BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

STATEMENT OF CHAIRMAN ECCLES

BEFORE THE

JOINT COMMITTEE ON THE ECONOMIC REPORT

WEDNESDAY, DECEMBER 10, 1947

FOR RELEASE ON DELIVERY

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss further the problem of what might be done in the monetary and credit field to deal with inflationary forces. Since my previous appearance before this Committee, there has been considerable discussion of the Reserve Board's proposal for a temporary special reserve requirement. There is a good deal of misapprehension and misunderstanding about it. I should like, as briefly as possible, to put it in what appears to me to be the correct perspective.

In my initial testimony before this Committee, I explicitly stated and I want to reemphasize that the proposed special reserve is only a part, though a necessary part, of any effective anti-inflationary program, and that the need for this authority would be less to the extent that appropriate action is taken on other fronts. By far the most important action is a continuing, vigorous fiscal policy. Because of that policy there is likely to be little need for the special reserve requirement during the next four months. In that period Treasury surplus funds, taken from the market through taxes, will be available to retire a substantial amount of bank-held public debt. However, after that period we may be exposed to an unbridled expansion of bank credit because the Reserve System's existing powers, in the face of its newly-acquired responsibilities for the Government security market and in the face of a continued inflow of gold, are insufficient to restrain further bank credit expansion. Considered in this light, our proposal is a precautionary measure to guard against possible disaster later.

Many bankers and certainly the Federal Reserve people are agreed that the Government bond market must be supported and stabilized. There is agreement that the present program of the Federal Open Market Committee and the Treasury should be vigorously prosecuted. There is agreement that supervisory policy and moral suasion on the bankers to avoid loans for non-productive purposes should be aggressively pursued. There is agreement on fiscal policy and the need for maintaining as large a surplus in the Treasury's cash budget as possible in order to pay off bank-held debt. There is agreement as to the need for strengthening the savings bond program of the Treasury. These are important areas of agreement and they ought to be kept in the foreground of any further discussions of the use of monetary and credit policy as a brake upon further inflation. At the same time, we should not fail to keep in mind the fundamental issue: Bank credit is still expanding, mainly because of loans, gold is flowing into the country, the money supply is still growing, inflation is continuing. The question is: What is the next step, if any is required, in doing something about it?

Banking leaders who have already had some opportunity to study the proposed special reserve plan and have arrived at opinions adverse to its adoption, voice this opposition along two lines of argument. On the one hand, they contend that the plan is impractical, socialistic, and unnecessarily drastic. On the other hand, they assert that the plan is not strong enough to accomplish its expressed objectives. The contrast between these two lines of argument is striking. Both cannot be correct.

First, does the proposal mean regimentation of the banks; will it unduly interfere with the operation of their business, and will it be a step toward socialization?

In the Board's judgment, the type of authority proposed is neither novel nor revolutionary. The authority provided by the Banking Act of 1935 to raise reserve requirements of member banks to twice the then prevailing statutory level was similar. Except for a small margin applicable only to New York and Chicago banks, this authority to increase member bank required reserves has already been exhausted.

In late December 1940 the Reserve Board, the presidents of the Federal Reserve Banks, and the Federal Advisory Council unanimously joined in a special report to the Congress pointing out the inflationary dangers for the national economy inherent in the defense effort. This special report, recognizing that the authority of the Federal Reserve System was wholly inadequate to deal with the potential excess reserve problem of the banks, recommended that Congress --

> "(a) Increase the statutory reserve requirements for demand deposits in banks in central reserve cities to 26 per cent; for demand deposits in banks in reserve cities to 20 per cent; for demand deposits in country banks to 14 per cent; and for time deposits in all banks to 6 per cent.
>
> "(b) Empower the Federal Open Market Committee to make further increases of reserve requirements sufficient to absorb excess reserves, subject to the limitation that reserve requirements shall not be increased to more than double the respective percentages specified in paragraph (a).
>
> "(c) Authorize the Federal Open Market Committee to change reserve requirements for central reserve city banks, or for reserve city banks; or for country banks, or for any combination of these three classes.
>
> "(d) Make reserve requirements applicable to all banks receiving demand deposits regardless of whether or not they are members of the Federal Reserve System."

In addition to these major recommendations, the special report urged that the defense program be financed as far as possible from existing deposits and from tax revenues rather than from inflationary borrowing from the banks. I submit for the record a copy of this special report, because it called for far more onerous and drastic powers than the special reserve plan.

The special reserve plan, however, is identical in purpose with an outright increase in regular reserve requirements. The plan, in fact, is no more than an adaptation of this familiar method of dealing with the volume of bank credit. The plan now proposed by the Board would enable the banks to retain the same volume of earning assets they now have, in place of making them reduce earning assets, as would an increase in regular reserve requirements, with adverse effects upon bank earnings.

