REPLY OF THE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

To the Questionnaire of the Subcommittee of the Joint Congressional Committee on the Economic Report

NOVEMBER 1949

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CONGRESS OF THE UNITED STATES

Joint Committee on the Economic Report

August 22, 1949

The Honorable Thomas B. McCabe, Chairman
The Board of Governors of the Federal
Reserve System
Constitution Avenue and 20th Street
Washington, D. C.

My dear Mr. McCabe:

By direction of Congress, the Joint Committee on the Economic Report has undertaken a comprehensive study relating to the effectiveness and coordination of monetary, credit, and fiscal policies. This study will not be limited to issues of immediate importance, but will include all the major factors in the fields of monetary, credit, and fiscal policies that significantly affect our ability to achieve the purposes of the Employment Act. A Subcommittee composed of Senators Paul H. Douglas, Chairman, and Ralph E. Flanders, and Representatives Wright Patman, Frank Buchanan, and Jesse P. Wolcott has been appointed to conduct the study.

The Committee will appreciate your cooperation in answering the enclosed questionnaire and returning your answers to this office at your earliest convenience, but not later than October fifteenth. If convenient, please send thirty copies of your answers for the use of the Committee and its staff. It would also be extremely valuable if you would discuss any other subjects in the fields of monetary, credit, and fiscal policies which you believe the Committee should consider and which is not specifically covered by the questionnaire.

Very truly yours,

(Signed) Paul H. Douglas

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November 1, 1949.

Honorable Paul H. Douglas,
Chairman, Subcommittee on Monetary,
Credit, and Fiscal Policies,
Senate Office Building,
Washington 25, D. C.

Dear Senator Douglas:

In submitting these answers to your questionnaire of August 22 on monetary, credit, and fiscal policies, I would like to express my sincere appreciation of your consideration in granting me the few days of extra time to prepare them.

I had no idea of the magnitude of the task involved until I sat down with our staff and began to analyze the length and breadth of these most penetrating questions. In my judgment, if everyone to whom these questions have been addressed catches the constructive spirit of the inquiry and frames answers in a spirit of objectivity, you will have in your possession a most significant contribution to better understanding of this vital subject.

Although I had the benefit of the wealth of experience of the other members of the Board of Governors and of our very able staff, the final answers are my own. I have not asked the Board to share the responsibility of any of the conclusions.

With warmest regards,

Sincerely,

THOMAS B. MCCABE,
Chairman.

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I. OBJECTIVES OF FEDERAL RESERVE POLICY

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I. Objectives of Federal Reserve Policy

1. *What do you consider to be the more important purposes and functions of the Federal monetary and credit agencies? Which of these should be performed by the Federal Reserve?*

The principal purposes and functions of the various Federal monetary and credit agencies, taken collectively, may be stated broadly as follows:

(1) To accommodate commerce, industry, and agriculture by assuring an adequate but not excessive volume of money and credit at rates of interest appropriate to the general welfare of the economy;

(2) To preserve confidence, so far as these agencies can contribute to that end, in the country's money and in the financial institutions in which the savings of the people are invested;

(3) To maintain a valid rate of foreign exchange appropriate to the position of the American economy in the world economy;

(4) To foster continued strengthening of the democratic system and its related economic institutions by encouraging maximum reliance on private banking and other lending institutions;

(5) To promote active and effective competition among lenders;

(6) To assist in formulating and carrying out Government economic policies which are consistent with the Employment Act of 1946;

(7) To contribute, through participating in the formulation of international economic policies, to the solution of international monetary and economic problems.

THE FEDERAL RESERVE

Among the various Federal monetary and credit agencies the only one whose primary purpose is monetary is the Federal Reserve; the others (see final section of this answer) are not charged with statutory responsibility for general monetary

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policy, although some of them have functions of a monetary nature.

Monetary functions are those concerned directly with regulating the supply, availability, and cost of money. The most important responsibility of the Federal Reserve is that of determining policies with respect to these functions in accordance with the broad objectives of public policy—notably that of contributing to sustained progress of this economy (except in time of war, when other objectives supervene) toward the accepted goals of high employment and rising standards of living. Though not always stated by responsible authorities in just these terms, this purpose has been dominant throughout the life of the Federal Reserve. A recent statement of it appears in the 1946 Annual Report of the Board of Governors of the Federal Reserve System (italics supplied): "It is the Board's belief that the implicit, predominant purpose of Federal Reserve policy is to contribute, insofar as the limitations of monetary and credit policy permit, to an economic environment favorable to the *highest possible degree of sustained production and employment.*" A similar statement, indicating that the same concept was held by the founders of the System, was made in 1913 by the Chairman of the Senate Committee on Banking and Currency in discussing the bill to establish the Federal Reserve System (italics supplied): "Senate Bill No. 2639 is intended to establish an auxiliary system of banking, upon principles well understood and approved by the banking community, in its broad essentials, and which, it is confidently believed, will tend *to stabilize commerce and finance,* to prevent future panics, and place the nation upon an era of *enduring prosperity.*"

The Federal Reserve Banks hold the reserve balances that member banks are required by law to maintain against their deposits, and issue most of the currency that is put into circulation in response to the public's demand for cash money. Federal Reserve policies influence the supply, availability, and cost of money by adding to or subtracting from the supply of funds available to banks for extending credit or for meeting currency needs without depleting their reserves below the required level. The principal instruments employed by the Federal Reserve for this purpose are:

(1) Open market and discount operations, which

(a) add to or subtract from the supply of available funds, and

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(b) establish rates of interest at which such funds may be obtained; and

(2) The raising or lowering of the reserve requirements of member banks.

The System also has certain selective instruments which may be said to influence the availability of credit in particular sectors of the economy. The various instruments of policy used by the System are discussed further in answers to the questions in Part IV.

The Federal Reserve has a responsibility for adjusting the money market effects of international movements of funds and for helping to maintain the foreign exchange position of the dollar.

Monetary management in the public interest is the cardinal concern of the Federal Reserve System. It has the responsibility of advising the Government as a whole with respect to monetary matters, particularly as to the contributions of monetary and credit policy to general economic policy. It has an obligation through educational work to foster public understanding of monetary policies and the relation of money and credit to economic conditions and development. It collects and analyzes economic information to facilitate the attainment of the System's objectives. Together with the Treasury and the Government generally, the Federal Reserve System shares responsibility for maintaining universal confidence in our money and in our financial and economic institutions.

The System also has (or shares with other agencies) certain supervisory functions, including supervision not only of many banks but also affiliates and holding company affiliates of banks. It also performs certain important service functions such as supplying currency, facilitating the clearance of checks, and performing fiscal agency services for the United States Government. These functions are essential to the operation of the economy and require large staffs at the Federal Reserve Banks. The System also makes or guarantees loans to businesses in certain limited circumstances, as brought out elsewhere in this set of answers.

As I have indicated, the responsibilities of the Federal Reserve are not exclusively domestic. Movements of money into and out of this country affect, and in turn may be affected by,

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the operations of the Federal Reserve. This was notably true in the period when capital movements were not restricted by official controls. Federal Reserve policies influence the availability of funds for international loans and they may also offset or absorb the effects of international movements of funds on domestic money markets. The Federal Reserve System also has certain nondomestic operational functions, such as holding balances and acting as correspondent for foreign central banks and governments, making advances to foreign central banks, and passing judgment on applications by member banks and certain banking corporations to establish foreign branches and regulating their activities in foreign countries. In addition, as more fully described in the answer to Question III-1, the Federal Reserve System performs important advisory functions in the international field, both with respect to United States foreign financial policy and to financial problems arising in foreign countries.

As a general principle, I think that the Federal Reserve should perform those functions which are of a strictly monetary nature. How far functions which are not altogether of this nature should be confided to the Federal Reserve is discussed in the answers to other questions in this Questionnaire, particularly to some of those in Parts II and III and to Questions VI-2 and VI-5.

OTHER FEDERAL AGENCIES

Other Federal agencies whose primary spheres of activity affect monetary and credit policy are of a different category from the Federal Reserve. They include the Department of the Treasury and, in addition, a number of more specialized agencies of which the principal ones are the Reconstruction Finance Corporation, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Housing and Home Finance Agency, the Farm Credit Administration (each of the last two embraces a group of agencies), the Rural Electrification Administration, the Veterans Administration, the Export-Import Bank, and the Economic Cooperation Administration.

The Treasury has important monetary powers, such as those to purchase and sell gold and silver, to regulate the holding and the export of gold, and to mint coins and issue certain types of currency. In addition, it has important responsibilities for the international monetary and financial operations of this country.

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Other Treasury functions have an important influence upon monetary developments, particularly the handling of its cash balance and public-debt management. These relations are discussed in answer to the questions in Part II.

The other agencies are charged with responsibility for dealing with specific aspects of the credit situation; the operations of many of them take the form of granting credit to the public directly or of facilitating through guarantee and similar procedures, credit extension by others (as is brought out in the answers to Question VI-4 and VI-5). In some cases, their use of the credit mechanism is incidental to their primary purpose, which may be to aid agriculture, veterans, home owners, etc. Since the operations of all the specialized agencies have an influence on the general monetary and credit situation, even though none of these agencies is charged with responsibility for general monetary policy, there is need for some means (consistent with the responsibility of each agency) of bringing about a closer relationship between these operations and general monetary and credit policies. This problem is discussed elsewhere in this set of answers, particularly in the answers to Questions I-4, II-6, VI-4, VI-5, and VI-6.

2. *What have been the guiding objectives of Federal Reserve credit policies since 1935? Are they in any way inconsistent with the objectives set forth in the Employment Act of 1946?*

For the period since 1935, to which this question specifically relates, the credit policies of the Federal Reserve can best be described by dividing the period into four parts—before the war, during the war, the period of postwar inflation, and the recent period of abatement of inflationary pressures.

For the period from 1935 to the outbreak of the war in 1939, when the country was still in process of recovering from a deep depression, the Federal Reserve maintained a policy of monetary ease. The heavy gold inflow created a very large volume of bank reserves especially excess reserves, and led to the lowest interest rates in history. The Federal Reserve recognized that under conditions of the period an abundant supply of money at low rates was fully justified but at the same time was aware that the available supply of bank reserves was far in excess of any foreseeable needs in a peacetime economy. Accordingly

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steps were taken in 1936 and early 1937 to absorb some of the redundant reserves in order to forestall their subsequent use for excessive or unsound credit expansion. The over-all policy of monetary ease, however, was maintained.

During the war period, including for this country the period of defense preparation, Federal Reserve credit policies were in keeping with the nation's war requirements and at the same time were designed to help (along with more direct measures such as price regulation) to restrain inflation. During this period the objectives of Federal Reserve policy were: (1) to assure at all times an ample supply of funds available for financing whatever part of the defense and war effort was not financed through taxes and through the sale of Government securities to nonbank investors; (2) to maintain orderly conditions in the Government security market; and (3) to help maintain, in close collaboration with the Treasury, a structure of interest rates at approximately the levels existing at the beginning of the war—which had an anti-inflationary purpose to the extent that it would tend to induce nonbank investors to put money into Government securities instead of holding off in the expectation of higher rates. Anti-inflationary pressures were also exerted by the Board's regulation of consumer credit and stock market credit.

The war left the country with an unprecedented inflation potential which became active as reconversion proceeded, and continued until the end of 1948. In this period the objective of Federal Reserve policy was to apply as much restraint to inflation as could be applied without occasioning or risking so sharp a decline in the market for Government securities as might disorganize the capital markets. Pursuit of the second element of this composite objective involved providing support for the Government securities market so as to maintain relatively stable prices and yields. Pursuit of the first element included at one stage or another raising margin requirements to a maximum, elimination of a wartime preferential discount rate on short-term Government securities, discontinuance of a very low buying rate on Treasury bills and other measures conducive to increasing interest rates on Treasury bills and certificates, absorption of some bank reserves by open market operations, such as permitting maturing holdings to be retired for cash, some lowering of support prices on Treasury bonds, reimposi-

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tion of consumer credit regulation, and some increases in member bank reserve requirements.

More recently, as inflation began to abate and signs of some slackening in business began to appear, the policy of restraint was promptly moderated—initially by relaxation of restraint on consumer credit and stock-market credit—and then, during the second quarter of 1949, replaced by a policy of monetary ease, exemplified in particular by several successive reductions in member bank reserve requirements. The flexibility that is inherent in the structure and organization of the Federal Reserve System was never better demonstrated than in this most recent period.

Federal Reserve credit policies for all these periods—and related policies—are discussed more fully (and in broader context) in the answers to questions in Part II. It will be evident from this brief review, however, that for the entire period since 1935 Federal Reserve credit policies have been altogether in conformity with the objectives stated in the Employment Act of 1946.* Review of a longer period would show that throughout the System's existence Federal Reserve objectives have been in harmony with these broad purposes.

3. *Cite the more important occasions when the powers and policies of the System have been inadequate or inappropriate to accomplish the purposes of the System.*

It is well recognized that the policies pursued by the Federal Reserve System, over the 35 years of its existence, have not always been adequate or appropriate to accomplish fully the purposes which such an agency is designed to serve. How far this has been a result of inadequate or inappropriate legal powers, however, is a matter on which competent students of the subject do not seem to have come into general agreement. Remedial legislation has been enacted to take care of many of the problems which have arisen. The more important cases

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* "The Congress hereby declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power."

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where it has not are treated in other sections of these answers, particularly in Parts II, IV, and V.

4. *Would it be desirable for the Congress to provide more specific legislative guides as to the objectives of Federal Reserve policy? If so, what should the nature of these guides be?*

Whether Congress should provide more specific legislative guides as to the objectives of Federal Reserve policy is a question that has taken different forms at different times. Before the adoption of the Employment Act of 1946, with its declaration of a national policy to govern *all* Federal agencies, there were recurrent proposals that the Federal Reserve be given some very specific legislative mandate (such as one that would require the System to maintain a constant general price level). To these proposals the Board made vigorous objection, but on grounds which do not apply at all to the policy declaration set forth in the Employment Act of 1946. That declaration recognizes, as the Board had long maintained, that sustained national prosperity is not something that can be achieved by any single Government agency or by monetary means alone, or through using any narrowly defined guides to policy.

The carefully considered statement of objectives which is set forth in the Employment Act of 1946, since it applies to the Federal Reserve as well as to other Federal agencies, seems to be specific enough to serve the needs of the country in the monetary field. With that statement the directives to the Fed eral Reserve that are contained in existing legislation, though adopted earlier and sometimes in less specific terms, are entirely consistent.

This question is not taken to suggest that the Federal Reserve in pursuing the objectives of the Employment Act of 1946, should be specifically required to base policy decisions on some particular formula or some particular statistical guide (such as an index of general prices or the level of employment). Such a guide would not only traverse the principle recognized in the Employment Act of 1946 but would be likely to be so rigid as to defeat its purpose, since the making of decisions on monetary policy calls at all times for the weighing of a great many different factors *and* for the attaching of different weights to the same factor at different times. Such decisions must always be a matter of judgment, based on the fullest and widest information respecting all phases of the national economy.

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II. RELATION OF FEDERAL RESERVE POLICIES TO FISCAL POLICIES AND DEBT MANAGEMENT

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II. Relation of Federal Reserve Policies to Fiscal Policies and Debt Management

Monetary and credit policies are closely interwoven with fiscal and debt-management policies. These interrelationships have become increasingly important and binding as a result of the tremendous wartime expansion of the public debt to a dominant position in the over-all financial structure. It is essential that there be a high degree of coordination of decisions and actions and close cooperation on the part of the authorities operating in these fields.

Fiscal policies are in the final analysis determined by Congress in authorizing appropriations and legislating taxes, although the President and the various executive agencies of the Government have a major influence upon these policies in their recommendations for legislation and in carrying out the measures voted by the Congress. The Treasury has a primary responsibility for recommendations as to tax policy, as well as for the collection of taxes, and it has important discretionary authority with reference to the management of the public debt, which includes decisions as to the timing and nature of borrowing and of debt retirement. The Treasury possesses certain monetary powers—among these are the holding of monetary gold and silver stocks, the issuance of currency against them, and the minting of coins. The Treasury also has important responsibility with reference to the international financial operations of the Government. These various Treasury operations have a direct bearing on and are affected by conditions in the money market, with which the Federal Reserve is concerned.

The functions of the Federal Reserve are primarily monetary. As explained in answers to questions in Part I, most of the country's circulating currency is issued by the Federal Reserve Banks, and the System has primary responsibility for influencing the supply, availability, and cost of bank reserves, which provide the basis for the bulk of the country's supply of money and credit. Federal Reserve authorities, by exercising an influence on the cost and availability of reserves, can affect not only the level of interest rates but also the ability and willingness of banks to lend and invest. These policies necessarily impinge upon public-debt operations. The Treasury can

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affect the supply of bank reserves to a limited extent through the exercise of its powers with reference to gold or currency or through the handling of its cash balances. Moreover, the magnitude of public debt offerings (or retirements), the rates of interest paid by the Treasury, and the maturities and other features of the various issues are reflected in the demands for credit and can thereby influence the supply of money and the demands upon the Federal Reserve.

The rates of interest which the Treasury finds it necessary to offer on new issues of securities are to a substantial degree affected by the Federal Reserve's influence on the money market. Obviously if the Treasury and the Federal Reserve were preoccupied solely with the question of rates, they would sacrifice all other considerations to this end. Both of course must take account of the many broad aspects of their respective policies and the effects upon the entire economic structure. Because measures adopted by either agency must be taken into consideration by the other in determining its policies, it is most essential that the Federal Reserve and the Treasury cooperate in the effort to direct their respective policies toward common broad objectives of national policy. It is my view, as pointed out in answers to specific questions, that a splendid degree of cooperation now exists between the Treasury and the Federal Reserve.

1. *To what extent and by what means are the monetary policies of the Federal Reserve and the fiscal, debt management, and monetary powers of the Treasury coordinated?*

Coordination of Treasury and Federal Reserve policies is effected by frequent consultation between policy-making and operating officials of the two agencies. It is customary for Treasury and Federal Reserve officials to consult before decisions are made by the Treasury with respect to (1) the day-to-day variations in the Treasury's balance at the Federal Reserve Banks and calls on balances with other depositaries (these transactions temporarily affect the supply of bank reserves); (2) any changes in the usual amounts or terms of weekly offerings of Treasury bills; (3) periodic offerings of new issues of other marketable securities and refunding or retirement of maturing securities, with reference to amounts, rates, and terms; and (4) changes from time to time in the nature of offerings of nonmarketable securities. Purchases and sales of

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marketable securities by the Treasury for the account of Government agencies and trust funds are handled through the Federal Reserve Banks, acting as fiscal agents for the Treasury, and Federal Reserve officials are consulted as to monetary effects of such operations.

In connection with the consultations of the Secretary of the Treasury with Federal Reserve officials prior to the adoption of financing programs, the System's representatives have taken the opportunity to give the Secretary their best judgment about market conditions and about the preference of banks and other investors for particular kinds of securities. In this way representatives of the Federal Reserve System have made available the benefit of their close contacts with the market and have endeavored to be helpful in the solution of the technical market problems of financing the Government.

Beyond giving advice and assistance as to the details of financing, the Federal Reserve System has a vital interest from the point of view of its own responsibilities in the broader economic and financial consequences and implications of Treasury financing. The securities offered, particularly to banks, have an important bearing upon the maintenance of an effectively operating money market, of sound banking conditions, and of freedom to pursue flexible monetary and credit policies appropriate to changing conditions.

Because of the economic effects of fiscal and debt management operations and policies, Federal Reserve officials frequently offer suggestions to the Treasury regarding various aspects of these policies, either those of a current nature or longer-term programs. Likewise the Secretary of the Treasury is customarily asked by the Federal Reserve for his views with respect to action contemplated by the System to effectuate its monetary and credit policies.

2. *Cite the more important occasions since 1935 when Federal Reserve policies have been adjusted to the policies and needs of the Treasury.*

a. *What were the principal areas of agreement and what were those of conflict between the two agencies?*

b. *In what way were the differences adjusted?*

c. *When there were differences of opinion between the Secretary of the Treasury and the Federal Reserve*

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authorities as to desirable support prices and yields on Government securities, whose judgment generally prevailed?

3. *What were the principal reasons for the particular structure of interest rates maintained during the war and the early postwar period?*

4. *Would a monetary and debt management policy which would have produced higher interest rates during the period from January 1946 to late 1948 have lessened inflationary pressures?*

These questions can best be answered as a group by describing the principal developments with respect to Federal Reserve policies and operations that were particularly influenced by, or had a bearing upon, Treasury policies and needs during the period. I want to point out in advance that I was not directly connected with the determination of these policies until the last eighteen months of this period and, therefore, the discussion of events before that is based upon the available record.

In the fifteen years since 1935, the growth of the public debt and its management have been dominant elements in financial developments in the United States. During the early years of this period Government deficits resulted from expenditures to counteract depression and unemployment; later, financing of the war required unprecedented borrowings; and, finally, the problem of refunding and retiring parts of the vast public debt were of prime importance. Treasury needs were largely the result of taxation and expenditure policies determined by Congress and the executive authorities, first to combat depression and later to conduct a war. These situations required close contact between the Treasury and the Federal Reserve System.

