CREDIT POLICIES

HEARINGS

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CREDIT POLICIES

TUESDAY, APRIL 13, 1948

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

The committee met at 10 a. m., pursuant to call, in the main caucus room, Senate Office Building, Senator Robert A. Taft (chairman), presiding.

Present: Senators Taft (chairman), Flanders, and Watkins; Representatives Rich, Herter, Patman, and Huber.

The Chairman. The committee will come to order.

This is the opening of hearings which the committee wishes to conduct to study the whole question of credit control, particularly the control of bank credit, the maintenance of the interest rate, and the maintenance of the price of Government bonds. We also intend to ask the witnesses something regarding the question of the availability of money for investment, and whether there is a sufficient supply of equity capital as opposed to bank credit.

Mr. Eccles, you are the first witness, and we will be glad to have you proceed.

STATEMENT OF MARRINER S. ECCLES ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, D. C.

Mr. Eccles. Mr. Chairman and members of the committee, when I testified before this committee last November 25, I emphasized that I was speaking only for the Board of Governors of the Federal Reserve System. In presenting a further statement today covering the monetary and credit situation as it has developed in the intervening 4 months, I am again speaking only on behalf of the Board.

We, of course, do not participate in the Government's military or rearmament planning or in the formulation of programs for foreign relief. Accordingly, what the Board has authorized me to say with regard to the impact on our economy of military and relief expenditures is said solely from the standpoint of the implications so far as monetary and credit policies are concerned. We feel that in any effort to deal with monetary and credit problems under the situation now existing, we should clearly recognize the alternatives before us and the economic consequences of expanding military outlays superimposed upon the present large budgets for military purposes and for our program of world aid.

Never in our memories has the world been pervaded by greater fears, confusion, and discouragement, arising chiefly because of the disappointments of the past and the uncertainties of the future. The great hopes we had during the war for achieving a lasting peace in a prosperous world have been steadily diminished because a few ruthless and despotic men hold a sword of Damocles over the heads of free peoples throughout the world. It is difficult, if not impossible, to plan for a rational economic future either at home or abroad while that sword hangs over us.

We think that the prospect of removing the threat by peaceful means will be immeasurably enhanced the sooner we assert our moral and physical power to establish the foundations for peace before we are engulfed by the economic and social problems which grow more menacing the longer the establishment of a firm basis for permanent peace is delayed.

Monetary situation in November: When I last appeared before this committee, the country was faced with rapidly mounting inflationary pressures. The issue then was how to curb inflationary forces by striking directly at the basic cause, namely, an effective demand—composed of spending out of past savings, current income and new credit—in excess of the over-all supply of goods and services. As pointed out in the Board's statement to this committee, correction of inflation at its advanced stand had to be on a broad front; fiscal policy had to be our main reliance; and monetary and credit policy was supplementary to other fundamental actions. The Board felt then, as it feels now, that effective monetary and credit policy would require legislation to provide the Federal Reserve System with new powers that would serve as a partial substitute for those traditional powers which had become largely unusable in view of the huge public debt.

I would like to emphasize there that we say "new powers," and not "increased or greater powers." We speak of new powers, which are only a partial substitution for powers that have formerly been used, those which we call the traditional powers.

The essential monetary fact in the inflationary situation at that time was the amount of liquid purchasing power in the hands of the public, that is, currency, bank deposits and Government securities, aggregating in all about $254,000,000,000, or more than three times the amount held in 1940. This amount of cash or cash equivalent was in large part inherited from the financing of the enormous Federal deficits incurred in preparation for and prosecution of global war. Not only did we have this huge volume of cash or cash equivalent already available last November, but at that time, despite the anti-inflationary influence of the Government's large budgetary surplus, the amount of liquid funds was being rapidly increased as a result of bank credit expansion to finance businesses and individuals as well as state and local governments.

Because of the necessity for protecting the Government's fiscal and debt management position by maintaining an orderly and stable market for Government securities, the Federal Reserve System was then and still is unable to restrain effectively further monetary expansion. The commercial banking system held nearly $70,000,000,000 of Government securities, which were being converted into additional bank reserves through sales to Federal Reserve. In addition, the System was providing reserves to banks by purchasing Government securities sold by nonbank investors. That, of course, was in support of the Government bond market.

The CHAIRMAN. Will you spell out how that works, Mr. Eccles? That is, how banks are provided with reserves by the purchase of

Government securities held by nonbank investors? Will you spell it out so that it is clearer?

Mr. ECCLES. Yes.

If a corporation, or an individual, anyone other than banks, sells securities in the market, and the residual market is the Reserve System, they of course are paid for those securities in Federal Reserve funds. The recipient of the funds puts the money into the bank, and the bank therefore has excess reserves on one side and deposits on the other.

In other words, the Federal Reserve creates the money, that is, reserve money, whenever we purchase securities. When you purchase the securities from other than banks, the seller gets deposits, and the bank of course has excess reserves on the assets side of its ledger to offset the deposits it receives on the liabilities side.

The CHAIRMAN. That assumes that they do not reinvest in other securities.

Mr. ECCLES. Who?

The CHAIRMAN. The people who sell the bonds.

Mr. ECCLES. Well, if they do, then somebody else gets the money and that goes back into the banks in the same way. The only way that you can extinguish additional bank reserves, once created by the Reserve System, is for the Reserve System to sell an amount of Government securities to offset the amount which they purchased or to have the Government, through a budgetary surplus, retire Government securities which the Reserve System holds.

Senator FLANDERS. Is the result the same if the Treasury pays off securities?

Mr. ECCLES. Well, if the Treasury pays off securities out of its surplus funds, that is generally deflationary. Where the Federal Reserve buys securities, that is generally inflationary. It is exactly the opposite.

Senator FLANDERS. Is it deflationary or neutral if the Treasury receives funds from taxation and then pays off its securities? I do not see how that is deflationary. Is that not neutral?

Mr. ECCLES. No, it isn't neutral at all; because as the money goes out of the bank into the Treasury——

Senator FLANDERS. I am not talking about what is bank held, although we will come to that later. I was thinking of what is privately held.

Mr. ECCLES. But the Government doesn't pay off the privately held securities. What the Government does with its surplus funds is to retire the securities that the Federal Reserve owns, so that the money does not return to the banking system. If the Government took tax money that it receives and paid off securities held by taxpayers, then the same amount of money would be returned to the spending stream that was taken away in taxation.

Senator FLANDERS. That is neutral.

Mr. ECCLES. That is neutral.

Senator FLANDERS. What happens, however, if it takes tax money, reducing deposits thereby, and pays off bank-held securities?

Mr. ECCLES. Well, that would be neutral. Because the money that the bank held on deposit for the taxpayer goes to the Government, and the Government, of course, would return that money to the bank. What would happen is that the bank's deposit would be diminished when the tax was paid. An asset equal to that amount, of course, would be reacquired when the money is returned.

But what really happens as a practical matter when the tax money is drawn out of the banks? The banks are put under pressure to meet that withdrawal, and therefore they have to sell Government securities at the time the tax money is drawn out. If money is not returned to them by the Government as fast as it is being drawn out, then the banking system has to sell securities to meet the withdrawal of tax money. The Federal Reserve, of course, buys those securities from the banking system. Then the Government pays off securities held by the Federal Reserve.

The CHAIRMAN. Is not the net result, though, of the whole business more or less neutral? That is to say, you take a certain amount of taxes out of the banks. You thereby reduce their deposits. After the process is finished, they have replaced their bonds with cash. They have paid off their deposits.

Mr. ECCLES. That is not quite correct. The process is a reversal of war financing.

During the war period the banks bought Governments and created deposits. That is what is called deficit financing, done through the banking system. When there is a budgetary surplus and the funds are used to pay off the banks, then you have reversed the process. You extinguish the money created, and you likewise extinguish a like amount of the assets that the banks hold in the form of Government bonds. So that it is a reversal of deficit financing, which is inflationary. Therefore, it is equally as deflationary on the money system as it is inflationary during——

The CHAIRMAN. I do not see why it is deflationary at all. I could see why the drawing of deposits out is deflationary. But when you get all through, the bank has 100,000 less assets, we will say, and 100 less deposits.

Mr. ECCLES. That is deflationary. There is that much less money in the money system, just the same as budgetary financing is inflationary, because you create new money through the banking system when you finance the deficit, and you extinguish that money when you have a budgetary surplus.

The CHAIRMAN. Do they not actually have more money that you lend by reason of the fact that, although the assets are not turned into cash, you can turn them into cash?

Mr. ECCLES. But the point is that the banks are less willing to expand credit when they are deficient in their required reserve and find it necessary to sell or liquidate some of their earning assets. When the banks have a deficiency in their reserves, which they do as their deposits are drawn out in taxes, they must either collect loans or sell Governments or borrow from the Federal Reserve. Therefore, they are under pressure.

The CHAIRMAN. Now, they can sell Governments. In fact, the very hypothesis is that the Federal Government is paying the Governments off, so they replace their Governments with cash.

Mr. ECCLES. No; they do not replace them, because the Government uses its surplus cash to retire securities held by the Reserve System.

Representative HERTER. In one case the bank had both the bond and the cash; in the second case, it had only the cash. When it had both the bond and the cash, the bond becomes then an asset that they can discount at the bank, and again re-create credit. If you retire the bond, it becomes a deflationary operation.

Mr. ECCLES. But you see what happens: As the money is drawn out of the banks, in order to meet the withdrawal, the banks must sell something or collect a loan or borrow in order to meet the tax withdrawal.

The CHAIRMAN. Having done that, are they not just where they were when they began?

Mr. ECCLES. That is right. But when you do that, it is strongly deflationary. If you kept the process up long enough, instead of having, as you have today, 170 billions of cash and deposits, you would go back to the 66 billions we had before the war.

The CHAIRMAN. But as long as they have 70 billions of bonds, I do not see why it is deflationary. They turn it into cash, and they are exactly where they were before.

Mr. ECCLES. That is exactly why we proposed the special reserve before, and why we talk about reserve requirements; because of the ease with which the banks can meet current credit demands.

There is no problem at all of the banks meeting the withdrawal demands or the credit demands, because of the fact that they have this large amount of Government bonds that is readily convertible into reserves, upon which a multiple credit expansion can take place.

Senator FLANDERS. Mr. Eccles, as a project of adult education for the junior Senator from Vermont, I wish it were possible to put in balance-sheet form at the end of each transaction what happens in a bank statement when, in the process of deficit financing, banks acquire bonds, what happens when they let them go, how it affects reserves, how it affects loan capacity, and so on.

Now, my reason for wanting to see this in a single sheet that I can hold in my hand and look at the figures, instead of listening to dissertations, is this:

Out at the meeting of the American Economic Association in Chicago last December, I listened to dissertations. And I came out very much confused.

Just as an onlooker, not knowing all of the rules of the game, I judged at the time that the decision, perhaps on points, lay with those who felt that there was no automatic deflationary effect to the retirement of bank-held bonds; which completely reversed the automatic inflationary effect of acquirement by the banks of bonds in the process of deficit financing.

In other words, it was not completely the reverse.

And I wonder if it would not be possible for you to prepare and insert in the record at a later date these processes of acquiring and disacquiring Government bonds by the banks and its effect on the bank statement, on its ability to loan; its effect on reserves, and its ability to loan. I would rather see it in figures than in a mass of words.

Mr. ECCLES. I think that it possibly can be done.

Or course, to understand the process of creating money through the banking system, one first must understand the principles of accounting and likewise the principles of central banking. That becomes basic. And it really isn't simple. One can be very easily misled. It is a subject that requires study and concentration, and especially when you think in terms of 15,000 banks.

If you would think in terms of 1 bank with 15,000 branches, then the process becomes more easily understood. But it becomes extremely confused when you consider it from the standpoint of the State nonmember banks which carry reserves with Reserve city banks. And when you consider, in addition, in connection with the three types of member banks, it becomes quite confusing because of the different reserve requirements and the effects of different reserve requirements of member and nonmember banks.

If I may proceed with my statement, perhaps some clarification will come out of later discussion.

The CHAIRMAN. I would like to have the same thing Mr. Flanders does. But I think I understand the inflationary process, although it seems to me there is quite a difference of opinion in the reports I have read on this deflationary effect, the paying off of bonds in the hands of the banks.

I would like to see just what does happen when the taxes are drawn out and then when the bonds are sold or paid off. I think such a thing might be helpful.

Mr. ECCLES. Of course, how do you reverse the inflationary process? Certainly we know that financing of budgetary deficits through the banking system creates new deposits, just like any other form of credit creates deposits. If loans are being paid by one group of our citizens as fast as loans are being made by another group, there is no change in the total deposits.

But to the extent that all credit, including Government credit, is expanded by the banking system, you create new deposits. And just to the extent that credit is contracted, public as well as private credit, by the banking system, you are reversing the process and you are extinguishing deposits.

The CHAIRMAN. On the other hand, the bank has loaned a lot of money to the Government. The Government comes in and pays it off, and they take the money and loan it to somebody else. I don't see anything deflationary about that.

Mr. ECCLES. But they don't pay it to somebody else when the Government retires debt held by the Reserve banks. The money disappears. It never gets back.

The CHAIRMAN. But I am suggesting that, as to the mere fact that they have the additional money, and the Government pays off and turns around and lends to somebody else, there is not anything particularly deflationary about that.

Mr. ECCLES. What happens when the Government collects more money in taxes than it spends; that is, when it has a budgetary surplus? That money, that surplus money, actually, to the extent that it is used to pay off the Government bonds that the Federal Reserve System has acquired, is not returned to the spending stream, and it actually extinguishes an amount of deposits equal to the liquidation of that credit. The exact opposite would be the case if there was a budgetary deficit and the banks financed the deficit.

A budget surplus with retirement of Federal Reserve-held debt is a direct and complete reversal of deficit financing through the banks, and it extinguishes the same amount of money.

Representative HERTER. Following that same line of reasoning you mentioned a moment ago, the support of the bonds by the Federal Reserve; if the Federal Reserve has to support the bond market and has to go in and buy in order to hold the levels up, that becomes in itself an inflationary process, does it not?

Mr. ECCLES. That is correct. It makes it very easy for the banks, as long as they have the large volume of Government bonds which they acquired during their war financing operation, to get Federal funds or Reserve funds. They can get them with great ease. Therefore, it is difficult to put pressures upon the banks to hold down expansion of private bank credit.

Representative HERTER. Well, recently, when the bond market was dropping, did not the Federal Reserve have to put in a good deal to hold the bond market up?

Mr. ECCLES. The Federal Reserve dropped the bond market substantially in December, because we felt that there was no justification for supporting the market at the premium prices which had prevailed. In other words, we felt that there was too much of an inducement, both to the banks and to the nonbank investors who had market bonds to sell those bonds while they could not only get the return of their money, but could get a premium upon them, than would be the case if the premium disappeared.

And in many cases banks had bought Government bonds at a substantial premium. Then, when the Government bond market was permitted to drop, book value actually exceeded market value, because these banks had purchased Governments at considerably higher prices than the support level that we dropped to.

Now, that action deterred to some extent, and I think a very considerable extent, bank selling of Government bonds.

The CHAIRMAN. Will you proceed, then, Mr. Eccles?

Mr. ECCLES. If I may, to get this in the record—I believe I stopped at this point. In addition, the System was providing reserves to banks by purchasing Government securities sold by nonbank investors. Finally, bank reserves were being substantially augmented by a heavy inflow of gold.

In brief, the banks at that time were in a position to supply unlimited amounts of additional credit, and, in the face of strong demands for additional credit from all sources, further rapid monetary expansion was occurring, intensifying existing inflationary pressures. This situation was potentially explosive because production and employment were close to the maximum then possible.

In other words, to merely add to the supply of money when you were using your production and employment to practical capacity only forced up prices. And, of course, that is the difficulty in the various foreign countries today, where the amount of their bank deposits in currency so far exceeds the supply of goods, and where many of them are still operating on unbalanced budgets and creating more money, because the Government deficits that they are running are being financed by the banking system. And that is why you see the terrific inflationary situations that exist in other countries. It is the same process that proceeded here to a very limited extent. But it is exactly the same principle.

