countless instances, their savings and credit have already been exhausted.

The higher prices rise and credit expands, the greater the subsequent liquidation and downward pressure on prices is bound to be.

As the November letter of the National City Bank of New York correctly states:

> Rapidly accumulating debt is both a cause and a consequence of the inflationary pressures, for in a wage-price spiral, business constantly needs more and more money to keep going and this leads to the incurrence of more and more debt by business and more and more spending by the individual. To check this kind of spiralling—which is to the ultimate benefit of no one and to the injury of all—is not simple.

The problem we all face now is what can be done at this late stage, if necessary to curb further inflationary developments. As a practical matter, we cannot now put back the elaborate harness of wartime controls, and it seems that we are left only with the choice of certain curbs or restraints selectively applied at some of the more critical points of danger.

In the absence of a comprehensive scheme of controls we must continue to put our main reliance on fiscal policy, which is by far the most effective way to deal with the demand side of the equation, while we do everything possible to maintain and increase production.

We should have the largest possible budgetary surplus while the inflation danger exists. And this means taking from the public in taxes money that otherwise would continue in the spending stream. It means rigid Government economy. It means deferment of all expenditures, Federal, State, or local, to the greatest extent consistent with public obligations at home and abroad.

Using the budgetary surplus to pay off bank-held public debt as it becomes due will reduce the money supply by an equivalent amount. This is a reversal of the process by which the money supply was expanded.

In an inflationary boom such as we are experiencing, the Government should pay off as much of its debt as possible.

Public debt cannot be reduced during deflation. Budgetary deficits, not surpluses, are an inevitable consequence of serious deflation. Tax reduction would be appropriate after deflation sets in, not during an inflationary period.

If a reduction of taxes at this time would, in fact, call forth more production, then it would be justified. Today, we still have acute scarcities of labor and materials.

Adding to existing buying power, either by tax reduction or by aggregate expansion of credit, can only have the effect of bidding up the prices paid for both labor and materials.

If conditions were reversed and we had idle labor and a surplus of materials and productive facilities coupled with a shortage of capital and insufficient purchasing power, then reduction in taxes, particularly those which would stimulate mass buying power, would be in order.

If I were to outline a program to meet the situation with which we are now faced, I would list the following steps to deal with the causes rather than with the effects of inflationary pressures. They are listed in which I consider their order of importance.

1. Increased productivity both at home and abroad. Production is the ultimate solution for inflation. Nothing could be more effective than increased productivity of labor and longer hours of work by everyone.

In short, if all who are engaged in producing goods and essential services were to work more, and save more, and spend less, the unbalanced relationship between demand and supply would most effectively be corrected and prices would come down.

2. Suspension of future demands for wage increases, especially those of organized labor, where the increases have been greatest, is necessary if the present unbalanced relationship is to be corrected without severe deflation.

Business profits after taxes are more than double what they were in any prewar year, and almost double the profits in any war year, and therefore, business should hold prices down or should reduce them in accordance with what would be reasonable earnings.

3. A fiscal policy to produce the largest possible surplus to be used to pay off bank-held Government debt, and thus reduce the money supply.

This means the greatest possible economy in all Government expenditures. It means more adequate financial support of the tax-collection machinery of the Government to prevent tax evasion. It means no general decrease in tax rates at this time. It should also mean the elimination of the agricultural price support program unless price ceilings are reimposed.

4. Legislation giving the Federal Reserve System such authority as may be necessary to restrict further over-all expansion of bank credit.

The need for this authority would be less if Congress authorized other anti-inflationary measures such as restoration of consumer installment credit restrictions and if stricter appraisals and less liberal credit terms were applied under the Veterans' Administration, the FHA, and the home loan bank programs of housing finance.

5. Continuation and expansion of the Treasury's savings bond campaign, with adequate financial support by Congress. Funds so raised have a twofold effect: It removes these funds from the spending stream, and makes them available to pay off bank-held debt, thus reducing the money supply.

Other actions have been proposed which, however, deal with the effects rather than the causes. Allocations, construction permits, price and wage ceilings, commodity margin requirements, installment credit regulation, export and rent controls, and similar devices are all in the category of curbs rather than cures. Where they can be applied as a practical matter and enforced, they can be useful, but they do not go to the sources of the problem.

I should like to summarize what the Federal Reserve Board believes might be done in the monetary and credit field. In its 1945 and 1946 annual reports to Congress the Federal Reserve Board described the situation in which those with responsibility for monetary policy find themselves as a consequence of the war.

As the Board stated in the 1945 report:

> In common with other nations whose energies were devoted primarily to winning the victory, the United States had no choice, under the exigencies of a global war, except to use monetary powers in furtherance of essential war financing and not as an anti-inflationary weapon. There has been a widespread assumption that, with the coming of peace, such statutory powers as the Reserve System possesses should be exerted in the traditional way against the heavy inflationary forces at present confronting the country. The Board believes that such an assumption does not take sufficiently into account either the inherent limitations of the System's existing statutory powers, under present-day conditions, or the inevitable repercussions on the economy generally and on the Government's financing operations in particular of an exercise of such existing powers to the degree necessary to be an effective anti-inflationary influence.

Of late, the Federal Reserve System has been increasingly criticized for not adequately using its existing statutory powers to restrain bank credit expansion.

It is very important, therefore, that the Congress understand what those powers are and why the Board does not believe they can be used to deal with the credit problem and why we suggested in the 1945 and 1946 reports, and suggest now, that Congress consider providing other authority that may be necessary to cope with the situation.

We did not then, and we do not now, seek power, but we feel that we would be remiss, as an agency of Congress, if we failed to report the situation as we see it, and to propose alternative means of dealing with it inasmuch as we feel that our existing powers are insufficient.

The Reserve System has always had broad powers to influence the supply and cost of bank credit. Through open market operations, that is, buying and selling of Government securities, the System either gives reserves to the banks or absorbs reserves.

Reserves are the foundation on which bank credit is built. If banks have no reserves they cannot lend. But they can obtain reserves when they borrow from the Federal Reserve banks or sell Government securities to the Reserve banks. And the banking system automatically receives reserves through gold acquisitions, and also when the Federal Reserve banks buy Government securities from nonbank investors.

The Reserve System can restrain banks from borrowing by raising the discount rate sufficiently high to make the borrowing unprofitable. It could refuse to buy Government securities and shut off that source of reserves. It has no powers to deal with reserves arising from gold acquisitions.

Why, then, doesn't the System simply make the discount rate prohibitive and at the same time refuse to buy any more Government securities? Let me say that if Congress disagrees with us and feels, as do some bankers and insurance company executives, that we should more fully use existing powers, we would welcome such an expression from the Congress.

In that case, there would be no need to consider any alternative powers. On the other hand, if Congress agrees that our existing powers are not appropriate under present circumstances, full considreration should be given to any proposal that would help to meet the situation.

Senator O'MAHONEY. May I interrupt you?

Mr. ECCLES. If I could get through—I just suggest that I might finish this, Senator O'Mahoney, if I may.

First, let us consider what the effect would be of raising the discount rate by itself. Actually, the effect would be negligible, except for possible psychological reaction, because as long as the System stands ready to buy Government securities in the open market, banks can obtain reserves at will by selling such securities out of their portfolios.

Suppose then that the System refused to buy the securities, and that is the heart of the matter, what would be the consequences? Bear in mind that the total interest-bearing debt of the Government is $256,000,000,000, more than five times what it was before the war.

The public debt at the beginning of 1940 was about one-fifth of the total public and private debt of the country, whereas, at the present time it is nearly two-thirds of the entire public and private indebtedness of the country.

About one-third of the total Government debt is short-term marketable debt, and would need to be refunded into higher-rate securities. This would raise the cost to the Government, and therefore to the taxpayers, of carrying the public debt.

Already the Nation's tax bill for interst cost is approximately $5,000,000,000, or nearly one-seventh of the total Federal budget.

Just how high would interest rates have to rise to deter business and individuals from borrowing from banks? Higher interest rates do not deter the lender. Rising interest rates are like rising prices. At some point they do deter the borrower or the buyer. They do not deter the lender or the seller.

I doubt if anybody knows how high interest rates, especially short-term rates, would have to rise to discourage borrowers. Certainly, the rates would have to be substantially above the present relatively low levels.

Bank customers, particularly business, with seemingly insatiable markets awaiting their products, are hardly to be deterred by one or two points of increase in bank interest rates.

The additional costs to the Government in carrying the public debt would be difficult to estimate, but they would amount to billions a year over a period of time. If that were the only consequence, it might be argued that the extra cost to the Government would be justified because inflationary borrowings would cease.

However, this is only one aspect of the matter. In the process of leaving Government securities to the free play of variable forces in the market the Treasury would be confronted with a continuing puzzle in all of its constantly recurrent refunding operations.

It could not tell from day to day at what price it could sell its securities. It would be entirely at the mercy of uncontrolled factors in the market, if indeed, conditions did not become so confused and chaotic as to demoralize completely any refunding operations.

I recently saw a prediction by a very keen bond market analyst that failure of the Reserve System to support the 2½ percent rate of marketable Government bonds would lead to a wholesale liquidation of all Government bonds, including the nonmarketable E, F, and G bonds.

He declared that it would be the most dramatically inflationary move that could be made at this time, the repercussions of which would be, as he put it, so catastrophic as to make present fears appear as one raindrop in a storm. That is strong language. Nobody can say with certainty that it is too exaggerated.

In any case, I think it is fairly clear that withdrawing support from the Government securities market, and letting interest rates rise on Government securities would not increase the power of the Federal Reserve System to offset increases in bank reserves from gold acquisitions.

Sales of System holdings of Government securities for this purpose would have to compete with private credit demands.

Private borrowers might outbid us for these reserves. There would be no certain level of security prices or interest rates at which we could dispose of enough Government securities to offset gold imports.

On the other hand, we have to recognize what would happen if we follow the present course of policy in order to maintain the public's confidence in Government credit and avoid any unnecessary increase in the interest cost to the Government for carrying the public debt.

Commercial banks currently hold about $70,000,000,000 of Government securities. This sum is about 50 percent of their total deposits.

If they should sell half of these securities and the Federal Reserve System, in providing an ultimate market, should buy them, the banks would acquire an equivalent volume of new reserves.

On the basis of these reserves, the banks could expand credit by about six times, or by more than $200,000,000,000. This is nearly double the present net demand deposits and currencies.

While it is unlikely that the banks would dispose of so large a proportion of their holdings, it nevertheless is a measure of the potential bank credit expansion that can occur if the banks are left with complete freedom to convert their Government security holdings into reserves at will.