It may be said that in general during this entire period the Treasury and the Federal Reserve were guided by the same broad objectives and there was a reasonable degree of consultation and coordination, with consideration on the part of each agency of the views and interests of the other. Such differences of opinion as appeared between the Treasury and the Federal Reserve were chiefly with reference to procedures to carry out common broad objectives. They reflected principally differences of judgment of the kind that might reasonably be expected. Even now when they can be viewed in retrospect, it is frequently difficult to judge as between them.

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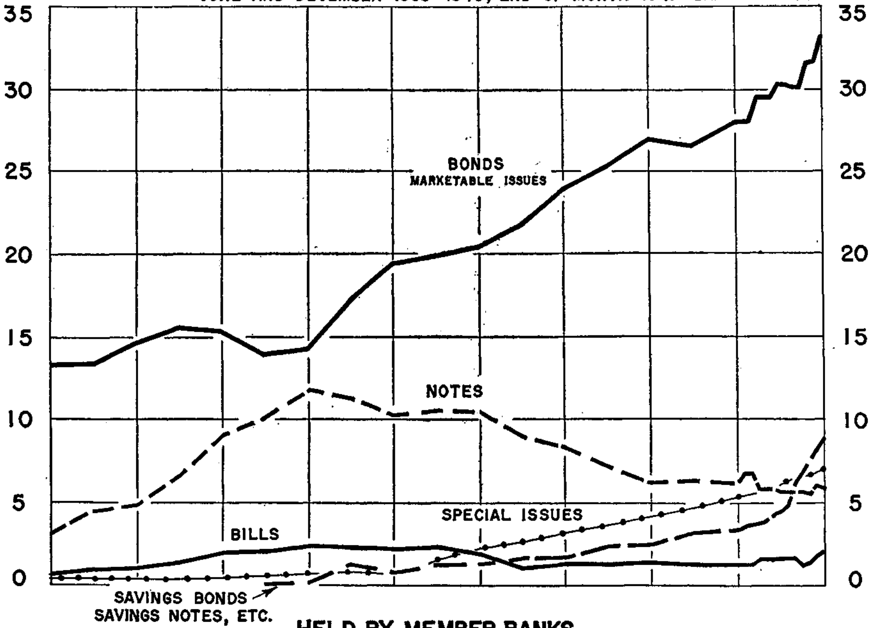
During the period from 1935 to 1940 continued budget deficits and the consequent growth in the public debt accompanied a relatively small amount of private credit demands and an expansion in the supply of bank reserves resulting from gold inflows. This combination of developments caused banks to expand greatly their holdings of Government securities and gave increased importance to market fluctuations in prices and yields of Government securities. The expansion in the public debt took the form mainly of bonds. As shown in the chart,

INTEREST-BEARING DEBT OF THE U. S. GOVERNMENT

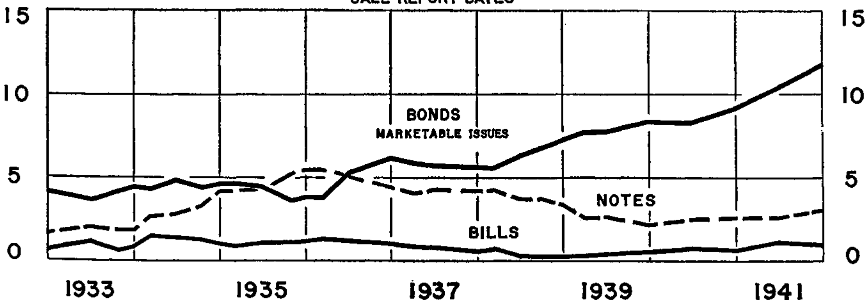
BY TYPES OF ISSUES

TOTAL OUTSTANDING



HELD BY MEMBER BANKS

CALL REPORT DATES



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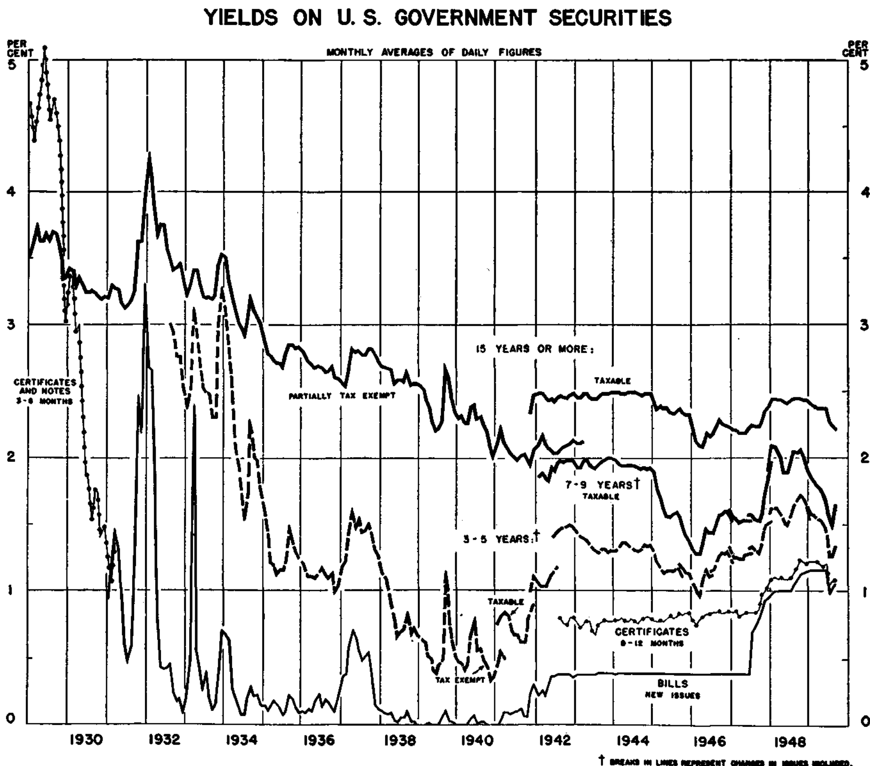
the volume of short-term Government securities outstanding actually decreased from 1936 to 1941 while bonds increased. These movements were reflected in bank portfolios where holdings of United States Government bonds increased while those of short-term securities declined. Treasury financing needs and operations, as well as market transactions in Government securities, thus became important money market factors and had to be taken into account in formulating Federal Reserve policies.

Term structure of interest rates. During the 1935-40 period, as shown on the next chart, interest rates gradually declined. By the latter part of the period, rates on short-term Treasury bills were close to zero; yields on high-grade long-term bonds, Government and corporate, were at record low levels. The low interest rates then prevailing reflected the effect of a huge supply of loanable funds in relation to the demand for such funds. The supply had been greatly expanded by the heavy gold inflow which gave unprecedentedly large excess reserves to banks; it also included a substantial volume of savings held by investment institutions seeking investments of relatively low risk. Demand



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for loans by borrowers, other than the United States Government, was small because of depressed conditions in the economy, as well as because of the large amount of liquid funds already held by nonfinancial businesses and by individuals.

The particular term structure or pattern of rates prevailing prior to the war reflected in large part the strong preference of lenders, and particularly of banks, for liquidity, together with a reduced supply of short-term assets which could be easily turned into cash. Such assets were in very large demand and commanded a substantial rate advantage over long-term securities. This desire for liquidity was a product of the rapid increase in available funds as well as of the experience of banks and other lenders in the early 'thirties when bond prices declined sharply.

Orderly market operations. It was during this 1935-1940 period that the Federal Reserve System accepted the responsibility for maintaining orderly conditions in the market for United States securities. In particular, the System gradually found it necessary to give more consideration to the bond market rather than to confine its operations largely to the short-term money market. When a sudden decline developed in the bond market in March and April 1937, it became quickly apparent that large-scale, and particularly disorderly, liquidation of bonds by banks could cause repercussions not simply in the Government bond market but also in capital markets in general, and possibly in the business situation. The Board of Governors in its 1937 Annual Report, after describing developments in the bond market in March and April 1937, made the following statement:

> "Intervention by the Federal Reserve System in the bond market in March and April, therefore, helped to stabilize that market. In recent years the bond market has become a much more important segment of the open money market, and banks, particularly money-market banks, to an increasing extent use their bond portfolios as a means of adjusting their cash position to meet demands made upon them. At times when the demands increase they tend to reduce their bond portfolios and at times when surplus funds are large they are likely to expand them. Since prices of long-term bonds are subject to wider fluctuations than those of short-term obligations, the increased importance of bonds as a medium of investment for idle bank funds makes the maintenance of stable conditions in the bond market an important concern of banking administration."

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A second comparable occasion arose at the outset of the war and the Board in its 1939 Annual Report explained its position as follows:

> "In undertaking large-scale open-market operations in September 1939, the System was guided principally by the following considerations:
>
> "(1) By helping to maintain orderly conditions in the market for United States Government securities the System can exert a steadying influence on the entire capital market, which is an essential part of the country's economic machinery, and disorganization in which would be a serious obstacle to the progress of economic recovery. The market for United States Government securities is the only part of the capital market in which the System is authorized by law to operate, and Government securities occupy a vital place in that market.
>
> "(2) The System also has a measure of responsibility for safeguarding the large United States Government portfolio of the member banks from unnecessarily wide and violent fluctuations in price. The System cannot and does not guarantee any current prices of Government obligations, nor does it undertake to preserve for member banks such profits as they may have on their Government securities, or to protect them against losses in this account. The Government security market, however, has become in recent years the principal part of the money market, and member banks are in the habit of adjusting their cash positions through sales and purchases of United States Government securities. This practice has arisen partly because of a shrinkage in the availability of other liquid assets, such as Street loans and bankers' acceptances, which in earlier years were in much larger volume and were the medium through which banks were likely to adjust their positions. In the enhanced importance of the Government portfolio to member banks, the System sees an additional reason for exerting its influence against undue disturbances in Government security prices."

Bank examination policies. During this same period official policies with regard to bank examinations were also revised in recognition of the growing importance of bonds in bank portfolios. The policy of not requiring deduction from capital of paper losses on highest grade bonds encouraged the banks to appraise their investment portfolios on a basis of longer range or intrinsic worth rather than by the precarious yardstick of current market quotations. Where declines in market prices of bonds reflect only changes in the level of long-term interest rates

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and not impairment of the credit position of the issuer, the position of investors holding the bonds is not materially affected unless they wish to sell them. For banks to sell bonds should be unnecessary when they have adequate secondary reserves in the form of short-term assets and when the Federal Reserve can make advances to meet any temporary needs.

FINANCING THE WAR

During the period of financing the earlier defense program and more particularly in that of heavy wartime expenditures, Treasury and Federal Reserve operations and policies were closely related. Treasury and Federal Reserve officials had frequent conferences and in other ways interchanged views with respect to plans for financing the war, organizing machinery for marketing United States Government securities, and developing and putting into effect credit policies that would meet the nation's war requirements while minimizing the inflationary effects.

At the beginning of the defense program banks had abundant excess reserves and the problem was in part one of preventing undue expansion of private credit under the stimulus of growing demands. With this situation in mind, various groups of Federal Reserve officials (the Board of Governors, the twelve Presidents of the Federal Reserve Banks, and the Federal Advisory Council) issued a joint report to Congress in December 1940, presenting a program of measures designed to provide the means for more effective restriction of possible inflationary developments.

As a part of the Government's program to combat inflation and for the purpose of reducing the large volume of excess reserves and thus establishing better contact between the Federal Reserve Banks and the money market, the Board in the autumn of 1941, after consultation with the Secretary of the Treasury, increased reserve requirements of member banks to the limit of its statutory power. At the time the Secretary of the Treasury and the Chairman of the Board issued the following statement:

> "The Treasury and the Board of Governors will continue to watch the economic situation and to cooperate with other agencies of the Government in their efforts, through priorities, allocations, price regulation, and otherwise, to fight inflation. Recommendations on the question of what addi-

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tional powers, if any, over bank reserves the Board should have during the present emergency and what form these powers should take will be made whenever the Treasury and the Board, after further consultation, determine that such action is necessary to help in combating inflationary developments.''

When the United States entered the war in December 1941, the Board issued the following statement with respect to war finance:

''The financial and banking mechanism of the country is today in a stronger position to meet any emergency than ever before.

''The existing supply of funds and of bank reserves is fully adequate to meet all present and prospective needs of the Government and of private activity. The Federal Reserve System has powers to add to these resources to whatever extent may be required in the future.

''The System is prepared to use its powers to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements.

''Continuing the policy which was announced following the outbreak of war in Europe, Federal Reserve Banks stand ready to advance funds on United States Government securities at par to all banks.''

Objectives of war finance. During the war period the Federal Reserve System and the Treasury endeavored to coordinate their respective policies and actions toward common objectives. The major objective, as stated in the Board's Annual Report for 1942 and in other connections, was to derive the largest possible amount of war funds from current income and from savings and to depend as little as possible on the creation of bank credit. This objective was fully shared by the Treasury. It was recognized, however, that all Government expenditures could not be raised by taxation and borrowing from nonbank investors and that some borrowing from banks would be necessary to supply funds for an expanding war economy with its abnormal demands for money. Another important objective of the Federal Reserve as well as the Treasury in connection with war finance was the maintenance of the structure of interest rates at approximately the levels existing at the beginning of the war.

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In furtherance of these aims, the Federal Reserve undertook to supply banks with additional reserve funds after those available at the beginning had been utilized. The large-scale purchases of Government securities by the Federal Reserve needed to keep short-term interest rates from rising fully supplied banks with all the reserves they needed to do their share in financing the war.

Discussions between the Treasury and the Federal Reserve during the war and postwar periods related particularly to the specific means of carrying out their common broad objectives in a manner that would augment to the smallest possible extent inflationary pressures, both immediately and in the future. It was recognized that the policies being followed were necessary in view of the exigencies of war finance and that inevitable inflationary developments would have to be restrained largely by use of other measures of control such as rationing and price fixing. It was acknowleged that, although the war might be financed at even lower rates of interest through the Federal Reserve and the banks, such policies would make more difficult the control of inflation through other measures and would also intensify postwar difficulties. Thus, a difficult combination of measures was needed—ready availability of additional reserves required for war finance but at the same time all feasible attempts to limit bank participation, which would unduly inflate the supply of money.

Any differences in point of view between the two agencies reflected their respective areas of operations and the policies adopted were determined after consideration of the various views. The Treasury had the direct responsibility for marketing an unprecedented volume of new issues, while it was the responsibility of the Federal Reserve to safeguard the credit structure as much as possible from current and prospective inflationary effects of these issues, particularly issues that were absorbed into the banking mechanism. The chief concern of the Federal Reserve was to place greater limitations on purchases by banks, actual or potential, of long-term, higher-interest bearing securities. The Treasury was conscious of this problem and devised special securities, noneligible for bank holding, tailored to tap specialized sources of savings funds. It also increased greatly the volume of short-term issues outstanding. Discussions between the agencies when differences of emphasis emerged related largely to the level and structure of short-term

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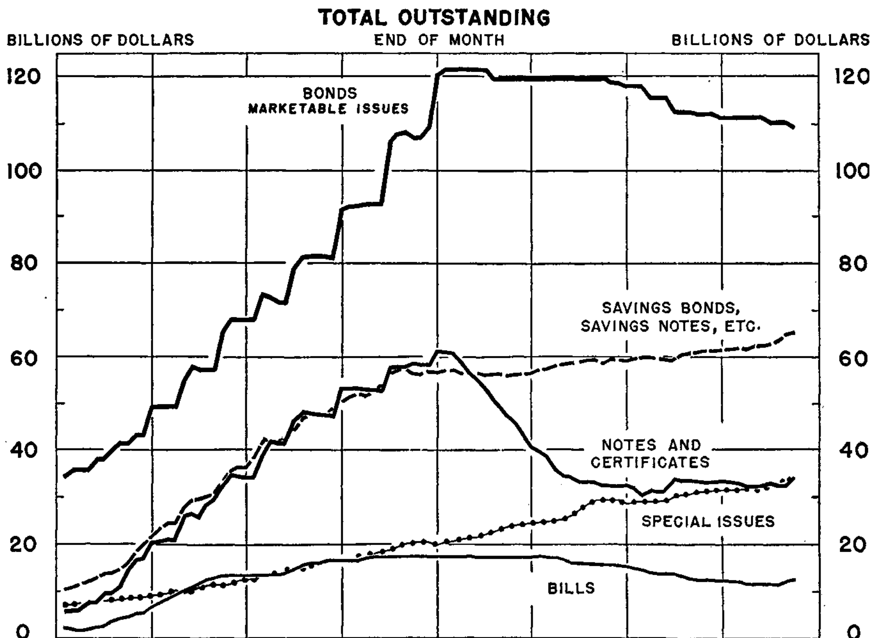
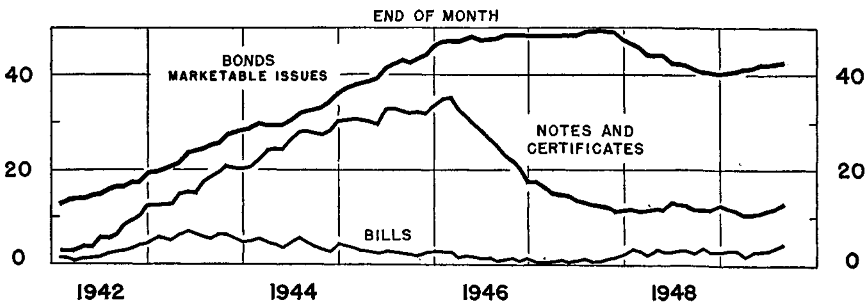
interest rates and the amounts and types of longer-term issues that were available for purchase by banks.

The results of war-financing policies are illustrated in the chart previously presented showing yields on United States Government securities and that on the distribution of the public debt by types of issues which appears below. The interest-rate structure showed little change until 1945 when longer-term rates declined. All types of Government securities showed substantial increases. Commercial banks added large amounts to their holdings of bonds, as well as to holdings of notes and certificates, but after 1942 reduced their buying of bills. Bills and

INTEREST-BEARING DEBT OF THE U. S. GOVERNMENT
BY TYPES OF ISSUES





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other short-term securities were purchased in substantial amounts by the Federal Reserve throughout the war.

Level and structure of interest rates.[1] The wide spread between short- and long-term interest rates, inherited from the prewar period of easy money, created some difficult problems under conditions of war finance in which funds had to be raised in unprecedented volume. Both the Treasury and the Federal Reserve were in full agreement that, for purposes of war financing, it would be desirable to finance the war at relatively stable interest rates. This conclusion was reached on the basis of the experience gained in financing World War I and was designed to eliminate the incentive to defer subscriptions in expectation of progressively rising interest rates. The decision to maintain a stable structure of interest rates was made to serve the following purposes:

(1) To encourage prompt buying of securities by investors, who might otherwise have awaited higher rates;

(2) To assure a strong and steady market for outstanding securities;

(3) To keep down the interest cost on the war debt; and

(4) To limit the growth in bank and other investors' earnings from their public debt holdings.

It became the responsibility of the Federal Reserve authorities consequently to see to it that sufficient reserves were made available to maintain a stable interest rate level.

Both the Treasury and Federal Reserve were also in full agreement that, if war financing was to be rapidly launched with a minimum of difficulties, it would not be desirable to make any substantial adjustment in the pattern of short- and long-term rates that prevailed at the time. Maintenance of a fixed structure of rates, however, gave a strong incentive to investors "to play the pattern of rates," i.e., to purchase longer-term securities not to hold to maturity but for resale at higher prices as maturity approached. With the low level of short-term rates stabilized by action of the Federal Reserve, there was no possibility that corrective market forces would eliminate the incentives that encouraged the practice.

These related decisions were shared by the Treasury and the Federal Reserve. As events developed and it became evident

[1] This part of the discussion relates in particular to Question 3 in this group.

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that the financing of the war was involving ultimately much larger amounts than were generally expected at the time these basic decisions had to be made the task of stabilizing an abnormal rate pattern created serious problems for the Federal Reserve. These problems led to a variety of suggestions for modifications in the war finance program. They became much more serious under conditions of reconversion after the war. The System suggestions in general fell under three heads: moderate adjustments in short-term rates to narrow the spread, further measures to limit purchases of securities by banks particularly the longer-term issues, and more offerings to nonbank investors of long-term bonds with restricted marketability. Some of these suggestions were adopted or led to modifications or changes in programs.

At the time, and even now from the vantage point of retrospect, one cannot be categorical about these suggestions or about their results. The money market is a complex structure and the needs of war finance were without precedent. Looking backward, it still seems that the decision not to let interest rates rise during the war was right in that the war was financed at an exceptionally low interest cost, the Treasury had no difficulty in obtaining all the funds it needed, and there was no lack of confidence in Government securities. The most important lesson of the war-financing experience is that it was desirable to have a stabilized level of rates during the war, but not necessarily the particular highly abnormal structure of rates which happened to exist at the beginning of the war.

In looking back on these problems, which antedate my coming to the Board, as well as in discussing those with which I have had to deal, I have sought to review the entire period covered by the questionnaire, not as the advocate, but in a more judicial spirit, mindful of the end result which was a truly splendid achievement in financing the most devastating and costly war of all time and in restoring the country to full peacetime production and employment.