Changes since November: Last November we expected some abatement of inflationary pressures in the first quarter of this year. Such a situation developed. It was recognized that there would be a large volume of funds drawn from the banks by business and individuals in order to pay taxes, which would result in a large cash surplus available to reduce the public debt.

It was also recognized that the existing and contemplated program of monetary and credit policy would have some restrictive effect. The program—that is, this contemplated program, which was carried out—included the statement by the bank supervisory agencies urging the banks to be more restrictive, the lowering of Federal Reserve support levels for Government securities late in December, a slight rise in rediscount rates early in January, and some increase in reserve requirements for banks in New York and Chicago in February.

The banking fraternity, recognizing the dangers in rapidly expanding bank credit and the need for restraint, undertook a Nation-wide educational program to bring about restriction by voluntary means. Finally, there was a widespread belief that the supply of goods in many fields was gradually catching up with deferred demands and that favorable crop developments would combine to lessen inflationary pressures by the spring of this year. That is what you would call a psychological effect.

Monetary developments since November have accorded generally with expectations held at that time. Fiscal and monetary operations together effectively offset factors increasing bank reserves during the period; that is, during this 4 months' period that we had some inflationary factors. And here is what they were: the inflow of gold, the return of currency from circulation—which has amounted to about $1,200,000,000 from its peak in December, and which, of course, adds to deposits of banks and to excess reserves—and purchases by the Federal Reserve of Government securities from nonbank investors.

Representative Rich. May I ask a question right there? Was that paper?

Mr. Eccles. Yes; that was paper currency. That is the currency in circulation, which decreased about $1,200,000,000 from its peak, in December.

Of course, it always goes up prior to the Christmas holiday season. There is always a seasonal drop in the volume of currency in the first quarter of the year, but the seasonal drop this year has been considerably more than normal.

Representative Rich. Was there any part of that, any great part of that, in coin?

Mr. Eccles. No; that wouldn't amount to much. The coin in circulation is a very small factor. It is bills.

To continue with my statement, these inflationary factors include the inflow of gold, return of currency from circulation, and purchase by the Federal Reserve of Government securities from nonbank investors. These factors all added to the reserves of the bank. However, they were more than offset by the fiscal and monetary operations during that same quarter. Here is what they were.

During the 4-month period December through March the Federal Reserve purchased 8.6 billion dollars of Government securities—which will give you some idea of the size of our operations—largely bonds, and sold in the market 6.3 billion dollars of securities, chiefly bills and certificates. That was because we dropped the Government bond market, and there was for a time fear that the price of longer term securities would go lower, therefore, they were being sold and replaced to some extent with short securities.

The Government retired $3,900,000,000 of its securities held by the Federal Reserve. That was the budgetary surplus. The net result of these operations was to reduce the Federal Reserve holdings by $1,600,000,000, and thus to keep the bank reserve positions under pressure during this period.

Now, $1,600,000,000 for that period as a reduction in total Federal Reserve holdings during that period was a very large amount. In other words, if we bought $1,600,000,000 more securities from the banks than we sold, that would give the banks $1,600,000,000 of reserves, upon which you could expand $10,000,000,000 of credit. We contracted enough Federal Reserve funds in that 4-month period to support the $10,000,000,000 of bank credit. That is what $1,600,000,000 amounts to.

The combined effect on the money supply of Treasury and Federal Reserve operations, which were only made possible by the large budgetary surplus, was strongly anti-inflationary. The money supply was contracted by nearly $4,000,000,000. Commercial bank loan expansion was sharply curtailed, partly reflecting fiscal and monetary developments, and partly reflecting the effectiveness of warnings by banking supervisors and the success of the bankers' own program of voluntary restraint, and partly reflecting the usual seasonal slack in business loan demand during the first quarter. There was an expansion totaling only about $700,000,000 of bank credit during the entire quarter; which, of course, was a very great slackening compared with what was happening last fall when bank credit was expanding at the rate of about a billion and a half a month.

Concurrently with these developments, the world crop outlook has become more promising, and prices of farm products and foods have declined. In addition, productive activity generally has held close to maximum levels. These developments have exerted an anti-inflationary influence.

Prospective monetary and credit situation: Notwithstanding these salutary developments, it cannot be said that inflationary dangers have been removed. Farm prices, though lower than they were, still continue firm, even though at present levels they are much higher relatively than prices of most other commodities.

Current and backlog demands for many goods continue to be very strong. Prices of industrial products, wages, rents, transportation, and some other services, are still advancing. The money supply, though contracted by an estimated $4,000,000,000, remains excessive in relation to the total product. Public holdings of cash or cash equivalent available for spending are nearly as large as last fall—$250,000,000,000, compared with $254,000,000,000—and continue to be broadly distributed among holders.

The cash equivalent, of course, is the Government securities held outside of the banks. Commercial banks, though obliged to sell some securities to offset shrinking deposits during this last quarter period, still hold $66,000,000,000 of Government securities, which are readily convertible at the bank's discretion into reserves. Upon these reserves, a 6 to 1 expansion of bank credit and deposits can be built. To the extent that the monetary gold stock is increased and Government securities are sold to the Federal Reserve by nonbank investors, still more reserves would be created. These additional reserves could also support an inflationary 6 to 1 expansion of bank credit.

On the basis of the monetary situation alone, there would still be a dangerous inflationary potential, even if no further impetus were given to inflationary pressures by other forces. However, upward pressures are now in prospect as a result of several important new factors. One of these is the tax reduction bill. This bill will add about $5,000,000,000 to the purchasing power of the public and take away a like amount from Federal revenues in the next fiscal year.

The international financial obligations which we have now accepted are another factor likely to add many billions to Government expenditures in the future. The expanding program of military preparedness will further increase the budget burden for next year and future years by still more billions. Stemming from these developments, on top of existing inflationary conditions, is a rapidly changing public psychology with respect to the inflationary outlook.

Businesses and consumers will be more disposed to use existing liquid resources, and to expand their borrowings to finance current expenditures. The prospect is that the demand for new financing, aside from Government requirements, will exceed the supply of available savings. This would mean that many in need of financing will turn to the banks for credit. A growth in the total volume of bank credit and money under such a situation can only add to inflationary pressures. Moreover, these pressures would be aggravated if the demands of the defense and foreign-aid programs for goods which are already in short supply further reduce the quantities available to the public.

The Government's fiscal operations for the balance of the calendar year 1948—that is, the last three quarters—are likely to show a budgetary deficit, which would eliminate the only remaining important anti-inflationary influence. During the last three quarters of the year, it is estimated that the budgetary deficit may exceed $3,000,000,000. You will note, in parentheses, in the statement, this observation:

In view of large tax receipts in the first quarter of 1949, however, there may be a small budgetary surplus for the 12-month period beginning with April 1 of this year.

The CHAIRMAN. This, of course, is highly conjectural on a lot of things.

Mr. ECCLES. Of course, you can't do other than make your estimates based on the known factors. It is, we admit, difficult to see very far into the future under these conditions. But we feel that the conditions are not likely to be more favorable than we anticipate. They could be less favorable. I think that the statement here is a conservative one, and does not undertake to exaggerate the possibilities.

Representative RICH. Is not the great question just what Congress is going to do between now and the end of the fiscal year in making commitments?

Mr. ECCLES. That, of course, is the basic question insofar as the budget picture is concerned.

Representative RICH. And you have already figured now that with the commitments that have already been made and passed into law, you are going to be three billions in the red.

Mr. ECCLES. Well, that is with some military expansion.

Representative RICH. You have given credit for some?

Mr. ECCLES. That is right.

Representative RICH. But you do not know what the ultimate amount is going to be. I guess nobody does.

Mr. ECCLES. That is right. We have the estimate for the next fiscal year, the 1949 fiscal year, of revenues, based on full production at approximately these price levels, and the tax revenues on that basis, together with the estimated expenditures.

The CHAIRMAN. Mr. Eccles, the first 9 months of this fiscal year there was a budget surplus of up to $8,000,000,000.

Mr. ECCLES. Or thereabouts.

The CHAIRMAN. Somewhere near eight. Now, of that eight billion dollars or so, practically all but $1,000,000,000 came in the first quarter of the year. Is that not correct?

Mr. ECCLES. I think most of it certainly did. There may have been more than a billion in the other quarters.

The CHAIRMAN. And in your estimate here, about a deficit of $3,000-000,000, you are taking the 9 months beginning the first of April, to the end of the year, and leaving out the first quarter, which was the lucrative quarter?

Mr. ECCLES. But, you see, the inflationary impact comes during the next 9 months. And that is a period in which the banks will be under no pressure whatever, but it will be a period when the Government may actually have to give reserves to the banking system. So the point that I will make here is to show what we have ahead of us for the next 9 months.

Now, it is true that the following 3 months, in the first of the year, will be likely mildly deflationary, if you get the budget surplus during that period that is contemplated.

But in the interim period, the next 9 months, during the period when we need some restraint, we will not have any. That is the point that I am making, because I am going to argue why we should get some more credit controls here in the picture, and that is the immediate problem.

The CHAIRMAN. I just wanted to make it clear that when you are talking about a deficit, you are talking about the 9 months which may produce a deficit even this year, and which consisted this year of a surplus of eight billion.

Mr. ECCLES. Yes; but I also pointed out what would happen for the year.

The CHAIRMAN. I did not question the accuracy, Mr. Eccles. I merely wanted to be sure that the newspapers understood what the basis of it was.

Mr. ECCLES. That is why we we put in parentheses here that for the year as a whole there would likely be a small budgetary surplus. It was to emphasize the 9 months that we were speaking about, where there would be the deficit. During that period, you will not have the anti-inflationary effect of a budgetary surplus.

The CHAIRMAN. Can you give us for the whole year your estimate of receipts? You said you had those estimated. I would just be interested to know what they were. Is that from April 1 to April 1, or the fiscal year?

Mr. ECCLES. The fiscal year.

The CHAIRMAN. The next fiscal year?

Mr. ECCLES. Yes. These are cash budget receipts; 42½.

The CHAIRMAN. Forty-two and a half after the tax reduction?

Mr. ECCLES. Yes.

The CHAIRMAN. Now, in all of these estimates, you, of course, have not taken account of $3,000,000,000 of cash surplus, of money which is taken into the trust funds of the Government and not paid out; so that from an inflationary-deflationary standpoint, you have got to add $3,000,000,000 to any surplus you have, or deduct that from any deficit that you are talking about.

Mr. ECCLES. Well, we estimate, however, as I will show in this statement, that we recognize what that is. The effect of that is covered.

The CHAIRMAN. In other words, the Government's cash position is about $3,000,000,000 better than the budget position.

Mr. ECCLES. No, we estimate that it will take those receipts, plus the receipts from the sale of savings bonds, to pay off the redemption of savings bonds and to likewise pay for the redemption of other securities held by holders that will not accept refunding. I refer to maturing marketable Government securities. On these, as they mature and refunding issues are offered, there is always a substantial amount that has to be paid in cash.

The CHAIRMAN. I understand. That is what you do with it. But that does not change the Government cash position. If you wish to take the Government's cash budget as against its book budget, you still have to add about $3,000,000,000 for the cash budget; do you not?

Mr. ECCLES. But you see, we take into account the receipts from social-security taxes, and that is largely where the cash surplus comes from. It will take that cash, plus the estimated cash they get from the sale of savings bonds, to pay off the savings bonds that are being redeemed and other securities that fall due that will not be refunded. Therefore, those funds are not available for other expenditures, as I will bring out here.

Now, here it is: It is also estimated that combined sales of savings bonds and other public debt receipts will approximately cover voluntary redemptions of public debt by holders of maturing issues. Well, that is just what I said. That is what our statement means.

The current deficit will need to be financed by drawing on Treasury deposits which have been built up by tax receipts during recent weeks, or by borrowing in the market. Under these circumstances there can be no net retirement of Government securities held by the Federal Reserve System; that is, during this 9-month period. To the extent that the Treasury may need to borrow new money, it probably will have to be obtained largely from the banking system.

Representative HERTER. Is there not a drive being started very shortly in that connection?

Mr. ECCLES. It is already under way. But we do not estimate that that drive is going to bring in more than enough revenue to offset the redemptions.

Representative PATMAN. I notice an effort is being made to reduce the interest on postal savings from 2 to 1 percent. That will not be helpful in your savings drive; will it, Mr. Eccles?

Mr. ECCLES. Well, I do not think that the savings drive is for postal savings. The savings drive, of course, is largely for the sale of E bonds, which yield 2.9; and the postal savings mechanism, I think, is not a comparable or a competitive savings operation with the sale of Government bonds.

The bankers, of course, feel that the Government pays 2 percent, which is what they paid when savings money was worth 4; that is, when the banks used to pay 4 on savings money. The Government still pays 2. Now, the banking system pays anywhere from 1 to 1½.

Very few banks can pay 2 for savings funds. The banks feel, therefore, that the Government is in competition, and paying for savings funds more than the banks can afford to pay; and that the Government should reduce the rate that it pays on savings payable on demand.

Postal savings are really demand money.

Representative PATMAN. I understand the arguments for it. But the fact remains that if you put your money into postal savings, it has the same effect as putting it in bonds; does it not?

Mr. ECCLES. Oh, sure. The Government puts the postal savings in bonds.

Representative PATMAN. Well, why discourage the people about that? A lot of people will put their money in postal savings that will not put it in banks, as evidenced by the fact that postal savings have increased up to about $3,000,000,000; have they not?

Mr. ECCLES. I don't know what the postal savings amount to.

Representative PATMAN. I think it is proabbly near three. That being true, if you reduced the interest rate to 1 percent, you will probably encourage a lot of people to take that money out and put it in a spending stream, which would be inflationary.

Mr. ECCLES. It is just a question of the competition of Government with private interests. That is what the issue is.

Representative PATMAN. But that has nothing to do with the savings, the way I view it. Of course, that is a good argument for the banks.

Mr. ECCLES. Of course, if the Government wants more savings, they could pay 3 percent on postal savings.

Representative PATMAN. I am not talking about increasing them, of course.

Mr. ECCLES. I think it would have very little effect. I think that you would find that people put money in postal savings, not because of the 2 percent interest. I think, for example, that there are a great many foreigners who have put their money with the Government, because they just feel that is the safe place to put it. And I think it is the principal they are interested in more than the return.

I don't believe that the rate would really be as effective in changing the amount of savings as a lot of people think. I don't believe the banks would get much of that money, even if the rate were less. I think they might get a little, but I do not believe it would affect it. Because certainly 2 percent for savings that can be drawn out on demand is a very high rate under present conditions, and you would think that postal savings would have grown far beyond anything that they have.

Representative PATMAN. But the Federal Reserve Board made the conditions, did it not? Did not the Federal Reserve Board fix the rate of interest that the banks can pay on time deposits?

Mr. ECCLES. All we do is to fix the maximum.

Representative PATMAN. And you fixed it low, did you not?

Mr. ECCLES. No.

Representative PATMAN. How low is it?

Mr. ECCLES. Two and a half.

Representative PATMAN. Two and a half percent.

Mr. ECCLES. But nobody is paying it. The rate that the Federal Reserve has fixed is possibly higher than any bank in this country pays.

Now, one of the reasons that we did not put it lower—I think we would have put it down to 2 percent some time ago—was because the Federal Deposit Insurance, which had the fixing of the rate on the nonmember banks, would not go below 2½ percent, and therefore, because of that situation, the Federal Reserve felt they were in no position to reduce the rate below two and a half.

I think it is an academic rate. It is entirely meaningless in relationship to the rate that could safely be paid.

Representative Rich. You stated that the banks, for savings, were unable to pay more than one or one and a half percent?

Mr. Eccles. That is right; the commercial banks.

Representative Rich. The commercial banks?

Mr. Eccles. That is right.

Representative Rich. If the Government pays 2 percent, how can they afford to pay 2 percent, if the banks are unable to pay more than 1½ percent?