This bank credit expansion potential is apart from other sources of bank reserves. Gold is now flowing into our banking system in large quantities from foreign holdings. As a result, deposits are increased and on the asset side banks gain an equal amount of reserves.

Over the next year, the gold inflow is estimated at from 2 to 3 billion dollars. Multiplied by six, this would permit an expansion of bank credit of from 12 to 18 billions.

There are two other important potential sources of increased bank reserves. Nonbank investors, mainly business corporations, hold about $13,000,000,000 of short-term Government securities.

Businesses face increasing needs for working capital under prevailing inflationary conditions. To some extent, these needs will be met by sales of short-term Government securities, which the Federal Reserve System may have to buy.

The second possible source of bank reserves is the 59 billions of marketable, medium, and long-term Government securities held by nonbank investors.

With widening opportunities for the placement of funds in private investment at increasingly attractive yields, there is a small amount of shifting by investors of their holdings of marketable long-term Government securities.

If inflation continues, this shifting will likely increase. Such sales have to be met by Federal Reserve support of the prices of marketable Government bonds so as to protect the 2½ percent rate on long-term issues. The result of these support operations is to increase bank reserves and thus to support further inflation.

Under present and prospective conditions, it is not only desirable but essential in the opinion of the Treasury and of the Reserve System, that the established 2½ percent rate on long-term marketable Government securities be maintained.

The Federal Reserve Board has one other power that it has been criticized by some for not using. That is the power to raise the reserve requirements of the banks in New York and Chicago from 20 to 26 percent of their net demand deposits.

This is a relatively minor matter and does not in any way go to the heart of the problem. Any action taken would have an effect on banking conditions only in two cities in which the credit expansion, as well as deposit growth, has been relatively less than for the rest of the country.

We have given a great deal of study to this admittedly difficult and complex problem. We are convinced that the remedy of letting interest rates on Government debt go up on the theory that this would bring an end to inflationary borrowing is dubious at best, as has been demonstrated in past monetary history, notably in the twenties, when high rates were unsuccessful in restraining speculation in the stock markets, real estate, or otherwise.

As was made clear in the annual report for 1946, we are not opposed in principle to higher interest rates if some desirable ends and the public interest can be served by such a policy.

In fact, in recent months we have cooperated with the Treasury in permitting some moderate, corrective rise from wartime levels of interest rates on short-term Government securities.

This adjustment was made to reduce the wide differential prevailing between short-term and long-term interest rates. Such a large differential was having the effect of encouraging banks to sell short-term securities, which the Federal Reserve bought, and to buy long-term securities in the process, thereby encouraging multiple credit expansion.

The differential in rates was also exerting a strong downward pressure on yields of long-term securities.

We were aware that this decline was artificially induced by investment policies of the banking system known as monetization of the public debt, and resulted in bank credit expansion.

We also recognized the importance of checking the decline in long-term interest rates to protect educational, charitable, and pension funds, as well as insurance institutions, savings banks, and individuals depending upon interest for income.

The action permitting a moderate rise in short-term interest rates coincided, however, with strong demands for long-term funds, which put considerable strain on the market for corporate and municipal securities.

As a consequence, these issues have been made more attractive as investments. They are thus somewhat more competitive with long-term Governments than before.

We have to face this fact of the market place, and be prepared to offset any shifts in investor holdings from Government bonds to other securities.

The undesirable aspect of the situation, from the standpoint of inflationary credit conditions, is that support of Government bonds adds to bank reserves.

These developments indicate that a policy of permitting interest rates on short-term Government securities to rise has gone about as far as can be justified under present circumstances.

We have, therefore, been compelled to seek some better alternative than higher interest rates to restrain further bank credit expansion.

We believe that one is available which will not make the Government and the taxpayer bear the added cost of the restraint, that will impose very little, if any, hardship on the banks, that will, in fact, have a compensating aspect in that the restraint imposed would increase interest rates on private borrowings without additional cost to the Government.

I refer to the second alternative proposed in the 1945 annual report. We recommend for consideration, as the best alternative we have been able to devise, that all commercial banks be required as a temporary measure to hold some percentage of their demand and time deposits, in addition to present reserves, in a special reserve in the form of Treasury bills, certificates and notes, or cash, cash items, interbank balances, or balances with Federal Reserve banks.

Such a requirement would be far less onerous for the banking system than any other effective method that has been suggested in the long period in which this problem has been discussed by bankers, by economists, and public officials.

Manifestly, such a requirement would have to be imposed gradually, if at all, as an offset, for example, to bank reserves created by gold acquisitions, and by the purchase of Government securities from nonbank investors, and also to limit the too-ready availability of reserves, now enabling banks to obtain them at will. A multiple expansion of credit can be built on these reserves at a ratio of fully $6 of lending for every dollar of reserves.

We would propose that the special reserve requirement be limited by law to a maximum of 25 percent on demand, and 10 percent on time deposits.

It should be made applicable to all commercial banks. It would not be effective if applied only to member banks of the Federal Reserve System, and would be an unjustifiable discrimination.

We recognize that this proposal is no panacea, but it would be an important, available restraint, now lacking, to be applied equally to all commercial banks so that the individual banker would be in the same competitive situation he is in today.

Over the next 4 months there is likely to be little need for the suggested special reserve because of the large amount of Treasury surplus funds. taken from the market through taxes, which will be available to retire bank-held public debt.

This would temporarily exert pressure against bank credit expansion.

The proposed special reserve requirement has a number of important advantages over other methods of dealing with the problem of restricting the banks' expansion of credit:

1. The plan would have about the same effect in limiting credit expansion as an increase in primary reserve requirements, which was proposed as the third alternative in the 1945 annual report. It would enable the banks to retain the same volume of earning assets that they now hold, whereas, an increase in basic reserve requirements would make it necessary for them to reduce earning assets, with adverse effects upon the earnings position of banks.

2. The ratio of potential credit expansion on a given increase in reserves would be narrowed to the extent that the special reserve was required. At the maximum requirement proposed, it would be lowered from 6 to 1 to nearly 2½ to 1.

3. It would bring about an increase in interest rates on private debt and would increase earnings of the banks from this source where rates on loans are comparatively low. It would accomplish this purpose, moreover, without increasing the interest cost on the public debt or permitting unstable prices in the Government securities market. The plan, in effect, would divorce the market for private debt from the market for Government securities.

4. The plan would not rely on higher interest rates to restrain private borrowing, but to the extent higher interest rates restrain such borrowing, the proposal would make use of the interest rate mechanism. Hence, the cost of restraining credit would be borne by private borrowers who are incurring additional debt, and not by the Government which is reducing its debt.

5. The main effect of the plan would be to reduce the availability of bank credit. This would be accomplished by putting the restraint on the lenders, that is, the banks. They would be less willing to sell Government securities in order to expand credit because the amount of such liquid assets as they held as secondary reserves could be greatly reduced by the requirement. Such a possibility, even without action being taken by the Reserve authorities, would have a very restraining influence.

6. The plan would restore use of the customary instruments of Reserve influence on bank-credit expansion, namely, discount rates and open-market operations. Support of these instruments by the special reserve requirement would enable the Federal Reserve to make it more difficult and costly for banks to borrow Federal Reserve funds.

7. No alterations in the banking structure, in the authority of the supervisors, in customary methods of bank operations, or in established interbank relationships would be introduced as a result of imposing the requirement.

8. The banks would be left by the plan with sufficient latitude to meet essential needs of the economy for credit, and the public would be assured of a high degree of liquidity and safety for the banking system.

Many bankers argue that this proposed requirement is unnecessary because the banks themselves have a vital interest in the conservative extension of credit, and will prevent excessive credit expansion as a matter of ordinary banking prudence.

The banks, however, are confronted by a situation in which they can readily meet unlimited private credit demands and in which such demands are vigorously sustained by inflation while, at the same time, these demands are contributing to inflation. They are both cause and effect.

The banks are not in a position to refuse legitimate, sound credit demands of individual customers, and current loans, taken separately, which in the light of the customer's satisfactory credit risk do appear to represent legitimate credit needs. But in accommodating these credit demands freely, the banks as a system are expanding bank deposits and adding to the money supply.

From the beginning of 1946 through October of this year, the banking system as a whole has increased its loans and investments—other than Treasury obligations—by an estimated $12,000,000,000. This has added a like amount to the money supply.

This, together with gold acquisitions, is largely responsible for an increase in privately held deposits of $14,000,000,000.

Reconversion of the economy from war to peace required aggressive bank financing of agriculture, commerce, and industry in order to facilitate the earliest possible attainment of peacetime activity on a much higher level than prevailed before the war.

Some of this bank credit expansion for private purposes, therefore, was justified. High levels of peacetime activity have long since been attained, however; yet, bank credit expansion is continuing and in recent months has gained rapid momentum.

None of us likes restraints. I am sympathetic with the bankers who resent seeming to be singled out for a special restraint on their wares, which are loans and investments. To the uninformed, it might appear that the banking system has been or is now to blame for the oversupply of money. This is not the case.

Instinctively and naturally, bankers do not relish restrictions on their activities, any more than labor likes wage controls, or agriculture likes price ceilings.

We realize that the special reserve proposal which we consider the best alternative, after considering all of the circumstances, will be very strongly resisted by those bankers who fear that it points accusingly at them, or that it is more regimentation, more bureaucratic reaching for power, or an encroachment on State rights, or an opening wedge to force nonmember banks into the Reserve System.

All these things have been said to us privately or publicly and we can only say that if a better alternative can be devised, we would welcome it.

The Board recommends that the administration of the special reserve plan be placed in the Federal Open Market Committee, whose members, in addition to the Reserve Board, are five presidents of the

Federal Reserve banks. This should help to remove some of the misgivings of bankers.

The opposition of some very prominent bankers to any new power for the Federal Reserve is expressed in a statement which they have asked me to submit for the record. It is a statement of the Federal Advisory Council, composed of 12 bankers, one from each Federal Reserve district.

Often we agree. In this case, they unitedly oppose the remedy we advocate. They contend that banks are not indulging in inflationary expansion of credit; that, therefore, the problem should be attacked on other fronts, and that no legislation is required on the banking front. They differ with us also in unanimously opposing reinstatement of installment credit regulations.

I am sure that the Council's views reflect the opinion of a great many bankers, who are entirely sincere in the belief that the loans they are extending are safe, deserving risks necessary to sustain full production.

