Statement of Thomas B. McCabe, Chairman of the
Board of Governors of the Federal Reserve System
Before the Senate Banking and Currency Committee
July 29, 1948

When Senator Tobey very kindly asked me yesterday afternoon if I would appear before you this morning, I requested that he postpone any appearance until after the scheduled meeting of the Board of Governors tomorrow, as I had promised the Board that I would submit to them for approval the statement that I was preparing for the House Banking and Currency Committee before whom I was previously requested to appear.

On the urgent insistence of Senator Tobey, followed by a special request from the President, I prepared a condensed statement of the official view of the Board of Governors and submitted it for approval to the individual members by telephone last night. After obtaining their favorable approval, I telephoned Senator Tobey about 10:00 p.m. and told him that I would be pleased to appear this morning.

The statement of the Board is as follows:

Anti-Inflation Act of 1948

The proposed "Anti-Inflation Act of 1948" includes two titles relating to credit controls. Both are, in substance, part of the comprehensive anti-inflationary program which the Board of Governors has previously recommended to Congress. Title One relates to regulation of consumer credit and Title Two relates to bank reserves. As you gentlemen know, the proposed regulation of consumer credit is identical, except for the date, with the bill passed by the Senate, and acceptable to the Board of Governors as one part of an overall program.

The proposal with respect to bank reserves is similar to that advanced by the Board in April, except that the increased requirements would be applicable only to member banks, whereas the Board had recommended that they be made applicable to all commercial banks. This is a significant difference. We feel deeply that it is not fair to member banks in their competitive relations to non-member banks to require that they be singled out to carry the additional reserves that may be necessary to combat this inflationary situation. As an emergency measure, however, the bill would be adequate to meet the immediate need for additional authority to deal with reserves.

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In thus stating the views of the Board on these two titles of direct concern to the System, I do not want to create the impression that action in the credit field alone will solve our inflationary problems. Other areas, particularly a budgetary surplus, are more important.

Now, I will give you some of my personal observations concerning the impact of the inflationary forces on our credit control mechanism.

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Consideration of the pressures now at work in our economy must be based on an understanding of the fact that the financial forces generated in a great war are the most disrupting factors that can affect the economic system. We are now dealing, and for years shall be forced to deal, with the monetary backwash of the greatest and most costly war of all time. We are faced with the problems of liquidating the effects of that war upon our own economy, and indeed upon the economy of the world. If history is a guide, we must realize that these problems will not be solved in a day. They will extend over a number of years--how many depends upon how wisely and how courageously we devote ourselves to the task.

The financial cost of the last war, if all conceivable items of cost were included, perhaps could never be accurately summed up. Suffice it to say that our national debt rose to approximately $280 billion and is still above $250 billion. The solution of our present problems does not require us to determine whether the debt should have risen so high, whether we should have spent so much, whether we should have taxed ourselves more and borrowed less, or whether the pattern of our borrowing was well conceived. What has been done is in the realm of fact and the consequences must be dealt with accordingly. One of the important facts is that the creation of our national debt resulted in a tremendous expansion of the money supply. While the Government borrowed vast sums from nonbank lenders, other vast sums were supplied by the commercial banking system. And let me say right here that this nation owes a debt of gratitude to commercial bankers generally for their service in the task of financing the war. The rapid expansion of the money supply which resulted from their contributions must not be permitted to rise and plague them as if they had cunningly contrived it for their own selfish ends.

Nevertheless, as a net result of war financing, there were increases in the public's holdings of demand deposits and currency from less than 40 billion in 1940 to 110 billion at present; of time deposits from less than 30 billion to nearly 60 billion; of United States Government securities, which are readily convertible into money, from a few billion to over 90 billion. The total supply of these forms of money and potential money is now more than three times the prewar total.

The productive capacity of the nation was largely devoted to war purposes for almost five years. At the peak more than 50 per cent of our record production was for war use. While 140 million people were coming into possession of more money than any people had ever had to spend and save, there was a scarcity of things to spend it for. Consequently two great backlogs rapidly accumulated--a backlog of unfilled wants and a backlog of money savings. With removal of controls this pent-up spending power plus an unprecedented volume of current income were turned loose in a market characterized by scarcities and shortages. Prices rose rapidly. Pressure on wages quickly ensued and the spiral of price-wage inflation was on its way. At present total physical production of all goods and services is probably not over two-thirds greater than at the prewar maximum, while prices have risen by about three-fourths.