Mr. Eccles. The banks pay taxes and have a lot of expense to absorb, and the Government does not.

Representative Rich. The Government has no expense?

Mr. Eccles. Not in postal savings. The postal savings money is immediately invested in Governments.

Representative Rich. The Government pays the clerk for looking after that.

Mr. Eccles. Well, it is paid by the Post Office.

Representative Rich. And the Post Office is $400,000,000 in debt. So the Government is paying for that, and they are going in the red.

Mr. Eccles. Well, but the Government is paying a lot of money too for war bond drives, in order to sell money to the public.

Representative Rich. I still contend that the Government has expense in handling the postal savings.

Mr. Eccles. I suppose they do. I suppose they have some expense, of course. But the fact that it is done through the Post Office is important. They don't have the rent to pay. They don't have the same expenses that the banks have to pay.

Representative Rich. I think they do. I think they have the same expense. In fact, I think the Federal Government has a whole lot more expense than the banks when it comes right down to it.

Mr. Eccles. Yes, but not for operating the postal savings system,

Representative Rich. Well, that is the Government's way of keeping books, and they have been used to that, and the public pays the bill.

Mr. Eccles. All I am saying is the no bank can pay 2 percent, certainly the way the money market has been over a long period of years, for savings funds. Because when they get 1 percent on Treasury bills, and they get one and an eighth, on Treasury certificates, the highest rate they get is the 2 percent on the Treasury eligible bonds. There are a few prewar bonds that were issued at 2½ percent, but they are selling at such premium that the return is possibly around 2 percent for very long-term bonds. And for commercial paper, the rate is 1¾.

True, there are some loans and investments that banks can get that are above two, but I would say that the average rate, certainly of the commercial banks in the reserve cities would not average 2 percent on their entire portfolio.

Representative PATMAN. But that is on a basis of 6 to 1 expansion too, is it not, Mr. Eccles?

Mr. ECCLES. Yes, but why would they want to pay 2 percent for money in order to be loaned it at 2 percent? They have to carry a reserve against those deposits.

Representative PATMAN. They would loan it six times.

Mr. ECCLES. No, they don't. Not that bank. It is the banking system.

Representative PATMAN. I mean the banking system.

Mr. ECCLES. But the banking system isn't one bank.

Representative RICH. I quite agree with you that the banks cannot pay more than 1½ percent on their savings under present-day conditions, and, for the same reason, the Federal Government cannot afford to do it. Because it shows from the handling of it under the Post Office Department, that all branches of the Post Office Department except the first-class mail have gone into the red.

Mr. ECCLES. I think it is contended that the Government should pay less on postal savings. That is the point that Congressman Patman is making here.

Representative RICH. What do you think?

Mr. ECCLES. I think there is some merit in reducing that rate. I think that the 2 percent has been paid over a long period of years, and there has been a very great change in the interest rate on money over that period. But I think that is a little aside from our subject today.

The CHAIRMAN. All right, then. Will you proceed with your statement?

Mr. ECCLES. I said here that to the extent that the Treasury may need to borrow new money, it probably will have to be obtained largely from the banking system.

During the next few months, Treasury use of accumulated balances with the Federal Reserve banks will add to bank reserves.

Now, let me explain that.

Some of the tax money beyond what the Government has spent has been deposited with the Reserve banks and the balances of the Government with the Federal Reserve banks have been built up. Therefore it is unavailable as reserves to the private banks. If the Treasury was not going to need those balances, it would use that money to pay off its Government securities held by the Reserve banks.

But the Treasury is going to need all of those balances, and they will be drawn down. They are not very large; I think at this time they are a little over a billion dollars. They were large earlier, but the Treasury has been using the balances as they came into the Federal Reserve to pay off the securities held by the Reserve banks. That is why there was the reduction of securities held by the Reserve banks that I spoke of earlier. From this point on, the balances will no longer be used to retire Government debt held by the Reserve banks, but will be disbursed into the spending stream, and will become excess reserves to the banking system. That is the point I want to make here: that these balances will add to bank reserves as they are spent. The bank reserves will also continue to be augmented by the inflow of gold, and possibly by further Federal Reserve purchases of Government securities from holders wanting funds for other uses. These last two factors may operate for a long time in the future. As long as we have to support the Government market and nonbank investors find other markets for their funds, which, under inflationary conditions they do——

Representative HERTER. When you say you have to, is that not a matter of decision with you?

Mr. ECCLES. It is a matter of decision by the Government, too. It is a matter of decision by the Federal Reserve and also the Treasury. We feel, if we are going to have to manage the public debt, you have to manage the market, and the failure to support the Government market would make it, we feel, practically impossible to do the necessary refunding that the Treasury has to do currently.

Representative HERTER. May I ask you there: You speak of its being inflationary when you buy all of these long-term Government bonds in order to support the market.

Mr. ECCLES. That is right. That is the dilemma.

Representative HERTER. And you bought 4 or 5 billions of them. On the other hand, the market is falling off.

Mr. ECCLES. If you raise the interest rate, then you drop the market, and it raises all kinds of serious questions. Of course, that is quite a debate all in itself.

Representative HERTER. But that is a discretionary matter with you. There is nothing statutory as far as that is concerned.

Mr. ECCLES. That is right. It isn't statutory at all. I raised the question before that I wished Congress would indicate that, if they felt we should no longer support the Government market. I felt that Congress should take some responsibility for that.

Representative PATMAN. Suppose you should not support the market, what would happen to these banks, if the bonds were to go below par?

Mr. ECCLES. The difficulty is that you do not know the support price. That is one of the problems you are confronted with. And that raises the critical problems of refunding operations in connection with public debt. It has implications that are very far reaching. We have given lots of thought to the problem, and we have studied it from various angles.

The people in the Reserve System, not only the Board, but the Reserve bank people, as well as the Board people, are unanimous, I think, in feeling that, taking the matter on balance—with the public debt the size that it is, so much larger than the entire private debt, in fact equal to about 60 percent of all the debt—we must maintain stability of Government securities market and confidence in it. The public have taken quite a drubbing already on the decrease in the purchasing power of the dollar that they put in bonds, and now, to make them take a further decrease, by letting the bonds drop below par would be a very serious step.

I want to make another matter clear: We have never made the statement that we should support all Government securities at par. What we have said is that we should maintain the 2½ percent rate on the long-term bonds. That should be the basic long-term rate.

The short rate should be permitted to fluctuate to the extent that it can be useful. And if the short rate should go up, certainly the very short securities may drop below par. And they have. The Federal Reserve System has never taken the position that every issue of Government bonds should always be redeemable at par; we have taken the position that the 2½ percent rate should be maintained, and shorter term issues could fluctuate as the shorter term rate might fluctuate.

Representative RICH. Let me ask you this: The stability of bonds created by the purchase of them by the Federal Reserve is not any more likely to make for a stable and economic Government than it is if the Congress does not stop the spending because we will be just as bad off in the future, because there will come a time when you cannot stabilize the bonds if they increase the size of our national debt.

Mr. ECCLES. You can stabilize the bonds, but you do not stabilize the purchasing power of the dollar. A dollar could be worth far less than it now is, and the bond could still be supported at par.

Representative RICH. The point is that we are not making for a stable government as long as we keep on with the spending.

Mr. ECCLES. That is right; especially deficit spending.

The CHAIRMAN. Can we get along now?

Mr. ECCLES. I would like to finish this, if I can, without any interruption.

The CHAIRMAN. Fine.

Mr. ECCLES. As I said, these last two factor may operate for a long time in the future; that is, the gold imports adding to the reserves, and the purchase of Government securities from nonbank investors. If the international outlook does not improve, Government deficits may continue, and even increase substantially, and banks may be called upon to purchase additional Government securities. Under these conditions, the Federal Reserve would find it difficult, and perhaps impossible to sell Government securities in order to absorb the bank reserves without seriously unsettling the market for such securities.

Where you have a deficit, and if the banks are required to buy, then, of course, the Federal Reserve is more likely to have to support the market, in other words, to have to buy. Under those circumstances you certainly cannot sell in the market and thus absorb the reserves that gold imports create, or the reserves that are created when the Federal Reserve buys bonds from nonbank investors. That is the point that we make here, namely, that it is very difficult to absorb excess bank reserves in these conditions by reversing our action by selling in the market.

Prospects are, therefore, that in the future gold inflow and Federal Reserve purchases of securities in maintaining an orderly market for long-term Treasury bonds, will further increase bank reserves. Banks would thus be in a position to expand loans and investments for private purposes, and this would mean still more inflationary expansion of the money supply. To restrain such potential expansion, the Federal Reserve would have to take action to absorb an excessive volume of reserves. Two type of measures should be considered:

First, interest rates on short-term Treasury securities and discount rates—that is, the discount rates of the Reserve banks—should be permitted to rise to the extent possible without raising rates on long-term bonds; that is, without raising the long-term 2½ rate; and, second, to the extent that this action is not adequately restrictive, the Federal Reserve should have the power to increase Federal Reserve requirements substantially to cover at least any growth in the total supply of reserves.

The first of these measures which could be adopted by the Federal Reserve and the Treasury without new legislation would be designed to induce banks to purchase short-term Government securities, and to discourage the extension of credit to private borrowers. Policies during the past year have moved in that direction about as fast as is feasible without unduly upsetting the market. There are limits, however, to such a course. Short-term rates probably cannot be raised much more without unsettling the 2½ percent rate for long-term Treasury bonds.

When I say "cannot be raised much more," I am thinking in terms of an eighth of 1 percent, to a maximum, say, of one-quarter. If you made the certificate rate 1¼ that would be raising it an eighth. If you raised it a full quarter, ultimately that would be 1⅜. There may be, under certain conditions, a possibility of going as far as 1½ in a short-term rate, but I certainly can't foresee that now.

Such an action, of course, would tend to induce the banks, when they got reserves, to buy securities from the Federal Reserve; whereas at 1 percent for bills, and 1⅛ for certificates, there is a good deal of pressure on the banks to go out into the market and make loans at higher rates. That creates new money, whereas, if they bought the short-term Governments from us, it wouldn't do so.

Clearly, you can't let the short rate go up to a point where pressure on the long-term rates result, so you have to support the long-term market. The problem is one of maintaining a balance, depending upon the conditions. However, it is doubtful how much any rate that is feasible will deter banks from making loans to private borrowers or purchasing higher-rate securities. In other words, there is a question, even if you went up an eighth or a quarter, as to just what extent that might deter the credit extension. We think it would have some effect, but we can't say that it would be very anti-inflationary, or very restrictive.

Representative HUBER. At that point, Mr. Eccles—during consideration of the tax bill, it was often said that the legislation would provide an incentive for risk capital. Are not the banks bulging now with money? Would you feel that that statement was true?

Mr. ECCLES. You mean the money of their depositors?

Representative HUBER. Well, it would provide an incentive for risk capital.

Mr. ECCLES. What would?

Representative HUBER. The tax reduction bill.

Now, is there not a surplus of money throughout the banks of the nation?

Mr. ECCLES. Yes. I think Senator Taft said he wanted to discuss that a little later. If I can finish this, I would like to say something on that subject in relation to budgetary deficits.

Representative HUBER. I would like to hear you.

The CHAIRMAN. The lack of risk capital is more the unwillingness of people to put their money into that kind of thing. It has nothing to do with the amount of money. They have the money, apparently.

Mr. ECCLES. As to the need for additional powers, I have tried to build up the case here, to show what has happened in the last quarter. And now I point out what may well be the need for additional powers.

NEED FOR ADDITIONAL POWERS

Accordingly, the Board believes that the System should be given authority to increase the reserve requirements of all commercial banks. For the present, this authority should make it possible for the System to require all commercial banks to maintain primary reserves with the Federal Reserve System, amounting to 10 percent of the aggregate demand deposits, and 4 percent of the time deposits, in addition to present requirements. This would give to the Reserve System power to increase bank reserves in the aggregate by a maximum of about $12,000,000,000.

An authority of this amount would enable the System to absorb the reserves that are likely to arise from gold acquisitions, or from necessary System purchases of Government securities sold by nonbank investors over the next few years. In other words, it would enable the System to sterilize the gold imports and reserves created by our support of the Government bond market.

In case banks should persistently follow the practice of selling Government securities to the Federal Reserve in order to expand private credits, notwithstanding higher short-term interest rates and increased primary reserves, as indicated, then the system should be granted supplementary authority to impose a special reserve requirement along the lines proposed by the Board last November. This type of authority may be described as an optional reserve requirement, because it could be held at the option of the individual bank, in specified cash assets, or in short-term Government securities.

The maximum requirement under this plan could properly be limited to 25 percent of the aggregate demand deposits, and 10 percent of the time deposits. To be effective and equitable, it should apply to all commercial banks; that is, the nonmembers, as well as the members. A detailed description and analysis of the Board's special or optional reserve proposal—I say optional because that is a more accurate description of it than special—was submitted to the House Committee on Banking and Currency, and has been published in the Federal Reserve Bulletin.

The CHAIRMAN. I do not quite understand.

Does this 25 percent include the 10 percent?

Mr. ECCLES. No; that is entirely another item. It would have different use, different application.

The CHAIRMAN. You are proposing 10 percent plus 25 percent?

Mr. ECCLES. We are saying that the 10 percent would be the cash reserve requirement, in case the bank should persistently follow the practice of selling Government securities, and so forth, in order to do this, notwithstanding the raising of the short rate, and notwithstanding the increase in the primary reserve requirements.

The CHAIRMAN. Is not your total 10 percent higher than last fall? Last fall I thought you had the 25 percent.

Mr. ECCLES. Now we are suggesting deferring the 25 percent special reserve until we see if the 10 percent primary reserve is adequate.

The CHAIRMAN. So that when you came along with the 25 later, you could absorb, and would not necessarily have to put the whole 25 on top of the 10.

Mr. ECCLES. No; the 10 is strictly a cash reserve, largely for the purpose of sterilizing gold imports and reserves that we would create by the purchase of securities from nonbank investors. But if banks, in spite of that, continued to sell Governments to get reserves for the purpose of making credit expansion, we would need the optional reserve. You see, it depends upon inflationary developments, especially upon the budget picture. As I will bring out later, the possibility of needing the special reserve as an additional authority depends upon conditions, and all we are doing now is pointing out what would seem to be a maximum possibility in the field of monetary and credit policy, to deal with an emergency.

The CHAIRMAN. I was only trying to get clear as to what your proposal was. It is now 14, 20, and 26; and if you add 20 percent, it will be 24, 30, and 36. And then your suggestion is that in some events, you would add 25 percent on top of that?

Mr. ECCLES. Yes, but we would give the banks the option of holding the special reserve in cash or in Government securities.

The CHAIRMAN. That would hardly be in bonds, I take it.

Mr. ECCLES. It could all be in securities, that is, short-term securities, if they wanted to hold it. The whole thing would be in bills and certificates. As a matter of fact, of course, the 25 could include the 10. That is a question of action by the Congress. In other words, if you wanted to give authority to increase the reserve from the 10 to the 25, making it optional to put those reserves in short-term governments, that could be done. That would be a modification.

The CHAIRMAN. All right. Proceed.

Mr. ECCLES. To the extent that it may become necessary to rely upon the banks for any new Government financing operations, the optional reserve requirements would be an especially valuable instrument. And in the case of large-scale deficit financing, it would be essential. In such financing, it would be advisable to make available to banks only short-term securities. Application of the optional reserve requirement would have the effect of immobilizing these securities, so that they could not be used to obtain reserves to pyramid new bank assets upon them on a 6 to 1 ratio. In other words, securities issued in new Treasury financing through banks would be tied to the deposits created by their purchase.

If we had done that in the financing of the last war, we would have avoided a lot of the trouble with which we are now confronted. In other words, if the banks had been limited in their purchase of securities, to short-term securities, and then those securities, at least a portion of them had been required to be held against the deposts they had, you wouldn't have had this freedom which the banks now have to create a multiple credit expansion, leaving the central banking system unable to deal with the situation, so long as it is obliged to support the market. What we are trying to do now, when we propose that requirement, is to go back and to correct some of the mistakes that were made in the form of Government war financing.