PROBLEMS OF POSTWAR INFLATION

In the transition period from a war to a peacetime economy the inflationary problem became more acute, notwithstanding the termination of heavy Government deficits. The development of inflation was made possible primarily by the large vol-

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ume of liquid assets built up during the period of war finance, accompanying shortages of goods and deferred demands, but it was augmented by postwar expansion of credit to private borrowers. Liquidation of Government securities was an important source of funds for current spending and for credit expansion, and the Federal Reserve found it necessary to purchase securities in order to maintain a stable and orderly market for Government securities. These purchases supplied additional bank reserves. Under the circumstances action for counteracting inflationary developments had to be limited to relatively moderate measures.

Federal Reserve officials were thoroughly aware of the dilemma presented by the conflicting problems of debt management and monetary policy in the postwar period and endeavored by various means to restrict credit expansion while at the same time stabilizing the market for Government securities. The Treasury also endeavored through fiscal and debt retirement operations and the use of its deposit balance to exert an anti-inflationary influence. Proposals were made by the Federal Reserve for legislation to provide additional powers needed to deal more effectively with the situation, but none of these was adopted until the summer of 1948.

Following is a summary of developments and of measures adopted or considered by the Treasury and the System with respect to debt management and monetary policy in the postwar period.

Playing the pattern of rates. The practice of "playing the pattern of rates" increased considerably in 1945 and became most prevalent early in 1946. It resulted in such a rise in bond prices that market yields on long-term restricted bonds declined to a little over 2 per cent, while those on medium-term bank eligible bonds declined below 1½ per cent, as shown in the chart previously presented. The short-term securities sold were largely purchased by the Federal Reserve, and the bank reserves thus created were pyramided into a larger volume of bank credit expansion and consequently a further rapid growth of bank deposits.

One remedy for this situation would have been to permit short-term rates to rise to a point at which such shifts were not sufficiently profitable. The System, however, recognized the disadvantage to the Treasury, as well as the possible dis-

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turbance in the Government securities market, of any marked advance in short-term rates. Attempts were made to solve the problem by other means, while moderate adjustments in some rates most out of line were recommended by the Federal Reserve.

Preferential discount rate. In 1945, the System came to the conclusion that it should discontinue a preferential discount rate of ½ of one per cent on 15-day advances to member banks secured by short-term Government securities established early in the war to encourage banks to purchase and hold such Government securities. Banks were using this facility at times to hold Government securities when faced with a loss of reserves, and this use served to create additional reserves. The Treasury opposed the proposed elimination of this rate but the change was finally made in April 1946.

Elimination of bill-buying rate. Federal Reserve authorities in 1945 and 1946 considered the discontinuance of the bill-buying rate of ⅜ of one per cent and the repurchase option established early in the war. It was proposed that the rate on bills be permitted to approach the ⅞ per cent rate on one-year certificates, with support of the latter rate continued at that level. The purpose of these steps was to reduce the abnormal spread in the pattern of rates and to encourage banks to hold more bills. In 1947 the Treasury concurred in the discontinuance of the buying rate on bills and the repurchase option as a part of a program in which an increase was permitted also in the rate on certificates. This action is discussed below.

Special reserve requirement. In order to place limitations on bank credit expansion on the basis of reserves created by purchases of Government securities by the Federal Reserve and at the same time avoid a substantial rise in interest rates, the Board of Governors proposed various special measures of legislation for consideration by Congress. These proposals were first presented in the Board's Annual Report for 1945 and more definitely recommended in modified form on various subsequent occasions. The principal proposal was for the System to be granted authority to require that banks hold, in addition to other required reserves, special reserves in the form of Treasury bills or Treasury certificates of indebtedness, balances with Federal Reserve Banks, or other cash assets.

This proposal was designed to give the Federal Reserve means of further restricting bank credit expansion, without raising

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interest rates on Treasury obligations, but it was not enacted by Congress. In August 1948 Congress gave the Board emergency authority to raise reserve requirements for member banks by limited amounts. This authority, which is discussed in a later section, was used in part and served some of the purposes aimed at by the other proposals.

Treasury debt retirement. Use by the Treasury of surplus cash to retire bank-held securities became the dominant anti-inflationary factor of the postwar period. This action served to diminish the practice by banks of shifting from short-term to long-term securities, which during 1945 and 1946 provided the basis for expanding bank reserves. In 1946 the Treasury offered new issues in exchange for only a portion of maturing securities and the remainder were redeemed for cash, drawing upon a large Treasury cash balance in excess of needs built up in the Victory Loan Drive at the end of 1945. This policy brought about some decline in the volume of bank credit to the extent that commercial banks held the redeemed securities and of bank reserves in the case of securities held by the Reserve Banks. In this way the liquidity position and also the reserves of banks were reduced. As a consequence banks were less willing to dispose of additional amounts of short-term securities in order to purchase longer-term issues.

Beginning in 1947 the Treasury confined its retirements largely to Federal Reserve holdings of maturing certificates and to Treasury bills, of which the Federal Reserve held the major portion. Substantial retirements of maturing securities were made from the proceeds of a budgetary surplus and also by use of funds obtained through sales of savings bonds to the public. This policy, which resulted in a direct drain on bank reserves and on bank liquidity positions, was continued into early 1949 and was by far the most important and effective measure of restriction on inflationary credit expansion.

Increase in bank loans. Another development which brought to an end bank purchases of long-term securities, but not their selling of short-term securities, was the growing demand for bank loans. Loans to businesses, consumers, and property owners increased sharply during 1946 and 1947. In order to meet these demands banks sold securities to the Federal Reserve. These sales created reserves which supplied the basis for multiple credit expansion.

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Rise in short-term rates.[2] In the middle of 1947 the Federal Reserve and the Treasury agreed upon a policy of permitting rates on short-term securities to rise. This policy and its purposes were described in the Board's Annual Report for 1947 as follows:

> "Beginning in July the Federal Reserve System and the Treasury adopted measures to permit some rise in interest rates on short-term Government securities in order to increase their attractiveness to banks and other investors and to place an additional restraint on further monetary expansion. The System discontinued its buying rate on Treasury bills, which had been fixed at 3/8 per cent since 1942. The rate on bills rose during the remainder of the year to nearly 1 per cent, as is shown in the chart. The length of term to maturity of newly offered Treasury certificates was shortened in August and September and subsequently higher issuing rates were placed on new issues; these rates rose from 7/8 per cent to 1 1/8 per cent by the end of the year."[3]

The policy, which continued until the rate on certificates had reached 1 1/4 per cent in October 1948, was effective in reducing the shifting of short-term securities to the Federal Reserve and in encouraging banks to increase their holdings of such securities. There developed a tendency on the part of banks to reduce holdings of long-term securities and to buy short-term securities, as well as to expand their loans. This tendency reflected in large part the gradual retirement of maturing bonds and their refunding into short-term securities. It showed a willingness on the part of banks, for liquidity reasons, to hold short-term securities at moderately lower rates than bond yields, whereas they would not do so at very low short-term rates. The profits of playing the pattern of rates were substantially reduced. Another factor in this change probably was a feeling that the rise in short-term rates might lead to a reduction in premiums on bonds.

In any event, during 1947 and part of 1948 banks in general reduced their holdings of Treasury bonds and increased somewhat their holdings of bills. The higher short-term rates, therefore, had the desired effect of encouraging banks, as well as others, to hold short-term securities. As a consequence, the Reserve System was enabled to reduce its holdings and thereby absorb bank reserves. To some extent the reserves absorbed

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[2] The discussion in this section relates particularly to Question 4 in this group.

[3] *Thirty-fourth Annual Report of the Board of Governors of the Federal Reserve System*, page 5.

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were supplied by System purchases in supporting the bond market, as explained below.

While the Treasury and the Federal Reserve were in general agreement on the policy of higher short-term rates, Federal Reserve authorities favored somewhat more frequent increases in rates. It was hoped that the rise in short-term rates would permit a somewhat more flexible policy in open market operations. Since a rigid pegging of all rates prevents money-market forces from developing their own correctives, the change in policy was looked upon as a step toward reducing the ready availability of bank reserves provided by rigidly maintaining short-term rates at low levels.

Nonbank sales of securities and Federal Reserve support of bond prices.[4] In the latter part of 1947 investment institutions and other nonbank holders of securities began to sell Treasury bonds in substantial amounts. This movement reflected primarily growing demands for investment funds on the part of the borrowers, particularly corporations, State and local governments, and property owners. Partly because of these demands and partly because of credit restriction measures, money rates and bond yields generally rose during the last half of 1947. This movement began to be reflected in the Government bond market and caused a sharp decline in the prices of these bonds from the high premiums at which they had been selling. As a result, the nature of the problem changed from one in which the Federal Reserve was buying short-term securities, while the market bought bonds, to one in which the Federal Reserve was called upon to purchase large amounts of bonds.

A considerable degree of uncertainty developed as to the maintenance of support buying by the Federal Reserve or as to the prices at which support would be supplied. A broad wave of bond selling ensued. The System maintained its purchases but late in December 1947 support prices were lowered to a level which would keep all bonds at par or slightly above. Widespread selling of bonds by nonbank investors slackened somewhat in the spring of 1948 but was resumed in the summer. Finally, in November 1948, selling definitely slackened. Subsequently the Federal Reserve was able to reduce its holdings, and did so after consultation with the Treasury.

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[4] The discussion in this section relates in particular to Question 4 in this group.

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During the period of support operations, questions arose as to the advisability of the Federal Reserve continuing to supply inflationary funds through purchasing at par or higher prices Government bonds being sold by investors to shift funds to other uses. It was suggested that an effective means of restraining inflation would be not to provide funds for these purposes so readily and to permit higher long-term interest rates to operate as a restraining influence. The large-scale purchase of bonds by the Federal Reserve accentuated inflationary developments, and presumably a contrary policy would have exerted a strong anti-inflationary influence, since increasing long-term interest rates has generally been a more effective deterrent on business commitments and plans than increasing short-term rates.

The Federal Reserve, however, was in entire accord with the Treasury that maintenance of a stable and orderly market for Government bonds was an over-riding objective under conditions prevailing at that time. It was agreed that the longest-term bond should not be permitted to decline below par. Considerations entering into this decision included the unprecedented volume of Government bonds outstanding, the large refunding problem of the Treasury, the possibility that fear of declining bond prices would lead to much more liquidation, and concern that a decline in bond prices might cause a deterioration in the position of many financial institutions holding large amounts of bonds. As I stated before the Senate Banking and Currency Committee on May 11, 1949:

> "In retrospect, I am certain that our action in support of the Government securities market was the right one. That program was a gigantic operation. In the two years 1947 and 1948, the System's total transactions in Government securities amounted to almost 80 billion dollars. Despite this huge volume of activity, the net change in our total portfolio was relatively small. I am convinced that we could not have abandoned our support position during this period without damaging repercussions on our entire financial mechanism as well as seriously adverse effects on the economy generally."

It needs to be recognized in the long run, however, that interest rates perform an economic function and should reflect the relation between the supply of savings and the needs for capital formation. To keep down the rate of interest by making credit freely available at a time when capital demands exceed current savings has an inflationary result. Conversely, to increase rates

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of interest and thereby discourage borrowing at a time when business activity is low, is conducive to further contraction. Monetary policies should be flexibly adapted to the changing needs of the economy. However, in view of the large outstanding public debt and its widespread distribution, the Federal Reserve faces the dilemma of endeavoring to follow flexible monetary policies without detracting from the willingness of investors to be firm holders of Government securities.

Increase in reserve requirements. While the System could not stop purchases of Government securities and still maintain a stable bond market, it had some power to limit the effect of such purchases upon bank credit expansion. As pointed out, higher short-term interest rates operated toward this end by encouraging banks and others to buy short-term securities from the Federal Reserve. Increases in bank reserve requirements also provided a means of immobilizing the additional reserves created by Federal Reserve purchases of securities from nonbank investors, so that they would not give the basis for a further multiple credit expansion.

During the first half of 1948 the Board exercised virtually all the remaining authority it had to increase reserve requirements. The authority it had not exercised was limited to central reserve city banks. Requirements against demand deposits of these banks were raised by two points in February and again in June and these increases added about a billion dollars to required reserves.

In August 1948 Congress granted the Board emergency powers to increase reserve requirements for all member banks, and increases made under this authority in September absorbed about 2 billion dollars of reserve funds. These increases in reserve requirements just about offset additional reserves supplied during the previous ten months by net purchases of securities from nonbank investors. They served to reduce the liquidity positions of banks and thereby to discourage further extensions of credit.

ABATEMENT OF INFLATIONARY PRESSURES

In view of the changed economic situation that became apparent early in 1949, the Board took action in May and June to reduce reserve requirements of member banks. The emergency power to raise reserve requirements expired June 30, 1949. On

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June 28 the Federal Open Market Committee issued the following statement:

"The Federal Open Market Committee, after consultation with the Treasury, announced today that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture it will be the policy of the Committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve Banks with primary regard to the general business and credit situation. The policy of maintaining orderly conditions in the Government security market, and the confidence of investors in the Government bonds will be continued. Under present conditions the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased."

In August 1949, after further consultation with the Treasury, additional reductions in reserve requirements were made on the basis of permanent statutory authority to release about 1.8 billion dollars of reserves. This series of reductions in reserve requirements resulted in a substantial demand by banks for Government securities. Bond prices rose sharply and yields on short-term securities declined. For the purpose of maintaining orderly conditions in the money market, the Federal Reserve met the demand for short-term securities by selling a part of the System portfolio and thus moderated the decline in money rates.

At the same time the System discontinued the practice of freely selling Government bonds. With the adoption of this policy, pressure of market forces brought about a decline in yields on medium and long-term Government securities. This had the effect of encouraging investors to seek corporate and municipal securities and mortgage loans as outlets for the funds they had available for investment.

This greater flexibility in open market policy places the System in a better position to carry out its functions in adjusting to changed economic conditions.

5. *In what way might Treasury policies with respect to debt management seriously interfere with Federal Reserve policies directed toward the latter's broad objective?*

(Note: The following also provides an answer to Question II-6a, which reads:

"*What changes in the objectives and policies relating to the management of the Federal debt would contribute to*

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the effectiveness of Federal Reserve policies in maintaining general economic stability?")

As explained in the answer to the preceding questions, because of the great importance of the public debt in the present financial structure of the country, Treasury policies with respect to new borrowing, retirement, and refunding of the debt unavoidably affect credit and money market developments and influence Federal Reserve operations. Likewise Federal Reserve policies can have an important influence upon management of the debt by the Treasury. For these reasons the Treasury and the Federal Reserve must be constantly mindful of each other's needs in determining their policies.

The importance of the problem of debt management is indicated not merely by the size of the present Federal debt, in excess of 250 billion dollars but by its proportion to the total of all debt, the impact of its management on all interest rates, the cost of servicing the debt, and proper provision for its retirement. The total Federal Government debt is now almost exactly the same as the gross national product valued at the current postwar price level whereas in 1939, for example, it was little over one-half of the gross national product. The Federal debt is now over half of all public and private debt in this country, compared with less than one-fourth of the total in 1939 and less than a tenth in 1929.

While these comparisons are not intended to suggest that there are certain normal relationships that should be maintained, the broad changes that have occurred do indicate that the public debt has become a far more important element in the economy than formerly. They also suggest that changes in the holdings of the debt might have far-reaching effects on the economy. It seems essential that debt management be directed not merely to the financial considerations of Government itself, as important as they may be, but to the effect of such management on our entire economy.

The present distribution of the Federal Government debt by types of issues and by broad groups of holders is shown on the attached table. The bulk of the debt is in marketable issues held by banks, other investment institutions, business corporations, and individuals. Ninety billion dollars of Government securities are due or callable within about three years and over two-thirds of these are held by the banking system, including the Federal Reserve Banks.

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ESTIMATED OWNERSHIP OF U. S. GOVERNMENT SECURITIES[1]

August 31, 1949

(Par values—in billions of dollars)

Type of security	Total all investors	Investor classes					
		Federal agencies & trust funds	Federal Reserve Banks	Commercial banks	Mutual savings banks	Insurance companies	All other investors
Marketable securities:							
Treasury bills	12.1	.1	3.5	4.5	*	*	4.1
Certificates of indebtedness and Treasury notes	32.8	.1	6.3	14.4	.2	.8	11.1
Bonds:							
Bank-eligible:							
Total[2]	61.0	.7	2.9	44.6	1.8	3.6	7.5
Due or callable:							
Within 5 years	46.9	.3	2.7	34.2	1.5	2.4	5.8
5–10 years	9.8	.3	.1	6.9	.2	.9	1.3
After 10 years	4.3	.1	*	3.4	.1	.2	.4
Bank-restricted	49.6	4.6	4.9	1.0	8.9	15.0	15.2
Total marketable securities	155.6	5.4	17.5	64.4	11.0	19.4	37.9
Nonmarketable securities:							
Savings bonds	56.5	*	....	1.5	.5	.7	53.8
Savings notes	6.8	*	....	.1	*	.1	6.6
Special issues to Government agencies and trust funds	33.4	33.4	....	....	....	....	....
Other, including non-interest-bearing securities	3.7	.1	....	.6	.1	.3	2.5
Total nonmarketable securities	100.3	33.5	....	2.2	.6	1.2	62.8
Total, all securities	255.9	38.8	17.5	66.7	11.6	20.6	100.7[3]

* Less than 50 million dollars.
[1] Total gross public debt and guaranteed securities.
[2] Includes Treasury bonds and minor amounts of other bonds.
[3] Consist of 69.1 billion dollars held by individuals, 8.3 billion held by State and local governments, and 23.3 billion held by "other corporations and associations."

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For the Treasury the immediate problem of debt management is concerned primarily with refunding maturing issues. The nature of these refundings has an important bearing upon the problems that the Federal Reserve may need to face to assure an orderly market and at the same time to be in a position to follow flexible monetary policies. There is an annual turnover of some 45 billion dollars a year in short-term securities and in addition bond issues that become callable or mature amount to from 11 to 17 billion dollars in each of the next three calendar years. The types of securities offered to refund these maturities will have a bearing upon the demands for bank credit and thus upon the Federal Reserve System.

Manifestly, policies with respect to interest terms, maturities, and types of securities to be offered for the purpose of obtaining new money or for refunding or retiring maturing issues all have a bearing on current as well as possible future problems and policies of the Federal Reserve. Debt management policies and Federal Reserve policies must therefore be harmonized basically with a view to maintaining economic stability at high levels.

6. *What, if anything, should be done to increase the dedegree of coordination of Federal Reserve and Treasury objectives and policies in the field of money, credit, and debt management?*

The close relationship of monetary policy and debt management will continue to require constant cooperation and coordination between the Treasury and the Federal Reserve.

As I have stated in answer to Question II-6b., close cooperation now exists between the Treasury and the Federal Reserve in all matters of mutual concern. Cooperation and coordination between responsible heads of governmental agencies depend upon the individuals concerned and their grasp of mutual problems and responsibilities. The present method of consultation between policy-making and operating officials of the two agencies is on a voluntary basis. I can conceive of no formalized action that would add to the satisfactory relationships that prevail.

(For answer to Question 6a see II-5)

6b. *What would be the advantages and disadvantages of providing that the Secretary of the Treasury should be a*

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member of the Federal Reserve Board? Would you favor such a provision?

For many years prior to the enactment of the Banking Act of 1935 the Secretary of the Treasury was an ex-officio member of the Federal Reserve Board. Experience demonstrated, however, that this arrangement had serious disadvantages. Being fully occupied with the extensive duties of his own Department for which he was primarily responsible, the Secretary was unable to devote adequate attention to the problems of the Board or to attend its meetings with regularity. Today the burden of official responsibilities borne by the Secretary is even greater.

In the course of hearings on the Banking Act of 1935, both Senator Glass and Senator McAdoo, each of whom had previously occupied the office of Secretary of the Treasury at a time when the Secretary was also ex-officio Chairman of the Reserve Board, expressed the opinion that the Secretary should not be a member of the Board. During the same hearings, Secretary of the Treasury Morgenthau, who was at the time ex-officio Chairman of the Board, indicated that he believed the various controls of credit should be centered in a Government agency which should be as independent as possible in its determinations of credit policies.

The closest working arrangement now exists between the Treasury and the Federal Reserve, with constant consultation in all matters of mutual concern and a full appreciation of the responsibilities placed upon both. There is therefore no need for restoring the ex-officio status of the Secretary on the Reserve Board.

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III. INTERNATIONAL PAYMENTS, GOLD, SILVER

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III. International Payments, Gold, Silver

1. *What effect do Federal Reserve policies have on the international position of the country? To what extent is the effectiveness of Federal Reserve policy influenced by the international financial position and policies of this country? What role does the Federal Reserve play in determining these policies? In what respects, if any, should this role be changed?*

During the period since the passage of the Federal Reserve Act, the international financial position of this country has undergone profound changes incident to two world wars and the world-wide depression in the early 'thirties. The country, transformed from a debtor to a creditor nation, has not been adequately prepared to cope with the resultant new problems. The changed international situation brought to the United States a heavy inflow of gold, which greatly expanded the reserves and lending power of the banking system; it also presented this country with strong demands from abroad for financial and other economic assistance through investment, extension of credits, grants, and other means. These various developments deeply affected the domestic economy and the value of the currencies of other countries relative to the dollar.

