STATEMENT OF THOMAS B. McCABE, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, TO THE JOINT COMMITTEE ON THE ECONOMIC REPORT, MAY 27, 1948

The Committee has requested my views concerning the adequacy of present powers of the Federal Reserve System to deal with the expansion and contraction of bank credit.

Shortly before I took office the Committee received the recommendations of the Board of Governors. It also has heard Mr. Allan Sproul, President of the Federal Reserve Bank of New York, express his views, which differ in some respects from those of the Board. Consequently, what I shall have to say should be taken as an expression of my own personal views. The Committee will appreciate that I have been in my present office about a month and that I am only beginning to get my feet wet. While I can not at this early date speak with precision upon some matters of technical detail, nevertheless, I welcome this opportunity to state my position on the basic questions into which the Committee is inquiring.

Throughout my business experience I have operated under limitations and have had to know what those limitations were. Every executive is forced to make his plans as well as his day-to-day decisions within the limits imposed upon him by his authority and the resources at his command. I have long been resigned to the realization that increased authority and freedom of action are not easily obtainable. In fact I have frequently found in business that better results are obtained if our energies are directed to the most effective use of existing facilities.

I did not seek this position and I did not assume the office I now hold without searching appraisal of the responsibilities involved. This appraisal included the job the Federal Reserve System has to perform and the adequacy of its tools. My appraisal convinced me that the job could be done. I am still of that opinion.

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 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 for their patriotic 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.

The productive capacity of the nation was largely devoted to war purposes for almost 5 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.

One of the few controls that was not removed or immediately modified was the pattern of rates that was maintained by the Federal Reserve System in support of the Government securities market. This policy was deliberately adopted early in the war as essential to its financing. Experience gained in the First World War had taught the fiscal and monetary authorities that without a fixed pattern of rates which the money market could confidently expect to be maintained, interest rates would tend to rise as the financing program proceeded. The inevitable results of such a tendency would have been to increase the interest cost of the debt, and, of even greater importance, to encourage the withholding of funds by investors awaiting anticipated higher rates. Moreover, the effects of an unstable and disorderly market in the postwar period would have greatly complicated the problems of reconversion. In view of these and other considerations the decision to maintain a pattern of rates was taken early in the financing program of World War II. It is important to remember that the general characteristics of this pattern resulted from the condition of monetary ease which developed in the 1930's.

The support of the rate pattern had to come from the Federal Reserve System. As the market became more and more convinced that the pattern would be maintained, it began to sell increasing amounts of short-term securities to the System in order to secure funds for investment in long-term securities bearing higher rates. These support purchases by the Reserve Banks increased the reserves of the commercial banking system and thus made possible a multiple expansion of bank credit.

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 $20 billion in the volume of Government securities held by commercial banks, demand deposits and currency increased by $11 billion from the end of 1945 to the end of 1947. The Board of Governors has kept the Congress and the public informed concerning these results of supporting the rate pattern. It has repeatedly pointed out that the effect has been to increase significantly, and it may be dangerously, the money supply.

Our problem is to find a common ground on which all can unite to avoid further inflation as a result of this swollen money supply. It is an objective which all recognize as essential to our well being. It is my firm view that too much emphasis can not be placed upon the necessity for cooperative effort. The problems we now face are not the exclusive problems of the Federal Reserve System, the commercial banking system, or the Government. There is grave responsibility also upon every citizen, upon every group or organization of citizens, upon labor, industry, business, and agriculture. We must do all we can to increase the total output of goods, especially those in short supply, by working as hard and as efficiently as possible. I think we shall fall into grievous error if we assume complete responsibility for the future is concentrated in any one place. Here is a crying need and a magnificent opportunity for team work. And let me emphasize that everybody is on the team.

I should now like to refer briefly and somewhat more specifically to the place on the team which the Federal Reserve System occupies.