Representative RICH. Under those conditions, would you not expect the banks to stabilize the market, then, instead of the Federal Reserve?

Mr. ECCLES. We can only stabilize it through the banks, we have no way of doing it except through the banking system. We have to operate through them.

Representative RICH. You would not expect them, as individuals, to go out and do what you are supposed to do, as the Federal Reserve, would you?

Mr. ECCLES. No. But we stablized the market by buying securities in the market. And we have no way of stopping the banks from selling the securities that they have, and thus creating reserves upon which they can expand $6 worth of credit. That is the point.

Representative RICH. If you had that power, you could do what the banks could.

Mr. ECCLES. We have always had more power than the banks. We have no power now to control the bank credit expansion, and that is the point I want to make.

The special reserve plan would assure a ready market for short-term Governments, and the Treasury would be helped in successfully carrying out both its refunding operations and its deficit financing. These are the important aspects of the proposal, if we get into substantial deficit financing. At the same time, the Federal Reserve would be enabled to exercise some restraint on the money market for private credit. This is the basic merit of the optional reserve plan.

The dominance of public debt in the present credit situation has rendered the system's traditional powers generally unusable for purposes of restraining further inflationary credit expansion. The Reserve Board is not seeking additional power beyond what it formerly possessed; it is merely pointing out that the system has little or no authority to deal with the credit situation as it currently exists, and seems likely to develop.

If the Congress wants the Federal Reserve System to perform the functions for which it was established, the System must have a substitute, or at least a partial substitute for those powers that have become unusable. The Board feels that it would be remiss if it failed to bring this matter to the attention of the Congress.

There is no simple way of holding in check bank credit expansion in excess of essential public and private needs. The problem should be met in a combination of ways—by general credit controls, and in particular areas by selective controls, such, for example, as the reimposition of consumer installment credit regulation, and the continuation of existing margin requirements on stock market credit.

OTHER ANTI-INFLATIONARY ACTIONS

The Congress is currently considering the continuance of easy mortgage credit for housing. Easy mortgage credit is one of the most inflationary factors in the domestic credit picture. At the very most, Government mortgage credit programs at this time should be limited to relatively low-cost housing, particularly for rental housing, and should be accompanied by some restriction on other less essential types of housing. The housing shortage cannot be overcome by increasing the competitive pressures on scarce supplies of materials and manpower. They are the limiting factors on the volume of construction. It is one thing to provide easy credit facilities to encourage special types of residential construction activity under a system of allocations and permits. It is quite another thing to provide such encouragement in a free market already characterized by heavy accumulated demands and by strategic shortages in supply that are likely to be intensified by the defense and world-aid programs.

In restraining inflationary pressures under present and prospective conditions, monetary and credit policies must be combined with fiscal and other governmental policies. The public should be given every possible assurance that the Government will protect the purchasing power of the dollar so that the public would be more willing to defer the satisfaction of wants, particularly for houses and durable goods.

Wherever possible, Government expenditures that will add to pressures on the labor and capital goods markets should be deferred, and State and local governments should be requested likewise to defer nonessential expenditures of this type. There should be early action to close loopholes in our tax laws, and to strengthen the tax collection machinery. If the stage is reached at which Government expenditures again threaten to create large budgetary deficits, then a reimposition of wartime levels of taxation and direct economic controls along the lines proposed by Mr. Baruch, for example, should be undertaken.

Now, you notice, I have said, "If the stage is reached at which Government expenditures again threaten to create large budgetary deficits, then a reimposition of wartime levels of taxation and direct economic controls along the lines proposed by Mr. Baruch, for example, should be undertaken.

If young men are to be drafted into the military forces, then a way should be found to keep men at work in essential industries, and thus prevent the serious inflationary effects brought about by strikes.

The situation now and in 1940: I want to bring out that this reversal of our program, which indicates a substantial expansion, looking to the future of our military, as well as a foreign aid program that we can't see the end of, is a much more difficult program to carry out than would be the case if the situation now was comparable with that of 1940.

The Board believes that any realistic appraisal of the economic outlook from the standpoint of monetary and credit policy must take account of the underlying facts of the international situation.

During the war, there was no doubt about the ultimate victory. the country looked forward confidently to an era of stability and peace following the hostilities. Nearly 3 years after the end of the fighting, however, we seem to be further away from these goals than ever. Our national debt still exceeds $250,000,000,000, or more than five times the prewar levels. Federal budgets have never fell under $37,000,000,000 a year, and we are confronted now with the prospects of an expanding debt and budgets. During the war, we expected the peace to bring an end to these enormous drains on our resources.

Today there is no end point in sight. Threatening as the inflationary potential was at the end of the war, it is worse today. When we embarked upon the defense program in 1940, we had a tremendous slack in the labor force with nearly 12 millions fewer employed than now. We had surpluses of most raw materials, of unused industrial capacity, of housing, of foodstuffs and of countless other things. The impact of our heavy armament expenditures was not inflationary so long as the total demand on our resources did not exceed our capacity. It rapidly became inflationary as civilian purchasing power created by the war expenditures, through deficit financing, began to exceed the available supplies of goods and services.

We held the excess purchasing power fairly well in check while the was was on. We have now seen the consequences of premature removal of the harness of wartime controls. Even the one remaining anti-inflationary force, that is, a large budgetary surplus used to reduce our money supply, is no longer in prospect.

Over-all policy alternatives: On the basis of present trends, we believe that the country, sooner or later, has to choose between three broad alternatives.

First, we can continue on the present course of providing essential foreign aid, and of carrying out a military program on a scale of as yet undetermined size and cost, while at the same time we have no effective checks on the free play of economic forces. That is the certain road, if followed long enough, to a ruinous inflation. Surely no one would seriously contend that we can go on adding more and more pressure in the boiler of inflation without an ultimate explosion. Those who view us with a hostile eye no doubt hope that we will wreck our economy on the shoals of inflation. It would be a cheap way to defeat us.

Secondly, the country could be subjected to a full harness of direct economic controls—for example, allocations, construction permits, rationing, price and wage controls, as well as taxation at higher levels.

Without such a harness, amounting to a regimentation of the economy in peacetime, there is no sure protection against inflationary dangers that may lie ahead. They cannot be successfully combatted by any single means, or on any single front. There is no power that the Board now possesses, or that Congress can give us in the monetary and credit field that would be adequately effective by itself—and I should add there, "under the conditions of large budgetary deficits."

Beyond that, we must ask ourselves whether the public would be willing in peacetime to submit to the sacrifices and rigid restraints of a wartime economy. If our preparedness program calls for a military draft upon our young men, should it not call also for control of the profits arising from that program?

We may well ask for how many years must we maintain enormous and probably expanding military expenditures—and I could add "and world aid." The question is: how long? to what end? and at what consequences to our economy? We do not have the inexhaustible supplies of manpower and resources to support indefinitely, with no end point in sight, programs of the magnitude which we now are shouldering or contemplating.

The CHAIRMAN. "Contemplating" might do. But why the "shouldering"? Your own figures show that you get 42½ billion from present taxes, and you are not going to spend that much.

What is the burden of shouldering, that you cannot go on shouldering if you have to? I would like to cut it down, but what threat is there contained in it?

Mr. ECCLES. I do not think you can do it indefinitely, sir. You have inflationary pressures, as we have pointed out, with what you are already doing, and you have plenty of inflationary dangers even with some budgetary surpluses. With practically no budgetary surpluses, inflationary dangers are very much greater than would otherwise be the case.

The CHAIRMAN. We are no better and no worse off. Maybe it is the exceptional condition, but we are no worse off from an inflationary standpoint than we were in November, when you were here before.

Mr. ECCLES. We do not think that you can go on indefinitely.

The CHAIRMAN. You cannot go on increasing, but when you say "those that you now have," I do not see why you cannot go on indefinitely.

Mr. ECCLES. I don't see how you can, without getting an inflationary development. I think you have got to have some budgetary surpluses in this situation.

Representative RICH. Mr. Eccles, you made this statement in your previous paragraph:

"If our preparedness program calls for a military draft upon our young men, should it not call also for control of the profits arising from that program?"

Then should we not have controls on everything? And then we would have just exactly what Russia has.

Mr. ECCLES. Well, what I am saying is that if you get into a budgetary deficit, if you get into an expanding Military Establishment, due to a world situation, then you certainly do not want an uncontrolled inflation here, which could well result. Therefore, the next thing to do is, as I indicated, have Baruch plan of such controls.

Certainly that would be most difficult in peacetime, and certainly, if we should develop what we call a preparedness program on a scale that would create such deficits—and some people talk of such a program—such controls would become necessary. A preparedness program of that sort means an armament race, and an indefinite expansion, if you are going to be prepared. Preparedness is a relative thing. To be prepared, you have got to be better prepared than the people you are preparing to deal with. That, I think, is one of the discouraging things in the picture today, so far as the American public is concerned.

Representative RICH. When a bill was set up for universal military training, and selective service, and those things were put into effect, then, according to your statement, we have to put regulation on everything.

Mr. ECCLES. I did not mean that by my statement. If that is the way it is interpreted, that is not the way it is meant.

Representative PATMAN. It refers to profits, does it not, Mr. Eccles?

Mr. ECCLES. Yes. Certainly if we are going to carry out a program here, of armament expenditure, and you are going to draft men—I don't know whether you are going to get universal military training or not, but I mean if you do that—certainly there will be substantial profits created or maintained, or that are likely, as a result of large Government expenditures. The question arises as to whether you wouldn't be justified in recapturing some of those profits, as a result of armaments expenditures, and thus improve the budget picture and lessen the inflationary pressures.

Now, that is something for the future. I am not talking about that for the present. I am merely saying that in this statement we are trying to review briefly the past. We are trying to consider the immediate present over the next 9 months. And then we are trying to look beyond the uncertain future as to what some of the problems indicated may well be.

The CHAIRMAN. Mr. Eccles, do you want to finish this morning?

Mr. ECCLES. If I could finish this statement, I would like to do that.

The CHAIRMAN. Then, after that, does the committee want Mr. Eccles to come back for questioning? And if so, when?

Mr. ECCLES. I am available at the pleasure of the committee, either this afternoon or tomorrow, or whenever the committee wants to interrogate me.

Representative PATMAN. He only lacks a page and a half, to finish.

The CHAIRMAN. Yes. But for me, tomorrow morning would be more favorable. However, the House is not in session today so I guess this afternoon would be better.

Mr. ECCLES. That would suit me fine.

The CHAIRMAN. Then when we recess, we will recess until 2:30.

Mr. ECCLES. Thank you.

The CHAIRMAN. One thing, Mr. Eccles, on the question of inflation:

These things seem to be so difficult to predict. People are so likely to be wrong. I never have any great confidence about future things, until at least there is an indication of what is happening?

One thing that everybody seemed to agree on was that the price of meat was going up. I admitted it. But it does not seem to have gone up.

Senator FLANDERS. Mr. Chairman, may I make some remarks about that?

The CHAIRMAN. Certainly.

Senator FLANDERS. In the first place, I think that the proposed legislation and the discussion had a great deal to do with consumer resistence, which helped to keep the price down.

It did another thing. It filled up every freeze locker, both private and public in the hands of the packers and in the hands of the chain stores, full of meat. That is now coming out, and again helping to keep the price down. And maybe we will have it in the fall, but I think our little crusade worked out very nicely.

The CHAIRMAN. Oh, very well. But I was just talking about these predictions.

I was out West, and I find that today nearly half of the packing houses have been shut down by strike, and still the price has not gone up. And a great deal of meat is being held back on the farms, because they do not want to send it in when there is a strike, so when the strike is settled, you are likely to get a large amount of meat in addition.

I see no immediate prospect for the carrying out of these predictions on meat, which was the key food practically.

So I do not know whether these inflationary threats are quite justified or not.

Mr. ECCLES. You have to anticipate. If you don't, it is too late after you get it. And it seems to me that you have got to take into account the matter of what are the potentials. You have to be prepared to deal with those potentials if inflation really begins to develop. Because if you are not prepared, it develops, and it is too late to deal with them.

Of course, we have had, without any question, a very serious inflation already. We talk about inflation as something in the future. We already have got it. And the purchasing power of the money that our people have saved and put into bonds and put into fixed income-bearing securities, has already been almost cut in half in its purchasing power.

Therefore, we cannot afford, it seems to me, to jeopardize the possibility of a further devaluation in the purchasing power of our money.

We must be prepared to deal with it vigorously; and to do so, we must anticipate it.

The CHAIRMAN. I agree with you. I think there are likely to be some further increase. I am not claiming that there will not be. I just wonder if it is quite as direful as you seem to predict.

Mr. ECCLES. Well, I am not trying to throw any fear into this. I am merely pointing out what the real possibilities are today. And certainly if the world situation should improve, if we got a basis of peace, if our Government expenditures can be curtailed, if the world recovery is rapid, and we are relieved from a lot of the foreign aid, such as we are now undertaking, if our military expenditures, instead of expanding into the further billions can be held within the range where they are, then, of course, that could change the situation.

On the other hand, the world situation, we must admit, is ominous. And we have got to anticipate what may be the responsibilities of the Government, the burden of the budget, and the inflationary effects if conditions do not improve. We cannot go on year after year bearing these crushing costs without jeopardizing what we seek to save. If we were confident of the early establishment of peace, we could tolerate a tightly controlled economy. We believe that the time element is the very essence of this grave problem.

Our Nation sought neither territory nor reparations in either World War. We seek neither now. We ask only for the earliest possible establishment of the foundations for enduring peace. To that end, our third and best course may be to choose a combination of alternatives; that is to say, acceptance of such controls as may become necessary to prevent inflation at home, while abroad we lay at the earliest possible moment the foundations for peace. And by that I mean: by doing whatever is called for to assure an establishment of peace, rather than an indefinite program of increasing military expenditures for a preparedness program that may end in an armament race.

We simply cannot afford an indefinite armament race that calls for an expanding of Government expenditures, without, of course, either having inflation, or an imposition of all of the restraints that our people do not want and should not have. Rather, we must relieve our budget load, and in that way we get away from risking these Government controls, high levels of taxation, or inflation. Only in that way can we do it.

Representative RICH. Mr. Eccles, from what we were doing now, you would think we had lost the war. We are paying to everybody.

But you made a statement here a moment ago. You said "our foreign expenditures which we cannot see the end of."

Now, what do you mean by that? Have you something in your mind that these Members of Congress have not been told yet?

Mr. ECCLES. That is all I have to say on that, Mr. Congressman.

Representative RICH. Do you not think it is about time that we stopped this foreign spending?

Mr. ECCLES. I have nothing to say on that. I merely say that I do not see the end of them, and I do not know that you do, or anyone else.

Representative RICH. I thought from that statement that you probably knew something that has not been conveyed to us yet, as Members of Congress.

Mr. ECCLES. I said in the beginning of the statement that we had nothing to do whatever with either the preparations for war, or the foreign expenditures. I made that very clear in the beginning. And in what I am saying here, a lot of these remarks are aside.

This statement is the Board's statement.

Representative RICH. Do you not think we have already spent too much on foreign countries?

Mr. ECCLES. A discussion of that subject is not appropriate at this time.

Representative RICH. I am trying to keep a sound financial structure here in this country. That is what I thought we were going to discuss.

Mr. ECCLES. An answer to that question would not help you in establishing a sound financial structure.

Representative RICH. Surely it does. The more we spend, the more trouble you get into.

Mr. ECCLES. An answer to your question will hot help, in my opinion, to clarify the matters under discussion.

Surely an informed public would be ready to accept even burdensome controls and taxation if convinced they are essential to safeguard our economy against a ruinous inflation, and that there is an early endpoint in sight which will enable us to maintain our system and our institutions in a peaceful world.