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Public Debt Holdings Provide Basis for Postwar Credit Expansion

In helping to finance the Government's large war expenditures and to provide the money supply demanded by the expanding and abnormal war economy, the commercial banks of the country and also the Federal Reserve Banks greatly expanded their holdings of Government securities. Commercial bank holdings of Government securities of all types increased from about 16 billion in 1940 to a peak of 90 billion at the end of 1945 and then were reduced during 1946 to 70 billion, largely by Treasury use of its excess bank deposits to retire debt. To meet the demands of rapidly expanding private economy in the postwar period banks have further reduced their holdings of Government securities, but they still hold 65 billion dollars of them. Other investors have also sold or redeemed some of the holdings of Government securities in order to obtain funds for other uses.

Sales of U. S. Government securities in the market by banks and others have not been absorbed by purchases on the part of other investors. In order to keep the prices of Government securities from declining, the Federal Reserve System has continued to carry out its wartime responsibility of supporting the market by buying at relatively stable prices securities offered for sale and not purchased by others. The result of these purchases by the Federal Reserve Banks is to supply additional reserve funds to banks. Because of the fractional system of reserve requirements, these new reserves in turn provide the basis for an increase in bank credit that may be many times the amount of new reserves obtained.

In the postwar period these reserves supplied the basis for an increase in bank credit in response to an active demand for loans to finance the operations and expansion of the business system in an era of high demand, accelerated activity, rising costs, and rising prices. There is ample evidence that bank credit is also being used for purposes ordinarily served by the capital market. As a result, despite a reduction of $25 billion in the volume of Government securities held by commerical banks, deposits and currency held by the public have increased by $15 billion since the end of 1945. This has been largely the result of an increase of $15 billion in bank loans. The Board of Governors has kept the Congress and the public informed concerning these results of supporting the market for Government securities. It has repeatedly pointed out that the effect has been to increase significantly, and it may be dangerously, the money supply.

Policies Adopted to Restrain Inflationary Credit Expansion

The Federal Reserve System and the Treasury have adopted policies designed to offset the expansive effect on bank reserves of market purchases of Government securities by the Federal Reserve System. The first and quantitatively more effective of these measures has been the use of the Treasury surplus to retire maturing securities, particularly those held by the Federal Reserve Banks. The debt retirement program was made possible first by a large cash balance built up by the Treasury in the Victory Loan drive in 1945 and later by a substantial surplus of cash receipts over expenditures. In paying out a large part of the excess cash collected from the public to the Federal Reserve for retirement of debt, that amount of money was eliminated from the money supply and also from bank reserves.

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As a second measure of restraint, about a year ago the Federal Reserve and the Treasury embarked upon a program of permitting yield rates on short-term Government securities to rise from the very low levels at which they had been pegged during the war. The purpose of this action was to encourage banks and others to invest available funds in short-term securities. This enabled the Federal Reserve to reduce its holdings of short-term securities and thus offset the effect on reserves of its purchases of longer term bonds. The rate on 90-day Treasury bills rose from 3/8 of one per cent to about 1 per cent, and that on one-year Treasury certificates from 7/8 to 1-1/8 per cent. Late in 1947, market yields on Government bonds also rose, i.e., prices of bonds declined in the market. This adjustment was in large part inaugurated by sales by financial institutions to obtain funds to invest in corporate securities and mortgages, but it was accelerated by sales made in fear of further declines in prices of bonds, which had been selling at substantial premiums. In order to check this decline, the System adopted a policy of freely purchasing bonds at an established series of prices, which maintained yields in accordance with a pattern ranging from 1-1/8 per cent for one-year issues to 2-1/2 per cent for the longest-term bonds.

It may be of interest to review credit developments and the effects of these policies during the past twelve months. In the year ending June 30, 1948, as shown on the charts, commercial banks showed a small increase in their deposits and their total loans and investments, although there were some wide fluctuations during the period. In the twelve months, commercial banks increased their total loans and their holdings of corporate and State and local Government securities by a total of 7 billion dollars. Most of this growth occurred in the latter half of 1947 and was accompanied by an expansion in bank deposits and reserves. In the early months of 1948, however, deposits were withdrawn to make seasonal heavy tax payments, which were not offset by Treasury expenditures. Banks met the drain by reducing their holdings of Treasury bonds. Some maturing bonds were exchanged for certificates or notes and a part of these issues were sold. At the same time banks in general purchased added amounts of Treasury bills, an indication of the effect of the higher short-term rates in attracting available funds.