Is the Board's proposal unnecessarily drastic?

In pointing out the inflationary dangers that exist when the supply of money in the hands of people who seek to spend it greatly exceeds the volume of goods and services available, the Board in its Annual Report for 1945 indicated that there were three alternative methods for dealing with the monetary aspects of the postwar inflationary problem: First, a limitation on the Government bond holdings of banks; second, an increase in their regular reserve requirements; and, third, the holding of short-term Government securities or cash under a special reserve requirement. Our study of the problem led us to select the special reserve method as the least onerous, the most equitable, and the most practicable method.

These specifications for the proposal call for the immobilization, even at the maximum, of only a part of existing large holdings by commercial banks of Government securities. About one-third of the 70 billion dollars of Government securities held by the banks could be immobilized even if the entire authority were used. The special reserve could be imposed only gradually, and if inflationary bank credit expansion can be otherwise brought under check, the requirement would not be imposed at all. Under the plan suggested, the individual banker would be left in the same competitive position he is in today. Contrary to what has been stated by a recent National City Bank Letter, among others, banks would not be under legal compulsion to buy Government bonds; the holding of Government securities in lieu of cash or balances with other banks to meet the special reserve requirement would be entirely optional with the individual bank.

The special reserve plan is a middle-of-the-road proposal for helping to deal with the credit and monetary aspects of the difficult and complex inflationary situation. The Board feels, however, that the purpose of restraining further inflationary expansion of bank credit can be adequately accomplished by the specifications it has drawn for the plan, if its use is accompanied by appropriate fiscal and other policies. It would seem that bankers would prefer this proposal to an increase in regular reserve requirements, which they recommended in 1940 in anticipation of inflationary developments.

Are existing powers adequate?

The argument that the Board's proposal is unnecessarily drastic implies that the suggested special reserve requirement is not needed because the System's existing powers are adequate to restrain credit expansion if the System would use them.

Existing powers are being and will continue to be used to the fullest extent consistent with maintaining the market for Government securities. Under present conditions, however, any further absorption of bank reserves is entirely dependent upon a continued surplus in the Federal budget that can be used to retire public debt held by banks. There will be little or no surplus in 1948 after March. Any subsequent surplus will depend on appropriations and tax legislation yet to be adopted.

Sales of some of the large volume of Government securities held by the Federal Reserve System would, of course, absorb bank reserves, but such sales, particularly when banks are selling securities to expand other credit, would demoralize the market and cause a sharp break in Government bond prices.

The discount rate should be kept high enough to discourage borrowing from the Federal Reserve Banks, but its effectiveness is limited as long as banks can obtain reserves by selling short-term Government securities.

The only remaining power we have is to raise regular reserve requirements at New York City and Chicago banks, as I have indicated. This would be restrictive to a small degree, but would be met by sales of short-term securities by those banks to the Reserve System. These particular banks, moreover, have shown relatively much less credit expansion than have other banks.

For some months the Reserve System and the Treasury have been carrying out a program combining monetary, fiscal, and debt-management restraint on current inflationary bank credit expansion. Some moderate, corrective rise has been permitted in wartime levels of interest rates on short-term Government securities, together with some adjustment in yields on long-term issues from very low levels. In addition, excess funds in Treasury balances arising from current budget surpluses have been applied to the retirement of maturing bank-held Government securities.

The System has also urged all banks to maintain conservative standards in the extension of consumer instalment credit, and has joined with other Federal and State bank supervisory agencies in recommending that all banks pursue conservative lending policies.

This program of restraint has helped to reverse the processes that contributed so strongly to the wartime expansion of bank credit, and will be carried on as the proposed special reserve plan is not a substitute for this program, but may be necessary to supplement and reinforce it.

Despite the pressures of fiscal policy during September and October, which drew upon bank deposits and permitted retirement of over one billion dollars of Government securities held by the banking system, deposits of businesses and individuals at commercial banks increased by 2.5 billion dollars, reflecting largely extension of bank loans to businesses, consumers and owners of real estate. Current reports indicate that the expansion of credit to these groups of bank customers continues to be at an unduly rapid rate.

Will the special reserve plan unduly restrict bank loans for productive purposes, handicap production in catching up with demand and thereby defeat its anti-inflationary purpose?