To sum up the situation as the Board sees it, we are faced with the possibility that still further upward pressures will be added to the tremendous inflationary potential generated by war financing and intensified by subsequent developments. We should do everything possible within the existing authority of the Government to moderate and counteract these forces. Federal, State, and local governments should practice the strictest economy and defer all public works and similar expenditures that can be postponed until there is a surplus of manpower and materials instead of the shortages that now exist. Every effort should be made not onoy to preach, but to practice economy and savings at this time. The need still is urgent to spend less and save more, and to invest in Government savings bonds. Every assurance should be given that the purchasing power of these savings will be protected.

Representative RICH. I will say that that is a fine statement.

Mr. ECCLES. So far as the monetary and the credit field is concerned, we have tried to make clear that action on these fronts alone cannot guarantee stability. Nevertheless, we believe that the Reserve System should be armed with requisite powers, first, to increase basic reserve requirements of all commercial banks and, later on, if the situation requires it, to provide that all such banks hold an additional special or optional reserve. Both of these would be protective measures.

The first could be used to offset gold acquisitions and purchases of Government securities by the Federal Reserve, and thereby restrict the continued expansion of our already excessive money supply. The second would be essential in case banks embark upon an inflationary credit expansion through the sale of Government securities to the Federal Reserve, or to assist the Government in case of large-scale deficit financing.

We believe it is the part of prudence to recognize clearly that the underlying cause of continuing inflationary dangers arises from the disappointment of our great hopes for the early establishment of world peace. Surely we must summon all of our human and material resources needed to assure that peace. If necessary to protect our economy at home, so that we shall not lose by inflation what we seek most of all to save, we should be willing and prepared to reimpose in the future to whatever extent the situation demands a harness of controls, including higher levels of taxation. Nobody wants such regimentation, but in the hard choices before us, it is infinitely preferable to economic chaos and possible collapse of our system, to which all freemen look to deliverance from the evils of war and misery that feed on economic distress.

We are aware that the questions of policy designed to achieve the cardinal purpose of assuring an enduring world peace are outside the domain of those charged with responsibilities in the monetary and credit field, but we feel that such responsibilities have to be exercised in the light of the burdens which the economy must bear. The earliest attainable settlement of the issues that now stand in the way of lasting peace offers the best hope for the preservation of our institutions, and our freedoms. Meanwhile, they must not be jeopardized either by uncontrolled inflation or long-continued regimentation at home.

The CHAIRMAN. The specific recommendation for legislation, I take it, boils down at the moment to a 10-percent increase in reserves; maintaining the ratio, from 14–20–26 up to 24–30–36. Is that the same relationship between the different types of banks?

Mr. ECCLES. I would simplify the statement. We said 10 percent. I think if legislation was to be considered, we would make some slight modification, and make it a little simpler by saying: As to the non-reserve-city banks, which are 14, make that 25; as to the reserve city banks, which are 20, make that 30; and as to the central reserve city banks, which are 26, make that 35.

The CHAIRMAN. 25–30–35.

Mr. ECCLES. That is right. I think that would be a little fairer. The credit expansion is just as great, if not greater with the non-reserve-city banks, and they are, I think, even more liquid from the standpoint of short-term Governments and reserves than are the city or the larger banks.

The CHAIRMAN. Of course, the increase in reserves, the straight increase in reserves, is not a difficult legislative task. But I take it it involves an increase of 10 percent, or a new reserve of 10 percent on all banks, whether they are part of the Federal Reserve System or not.

Mr. ECCLES. Yes; that is correct.

The CHAIRMAN. And that does present, I concede, legislative problems.

Mr. ECCLES. It does. We would not advocate any increase whatever, unless it covered all banks. I think that to try to cover only member banks would be certainly a terrific discrimination. Even when we doubled reserve requirements on member banks, it was quite an imposition, and it makes it practically impossible to increase the membership of the System.

I think that if you increased reserve requirements of member banks only, membership would be too much of a penalty, and certainly further increases in reserves would likely drive a good many banks out of the System. And to the extent that banks are out of the System, your whole monetary control is weakened.

The CHAIRMAN. Is there any doubt about our power, our constitutional power, to do that, do you think?

Mr. ECCLES. You mean increasing the 10?

The CHAIRMAN. The reserve on non-member banks and State banks who are not members.

Mr. ECCLES. There is no question about it. The question of whether banks are engaged in interstate commerce has already been decided in the Wage-Hour Act. And the Board has administered regulations on consumer credit that covered all non-member banks.

The CHAIRMAN. But the question is that that might have been a war power.

Representative PATMAN. Maximum interest rates, too.

Mr. ECCLES. Well, no interest can be paid on demand deposits. We administer that only for all member banks.

The CHAIRMAN. The committee will recess until 2:30.

(Whereupon, at 12:30 p. m., a recess was taken to reconvene at 2:30 p. m., of the same day.)

AFTER RECESS

(The hearing resumed at 2:30 p. m.)

The CHAIRMAN. The committee will come to order.

STATEMENT OF MARRINER S. ECCLES, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ACCOMPANIED BY WOODLIEF THOMAS, DIRECTOR OF THE DIVISION OF RESEARCH AND STATISTICS; AND RALPH A. YOUNG, ASSOCIATE DIRECTOR OF THE DIVISION OF RESEARCH AND STATISTICS, FEDERAL RESERVE SYSTEM—Resumed

The CHAIRMAN. Mr. Eccles, I think I remember going over with you some tables showing the effect on bank reserves of different inflationary elements. Have you anything of that sort on the next 3 months or the next 9 months, or whatever period you choose? It seemed to me that I remember estimates of gold imports and things of that kind that might throw a little light on the subject.

Mr. ECCLES. I have not seen any tables, and I do not know whether the economists in our research department have anything on that. You do not mean charts, you mean tables?

The CHAIRMAN. I meant tables; yes, of what the effect on the bank reserves is going to be in terms of actual figures; what they are now and what they are likely to be. To interpret your statement with actual figures, I mean.

You are asking for a 10-percent increase in reserves which I say will take up the estimated increase in reserves during some period. I wanted to see why you estimate those and what the figures will show.

Mr. ECCLES. What we say here, Senator, is the potential which would be available from gold imports and would be available from the purchase of nonbank securities. We suggested that there were two things that might be done in order to deal with that situation. The first one was that the interest rates on short-term securities and the discount rates should be permitted to rise to the extent possible.

The CHAIRMAN. As far as you could and maintain 2½ percent long-term rate?

Mr. ECCLES. That is right; and that was the one thing. The other, of course, was that to the extent that this action is not adequately restrictive, that is, that it would not divert the reserves that the banks got into those short securities held by the Federal Reserve, then the Federal Reserve should have the power to increase reserve requirements substantially to cover at least any growth in the supply of such reserves.

Then we went on to say later that if we got this power up to the 10 percent, it would equal in the aggregate $12,000,000,000, and that should be sufficient under the present situation for several years. Now, we go on to say that if the budgetary situation should be such as to create substantial deficits, and we go on to say further that if, in spite of the rise in short rates or the increase in reserve requirements, that the banks continued an expansion of private credit on a dangerous basis, or an inflationary basis, then the other power should be added.

The CHAIRMAN. I understand that, but what I want to know is why 10 percent; why the $12,000,000,000; what is it that supports that figure that is necessary for the increase in reserves?

Mr. ECCLES. I suppose we could get along with a less amount and then request additional authority if it was needed. Congress could do that. The only thing is the very fact that the Board had that much power I think psychologically would be effective and desirable. I think the fact that the Board could increase the reserve requirements would tend to keep the banks in a much more liquid position than if they felt they had no further power; that they would be inclined to keep their governments and particularly their short-term governments to be able to meet an increase in the reserve requirements.

If, on the other hand, the authority was of a lesser amount than that, I think it would be much less effective as an anti-inflationary influence.

The CHAIRMAN. Breaking down these deposits, how do you get the $12,000,000,000 as between demand and time?

Mr. ECCLES. I think that we can supply the figures.

Mr. YOUNG. That would be about $10,000,000,000 against demand deposits and nearly $2,000,000,000 against time deposits, breaking that $12,000,000,000 down.

The CHAIRMAN. That is about $10,000,000,000 more than now or more than you can do if you increase requirements at central reserve city banks to the limit allowed.

Mr. YOUNG. Yes.

The CHAIRMAN. You could increase it some without any additional authority.

Mr. THOMAS. Reserves could be increased about $1,000,000,000 now.

The CHAIRMAN. I am wondering where the 12 comes from. It seems to be $8,000,000,000 on demand and 1.4 billion dollars on time, and that is 9.4 billion dollars, and what is the rest of it? Does that include only the Federal Reserve System or what?

Mr. THOMAS. It would be around $10,000,000,000 on demand, because you have to include the interbank deposits. The $82,000,-000,000 of demand excludes interbank deposits. We will insert a table which shows the break-down by class of bank, using deposit figures for a recent date.

Existing and requested potential increases in commercial bank required reserves (estimates as of Feb. 29, 1948)

[In billions of dollars]

Potential increase in required primary reserves under—	Class of bank				
	All banks	Member			Nonmember banks
		Central reserve city	Reserve city	Country	
Present authority of the system	1.0	1.0	None	None	None
Demand deposits	1.0	1.0	None	None	None
Time deposits	None	None	None	None	None
Additional requested authority	11.9	2.6	3.8	3.8	1.7
Demand deposits [1]	10.4	2.5	3.3	3.2	1.4
Time deposits [2]	1.5	.1	.5	9.6	.3

[1] Figured on the basis of 9 percent for central Reserve city banks, 10 percent for Reserve city and nonmember banks, and 11 percent for country member banks.
[2] 4 percent of time deposits for each class of bank.

The CHAIRMAN. How do you figure that? Do you have any estimates on the import of gold? What are they running since the first of the year?

Mr. THOMAS. It is $400,000,000 since the first of the year.

Mr. ECCLES. We figured from 1.5 to 2 billion dollars, and we figured not less than 1.5 billion dollars and not more than 2 billion dollars. That is about as near as the amount can be estimated.

The CHAIRMAN. For the year, per annum?

Mr. ECCLES. That is right, for the year. There may be further contractions of currency.

The CHAIRMAN. How far does that affect the reserves, is that dollar for dollar?

Mr. ECCLES. Dollar for dollar, and it also affects deposits dollar for dollar.

The CHAIRMAN. And the other element is what?

Mr. ECCLES. That is the purchase of nonbank holdings of Government securities by the Reserve banks. Supporting the market, buying securities from corporations and individuals selling on the market increases bank reserves and deposits dollar for dollar.

The CHAIRMAN. If you have just a break-even budget, what is the situation then?

Mr. ECCLES. That, of course, would mean that the Treasury would not have to offer any new securities to the banks. But depending upon the amount of demand for municipal financing and long-term corporate financing, what we find has happened is that insurance companies, savings banks, and various institutional investors have sold their Governments, substantial amounts of them, to make other investments that are more remunerative.

You see, during the war they had no outlet for the funds they accumulated. The insurance companies and savings banks, as well as many institutional investors, purchased billions of dollars of the marketable Government securities, which meant, of course, that the savings of the people in those institutions were already spent. They were spent for war. Those institutions are now selling off those bonds that were bought out of savings. They are being sold faster than other savers in the market will buy them. To hold the market the Federal Reserve has to buy them, and that creates reserves.

The factors that cause that sale and that determine the extent to which they will sell depend somewhat on inflationary developments. If there should be no inflationary developments, there would be much less likelihood, and possibly, I think, little likelihood of those market bonds held by nonbank investors being sold on balance.

The CHAIRMAN. Do you not have the same situation with nonbank investors exactly like banks? As long as you have large amounts of Government bonds out, and the Federal Reserve bank will buy them at par, whenever another good investment comes along they sell them to you and put the money into the new investment.

Mr. ECCLES. That is much less true of the banks, very much less true of the banks than it is of the other institutions.

The CHAIRMAN. They make loans, but I am talking about the insurance companies. Somebody comes along with 3 or 4 percent mortgage to build a new building, and since you are willing to buy the bond at par and they can get 3½ instead of 2½, they sell them to you. That raises the whole question that we are raising, the question that some people, that whether or not the policy of always maintaining Government bonds at par is not necessarily inflationary and whether as long as you maintain it you can in any way prevent the lending of money by banks and insurance companies or anybody else who has invested in Government bonds to any degree they want to invest.

Mr. ECCLES. Of course, we recognize the difficulty that that problem raises, and we have recognized it all along, that to hold a rate for an indefinite period on a Government security does raise the very question that you have mentioned here. But it is a question of alternatives. It is a dilemma that we are confronted with. We have recognized that and pointed it out to the committee last fall.

Now, we are not proposing to hold all Government securities necessarily at par. What we have said is that we maintain the long-term 2½ rate, letting the short-term rate fluctuate. Of course that depends upon the Treasury's willingness, I think, because we have tried to cooperate fully with the Treasury, and at no time have we tried to force a rate on to the Treasury that they are unwilling to accept. I do not think that it would be practical to do so. I think the central bank has certainly got to recognize the responsibility of the Treasury and to advise and work with Treasury officials in that regard; and I will say this, that in that connection the Treasury and the Federal Reserve have cooperated pretty fully in connection with the management of the public debt. But the short-term rate is the rate that should be permitted to fluctuate, depending upon the market demand or the market situation so far as it would fluctuate while you are maintaining a 2½ rate.

Now, it is not going to fluctuate so much as long as you have a peg on a 2½ long-term rate, as I indicated this morning.

The CHAIRMAN. My question goes to the 2½ long-term rate.

Mr. ECCLES. It has got to go to that point. That is the basic question.

The CHAIRMAN. How many of these 2½'s do the insurance companies hold altogether?

Mr. ECCLES. They hold a very large amount of them.

The CHAIRMAN. And necessarily to get more return as fast as 3½ or 4 percent mortgages come along, they are going to sell the Governments, because here is a bond you are bound to get par for, and you turn around and you can increase your interest.

Mr. ECCLES. The point is the Government itself has helped that more than the insurance companies. For instance, the title 6 mortgages for housing and what we call the GI guaranteed housing program has been a tremendous stimulation. In other words, the Government has competed somewhat against itself for this rate by its policy in connection with the ease with which it has made very long-term mortgage money available.

However, I will say that only comparatively recently was the 2½ rate reached. You see, the long-term yield last year was down to 2¼, with the 2½ bonds selling at a substantial premium. The short-term yield was permitted to rise last year from ⅞'s to 1⅛. We also raised the rediscount rate a little. The effect was to tend to bring down, or at least one of the effects was to bring down, the price of long-term Governments. In other words, to raise the rate to 2½. Rates on other bonds which were selling almost at a 2½ percent rate, gilt-edged industrial and municipal securities, went up to 3 percent.

Many of the municipals which are entirely tax-exempt and do attract the funds of wealthy people were selling at 1½ percent. Now, they are the same ones that are selling at around 2½. Now, the 4 percent mortgage, 20 or 25 year mortgages, which involve monthly payments and a lot of work and a lot of trouble, are no longer attractive. So the Government is now proposing that the Congress appropriate another $500,000,000 to provide a secondary market so that the Government itself can buy a guaranteed mortgage, that the Government, in effect, guarantees.

Now, that is competing with itself for the 2½ rate, and that certainly is a policy that is diametrically opposed to an anti-inflationary policy. I think that should be recognized.

The CHAIRMAN. On the other hand, it is quite possible that banks might get more money for mortgages for lending on housing if there were no FHA and that they might be more willing to sell their Governments.

Mr. ECCLES. I am not arguing against the FHA, but I am arguing against the Government appropriating money which cuts into the budget picture for the purpose of providing a secondary market. Now, the reason that it needs a secondary market, if it needs one, is because the insurance companies and others are not willing to sell 2½ percent Governments today as they were. There is very little sold on balance any more. That is the way this situation at the moment is at least. Although there was a lot sold last December and in January, of the long-term 2½'s, the effect of our dropping them to par and the fact that they have confidence that the market is going to be maintained, tended to make them hold on to long-terms. The whole long-term market is stabilized around that 2½ rate. Today, there is not as much housing mortgage money available at 4 percent as there was because the holders of Government bonds are no longer as willing to sell them to make mortgage loans.

