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Preliminary Statement of Mr. Allan Sproul,
President of the Federal Reserve Bank of New York,
Before the Subcommittee on Monetary, Credit, and
Fiscal Policies of the Joint Committee on the
Economic Report, December 2, 1949.

As I understand it, your interest at these hearings is in exploring the various points of view developed in response to your questionnaire inquiry, rather than in having individual witnesses try to cover all of the ground from the beginning, by means of a long prepared statement. In any case, I have given you my views on the general subject of your inquiry in the extended answers to your questionnaire prepared by a special committee of the Federal Reserve Banks, which I sent you with a covering letter of my own. Today with your permission, therefore, I shall confine my preliminary remarks to a few brief comments on one or two critical points which, as I see it, need fresh emphasis or elaboration, in view of the other replies and testimony you have received.

(1) In an inquiry as broad as that which you are conducting, there is well-founded and proper concern with a host of questions, many of which, however important in themselves, may tend to divert attention away from the central problem. In the area of monetary, credit, and fiscal policies, and under present conditions, I believe that problem is how to combine effective monetary management with effective debt management. There cannot be a purposeful monetary policy unless the Federal Reserve System is able to pursue alternating programs of restraint, "neutrality," and ease, in a roughly contra-cyclical pattern. Such programs must, as they accomplish an increase or contraction in the volume of credit and a tightening or loosening in the availability of credit, affect interest rates, not only for private credit, but for Government securities. The terms of Treasury offerings for new money, and for refunding issues, must be affected. Yet those effects will, at times, be inconvenient and burdensome to the Treasury in its management of the enormous public debt, and may conflict with otherwise praiseworthy efforts to minimize expenditures for debt service.

This is an inherent conflict. It will continue to arise, in one form after another, so long as this public debt, huge in relation to our present national income, is with us. It is important, therefore, that better means be found, if possible, for reconciling potential differences between the Treasury and the Federal Reserve System so that action in the credit sphere may be taken promptly, as needed, in reasonable harmony with the action being taken by the Treasury in the sphere of debt management.

The record of cooperation in the postwar years has been better than might have been expected, and so has the record of our economy, whatever connection there may be between the two. But agreed action, in my opinion, has most often been too little and too late, so far as the aims of an effective monetary program were concerned. For example, the System wanted to discontinue its preferential discount rate on Government securities maturing within one year, before the end of 1945; Treasury acquiescence, and the action, did not come until April 1946. From the closing months of 1945 through all of 1946, the System was pressing for discontinuance of its artificially low buying rate - 3/8 of 1% - on Treasury bills; the action finally came, with Treasury agreement, in July 1947. From that point on, as inflationary pressures increased, the System wished to follow a program of

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credit restraint which would have necessitated small but, perhaps, frequent increases in short term interest rates which would have meant similar increases in rates on Treasury bills and certificates, and some increase in the yield of other short and intermediate Government securities. The Treasury did a large part of the job, of course, by devoting its substantial cash surpluses to the retirement of debt in such a manner as greatly to aid in achieving the common objective; but the Treasury was generally several months behind in accepting the implications of a tightening policy for the interest rates on its short term securities.

Now, and so far as we can see into the next fiscal year, there is not much chance of the Treasury's enjoying cash surpluses; in fact, cash deficits with their inevitable bias toward inflationary pressure, when the economy is already working close to capacity, seem to be in the cards. It may become all the more important under such circumstances, and would become most important if inflation should in fact return, that the Treasury be receptive to rising rates -- the same rising rates that would be required in attempting to hold in check any inflationary tendencies in credit expansion to the private sector of the economy.

It is this situation which lends weight to the suggestion that there be a Congressional directive, specifying as part of the legislative framework for debt management that the Treasury should work within the structure of interest rates appropriate to the economic situation. The implication of such a directive would be that the Treasury could not, as a matter of right or of superior position, call upon the Federal Reserve System to "make a market for its securities" at rates which the System believed to be out of line with the degree of credit restraint considered necessary by the System. I recognize that there would continue to be differences of opinion about these matters, and I realize that you cannot legislate cooperation between people, but the Congress, as final arbiter, might be able to provide a mandate which would charge debt management as well as monetary management with some responsibility for the objectives specified in the Employment Act of 1946. The country cannot afford to keep money cheap at all times and in all circumstances, if the counterpart of that action is inflation, rising prices, and a steady deterioration in the purchasing power of the dollar -- including the purchasing power of the dollars which the Government itself must spend and the purchasing power of dollars invested by the public in Government securities.