Banks also continued to increase their loans in the first half of 1948, by about 1.7 billion, although at a somewhat slower rate of growth than in 1947. Most of the dollar increase in bank loans during 1947, particularly in the last half, was in commercial and industrial loans, but the increases in consumer loans and real estate loans showed larger percentages in 1947 and have continued to expand in 1948.

Savings institutions, particularly insurance companies, also considerably expanded their holdings of mortgages and investments other than United States Government securities during the past year. In the aggregate, these assets of selected groups of financial institutions increased by 8.6 billion dollars in the period, of which 6.4 billion was met by receipts of new savings from the public and 2.2 billion

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a reduction in their holdings of Government securities. Nonbank investors, as a group, sold and redeemed bonds, but purchased certificates and bills, reflecting increased popularity of these issues with the rise in rates. Another chart shows how life insurance companies substantially increased their holdings of Government securities during the war and then in the postwar period reduced these holdings while increasing their mortgages and other investments.

Sales of Treasury bonds by nonbank investors and by banks in the past year have been largely purchased by the Federal Reserve System. The System purchased 5.7 billion dollars of Treasury bonds in the market and also purchased in the market a net amount of about 2.6 billion dollars of notes and certificates, but sold on balance nearly 4 billion dollars of bills to banks and other investors. In the same period the Treasury redeemed for cash about 5 billion dollars of maturing issues of various kinds held by the Federal Reserve Banks. With all of these wide shifts in holdings of different types of securities, there was only a small net decline in the System's aggregate holdings of Government securities, although the total fluctuated considerably from time to time.

The purpose of this detailed survey of figures is to illustrate how shifts in holdings of the public debt are being used to finance inflationary spending, and how Federal Reserve and Treasury policies endeavor to offset these tendencies. Treasury use of surplus funds to retire securities held by the Federal Reserve drains reserves from banks and makes it necessary for them to sell securities if they wish to maintain their loans, and even more so if they want to expand credit. The higher rate on Treasury bills encourages banks and other holders of liquid funds to buy bills rather than invest in other assets. Since most of the bills have been held by the Federal Reserve, a reduction in System holdings is made possible and bank reserves are thereby absorbed. Nevertheless, sales of bonds to the Federal Reserve, primarily by nonbank investors, have been so large that the restrictive effect of the other policies has been fully offset.

It should be mentioned that bank reserves have also been supplied in the past year by an inflow of gold amounting to 2.2 billion dollars and also by a decline of about half a billion in currency in circulation. A temporary increase of 1.3 billion in Treasury deposits at the Federal Reserve offset in part these factors. The total growth in reserves was 1.4 billion, sufficient to cover increases of about a billion dollars in reserve requirements at central reserve city banks in New York and Chicago, as well as increased requirements resulting from deposit growth.

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Prospective Demands for Credit

Economic prospects indicate a continuation of strong inflationary pressures during the next several months and perhaps for a much longer period. Individual incomes have continued at a high level, with a tendency to increase as prices and wages have risen and employment has grown with the labor force. Consumer spending, based on current incomes, the use of past savings, and borrowing, also has continued to expand. Construction volumes seem likely to remain for a while at capacity levels, with possible further rises in prices. Business expenditures are also expected to continue in large volume. Government expenditures are increasing, while the recent income tax reduction will lower receipts.

Continuation of these tendencies will call forth further credit expansion. Borrowing by consumers and homeowners will no doubt continue to expand and thereby add to consumer spending and to demands for housing, which are already excessive. Prospective large outlays by business for expansion of inventories and plants will probably exceed internal funds available and also amounts obtained by flotation of new securities. Over-all demands for funds may continue in excess of the current volume of savings readily available for lending for such purposes. To help meet the demands for credit and capital, corporations, individuals, and financial institutions will sell some of their holdings of Government securities and also increase their borrowings from banks.