The CHAIRMAN. If it is supposed to be a Government guarantee, they are a little shy of having too much of one type of security like that, I think. Many of the smaller banks are filled up to their limit, what they think is their limit, for that kind of paper.

Mr. ECCLES. They are not as readily marketable. A guaranteed FHA mortgage, title 6 mortgage, does not have the ready market today that it did have.

The CHAIRMAN. Do you think the Government can maintain Government bonds at par?

Mr. ECCLES. Yes; I think so. I do not think that that is going to be any problem. But it is inflationary certainly to the extent that you create reserves in the banking system unless we have an opportunity to sterilize the effect. There would be no problem at all if you could do that. You could maintain the long-term 2½ rate indefinitely.

The CHAIRMAN. Would you get concerned if the Federal Reserve banks got completely filled up with these Government bonds?

Mr. ECCLES. The question is what is being filled up? When?

The CHAIRMAN. You have got $20,000,000,000 now.

Mr. ECCLES. We have got over $20,000,000,000 now, that is everything, short and long, and the whole portfolio.

The CHAIRMAN. If it runs up to $60,000,000,000, suppose that happens?

Mr. ECCLES. The total volume of marketable long-term bonds held by nonbank investors is, I think, about $50,000,000,000. That is the marketable ones. You see, we have over $50,000,000,000 of the E, F, and G bonds. These savings bonds are not marketable but of course are cashable at par. The long-term marketable are not eligible to the banks, and they amount to something around $50,000,000,000.

The CHAIRMAN. And the banks hold how much?

Mr. ECCLES. The banks own $67,000,000,000 of the total Governments, but they are not the restricted type; they are another type.

The CHAIRMAN. Who has the rest? There are $50,000,000,000 E, F, and G and $50,000,000,000 2½'s outside and $67,000,000,000 to banks, and that leaves about $83,000,000,000.

Mr. ECCLES. You have got $13,000,000,000 of weekly bills that fall due every week, a billion a week.

The CHAIRMAN. Those are the banks?

Mr. ECCLAS. They are held by corporations, some of them, just in anticipation of taxes, and the Federal Reserve is a very large holder of bills, most of our portfolio of $20,000,000,000 is bills and certificates. You see there is something like twenty-odd-billion dollars of certificates, 1⅛ percent certificates. Then, of course, there are these securities that are held by the trust funds, too; the Government itself has a substantial amount of that debt held in the social security and other funds.

I have a table here which shows estimated holdings by investor classes as of March 24, 1948.

Estimated ownership of interest-bearing Federal securities,[1] *Mar. 24, 1948*[2]

[Par values in billions of dollars]

Type of security	Investor classes						
	Total all investors	Federal Reserve banks	Commercial banks	U.S. Government agencies and trust funds	Insurance companies	Mutual savings banks	All other investors
Marketable securities:							
1. Bills, certificates, and Treasury notes	45.7	15.0	16.5	0.1	1.1	0.6	12.4
2. Treasury bonds, due or callable:							
(*a*) Within 1 year	4.1	.1	2.7	(4)	.1	.1	1.1
(*b*) 1-5 years	46.4	2.0	34.0	.3	3.0	1.9	5.2
(*c*) After 5 years	65.0	3.5	11.4	5.0	18.8	9.1	17.2
3. Miscellaneous [3]	.2		(4)	(4)	(4)	(4)	.1
4. Total marketable	161.5	20.6	64.6	5.6	23.0	11.7	36.0
Nonmarketable securities:							
1. Savings bonds	52.9		1.2	(4)	.4	.3	51.0
2. Savings notes	5.1		.1	(4)	(4)		5.0
3. Depositary bonds	.3		.3				
4. Special issues	29.3			29.3			
5. Armed forces leave bonds	.7						.7
6. CCC demand obligations	(4)		(4)				
7. Treasury bonds, investment series	1.0		.3	.1	.3	.1	.2
8. Total nonmarketable	89.2		1.8	29.4	.8	.4	56.8
Total all securities	250.7	20.6	66.4	35.0	23.8	12.1	92.8

[1] Consists of all interest-bearing securities, issued or guaranteed by the U. S. Government.
[2] Preliminary.
[3] Federal Housing Administration debentures, postal savings and Panama Canal bonds.
[4] Less than $50,000,000.

The CHAIRMAN. How many bonds would the 25-percent special reserve immobilize?

Mr. THOMAS. About $16,000,000,000.

The CHAIRMAN. That is only 16 out of the 67.

Mr. THOMAS. That is short-term.

Mr. ECCLES. I think it is more than that. I think that we can insert a table on the figures. Last November we had all of those figured out as of the figures available at that time. It would need to be brought up to date, making use of the latest call-report figures; namely, those for December 31, 1947. I will also insert into the record a table showing the estimated distribution of bank holdings of Government securities, by call date and class of bank.

Potential requirement for holdings in short-term Government securities under the special or optional reserve plan

[Estimates as of Dec. 31, 1947, in billions of dollars]

	Class of bank				
	All banks	Member banks			Non-member banks
		Central Reserve, city	Reserve, city	Country	
Maximum special reserve requirement	30.2	7.5	9.9	8.9	3.9
Less holdings of excess cash assets	9.7	2.7	3.2	2.9	.9
Maximum requirement for holdings in short-term Government securities	20.5	4.8	6.7	6.0	3.0

[1] Based on aggregate figures by classes of banks.

Estimated distribution of United States Government securities held by all commercial banks Mar. 24, 1948, by call date and by class of bank

[Book value, in billions of dollars]

	U. S. Government securities call class						
	Total	Within 1 year	1 to 5 years	5 to 10 years	10 to 15 years	15 to 20 years	Over 20 years
All commercial banks	67.0	20.7	34.5	6.7	2.2	2.9	
Member banks, total	55.9	16.9	29.0	5.9	1.9	2.2	
Central Reserve city:							
New York City	11.1	3.4	6.1	1.2	.3	.1	
Chicago	2.8	.8	1.2	.5	.2	.1	
Reserve city	19.5	6.2	9.1	2.1	.7	.6	
Country	22.5	6.5	11.8	2.1	.7	1.4	
Insured nonmember banks	9.9	3.4	4.9	.7	.3	.6	
Noninsured banks	1.2	.4	.6	.1	[1]	.1	

[1] Less than $50,000,000.

Mr. THOMAS. That would be about $30,000,000,000, and you would have about $10,000,000,000 of other assets.

Mr. ECCLES. That is more like it. That is $30,000,000,000 of short-term Government securities.

The CHAIRMAN. That $30,000,000,000 would be immobilized.

Mr. ECCLES. Yes; except that you permit them to use other assets in lieu of that. That is any assets that they have above 20 percent of the demand deposits, and the reason for that is, for instance, that a bank that is a member of the Federal Reserve System has its reserve requirements with the Reserve bank, and they have cash on hand, and they have items in process of collection that they call transit items, and they have balances with city banks.

Now, they may have as much as 30 percent reserve in all of those factors, and it would be unfair to impose the 25 percent on any bank, no matter what reserve they had. Therefore, you start with 20 percent as the basis, and any bank which is carrying reserves and cash of more than a 20 percent figure, it would apply that against the 25 percent special reserve. In other words, the special reserve is composed of short-term securities or other cash items, balances in other banks, which is above 20 percent.

Now, if you did not do that, then you would practically destroy the correspondent bank relationships. There are a lot of nonmember banks as well as member banks that would maintain substantial balances with the correspondent bank; and if those balances, plus cash on hand, plus excess reserves with the Federal Reserve, in the case of a member, are above 20 percent of demand deposits, they would be permitted to count that as part of the special reserve.

In other words, you have got to start on a base point of 20 percent. Now, some banks carry as high as 40 and 50 percent of demand deposits in interbank balances and cash and currency, in which case they would practically have no requirement under the 20 percent because they already are in that position. So now to explain the application of the 25 percent, if banks had nothing above the 25 percent, then to apply the 25 percent would immobilize $30,000,000,000 of short-term Governments; but taking the picture as it now is, there is about $10,000,000,000 of the cash items and balances such as I have mentioned above the 20 percent of demand deposits. So that that would mean if this were applied, it would only immobilize about $20,000,000,000 of short-term Governments.

The CHAIRMAN. In effect, if you exercise full power, they could not put in loans and investments of more than half of their deposits?

Mr. ECCLES. That is about right. And what is more, that fractional reserve of 6 to 1 is cut down to about 2½ or 3 to 1, and not more than 3, I would say closer to 2½. Therefore, you get away from that large multiple deposit expansion. So that even if banks then did sell Governments to the Reserve banks, the ability of the banking system to expand on the basis of the reserves thus obtained would be reduced.

In suggesting the use of the optional reserve power, as you well know, we have indicated here that it would be applied only in case the credit expansion and inflation is continuing, in spite of the use of the powers we might get under the increasing of reserve requirements also, if a substantial budgetary deficit is incurred, we would be unable to increase reserve requirements because either a substantial part of it or all of it would have to be financed by the banks. Deficit financing would mean that you actually wanted the banks to buy Government securities. Therefore you would not increase the cash reserve because that would force them to sell Government securities. Consequently, if you run into large budgetary deficit financing, this special reserve requirement seems to us essential, if you are going to do that financing on the basis of selling short-term Governments to the banks.

We feel that that is the way to do unavoidable bank financing of a Government deficit. We should not want again to see long-term Government securities sold to the banks and have the trouble that we have had in the past. By this special reserve requirement, you would immobilize the securities sold to the banks as you put them out. If you made the special requirement higher, that would be an inducement for the banks to buy more Governmnet securities. The special reserve would also be of great assistance in refunding maturing issues, because the banks then would not be inclined to sell the securities to make loans, in fact, they would probably be obliged to hold some securities as a part of the optional reserve.

The CHAIRMAN. I have one thing, Mr. ECCLES. I might have to go over to make a quorum, and Mr. Patman has some questions to ask.

Will you put in the record the figures that we referred to, that is, the figures showing the effect of this thing on the reserves, and also I think any other figures dealing with the total outstanding bonds and whether held by banks or private individuals, and so forth. There is a table here in the Treasury Bulletin of March 1948, but I think it would be desirable to have those figures in the record, whatever you think is material to the committee.

Mr. ECCLES. We will put them in at the appropriate places.

I would like to say one thing, Senator, on this question of interest rates, because I think that I may have made a wrong impression in my remarks this morning. I come to that conclusion by reason of a report over the Dow-Jones ticker that I saw when I went back to the office. The report is that Eccles told the committee that the Reserve Board is considering raising interest rates on short-term securities and discount rates. That is, I think, a misinterpretation of my statement. What I certainly meant to say, and what I think my statement implied is that restrain such potential expansion—and that is the expansion that would be created or possibly could be created by the reserves that would come into the banks from the sources that have been enumerated—I said the Federal Reserve would have to take action to absorb any excessive volume of reserves. To restrain credit expansion, we would have to take some action. I said that there are two types of measures which should be adopted. It might have been better to have said two types of measures should be considered, but certainly to deal with a potentially inflationary situation, I am sure that it is the view of the Board that they should be adopted.

One of these measures is some further rise in short-term interest rates and in discount rates. The question of raising the interest rates is not a matter for the Board. The question of raising the interest rates on short-term Government securities is a matter for the Treasury, in consultation with the Open Market Committee, and in the light of the advice of the Open Market Committee.

Now, the question of raising the discount rates is a matter for Board approval. The Board does exercise control over the discount rates. We can approve of the rates submitted by the banks, or if we disapprove of them then they have to submit a rate that we will approve, so the practical effect is that we can control the discount rates.

I went on further to say that the first of these measures, namely, that of increasing the interest rate on short-term Government securities, was the matter that could be adopted or considered by the Federal Reserve and the Treasury without any new legislation. I also said that the action would be designed to induce banks to purchase short-term Government securities.

It would look from the reporting of this morning's testimony that the Reserve Board, if they decided you should raise short-term rates, would just proceed to raise them. As I stated, that is not a power which the Reserve Board has. The Treasury fixes the rates on the short-term securities that they are going to offer, and it is done in consultation with, and on the advice of, the Open Market Committee, of which all of the Board are members. In addition to the Board members, there are five Reserve bank presidents; so that the Board, of course, exercises a very considerable influence in advising on the question of interest rates.

But this reporting gives the impression that interest rates might be raised tomorrow because we favor doing it, and therefore we can do it. I just wanted to have the press get the correct picture here, namely, that although we favored, under the conditions which are indicated, dealing with them by raising the rates to the extent that we can do it without raising the rates on long-term bonds—and that may be a very limited amount—the raising of interest rates is not a power which is within the Board's prerogative.

Representative PATMAN. I understood you to say this morning that the 2½ percent interest rate on government securities should be maintained.

Mr. ECCLES. That is right.

Representative PATMAN. You mean to say the 2½ percent rate on Treasury bonds; in other words, the bonds will be taken at par, so that the rate will not go down or will not go up; is that right?

Mr. ECCLES. Well, if the 2½ percent rate on the longest term Government securities is maintained, that means that longest term bond would be supported at par.

Representative PATMAN. Do you expect to-do that?

Mr. ECCLES. As a matter of fact, the support price is 100$\frac{2}{32}$. The reason for this support price is to enable the ultimate seller to get par, because when he sells his bond he cannot bring it right in to the Federal Reserve bank. He sells his bond to a security dealer, and by the time it gets to the Reserve System there is some cost in handling it. We wanted to be sure that the seller would get par. And to do that, we had to allow $\frac{2}{32}$ above par to allow for the commissions and costs in between.

Representative PATMAN. That is about what they are selling for now; is that not right?

Mr. ECCLES. I think they are slightly above that. They have fluctuated. They have been up eight-thirty-seconds above that.

Representative PATMAN. It is the intention of the Board to maintain at least that rate?

Mr. ECCLES. It is the announced purpose of the Open Market Committee, and also the announced purpose of the Treasury, to maintain that rate on the longest term Government bonds. There is no commitment, so far at least as the Open Market Committee is concerned, to maintain securities, all securities, at par.

Representative PATMAN. I did not mean to say all securities. I meant the 2½ percent securities.

Mr. ECCLES. That is the basis.

Representative PATMAN. You expect to keep them at par?

Mr. ECCLES. Yes, and that means, of course, as long as you do that, the shorter, medium-term securities will sell at a premium. Therefore, there is not much likelihood of any of the securities going below par except if the short-term rate is raised. If the short-term rate is permitted to rise as much as a quarter, then the securities falling due within a year or maybe 2 years might fall slightly below par.

Representative PATMAN. What is the average going interest rate now for the Government bonds, or the Government securities?

Mr. ECCLES. I think around 2 percent.

Representative PATMAN. Is it not a little higher than that?

Mr. ECCLES. It fluctuates, depending upon the amount of savings bonds out, because that is a fairly high rate. Of course, you have to take the average rate into account, in raising the short-term rate I should point out that a good portion of the increase in the short-term rate would go to the Federal Reserve, which in turn would return the lion's share to the Treasury as a tax.

Representative PATMAN. Because the Federal Reserve owns most of the securities?

Mr. ECCLES. It owns a large amount of bills and certificates.

Representative PATMAN. I notice they were increased from about three-eights in January of 1947 to about ninety-seven one-hundredths.

Mr. ECCLES. That was done practically all at once, because that three-eights was an unreal and unnatural rate. That three-eights rate then prevailing represented the rate on securities owned by the Federal Reserve. There was no market for bills outside the Federal. What we felt should be done was to make the bills a market instrument; in other words, to put them on a real bid basis instead of the existing artificial basis. That is to say, we felt that we should let the market determine what a 1-year bill should pay or yield.

Representative PATMAN. I notice, though, Mr. Eccles, that the bankers' acceptances, 90-day bankers' acceptances, went up from about eighty-one one-hundredths in January of 1947 to about 1.08 in 1948. They went up considerably, too, along with those securities.

Mr. ECCLES. That is right, because the yield on bills and certificates went up.

Representative PATMAN. Which one pulled the other up?