The present situation, as the Board emphasized in its Annual Reports for 1945 and 1946 and has been reemphasized time and again in the Federal Reserve Bulletin, is one of effective demand in excess of available supplies of goods, and of effective demand being continuously fed by still further expansion of bank credit. There can be considerable reduction in the volume of demand without bringing it below available supplies of goods and upsetting production. Such a contraction of demand is essential to avoid further price increases. When a situation is finally reached where supply exceeds demand, that will be the proper time to encourage credit expansion. The Board's proposal is not a one-way street.

It would not prevent banks from making essential loans. It is designed, rather, to encourage banks to make loans out of the existing supply of loanable funds, replacing one loan with another or selling securities which the public or other banks will purchase. It would accept the present volume of outstanding bank loans, amounting to nearly 37 billion dollars, as a huge revolving credit pool for the financing of necessary production and permit banks to sell off other assets to make loans if this pool proved inadequate. What it would not do is to permit banks to go on expanding the total volume of their loans by selling securities which only the Federal Reserve will buy, thereby creating additional reserves, which can be expanded by the banking system into loans and investments amounting to six or more times their amount.

Some would argue that bank loans at this time which are accompanied by increased production are not inflationary or are even anti-inflationary. This argument is of dubious validity because the money once created by loans and spent by the borrower finds subsequent uses which are beyond the control of the banker or the borrower and are highly inflationary in character. In describing the recent loan expansion and its inflationary effects, the November issue of the Federal Reserve Bulletin states: ". . . to the extent that the loans have not facilitated increased production, loan expansion has accelerated inflation. In addition, the deposit funds created in the first instance by loans, whether for production, consumption, or speculation purposes, have found many inflationary uses in subsequent transfers among holders."

What the plan cannot do is to reduce the existing volume of bank deposits. The only way this total can be reduced is by paying off in the aggregate the public and private debt held by the banks as assets against these deposits. This is inevitably a slow process at best.

Could the special reserve plan be applied without resulting in a violent upset in the Government securities market?

There is no reason why the transition could not be accomplished in an entirely orderly manner. The introduction of the proposal would be gradual. Any bank that might not be able to meet the proposed special reserve requirement introduced in this gradual way on the basis of their present holdings of short-term Government securities should get into a more liquid position.

I should like to submit for the record a table showing for each major group of insured banks the relation of available special reserve assets on June 30, 1947, to selected levels for the proposed special reserve requirement. The table also shows the percentage holdings of short-term Government bonds which these groups of banks held at mid-year, which were available for sale in the market to obtain eligible assets. This table makes clear the feasibility of the plan from an operating standpoint. Of course, statistics for individual banks would show wider variations in holdings of eligible assets than are indicated by the table for groups of banks, inasmuch as aggregates conceal individual bank variations. However, the table should allay fears that the plan would have disruptive effects.

Would the imposition of the plan perhaps lead to deflation and depression?

A fear expressed by some bankers who have discussed this Board's plan publicly -- and they include those who are prepared to renounce the use of monetary and credit controls for anti-inflation purposes -- is that the use of this plan might upset the present state of high production and over-full employment and induce severe deflation and depression. The object of the plan is not to bring on deflation, but to minimize the deflation that is inevitable if we follow a let-nature-take-its-course policy.

The Board recognizes that the proposal is no panacea and that there would be some risks in its use. But it would be an important restraint available to be used, and to be used only, in the event of continued inflationary banking developments. Any anti-inflationary program involves some risk of precipitating a downturn and readjustment in business conditions. It would have been better to have had the power available for use earlier. Had the Reserve System been given the additional power that was recommended in the special report in 1940, it would no doubt have used it in view of developments during and since the war.

There is some feeling within the Reserve System that it will be held responsible for deflation if even the mildest use of this requirement should happen to coincide with a deflationary readjustment. It is because of this possibility that the Board is not eager to have the grave responsibility for using the authority. Nevertheless, the Board feels that the System should not shrink from bearing its share of responsibility for restraint on further inflationary developments in the credit field.

Is the special reserve plan strong enough to accomplish its expressed purposes?

We have been at pains to draw a plan that would be moderate and equitable and at the same time capable, when applied in conjunction with other monetary and fiscal policies, of accomplishing the purpose of restraining further inflationary expansion of bank credit. This is the sole objective of the plan. We think the authority would prove adequate for the purpose in view.

It would immobilize, at the maximum, about one-half of the wartime growth in bank holdings of Government securities which in turn equals about one-half of the total deposits of commercial banks. Since the immobilization of this volume of Government securities would greatly reduce the banks' available secondary reserves, which they now feel free to draw upon, the plan would certainly make many banks more cautious about seeking or making new loans. It would end aggressive solicitation of new loan business in which a great many banks are actively engaged.