Traditional functions of central (or reserve) banking organizations include the two tasks of helping to maintain domestic economic activity at the highest sustainable levels and also of aiding in keeping international financial payments and receipts currently in balance. Broadly speaking, free enterprise countries look to their central banking institutions for performance of functions that relate to current movements of foreign exchange and of gold. In most of these countries, the international exchange of goods and services is greater relative to aggregate internal economic activity than it is in the case of the United States. In most of these countries the central bank participates directly in the management of foreign exchange operations.

In the United States the Federal Reserve System has not customarily participated directly in foreign exchange operations, except in the sense that imports and exports of gold di-

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rectly affect the availability of dollar exchange in the world market. The strength of the dollar has been of such a nature and our gold reserves have been so large that any direct intervention in foreign exchange markets has not been necessary. The Federal Reserve System, however, also provides services as correspondent for foreign central banks and monetary authorities. This function includes foreign exchange operations for foreign central banks, and also the making of advances to them, as well as the holding of dollar balances of foreign correspondents.

In the experience of the Federal Reserve System, from its inception to date, movements of gold have constituted a factor of the first importance in determining the magnitude of its operations in the domestic markets, since gold imports and exports have a direct effect upon the reserves of member banks and, therefore, upon the demand for credit at Federal Reserve Banks. Throughout most of the history of the Federal Reserve System, the international financial position of the country has been strong and the Federal Reserve System has not had to fear excessive gold withdrawals. Its problem rather has frequently been to prevent the gold that has flowed to this country from inflating the economy of the United States. The Federal Reserve System must always take account of the fact, however, that its policies directed toward the supply, availability, and cost of money within the United States directly affect the balance of international payments of this country. Because of the important position of this country in the world economy, there are likely to be accentuated world-wide effects from domestic developments. These effects are sometimes amplified by the psychological repercussions which fluctuations in the United States may have in foreign countries.

In turn, the maintenance of international stability, economic and political, has become of critical importance to the internal stability and security of the United States. In a longer view, any contribution which Federal Reserve policies may make to this country's economic well-being may well be lost unless economic and political stability is achieved in the rest of the world. Even though foreign trade forms in absolute volume a small percentage of our total trade, the fluctuations both of prices abroad and of export and import volume have wide effects on our whole economy. A steady expansion of mutually beneficial trade between the United States and other countries

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can take place only if prices remain tolerably stable throughout the trading area, if exchange rates are appropriate and also reasonably stable, and if the balances of international payments are consistent with the resources of the main debtor and creditor countries. To establish and maintain such conditions is beyond the power of any single country acting alone. Similarly, the achievement of endurng peace requires economic progress throughout the world. Progress toward economic prosperity and political stability depends in great measure on the wisdom of governmental economic and financial policies in each country.

Domestic monetary and credit policies and the international financial position and policies of the United States are thus inextricably linked together. In addition to the tasks in foreign financial operations of the United States which it now performs, the Federal Reserve System is equipped to do more in this field. The System has a direct interest in United States foreign financial policy not only because of its immediate relation to the domestic monetary situation but also because of the general interest of the United States in the achievement and maintenance of monetary and financial stablity abroad.

The role of the Federal Reserve with respect to international financial policies is at present most directly performed through membership on the National Advisory Council on International Monetary and Financial Problems. The Chairman of the Board of Governors is by law a member of this Council, and members of the Board's staff participate in the Council's well-organized staff work. This Advisory Council is responsible for coordinating the policies and operations of all United States Government agencies which Congress authorizes to engage in foreign financial, exchange, or monetary transactions.

Apart from the work of the Federal Reserve in connection with the National Advisory Council, the System is frequently called upon for advice and counsel to Congress and to Government agencies dealing with international monetary problems. The System also functions operationally in the foreign field, as mentioned in question I-1, by holding balances and acting as correspondent for foreign central banks and governments, making advances to foreign central banks, and passing judgment on applications by member banks and certain banking corporations to establish foreign branches and regulating their activities in foreign countries.

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In postwar years, the United States has had a vital interest in the achievement of internal stability in many foreign countries, and in their making the best possible use of their own resources and of the aid they are receiving from the United States. In the cases of Germany and Japan, where the United States has had a direct responsibility as an occupying power, the occupying agencies have on occasion consulted the Federal Reserve with respect to monetary policies to be followed. There have also been frequent occasions when foreign countries have sought the technical advice and assistance of the Federal Reserve or when a United States Government agency (such as the Economic Cooperation Administration), having responsibilities that directly concern a foreign country's monetary and financial policies, has requested special help from the System. By providing technical missions to help foreign countries in the development of appropriate policies, the Federal Reserve System has contributed to achieving more fully the basic objectives of United States policies.

The principal problems which arise for consideration in the National Advisory Council are those which are intimately connected with the restoration of stability in the world economy through providing an adequate supply of dollars. These problems are therefore closely interrelated with Federal Reserve policies in the domestic field. During recent years, the most important problems coming to the Council's attention have related to giving aid to foreign countries in the form of loans and grants. There have also been important problems of exchange rates and exchange controls in other countries. Also related to these problems has been the question of United States policies with respect to the purchase and sale of gold. The National Advisory Council has proved to be an efficient and desirable medium for bringing together representatives of the Federal Reserve System and representatives of other Government agencies whose responsibilities bear on foreign financial policies.

Although, in recent abnormal circumstances of international imbalance, the Reserve System's operating functions in the foreign field have been of limited scope, its representatives have generally been able to play an important part in the Council's activities because of their familiarity with the kinds of analysis that are involved. Strengthening of the Reserve System's operating collaboration in the field of international finance may be expected as further progress is made toward the re-estab-

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lishment of more normal international financial relationships and mechanisms.

2. *Under what conditions and for what purposes should the price of gold be altered? What consideration should be given to the volume of gold production and the profits of gold mining? What effect would an increase in the price of gold have on the effectiveness of Federal Reserve policy and on the division of power over monetary and credit conditions between the Federal Reserve and the Treasury?*

An increase in the price that the United States pays for gold would have two major monetary results aside from dangerous psychological repercussions: (1) The amount of the increase *with respect to any gold purchased* would provide monetary aid from the American economy as a whole to producers of gold (largely foreign) and to foreign countries selling gold from accumulated stocks. (2) A corresponding addition (again with respect to gold purchases) would be made to bank reserves, which would provide the basis for a manifold expansion of credit that might be highly inflationary.

As to the first result, an increase in the price of gold would provide additional dollars to foreign countries without reference to the needs of the recipients. The extending of grants or credits, in such amounts as are in conformity with the real needs of the countries receiving them and are in the interest of the United States, is far better than increasing the price of gold as a means of providing any additional dollars needed. The United States is thus able to select the countries and the periods of time for which such aid would be given.

Concerning the second result, this country has no shortage of money. In fact, there is an abundance of gold reserves, on the basis of which additional money could be readily created by monetary and fiscal action. Increasing the price of gold is a deceptively easy, as well as potentially dangerous, way for the Treasury to provide more dollars for foreign aid (by buying foreign gold) or for domestic purposes (by buying domestic gold or by revaluing its existing stock) without having to raise taxes or to borrow. Such an arbitrary creation of more dollars is as inflationary as would be the arbitrary creation of an equal amount of "greenbacks" and more inflationary than Treasury borrowing of a corresponding amount from the banking system.

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This country should not resort to such potentially harmful means of raising funds.

Any change in the dollar price of gold, either up or down, would have the following important effects: (1) Unless accompanied by a proportionate change in the price of gold in terms of all other currencies, it would dislocate the entire pattern of foreign exchange rates; (2) it would change the dollar value of existing gold reserves, both at home and abroad; (3) it would alter the profitability, and thus the level of production, of the gold-mining industry; (4) it would change the dollar value of this country's gold stock and all future additions to it, and thus be a basis for monetary expansion or contraction; and (5) it would constitute a major change in United States monetary policy, with unforeseeable psychological effects. In what follows each of these effects is discussed.

1. Unilateral changes in a country's price of gold have in the past been a means of altering exchange rates, and thus have served to adjust disparities between commodity price levels in that country and in the outside world. For example, if commodity prices and costs in a given country are too high in relation to those in the outside world, it might help to restore equilibrium by raising the price of gold in that country's currency, i.e., by depreciating its currency in terms of gold and also of such foreign currencies as remain unchanged in terms of gold. Conversely, if prices in the outside world were higher than in the given country, the country might reduce its price of gold in order to help bring about a better relationship.

During the spring and summer of 1949, price levels in many foreign countries were too high in relation to prices in the United States. To attempt to correct the disparity by a change in our price of gold (assuming that other countries made no change), would have called for a reduction in the gold price from $35 to some lower figure, that is, by an upward valuation of the dollar in terms of gold and of other currencies. This, however, would have caused serious dislocations in many foreign countries and would have had severe psychological consequences domestically. The needed adjustments were brought about in September by devaluations (in terms both of dollars and of gold) of a number of foreign currencies.

2. A change in the dollar price of gold would alter the dollar value of all existing gold reserves in direct proportion to the

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change in price. Thus a 50 per cent increase in the price of gold would result in a 50 per cent increase in the dollar value of gold reserves, both in the United States and throughout the world.

In the case of the United States, it is clear that a rise in the price of gold is not needed to augment the value of domestic gold reserves, since these are more than adequate for present and foreseeable monetary needs. Under present legislation, the Federal Reserve System is required to maintain a reserve of 25 per cent against Federal Reserve notes and deposits, but the present ratio is actually about 55 per cent. Even if the latter ratio were to fall to the legal minimum, an increase in the gold price would not be an appropriate means of correction.

In the case of foreign countries, the situation varies. Many countries, because of postwar dislocations, are seriously handicapped at the present time by a domestic shortage of gold and dollar reserves. But a rise in the price of gold would help most those countries which already have large reserves. Every country which holds gold would automatically receive an increase in the number of dollars available to it, so that the largest increases would go to the largest holders, which are the Soviet Union and Switzerland as well as the United Kingdom. Under present and prospective circumstances, if the United States wished to make more dollars available for foreign reserves, it would be preferable to do so by extending stabilization credits to those countries whose reserves we wish to increase. Making dollars available to selected countries by means of credits would cost the United States less, in real terms, than trying to help these countries by making dollars available indiscriminately in exchange for gold.

3. A change in the dollar price of gold would alter the profitability of gold mining, and thus the level of gold production. Following the increase in the dollar price of gold in 1933-34 (from $20.67 to $35 per ounce), gold production, both in physical volume and even more in dollar value, was greatly stimulated all over the world. Because of the world-wide rise in costs of labor and materials which occurred as a result of World War II, the profitability of gold mining has sharply fallen, and production has contracted considerably from the peak level of 1940. Accordingly, proposals have been freely forthcoming from world gold-producing interests to raise the dollar price of gold. The dollar price of gold, however, is still higher relative to the general

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level of commodity prices than it was in the 1920's, and gold production remains above the level of that period.

An increase in the price of gold would no doubt stimulate gold production. As for the United States, however, there is clearly no need for an increase in domestic gold production, since gold reserves in this country are far in excess of minimum requirements. An increase in the dollar price of gold obviously cannot be justified on the sole ground that it would increase the profits of gold mining.

In the case of foreign countries, those producing gold—which would be the immediate beneficiaries of a rise in the gold price—are not the ones whose need for assistance is greatest. While they might use the augmented value of their gold to pay for imports from Western Europe and thus enable Western Europe to do more towards balancing her trade with the United States, it would be much more to the advantage of the United States to accomplish this end by extending grants or loans.

4. As to the effects that an increase in the price of gold might have on our domestic monetary system, it is important to emphasize that this country's existing gold holdings, valued at the present price of gold, would support a far greater volume of money than needed for any likely future contingency.

The immediate monetary effect of an increase in the price of gold would be a "profit" from the revaluation of our existing gold stock. Expenditure of this "profit," which presumably would be within the discretion of the Treasury, would increase commercial bank reserves, and thereby foster a multiple expansion of bank credit, subject to the reserve requirements of banks in effect at the time. Increased bank reserves and resulting multiple expansion of bank credit would also be fostered by accelerated inflow of gold from foreign sources and domestic output. These developments would expose the economy to great inflationary dangers.

The Federal Reserve has no means adequate to cope with such a danger. In the absence of greatly expanded authority to absorb or immobilize the inflationary reserves thus created, the Federal Reserve would be incapable of performing its function of adjusting the credit supply to the needs of a stable economy.

Increasing the price of gold would be an awkward and dangerous instrument for this country to use, particularly in view of the fact that other more effective and far less risky means are

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available or could readily be found to accomplish anything constructive that would be accomplished by changing the price of gold.

5. Lastly, it should be emphasized that any change in the price of gold would constitute a major change in the foreign economic policy of the United States. Since January 1934, the price of gold in terms of the dollar has remained unchanged at $35 per ounce. Thus, for over fifteen years, there has been a fixed relationship between gold and the dollar—one of the few elements of stability in an international economic situation that is only slowly recovering from the ravages and disruptions of extended world war. Changing the dollar price of gold would inevitably weaken the high confidence that this country's currency universally enjoys.

3. *What would be the principal advantages and disadvantages of restoring circulation of gold coin in this country? Do you believe this should be done?*

The advantages which might be gained by restoring the circulation of gold coin in this country are negligible and serious disadvantages would be incurred. None of the important domestic or international monetary problems now facing us would be appreciably helped toward solution.

Confidence in money, in our day, is based upon its internal purchasing power and the ability of a country to meet its external obligations, not upon internal convertibility of the money into gold. The currency of the United States is the most generally acceptable currency in the world today. Confidence in it is assured by the productive power of the United States economy. Gold is readily available and existing reserves are more than adequate to meet any conceivable international drain of funds. Since the chief argument for instituting a gold coin circulation would be the strengthening of confidence in the currency, it is clear that on these grounds no need for taking such a step exists today.

The argument that a return of gold coin circulation would bring about a desirable and automatic regulation of the domestic money supply and would assure the country a "sound" monetary system—in the sense that such a system would be "sounder" than the present one—is not valid. On the contrary, the adoption of a gold coin standard might actually hinder the maintenance of a stable and prosperous economy, since there is no automatic

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relation between the demand for gold coin and the economy's need for money. The demand for gold for individual use, as contrasted with its use to balance international payments, reflects various speculative and capricious influences which should not affect monetary policy, and fails to indicate other conditions which ought to guide monetary policy. Thus a strong public demand for gold coin might arise in time of depression as occurred in 1931-33, imposing a restrictive monetary policy at the very time when the opposite policy is necessary. In time of rising prices, when shifts from money to commodities are likely, demand for gold might be small, so that the necessary restrictive action would not automatically occur. If during a wartime, moreover, heavy demands for gold should appear, free sales of gold would reduce our gold stock, stimulate speculation against the currency, and hinder the financing of the war. Furthermore, depletion of gold reserves resulting from private hoarding could conceivably impair our ability to meet extraordinary wartime expenditures abroad.

An over-riding reason against making gold coin freely available is that no government should make promises to its citizens and to the world which it would not be able to keep if the demand should arise. Monetary systems for over a century, in response to the growth in real income, have expanded more rapidly than would be permitted by accretions of gold. In the United States today, our gold stock, although large, is only 15 per cent of our currency in circulation and bank deposits, and less than 7 per cent of the economy's total holdings of liquid assets. The retention of a gold base is desirable in order to maintain *international* convertibility, and a gold standard system has therefore evolved in which the various forms of money and near money in the country are ultimately convertible to gold, where that is necessary to meet the country's international obligations. Return to a gold coin standard, however, would clearly expose the economy to the risk of drastic and undesirable deflation at times of high speculative demand for gold for hoarding, or else the Government would have to withdraw its promise of gold convertibility. Conjecture as to the possibility of such a withdrawal would stimulate a speculative demand for gold and might precipitate the event feared. The long run effect would be to weaken rather than to strengthen confidence in the dollar.

In regard to the international effects, it is often contended that if gold were made freely available by the United States, whether

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in the form of coin or otherwise, one effect would be to eliminate the premium at which gold is quoted, in relation to the United States dollar, in black or free markets abroad. However, the present premium of gold over the dollar in foreign markets is a matter of very limited importance. It reflects chiefly the special suitability of gold for hoarding, its great familiarity, and its anonymous nature. It cannot even remotely affect the stability of the United States dollar.

4. *What changes, if any, should be made in our monetary policy relative to silver? What would be the advantages of any such changes?*

In considering the role of silver in our currency system the pertinent facts may be summarized as follows:

Of the total paper money and coin in circulation amounting to $27.5 billion at the end of June 1949, there were $2.1 billion of silver certificates and $1.1 billion of silver dollars and subsidiary coin containing silver. The Treasury purchases newly mined domestic silver at a price fixed by law in 1946 of 90.5 cents per ounce. The Treasury may also purchase other silver at whatever price it deems appropriate. Because of the fact that the New York free market price of silver is currently around 73 cents an ounce, all domestic production is sold to the Treasury.

The silver thus acquired by the Treasury may be monetized at any time, either through coinage or through issuance of silver certificates at the statutory price of $1.29 per ounce. The silver received by mints and assay offices in 1948 totaled about 37 million ounces, costing the Treasury about $33 million. Since the end of 1934 silver acquired by the Treasury has cost $1.4 billion and silver certificates and coin issued have aggregated $1.7 billion.

To the extent that silver purchases increase the country's money supply, there is a resulting increase in bank reserves and thus in the base for credit expansion. These arbitrary additions to bank reserves have no relation to the need for reserves and, so long as the supply of gold and Federal Reserve credit continues ample, are unnecessary. So long as additions to reserves through silver monetization remain relatively small, their monetary effects can be offset whenever desirable.

In regard to the international monetary aspects of silver, these are of secondary significance in the present-day world

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since no important country is on a silver standard, although several countries use silver for coinage and a few (chiefly Mexico and the Netherlands) maintain part of their currency reserves in silver. The vital problem of the stabilization of foreign currencies today involves their relation to gold and the dollar, and the carrying out of necessary internal adjustments, rather than their relation to silver which has practically no status today as a means of settlement of international balances.

Accordingly, in the light of the aims and present operation of our monetary system, no extension of the role of silver in the monetary system would be desirable.

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IV. INSTRUMENTS OF FEDERAL RESERVE POLICY

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IV. Instruments of Federal Reserve Policy

INTRODUCTION

Purposes and functions of the Federal Reserve System, as indicated in the answers to the questions in Section I, are primarily concerned with regulating the supply, availability, and cost of money with a view to the basic objective of promoting economic stability at high levels of employment and production. This broad objective coincides with the guiding principles set forth in the Employment Act of 1946 as the continuing policy and responsibility of the entire Federal Government. The instruments which the different branches of Government may use in furthering this objective vary in accordance with the functions of the respective agencies. In a private enterprise society such as ours, Government action to promote stability should be as much as possible of a type that will operate in a general manner, while specific decisions as to what shall be produced and bought should be left largely to the free choice of individuals in the market.

The Committee for Economic Development, in its statement "Monetary and Fiscal Policy for Greater Economic Stability," set out the principles of Government action best suited to our system as follows:

> "The appropriate powers of government in a free society are powers than can be democratically exercised without arbitrary discrimination among and coercion of individuals. This consideration does not debar the people from establishing through their government the general framework, equally applicable to all, within which the members of the society shall operate. The government must, for example, establish the terms on which individuals must contribute to the support of the government through taxation; it must establish the general conditions under which money can be created. If certain basic rules of nondiscrimination are observed, the power to levy a tax or to limit the creation of money can be used without coercion of individuals. But the exercise of these powers does have a great effect upon the stability of the economy. The important distinction is between power to coerce individuals and power to affect the general behavior of the economy."

Monetary policies of government are particularly adapted to this objective. They are designed to help stabilize the economy

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and at the same time leave specific decisions of lending and borrowing to individual bankers, businessmen, and others. Instruments which the Federal Reserve may use to influence the credit situation and the money supply fall into two major groups—general instruments which affect the total volume, availability, and cost of bank reserves, and selective instruments which supplement general instruments in particular sectors without directly influencing other areas of the market.

General instruments include those which affect primarily the volume of member bank reserves, such as open market operations and discounts; those whose major influence is upon the availability of reserves, such as changes in reserve requirements and policies and regulations regarding the eligibility or acceptability of bank assets as a means of obtaining access to Federal Reserve credit; and those which affect primarily the cost of bank reserves, such as discount rates and buying and selling rates on Government securities and on acceptances.

The principal selective instrument which the Federal Reserve is empowered to use at this time is the authority to establish and change margin requirements on listed securities. For limited periods in the past the System has been authorized to regulate consumer instalment credit.

Appraisal of the effectiveness or the adequacy of instruments of Federal Reserve policy must take into consideration the surrounding circumstances in each case, and the interrelation of different instruments. Each instrument is important to the extent that it helps to round out the entire framework designed to achieve the objectives of Federal Reserve policy. Thus authority to change reserve requirements is needed and justifiable only because without it the System would be severely handicapped in efforts to maintain an effective influence over the money supply.