That conviction, honestly held, is unhappily characteristic of boom psychology. In 1920, or in the latter part of that decade, bankers would have made the same replies that they give today if asked whether they thought the loans they were making should not be made. A short time later, they were trying desperately to liquidate some of these loans. The individual banker is judging by standards applying to the individual borrower and risk.

The Reserve Board, the Congress, and all responsible for public policy must necessarily approach the whole problem from a different standpoint.

The question we must ask is whether any further expansion in the aggregate amount of credit is desirable or dangerous. If it, in fact, calls forth more production it would be desirable. If it only permits one borrower to bid against another would-be buyer for scarce goods and thus adds to upward pressures on prices, it is dangerous.

It is our best judgment that over-all expansion of the money supply at this time is inflationary and dangerous.

It is unfortunate, I think, that banking leaders oppose protective measures against inflationary forces arising in the credit field. They seem to forget that in order to assist in war financing, the Government provided the banking system with additional reserves which enabled the banks to buy Government securities; that this created new deposits in the banks; and that banks have had also the benefit of interest received on the government securities they have held and will continue to hold for an indefinite period.

They object even to a temporary limitation on the further use of these funds as a basis for loans to private borrowers, which would in turn create more and more deposits.

The Government has an obligation and a duty to step in at this time of national danger to say to the banks, "We are not proposing to deprive you of benefits you have already derived and will continue to derive from the vast increase in bank deposits resulting from your purchases of Government securities, but we do say that you should be willing to accept a reasonable limitation on using a war-created situation to multiply private loans in peacetime when they serve to intensify inflationary pressures."

To sum up, the proposed special reserve requirement is only a part, though a necessary part of any effective anti-inflationary program.

As I have indicated, action on other fronts, by far the most important of which is fiscal policy, is necessary to the success of that program. And the need for action on the monetary and credit front would be reduced to the extent that needed action is taken on other fronts.

I want to apologize for such a long statement, Mr. Chairman, but I did not feel that otherwise I could cover this situation adequately. I wanted, for the sake of the record, and the Board wanted for the sake of the record to make this rather comprehensive statement. It is one of the most important statements, I think, that we have ever made.

Senator O'MAHONEY. I think it was comprehensive.

The CHAIRMAN. I think it was comprehensive and sets out the arguments on both sides very completely, which presents problems that are not easy to decide on our part.

Mr. Eccles, I wanted to get the amounts of these credits. Have you the figures supporting and showing the statements made toward the end of your statement regarding the increase in bank loans, currency in circulation, deposits, and so forth, by months?

Mr. ECCLES. Yes, we have them.

I would like to put something in the record. I referred in my statement to a statement of the Federal Advisory Council, which was addressed to the Board on November 18, and we submitted to the Council, which meets with us four times a year, this question for their consideration and advice:

> The Board is very much concerned about the rapid expansion of bank credit. The Board, therefore, desires to have the views of the Council as to the further steps that might be taken to correct this serious situation through monetary or fiscal means.

That was the question, and that brought forth this reply from the Council, which they have asked that we put in the record, and we also told them that we would expect the Board to reply specifically to their answer to our question, and therefore, I should like to put into the record the answer of the Council to the Board's question as well as the answer of the Board to the Council's reply, if I may do so.

(The documents are as follows:)

STATEMENT OF FEDERAL ADVISORY COUNCIL, ADDRESSED TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, NOVEMBER 18, 1947

INQUIRY OF BOARD

The Board is very much concerned about the rapid expansion of bank credit. The Board, therefore, desires to have the views of the Council as to the further steps that might be taken to correct this serious situation through monetary or fiscal means.

ANSWER OF COUNCIL

The Council has reviewed the question of the volume of bank credit both in the aggregate and as shown in the banks with which they are familiar.

We do not know what "serious situation" in bank credit the Board has in mind. For the past year the total volume of bank credit (i. e., the available amount of bank money) as measured by adjusted demand deposits has shown only a moderate increase. As bank loans have increased, the banks have decreased their investments.

We find nothing in bank loans themselves to suggest that growth of loans has been an active inflationary factor. It rather appears to have been a reflection of the very high level of business activity and high prices.

To a large extent growth of loans is a direct result of Government policies. For example, an increase of nearly $4,000,000,000 in the real estate loans by insured banks since the end of the war reflects directly the purchase of FHA and GI mortgages in the housing program.

The Reconstruction Finance Corporation is encouraging bank lending by guaranteeing risky loans.

Commercial loans are influenced by high prices and active movement of agricultural and manufactured products for the foreign-aid program.

High wages and high costs of materials have meant that business needed more money to take care of its customers.

There is nothing in the figures or our experience to suggest that there exists any substantial lending for speculation or for unnecessary uses. Loans for carrying securities are much reduced.

In this period the Government, through various agencies, has been making loans that the banks refrained from making because of their speculative nature. The Reserve System itself is asking for more power to guarantee loans on the presumption that bank lending is too cautious.

The causes of our present inflation are not in current banking policies but are found in the great wartime expansion of buying power together with unusual events and public policies since that time. Among recent inflationary causes may be listed the following:

The foreign-aid program.

A cycle of wage increases in excess of increases in either the cost of living or productivity.

A shorter working week.

A short corn crop.

Veterans bonuses and relief payments.

Agricultural price subsidies.

United States Government spending of $36,000,000,000 a year.

Housing subsidies.

In the face of these developments a substantial increase in bank loans was inevitable and the banks have shown restraint. The dangers in the present situation are understood by bankers and there is hardly a bank in the country which has not been warning its customers against overexpansion. The loans being made are mostly for direct production.

The first thing to do is to reconsider Government policies which are inflationary and especially excessive Government spending and subsidies.

We recognize that even though the causes of inflation are largely outside the sphere of monetary policy, the Reserve System has a special responsibility for bank credit and in this situation should take all reasonable care to assure conservative credit policies.

In this special area we suggest that the System and the Treasury already have large powers, without new legislation, to place credit under broad restraints.

One of these powers is the discount rate which is a recognized instrument for serving notice on the public of the need for restraint in the use of credit.

Similarly by open-market operations the System can control the reserves of the member banks and limit their lending power.

The Board also still have the power to raise reserve requirements in central Reserve cities and so tighten money.

The Treasury by the pricing of new issues and the handling of its balances has great influence on the rate and volume of money.

In the past year the System and the Treasury have used these powers effectively.

The money markets and the policies of businessmen are today so sensitive to action of these sorts which the Reserve System and the Treasury take that present powers are ample to place all restraints on credit expansion which the System and the Treasury may consider necessary.

The Council wishes it clearly understood that it shares the apprehension of the Board of Governors with respect to inflation dangers. It does, however, most strenuously object to the singling out of the increase in bank loans as a principal contributing factor; and it has attempted to point out above, the vastly more important elements of inflation—of which bank loans are a barometer.

This is not to say that there have not been unwise bank loans in some cases. After all, banking is a form of human endeavor, operated by human beings. It would be amazing if there were not some errors in judgment. But we submit that, on the record, there is no evidence of bank-credit expansion beyond that which could be expected under all the circumstances. There is every evidence that loans are today doing a wholesale and constructive work in their intended place in the economy.

The Council has studied the increase in consumer credit in relation to the termination of regulation W. While consumer credit has increased substantially, much of this reflects the availability of automobiles and household appliances. There is so far too little experience on which to judge the effect of the termination of regulation W. The American Bankers Association is undertaking with considerable success to insure maintenance by banks of sound lending standards. This effort toward voluntary cooperation seems to the Council the sensible and the democratic method of dealing with this problem, both with respect to the banks and other lenders. The Council is opposed to legislation giving the Board new regulatory powers in this matter.

Suggestions in the President's message to Congress with respect to credit control indicate the possibility that the Federal Reserve Board may present to Congress the proposal in its 1945 annual report for a required bank reserve of short term Government securities. The Council therefore wishes to state its views on this proposal.

The proposal as we understand it is that banks should be required by law to maintain, in addition to cash reserves, reserves of short term Government securities in a percentage relationship to deposits, to be fixed from time to time by the Federal Reserve Board.

The Council is unanimously opposed to this scheme for the following reasons:

1. It is impractical. The operations of banks are so different, reflecting as they do adaptation to the varying needs of their communities and customers, that no percentage of short-term Government security holdings can be applied fairly or practically to all banks. Any percentage high enough to offer any measure of restraint on a substantial number of banks will have disastrous effects on many other banks, compelling them to liquidate sound and necessary loans and thus actually check production. The very banks which have served the business in their communities most aggressively and helpfully would be hardest hit.

2. Such a plan would substitute the edicts of a board in Washington for the judgments of the boards of directors of 15,000 banks throughout the country as to the employment of a substantial part of the funds of their banks. This is a step toward socialization of banking.

3. As indicated earlier, the Federal Reserve System and the Treasury already possess large powers of credit control not now being fully used. Such new powers as those proposed are not necessary.

RELATION OF BANK CREDIT AND INFLATION—REPLY BY BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM TO STATEMENT ISSUED BY FEDERAL ADVISORY COUNCIL

Board of Governors of the Federal Reserve System, November 25, 1947

The Federal Advisory Council, composed of one banker from each of the 12 Federal Reserve districts designated under statutory authority to advise the Board of Governors of the Federal Reserve System, was recently asked by the Board for an expression of the Council's views as to the present credit situation. The Board stated that it "is very much concerned about the rapid expansion of bank credit. The Board, therefore, desires to have the views of the Council as to the further steps that might be taken to correct this serious situation through monetary or fiscal means."

The Council's reply, which has been released for publication by the Board and presented to Congress by the Chairman of the Board, states that the Council finds "nothing in bank loans themselves to suggest that growth of loans has been an active inflationary factor. It rather appears to have been a reflection of the very high level of business activity and high prices." While the Council shares the apprehension of the Board with respect to inflation dangers, it believes that "the causes of inflation are largely outside the sphere of monetary policy." Nevertheless it recognizes that "the Reserve System has a special responsibility for bank credit and in this situation should take all reasonable care to assure conservative credit policies." The Council expresses the view that in this special area present powers are ample, without new legislation, to place all restraints on credit expansion which the System and the Treasury may consider necessary.

Recent credit expansion.—The rapid expansion of bank credit, about which the Board is concerned, is indicated by the growth of bank deposits held by businesses and individuals at all commercial banks in the United States, which increased by $14,000,000,000 from the end of 1945 to the end of October this year. The growth exceeded $3,000,000,000 in the last 4 months and is continuing. This growth was on top of a nearly threefold wartime expansion in deposits and currency which was greatly in excess of needs and has been an important basis of postwar inflationary pressures.