Mr. ECCLES. The Governments pulled up the others, I think.

Representative PATMAN. Pulled up the private ones?

Mr. ECCLES. The Governments dominate the whole market.

Representative PATMAN. Now you take the corporations, the interest rate increased from 3.13 in January of 1947 to 3.53 in January of 1948.

Mr. ECCLES. That is right.

Representative PATMAN. You say the Governments pulled them up?

Mr. ECCLES. Entirely.

Representative PATMAN. Why should the Governments do that?

Mr. ECCLES. Because, with a marketable public debt of 165 billion dollars, Government securities dominate the market.

Representative PATMAN. It occurs to me that that is interfering with the market.

Mr. ECCLES. It was not interfering at all, because we were supporting an artifically low level. We were the ones that were pegging the short-term rate at seven-eighths for certificates and three-eighths for bills, and therefore there was no market for bills and practically all bills went to the Federal Reserve, and a great many of the certificates at seven-eighths went to the Federal Reserve.

Because we were paying such a low rate on the short-term paper, the 2½ percent Governments went up to a premium of nearly 107, and the municipals dropped down to a 1½ percent rate. It was all due to the fact that we're permitting the banking system to create money at a very, very rapid rate.

What the banks were doing was this: Because the rate was so low on the short-term paper, they were selling the short-term paper to the Federal Reserve and buying the longer-term paper in the market. And a 2-percent bond that was eligible for the banks to purchase went down as low as 1¼ percent yield, and to a very high premium.

In other words, we forced the rate down and prices up through pegging the market at seven-eighths on the short term.

Now, we have shifted the emphasis of our support program to the 2½ long-term rate. What we were doing—the fact that we were pegging seven-eighths short-term rate—drove the long-term rate down. Under these conditions, the refunding which was being done by private corporations and others was at lower and lower rates. We were getting into a position where it was increasingly difficult to ever let the short-term rate go up without also raising the long-term rate and causing insurance companies and many others to incur very large losses on the securities that they had purchased at the low rates.

We felt that there is some obligation, certainly, to investors as well as there is to borrowers; that there was no justification in maintaining that short rate and forcing the long rate up. You can make a pretty good case for holding the long-term rate at 2½, while the public debt is as large as it it. If it were not for the fact that the public debt is so large that there is a very big job of refunding to be done constantly, and that these securities are held so widely by banks and many other institutions, then certainly in a situation today where the total volume of savings in the country possibly does not equal the demand, you should let the savings rate really go up. We are tending to keep the savings rate down as long as we hold the 2½-percent rate, and we are criticized for it.

But as I said to Senator Taft, you have a problem of alternatives here. It is the judgment of the Board that even though the demand for savings might temporarily justify a higher rate because the savings today are possibly less than the demand for money, we should continue to hold the 2½-percent long-term rate. However, we also agree that the long-term rate should reflect the actual volume of savings that is taking place in the country in relation to the sustainable demand.

Representative PATMAN. But there is plenty of money or credit available.

Mr. ECCLES. The trouble is, it is bank credit. Borrowers go into the banks and obtain bank credit. That expands the total volume of money, and because you cannot expand the supply of goods and labor, it reflects itself in higher prices.

Representative PATMAN. Really, there is about three times as much money and credit available now as ever before in history.

Mr. ECCLES. But you have also the fact that the national product has pretty largely absorbed that inflation of money. The national product has gone up since 1940 from $100,000,000,000 to $240,000,000,000. Now, that is an increase of one and two-fifths; whereas, the supply of money has increased nearly one and two-thirds. The supply of money is still more than adequate; there is an excess of it.

Representative PATMAN. That is what worries me. I cannot understand, Mr. Eccles, this fact: It occurs to me that the law of supply and demand would cause interest rates to go down instead of going up, since you say there is adequate credit, more than we have ever had before.

Mr. ECCLES. But there is a question of who wants to borrow the money and who wants to lend it. You cannot assume that a person who owns money is necessarily going to be willing loan it at these rates. That is, one of the reasons that the money may not be flowing, to even though you have got a lot of it, as freely and readily as otherwise it would flow, is because there are some who feel that the rates do not justify the risk. What you have today is an abnormally low velocity of money.

Representative PATMAN. Here is the danger that I see in this increase in the interest rates. You take the cities and counties and States—they will have to pay more.

Mr. ECCLES. They ought to pay more. Why shouldn't the investor get more interest when the purchasing power of the dollar is diminishing?

Representative PATMAN. And that, of course, causes an increase in taxes, too.

Mr. ECCLES. Possibly so, that is right. But why shouldn't people pay more taxes, or why shouldn't the farmer pay more taxes when he gets three times as much for his wheat? Why shouldn't the laborer who gets two or three times as much for his wages pay more taxes, and why should the entire cost of the inflation be borne by the saver, the person who has got money to rent?

Representative PATMAN. Utilities will have to pay more interest, and they will want an increase in rates, and it increases everything. That is inflationary.

Mr. ECCLES. The rates are still excessively low. Money rates are the one part of the economic situation that is still deflated. The person who has been hurt the worst is the pensioner, the saver, and the person who depends upon a return from a fixed investment. There are two reasons for this.

Representative PATMAN. Or fixed salaries and wages.

Mr. ECCLES. That is right, too. The saver not only gets a much smaller return on his dollars, on his loans or investments, than he ever got in the 1920's or in previous years, but the dollar will likewise purchase a lot less, so that if it were not for the problem that the management of the public debt would create, and the huge size of the public debt, and what it would do to the value of the securities held by banks, insurance companies, and institutions generally, there is a very good case on the grounds of equity today to make for raising of the rate.

Representative PATMAN. You are raising the rate.

Mr. ECCLES. I am speaking of the long-term investment rate. The short-term rate is not the investment rate; the short-term rate is the bank rate.

Representative PATMAN. But something has caused the corporate rate to go up considerably.

Mr. ECCLES. It is because the short-term rate went up, and that reflected itself in the long-term rate until the support price of the 2½ bonds was reached.

Representative PATMAN. It occurs to me that, although I am sure the Board did not intend it that way, it is going to practically stop the housing program based on 4 percent equity. It will not be long before the people will not take these 4 percent mortgage loans.

Mr. ECCLES. I think that they will take the 4 percent mortgage loans; that is not so much the problem. If the loans were better loans than they are, they could be sold. One of the troubles with these loans is that there is no down payment. And certainly it would be a good thing if there was a smaller market for mortgage loans. In that case there would possibly be fewer people trying to build houses, and if there were, then the cost of building labor and materials would not go higher. The trouble in the housing field has been that you have an inflation here since the war ended of practically 100 percent in the cost of houses, and you are getting people in debt at excessively high-priced housing today. If we should at some time get a change in these values, and get any recession, it is going to put a real burden on these people that we want to help. You do not help a person by getting them in debt to buy property on a long-term basis at an inflated price, and it seems to me that one of the reasons that construction costs are so greatly inflated is because the amount of money made available for construction, and particularly in the housing field, has exceeded the supply of building labor and material. Because there has been practically no down payment required, it has taken practically no capital to get into the industry, and we have found literally thousands of speculative builders go into the business with practically nothing on their own. The net result is that there is a highly speculative situation in the housing field. If that has slowed up and if there is not the mortgage money available, I think that that is one of the most wholesome situations that can happen as an anti-inflationary development at this time. One of the best things that could happen at this particular stage—as an anti-inflationary measure—would be to have the cost of housing come down, particularly the cost of the materials and the labor that goes into the housing.

Representative PATMAN. Construction costs you only pay one time, and interest you pay every year until it is paid off.

Mr. ECCLES. That is right.

Representative PATMAN. Do you not think it is easier now to pay $10,000 for a home with a low interest rate over a period of 30 or 40 years, than before the war to pay $5,000 with a high rate of interest, may be with three mortgages?

Mr. ECCLES. What I am advocating—and I am not saying that even the 4 percent rate should necessarily change—is that there should be some down payment required; that people should not go into the business without any money or capital of their own, and that people should not buy houses without any equity of their own. That is what I am largely contending here.

Now, it may well be that an increase in the rate on housing mortgages of one-half of 1 percent would be all that would ever be required, so long as the 2½ percent rate is maintained on long-term Governments. It is that close a margin. The margin between the desirability of a 4 percent housing mortgage and a 3 or a 3½ percent bond is just about one percentage point.

Representative PATMAN. I know, but one-half of 1 percent every year for 40 years runs into money, you know; that is paid every year.

Mr. ECCLES. If they paid it in 20, it would be half as much.

Representative PATMAN. We have a bill over in the House, and of course I am in favor of Senator Taft's bill, the Taft-Ellender-Wagner bill, because it has some public housing in it, too, and I am for that.

Mr. ECCLES. We ought to wait for a period when it is favorable to do that.

Representative PATMAN. Are you not going to consider the people who are out of homes?

Mr. ECCLES. But you are not going to get more homes. All you are doing is inflating the price of homes. If by reducing the rate from 4 to 3 that was actually going to build more homes, at less money, then I would be for it. If you had idle men and idle material, and the thing that was short was money, then we ought to do everything for the Government to help to stimulate the construction industry in order to use up the idle labor and the idle facilities.

Representative PATMAN. Do you not think that there are certain things that we have to do, although possibly inflationary, in order to give homes to people?

Mr. ECCLES. I think if you were getting more homes, that is one thing. But merely by making more favorable terms you do not get more homes. It is like I said in the installment credit field: Merely by making installment credit terms more favorable to buy an automobile is not going to produce more automobiles.

The CHAIRMAN. I think it does produce more homes, though.

Mr. ECCLES. I doubt it.

Representative PATMAN. I think so, definitely.

The CHAIRMAN. I think we have gotten beyond the bottleneck stage in homes, pretty nearly.

Mr. ECCLES. I hope so, but so long as you have the shortages that you have in the basic materials and building labor, I cannot see how more credit will produce more housing. Lumber is a terrifically inflated item; it is still up. I know something about it. Lumber is up from the OPA ceiling price by more than 100 percent.

The CHAIRMAN. Why should we send $300,000,000 worth abroad, then?

Mr. ECCLES. That is another question, but certainly lumber is fantastically high. It is higher than any farm product, I think. And on top of that, you have building labor that is extremely high and very inefficient, generally speaking.

Representative PATMAN. And on top of that, you know what the steel situation is. I know people in the building business, and they do not verify the fact that it is easy to get deliveries on materials at all. They are still very tight, and there are still gray markets in many items.

Representative PATMAN. I want to ask you a few questions bearing directly on your testimony, Mr. Eccles, please.

Now, you want these reserve requirements raised. At least you want the Board to have the power and the authority to raise them if necessary. You believe that will make credit harder to get; and credit being harder to get will stabilize the economy just a little bit better and keep prices down.

Mr. ECCLES. Let me put it this way: We feel it would sterilize the inflationary effects of the excess reserves that gold imports create, and it would tend to sterilize the effect of the reserves that would be created in our support of the 2½ market if insurance companies and others sell 2½ bonds.

Representative PATMAN. You made that very plain in your testimony.

Mr. ECCLES. Otherwise, the banks would have these reserves and they would be out under pressure to be making loans, under an inflationary condition. If we had that condition in deflation, it would be fine. But in a condition now where the supply of money is already excessive in relation to the total product, to be inducing the banks to seek loans and to be putting in a condition where it is in their interest so to do, because they have idle funds, idle reserves, that we have created for thm, or our gold policy has, is something that we do not want to do.

Now, last year they were doing just that.

Representative PATMAN. If you had this power, Mr. Eccles, and you exercised it, which, of course, you would do under the circumstances——

Mr. ECCLES. Well, we would if bank credit expanded, and if it didn't we wouldn't be justified in doing it.

Representative PATMAN. If you did, do you think that would have a tendency to keep prices down?

Mr. ECCLES. Yes. It would have a tendency to keep credit expansion down. And to the extent that credit expansion was kept down the money supply would be kept down. Certainly you can't get inflation without money. Inflation is a reflection of the expansion of the money supply; not directly, because velocity must be taken into account, too; but certainly, without an expansion of the volume of money on a given supply of goods and services, you are not going to get a dangerous inflationary situation.

Representative PATMAN. Suppose the Board had the power today. Would you want the Board to exercise that power to lower the present prices?

Mr. ECCLES. Well, we couldn't. There is no power today under which we could do that.

Representative PATMAN. I say if you had the power you are asking to be given to you, had that power now, would you use it to lower prices and wages?

Mr. ECCLES. You couldn't lower prices and wages by doing it. If we undertook to lower prices and wages, it would have to be done by withdrawing support from the Government market and raising the discount rate.

Now, we could actually make credit so tight if we refused to buy Governments and raised the discount rates accordingly that it would be just like it was after World War I. You certainly could create that kind of a situation with that kind of a policy. But so long as you support the 2½ percent Government rate you really can't make bank credit tight. And that is something to which we are committed for the foreseeable future.

Nobody wants to say forever, but certainly so far as the Federal Reserve people can see things at the present time, we have an unavoidable responsibility to the support of the 2½ percent rate.

As I stated, while you are doing that, you really can't make bank credit tight. If you increased the reserve requirements to the full extent that is indicated here, that is a total amount of $12,000,000,000, and the banks have $67,000,000,000 of Governments, they could easily meet that requirement. They could meet it simply by selling $12,000,000,000 of Governments, and they would still have $57,000,000,000 left.

Representative PATMAN. Now, I want you to apply that from a practical standpoint by using a Reserve city bank as an illustration.

How could a Reserve city bank increase its reserves to make additional loans? And how much could they increase them?

Mr. Eccles. How do you mean?

Representative Patman. How could a Reserve city bank, in selling bonds to the Federal Reserve bank of that district, increase its ability to expand its loans?

Mr. Eccles. Well, if a bank hasn't got any excess reserves, or, that is, has no money to lend—then, let us say they wanted a million dollars of reserves. They would sell a million dollars' worth of their Governments. Those Governments would be purchased by the Federal Open Market Committee from the dealers to whom they were sold, and funds would be credited to that bank that sold the bonds.

Now, assume that bank makes a loan, and this is the way it makes a loan. It gives credit to the borrower in the form of a deposit account. Then, in place of the bond that is held, the bank has a note of the borrower.

Representative Patman. They could have an aggregate of how much in notes?

Mr. Eccles. Well, just one for one; that bank.

Representative Patman. I know; that particular bank. But in the entire Reserve System, it would be about 10 to 1.

Mr. Eccles. When the customer draws down that deposit, it is transferred to another bank. That other bank must lay 20 percent against its new deposit and then has 80 percent of that money to loan. It doesn't know where the deposit came from. It doesn't know anything about it. It is the reserve funds that were created in the first instance which are important. And when these reserve funds once get into the spending stream, then the effect of their use is to create at least six times that amount of money, which in turn becomes part of the spending stream.

Representative Patman. That is the average.

Mr. Eccles. Yes; that is minimum. You have to take savings into account and also nonmember banks. Nonmember banks are not now subject to Federal Reserve requirements. Under State banking laws, nonmember reserve requirements can be met by holding deposits with member banks.

Representative Patman. How large a national income do you think we should try to maintain in order to pay our national debt, Mr. Eccles, with the least discomfort and inconvenience?

Mr. Eccles. I think if we are going to have reasonably full employment at current price levels we have to maintain a national income, certainly, with the present population, of around $200,000,000,000.

Representative Patman. $200,000,000,000?

Mr. Eccles. I think so.

Representative Patman. I would just like to know that the Federal Reserve Board certainly has nothing in mind like what happened in 1920.

Mr. Eccles. Well, you can be perfectly sure of that. As far as the present Board is constituted, I am perfectly certain of it.

Representative Patman. That is the reason I wanted you to say "about $200,000,000,000," because if you keep it about $200,000,000,000, you cannot go to far on that.

Mr. Eccles. The idea that the Federal Reserve can——

Representative Patman. Yes; but to encourage it, Mr. Eccles; not to do anything to stop it. That is what I have reference to.