It is also necessary in appraising the adequacy of instruments used by the Federal Reserve to give proper weight to all of the accompanying economic conditions and factors. Monetary policy alone cannot assure economic stability. Fiscal and other policies of Government or business may at times make positive action in the monetary field unnecessary or prevent such action from being effective. The instruments used by the Federal Reserve should not, strictly speaking, be referred to as "controls"; they generally do not control in a direct manner, but only influence the course of economic developments. Under

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some conditions, mild measures may be sufficient to exert considerable influence, while under other conditions more vigorous measures may be essential to affect economic forces. Changes occur, moreover, which reduce the effectiveness of instruments as compared with what they had been or call for the application of new instruments.

1. *What changes, if any, should be made in the law governing the reserve requirements of member banks? In the authority of the Federal Reserve to alter member bank reserve requirements? Under what condition and for what purposes should the Federal Reserve use this power? What power, if any, should the Federal Reserve have relative to the reserve requirements of nonmember banks?*

Banks as a group need to hold reserves to promote monetary and general economic stability. From the standpoint of the individual bank, its required reserves are assets that cannot be loaned or invested to earn an income and, accordingly, represent a contribution which that bank makes to effective national monetary policy. It is important that the basis used for allocating among different banks the total burden of holding required reserves be as fair and equitable as it can be made.

The existing statutory basis for member bank reserve requirements tends to be inequitable in important respects as among banks. The present system of classifying banks for reserve purposes on the basis of geographic location dates back to the establishment of the National Banking System over 85 years ago. A member bank's designation for reserve requirement purposes depends on whether it is located in a central reserve city or in a reserve city, or whether it is outside of these cities—a so-called country bank. A member bank located in a central reserve or reserve city must hold reserves at the higher percentages designated for such a center, irrespective of whether it is doing the correspondent banking type of business (holding of interbank balances and nonmember bank reserves, which is associated with the designation of a reserve city and initially was the justification for the higher requirements for banks in reserve cities. On the other hand, another member bank holding an important volume of deposits of banks, but located outside the reserve city areas, need maintain only the reserve percentages required of country member banks. Some inequities of this kind have been relieved by the Board's discretionary authority relat-

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ing to outlying areas of reserve cities, but many cases of inequity cannot be solved in this way and a basic problem of equity of treatment as among member banks still remains.

In order that the necessary burden on banks of holding reserves in the public interest may be as fairly distributed as possible, consideration should be given to a fundamental revision in the basis for establishing bank reserve requirements. Differences in reserve requirements should be based more largely on the nature of deposits than on the location of banks. Higher requirements might be set against interbank deposits than against other types of demand deposits and lower requirements, as at present, against time deposits, strictly defined.

A second problem of fairness in connection with member bank reserve requirements arises in connection with the treatment of vault cash. At present, member banks may count as legal reserves only funds on deposit at the Federal Reserve Banks. Some banks, because of location or the particular needs of their customers, need to hold substantially larger amounts of vault cash than others. From the standpoint of its contribution to the effectiveness of monetary controls, however, the vault cash which banks need for operating purposes is the equivalent of deposits at the Reserve Banks; both are in effect liabilities of the Federal Reserve Banks. When banks obtain currency they must draw on their reserve balances or obtain equivalent reserve funds, and they can obtain reserve deposits in exchange for currency. If a basic revision in bank reserve requirements is made, provision should be made to permit banks to count vault cash as reserves.

Banks should probably also be permitted to count as part of their reserves that part of their interbank balances which the correspondent bank in turn must hold as reserves with the Federal Reserve. Under a revised system of requirements, such balances might require more reserves than other types of deposits.

The staff of the Federal Reserve has studied for some time the matter of a fundamental change in the basis for reserve requirements. A preliminary report by a staff group was made to the Joint Committee on the Economic Report, at its request, on May 27, 1948. The staff is still studying this question, and when Congress may wish to consider specific proposals we shall be glad to make available the results of this work.

The authority to change reserve requirements is an important instrument for generally contracting or expanding the liquidity

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position of the banking system and for making other credit instruments effective. It may be needed particularly to absorb excessive reserve funds of banks obtained from large gold inflows or return of currency from circulation, and perhaps also from Federal Reserve purchases of Government securities in maintaining orderly markets. Although the Federal Reserve now holds about 17 billion dollars of Government securities which might be sold to absorb reserves arising from inflows of gold or currency, these inflows could over a period of years be so large as to deplete the System's resources to below a reasonable operating level. Moreover, it would be disruptive for the System to endeavor to sell Government securities at a time when other holders would be selling on balance.

The Federal Reserve should have authority broad enough to meet its responsibilities under different situations. The Federal Reserve cannot function properly if it must go to Congress for adequate authority after an emergency has arisen. Monetary and credit actions work best when they can be applied in time to prevent a crisis from arising.

Reserve requirements are imposed on banks in the national interest and in the interest of the entire banking system. They are part of the necessary mechanism by which the supply of money and credit may be influenced to promote economic stability. To the extent that banks do not bear their fair share in what is a national responsibility, the effectiveness of monetary policy is weakened, to the detriment of all banks. It is clearly unfair and inequitable to ask member banks alone to bear the burden. This aspect of the question is discussed in the answer to Question V-1.

2. *Should the Federal Reserve have the permanent power to regulate consumer credit? If so, for what purposes and under what conditions should this power be used? What is the relationship between this instrument and the other Federal Reserve instruments of control?*

The Board has heretofore proposed that the authority to regulate consumer credit—or rather, consumer instalment credit—be made permanent. It is unquestionably a useful tool, supplementary to reserve requirements and other available instruments, to influence credit conditions in the interest of economic stability. The arguments for the proposal have been so extensively presented in the Board's annual reports and elsewhere that I shall not undertake to review them here, but I shall, of

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course, be glad to discuss this subject before the committee if you should so desire.

3. *What, if any, changes should be made in the power of the Federal Reserve to regulate margin requirements on security loans?*

A few minor changes in the margin provision of the Securities Exchange Act of 1934 might be desirable. These provisions have worked reasonably well as they stand.

The statutory objectives for which the power is to be used are in line with those set forth in the Employment Act of 1946, and, taking the Securities Exchange Act as a whole, are set forth with sufficient precision to serve the desired purpose.

A possible change, in a liberalizing direction, would be one clarifying and extending the Board's power to make rules to permit brokers to extend credit on unregistered (i.e., unlisted) securities—when this would serve the public interest and not be inconsistent with the purposes of the Act.

There is a possibility that need for a provision permitting regulation of bank loans for the purchase or carrying of unregistered securities might develop at some time in the future, but up to the present there has been no evidence of the necessity for such authority.

4. *Should selective control be applied to any other type or types of credit? If so, what principles should determine the types of credit to be brought under selective control?*

As of the present time, we do not advocate that selective control be applied to other types of credit.

Persuasive argument can be made for selective regulation of real estate credit, since it can exert an unstabilizing influence on the course of business in much the same way as consumer credit does. However, the administrative difficulties of regulation in the real estate field are formidable. It is possible that similar objectives can be achieved by closer coordination between Federal Reserve monetary policies and the policies of Government agencies which make, guarantee, or encourage real estate loans. Reference here is to a domestic advisory council, referred to elsewhere. Since real estate credit activities of Government agencies exert a strong influence on monetary and credit conditions, further exploration of this problem is very desirable. With abatement of abnormal demand for housing, it should be possible

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to bring about more coordination of policies in the interest of better stabilization in this area.

5. *In what respects does the Federal Reserve lack the legal power needed to accomplish its objectives? What legislative changes would you recommend to correct any such deficiencies?*

By far the most important deficiency in the System's legal powers is found in the field of bank reserves. The desirability of correcting these deficiencies and rationalizing the basis for determining reserve requirements is discussed more fully in the answers to questions IV-1 and V-1.

Although of somewhat less significance, there are a number of deficiencies in other areas that deserve mention. Some of these are discussed in the answers to other questions as follows:

Consumer credit, discussed in the answer to Question IV-2;

Capital requirements for admission to the Federal Reserve System, discussed in the answer to Question V-2; and

Financing of small businesses, discussed in the answer to Question VI-5.

In an effort to prevent abuses which had developed in connection with the operation of bank holding companies, the Banking Act of 1933 authorized the Board to impose certain restrictions on such holding companies as a condition to their right to vote stock controlled by them in member banks. Subsequent experience, however, has demonstrated that the 1933 legislation is inadequate for effective regulation of bank holding companies.

Almost every one of the Board's annual reports since 1943 has recommended legislation to improve the situation, and S. 829, a measure for that purpose in the 80th Congress, was favorably reported by unanimous action of the Senate Banking and Currency Committee. Currently, S. 2318 and H. R. 5744 have been introduced in the 81st Congress on the subject.

Except between 1935 and 1942, the Federal Reserve Banks throughout their 35 year history have always had authority to purchase Government obligations directly from the Treasury. Since 1942, however, the authority for such direct purchases has been limited to an aggregate maximum of $5 billion at any one time, and the authority has been in temporary form. The time limit has been extended from time to time, but under present law the authority will expire on June 30, 1950.

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The provision for the Reserve Banks to make such direct purchases provides a flexible method of easing the money market in occasional brief periods of heavy drain, as, for example, around tax payment dates. It affords the Treasury a source from which it may obtain funds to meet temporary contingencies, making it possible for the Treasury to operate with a smaller cash balance than might otherwise be necessary. This mechanism has been used from time to time for short periods. It should be extended beyond the present deadline of June 30, 1950, and preferably made permanent.

In addition to the matters mentioned above, there are certain features of the law which, although not of vital importance, may deserve reference here. These are requirements which are impracticable or unnecessary and impair to some extent the efficient functioning of the Federal Reserve System. Some examples of such requirements may be mentioned:

The requirement of section 16 of the Federal Reserve Act for the segregation of collateral against Federal Reserve notes in the form of eligible paper, gold certificates, or Government obligations is cumbersome and yet adds nothing to the quality of such notes since they are a prior lien on all the assets of the Federal Reserve Banks and are obligations of the United States. There could be written into the law a formula which would accomplish the same purpose without the procedural requirements of this provision.

The provision of section 16 prohibiting any Federal Reserve Bank from paying out Federal Reserve notes issued by another Federal Reserve Bank, except under penalty of a 10 per cent tax, serves no useful purpose and the cost of sorting and returning such notes results in at least $350,000 a year of unnecessary expense to the Federal Reserve Banks.

The requirement of section 14(d) of the Federal Reserve Act that each Federal Reserve Bank must establish discount rates every fourteen days has entailed unnecessary inconvenience and might well be modified so that at least in the ordinary cases such rates could be established less frequently, say, once during each month.

The provision of section 10(b) which requires an interest rate higher by at least ½ per cent per annum than the highest discount rate of the Federal Reserve Bank for advances to member banks secured by any satisfactory collateral other than eligible paper should be eliminated.

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V. ORGANIZATION AND STRUCTURE OF THE FEDERAL RESERVE SYSTEM

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V. Organization and Structure of the Federal Reserve System

1. *In what respects, if at all, is the effectiveness of Federal Reserve policy reduced by the presence of nonmember banks?*

The effectiveness of Federal Reserve policies is reduced by the fact that nonmember commercial banks, some 7,250 in number, are not subject to the same reserve requirements as the 6,900 member banks, and that they do not have the same direct access as member banks to the credit facilities of the Reserve Banks. This is true even though the lending power of nonmember banks is indirectly affected by changes in the total volume of reserves available to the banking system and they share indirectly in the benefits growing out of the existence of the Federal Reserve System. The table below shows the composition of the commercial banking system by class of banks as of June 30, 1949.

Number and Deposits of All Commercial Banks In United States By Class of Bank, June 30, 1949

	Number of banks		Total deposits	
	Number	Percentage of total	Millions of dollars	Percentage of total
Member banks				
National	4,987	35.3	78,219	56.8
State	1,913	13.5	38,745	28.2
Total	6,900	48.8	116,964	85.0
Insured nonmember	6,517	46.0	18,410	13.4
Noninsured	733	5.2	2,146	1.6
All commercial	14,150	100.0	137,520	100.0

I wish at the outset to indicate my general position on the problem raised by this question, mainly with respect to the implications of a divided banking structure.

There is no simple answer to the problem presented by a divided banking structure. It must be considered from many angles, historic and institutional as well as political and economic. If it is the purpose of this inquiry to point out a constructive course of future action, little would be gained by a simple reiteration at this point of the many problems presented to those charged with the administration of national policies

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by the existence of thousands of nonmember banks. The dangers inherent in a divided banking system such as ours have been repeatedly considered by the Congress, and on various occasions legislation has been enacted looking toward eventual integration of our thousands of individual banks into a more logical banking structure. In each instance, however, forces have arisen of sufficient strength to nullify the action or to prevent such integration before the deadline date.

It seems fairly clear to me that these forces are no less powerful today than they have been in the past and that, in the absence of a major banking catastrophe, it would be futile to premise a course of constructive action upon the promotion of legislation requiring all commercial banks, or even all of those that enjoy the benefits of Federal deposit insurance, to undertake all of the responsibilities that are carried by members of the Federal Reserve System. If we are to be realistic as well as conscientious, I would prefer rather to have us bend our efforts toward measures sufficient to buttress the most glaring weaknesses in our present structure. This, it seems to me, is the path of wisdom if we are to avoid the widespread calamities that might yield us in the end a more logical and integrated structure of banking but only after and at the expense of another banking collapse.

I want to make my own position clear. I have always supported the dual banking system. I welcome it as a source of flexibility and decentralization in our banking supervisory structure. Our thousands of individual unit banks established in our separate communities, chartered and supervised in some cases by Federal and in other cases by State authorities, have made a distinct contribution to our free enterprise society, a contribution that finds little parallel in the more centralized banking systems of other countries. They are in intimate contact with their local customers. They are sensitive to local needs. They have helped build and maintain the vitality of small and medium-sized business in this country and they have contributed to the spirit of competition and initiative that is characteristically American.

The term "dual banking" should not be confused with "the divided banking system," i.e., the division of banks into members of the Federal Reserve System and nonmembers. The Federal Reserve System was created originally to preserve our

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unit banking system and our dual banking system and to protect it from its one fatal weakness, namely, the recurrence at relatively frequent intervals of devastating money panics. It was established with full recognition of the desirability of continuing dual banking and membership in the System has not destroyed it. The Federal Reserve System itself is vulnerable, however, to the extent that it lacks direct contact with half of the banks of the country, mainly, the smaller banks. We need direct contact with these banks and there are times, particularly times of strain, when they vitally need contact with us. That contact, of course, would be provided if they all took out membership in the System, but it seems to me that universal membership is not a feasible solution of the problem. I want naturally a membership that is as large as possible and I would recommend changes in the Federal Reserve Act to make it easier for nonmember banks to join the System. I am not in favor of compulsory membership in the Federal Reserve System. I think it is important that our membership remain on a voluntary basis.

While I personally favor the preservation of dual banking and voluntary membership as the basis of our Federal structure of reserve banking, I do not wish to minimize the fact that this lack of integration presents a very serious problem.

What does it mean to have a commercial banking structure that consists of over 14,000 individual banks, of which fewer than 5,000 hold national charters while the remaining operate under the differing charter provisions of the 48 separate States? Does the existence among all these banks of a small number of large correspondent banks, as well as a few branch and group banking systems, provide sufficient interconnection to assure an adequate flow of loanable funds from regions where financial resources are ample to regions in need of outside financial assistance? What are the limitations imposed on national monetary policies by the fact that less than 2,000 of the 9,000 State chartered institutions have chosen to take out membership in the Federal Reserve System? To what extent are these limitations offset by the fact that most of the larger banks, including most of the correspondent bank and branch banking systems, are members of the Federal Reserve System so that it includes 85 per cent of the total deposits of the commercial banking system? Does the fact that the Federal Deposit Insurance system covers all but a handful of our banks provide

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indirectly that hard central minimum core of essential unity which first the national banking system and later the Federal Reserve System failed to achieve?

There are many, particularly among the commercial bankers, who feel that the division in our banking structure, and even in the authority of the Federal Government to supervise banks, is no longer a danger. They believe, in fact, that this division has become an asset in that it diffuses governmental power and responsibility and, consequently, safeguards the banks from capricious and arbitrary acts on the part of the public authorities. This consideration, however, runs both ways. If the minimum unification essential to survival has not, in fact, been achieved, the present division of powers between the various authorities may very well turn into competition in laxity in periods of prosperity as well as into impotence in time of stress. Something of this sort happened in the early 1930's when the problem of bank failures was acute. Difficulty again threatened in 1947 and 1948 when the efforts of the Federal Reserve System to temper the postwar inflation, through increases in reserve requirements, brought into sharp focus the competitive situation between member and nonmember banks. As the Federal Reserve System raised the reserve requirements of member banks, these member banks became increasingly aware of the competitive advantages with respect to reserve requirements held by nonmember banks, and correspondingly restive. Had the conditions of 1948 persisted much longer the ability of the System to meet its responsibilities might have been seriously impaired by withdrawals among its members.

The acute phase of the postwar inflation, fortunately, seems now to be in the past, and the particular circumstances that complicated central banking administration in that period have abated. We must, however, take counsel to forestall a comparable episode from arising in the future. We cannot rest content with a situation in which those charged by Congress with the administration of the Federal Reserve System may be prevented from discharging their responsibilities because of the competitive situation created by the inadequate reserve requirements of nonmember banks.

I feel that we may reach a constructive and practical solution of this problem if we concentrate on the two aspects of the situation where mandatory legislation is not only justified

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but essential to the nation's welfare. One is that the legal reserve requirements which all banks must observe to retain their charters, whether they be State or Federal, be so drawn that the monetary strength of this country is not affected by a bank's voluntary decision to enter or withdraw from the Federal Reserve System. The other is that access to the Federal Reserve System, that is, to the ultimate source of financial liquidity in times of strain, be open to every commercial bank whether or not it is a member of the Federal Reserve System. These two changes are not separable. They must be linked together.

The legislation that would most directly accomplish these results would provide first that all commercial banks, that is, all banks carrying deposits subject to check, or at least all insured commercial banks, observe the same reserve requirements irrespective of whether they are member banks or nonmember banks. Such legislation would not affect the authority of the State supervisors over nonmember banks but it would remove once and for all the danger that the relative competitive advantages of membership, as compared with nonmembership, in the Federal Reserve System would affect the aggregate money supply of this country and inhibit the power of the Federal governmental authorities to deal effectively with problems of inflation.

If such legislation were enacted, it should provide for a revision of the reserve requirements now applicable to member banks, which contain many anomalies inherited from the past. The uniform reserve plan outlined to your Committee last year contains many features that merit consideration. It is discussed in the answer to Question IV-1. This proposed uniform reserve plan would provide for a fairer distribution of reserves among member banks, and the requirements could be met by many nonmember banks with little change in their operations.

Should Congress be disposed to meet the problem presented by the continued existence of nonmember banks in this forthright fashion, I would recommend that direct access to the discount and loan facilities of the Federal Reserve Banks be extended to all commercial banks without distinction as to whether or not they were members of the Federal Reserve System. Such a move would make generally available the most important present material advantage of membership in the Federal Reserve System. It might result in some losses in our membership, and, therefore, in the applicability of some of the super-

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visory safeguards that Congress has written into the Federal Reserve Act as a condition of membership, and perhaps in a decreased coverage of the par collection system. Much as I would deplore this weakening in System membership, I would prefer such a solution to a continuance of the present position. We would at least be sure that the aggregate volume of effective commercial bank reserves of the country would no longer be threatened by competition between member and nonmember banks. I would, of course, welcome the fact that all commercial banks would have direct access to the credit facilities of the Federal Reserve Banks. It might well rescue many nonmember banks from trouble in times of strain.

A somewhat similar, but much less effective, suggestion has recently been advanced to deal with this same situation, namely, that Congress require all commercial banks to hold the same percentage of reserve against their deposits but that nonmember banks be permitted to count their balances held with correspondent banks as part of the assets available to meet the requirement to a much greater degree than would be permitted to member banks. This suggestion would not meet the basic logic of the situation since it would not provide assurance that the aggregate volume of effective bank reserves would be adequate to permit the central banking authorities to meet their responsibilities. It would go part of the way, however, toward minimizing the dangerous effects of a competitive situation, such as developed last year, in that the percentages of reserves which nonmember banks were required to carry would have changed parallel to changes in the percentages of the reserves which member banks were required to carry. If this improvement were all that could be achieved, it would not be safe to give direct access to the credit facilities of the Federal Reserve Banks to all nonmember banks. It should be feasible, however, to provide direct access to the credit facilities of the Federal Reserve Banks to all nonmember banks that chose of their own volition to carry their reserves in the Federal Reserve Banks.

In considering any such legislation, Congress should review the other requirements now imposed on member banks.

My support of the dual banking system and my feeling that problems which need to be dealt with should be solved within this framework, even though it entails continued existence of a considerable number of nonmember banks, rests largely on my reading of the basic philosophy of the people of this country.