The basis of this continued expansion in bank deposits has been primarily the growth in bank loans, which has been at a more rapid rate than at any time in American banking history, amounting in the aggregate to $10,000,000,000 since the end of 1945. Other factors in the deposit increase have been an addition of nearly $2,000,000,000 to bank holdings of securities other than those of the Federal Government and gold acquisitions amounting to about 3 billions.

These increased loans have been made to businesses, to holders of real estate, and to consumers. Only loans on securities have declined. This decrease is due to liquidation of loans made to purchase Government securities in war loan drives, but loans on other securities have also failed to advance. This is an exceptional situation for a period of inflationary development and is in large part due to the Board's regulation of margin requirements.

It is true, as the Council points out, that banks have reduced their holdings of Government obligations as loans have increased. This decline, however, followed a temporary peak reached during the Victory loan drive and resulted almost wholly from Treasury use of its excessive balances at banks temporarily built up to a high level during the drive. It has not had any effect in reducing private deposits.

Inflationary impact of bank loan expansion.—The Board agrees with the Federal Advisory Council that the basic causes of inflation lie primarily outside of the area of current monetary and banking developments. However, the Board believes that all possible measures and policies should be adopted by Government, business, farmers, and workers to produce more, consume less, and save more, and to avoid cost- and price-raising actions. Furthermore, the Board considers that the most effective means of diminishing the basic causes of inflation is maintenance of the largest possible surplus in the Government's budget. This important means of dealing with the problem is entirely ignored by the Council.

The Board also recognizes that individual banks in making loans are no doubt being guided by the aim of meeting the necessary and constructive needs of borrowers, and that many banks are aware of the dangers in the present situation and are exercising some restraint on borrowers. Expansion in lending has to a large extent been necessary to supply working capital needed by business to maintain or increase production at rising prices. As accumulated cash balances are drawn down funds must be borrowed. Consumers also borrow to supplement incomes and purchasers of homes borrow more than sellers repay because of advancing real estate prices.

In the Board's opinion it is not correct to contend that because inflation calls forth an increased demand for bank loans, these loans do not contribute to inflation. The economy now is caught in a partly self-generating spiral of rising wages, costs, prices, and profits supported by active use of previously accumulated liquid assets and by expanding bank loans. Credit is contributing to the continuation of inflationary pressures. As was well stated, in a recent monthly letter of the National City Bank of New York:

"Rapidly accumulating debt is both a cause and a consequence of the inflationary pressures, for in a wage-price spiral, business constantly needs more and more money to keep going and this leads to the incurrence of more and more debt by business and more and more spending by the individual. To check this kind of spiraling—which is to the ultimate benefit of no one and to the injury of all—is not simple."

Although each loan, taken separately, may aid in the production and movement of goods, yet in view of the limited supplies of goods available, a loan to one business or individual to finance the purchase or holding of goods permits the borrower to bid against someone else who has or is able to obtain funds. Credit expansion thus is called for by price increases and provides the basis for further increases. This process, unless checked by positve limitations on the available supply of credit, could easily lead to catastrophic collapse.

Bankers, businessmen, farmers, wage earners, who in their operations unwittingly contribute to the rising spiral of inflation, cannot individually be held responsible for its course. That course is the result of reliance on the free-enterprise, competitive price system in a situation where demand, supply, and price are not in equilibrium and where a rise in prices can be prevented only through the maintenance of a harness of controls by Government.

For these conditions, the bankers are not responsible either individually or as a group. Their job is to meet the credit needs of their communities constructively, competitively, and profitably; they are not individually in a position to refuse the legitimate, sound credit demands of their customers. They find themselves in a situation in which they can readily meet unlimited credit demands from the public and in which the public's credit demands are vigorously sustained. That situation was created by war, by the necessities of war finance, and by premature abandonment of controls, thereby releasing inflationary pressures. Responsibility of the individual banker for developments can go no further than observance of prudent policy in the extension of credit and the maintenance of proper soundness of loans and liquidity and safety of individual banks.

Responsibility of Government for credit expansion.—The Federal Advisory Council states that Government agencies have been making loans that banks refrained from making. Except in the field of foreign lending, the volume of loans by Government credit agencies is very small relative to the volume of bank loans and the total has not increased. It is true that some of the activities of Government agencies, furthering objectives set forth by Congress, have encouraged unhealthy credit expansion in the field of housing, primarily to aid veterans. Foreign lending by the Government has expanded because of the urgency of restoring production abroad and the difficulties and inadvisability of obtaining private credits for these essential purposes.

The Council refers to the Board's request for authority to guarantee loans in cases where credit is needed but cannot be obtained from banks. The Board wishes it clearly understood that it is requesting merely an amendment of an existing provision of law, for the purpose of rescinding a power which the Reserve banks already have to make loans and revising somewhat their power to guarantee loans. Under existing conditions these powers are not likely to be used but some such power will be needed at times in the future to provide for small business a source of capital, which large corportions can obtain through sales of securities in the market. Amendment of existing law has been recommended to enable the System to return certain funds to the Treasury and this provides an appropriate opportunity to make other long-needed revisions. With reference to this bill the Federal Advisory Council expressed its views on November 18, 1947, as follows:

"The Council is cognizant of the investigation of the activities and powers of the Reconstruction Finance Corporation now being made by a congressional committee. Until Congress has determined whether the Reconstruction Finance Corporation should be continued, and, if continued, what powers to make or guarantee loans should be given it, the Councul feels that no action by Congress should be taken on Senate bill 408. The Council feels that Senate bill 408 should be considered only as an alternative to legislation continuing the present loan and guarantee powers of the Reconstruction Finance Corporation. If the Congress should decide to continue the Reconstruction Finance Corporation without greatly curtailing its loan and guaranteeing powers, the Council would be opposed to the passage of Senate bill 408. The majority of the Council would prefer Senate bill 408 to the continuation of the Reconstruction Finance Corporation powers, but it should also be noted that a minority of the Council is against giving any guarantee or commitment powers to the Federal Reserve banks under any circumstances, as proposed in Senate bill 408."

Means of restricting inflation.—The Board cannot agree with the Council's view that the Reserve System and the Treasury have ample power to place all restraints on credit expansion that the System may consider necessary. As the Board has pointed out in its annual reports for 1945 and 1946 and in other statements, banks are in a position to provide any additional credit demanded by borrowers and the System cannot prevent such expansion. This is the case because commercial banks of the country now hold $70,000,000,000 of United States Government securities, any part of which they can readily sell in order to obtain funds to make loans.

When banks sell Government securities, the Federal Reserve, which provides the ultimate market for Government securities, must purchase them in the absence of other buyers in order to prevent a break-down of the securities market. Federal Reserve purchases create bank reserves which can be expanded by the banking system into more than six times as much in loans and investments.

The Council suggests that the System can restrain inflationary credit expansion through use of existing powers, including authority to increase the discount rate, to sell securities in the open market, and to raise reserve requirements at central Reserve city banks. None of these powers can be used effectively if banks continue to sell Government securities to the Reserve System and thus create additional bank reserves.

In fact attempt to use these powers would increase sales of Government securities in the market by banks and others. If the System refused to purchase any more securities, bond prices would decline sharply. The threat of such a policy would induce a wave of selling of marketable bonds, and if prices on these bonds declined there might be widespread redemptions of savings bonds, which are redeemable on demand. The Reserve System would have to purchase securities in order to meet the drains on the Treasury, and new reserves would thereby be created.

Recent measures by the System and the Treasury to raise interest rates on short-term Government securities have diminished somewhat the inducement to banks to sell short-term securities and to purchase longer-term higher-rate issues. Higher rates on short-term securities, however, have but little, if any, influence in discouraging banks from selling them to make loans. Moreover, a recent increase in capital demands has put some pressures on the long-term securities market, and has resulted in a decline in bond prices. This places a limit on the extent to which short-term rates may be permitted to rise without causing an undue drop in Government bond prices.

The Board has proposed a means of curbing the ability of banks to create additional reserves by selling Government securities to the System and of reducing the amount of credit expansion that may be possible on the basis of reserves thus created or arising from a continued gold inflow. This proposal calls for granting to the System a temporary authority to require all banks to hold a special reserve in Treasury bills, certificates, and notes or in certain cash assets, in addition to present basic required reserves.

This measure would enable the System to impose some restriction on undue credit expansion without depriving banks of earning assets. It would permit a rise in lending rates to new private borrowers without raising the interest cost on the outstanding debt of the Government, which is not now increasing. It would not prevent banks from meeting essential credit needs of the economy but would discourage unrestrained expansion of credit for any purpose.

Use of an instrument such as the one proposed would enable the System to curb credit expansion with much less burden on banks and less threat to Government credit than would result from attempt to use effectively any of the existing powers mentioned by the Federal Advisory Council.

Senator O'MAHONEY. Are the names of the members of the Council attached to the statement?

Mr. ECCLES. No, but they are a matter of record.

Senator O'MAHONEY. I think it would be well if they were made a matter of this record at this point.

Mr. ECCLES. Will you make a note of that and see that that is put in the record?

We will see to it that the names of the members of the Council are put into the record.

(The names of the members of the Council are as follows:)

Federal Reserve district:

No. 1. Charles E. Spencer, Jr., president, the First National Bank of Boston, Boston, Mass.

No. 2. W. Randolph Burgess, vice chairman, the National City Bank of New York, New York, N. Y.

No. 3. David E. Williams, president, Corn Exchange National Bank & Trust Co., Philadelphia, Pa.

No. 4. John H. McCoy, president, the City National Bank & Trust Company, Columbus, Ohio.

No. 5. Robert V. Fleming, president, the Riggs National Bank, Washington, D. C.

No. 6. J. T. Brown, president, the Capital National Bank of Jackson, Jackson, Miss.

No. 7. Edward E. Brown, chairman, the First National Bank of Chicago, Chicago, Ill.

No. 8. James H. Penick, president, Worthen Bank & Trust Co., Little Rock, Ark.

No. 9. Henry E. Atwood, president, First National bank of Minneapolis, Minneapolis, Minn.

No. 10. James M. Kemper, president, Commerce Trust Co., Kansas City, Mo.

No. 11. Ed H. Winton, president, Continental National Bank of Fort Worth, Fort Worth, Tex.

No. 12. Reno Odlin, president, Puget Sound National Bank of Tacoma, Tacoma, Wash.

Senator FLANDERS. Do you have enough of those for the members of the committee?