Whether or not a directive is possible or may be forthcoming, there seems to me to be a clear need to study this question of how to bring about a more regular relationship for consultation between the Treasury and the Federal Reserve System than that now temporarily provided through fortunate personal relationships. One suggestion along these lines which may deserve your consideration is that there be created a national advisory council on domestic financial policy, a consultative body which would bring together the heads of the four or five principal agencies whose activities affect, directly or indirectly, the areas of prime responsibility of the Treasury and Federal Reserve System. Such a council might also extend its scope to include within its purview, on a purely consultative basis, the lending and loan guarantee activities of all other Federal financial agencies -- in the interests of frequent consideration of overlapping mutual problems. This suggestion is open to the criticism that it might be just another piece of machinery, delaying decision but not leading to

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harmonious action. Nevertheless it is worth exploring. Another suggestion is that the Secretary of the Treasury be made a member of the Board of Governors of the Federal Reserve System. I have a latent distrust of these ex officio relationships and it didn't work well in the early years of the System, but the idea should at least be re-examined in the light of present conditions.

(2) If a suitable permanent framework for the relations between debt management and monetary policy can be established, the tasks of monetary control and debt management will not be impossible. While the money market is not so sensitive to slight changes or disturbances as it was from 1946 through much of 1948, when large segments of the swollen public debt had not yet settled into firm hands, it is still sensitive to relatively small changes in the interest rate structure, and to any uncertainty concerning the future direction of rates created by such changes, in terms of its readiness to make funds available for expansion. Through judicious use of discount rates and flexible open market operations, it should be possible to make monetary policy reasonably effective without such abrupt and such wide changes in interest rates as used to be considered a necessary part of central banking technique. Such a monetary program would be consistent with very moderate fluctuations in the cost of servicing the debt, and would not contemplate (nor require) large changes in the prices of outstanding Government securities.

In this context, the question of par support of Government securities, to which considerable attention has been given at past hearings and which has evoked some comment by witnesses before your committee, would shrink to a relatively minor issue. With the market susceptible to and habituated to small rate changes, any slight and probably temporary decline in prices below par would not be a matter of major concern. The likelihood that we shall be operating in this sort of climate is strengthened by the fact that we have already passed through the postwar period of most extreme capital demand, in excess of current savings, and an early recurrence of that kind of disparity, with the great upward pressure it exerts upon long term rates, is improbable. Moreover, the maturity of the Government debt now outstanding is being shortened automatically by the passage of time, a factor which exerts a mechanical downward pressure on the market rates for these issues (i.e., a rise in their price, over time), allowing more and more leeway, each year, so far as outstanding issues are concerned for fluctuations to occur above the par level.

This does not mean, however, that there has been or can be a commitment, express or implied, to support all Government securities at par at all times. Such a commitment would make any pretense of credit policy over the long run rather ridiculous, since the essence of credit control is fluctuating rates, reflecting credit availability. And just as the pretense of credit policy would be made ridiculous, the present forms of debt management would be made obsolete. If all Government securities of all maturities can be liquidated at par at any time, they become, in effect, demand obligations and need only bear varying rates of interest if we want to reward various kinds of holders in various ways. And again I say it would be a spurious gain to support all Government securities at par or better, ad infinitum. There may be extreme situations, which we cannot now perceive, when there would be greater losses and damage to the economy by reason of unbridled inflation, unrestrained by monetary action, than would result from allowing the price of Government securities to go below par.

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(3) I favor the extension of national reserve requirements to all (or at least all insured) commercial banks; I also favor the uniform reserve plan, relating reserve requirements to type of deposit, and abandoning the outmoded geographical classification. But both of these are essentially matters of improved housekeeping, they do not affect the real fundamentals of monetary control. I do not apologize for them on that account. I think it is unfortunate that needed improvements, which will add to efficiency and remove burdensome inequities, are often dismissed for lack of glamor or lack of urgency. But it is equally unfortunate if, in order to attain these improvements, they are "oversold" -- being offered as powerful remedies for problems that can better be solved in other ways.

As I see it the case of these proposals rests on simple grounds. So far as the application of reserve requirements to state chartered commercial banks is concerned, it is important to remember that these banks are exercising, by the acquiescence of Congress, a constitutional Federal function -- the power to add to or subtract from the money supply. While no one is more anxious than I to preserve those characteristics of local responsibility and initiative which are fostered by the state chartering of banks, I do question whether the arrangements which permit these advantages should also be used to avoid a proper share in the responsibilities of national monetary policy. To say that it would strike at the foundation of the state banking system to make nonmember banks subject to national reserve requirements seems to me to be putting the cart before the horse and then belaboring the horse.