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We have here a most elaborate body of law, State and Federal, that deals with the financial structure. The American people have shown no reluctance to enact legislation to safeguard the soundness of banks, their safety, and their liquidity, although sometimes the need for such legislation was learned only through disaster. These purposes are common to the banking legislation of the 48 States and of the Federal Government, including the legislation creating the Federal Reserve System and the Federal Deposit Insurance Corporation. At the same time, the history of our banking legislation has shown definitely that the American people not only want banks and a central banking system that are simply sound, safe, and liquid, but they insist also on the preservation of banking institutions that are locally owned and locally managed. It is this insistence that explains the continued existence of our unit banking system, the preservation of our dual banking system, our separate regional Federal Reserve Banks, and the unwillingness to unify our banking structure compulsorily under the Federal Reserve System. I, for one, am content as a realist to accept that insistence. Even more, I find myself in accord with it. Possibly, students of the problem in the past have been mistaken in seeking to safeguard our monetary structure by advocating universal membership in the Federal Reserve System, for that membership involves conformity with national standards with respect to a great many of a bank's activities. It is not solely confined to conformity with respect to reserves.

I suggest that instead of pushing for compulsory universal membership in the Federal Reserve System it would be better if we all were to concentrate on the elimination of competition in laxity with respect to reserve requirements. If we can gain that one objective, we can then direct access to the credit facilities of the Federal Reserve System and we will have dealt with the most serious threat to our ability to safeguard the monetary structure of this country.

The foregoing suggestions are based on the fact that Federal Reserve policies are accomplished in the main through expanding or contracting the amount of reserves available to banks. In the monetary system of the United States today balances with the Federal Reserve Banks and vault cash supply the basic reserves of the entire banking system; increases in the amount of these reserves make possible expansion in the supply of money while decreases are likely to necessitate contraction. The

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amount of these basic reserves that banks are required to hold against their deposits determines the volume of credit that can be extended by the banking system on the basis of any given total volume of such reserves. Under existing conditions the total volume of deposits in all commercial banks is approximately 7½ times the aggregate of reserve balances with Federal Reserve Banks and vault cash held by commercial banks.

Member banks are required to hold balances with Federal Reserve Banks as reserves against their deposits. Nonmember banks, on the other hand, may hold their reserves in the form of vault cash, balances due from other commercial banks, and, in some States, certain amounts of securities of the United States, States, and political subdivisions. Only the vault cash, which must be obtained indirectly from the Federal Reserve, will be reflected dollar-for-dollar in the demand for Reserve Bank credit. Vault cash, however, constitutes only a very small portion of required reserves of nonmember banks; their reserves consist largely of balances due from other banks. Balances due from other banks, since the banks with which the funds are deposited can lend or invest them, do not restrict credit expansion except to the small extent that reserves are held against these deposits in the form of vault cash or of balances at the Federal Reserve Banks. Balances deposited with correspondent banks are in large part available for lending by correspondent banks and thus may contribute to the process of multiple credit expansion on the basis of a given amount of basic reserves. Reserves consisting of securities are not effective as reserves in a monetary sense—i.e., as a means of regulating the total amount of credit that can be supplied by the banking system—because they are not immobilized assets but rather are assets which reflect credit expansion. A reserve requirement in the form of specified securities, e.g., United States Government securities, is, however, a limitation on the proportion of bank funds which can be invested in other loans and securities.

With reference to required reserves, it should be pointed out that member banks in practice hold as working balances certain amounts of vault cash and deposits with correspondents, in addition to their required reserves with Federal Reserve Banks, whereas nonmember banks can count their minimum working balances as required reserves. Thus, the differences in percentages of deposits required to be held as reserves do not ac-

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curately reflect the actual differences in effective reserves that must be held by the member and nonmember banks.

Although member banks hold about 85 per cent of total deposits of all commercial banks, it must be remembered that the effectiveness of reserve requirements lies not only in the aggregate volume of dollars required to be held as reserves; to a very considerable extent it lies in the direct impact of those requirements upon the loan and investment policies of the thousands of individual banks and the influence those policies exert upon the myriad users of bank credit. Accordingly, the fact that more than one-half of all commercial banks are not members of the Federal Reserve System and are not subject to Federal Reserve requirements can seriously weaken the effectiveness of these requirements. Moreover, the geographical distribution of the nonmember banks is not uniform throughout the country but varies widely, ranging from approximately 15 per cent of all commercial banks in the Federal Reserve District of New York to approximately 71 per cent in the Federal Reserve District of Atlanta. As a result, the impact of Federal Reserve policies and the possibility of rendering assistance and support in time of need varies widely in different areas of the country.

NUMBER OF ALL COMMERCIAL BANKS AND PER CENT WHICH ARE NONMEMBERS, BY FEDERAL RESERVE DISTRICTS, June 30, 1949

Federal Reserve District	All commercial banks	
	Number	Per cent which are nonmember banks
Boston	498	33.1
New York	909	14.5
Philadelphia	843	23.8
Cleveland	1,128	37.9
Richmond	1,026	53.3
Atlanta	1,195	70.9
Chicago	2,498	59.8
St. Louis	1,473	66.4
Minneapolis	1,281	62.8
Kansas City	1,768	57.1
Dallas	1,019	39.1
San Francisco	512	48.0
Total	14,150	51.2

2. *What changes, if any, should be made in the standards that banks must meet in order to qualify for membership in the Federal Reserve System? What would be the advantages of such changes?*

The present statutory requirements with respect to the amount of capital necessary for admission of a State bank to member-

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ship in the System are arbitrary, unrealistic, and have little relationship to the capital needed by the banks. They should be substantially modified. For the same reasons, specific provisions regarding the minimum amount of capital stock required for the admission to membership of a State bank operating an out-of-town branch or branches, or for the establishment of an out-of-town branch by a State bank, should be eliminated.

As a result of present capital requirements, sound banks which are otherwise entitled to membership, and most of which are insured banks, are prevented from becoming members of the Federal Reserve System or from establishing branches as member banks. A recent survey indicates that there are approximately 2,000 State banks which were not eligible for membership because of the present capital requirements.

Furthermore, present capital requirements have caused some State member banks to withdraw from membership in order to establish or continue out-of-town branches, which they can do as insured nonmember banks but cannot do as member banks. Since January 1, 1946, eleven State member banks have withdrawn from membership for this reason. In each case, after considering all of the factors prescribed by law, including the adequacy of capital structure, the Federal Deposit Insurance Corporation approved the bank's application for continuance of insurance as a nonmember bank and establishment or continuance of the branch. In each case the bank's capital stock was less than the amount required for the operation of branches as a member bank.

As a general rule, banks which are eligible for Federal deposit insurance should not be barred from membership in the Federal Reserve System by arbitrary capital requirements. The following proposed changes are desirable in and of themselves and necessary in order to eliminate unwarranted discrimination against membership in the Federal Reserve System.

Instead of the present capital requirements, which relate only to the amount of capital stock and are based upon population, there should be only one specific capital requirement for admission to membership—a minimum of $50,000 paid-up capital stock, with the exception that a bank organized prior to the enactment of the proposed legislation might be admitted with paid-up capital of $25,000. The adequacy of a bank's capital structure should continue to be included among the factors to be

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considered by the Board of Governors in passing upon the application of a State bank for membership.

The Board has recommended such changes and bills incorporating the recommendations have been introduced in the present Congress as S. 2494 and H. R. 5749.

Except for the suggested minimum capital stock, the discretionary authority proposed would be similar to that now prescribed for the Federal Deposit Insurance Corporation in passing upon applications for insurance and for the establishment of branches by insured nonmember banks.

PROVISIONS OF EXISTING LAW

The existing law provides, in general, that no State bank shall be admitted to membership in the Federal Reserve System unless it possesses a paid-up unimpaired capital stock of at least:

$50,000 if in a place of not over 6,000 population
$100,000 if in a place of over 6,000 but not exceeding 50,000 population
$200,000 if in a place of over 50,000 population

Exceptions permit, in certain circumstances, the admission of State banks with a minimum capital stock of $25,000 if located in a place of not over 3,000 population, and with a minimum capital stock of $100,000 if located in an outlying district in a city with a population of over 50,000.

If a bank with an out-of-town branch established after February 25, 1927, wishes to become a member, or a State bank which is a member wishes to establish an out-of-town branch, it is required by law to have a capital stock of at least $500,000, except in a few States with relatively small population. A minimum of $250,000 is applicable in a State with a population of less than 1,000,000 and in which there is no city with a population exceeding 100,000; a minimum of $100,000 is applicable in a State with a population of less than 500,000 and in which there is no city with a population exceeding 50,000. In addition, the bank must have capital stock not less than the aggregate required for the establishment of National banks in the various places where the bank and its branches are located. In many cases the capital requirements for the establishment of branches by State member banks (which are the same as for National banks) are much more stringent than those under the State law.

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3. *What changes, if any, should be made in the division of authority within the Federal Reserve System and in the composition and method of selection of the System's governing bodies? In the size, terms, and method of selection of the Board of Governors? In the Open Market Committee? In the Boards of Directors and officers of the Federal Reserve Banks? What would be the advantages and disadvantages of the changes that you suggest?*

BOARD OF GOVERNORS

Before the recent debates on the executive salary bill (H. R. 1689), I would have answered the question with respect to changes in the size, terms, and methods of selection of the Board of Governors by recommending that no change be made, or at most that the membership of the Board be reduced from seven to five. However, these discussions reflected a widespread misunderstanding of the Reserve System's responsibilities for monetary and credit policies and of the need for salaries for members of the Board commensurate with their responsibilities. As I am in no way dependent upon my salary as a member of the Board, my comments on the question of salaries are actuated only by a desire to increase the effectiveness and prestige of the Federal Reserve System.

The executive salary bill as passed by the Congress increases the salaries of the Board from $15,000 to $16,000. The salaries of members of the Cabinet were increased from $15,000 to $22,500, undersecretaries formerly receiving $10,000, $10,330, or $12,000 were increased to $17,500, and a number of other official salaries, ranging from $10,330 to $15,000, were increased to $16,000 and more. When the System was first organized the salaries of the members of the Board were the same as those of members of the Cabinet and they have been at that level for many years past. The fact that the Congress did not maintain in the executive salary bill the salary status of the members of the Board has disturbed me greatly because it reflects either a misunderstanding as to the Board's responsibilities or a feeling that they are no longer as important as they have been in the past. Since the Board's responsibilities have increased over the years, particularly during and since the war and because of the great growth in the public debt, I am convinced that the action of the Congress is the result of a misunderstanding.

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The availability of credit for the financing of business is the life blood of a dynamic society. When an agency is given the responsibility—as the Federal Reserve System has been—for increasing or decreasing the amount of credit available and the cost of such credit, its decisions and policies have a profound effect on all segments of the economy. Failure to meet that responsibility wisely in the public interest could do untold damage to business, industry, and agriculture. Sound national monetary conditions are essential to achievement of the objectives of the Employment Act of 1946. Primary responsibility in this field is vested in the Board of Governors. It would be difficult to exaggerate the importance of this responsibility and hence the need for confiding it to men of wide experience who have great breadth of vision and understanding. In my opinion, this duty alone justifies a salary level for Board members that is substantially above the limitation set by the current legislation. In addition the Board has other important duties. It has general and other major supervisory functions in connection with the operations of the 12 Federal Reserve Banks and their 24 branches which perform central banking functions in the public interest and, therefore, are entirely different in their purposes and functions from the commercial banks which are private institutions. The Board also exercises special supervision over the relations of the Reserve Banks with foreign banks and bankers. Its duties include the supervision and examination of banks. Additional responsibilities, among others, include the issuance and retirement of Federal Reserve notes which is the major portion of our currency, and the issuance of regulations relating to the many subjects to which the jurisdiction of the Board extends.

In the light of the above, I am satisfied that it is essential to the effective discharge of the Board's functions that the prestige of the position of a member of the Board and the salary for the position be such as to attract the best qualified men available. Whether the Board consists of three, five, or seven members is not as important as to have the positions filled with men of the highest qualifications and competence who will be induced by the nature and standing of the position to accept and remain in office. There is no question in my mind that if the subordinate salary relationship established by H. R. 1689 is continued it will be most difficult, if not impossible, to attract to the Board men of the calibre I have indicated. After serving for a period of 18 months as Chairman, I feel that the salary relationship which

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existed in the past should be maintained and if the only way to restore that relationship is to reduce the number of members of the Board, I would strongly recommend that step. In this connection it should be borne in mind that salaries and expenses of the Board and its staff are not paid from appropriated funds or Governmental revenues or from assessments upon member banks but from earnings of the Federal Reserve Banks in the normal course of their operations, particularly open market operations.

If the Congress should reduce the present Board to five members and retain the present Open Market Committee, it would be my suggestion that the representative membership on the Committee be reduced to three or four instead of five as at present.

The present law requires that from the membership of the Board the President shall designate one member as Chairman and one member as Vice Chairman to serve as such for a term of four years. The purpose of this provision of the law was to afford a new President an opportunity to designate a Chairman and Vice Chairman of the Board. In practice this provision has not worked out satisfactorily because it has not been possible to make appointments so that they would coincide with the term for which the President is elected. It would be preferable if the law were changed to provide that the President shall designate the Chairman and Vice Chairman for terms expiring on March 31, 1953, and March 31 of every four years thereafter.

FEDERAL OPEN MARKET COMMITTEE

Differences of opinion have always existed as to the most desirable distribution of functions within the various parts of the Federal Reserve System and particularly as to where responsibility for the instruments of credit policy should be placed. One view expressed in answers to questions of the subcommittee is that authority with respect to more of these instruments should be lodged with the Federal Open Market Committee. It is my considered opinion that the present arrangement works very well. It has been my experience that the Board is constantly seeking and benefiting from the advice on System policies generally as provided not only through the Open Market Committee but also through consultation with all of the presidents and the chairmen of the Federal Reserve Banks and the

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Federal Advisory Council. A splendid spirit of cooperation and understanding on policy and procedure exists throughout the System, and my chief interest is to preserve and improve it.

If any change were to be made in this regard, I would prefer to consider an amendment to the law to place authority over open market operations, and of all powers and authorities vested in the Board of Governors, in a reconstituted Board (which would be known as the Federal Reserve Board) consisting of three members appointed by the President with the advice and consent of the Senate, and the presidents of two of the Federal Reserve Banks, making a Board of five full-time members. The terms of the three members appointed by the President would be 12 years so arranged that one term would expire every four years. The present requirement that a member shall be ineligible after the completion of a full term should be eliminated except that no one should be eligible for appointment for a term or the unexpired portion thereof if he would reach 70 years of age before the end of the term.

The two members chosen from the presidents of the Federal Reserve Banks would each serve for a period of one year in accordance with a system of rotation among the 12 Federal Reserve Bank presidents which would be written into the law. The two president members of the Board would be required to give their full time to the work of the Board. To be eligible for service as a member of the Board, a president of a Federal Reserve Bank should have served as an officer of the Bank for at least two years.

Such a proposal would terminate the existing arrangement under which authority over instruments of credit policy are divided between the Board of Governors and the Federal Open Market Committee. It would preserve the present advantages of having presidents serve on the Open Market Committee, and would be in harmony with the regional character of the Federal Reserve System which contemplates that the coordination, supervision, and final determination of national credit and other major policies would be in the hands of a supervisory governmental body located in Washington. Because of the importance of the New York money market, provision should be made for participation of the president of the New York Federal Reserve Bank in the consideration of open market policies and operations.

However, unless future experience should reveal a greater need than now exists for changing the duties or composition of

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the Federal Open Market Committee, I would not recommend a change.

DIRECTORS OF FEDERAL RESERVE BANKS

One of the major advantages of having a Board of Directors at each of the Federal Reserve Banks is that it brings to bear on the problems of the System the wide range of training and experience possessed by the Directors. This advantage can be most effectively utilized, however, if there be injected regularly into the membership of the Board of Directors fresh points of view. This can best be accomplished by a system of rotation of membership on the Bank Boards. Another advantage of such a system would be that a more frequent turnover of Directors would result in more of the outstanding business men in the various Federal Reserve Districts having close contact with and understanding of monetary and credit policies. These problems are complex. They are not generally understood by the public. Men who serve as Directors of the Federal Reserve Banks or as members of the Federal Advisory Council gain a much better understanding of national monetary and credit problems and of policies designed to meet such problems and they are thus able to inform other business men and bankers on these subjects. This results in a far wider understanding and acceptance of System policies.

In 1935 the Board adopted a policy under which Class C Directors of Federal Reserve Banks (who are appointed by the Board) who had served six or more consecutive years (except in the case of the Chairman of the Board of Directors) would not be reappointed. It was the hope of the Board that the same policy would be followed in the election by the member banks of Class A and B Directors of the Reserve Banks but that course was followed only to a limited extent. Accordingly, in 1942 the Board announced that it had abandoned any fixed rule as to the length of service of Class C Directors but that it would adhere generally to a policy of rotation. Since it has not been possible to bring about a system-wide policy in this regard, it would be my recommendation that the law be changed to provide that Directors of Federal Reserve Banks (perhaps with the exception of the Chairman of the Board of Directors) shall be ineligible for service as Directors after the completion of two consecutive full terms of three years each.

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OFFICERS OF FEDERAL RESERVE BANKS

The Banking Act of 1935 required that the chief executive officer of a Federal Reserve Bank be a President, appointed by the Directors with the approval of the Board of Governors for a term of five years, and all other executive officers and employees of the bank are directly responsible to him. Provision was also made for the appointment of a First Vice President in the same manner and for the same term as the President and he serves as the chief executive officer in the absence or disability of the President.

For a variety of reasons relating to the freedom to assign responsibilities to officers and the selection of men to fill the second position on the executive staffs of the Federal Reserve Banks, it would be preferable if the position of First Vice President were eliminated. If that were done, the Directors would be free to shift the more important duties and responsibilities among the vice presidents and make changes in the official line-up of officers without the difficulties sometimes encountered under the present arrangement.

FEDERAL ADVISORY COUNCIL

There is no formal limitation on the length of time that a member of the Federal Advisory Council may serve. For the same reasons as are given above for the adoption of a system of rotating membership on the Boards of Directors of the Federal Reserve Banks, I believe it would be desirable to provide for rotation in the membership of the Federal Advisory Council. The desirability of such rotation has been recognized in resolutions adopted by the Chairmen of the Federal Reserve Banks as well as by the Federal Advisory Council itself, but the Directors of some of the Federal Reserve Banks have not acted to put the suggestion into effect. Accordingly, I would favor a change in the law to provide that an individual shall not be eligible to serve as a member of the Council for more than three full consecutive calendar years.

OTHER CHANGES

There are other changes of lesser importance in the organization of the System which I shall not undertake to detail in this reply but which would be desirable in the event a general revision of the Federal Reserve Act were undertaken.

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VI. RELATION OF THE FEDERAL RESERVE TO OTHER BANKING AND CREDIT AGENCIES

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VI. Relation of the Federal Reserve to Other Banking and Credit Agencies.

1. *What are the principal differences, if any, between the bank examination policies of the Federal Reserve System and those of the FDIC and the Comptroller of the Currency?*

At the present time, the differences between the examination policies of the Federal Reserve, the FDIC, and the Comptroller of the Currency are not of material consequence. Such variations as formerly existed related mainly to the appraisal of assets held by the examined bank, and these appear to have been largely eliminated by an agreement on appraisal standards—more fully described in the answer to Question VI-2—which was worked out among the three agencies in 1938 and revised by them in 1949. The differences might be greater and of more significance in periods when inflationary and deflationary pressures are less evenly balanced and one or the other is tending to unstabilize the economy.

It is only natural that there should be some differences among the supervisory policies of the three agencies (as implemented by bank examinations and otherwise), in view of the fact that the responsibilities and principal functions of the respective agencies are not the same, but the differences in policies are on the whole less important than the similarities. General statements respecting their varying responsibilities, if made by any one of the three agencies, would perhaps be unacceptable to both the others. By reason of their institutional connection the examiners of the Federal Reserve System are particularly attentive, in appraising a bank's assets and the character of a bank's management, to taking into account the general business and credit conditions and the current monetary and credit policy of the Federal Reserve authorities.

2. *To what extent and by what means have the policies of the Federal Reserve been coordinated with those of the FDIC and the Comptroller of the Currency where the functions of these agencies are closely related? What changes, if any, would you recommend to increase the extent of coordination? To what extent would you alter the division*

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among the Federal agencies of the authority to supervise and examine banks?

3. *What would be the advantages and disadvantages of providing that a member of the Federal Reserve Board should be a member of the Board of Directors of the Federal Deposit Insurance Corporation? Would you recommend that this be done? Should the Comptroller of the Currency be a member of the Federal Reserve Board?*

These questions relate in reality to a single problem—one of long standing and great complexity. It grows out of the fact that Federal supervision and regulation of banks are divided among three agencies set up by Congress for different purposes and at widely separated times in our banking history. The Comptroller of the Currency over 85 years ago was charged with the responsibility of chartering and examining national banks. As passed in 1913 and with later amendments, one of the purposes of the Federal Reserve Act stated in its preamble was "to establish a more effective supervision of banking in the United States," and the Act places upon the Federal Reserve Board and the Federal Reserve Banks, among other responsibilities, supervisory and examining functions with respect to all member banks. In the depression period of the early 1930's, the Federal Deposit Insurance Corporation was created to administer a bank deposit insurance fund, and was given certain limited powers over all insured banks, including national banks and State member banks, and special powers of supervision and regulation with respect to nonmember insured banks. As a result, each of the three agencies is primarily concerned with a certain class of banks; but each also has regulatory functions in specific areas which affect banks primarily under the jurisdiction of one or both of the other agencies. In addition, Congress has placed upon the Board of Governors important responsibilities in the field of credit and monetary policy with which bank supervisory and regulatory policies have a definite relationship.