If these tendencies continue, sales of Government securities by nonbank investors may exceed 1.5 billion in the last half of 1948 and perhaps be much greater early in 1949. These sales will keep the Government bond market under pressure and require support purchases by the Federal Reserve, if the policy of maintaining the 2-1/2 per cent yield level on long-term Treasury bonds is continued. Thus additional reserve funds would be made available to banks which, unless otherwise offset, could sustain a further very large inflationary expansion of bank credit. Additional reserves supplied through the gold inflow may be approximately offset by the drain resulting from seasonal currency demands.

To avoid an abundance of reserves, an easy short-term money market, and continued inflationary credit expansion, positive measures to absorb reserves will be needed. In view of the pressure of current demands, the continued shortages of many goods, the limited capacity for increased output, and the available accumulations of liquid assets, further credit expansion will add to the pressure for rising prices. Continued credit expansion will store up trouble for the future and make the inevitable adjustment more dangerous for the stability of the economy.

This course of economic and monetary developments has been the source of increasing concern to the Federal Reserve authorities. We are convinced that, so long as the present situation lasts, it is important to restrict further credit expansion and to promote a psychology of restraint on the part of both borrowers and lenders. To keep the

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reserve position of banks under pressure and discourage further inflationary credit expansion will require carefully coordinated operating measures on the part of both the Treasury and the Federal Reserve System.

Of the two sets of measures used to restrain the growth of bank reserves during the past year -- namely (1) use of the Treasury cash surplus to retire Federal Reserve-held securities and (2) reduction in Federal Reserve holdings of Treasury bills through a rise in short-term rates -- the first has been greatly reduced in its potency. Whereas the Treasury showed an excess of cash income over cash outgo of 9 billion dollars in the fiscal year 1947-48, the prospects for the current year on the basis of very tentative and unofficial estimates are for a cash surplus of only about 3 billion. This difference reduces considerably the most important anti-inflationary influence in the situation during the past year.

The Treasury cash surplus was a particularly effective device because it exercised a drain on bank reserves. As a result the banks losing reserves had to sell securities in order to maintain their reserve positions. While under these pressures they are less likely to be seeking new loans and in some cases less willing to meet loan applications.

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This brings us to the various ways in which restraint may be exercised over credit expansion.

The first means is voluntary self restraint on the part of borrowers and lenders. I am convinced that the voluntary program originated and actively developed by the American Bankers Association has had a significant effect in developing a more cautious and critical attitude on the part of bankers toward so-called unproductive or speculative loans. If inflationary pressures were mild, voluntary restraint might be adequate to hold them in check. Continued and intensified voluntary restraint will make our joint task easier.

There are a number of reasons, however, why voluntary restraint cannot be expected to do the whole job alone when inflationary pressures are as strong as they are at the present time. Perhaps the most important reason is that a loan which may appear productive when viewed by itself may not add to the total output of the economy as a whole. For example, a customer may increase his production by borrowing funds to purchase needed parts that are in short supply. Such a loan would appear to be productive from the individual point of view of both the borrower and the lender. But will the loan increase the supply of the parts or total output? If all resources are being used to capacity, the loan may merely enable the borrower to secure parts that otherwise would have been bought by another firm. From the point of view of the economy as a whole, the loan has increased the demand for goods but it may not have increased total supply at all. Basically, that is why I believe that self restraint, though important, is inadequate to check a strong inflationary development.

Another reason is the force of competition not only among banks but among all lenders. We have in the United States not only 14,000 commercial banks but also many thousands of other lending agencies. Because of concern for the general interest a bank may refuse to lend even to a good customer. This does not mean that the customer will not secure the funds. It may merely result in a permanent loss of the customer to the bank. And unfortunately the new lender may secure the funds from sale of Government securities, with the result that the loan may be just as inflationary as if the bank had made it in the first instance.

I want to emphasize that I support strongly the self-restraint program developed by the American Bankers Association and would like to see it pursued aggressively, not only by banks but by all lenders. It is an important step in the right direction. Primarily for the reasons I have mentioned, however, I do not think it can do the job alone.

Another approach to the problem is through control over member bank reserves. Bank credit cannot expand unless banks acquire or have reserves on which to expand. One way in which the System has supplied reserves has been through purchases of long-term Government securities. A means of restraint would be for the System to limit its purchases of such securities either by refusal to buy or by reducing its prices suf-

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ficiently to attract other purchasers. As you know, the System has made a public commitment to support the 2-1/2 per cent yield level on long-term Government bonds for the foreseeable future. I gave my reasons for subscribing to that commitment when my confirmation was under considera-tion by the Senate Committee on Banking and Currency. Although that commitment substantially limits our freedom of action, I believe there is a better way to operate against credit expansion than now to abandon that commitment.