Mr. ECCLES. I do not. This reply to the Board was finished late last night, and some time this morning.

Senator FLANDERS. Can you get some extra copies for us?

Mr. ECCLES. We can. We would be glad to give you some copies.

Please send copies of the Council's statement and the Board's reply to all of the members of the committee.

The CHAIRMAN. Mr. Eccles, the first question that I want to discuss is whether this increase in bank credit is a serious problem.

The increase in the total bank loans that I have, considering January 1946, nearly 2 years ago now, is from $30,355,000,000 in January 1946 up to, as I gather from your over-all statement, though I do not have the figures on all banks, about $42,500,000,000 in November. In any event, in 2 years, the bank loans have increased about $10,000,000,000; is that correct?

Mr. WOODLIEF THOMAS. Yes.

The CHAIRMAN. Is there anything to support the statement that that is increasing?

The bank loans for 101 cities seem to be almost the same in November as in September.

Mr. ECCLES. Do you have the latest figures on that?

Mr. WOODLIEF THOMAS. There have been some fluctuations, yes.

The CHAIRMAN. Mr. Eccles stated in his statement that it showed signs of a growing inflation and I wondered what figures supported that.

Mr. WOODLIEF THOMAS. Commercial loans have been increasing. Real estate loans have been increasing. Consumer credit loans have been increasing.

The CHAIRMAN. I want to get the figures of the amount, whether it is an increasing amount over the previous periods or not.

It seems to me we ought to have the whole thing by months from January 1946, with some reference back to 1939.

Mr. ECCLES. Well, you see, we get these calls for all banks about twice a year. There are nonmember banks, and we have to wait until the calls are made by the State bank commissioners, and June 30 is the last report.

So, from then on, you estimate it, based upon the 450 odd weekly reporting banks. The figures are as follows:

Loans at all insured commercial banks, by kind

[In billions of dollars]

Date	All loans	Kind of loan				
		Commercial, industrial and agricultural	Real estate	Consumer	Loans on securities	All other
1939, June 30	16.0	6.9	4.0	[1] 2.4	1.6	[1] 1.1
1945, Dec. 31	25.8	10.8	4.7	2.4	6.8	1.2
1946, June 29	26.8	11.7	5.7	3.1	5.1	1.2
Dec. 31	30.7	15.4	7.1	4.1	3.1	1.1
1947, June 30	33.3	16.3	8.2	4.9	2.8	1.0

[1] Estimated.

NOTE.—Excludes loans at noninsured commercial banks which comprise about 1 percent of the loans at all commercial banks.

Loans at member banks in leading cities [1]

[In millions of dollars]

Date	All loans	Kind of loan				
		Commercial, industrial, and agricultural	Real estate	Other—largely consumer	Loans on securities	Loans to banks
1947—June 26	20.2	11.8	3.0	3.1	2.3	0.2
July 30	20.5	12.0	3.1	3.1	2.1	.2
Aug. 27	21.1	12.4	3.2	3.2	2.2	.2
Sept. 24	21.6	12.9	3.2	3.2	1.9	.3
Oct. 29	22.6	13.8	3.3	3.3	1.9	.2
Nov. 19	22.9	14.2	3.4	3.4	1.8	.2

[1] Includes 441 member banks in 94 leading cities.

The CHAIRMAN. Well, it seems to show, just summing up the general effect, it seems to show that the total expansion of credit, bank credit of all kinds, is at the rate of $5,000,000,000 to $6,000,000,000 a year, for the last 2 years.

Mr. ECCLES. That is right.

The CHAIRMAN. That is about right. Is that $5,000,000,000 or $6,000,000,000 a year; is that any reason to think that is excessive? That is, where you are developing a new economy and making new loans?

Mr. ECCLES. Well, it would not be excessive in a normal condition where you were not experiencing a rapid inflationary development; but any expansion of bank credit added to the total volume of the bank deposits and currency is excessive today. As a matter of fact, if there were no further extension whatever of bank credit, with any normal velocity, and that is the velocity that we have been accustomed to in the past, on the existing supply of money, if there were no further increase in it at all, we could have a much further inflationary development.

The CHAIRMAN. That may be; but in the war, the banks were lending the Government money, because they had to have it. Now there is no longer a war and they are lending it to the private people who want to borrow, and presumably for legitimate purposes, because you check all of the loans yourself to see whether they are sound loans.

Is there any real evidence that $5,000,000,000 a year in the postwar period, where people are going back to peacetime production, is in any way an excessive increase in credit?

Mr. ECCLES. I think it is at this time. I do not think it was in the first part of 1946, when the reconversion was going on. I think it is only an excessive extension of credit when you already have such a shortage of labor and materials in nearly every field.

The CHAIRMAN. But you would not just say to the banks, "You shall no longer increase credit at all"?

Mr. ECCLES. On the over-all credit there are many things to be considered. There are loans being paid all the time, and there are loans being made. We are not saying that banks should not make loans.

The point is that the banking system as a whole should have some restraint. Our plan here does not put them in a vise, where they can make no loans, but it puts the lender under a restraint which today he is not under.

Today, he is under pressure to make loans, not only because of the demand of the borrower, but because he finds that he has reserves. He does not know where they come from, but when gold comes into the country, and that is coming in at the rate of $200,000,000 a month, as that gold comes in, it immediately goes into the banking system and becomes reserves. Therefore, the banks have money to invest.

The CHAIRMAN. They have not, however, been hampered in making loans by any reserve requirements?

Mr. ECCLES. No. They have not been hampered at all.

The CHAIRMAN. They can sell governments?

Mr. ECCLES. That is right, but this gold only adds reserves to those created by selling of governments. The gold gives them the reserves without the bank selling governments at all.

In addition to that, any purchase that the Federal Reserve will have to make to support the long-term rate of securities, that are not bank eligible, increases it.

Now, the extent to which we may have to support the long-term market is, of course, unknown. Today it is not an important factor, but it is becoming increasingly important because, as inflation develops, the demand and the need for money become greater in order to do a given, like amount of business.

Therefore, the corporations that have not borrowed, and who have governments, sell those governments, and that puts reserves in the banking system.

The CHAIRMAN. I understand that, but what I am concerned about is this: Is there really a problem? That is the question we have to start with. Is there any abuse of this power? Is this expansion excessive?

You, yourself, are exercising authority, and you are asking for authority before the Banking and Currency Committee to increase the lending power of the Federal Reserve System to your small businesses, presumably to increase production, and is not lending necessary to increase the production?

Mr. ECCLES. We are asking for less authority than we have. We have today an authority to make direct loans under 13 (b), and we are asking the Congress to take over that $139,000,000 of gold that was set aside for that purpose, and put it into the revenue of the Government, and repeal the Board's authority to loan and substitute therefor as a stand-by service for deflationary requirements, the right to insure loans that are submitted by the banks.

That does not necessarily mean to say that you will insure them, but it is a substitute that is a less power than we already have.

The CHAIRMAN. But it would increase, then, the loans that the banks would make, guaranteed by the Board.

Mr. ECCLES. Yes, but it is much worse if we make loans now. If we make direct loans today, the Federal Reserve, we would put reserves in the banking system so that every dollar of direct loan the Federal Reserve makes today would put that amount of excess reserves in. We are asking that that power to create multiple expansion be taken away.

The CHAIRMAN. Which you are not exercising.

Mr. ECCLES. No, sir, we are not exercising it.

The CHAIRMAN. You want a more practicable power to increase loans through the banks, which has the same inflationary effect.

Mr. ECCLES. It does not have any multiple effect at all. The loan would originate from the bank. The only purpose for which we want it is on the books as a stand-by service.

We are not very particular about it as a matter of fact.

The CHAIRMAN. You might as well put it off for another year, when there is a deflation.

Mr. ECCLES. The only thing is, it is a question of repealing what we have. The only reason it came up at all was that the budget wanted to get this $139,000,000, and in order to get it, you had to repeal section 13 (b), and we merely suggested to the Congress that in its repeal that they give the Board this stand-by service of insuring loans if need be. So it is not that we brought it up. It was brought up in an effort to get this $139,000,000 into the Government's revenues.

The CHAIRMAN. Mr. Eccles, I still go back to the question as to whether we really have an abuse here or a problem that we have to do something about.

I notice the total bank loans in 1939 were this figure of $22,000,000,000. Now they are about $42,000,000,000. They have not quite doubled.

Considering the increase in the national income, the increase in production, which is more than double in the output, do you think the present volume of bank loans is excessive?

Mr. ECCLES. I think, in view of the amount of government, they are. It seems to me that an expansion of bank loans, in view of the existing volume of deposits already in the banking system, because of the huge amount of credit created to finance the war, should make any further bank credit expansion unnecessary on balance, because you are adding to the means of payment in the economy whenever you expend bank credit on balance.

I think when you get a situation of inflation as acute and as dangerous as the present situation is, that you cannot say that 14,000 banks should have the ready access that they have today to reserve credit. They should not have the reserve credit that they get from gold imports, and from the Federal Reserve's purchase of market securities without some offsetting means of curbing that easy credit situation that we are forced to put them in.

The CHAIRMAN. I understand that, but in comparison to the prewar condition as to the amount of loans in 1939, the amount today is in no way exceptional.

Mr. ECCLES. If the Government credit is compared with 1939, no. But when you look at the private credit structure, you have to take into account the Government credit structure which created money.

If it were not for the Government deficit financing that increased the amount of deposits of currency over 300 percent, if it were not for that, then I think the economy, with the kind of production we have, would be such that the bank loans would have to be far greater than they are, but industry, today, and individuals, own this 300 percent increase in deposits, and there they are. It is in the form of money, and they own it, and any time that the banks make further loans, they add to that spending stream.

I can understand how any one banker says, "This loan is good and I am only loaning my surplus money." I can perfectly understand his attitude, because he does not see the over-all picture which we have to take a look at.

The CHAIRMAN. What bothers me more is shutting off of loans from people who say they need them and who, presumably, have the assets on which to borrow.

Mr. ECCLES. You will not shut off loans.

The CHAIRMAN. Is that not a serious limitation?

Mr. ECCLES. You will not shut off loans to them at all with any such program as we have.

The CHAIRMAN. Then what is the purpose of it?

Mr. ECCLES. There is no prohibition of loans.

The CHAIRMAN. What is the purpose of it?

Mr. ECCLES. There is this restraint; let me put it this way: The banks today have about 50 percent of their assets in Government securities.

The banks, as I showed in this statement, could sell one-half of those Government securities, and create reserves upon which they could build $200,000,000,000 of credit.