In the circumstances, a layman examining an organization chart of the three agencies or a description of their functions would expect to find little evidence of coordination in their supervisory policies and would probably expect them to be working completely at cross purposes. There has been no specific directive from Congress requiring cooperation between them and, except that the Comptroller of the Currency is an ex-officio

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member of the Board of Directors of the FDIC, each of the agencies is quite independent of the others. Actually, however, the agencies have accepted the need for cooperation as a practical matter and each of them has made its own contribution to this end.

In the field of bank supervision, which has to do with individual banks and is implemented by bank examinations, the three supervisory agencies appear to have achieved reasonably uniform standards for the appraisal of bank assets by bank examiners. This has resulted chiefly from the adoption of a written agreement between the three agencies and the National Association of Supervisors of State Banks, first in 1938 and revised, in detail but not in principle, in 1949. In such matters as the chartering of banks, admissions to deposit insurance or to membership in the Federal Reserve System, and grants of permission to establish branches, a great deal of coordination has been likewise attained.

Serious problems of coordination have arisen from the fact that the three agencies are authorized under the law to issue and interpret regulations applicable to the classes of banks under their respective jurisdictions which relate to the same general subject matter and also from the fact that as to certain matters one of the agencies may possess regulatory authority with respect to a class of banks primarily under the jurisdiction of another agency. Even here, however, a considerable degree of uniformity has been accomplished.

Both in connection with supervisory and examination policies and the issuance and interpretation of regulations, coordination has resulted from constant efforts to foster discussions and consultations between the agencies both at top level and at the staff level. The 1938 agreement with respect to bank examination policies is an excellent example of the cooperation that may be accomplished through such methods.

A common understanding of mutual problems at the staff level has been substantially aided by the fact that in several districts the Federal Reserve Banks have provided office accommodations for the chief national bank examiners of the Comptroller's office and also for the corresponding field representatives of the FDIC. In the case of the FDIC, however, differences in areas covered by the various districts from those in Federal Reserve Districts made more cooperation difficult in some regions.

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There are, of course, certain particulars in which complete coordination and uniformity with respect to examination policies as well as regulatory functions have not yet been achieved. That all reasonable steps should be taken to increase cooperation in these areas is obviously desirable. However, in proposing additional means of achieving closer cooperation, each of the three agencies would naturally be influenced by the special functions and objectives which have been assigned to it by the Congress.

While it is natural to consider the possibility of ex-officio relationships between the agencies concerned as a means of encouraging increased coordination of policies, such relationships are subject to certain inherent disadvantages. An officer attached to a particular agency is unlikely to devote adequate attention to all of the problems of another agency served by him in an ex-officio capacity; and he is often unable to attend meetings of the other agency with regularity or to participate as fully as would be desirable in its deliberations.

4. *In what cases, if any, have the policies of other Government agencies that lend and insure loans to private borrowers not been appropriately coordinated with general monetary and credit policies?*

A large number of Federal corporations and agencies have independent responsibilities for making credit available to private borrowers. Congress has given some agencies certain powers to make loans and other agencies powers to insure or guarantee loans made by banks and other private financing institutions. (A few have authority both to lend and to guarantee loans.) In some cases the lending or loan-insuring functions are related primarily to specific purposes such as aid to agriculture, homeowners, and veterans, and in other cases they are intended primarily to make credit available on risks and terms not ordinarily accepted by private lenders.

Altogether the operations of these agencies play an important role in influencing the supply, availability, and cost of credit to private borrowers and consequently in the effectiveness of national credit policy. The aggregate volume of credit obtained by private borrowers in domestic fields through the aid of Federal financing agencies more than doubled in the three years 1946-48, and totaled more than 20 billion dollars at the end of 1948, as shown in the attached table. About three-fourths of the outstanding credit was home mortgage loans, most of which

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had been extended by private lenders under guarantees or insurance of the Federal Housing Administration and the Veterans' Administration. Nearly one-fifth of the total represented various types of credit to farmers, a substantial part of which had been extended by the Rural Electrification Administration, the Commodity Credit Corporation, and the Farmers' Home Administration. A small remaining amount consisted largely of

DOMESTIC LOANS AND LOAN GUARANTEES AND INSURANCE BY FEDERAL CORPORATIONS AND CREDIT AGENCIES

(In millions of dollars)

	Outstanding Dec. 31, 1948	Change during		
		1948	1947	1946
Total	20,520	+5,553	+4,553	+1,805
Loans	5,286	+ 949	+ 592	− 278
Loan guarantees and insurance	15,234	+4,603	+3,962	+2,083
To aid homeowners and housing, total	15,860	+4,171	+4,024	+1,778
Loans:				
Reconstruction Finance Corp	184	+ 51	+ 110	− 26
Federal National Mortgage Ass'n	199	+ 195	− 1	− 2
Home Owners' Loan Corp	369	− 117	− 151	− 216
Federal home loan banks	515	+ 79	+ 142	+ 99
Public Housing Authority	295	+ 17	− 1	− 7
Other	22	− 43	+ 39	+ 6
Loan guarantees and insurance:				
Federal Housing Administration	7,276	+2,489 [1]	− 886 [1]	− 379 [1]
Veterans' Administration	7,000	+1,500	+3,000	+2,300
To aid agriculture, total	3,792	+1,368	+ 469	+ 159
Loans:				
Federal Farm Mortgage Corp	80	− 30	− 40	− 93
Federal intermediate credit banks	426	+ 89	+ 63	+ 42
Banks for cooperatives	305	+ 30	+ 44	+ 35
Commodity Credit Corp	620	+ 439	+ 173	− 1 [e]
Rural Electrification Adm	999	+ 265	+ 206	+ 120
Farmers' Home Administration	523	− 32	− 32	− 10 [2]
Other	6	− 2	− 1	− 6
Loan guarantees [3]:				
Commodity Credit Corporation	673	+ 574	− 14	+ 22 [e]
Veterans' Administration	160	+ 35	+ 70	+ 50
To aid industry, total	575	+ 36	+ 78	− 11
Loans:				
Railroads (R.F.C.)	140	− 7	− 23	− 53
Other industry:				
R. F. C	272	+ 31	+ 91	+ 2
Other agencies	38	+ 7	− 10	− 43
Loan guarantees:				
R. F. C	[4]	[4]	[4]	[4]
Veterans' Administration	125	+ 5	+ 20	+ 90
Loans for other purposes, total	293	− 22	− 18	− 125
To States and territories:				
R. F. C	137	+ 14	+ 14	− 10
Other agencies	86	+ 11	[5]	− 5
Other:				
R. F. C.[6]	47	− 39	− 29	− 59
Other agencies	23	− 9	− 2	− 49

[e] Estimated.
[1] Excludes loans insured under Title I of National Housing Act.
[2] Includes emergency crop and feed loans, which were handled by the Farm Credit Administration until October 31, 1946.
[3] Excludes a small amount of loans insured by the Farmers' Home Administration.
[4] Not available.
[5] Less than $500,000.
[6] Reflects largely loans to businesses for nonwar purposes.

NOTE.—Loans outstanding represent gross amounts and are based on figures published by the U. S. Treasury Department; groupings of agencies are by Federal Reserve. Loan guarantees and insurance represent principal amount of loans outstanding and are based on reports and information from the respective agencies. The number of agencies included in "Other" and not already listed in the table is as follows: To aid agriculture, 4; to aid homeowners, 2; to aid industry, 3; and other purposes, 4.

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Reconstruction Finance Corporation loans to businesses. Most of the credit reflected the financing operations of the 13 agencies listed in the table, but some 13 other agencies also made or insured loans.

The powers given by Congress in connection with the activities of these Federal agencies are primarily to meet special problems. No general provision has been made to coordinate the numerous credit activities with over-all credit policy of the Government.

In approaching this aspect of Federal credit agencies we should take into account the important nonmonetary purposes that are served by the lending activities of these agencies and the fact that nonmonetary considerations may be compelling in determining the policies of individual agencies. At the same time it should be borne in mind that credit extended does become a part of the country's money supply and can interfere with or facilitate the effectiveness of national credit policy. At times, moreover, monetary effects of the credit activities of Federal agencies may be a major consideration of the Government in determining the over-all contribution of its numerous and varied activities to accomplishing the objectives of the Employment Act of 1946.

For such reasons, considerations of the bearing of the lending and loan-insuring policies of Federal agencies on general credit policy should not be ignored. These agencies have varying degrees of discretionary authority which can be used to influence the volume of credit extended. It would be desirable, moreover, that those responsible for general credit policy be fully informed at all times as to the probable effects of various loan or loan-insuring programs on the supply of credit, so that general credit policy could be formulated in the light of these prospective developments.

For a number of years there has been increasing recognition of the desirability of bringing the policies of the various lending and loan-insuring agencies into closer relation with each other and with general credit policy. In testifying before the Senate Banking and Currency Committee on May 11, 1949, I emphasized "... the need for some mechanism of policy coordination on the domestic financial front as we have available through the NAC on the international financial front."

Such a mechanism would permit consideration of those policies of the agencies that affect the extension of credit to private bor-

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rowers with a view to bringing about a greater consistency among the agencies and a greater consistency with over-all credit policy. It could also inform the President and the Congress as to the extent to which lending and loan-insuring policies of Federal agencies are compatible with each other and with the objectives of the Employment Act of 1946. Other aspects of a domestic financial advisory body are discussed in the reply to Question VI-6.

5. *What changes, if any, should be made in the powers of the Federal Reserve to lend and guarantee loans to nonbank borrowers? Should either or both of these powers be possessed by both the Federal Reserve and the Reconstruction Finance Corporation? If so, why? If not, why not?*

Small business is of vital importance to the maintenance of a flourishing national economy under our system of competitive private enterprise. It is essential, therefore, that all credit-worthy small businesses should have access to adequate sources of financing.

In general, current working capital requirements of small businesses are met by their local banks. However, the usual sources of short-term credit may not be adequate in times of financial depression or in abnormal times such as occurred during the defense and war periods. Moreover, an important need of the smaller independently-owned business enterprises in normal times is for longer-term funds for such purposes as plant modernization and the purchase of machinery and equipment. As a rule, the owners of small enterprises prefer to obtain such funds on a loan rather than on an equity basis.

Whether the need is for current working capital or for longer-term funds, the use of the private banking system should be encouraged in the financing of small business enterprises. It is obviously desirable that loans to businesses should be made as far as possible by local banks dealing with local concerns with whose problems they are familiar. Governmental agencies should function in this field only when adequate financing is not available from the customary private sources of credit, and then chiefly with a view toward helping to restore and maintain normal credit relationships between business concerns and their local banks.

It was on this basis that Congress in 1934, during a depression period, in the same statute authorized both the Federal Reserve

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Banks and the Reconstruction Finance Corporation to assist in the financing of business enterprises.

The twelve Federal Reserve Banks, as permanent credit institutions, are especially qualified to provide financial assistance to business enterprises through the regular banking channels. With their twenty-four branches, the Reserve Banks constitute a regional organization to which financing institutions and businesses in all parts of the country have convenient access. Because of their long experience in the credit field and their daily relationships with banking institutions, they are thoroughly familiar with credit needs and problems of both banks and businesses. For these reasons, the Reserve Banks are especially fitted to assist local banks in making credit available to borrowers who, though otherwise meritorious, may present credit risks of a character which banks will not ordinarily accept; and, by such aid, the Reserve Banks can help to restore and maintain normal credit relationships between such borrowers and the banks. The Reserve Banks gained additional valuable experience in the field of business loans as the result of their active participation in the wartime V-loan program under which guarantees of war production loans aggregating nearly 10½ billion dollars were processed.

Notwithstanding their qualifications for the task, the Reserve Banks have been handicapped in carrying out their industrial loan function by the restrictive provisions of Section 13b of the Federal Reserve Act. Under present law, they may make commitments and loans only for working capital purposes, only to "established" business, and only with maturities not exceeding five years. These are severe limitations upon the ability of the Reserve Banks to render effective assistance in meeting the requirements of smaller businesses.

Unless appropriate changes are made in the law to place the authority of the Reserve Banks in this field on a more effective basis, I believe that it would be preferable to repeal the present limited authority of the Reserve Banks in its entirety.

If it is the desire of Congress to utilize effectively the services of the Federal Reserve System in the extension of financial assistance to small business in time of need, the Reserve Banks should be authorized to enter into participations and commitments with financing institutions with respect to loans made to business enterprises, on a basis under which a Reserve Bank

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might assume not more than 90 per cent of the risk involved and under which loans would not be limited solely to working capital purposes or restricted to "established" businesses. The maximum maturity on any such loan should be fixed at ten instead of five years. It would be the policy of the Federal Reserve to have the local bankers assume as much of the risk as possible. The Reserve Banks would be prepared to release to the banks at any time within the life of the loan any part of their participation.

Without entering into details, there are certain other changes in the law which would be desirable. Thus, the aggregate amount of participations and commitments by all the Federal Reserve Banks outstanding at any one time might be appropriately limited to, say 500 million dollars; and, in order to assure the availability of credit to the smaller businesses, it might be provided that the aggregate amount of participations and commitments individually in excess of $100,000 could not exceed 250 million dollars. Also, the existing appropriation of approximately 139 million dollars for the industrial loan operations of the Reserve Banks should be repealed and amounts heretofore received by the Reserve Banks for such operations should be returned to the Treasury, so that henceforth the Reserve Banks would utilize only their own funds in providing assistance to business enterprises.

It is my view that both the Federal Reserve Banks and the Reconstruction Finance Corporation may, without inconsistency, operate together in providing financial assistance for business enterprises, provided, however, that there is written into the law a provision which would require the Reconstruction Finance Corporation, before it extends financial assistance to a business enterprise, to consider whether such assistance is available, not only from commercial banks, but through the Reserve Banks. This would be in the nature of a clarification of the present statutory requirement that the Corporation shall render financial assistance only if it is "not otherwise available on reasonable terms."

As a source of extraordinary financial assistance, it is appropriate that the Reconstruction Finance Corporation should make loans of a kind, which, because of the size of the loan or the type of operation involved, are not ordinarily suitable for banks and which are not participated in by the Reserve Banks. Examples are to be found in the financing of railroads, air carriers and

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large public projects, and in the loans made by the Corporation for disaster relief. Aside from loans of this type, the Corporation's principal objective should be to provide needed financial assistance to small businesses in those exceptional circumstances in which regular credit facilities, including those of the Reserve Banks, are inadequate.

With the qualification mentioned above, there is ample room for the functioning of both the Federal Reserve Banks and the Reconstruction Finance Corporation in providing credit assistance to business, provided, of course, that their functions in this field are coordinated with national credit policies and are not exercised in competition with private financing institutions.

6. *What would be the advantages and disadvantages of establishing a National Monetary and Credit Council of the type proposed by the Hoover Commission? On balance, do you favor the establishment of such a body? If so, what should be its composition?*

In view of the large role which Government financial agencies have come to play in influencing the supply, availability, and cost of credit to private borrowers, as discussed in the answer to Question VI-4, I am sure that some mechanism for effecting a closer harmony between them would serve a constructive purpose. The specific objectives of an appropriate council, in my opinion, should be to promote consistency in the policies of Federal agencies extending loans, loan insurance and loan guarantees, and consistency of such policies with the general stabilization program of the Government in accordance with the objectives of the Employment Act of 1946. Such a council should have only consultative and advisory functions. It would serve in some respects as a domestic counterpart of the National Advisory Council on International Monetary and Financial Problems. However, there are important differences in the problems to be considered by the two agencies and there would necessarily be significant differences in organization and operation.

With the existence of such a council, each of the present Federal credit agencies would continue to exercise the authority and discharge the responsibilities which have been especially delegated to it by the Congress, but its policies and operations would have the benefit of joint study in the light of national

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monetary and credit needs and over-all stabilization policies. Furthermore, over-all monetary and credit policy could be formulated in the light of a clearer current picture of the various Federal financing programs and the prospective effects of such programs on the supply of credit.

A council such as I have in mind could help to achieve a more harmonious domestic financial program within the existing framework and without impairing the essential operating flexibility of the various agencies. In fact, it seems reasonable to expect that each of the agencies would gain greater long-run effectiveness as a result of a more definite and systematic mechanism for interagency discussion relating to the appropriateness of policies (from the standpoint of general economic stability) and the coordination of credit functions.

Such a council might be established by statute, as in the case of the National Advisory Council on International Monetary and Financial Problems, or it might perhaps be established on a less formal basis by executive action of the President. A statutory provision for the council would have the advantage of definite recognition by the Congress but would have the disadvantage of making it more difficult for the council to evolve gradually in working out an effective advisory and coordinating mechanism in the domestic field.

Because of the diverse interests and difficult problems involved, it would be desirable to provide ample flexibility for the functional evolution of the proposed council. In addition some problems of integrating the council's activities with those of the NAC would doubtless arise and these would need to be resolved on an empirical basis. It is entirely possible that considerable experience would be needed before such a council could be given its most effective form and function. Therefore, it would be well to test out the operation of a domestic lending advisory council under executive authority before attempting to make it the subject of specific statutory definition. If it should be covered by statute at this time, it would be desirable to limit the statute to broad outline, leaving ample room for adaptation in organization and operation. In general, it would seem undesirable to attempt at this time any close integration of activities of the proposed council with those of the already successfully operating National Advisory Council. Such integration in time might prove to be a construtcive step, but some

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period of operation in the domestic field should be allowed to determine the wisdom of that course.

The council, in my opinion, should comprise the top officials of Federal departments or other agencies having recognized interests or responsibilities in the credit field. Membership should not be too large. Agencies not regularly members would be expected to participate in the consideration of matters relating to their responsibilities.

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VII. DEPOSIT INSURANCE

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VII. Deposit Insurance

1. *What changes, if any, in the laws and policies relating to Federal insurance of bank deposits would contribute to the effectiveness of general monetary and credit policies?*

As the agency primarily responsible for monetary policy, the Federal Reserve System is vitally interested in the functioning of the deposit insurance program, which has as a primary objective the removal of one of the major threats to public confidence in monetary institutions and hence to general monetary stability. Deposit insurance is one of the important reforms intended to improve monetary stability by the banking legislation of the 1930's. Many of these were aimed at preventing another drastic shrinkage in the money supply such as occurred between 1929-33.

To that end the Board of Governors was authorized, among other things, to vary reserve requirements within certain limits, the Federal Reserve Banks were authorized to grant credit on any sound bank asset, and provisions for the issuance of Federal Reserve notes were liberalized. These changes in System authority, while providing necessary capacity in the banking system to cope with adverse conditions, deal only indirectly with one factor which in the past has greatly aggravated cyclical developments on the downward side, namely, panic conditions among depositors. Deposit insurance is the instrument which Congress set up to prevent that considerable part of a liquidating process which is due to panic withdrawal of funds by the general public.

When the insurance program was established there was little experience and information on which to develop a genuine basis for insuring bank depositors against loss. At that time, consequently, insurance coverage, rates of assessment, and the assessment base all had to be set more or less arbitrarily. We now have more than 15 years of successful experience in operating a national deposit insurance program. During this period our economy and our banking structure have undergone great changes. In view of our experience with deposit insurance and the important changes that have occurred over the past decade and a half, it seems appropriate to review and perhaps to revise certain of the judgments that were originally made with respect to deposit insurance.

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There are several points at issue which might be considered in connection with such a reappraisal. The $5,000 limit of deposit insurance coverage which was established when the program was set up has not been revised, but in the interim the price level has doubled, the average deposit account has more than doubled, and total bank deposits and average per capita income have nearly quadrupled. The rate of assessment burden on banks for deposit insurance has not been changed since 1935, although subsequent changes in the banking system have tremendously reduced the possibility of another major banking crisis and in every year of operation assessment receipts of the FDIC have dwarfed its nominal losses. If the deposit insurance reserve is not to be increased indefinitely, the insurance assessment rate should be geared to actual loss experience.

Some months ago the Board was asked by Congress for an expression of views concerning proposed legislation regarding the deposit insurance program, and accordingly the Board asked its staff to undertake a study of certain aspects of the program. This study has been circulated for comment to persons throughout the Federal Reserve System and now incorporates many of their suggestions. A copy was also sent several weeks ago to the Federal Deposit Insurance Corporation. In view of that agency's primary responsibility, I am naturally hesitant about offering a more specific answer to the Committee's question regarding deposit insurance until I have had the benefit of their review.