State chartering and state supervision (the real essence of a "dual banking system") would not be disturbed by the extension of the System's reserve requirements to all banks. We have nearly 2,000 state-chartered banks, at present, as voluntary members of the Federal Reserve System. Their aggregate earning assets are nearly twice those of the more than 7,000 state-chartered nonmember banks -- the reserve requirements of membership have apparently not prevented the state-chartered members from thriving, nor has their membership destroyed their essential state character. And yet monetary policy can't be fully effective unless all parts of the banking system, the whole banking community, have some understanding of it and play the game. There should be some direct contact between the Federal Reserve System and all banks (or all insured banks) of the country.

If wider access to the discount privilege on the part of nonmember banks is necessary to make this palatable, it might not be too great a price to pay, and would have collateral advantages in strengthening the emergency liquidity of the banking system. I must confess to some lingering feeling, however, that if banks want (or if in the national interest they should have) all or most of the advantages of membership, they ought to pay their dues. As a counter-weight to possible concern that System control over all reserve requirements places too wide a range of authority in a distant Washington body, it should be pointed out that a transfer of authority over reserve requirements from the Board to the Federal Open Market Committee would assure a representation of regional banking experience in the determination of these requirements.

The type of deposit vs. geographical location reserve proposal also rests on considerations of equity among banks, and on the desirability of modernizing a control apparatus in order to permit the System to carry out its general mandate from Congress in the most efficient, practicable manner.

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(4) No change in the System's power over reserve requirements should be presented, however, as an alternative to facing head-on the actual and potential conflicts between monetary control and debt management. It has been argued, for example, that increases in reserve requirements (whether primary or secondary or what not) provide a way of tightening up on the availability of credit, without affecting interest rates and, therefore, without trespassing on Treasury prerogatives of debt management. We tried that approach in 1948, without appreciable results. Following the increases in reserve requirements in that year, the banks sold Government securities to the market in a volume roughly equal to the dollar amount of their increased reserve requirements; the market in turn unloaded an equal volume upon the Federal Reserve Banks. That result was inevitable, I believe, so long as the Federal Reserve held its buying rates (that is, held interest rates) virtually unchanged.

We saw the reverse operation this past summer. Reserve requirements were lowered, and the banks used most of the proceeds to buy Government securities from the market, while the Federal Reserve Banks sold (or redeemed) a roughly corresponding volume. There were other factors at work, to be sure, in both of these periods but full review of the statistical record, making allowance for these other factors, still shows that the 1948 increases and the 1949 reductions in reserve requirements resulted mainly in shifts of Government securities between the Federal Reserve Banks and the commercial banks.

The inescapable fact, in my opinion, is that moderate changes in reserve requirements, up or down, will have no appreciable effect upon the availability of credit to the general economy, if rates have to be held constant. And if rates can vary, changes in reserve requirements are a crude way to do a job that the discount rate and open market operations can accomplish with much greater flexibility and precision. The proper role for changes in reserve requirements is in making long run "strategic" alterations in the banking structure, in response to sustained gold flows, for example, or shifts in the public's habitual use of currency. The one exception might be a period of runaway inflation, of an extreme form such as has not occurred in the history of the Federal Reserve System. Under such circumstances, when all traditional control instruments have been outdistanced and crude but drastic measures become necessary, it might be effective to make temporary, emergency use of very high reserve requirements, perhaps as high as 100 per cent, against <u>new</u> deposits, in order to immobilize for a time the money-creating capacity of the commercial banking system. Short of that, given the environment created by the present large national debt, changes in reserve requirements seem to me to have no significant role to play in the day-to-day adaptation of credit policy to the changing business situation. They cannot be substituted for rate flexibility, in influencing the availability of bank credit to the economy.

I have given you my views on what seems to me to be a central point of your inquiry, with some collateral comments. I shall be glad to try to answer questions raised by this presentation, or questions related to other aspects of your studies if you so desire.

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Remarks on the Organization of the Federal Reserve System
by Mr. Allan Sproul, Supplementing His Preliminary Statement
Before the Subcommittee on Monetary, Credit, and Fiscal Policies
of the Joint Committee on the Economic Report, December 2, 1949.