Now, it is only natural for each individual bank to be seeking all of the good loans it can get, and to sell Government securities which they have, bearing a much lower yield than some of the loans, and make these loans.

Now, they would be restrained, certainly, in undertaking to shift from governments into loans, if there were a prospect of this plan. That is, if the Board had authority to require an increase in their reserve of either cash or short-term Government securities. It would be at their option. To shift from governments in order to make loans would then reduce what is now a secondary reserve of 50 percent of their deposits.

It would have the possibility of reducing it to 25 percent. And the banks, with the amount of governments that they have, are free to sell to meet shifting deposit requirements, and there would be a very great restraint on further lending.

Certainly they would be very much more selective, and as a lot of loans were paid, they would use the funds to buy short-term governments.

I do not think there is any question but what they would finance all of the needed corporation movements and that type of production, but when each business finds that the cost of doing business is more, because wages go up, and inventory costs go up, and open account credit goes up, and outstanding credits are increasing, both due to inflation and due to an increasing slowness of collection, each corporation finds itself in need of more money.

And as the National City says, the need of more money creates inflation. It is part of the cycle. It is as much a part of the cycle, this expansion of credit, as increased wages are a part of increased prices, and profits are a part of increased prices.

It is the credit that sustains it. An advancing credit sustains higher prices and higher prices call for more credit, and more credit sustains higher prices.

The CHAIRMAN. If a man comes along with perfectly good assets and perfectly good credit and wants money, should not he be able to get it?

Mr. ECCLES. Not necessarily.

The CHAIRMAN. We can draw a distinction and say that is a loan that is not quite safe, and it is not a good loan, perhaps. We can draw a distinction between loans, but basically, do we want to cut off the right of business to borrow?

If their inventory does go up, over which they have no control, do they not have to borrow money to carry it?

Mr. ECCLES. That is right, and I have said that this is only a part of the program. Fiscal policy is a very essential part of the program. It would be a great mistake to try to control the entire inflation; merely by clamping down on bank credit.

Today, there is no real restraint on it, and all we are saying here is that there should be some way and some means to put some restraint on it if the need develops.

Now, certainly the Board would prefer not to have to enforce such a power. I will be perfectly frank to say the administration of this power would be a very, very unpleasant task.

The CHAIRMAN. Do you think the administration feels that way about the other powers they are asking for, too?

Mr. ECCLES. I could not say how they feel about them at all.

Senator O'MAHONEY. May I ask a question at this point, Mr. Chairman?

Mr. ECCLES. Just let me finish that one point.

We do not seek this power and as a matter of personal preference, there is not a member of the Board who would not hope that they do not get it. We cannot win. If we get it and inflation goes further, we will be blamed. If we use it and we get deflation, we will be blamed. But we, as an agent of Congress, could not do other than point out what this situation is and suggest to you the only way that we thought that we could contribute to restraint, was by getting this type of power. We wanted to make that perfectly plain, that the powers we have are not adequate without causing the problems which I have pointed out, and we do not want to be crucified for not stopping this inflation, and we are giving the reasons here why we do not think we can do it with the power we have, and what we think would be an adequate substitute.

I am not pressing for this legislation. I want to lay the thing on the table as the agency of Congress, and certainly we will be very glad from an administrative standpoint if Congress sees fit not to give us these powers.

The CHAIRMAN. Mr. Eccles, I raise one question about your testimony, which is the last question I want to ask.

You said, "an increasing rate." My figures seem to show that there was a very rapid increase in demand deposits, and making of loans, up to July, but that since July, it has been substantially retarded as a matter of fact, and the growth today is at a very much less rate than it has been in the past.

Mr. ECCLES. It is much faster. It is the most rapid it has ever been in our history.

The growth at banks in leading cities from September 10 to November 12, a period of 2 months, has gone up in commercial loans $1,430,000,000; real estate loans, $160,000,000; in all other loans $145,000,000.

In security loans it has gone down $175,000,000. That is the one we have control on.

So that you have here an expansion in a 2-month period of better than one billion five hundred million dollars.

Now, then, we have to look at this credit situation at more than just a month at a time. You have to take it over a cycle, because there is a certain seasonal fluctuation.

The CHAIRMAN. I understand that.

Mr. ECCLES. Therefore you have to make your comparisons over the year as a whole.

Now, it is true that there will be certain seasonal liquidation, but you have to compare the outstanding credit from year to year, and the way the situation is developing now, the way it has developed, is that it looks as if in the past 2 years there has been an over-all expansion without fluctuation of about $5,000,000,000 a year.

The CHAIRMAN. Yes, that is what I have here.

Mr. ECCLES. That is correct.

There is every indication, however, that with the speed with which the inflation has been going lately, that one of two things will have to happen.

Either business and construction, because the cost of construction is fantastic, and this housing situation is just unbelievable when it comes to the inflation that is in it, there is going to be required more and more money with the inflation, and it can gain momentum.

There is a possibility and a danger of it gaining momentum. We are not sure of it, but there is that possibility, and if it gains momentum, more and more bank credit would be required to do the same amount of business.

We merely point out that some restraint in this field along with other restraints is needed, that this should supplement fiscal policies, and it should supplement other policies.

The banks, naturally, are opposed to it. As I say, they have nearly always been opposed to any change. They were opposed to the original Federal Reserve Act. They were very much opposed to some of the powers we got in the Banking Act of 1935.

Senator O'MAHONEY. Mr. Eccles, you have about convinced me that you are right, and I hope that you are not going to back away from this proposal merely by laying it before this committee.

I think it is clear that the country faces a very unpleasant situation here. Inflation is here, and if we do not act intelligently, it is bound to get worse with disastrous effects.

Mr. ECCLES. It may.

Senator O'MAHONEY. The further it is permitted to run.

Mr. ECCLES. Well, I would not say it is bound to.

Senator O'MAHONEY. I say, if it is permitted to run.

Mr. ECCLES. I say it is very likely to.

Senator O'MAHONEY. Let us get my question clear. If inflation continues without restraint, it is bound to result disastrously; is it not?

Mr. ECCLES. Oh, definitely. Definitely.

Senator O'MAHONEY. Now, let me see if I understand your basis correctly.

Mr. ECCLES. It has already gone so far that we are facing some disasters, I think.

Senator O'MAHONEY. Now, that is a much better answer from my point of view.

Mr. ECCLES. Already it has gone that far.

Senator O'MAHONEY. You have convinced me of that.

Mr. ECCLES. It could become cataclysmic and the whole system would be jeopardized.

Senator O'MAHONEY. If I understand your proposal, you do not propose in making this recommendation to prevent loans to sound borrowers from the banks. Your fundamental desire is to prevent the accumulation of monetary reserves so as to increase the total over-all debt against the economy; is that right?

Mr. ECCLES. The total over-all bank credit which creates money.

Senator O'MAHONEY. Yes; but you are advising us that as we consider this problem of inflation, we must take into consideration both the Government debt and the private debt?

Mr. ECCLES. That is right.

Senator O'MAHONEY. So that if bank credits are expanded now, they have the effect of piling on a new debt, a new total debt beyond our already excessively high debt.

Mr. ECCLES. That is right. That is exactly right.

Senator O'MAHONEY. So that these restraints which you propose are intended not so much to prevent any proper borrower or business man from getting a loan from a bank, but to require the bank, if it makes such a loan, not to use a certain proportion of its reserves for other expansion of credits.

Mr. ECCLES. Buying other investments. They are out buying other investments, such as municipals and other investments. They, of course, have been expanding consumer credit, not to customers at all, but just out seeking the credit. They are expanding mortgage credit at a very rapid dangerous rate, and it is not to customers. It is merely a seeking of an outlet that is more profitable than the holding of short-term Government securities.

Now, there would be a great restraint on that seeking of credit if they did not have this 50 percent of their total assets in governments, and they feel a great liquidity or ease to dispose of them for other loans and investments.

The individual banker is not thinking about the multiple expansion. He is just thinking that he is transferring a Government bond to a loan, and he does not realize when he makes that loan, that becomes a reserve in another bank, and you get six times multiple expansion for every dollar of Government securities they sell.

The banker does not realize that individually at all.

Senator O'MAHONEY. But if that process is permitted to continue and all the banks of the United States, State and local, and national, continue this practice, the inflationary process also continues; is that right?

Mr. ECCLES. There is no question about it, but you have today a great expansion in municipal financing which is inflationary because they are spending more than they are collecting in taxes.

They are putting out new bond issues, for veterans and other purposes, in very large amounts. They are putting out issues to finance all kinds of public activities and at very high costs, and these securities are competing with private financing for funds.

Senator O'MAHONEY. Did I understand you in quoting from the November letter of the National City Bank to cite that institution as authority for the fact that these debts are rapidly accumulating now?

Mr. ECCLES. That is, they make inflation. I do not know how rapid. That is right, the implication was that this credit was expanding and it was creating more inflation.

Senator O'MAHONEY. Now, will you, for the record, provide us with the specific month to month figures so that there will be some possibility of measuring this rapid momentum of which you speak?

Mr. ECCLES. Well, I would say this: We would be glad to furnish those figures.

(The figures are as follows:)

Principal assets and liabilities of all commercial banks (figures partially estimated)

[In billions of dollars]

	Loans and investments				Reserves, cash, and bank balances	Deposits				Total capital accounts
	Total	United States Government securities	Other securities	Loans		Interbank	United States Government	Demand adjusted [1]	Time	
1939—June 30	39.4	15.7	7.2	16.4	19.8	8.2	0.8	27.4	15.1	6.9
1945—Dec. 31	124.0	90.6	7.3	26.1	34.8	14.1	24.6	75.9	30.1	9.0
1946—June 29	119.4	84.5	7.8	27.1	32.4	12.3	13.4	79.5	32.4	9.4
Dec. 31	114.0	74.8	8.1	31.1	34.2	12.7	3.1	83.3	33.8	9.6
1947—Jan. 29	113.8	74.3	9.0	31.5	32.2	12.2	3.1	82.5	33.9	9.6
Feb. 26	113.0	73.0	8.1	31.9	32.2	12.0	3.9	80.6	34.2	9.6
Mar. 26	113.1	72.4	8.3	32.4	31.6	11.8	3.8	80.4	23.3	9.7
Apr. 30	113.0	71.8	8.4	32.8	32.2	11.8	2.8	81.3	34.5	9.7
May 28	112.7	71.3	8.3	33.1	31.7	11.5	2.1	81.5	34.6	9.8
June 30	112.5	70.3	8.5	33.7	32.7	11.6	1.0	82.5	34.7	9.8
July 30	113.2	70.5	8.7	34.0	32.0	11.3	1.1	83.2	34.7	9.8
August	113.8	70.2	8.7	34.9	32.2	12.1	1.5	83.4	34.8	9.9
September	115.1	70.6	8.9	35.6	33.2	12.7	1.6	84.2	34.9	9.9
October [2]	116.4	70.5	9.0	36.9	33.8	12.4	1.5	85.5	35.3	10.0

[1] Gross demand deposits, other than interbank and United States Government deposits, less cash items in process of collection.
[2] Preliminary.