Our basic problem is to absorb reserves. Increases in reserves may be anticipated from three principal sources: (1) imports of gold, (2) return of currency from circulation, and (3) purchases of Government securities by the Federal Reserve Banks to support the long-term yield level. The principal problem before the System is to absorb or offset reserves arising from these sources. The only way it could do this effectively under present authority is to liquidate part of its holdings of Government securities. It would be necessary, of course, to sell them at prices the market would pay. The System has a large portfolio of bills, certificates, and other short maturities that it could use. If the inflationary demand for bank credit is strong, use of these holdings to absorb reserves would result in a further stiffening of short-term interest rates.

The Open Market Committee of the Federal Reserve System feel that a rise in short-term rates is a necessary and desirable step. An increase in the short rate would tend to attract funds from other uses to investment in short-term Government securities. The policy of allowing short-term rates to rise was begun about a year ago and has had some success.

At this point the necessity for teamwork between the Treasury and the Federal Reserve becomes apparent. I am keenly sensitive to the necessities of the Treasury in its task of managing the public debt. I thoroughly understand the Treasury's responsibility to keep the interest cost of the debt as low as possible consistent with all relevant factors. I know that the Treasury Department is equally sensitive to the respon-sibilities of the Federal Reserve in the field of monetary and credit policy. The problems of mutual concern to the Treasury and the Reserve System in their respective field are being approached in a continued spirit of cooperation.

The rediscount rate is another instrument of policy in the short-term market. Although its effectiveness is diminished in times like these when the volume of member bank borrowings is small, it should not be written off. If, for example, the yield on short-term Governments rises, it might become appropriate under these circumstances to increase the dis-count rate. This action would discourage the market from re-acquiring through the discount window the funds that had been withdrawn through the disposal by the Reserve System of short-term Governments. An increase in the discount rate has great psychological effect. Each increase repeats

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the warning that credit is in need of continued restraint. Changes in the rate and open market operations supplement each other as necessary parts of an over-all credit policy.

These two related instruments influence the volume of reserves of member banks. The third general instrument--reserve requirements--is designed to influence the amount of bank credit that can be based on a given volume of reserves. An increase in requirements immobilizes reserves and makes them unavailable for further lending and investing. As you know, the Board of Governors has presented various ways of dealing with the problem of reserves or immobilizing certain bank assets.

The method proposed in the bill before you is simple and direct, and involves no departures from existing principles. The bill would increase by 10 and 4 percentage points the reserves that member banks may be required to maintain against their demand and time deposits, respectively. The authorization would be granted for a period of two years. We feel deeply that it is not fair to member banks in their competitive relations with non-member banks to require that they be singled out to carry the additional reserves that may be necessary to combat this inflationary situation. The Congress might well find it desirable during this interval to reconsider the whole structure of reserve requirements, possibly along the lines developed recently before the Joint Committee on the Economic Report.

I should like to indicate briefly what can and cannot be accomplished through increasd reserve requirements. Changes in requirements cannot, of course, be considered in isolation. They must be related to other instruments of policy. In practice they are closely related to open market operations. One method that banks use to adjust their positions to the pressure exerted by an increase in requirements is to sell Government securities. To the extent that these are purchased by the Federal Reserve, new reserves are created which meet the higher requirements. This is not the whole story, nor does it happen invariably, but it does illustrate the complexity of our problem. An increase in requirements, of course, reduces the multiple credit expansion ratio as well as the liquidity of banks. Even when the Federal Reserve creates new reserves, it has a greater volume of securities available for sale. The extent to which it could use them, however, involves similar considerations to those arising in connection with disposals from the present portfolio, namely, the price at which they could be liquidated.

In other words, the purpose of increasing authority over reserve requirements is not to obviate the possible need for increasing short-term rates. That problem would still be with us.

The basic purpose of increasing the authority over reserve requirements would be to enable the System to acquire more--if necessary many more--long-term Government securities to maintain the long-term yield level. New reserves created by such System purchases--or in other ways--could be absorbed through increases in reserve requirements and thus be made unavilable for multiple credit expansion.

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