Another source of pressure on the banks that would result from the plan is that most of the banks would have to sell higher-rate issues from their holdings of Government securities in order to expand loans and at the same time maintain reserve positions. This would be even more effective, from the standpoint of restraining banks, than would a rise in the discount rate.

It would have this effect without causing a rise in interest rates on short-term Government securities. Thus, the proposed measure would be another step in a program of keeping the banks under constant pressure to restrain further credit expansion. It would not force liquidation or reduction in total bank credit outstanding. It would discourage expansion.

Can the plan be effective without permitting or encouraging a rise in interest rates?

Some bankers and others seem to believe that the only effective mechanism for the restraint of inflationary bank credit is a rise in the general level of interest rates. We doubt whether a reasonable rise in short-term interest rates under present conditions of business profitability would deter borrowers. We do not believe it would effectively deter lenders. Our plan places the restraint primarily on the lender. However, to the extent that the interest rate mechanism can have some effect, the Board's plan would not interfere with it. Any increased cost resulting from the plan would be borne by private borrowers who are increasing their indebtedness, and not by the Government which is reducing its indebtedness. This is the only reasonable solution to the interest rate problem. A general rise in interest rates high enough to halt the current inflationary expansion of bank credit would not only entail large added costs to the Government but would have a disastrous effect upon the Government bond market.

RATIOS OF AVAILABLE SPECIAL RESERVE ASSETS AND SHORT-TERM TREASURY BONDS TO GROSS DEMAND DEPOSITS, ALL INSURED COMMERCIAL BANKS, JUNE 30, 1947

	Percentage of gross demand deposits						
	Treasury bills, certificates, and notes	Excess cash assets[a/]	Total special reserve assets	Deficiency or excess of special reserve assets if requirements are: 25% of demand and 10% of time deposits	Deficiency or excess of special reserve assets if requirements are: 10% of demand and 4% of time deposits	Treasury bonds due or callable[b/]: Within 1 year	Treasury bonds due or callable[b/]: Within 1-5 years
Central reserve city member banks							
New York	8.9	6.8	15.7	- 9.9	+ 5.5	5.7	27.8
Chicago	12.0	5.9	17.9	- 8.8	+ 7.2	4.2	23.4
Reserve city member banks							
Boston	10.3	7.1	17.5	- 8.6	+ 7.1	5.1	18.3
New York	9.3	9.4	18.7	-11.8	+ 6.5	3.5	31.7
Philadelphia	6.7	8.3	14.9	-11.3	+ 4.4	1.5	22.6
Cleveland	8.0	6.4	14.4	-14.2	+ 3.0	7.1	33.7
Richmond	12.9	7.4	20.3	- 7.0	+ 9.4	2.5	32.5
Atlanta	14.4	8.7	23.2	- 3.9	+12.3	3.5	20.0
Chicago	20.6	7.1	27.7	- 2.7	+15.5	5.9	36.9
St. Louis	10.3	6.3	16.6	-10.2	+ 5.9	5.1	24.2
Minneapolis	8.8	7.3	16.1	-10.7	+ 5.4	3.7	28.0
Kansas City	16.8	6.0	22.7	- 3.7	+12.2	4.8	19.1
Dallas	13.3	6.1	19.4	- 7.1	+ 8.8	2.2	18.4
San Francisco	22.9	7.6	30.5	- .9	+17.9	6.1	31.3
Total	15.2	7.2	22.4	- 6.1	+11.0	4.9	27.8
Country member banks							
Boston	12.6	6.4	18.9	-11.1	+ 6.9	5.0	37.3
New York	12.7	9.3	21.9	-11.5	+ 8.6	4.3	45.7
Philadelphia	18.7	10.1	28.8	- 4.4	+15.5	5.0	41.4
Cleveland	17.8	11.1	28.9	- 3.5	+15.9	4.8	40.2
Richmond	17.0	8.5	25.5	- 3.9	+13.8	4.3	31.8
Atlanta	19.7	5.1	24.8	- 3.3	+13.6	3.9	25.0
Chicago	21.6	10.5	32.1	+ .6	+19.5	5.9	41.8
St. Louis	21.7	3.8	25.5	- 3.2	+14.0	4.0	28.7
Minneapolis	23.8	6.4	30.2	- .3	+18.0	7.3	39.8
Kansas City	26.1	9.6	35.8	+ 9.3	+25.2	3.2	18.8
Dallas	21.3	11.1	32.4	+ 6.6	+22.1	2.9	16.7
San Francisco	17.6	7.9	25.5	- 4.9	+13.3	6.9	33.9
Total	18.8	8.6	27.4	- 2.8	+15.3	4.7	34.3

(Continued on next page)