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VIII. EARNINGS OF THE FEDERAL RESERVE BANKS AND THEIR UTILIZATION, 1940-

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VIII. Earnings of the Federal Reserve Banks and Their Utilization, 1940-

1. *Describe briefly the process by which the Federal Reserve Banks create money, the kinds of money created, and the amount of outstanding money on June 30 of the various years since 1935 that owed its existence to its creation by the Federal Reserve. Include a description of the process and the extent of money creation by the Federal Reserve—(a) by dealing in Government debt; (b) by dealing in private debt of various kinds.*

For the purpose of replying to this question, money will be defined as bank deposits, both demand and time at commercial and savings banks, and currency in circulation outside banks. The amounts of these money components or kinds of money which were outstanding on June 30 dates, 1935-49, are shown in the attached consolidated condition statement for banks and the monetary system. It will be noted from the consolidated statement on page 112 (third line from the bottom) that on June 30, 1949, total deposits and currency amounted to approximately 172 billion dollars, compared with 53 billion in 1935 and nearly 80 billion in 1941. (For references to discussions of the definition of money, to more complete analyses of the sources and processes of monetary expansion and contraction, and to explanations of the figures referred to in this answer, see note attached to this answer and entitled "Technical References.")

In analyzing the sources of this money supply and its expansion, it is necessary to distinguish between those sources which supply reserve funds to banks and those which are extensions of credit by banks to the public. The first group includes monetary gold stock, Treasury silver purchases and other Treasury currency, and Federal Reserve Bank credit. These elements may also be a direct source of money for the nonbanking public, but their principal significance is that they supply funds to banks, which may be used either to build up basic reserves or to obtain additional currency without depleting reserves. These basic reserves in turn provide the means for extensions of credit to the public through loans or the purchase of investment securities by banks. Under a fractional

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system of reserves the amount of credit eventually extended by the banking system as a whole can be many times the amount of reserves added. This process is briefly explained below.

On June 30, 1949, as may be noted from the attached consolidated statement for banks and the monetary system, the total amount of deposits and currency was 172 billion dollars, or 119 billion dollars more than on June 30, 1935. Of this increase nearly 20 billion dollars was in the form of currency and nearly 100 billion in demand and time deposits. Specific items on the asset side of the statement, which portray in a sense the way in which the money supply has been created, cannot be directly related to those specific items on the liability side which represent the money supply; there are other so-called liability items representing principally the capital funds of the banking system. However, an examination of the consolidated statements over the period since 1935 provides a reasonably clear picture of the extent to which credit extension and other factors have been responsible for the expansion of the money supply.

The various asset items showed the following approximate increases:

Gold and Treasury currency........17 billion dollars
Holding of United States
  Government securities:
 Federal Reserve Banks...........17 billion dollars
 Other banking institutions........63 billion dollars
Bank loans and other securities......29 billion dollars

Thus it is evident that the principal source of monetary expansion in this period was purchases of Government securities by the banking system. The Federal Reserve purchased part of these securities directly and, thereby, along with the gold inflow, made it possible for banks to meet the heavy wartime demand for currency and at the same time purchase additional amounts of securities and expand their loans. To a large extent this monetary expansion was essential to finance the war and the postwar readjustment. It could have been diminished (1) through increased taxes to meet the Government's war cost; (2) through larger sales of securities to nonbank investors rather than to banks; or (3) to a small extent by more restraint in lending by banks, particularly in the postwar period.

The process by which Federal Reserve operations increase total deposits or currency outstanding and thereby create money

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may follow a variety of alternative courses at various stages. Hence any brief description must necessarily be illustrative rather than definitive. A typical sequence of events might arise where a nonbank holder of Government securities wishes to sell such securities and the Federal Reserve System in carrying out monetary and credit policy purchases the securities. Utilizing the established broker mechanism, the Manager of the System Open Market Account would purchase the securities for the account of the System. These securities would be paid for by the Federal Reserve Bank of New York by a Federal Reserve check, which the broker would deposit in his account at a commercial bank. That bank in turn would deposit this money in its reserve account at the Reserve Bank. The effect of such a transaction is to create an additional deposit to the credit of the seller of the securities and also a corresponding increase in a member bank's reserve balance at the Reserve Bank. Thus, not only is the total money supply increased but also the total of bank reserves, thereby providing the basis for a further multiple expansion of deposits. The process and the final effect, while varying in details, would be broadly similar in the case of any other payment by the Federal Reserve to a bank depositor.

In the case of an advance by the Federal Reserve to a bank or the purchase of securities by the Federal Reserve from a bank, the result would be an increase in member bank reserve balances, but no direct or immediate increase in a depositor's balance at a commercial bank. The additional reserves would, however, as in the other cases, supply the basis for a multiple expansion of credit.

The ability of the banking system as a whole to create money arises from the fact that when an individual bank using funds deposited with it expands loans or investments, an additional deposit is thereby created. This deposit is likely to be transferred from one depositor to another and from one bank to another without generally being withdrawn from the banking system. If the initial deposit is in the form of new reserve funds, as in the example given above, the bank retains the portion of reserves required to be kept against the additional deposits and lends or invests the remainder. These proceeds are then deposited either in another bank or in the same bank and carry with them reserves that become the basis for a further extension of credit. The extent of the potential multiple expansion that may result through this process from any increment of new

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reserves is determined by the amount of such new reserves available to banks, by the ratio of reserves to deposits which banks are required to maintain by law or by practices which they may observe as a matter of custom or judgment, and the forms in which the money is held. In the United States at present, the ratio averages between seven and eight to one.

Whether the potential expansion takes place also depends on the availability of loans and investments which the banks regard as acceptable. Recipients also have an influence on the result in that they may choose to hold their funds as deposits or take them in the form of currency, or to pay off a loan at (or buy securities from) a bank. In the last case, the banks would continue to have capacity to expand credit. During the 1930's banks had large excess reserves which were not used as a basis for further credit expansion because of the absence of demand for loans or of satisfactory investments.

It should be kept in mind that no individual bank can take a given amount of reserve funds and extend five to ten times as much credit. This would be possible only in the unlikely case that the new credits remained indefinitely on deposit in that bank. As pointed out above, it is because the credits advanced are generally kept on deposit in some bank that the banking system as a whole can bring about a multiple expansion of credit and of money on the basis of a given amount of reserves.

Although it is incidental to the specific question, it may be relevant to point out that an important role of the Federal Reserve System is that of giving elasticity to the currency component in the money supply. The public may elect to hold its money either as deposits in banks or in the form of currency, and the relative amounts held in deposits and in currency are entirely determined by the preferences of the public. As public need or preference for currency increases and depositors withdraw cash, banks are able to supply the demand by drawing upon their balances at the Reserve Banks in exchange for currency, which the Federal Reserve can provide if necessary by issuing Federal Reserve notes. Banks replenish reserve balances, if necessary, by borrowing from, or selling securities to, the Federal Reserve. Before the establishment of the Federal Reserve System the supply of currency was limited and any increase in circulation caused a corresponding reduction in the basic reserves of the banking system, thus leading to forced liquidation and frequent monetary crises. Since the establishment of the System, a desire

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of the public to have more of its money in the form of cash rather than of bank deposits can be satisfied through Federal Reserve action without contraction in the volume of money or in the adequacy of bank reserves. An increase in the demand for currency can be met, without decreasing bank reserves, by discounting with a Federal Reserve Bank or by the sale of a security to such a bank; and a return flow of currency can be used to liquidate a discount at or to purchase a security from a Federal Reserve Bank and thus not add to bank reserves. This is the basis of currency elasticity in our banking system.

TECHNICAL REFERENCES

The composition and derivation of the figures given in the table is described in detail in *Banking and Monetary Statistics,* Board of Governors of the Federal Reserve System, Washington, D. C., 1943, pp. 11-12, and in Morris A. Copeland and Daniel H. Brill, "Banking Assets and the Money Supply Since 1929," *Federal Reserve Bulletin,* January 1948, pp. 24-32.

It should be particularly noted that the figures include data for mutual savings banks and the Postal Savings System, as well as for the commercial banking system. This is because of the difficulty of drawing a precise line between savings deposits in these various groups and between savings deposits and demand deposits. The bulk of the process of money creation through credit expansion takes place through commercial banks. For a discussion of the problem of defining money see Woodlief Thomas, "Money System of the United States," in *Banking Studies,* Board of Governors of the Federal Reserve System, Washington, D. C., 1941, pp. 295-305.

For further discussion of the sources of bank reserves and for the process of credit expansion, see *The Federal Reserve System, Its Purposes and Functions,* Chapters II and VIII, Board of Governors of the Federal Reserve System, Washington, D. C., 1947, and also the above cited chapter on "Money System of the United States" in *Banking Studies.*

2. *Prepare a statement showing the earnings of the Federal Reserve Banks as a group and the utilization of those earnings for each year since 1939. Show separately the earnings on United States Government securities and on other credit, dividends to member banks, payments to the Treasury, and additions to surplus.*

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Earnings and Expenses of Federal Reserve Banks, 1939-1948

Year	Current earnings	Current expenses	Net earnings before payments to U. S. Treasury [1]	Dividends paid	Paid to U.S. Treasury (Sec. 13b)	Paid to U.S. Treasury (Interest on F.R. notes)	Transferred to surplus (Sec. 13b)	Transferred to surplus (Sec. 7)
1939	$38,500,665	$28,646,855	$12,243,365	$8,110,462	$24,579	....	−$425,653	$4,533,977
1940	43,537,805	29,165,477	25,860,025	8,214,971	82,152	....	−54,456	17,617,358
1941	41,380,095	32,963,150	9,137,581	8,429,936	141,465	....	−4,333	570,513
1942	52,662,704	38,624,044	12,470,451	8,669,076	197,672	....	49,602	3,554,101
1943	69,305,715	43,545,564	49,528,433	8,911,342	244,726	....	135,003	40,237,362
1944	104,391,829	49,175,921	58,437,788	9,500,126	326,717	....	201,150	48,409,795
1945	142,209,546	48,717,271	92,662,268	10,182,851	247,659	....	262,133	81,969,625
1946	150,385,033	57,235,107	92,523,935	10,962,160	67,054	....	27,708	81,467,013
1947	158,655,566	65,392,975	95,235,592	11,523,047	35,605	$75,223,818	86,772	8,366,350
1948	304,160,818	72,710,188	197,132,683	11,919,809	....	166,690,356	....	18,522,518

[1] Current earnings less current expenses, plus profits on sales of U. S. Government securities and other additions to current net earnings, and less transfers to reserves for losses and contingencies and other deductions from current net earnings.

NOTE.—Each annual report of the Board of Governors contains a detailed statement of earnings and expenses of the Federal Reserve Banks for the year.

Current Earnings of Federal Reserve Banks, 1939-1948

Year	U. S. Govt. securities	Discounts and advances	Purchased bills	Industrial loans	Commitments to make indus. loans	All other	Total
1939	$36,903,367	$60,898	$2,323	$615,169	$128,577	$790,331	$38,500,665
1940	42,174,224	51,188	....	451,501	97,672	763,220	43,537,805
1941	40,151,501	55,934	....	399,319	90,270	688,071	41,380,095
1942	51,404,012	64,521	....	474,370	101,050	618,751	52,662,704
1943	68,089,456	151,915	....	414,281	48,904	601,159	69,305,715
1944	102,809,518	724,113	....	302,980	22,045	533,178	104,391,829
1945	139,552,881	1,977,081	110	100,755	12,533	566,186	142,209,546
1946	147,124,827	2,497,339	42,872	87,676	15,298	667,021	150,385,033
1947	155,563,861	2,194,546	3,890	60,438	19,205	813,626	158,655,566
1948	298,903,034	4,370,951	....	42,099	14,885	830,849	304,160,818

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3. *What changes, if any, should be made in the ownership of the Federal Reserve Banks? In the dividend rates on Federal Reserve stock?*

This question is understood to refer to the ownership of the capital stock of the Federal Reserve Banks. While this stock is owned by the member banks and they receive a 6 per cent statutory dividend thereon, the Federal Reserve Act prescribes the ownership of this stock and the organization and operation of the Reserve Banks in such manner that the relationship of the stockholders to the Banks is quite different from that ordinarily existing between a corporation and its stockholders. Furthermore, in the event of liquidation of a Federal Reserve Bank, any surplus remaining after the payment of all debts becomes the property of the United States.

The basic provisions of law with respect to the ownership of Federal Reserve Bank stock and dividends on such stock have remained unchanged since the Federal Reserve Act was originally passed in 1913. These provisions have worked reasonably satisfactorily and I would not recommend that they be changed at this time.

4. *What changes, if any, should be made in the legislative provisions relative to the disposal of Federal Reserve earnings in excess of expenses?*

Federal Reserve Banks are essentially public service institutions. They are operated for the benefit of commerce, industry, and agriculture—for the general economy of the country —and not for the purpose of making a profit.

The creation of Federal Reserve Bank credit through lending and through purchases of securities incidentally yields an income to the Reserve Banks. Ordinarily this income is sufficient to cover the general expenses and statutory dividend requirements of the Reserve Banks and leave a balance, although some of the Reserve Banks in certain years have operated at a loss. Such earnings as may accrue are an incidental result of monetary and credit policies which are designed, first and last, to serve the general public interest.

Because of their special character, the earnings of the Reserve Banks are, and should be, treated differently from those of ordinary institutions. When the Reserve Banks have a reasonable cushion of capital and surplus to protect their op-

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erations, as they now have, a large percentage of their earnings above expenses and statutory dividend requirements should be paid into the United States Treasury.

That is now being done under existing law. Therefore, I do not believe any change is needed at the present time in the provisions regarding the disposition of such earnings.

However, it may be of interest to review some of the background of the present procedure and explain some of the details of how it works.

The Federal Reserve Act as originally enacted in 1913 provided for the payment by the Federal Reserve Banks of a portion of their net earnings to the United States as a franchise tax. As amended in 1919 the Act provided that all net earnings should be paid into a surplus fund until it was equal to the subscribed capital of the Reserve Bank, which is twice the amount of its paid-in capital, and thereafter 10 per cent of net earnings should be paid into the surplus and the remaining 90 per cent should be paid in to the United States as a franchise tax.

Under these provisions of law the Federal Reserve Banks, to the end of 1932, paid franchise taxes to the United States Treasury amounting to $149,000,000, and at that time they had accumulated surplus accounts of $278,000,000, as compared with subscribed capital aggregating $302,000,000. By the Banking Act of 1933, which established the Federal Deposit Insurance Corporation, Congress required each Federal Reserve Bank to pay an amount equal to one-half of its surplus on January 1, 1933, as a subscription to the capital stock of the FDIC (the stock provided for no dividend and was later retired by the FDIC paying the amount to the Treasury). These stock subscriptions amounted to $139,000,000 and reduced the surplus of the Federal Reserve Banks to an equivalent figure, or considerably less than one-half of their subscribed capital. Congress, therefore, included a provision in the Banking Act of 1933 which eliminated the franchise tax of the Federal Reserve Banks in order to permit them to restore their surplus accounts from future earnings.

Net earnings for the next ten years were relatively small, and at the end of 1944 the combined surplus accounts of the Federal Reserve Banks were less than 80 per cent of their subscribed capital. During the next two years, however, net earnings

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increased substantially, due primarily to large holdings of Government securities accumulated through open market operations which were necessary to carry out System policies in the public interest. At the end of 1946 the subscribed capital of the Federal Reserve Banks was about $374,000,000, of which half was paid in, and their combined surplus was about $467,000,000.

Under the circumstances the Board concluded in 1947 that it would be appropriate for the Federal Reserve Banks to pay into the United States Treasury the bulk of their net earnings after providing for necessary expenses and the statutory dividend. For this purpose the Board invoked the authority granted to it by section 16 of the Federal Reserve Act to levy an interest charge on Federal Reserve notes issued to the Federal Reserve Banks and not covered by gold certificate collateral. The Board established on such Federal Reserve notes interest charges equal to approximately 90 per cent of the net earnings after dividends of each of the Reserve Banks, and consequently the Reserve Banks have been paying into the Treasury approximately 90 per cent of their net earnings since January 1, 1947.

Under this procedure, which is still in effect, Federal Reserve Banks have paid approximately the following amounts into the Treasury from their net earnings: For the year 1947, $75,000,000; for the year 1948, $167,000,000; and for the year 1949 to September 30, $147,000,000; the aggregate for this period being $389,000,000. On September 30, 1949, the subscribed capital of the Federal Reserve Banks was about $414,000,000, of which half was paid in, and the aggregate surplus was about $494,000,000.

As stated before, I believe that a large percentage of the earnings of the Federal Reserve Banks above expenses and statutory dividend requirements should be paid into the United States Treasury in present circumstances. Since this is now being done under existing law, I see nothing to be gained by amending the statutory provisions on the subject.

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CONSOLIDATED CONDITION STATEMENT FOR BANKS AND THE MONETARY SYSTEM, END OF JUNE DATES, 1935-1949

All Commercial, Savings, and Federal Reserve Banks, the Postal Savings System, and Treasury Currency Funds[1]

(In millions of dollars)

Item	End of June dates														
	1935	1936	1937	1938	1939	1940	1941	1942	1943	1944	1945	1946	1947	1948	1949
ASSETS															
Monetary reserve	11,622	13,106	14,868	15,676	18,991	22,976	25,773	26,050	26,465	25,277	24,358	24,809	25,818	28,097	29,063
Gold stock	9,116	10,608	12,318	12,963	16,110	19,963	22,624	22,737	22,388	21,173	20,213	20,270	21,266	23,532	24,466
Treasury currency	2,506	2,498	2,550	2,713	2,881	3,013	3,149	3,313	4,077	4,104	4,145	4,539	4,552	4,565	4,597
Bank credit	47,565	51,823	53,197	50,877	53,325	55,050	61,387	67,932	96,563	125,517	153,992	163,485	156,297	157,958	156,491
Loans, net	20,191	20,627	22,391	20,965	21,310	22,346	25,305	25,080	22,234	25,361	27,948	31,570	38,373	45,299	47,148
U. S. Govt. obligations	17,498	20,743	20,605	20,409	22,483	23,389	26,984	34,226	66,434	92,609	118,041	122,740	107,873	101,451	97,428
Commercial and savings banks	14,258	17,323	16,954	16,727	18,770	19,689	23,539	30,299	57,740	75,737	93,655	95,911	82,679	76,774	74,877
Federal Reserve Banks	2,433	2,430	2,526	2,564	2,551	2,466	2,184	2,645	7,202	14,901	21,792	23,783	21,872	21,366	19,343
Other	807	990	1,125	1,118	1,162	1,234	1,261	1,282	1,492	1,971	2,594	3,046	3,322	3,311	3,208
Other securities	9,876	10,453	10,201	9,503	9,532	9,315	9,098	8,626	7,895	7,547	8,003	9,175	10,051	11,208	11,915
Total assets, net	59,187	64,929	68,065	66,553	72,316	78,026	87,160	93,982	123,028	150,794	178,350	188,294	182,115	186,055	185,554
LIABILITIES AND CAPITAL															
Total adjusted deposits and currency	49,070	53,910	56,592	55,966	60,151	66,124	73,400	80,126	102,113	116,666	138,403	157,821	164,140	165,695	165,626
Currency outside banks	4,783	5,222	5,489	5,417	6,005	6,699	8,204	10,936	15,814	20,881	25,097	26,516	26,299	25,638	25,266
Demand deposits adjusted[2]	20,433	23,780	25,198	24,313	27,355	31,962	37,317	41,870	56,039	60,065	69,053	79,476	82,186	82,697	81,877
Time deposits adjusted[3]	22,650	23,677	24,638	24,985	25,530	26,171	26,576	26,005	28,684	33,688	41,596	48,710	52,263	53,982	55,224
Postal savings deposits	1,204	1,231	1,267	1,251	1,261	1,292	1,303	1,315	1,576	2,032	2,657	3,119	3,392	3,378	3,259
U. S. Government balances	3,779	4,329	4,204	3,762	4,299	3,248	4,008	4,314	10,771	22,452	27,259	16,500	3,437	5,435	4,049
Treasury cash	2,866	2,497	3,445	2,303	2,563	2,186	2,275	2,187	2,268	2,296	2,279	2,251	1,314	1,327	1,307
At commercial and savings banks	811	1,142	666	599	792	828	753	1,837	8,048	19,506	24,381	13,416	1,367	2,180	2,304
At Federal Reserve Banks	102	690	93	860	944	234	980	290	455	650	599	833	756	1,928	438
Foreign bank deposits, net	230	473	731	301	991	1,375	1,949	1,624	1,928	2,433	2,378	1,894	1,657	1,727	1,927
Total deposits and currency	53,079	58,712	61,527	60,029	65,441	70,747	79,357	86,064	114,812	141,551	168,040	176,215	169,234	172,857	171,602
Capital and miscellaneous accts, net	6,108	6,217	6,538	6,524	6,875	7,279	7,803	7,918	8,216	9,243	10,310	12,079	12,882	13,200	13,952
Total liabilities and capital, net	59,187	64,929	68,065	66,533	72,316	78,026	87,160	93,982	123,028	150,794	178,350	188,294	182,115	186,055	185,554

[1] Treasury funds included are the gold account, Treasury currency account, and Exchange Stabilization Fund.
[2] Demand deposits, other than interbank and U. S. Government, less cash items reported as in process of collection.
[3] Excludes interbank time deposits; U. S. Treasurer's "time" deposits, open account; and deposits of Postal Savings System in banks.

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