Mr. ECCLES. I would say this: that even aside from any rapid expansion, and that is a relative thing, that the monetary authorities in this kind of a situation should have a standby power as a substitute for a power that they cannot use because of the huge size of the public debt. In other words, Congress gave to the Reserve System in the beginning, 1913, and again in 1935, certain powers. It was expected that those powers would be used in the judgment of the Board to restrain excessive bank credit expansion.

Now, we cannot use those powers, as I have indicated. Therefore, all we are saying is that we would like the Congress to know that we cannot, the way the situation is today, restrain bank credit expansion.

Now, I do not know whether the bank credit expansion is going to continue at a rapid rate. We are going to do everything we can, whether we get these powers or not, to advise, to counsel, and by means of propaganda and otherwise, to restrain them.

Senator O'MAHONEY. You are trying to put the brakes on?

Mr. ECCLES. Maybe we will be partly successful, but my only point is I want the Congress to know and the public to know that we do not have adequate powers unless we breach the Government interest rate, with all the dangers involved, and we do not recommend that.

Senator O'MAHONEY. May I interrupt?

I want to refer to another part of your testimony. You spoke of the four aspects of the inflationary condition in which we find ourselves. Wage, price, profits, and credit.

Mr. ECCLES. That is right.

Senator O'MAHONEY. Now, do you regard those as all contributing toward the condition in which we find ourselves?

Mr. ECCLES. I certainly do. They are all cause and effect, and it is difficult to say which is first.

It is like, which is first, the hen or the egg? They are all intermingled. I would say credit came first, because when the war ended, there was the huge volume of money that the war had created.

Senator O'MAHONEY. Now, is it not a fact that those who are interested in better wages are inclined to say, "We are not responsible"?

Mr. ECCLES. That is right.

Senator O'MAHONEY. Those who are interested in increasing profits, or increasing prices, are likely to say, "Well, wages are responsible for the condition."

Mr. ECCLES. That is exactly what they do say.

Senator O'MAHONEY. And those who advocate increased credit, they say, "We are not responsible but some one of the other factors is the responsible one."

Mr. ECCLES. Exactly.

Senator O'MAHONEY. But you are telling us that we must treat all four together.

Mr. ECCLES. That is right. I am trying to give the whole inflation picture and say that you cannot treat each segment of it separately.

Senator O'MAHONEY. Are you not coming to us now at the beginning of the increased credit spiral and saying to us, "Now, you can put on the brakes before it goes too far?"

Mr. ECCLES. Well, we came to you in the report of 1945 and 1946 and reported exactly what the situation was and its dangers. We did not press at that time for legislation because it was not until the latter part of 1946 and early in 1947, when the inflation really began and there was a feeling on the part of a lot of people that maybe production would finally catch up and people would defer their buying and spending until prices were better.

There was a feeling last spring, if you recall, that maybe we could stop the inflation spiral, and due to several factors, though particularly I think the round of wage increases and the new wage increase of the coal miners, and the deal with the steel companies, and when coal prices went up and steel prices went up even more, that reflected itself all down the line.

There are the railroad rates.

It is just one of those things that feeds itself.

Now we are confronted with a situation which I think is more acute than anybody imagined and that is the world picture. That is another story, but it is the world picture that has really brought about in a very bold outline now this inflation problem.

Senator O'MAHONEY. I would like to keep you on this point before you discuss that world problem.

Mr. ECCLES. I am not going to discuss it.

Senator O'MAHONEY. Let me keep you right on these recommendations.

I have here a reprint from the Harvard Business Review for the winter of 1947, written by the chief of staff of this committee, Mr. Charles O. Hardy, who at that time was with the Chicago Association of Commerce. This was an article on the Federal Reserve System report for 1945.

Defining one of your recommendations included in the report, he wrote this:

Another suggestion which strikes at the root of the problem is that all commercial banks be required to hold a second reserve against their demand deposits consisting of vault cash, excess reserve balances, or short term Government securities. Presumably this reserve would be held chiefly in securities, since otherwise it would earn no revenue. Assuming that the reserve would be big enough to absorb the bulk of the short-term securities, this procedure would isolate the markets for certificates from the rest of the money market and make it possible to apply credit restriction of the traditional type without raising the cost of short-term money to the Government.

That is a correct summary of your recommendation?

Mr. ECCLES. That is right. What date is that?

Senator O'MAHONEY. This was printed in the Harvard Business Review for the winter of 1947. It was his analysis of the Federal Reserve System Report for 1945.

Mr. ECCLES. Yes, that is right.

Senator BALDWIN. 1946, you mean, Senator?

Mr. ECCLES. No. 1945.

Senator BALDWIN. You said it was printed in 1947.

Senator O'MAHONEY. That is right. All I know is what I read on the title page. I did not see it in the Harvard Business Review.

Mr. Chairman, I think I should say for the record, that when I refer to the article by Mr. Hardy, that I do not understand his article to have been an endorsement of the plan but an analysis of the plan suggested by the Board.

Mr. ECCLES. Yes. I had understood that.

Senator O'MAHONEY. Now, would you tell us again how this second reserve system would operate as against the restraint upon business borrowing? In other words, some of the criticism which has been directed against this suggestion, as I understand it, is that it would have the result of almost prohibiting business credit.

Mr. ECCLES. No; it would not at all, because in the first place, it would only prohibit to the extent that reserves were unavailable.

The only way you prohibit bank credit completely would be a 100-percent reserve requirement. That would mean, of course, the banks had no means of getting credit.

Now, there is no such proposal and the banks would have access to sources of credit with this reserve requirement in effect. One would be the discount rate. The discount window of the reserve banks. Banks can borrow from the reserve banks.

Now, they could not borrow with the ease with which they borrow today, with the 1 percent discount rate, which is tied to the short-term Government rate. So that you could then raise the discount rate substantially, if this were in effect, whereas you cannot do it today, because the banks prefer to obtain reserves by transferring from governments. So the discount rate is ineffective. It would then be effective as a restraint upon the bank lender. It would not mean he could not get credit, but he would be restrained. He would not get it with the ease and at the rate he would get it today. And he would pay a much higher rate, which he would pass on to the borrower, and there would be that general restraint there, which does not exist today.

Senator O'MAHONEY. What would be the effect upon the demand for scarce raw materials and labor?

Mr. ECCLES. There could be speculation in this credit. Of course, the banks say there is none, but it is very difficult to say when an inventory is a little bit bigger than it needs to be. It is just one of those things that if credit were a little more difficult, and costlier, there would certainly be less future buying, and there would be less speculative pressures.

If the short term rate for private borrowing went up considerably, it would have some influence upon the long rate, and if the long rate for capital financing went up, it would be a real deterrent on long term commitments.

Senator O'MAHONEY. What would be the effect on price?

Mr. ECCLES. Well, the effect on price would come if you reduced the demand for raw materials or for construction, for the products that are in short supply. If you reduced the demand you certainly would stop the inflation. Inflation is only the effect of demand and demand is created by having the money and credit available.

If you made it less available, you would reduce the pressure, and prices might go down. At least, you would stop them from going up.

Senator O'MAHOENY. If this policy is not followed, what is the alternative?

Mr. ECCLES. I do not know of any as a substitute in the credit field.

Senator O'MAHONEY. I do not mean as a substitute. Suppose this policy is not followed. What other policy is there to restrain the continuing spiral of prices?

Mr. ECCLES. Well, the most effective one is fiscal policy. The fiscal policy that has been in effect has been the only important anti-inflationary factor we have had in the entire economy, because during the past year, there has been a fairly substantial budgetary surplus.

In other words, the Goverment is collecting from the economy in taxes more than it is spending by five or six or seven billion dollars.

The figure is certainly running at that rate.

Now, that money is taken out of the economy and it is not put back into the economy. That money is used to retire the governments held by the Federal Reserve. It just does not go back. Or it is used to retire the bank held debt. So the bank loses a deposit on one side when the taxpayer pays his taxes and when the Government retires its maturing short term Government debt. The bank loses a Government security on the other side of the ledger.

In other words, this is a reversal of the wartime bank-financing process. That is exactly what you do when you get budgetary surpluses, and it is an anti-inflationary factor and it is the most important single element as a means of controlling both inflation and deflation.

Senator O'MAHONEY. Now, the Government has reduced the national debt by about $20,000,000,000 through the application of surplus and excess balance.

Mr. ECCLES. Well, most or the biggest part of the reduction in the public debt was, of course, not out of surplus.

Senator O'MAHONEY. Out of excess balance.

Mr. ECCLES. Out of excess cash balance that the Government got in the eighth war loan drive which it did not need.

Senator O'MAHONEY. But by whatever the source, the payment of that $20,000,000,000 on the debt was anti-inflationary.

Mr. ECCLES. No. Now, let me make this clear.

Senator O'MAHONEY. Was it not?

Mr. ECCLES. Let me make this clear. Not entirely. To the extent that the Government had blank billions of dollars in its war-loan deposits, that was not an inflationary deposit, because it could not be spent by individuals and corporations.

Senator O'MAHONEY. But it could have been spent by Congress.

Mr. ECCLES. That is right. But to the extent that the Government pulled out that balance, which did not come from taxes, since a substantial part of it came from banking finance, in the first place, practically half of the Government's balance came from an inflationary process, and they reversed the inflationary process when they paid the banks off.

Senator O'MAHONEY. So, to the extent that that $20,000,000,000 was not paid, it had a deflationary effect?

Mr. ECCLES. Yes. If that $20,000,000,000 had been spent by the Government, it would have been $20,000,000,000 more of inflation.

Senator O'MAHONEY. I understand. Your testimony now, this morning, is that the expansion of bank credit through October has been about $12,000,000,000?

Mr. ECCLES. In the two-year period.

Senator O'MAHONEY. So that the general over-all debt of the entire economic system, after having been reduced on the one hand, is being increased on the other?

Mr. ECCLES. As a matter of fact, the Government surplus has been less deflationary than the bank credit expansion has been inflationary, because the bank credit expansion has been greater than the Government's surplus which was applied on the bank debt.