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				25% of demand and 10% of time deposits	10% of demand and 4% of time deposits	Within 1 year	Within 1-5 years
Nonmember insured commercial banks							
Boston	19.2	1.2	20.3	-15.8	+ 5.9	5.6	41.5
New York	15.1	1.7	16.8	-16.2	+ 3.6	4.5	39.9
Philadelphia	20.9	.3	21.2	-11.1	+ 8.3	3.8	35.6
Cleveland	22.0	4.8	26.8	- 6.3	+13.5	4.6	37.6
Richmond	20.4	.2	20.6	- 9.2	+ 8.7	5.8	29.5
Atlanta	25.2	6.8	32.0	+ 3.8	+20.7	3.0	22.9
Chicago	29.0	5.9	34.9	+ 3.1	+22.2	4.6	39.8
St. Louis	25.0	4.7	29.7	+ 2.7	+18.9	2.2	22.5
Minneapolis	39.6	3.9	43.5	+12.8	+31.2	6.4	32.5
Kansas City	28.0	7.3	35.3	+ 8.6	+24.6	2.9	20.5
Dallas	16.5	10.4	27.0	+ .8	+16.5	.9	18.3
San Francisco	19.6	.6	20.1	-16.6	+ 5.5	7.7	39.3
Total	24.7	4.4	29.1	- 1.3	+16.9	4.2	31.0

a/ Total of (1) balances with Federal Reserve Banks, (2) excess of demand balances due from over demand deposits due to banks in United States, (3) coin and currency, and (4) cash items in process of collection, less (5) the sum of 20 per cent of demand deposits and 6 per cent of time deposits.

b/ These ratios are based on estimated holdings of such Treasury bonds.

STATEMENT BY CHAIRMAN ECCLES
AS RESULT OF CONFERENCE WITH SECRETARY SNYDER

December 10, 1947.

In view of the fact that some of the press has emphasized a difference in viewpoint between Secretary Snyder and myself in regard to the Board's so-called special reserve proposal, I would like to take this opportunity to clarify the record. I have discussed the matter with the Secretary. The fact is that the area of agreement between us is much more complete than has been represented. Such difference as exists is in evaluating the degree of restraint on inflationary expansion of bank credit that would be exerted by the special reserve requirement. He has expressed to this Committee some doubt as to its effectiveness. I am more sanguine about it. We both feel that whether the special reserve is needed at all or whether some stronger measure of restraint may be needed next year depends on factors which cannot be determined in advance with certainty at this time. We are in full agreement:

1. That the most effective anti-inflationary measure has been and should continue to be a vigorous fiscal program to insure the largest possible budgetary surplus consistent with the Government's obligations at home and abroad.

2. That coupled with an intensified savings bond campaign, the program accomplishes two vital purposes. To the extent that savings of the public are invested in savings bonds, spendable funds are taken out of the market place at this time of excessive demand and insufficient supply and can be used to pay off maturing debt held by the banking system. Likewise, a budgetary surplus can be used to reduce bank-held debt. Both measures reverse the process by which the money supply was increased during the war and are effective anti-inflationary influences.

3. That the program which the Treasury and the Open Market Committee have been pursuing during the year has been effective and will continue to exert restraint during the next few months, when the Treasury will continue to have a substantial cash balance that can be used to reduce bank-held public debt.

4. That some additional restraint may be expected as a result of the joint statement of Federal and State bank supervisory authorities cautioning banks against overextension and inflationary lending.

5. That the problem will present a different phase when current debt-payment operations are no longer available. If it appears that other restrictive steps are needed, increased reserve requirements or possibly some stronger measure may be necessary.

6. That this will depend on the course of events and in part upon self-imposed restraint by the banking community, which has gained a broader understanding of the problem as a result of discussions before Congress and in the press.

7. That the Board's proposal is not in any sense a substitute for but a supplement to the fiscal program and direct action on other fronts where inflationary forces are generated but cannot be corrected by monetary and fiscal policy alone.

8. That under present and prospective conditions it is essential to maintain the established 2-1/2 per cent rate on long-term marketable Government securities.

9. That restraints should be reinstated on instalment credit.

The area of disagreement, therefore, narrows down to whether the special reserve would be appropriate if additional measures prove necessary to limit the now unrestricted access of the banking system to reserves upon which a multiple expansion of bank credit can be built.

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Likewise, a budgetary surplus can be used to reduce bank-held debt. Both measures reverse the process by which the money supply was increased during the war and are effective anti-inflationary influences.

3. That the program which the Treasury and the Open Market Committee have been pursuing during the year has been effective and will continue to exert restraint during the next few months, when the Treasury will continue to have a substantial cash balance that can be used to reduce bank-held public debt.

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