In my reply to your questionnaire, I suggested that the responsibility for all major instruments of Federal Reserve policy should be lodged in the group now called the Federal Open Market Committee. Other monetary controls must be integrated with open market operations, and there is certainly strong logic on the side of unified direction over all of them. Such a change would also assure the regular representation of actual operating experience, and an awareness of differing regional problems, in the formulation of the interrelated aspects of a national monetary policy. It is not an ideal arrangement, nor even good administrative procedure, to place open market operations under a broadly representative committee, and to place the power over reserve and margin requirements, and the review and determination of discount rates initiated by the Reserve Banks, solely under the Board of Governors. The Federal Open Market Committee has worked well in guiding the most important instrument of Federal Reserve policy. The next step should be the transfer of other closely related powers of monetary control to that Committee.

This is a question on which men in the System may differ, displaying a bias, perhaps, toward the side they know best. As a Reserve Bank President, it is probably natural that I should see advantages in this proposal, while members of the Board may react against it, as an intrusion upon their authority. On this question, just as on the substantive questions of credit policy, both views deserve a hearing. My own view is that we shall do well to retain, wherever we can, the regional characteristics of the System, both in the matter of decentralized operation and, more important, in the matter of System national policy. No one would deny the need for coordination of general credit policy, but we now have, in the Federal Open Market Committee, the statutory means of achieving this while retaining some regional participation and responsibility. This Committee is composed, as you know, of the seven members of the Board of Governors and five of the Presidents of the Federal Reserve Banks. Here are brought together, under statutory auspices and with statutory responsibilities, men who are devoting their full time to the problems of the Federal Reserve System and who are in touch with governmental policies and private views and opinions, in Washington and throughout the country. It is the best expression which we have of the Federal character of the System, a character which is in tune with our political organization, with the continuously expressed intent of the Congress, and with the desires of our people.

And let me nail right here one or two arguments which have been advanced on the other side. First, there is the argument that the Presidents on the Federal Open Market Committee exercise authority without having responsibility. In the first place, as I have stated, membership on the Federal Open Market Committee, and the duties and responsibilities of the Committee are now fixed by statute. Every man who accepts a place on that Committee derives his authority from the Congress and assumes a responsibility to the Congress and, through it, to the public. These Presidents are mostly men who have devoted their lives to the Federal Reserve System - they are career men in the public service. It comes with ill grace for anyone who has ever served on the Committee to hint that they are swayed by private interests to compromise public duty. You do not plant honor and integrity in a man by bringing him to Washington and giving him an official position in the Government.

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Second, there is the argument by threat; by posing a wholly unacceptable solution as the only alternative to the giving of additional powers to the Federal Open Market Committee. This is the argument that if you are going to give additional powers to the Committee, you should abolish the Board of Governors. Such an argument seems to me to miss the whole point of the original suggestion. The essential and unique characteristic of the Federal Open Market Committee is its blend. The Board retains all of its existing duties, but exercises its principal powers through majority membership in the Federal Open Market Committee. The Presidents, with their experience gained through carrying out policy in the field, sit as minority members of the Committee. All participate in policy making discussions, and conflicting views are given the test of thorough debate. You are protected from being blown off your course by either the political winds of Washington or the financial winds of Wall Street.

The compromise solutions which have been brought forward do not impress me. It is not enough, I am sure, to bring the Presidents of the Reserve Banks into the discussion of these matters of credit policy as advisers. Occasional requests for comments are not enough, nor is it enough to provide for attendance at meetings without membership or vote. You have to "belong" to be able to insist on consideration of your point of view. Similarly, I do not believe that the suggestion that two of the Reserve Bank Presidents come to Washington each year for full-time service on the Board of Governors is practical. Such men would bring valuable lessons of past experience to the Board, but they would have divorced themselves from the insight produced by close contact with current operations. They would be cut loose from their own staffs, their directors, and their districts, and transplanted to the somewhat unfamiliar Washington scene, while their institutions would be deprived of chief executive officers for a year at a time, one year out of six.

This is a case where the whole cannot adequately be replaced by either of its parts. In my view, we have developed through the Federal Open Market Committee a unique contribution to the processes of democratic administration. The System will best meet its responsibilities if this successful pioneering experiment is expanded to embrace all of the major policy determination of the System.

Nor am I frightened by the express or implied threats that to insist on placing more powers in the Federal Open Market Committee is to hasten the nationalization of the Federal Reserve System, and the removal of any taint of private participation in its affairs. I think we shall do well to retain the modest measure of private participation in the affairs of the System which we now have, to make effective use of those public spirited men who are willing to serve as directors of the Federal Reserve Banks. And I believe the Congress will feel that way if and when it examines the situation. We are a successful working example of Government functioning in the economic field, with the aid and support of private business. Our experience in Government-business cooperation - with Government having the dominant and deciding voice - may be one signpost along the way to solution of that major problem - the relation between Government and business in our whole economy.

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