Senator O'MAHONEY. They represent the opposite extremes.

Mr. ECCLES. That is right, exactly. To the extent that bank-credit expansion is greater than the budgetary surplus it nullifies the effect of the budgetary surplus.

Senator O'MAHONEY. So if bank-credit expansion is permitted to increase, unless we reduce the public debt at the same time or reduce other outlays, the general net effect will be inflation.

Mr. ECCLES. That is right. The more bank credit expands, the bigger your budgetary surplus has to be to offset it.

The CHAIRMAN. Did you take account of the fact that some $2,700,000,000 or so of taxes taken in go into these old-age reserve funds?

Mr. ECCLES. Oh, yes.

The CHAIRMAN. That must be added to any budgetary surplus.

Mr. ECCLES. That should, and we do add it in and consider it. Any money collected out of the spending stream used to pay bank-held debt or Federal Reserve debt is anti-inflationary, and is a complete offset to bank credit expansion to industry or otherwise.

Senator FLANDERS. Mr. Eccles, there are two or three questions I would like to ask you.

On the foot of page 4, I gather that the measures you are proposing might restrict the credit going into housing.

Do you think it would decrease the amount of housing we build?

Mr. ECCLES. I am glad you brought that question of housing up because I hurriedly, late last night and this morning, had a statement made up. I thought housing might come up. In fact, I think Senator Taft mentioned to me that he would like me to be prepared to say something on housing credit.

If I may, I will just make a statement on this housing thing. I am not speaking for anybody but myself on this, because I have not had a chance even to discuss it with anybody else.

I want that understood, that it is just my own views that I have put together in a hurry.

One of the most inflationary factors—perhaps the most inflationary single factor—in the present situation is excessively easy mortgage credit for housing. During the past 2 years the amount of such mortgage debt has increased by more than $9,000,000,000 and the rate of current mortgage lending has risen from about $550,000,000 per month to about $1,000,000,000 per month. Terms of lending have eased substantially as compared with prewar. A large proportion of recent loans has been made on an installment basis at 4-percent interest on the unpaid balance for a period of between 20 and 25 years. Most of these loans have been made for a very high percentage of current sale price which is greatly inflated.

More than half of the current unprecedented volume of mortgage lending is sponsored by the Federal Government under legislation enacted by Congress. The Government must therefore assume much of the responsibility for any adverse effects of this type of lending. Prices of houses have advanced from 25 to 35 percent during the past 2 years. A large number of families of moderate and low income have been encouraged to assume mortgage debt which will be beyond their means when the present inflationary period is over, and is becoming increasingly burdensome as the cost of living goes up. Sellers and builders of houses have been enabled to make exorbitant profits. The Government has assumed and continues to assume contingent liabilities of great proportions.

It is entirely inconsistent to restrict credit terms on automobiles and other consumer durable goods partly to reduce the inflationary pressures and partly to protect the buying public, and at the same time to make housing credit terms so easy as to stimulate inflation and encourage people to go too deeply in debt. Any anti-inflationary program of the Government will lose much of its effectiveness so long as the Government sponsors the present inflationary housing-credit program.

Easy credit has greatly increased the effective demand for both old and new housing far beyond the supply and this has greatly inflated prices. In an effort to meet the demand and take advantage of this profitable market, builders have undertaken to construct a larger volume of housing than there are resources readily available to finish. As a result, published prices of materials have advanced and, in addition, a gray or premium market has developed for many building materials. In this competitive market, the services of labor are also being actively bid for and bonuses and other extras have become common.

The predominant feeling in the building industry is that only by building at current rates or even higher can the housing shortage be met and only by keeping demand high can the current levels of production be maintained. The prices that are being established now, however, are too high for long-sustained building. At inflated prices of materials and labor and inflated profits for builders a few more houses may be produced than would be the case if prices and profits were lower, but that condition makes it less likely that the market next year, and the year after that, will be able to pay the prices necessary to keep building going at the rate needed to overcome the housing shortage and stabilize this segment of the economy. An increasing number of families are being priced out of the market now, in spite of the extremely easy financing terms, even though their need for housing is very great.

If the easy credit situation were producing a substantial additional volume of housing at supportable values in the long run, it would be justified, but because of the limitations of labor and materials it produces, instead, a dangerously inflated market which cannot be sustained for both new and old houses. I believe that by curtailment of credit for housing in closer relationship to the supply of labor and materials, the price trend would be reversed and a market for houses assured over a long period of years. Good low-cost housing cannot be built with high-cost materials and high-cost labor. Neither Government nor private industry can produce this miracle.

For the reasons which I have stated, Congress should reconsider in the longer term interest of the county the present policy and program of the Federal Government in the field of housing credit. I shall be glad to be of any assistance I can in making suggestions for changes in the present housing credit programs. At this time I am merely indicating the nature of some of the changes that seem desirable.

Operations under the National Housing Act and the GI bill of rights are closely related in practice but not in law or in administration. These two programs sponsored by the Federal Government should be brought together so that appraisals are made by only one agency.

The 100 percent loans under the program of the Veterans' Administration for both old and new houses and the nominal 90 percent loans on new houses under title VI of the National Housing Act should be revised so as to reduce the demand for housing and thus bring prices down. This means that both buyers and builders should have more equity in their properties than under the prevailing lending policies so long as present inflationary prices continue for housing.

Lending by members of the Federal Home Loan Bank System should be subject to greater restraints by the use of a conservative uniform appraisal system, and by selective restriction on the terms of their loans.

Finally, from the long-range standpoint it is vitally important to prevent inflation in the housing field from getting any worse than it is. The greater the inflation, the more severe will be the aftermath of defaults, foreclosures, liquidations, and bankruptcy. Over the years, the construction industry, which is a major outlet for investment, and supports a wide variety of related manufacturing, transportation, and distributing activity, has been characterized by violent upswings and downturns. If greater stability could be introduced into this field, it would go far toward achieving the national objective of stabilizing production and employment at high levels. The more the backlog of demand for housing is filled at exorbitant prices now, the smaller will be the cushion under the entire industry when prices come down, and, therefore, the more intense the deflation in the industry will be.

Manifestly, this is not in the best interest of the general economy, and what is not good for the country as a whole is not good for any group—veterans or otherwise. As has been well said, there is no such thing as easy credit—true, it is easy to get into debt but the easier it is to get in, the harder it is to get out. That applies to all of us, including war veterans.

Senator FLANDERS. You are evidently not living with your mother-in-law.

Mr. ECCLES. Well, I am not, but if you get a foreclosure on your property you may have to go back to your mother-in-law.

Senator FLANDERS. But you have had a little vacation.

I think you have given me an answer to the question I asked, and it is a discouraging answer.

Now I want to ask you another question. I am afraid I will get a discouraging answer, but I may not.

Will the restraints on the granting of credit which you have described have any result on employment?

Mr. ECCLES. It may. You may get some temporary unemployment. I would sooner get some unemployment in a temporary deflation than get mass unemployment in a catastrophic deflation. I just do not know how to avoid these things altogether in a free enterprise system, a capitalistic economy. I do not know how you can maintain full employment and bring about an adjustment in prices. You cannot do it and we might as well be frank about it. It is a question that you have to deal with. It is a question of alternatives, and the alternative to me would be to put the whole system in a complete harness of controls. That is the alternative to your booms and busts, it seems to me, unless you restrict on the up side before it gets calamitous, and correct it on the down side before it gets calamitous.

Senator FLANDERS. On your page 4, if you could have the other four things going to the subject of your presentation, what would happen?

Mr. ECCLES. It would be far less important.

Senator FLANDERS. Might it not be possible to arrest deflation? They are not all of them subjects of legislation.

Mr. ECCLES. That is right. I do not think it is possible to get some of them.

Senator FLANDERS. Would it be possible to arrest deflation without unemployment?

Mr. ECCLES. You might arrest it if you could get the voluntary response. That is rather wishful thinking, from the standpoint of anyone who has been around as long as I have.

Senator FLANDERS. All right. Now, two more questions.

The next question is, How are you going to bring the State banks under control?

Mr. ECCLES. Well, under regulation W, we have covered not only the State banks, but we have covered all of the consumer credit concerns. All we would do is apply the regulation here with reference to the portfolio of short-term governments, or if the banks chose to do otherwise, to maintain balances.

The administration of that would be left up to the State bank commissioner. We would impose it, and the penalties for failing to comply with the requirements would be some interest penalty for deficiencies on the basis of an average over a month's period.

Senator FLANDERS. You could do that without State law?

Mr. ECCLES. Oh, yes, you could do it without State law, for the reason that it has already been determined that banking is interstate. It was the question in the wage-hour law. It has already been determined by the Supreme Court that State banks were subject to the wage-hour law, and there is no question on that, I think. At least, our lawyers think there would be no question about the Government's right to impose these requirements on State banks just as in the case of consumer credit requirements.

Senator FLANDERS. Now, just one more question.

You spoke of comparative ineffectiveness of control of interest rates. That was ineffective in the late twenties. Was it not effective in the early twenties, in braking the 1920 inflation?

Mr. ECCLES. I do not know how effective it was. It might have brought it forth a few months sooner than would otherwise have been the case, but I think that even without the high discount rate in the early 1920's, you still would have had the break that we did get, because in the field of agriculture there was a huge excess of agricultural products that came on the market with the end of the war.

You did not have the world left in as devastated a position as it is today, with the number of people to feed and clothe. The price of agricultural products would have broken, and were in a very weakened condition at the time.

Excesive inventories of raw products were accumulating throughout the world. It is exactly the opposite of what it is today, and the very things that broke the boom after the last war are the very things that are the shortest today throughout the world.

The CHAIRMAN. I am afraid that we will have to recess.

What does the committee desire to do? Do you wish to ask Mr. Eccles to return at some time? I do not believe we could return this afternoon, and possibly some one of these bankers will wish to testify, Mr. Eccles, on these questions of interest and so forth.

Mr. ECCLES. Well, I would be very disappointed and surprised if they did not.

The CHAIRMAN. We might postpone your further appearance, then, until after that, so that you will have an opportunity to reply.

Mr. ECCLES. Thank you.

The CHAIRMAN. Is that satisfactory to the committee?

We can question him at that time.

Very well, then, the committee will adjourn until 10 o'clock tomorrow morning at which time Mr. Harriman will appear.

(Thereupon, at 12:24 p. m., an adjournment was taken until Wednesday, November 26, 1947, at 10 a. m.)