Mr. ECCLES. Of course, it is a very difficult thing to stop inflationary pressures at this stage without, maybe, getting some deflation.

In this connection, I would like to make another observation. With reference to the matter of some rise in the short-term rate, we have already had some. In other words, the rate has gone up from ⅞ to 1⅛. Now, if you were to get some little further rise in the short-term rate, when the situation is reversed, you can drop it. But you cannot drop it if it is already on the floor.

And the same thing is true in the financing of housing. In this sort of a situation, if you get a little higher rate, and if then you get a deflation, you can lower the rate. It is a good thing to have some backlog of housing at lower prices rather than filling up the entire backlog at these inflated prices, so that if you do get a slump you have absolutely no backlog available.

Representative PATMAN. I think those of us who are looking at this housing problem are not looking at this from that standpoint solely. We are looking at it from the standpoint that although it might cause some inflation, it is justified by reason of the necessity of getting decent housing for people.

Mr. ECCLES. It is justified up to the point that there are labor and materials available without inflating further the price of labor and materials. I would like to qualify that. I would say that it would even be desirable if there was a little surplus labor and material in the housing field, so that you might get the cost down a little. Housing construction is so badly inflated that it would not hurt any if they had a little deflation.

Representative PATMAN. You would not try to adopt any policy that would cause that, would you, Mr. Eccles?

Mr. ECCLES. I would, if the question of supplying a secondary market was all that was involved. I would say if there was likely to be some easing in the price of housing, some increased efficiency in the building of housing, some slightly reduced cost in housing, if there was no secondary market provided, and hence if there was a little less housing taken for the time being, I would be all for it. I would be for it especially in view of the other inflationary pressures, due to the foreign aid, and our military, and our tax-reduction program.

Representative PATMAN. Mr. Eccles, suppose that, after you get those powers, lumber should go up 25 percent, for a known reason, and other basic materials like steel and cotton and wheat and things like that should also go up. Would the Board take any action calculated to reverse that trend?

Mr. ECCLES. If that was based on a further bank credit expansion; yes. I do not think that could happen without further bank credit expansion.

I think these prices that you indicate are going up will immediately reflect in increased bank credit.

Representative PATMAN. Then, if you deny them credit, that will have a tendency to keep the prices back.

Mr. ECCLES. That will keep them in line.

Representative PATMAN. That is a lot of power, Mr. Eccles.

Mr. ECCLES. That is right.

Representative PATMAN. Of course, in an exaggerated case such as I mentioned, it certainly would be justified.

Mr. ECCLES. But as I told the committee before, we certainly are not seeking any additional power, and what is proposed here is less power than the System has always had, but which it now is unable to use if it supports indefinitely the 2½ percent rate.

Representative PATMAN. All I want you to do is to make it plain and continue to make it plain that you are not contemplating anything that happened in 1920.

Mr. ECCLES. Well, I am perfectly sure that everybody in the Board is conscious that if the Board were to use any power that would tend to stop the boom, or interfere with the boom, it would be an unpopular thing to do. Booms are always popular, and it isn't possible for the Reserve System to ever win. They just don't have a chance to win. Because any action that they take is sure to be unpopular with a lot of people.

Whenever you try to curb any use of credit or expansion of credit, you can be perfectly sure it is a very unpopular thing to do. But after all, that is one of the jobs of the Board that the Congress meant to give them, and I think that the Board should have the courage to do something about it, or the power should be given to somebody else. Because certainly if you are going to have any stability in the economy, you have got to deal with it either by direct means, which is contrary to the American way of doing it—and I mean direct controls, allocations, and everything—or you have got to try to get it in an indirect way, in a functional way, through fiscal and monetary and credit policy.

Now, that, it seems to me, is the only alternative.

And I, for one, prefer to have some freedom, and fluctuation and try to get at it through fiscal, monetary, and credit policy, rather than a completely regimented and controlled economy, which we have to adopt in emergencies, in war. And if, for military or other causes, due to developments, we have to run a large budgetary deficit, then certainly we will have to put those controls in again, or we will have to have an inflationary development.

That is the point I tried to make.

The CHAIRMAN. Mr. Eccles, earlier today you suggested you might have some ideas on the question of whether under present conditions there is enough inducement for people to invest in equities as against loans.

One of the reasons that has been suggested for the excessive pressure for loans, is the inability to get equity money. If that is so, what has caused it, and what is the remedy?

Mr. ECCLES. There is certainly no shortage of equity or other money today. That isn't the problem. The problem today is the shortage of material. And if there was more equity money, there would be more demand for goods that are in short supply. The problem is not a shortage of money.

The CHAIRMAN. Now, we have had some cases brought to my attention. One was the company that wanted to sell stock and could not, and wanted to withdraw stock issues; and there were several stock issues withdrawn here some months ago. They could not sell more bonds, because the Public Utilities Commission said that would be an improper balance; that what they needed was more equity money.

Mr. ECCLES. That is right.

The CHAIRMAN. Would you think that that was a special case? Or do you think that situation has changed?

Mr. ECCLES. I think that there are a lot of such situations; and I think if the equity market was open, you would have more inflation than you have got. Because, if it was easier for corporations to get money than it is today, you certainly would have more of it spent. You would have more of them trying to expand the capital-goods market. There seem to be enough corporations with enough money already on hand or with Government bonds.

The CHAIRMAN. It is suggested, however, that most of that money comes from profits. Profits are very ephemeral and likely to disappear from the exchange; and they cannot get outside money, outside new money.

Mr. ECCLES. It is because they are trying to expand faster than savings are accumulating. And that is undesirable, because when you are expanding new investments, either by corporations or individuals, faster than the community as a whole saves the money, you have inflation again.

The CHAIRMAN. Well, of course, this is more of a long-term problem than it is an immediate problem; because, as you say, you do not need at the moment more money. But there is a study by Professor Kuznets, I think, simply to show that there was no net saving in the thirties; practically no new investment. We were not moving ahead as we had before.

Mr. ECCLES. Because you had a lot of unused capital facilities, and consumer purchasing was not in the then deflated conditions adequate to use what new investments had already been created in the twenties. You had idle capacity, and that is why in the thirties you didn't have a lot of new investment going forward; because there was too much idle capacity in almost every field.

The CHAIRMAN. Well, I mean, that is the cart before the horse. If you had had more investment, if you had had more willingness to put money into capital goods, you might have started up an industry that would have really pulled us out of the depression. In fact, that is the way we have gotten out of depressions before. In the thirties there was no such money. Except for a brief period in 1937, it collapsed overnight.

Mr. ECCLES. If we had had more consumption that might not have been true. As you survey the situation, we had an excess of office buildings and hotels and apartments and factory production of all kinds. We had idle railroads. We had an excess of utilities. We had an excess of automobiles. In almost any field you looked at in the thirties there was excess capacity. What was lacking at that time was consumer purchasing power.

Today you have a complete reversal of that situation. You have a situation where the general public's demand for saving has exceeded the total volume of savings. In order to carry forward the housing and other new investment, there has been a heavy reliance on the use of bank credit. When the bank credit starts to tighten up slightly, then the Government wants to step in and to supply it in one way or another.

The CHAIRMAN. Apparently nobody is willing to put any equity money into housing. That may be because nobody wants to put it into equities, or maybe they do not want to put it into housing. I do not know which. But very little is going in.

Mr. ECCLES. It is because of the inflated price, and people have no confidence in buying. When you put equity money in housing, it means that you have made an investment in housing at these prices. Few enterprisers want to do that. They are perfectly willing to have the little fellow come along and put his equity in and go in debt for the housing at these prices. The builder is unwilling to put his equity money in housing because he just does not have confidence that it is a good investment at these prices.

I think that is one of your major troubles in the housing field. That certainly would be my feeling. And I would feel the same way about putting money into an office building, or into a hotel.

The CHAIRMAN. It is suggested that with the present tax rates nobody with very much income can long afford to put money into equities.

Mr. ECCLES. Into what?

The CHAIRMAN. Put money into equities, and take a chance; when he can get 2½ percent on a Government bond.

Mr. ECCLES. What present tax rates do is to induce the people to put money into municipals. The wealthy people today put their money into municipals. The municipal rate will give them 4 or 5 percent, when you take into account the fully tax-free feature. There is no Government bond or comparable security that will pay them anything like that.

The CHAIRMAN. Do you not have the dilemma that the very wealthy man will not put money into equities and the poor man should not? The poor man puts it necessarily into insurance or savings banks, which have to put their money into loans. So the more you shift savings to the lower-income groups, the less equity money you have.

Mr. ECCLES. Of course, I know the argument of the brokers. They say if we would reduce margins, then, of course, the equity market would go forward. Well, that is merely a case of expanding credit largely for speculation, because that is how the margin trading would be financed. And that means bank loans to brokers or to others for the purpose of buying securities.

They would be better off to have the bank loan to the corporation in the first instance than to have the money loaned to individuals through the brokers, or directly for the purpose of buying the securities. You do not accomplish anything by that route. And the only way you can help the equity market is where you have more savings available, and then there is a chance for those funds to go into equities.

The CHAIRMAN. I would say, off-hand, just from having contact with a few securities, that there is very little interest in buying stocks today. I am not talking about margins. I mean investing in stocks. I do not know just why.

Mr. ECCLES. Well, it is because people have no confidence in the future. It is the whole uncertainty. People are feeling today that they do not know whether you are going to have a deflation or an inflation. The whole question of what is going to happen in the world picture is causing people to be very, very hesitant. If there was some assurance that you were going to have more of an inflation, it would improve your equity market tremendously. On the other hand, if there was a feeling that you were not going to have any further inflation, then, of course——

The CHAIRMAN. As of November, everybody was rushing in here saying there was going to be an inflation surely, inevitably. It did not produce anybody rushing out to buy stocks that I ever discovered.

Mr. ECCLES. We didn't come in and say there was going to be an inflation. We have pointed out definitely that so far as the monetary front was concerned, there would be no inflation on that front until after the first quarter. During the first quarter, we said that there would be a deflationary situation, due to taxation. You will recall that we said, as to the proposal that we discussed at that time before the committee, the special reserve plan, that there was no pressure for it at the time; that it could be considered after the first quarter.

The CHAIRMAN. That was not the general tone during the special session in the fall. Yours was the most conservative view we had on it.

Mr. ECCLES. I was dealing with it, of course, only on the credit and the monetary front. And with reference to the question of equities, this argument has been raised: that a reduction of taxes in the higher brackets would induce the well-to-do people to use the savings that they would get as a result of the tax reductions to buy equities; and thus, it would not be necessary for the corporations to use bank credit to the same extent. It may be that some of the tax savings of the well-to-do would go into equities, and corporations would carry out their expansion as a result of getting that money, instead of using bank credit. Or they might carry out an expansion which they would not carry out if they could not sell their equity; and that expansion might might be inflationary and undesirable.

Again, they may already have the bank credit, and if they could sell equities, they would pay off the bank loan. That would be deflationary. But to the extent that the Government would lose revenue in taxes, and just to that extent, the Government would be less able to pay off its debt at the banks.

You have got to remember that the Government has debts as well as corporations, and the question of taxation is a question of whether or not the taxpayer pays it to the Government and the Government applies that on its debt, or whether the individual keeps the money and provides the equity money to the corporation, so that the corporation can pay it on its debt.

Now, in an inflationary situation such as you have now, I think it is more constructive for the Government to collect it and apply it on its debt. I certainly think if you had a reversal of business conditions, that is, a deflationary situation, then you would want to reverse that.

If we try to do everything in an inflationary situation that we ought to do in a deflationary situation, we will have nothing to do, if we ever get a deflationary situation to counter it. The principal hope of a capitalistic democracy, it seems to me, is to be able to use its fiscal and monetary policy both against deflation and against inflation. Flexible fiscal and monetary policy is essential to stability.

I recognize that that is not an easy thing to do. And the opposite to that is to let nature take its course on the boom-bust theory that private capital, and individuals left to their own devices without Government doing anything, will work their own way out better. That is the other side of it.

The CHAIRMAN. Your theory sound like a theory of mine. I always refused to have my tonsils taken out, on the ground that if I ever got sick I wanted to have something left to do to cure it.

Mr. ECCLES. I would not say that, if we didn't already have a continuing inflation.

The CHAIRMAN. I agree.

This question that we are raising is a long-term question. I mean I am not trying to apply it to the immediate problem. I don't think there is any concern about it at this moment. But I do think there is a good deal of doubt whether, as we have the high tax rate, which I think we are bound to keep on high incomes, and more of savings in the lower income groups, we are going to get equity money.

It does seem to me that that presents a long-term problem that somebody is going to have to consider.

Mr. ECCLES. Of course, the community-property tax has gone a long way to help very substantially the people in the higher brackets. Certainly from $25,000 to $100,000 they have had real relief as a result of that community-property tax; that is, those who were not already in community-property States, and I happen to be one of them.

The CHAIRMAN. And those who had not already divided their property with their wives.

Mr. ECCLES. I was all in favor of the community-property provision.

The CHAIRMAN. In any event, you do not think that there is any concern immediately regarding the question of getting more equity money?

Mr. ECCLES. No, I don't think there is any concern at all. I think that concern would come and would possibly be met, if you had a deflationary situation.

Certainly at that time, I think the Board, Senator, would be justified in reducing margins very substantially on security. If you had a deflationary situation, where bank credit was rapidly contracting and unemployment developing, we certainly would not hesitate to encourage bank credit.

Representative PATMAN. On the question of equity capital, Mr. Eccles, is it not a fact that most investors can get the benefit of the capital-gains tax and not be out over 25 percent in taxes anyway?

Mr. ECCLES. Yes; they can get it on real estate. They can get it on any asset.

Representative PATMAN. Is not most equity capital in that category?

Mr. ECCLES. It is all in that category. If you buy it and it goes up, and you sell it while it is up, after a 6-months' period.

Representative PATMAN. That is what I mean; for a profit.

Of course, if it goes down, you are at a disadvantage taxwise.

Mr. ECCLES. That is true.

Representative PATMAN. You can only deduct how much, as a maximum amount, on a long-term capital loss?

Mr. ECCLES. Over a 6 months' period you get the benefit of a capital gain.

Representative PATMAN. That is where it increases.

Mr. ECCLES. If you have a capital gain, it means 25 percent. That is really where the tax is.

Representative PATMAN. That is when it increases. But suppose it goes down? There is a limit to what you can charge off, is there not?

Mr. ECCLES. That is right. I think you can charge off not more than a thousand in any one year, unless you charge if off against the capital gain. You can charge off the capital loss on one security against a capital gain on another, but if you do not have a capital gain, and take the capital loss, then you can only charge off a thousand, I think it is, a year.

Representative PATMAN. It is not cumulative.

Mr. ECCLES. Up to 5 years; $1,000 a year up to 5 years.

The CHAIRMAN. Of course, in that kind of equity investment, you only bring that result about by selling out. You put the money into a business, and then you have to figure on selling it out and putting it in another business.

Mr. ECCLES. I will tell you one of the principal reasons that corporations have a disadvantage in selling equities against bonds: that in the case of financing by bonds or mortgages, they can deduct the interest against their income tax. If they finance on an equity basis they of course cannot deduct their dividends against the earnings.

Corporations prefer debt up to a point of safety. Naturally they do not want to get to a dangerous point, but they actually prefer debt, because there is such a tax advantage. The stockholder of the corporation pays his share, in effect, of the corporation tax, which is about 40 percent, out of earnings. Then, on the earnings that are left, to the extent that they are paid in dividends, he pays surtax on the dividends.

So, you see, there is quite a premium on the use of equity capital as against debt. And that is one of the principal deterrents to the use of financing by equity capital. That is a much more important factor in the picture than any other: the tax disadvantage of equity capital as against using the debt form.

Representative PATMAN. I have no other questions.

The CHAIRMAN. We thank you very much, Mr. Eccles.

The committee will recess until Friday at 10 o'clock, and will meet in room 138 at that time.

(Whereupon, at 4:20 p. m., an adjournment was taken, to reconvene at 10 a. m., Friday, April 16, 1948.)