The responsibilities of the Federal Reserve System are specified in the law. The basic objective toward which the System is required by law to direct its credit policies is perfectly clear. Under provisions of the Federal Reserve Act the System is required to fix rates of discount "with a view of accommodating commerce and business"; the power to change reserve requirements is required to be exercised "in order to prevent injurious credit expansion or contraction"; and the power to conduct open market operations must be exercised "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country." As a result of these powers and the standards which govern their use, it is the function of the Reserve System to provide the country with a supply of money that is appropriate to its needs. It has just as much responsibility to prevent injurious credit expansion as to prevent injurious contraction.

The paramount consideration bearing upon the general credit situation of the country during war times was the necessity to finance the war. The use of open market operations to support the rate pattern was undertaken by the System in discharge of a responsibility to assist in the mobilization of credit in the war effort. The effects of that action on the monetary situation of the country were of secondary importance. Since the end of war financing, the Government's financial needs, though still very large, have become less important than the need for dealing with inflationary forces originating largely during the war as a result of the Government's financial needs. Monetary considerations are no longer of secondary importance.

A number of steps have been taken in recognition of this shift in emphasis among objectives. After offerings of new issues of long-term Government securities ceased with completion of the Victory Loan Drive, investors forced down long term yields by bidding up the price for outstanding issues. This created further inflationary pressures, because some of the bidding came from investors who sold short-term issues to buy these bonds and the Reserve System purchased the short issues to support the short end of the rate pattern. It was to discourage this practice that short-term rates were permitted to move up after mid-1947. This had a very salutary effect.

Thus the pattern of rates maintained during the war was broken. It was necessary to do this in order to discharge the duty of the Federal Reserve System to prevent an injurious expansion of credit. At the same time the System has always kept in mind its other important objective of maintaining orderly and stable conditions in the Government securities market. Although these twin objectives complicate the problems of the central banking system, I am confident that our responsibilities in both fields can and will be discharged in so far as one can now see.

What problems are involved in a policy directed toward these ends? As I see it, they may be discussed under four heads. It might be well to enumerate them at the outset so that you will have an over-all view:

1. How to prevent further expansion in member bank reserves.

2. How to maintain the 2-1/2 per cent yield level for the longest-term Government bonds for the forseeable future.

3. Whether funds should be absorbed from the market by liquidating securities or by increasing reserve requirements.

4. How orderly conditions in the Government securities market may best be maintained.

I should like to discuss briefly each of these components of a comprehensive policy.

1. Control of member bank reserves. Bank credit can not expand unless banks acquire or have reserves on which to expand. That is why the volume of reserves can not be left to the determination of the market if an inflationary development is to be halted. The time has come when the volume of reserves must again be given primary consideration in our policy. As long as inflationary forces are dominant there should be strong brakes on further expansion of reserves. Indeed, if there should be a rise in the rapidity with which our existing stock of money is being spent, the existing volume of reserves may prove too high. It should be emphasized that preventing reserves from increasing does not imply a contraction of bank credit. It will not force banks to stop lending as seems often to be alleged. Loans are being repaid continuously so that new loans must be placed on the books with equal continuity simply to maintain a loan portfolio.

2. Support of the 2-1/2 per cent long-term yield level. The System has made a public commitment to support the 2-1/2 per cent rate on long-term Government bonds for the forseeable future. I gave my reasons for subscribing to that commitment when my confirmation was under consideration by the Senate Committee on Banking and Currency. Although that commitment substantially limits our freedom of action, I am confident that for the present and under conditions as I now see them we can make good on that commitment and at the same time exercise an effective restraining influence on further credit expansion.

3. Instruments of policy. Increases in reserve funds 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 2-1/2 per cent long-term rate. The problem before the Reserve System, therefore, is to absorb any additions to the supply of reserves from these sources. The only way it can do this under present authority is to sell part of its holdings of Government securities. The System has an ample portfolio of bills, certificates and other short maturities. If the inflationary demand for bank credit is strong, the use of these holdings to absorb additions to bank reserves will result in a further stiffening of short-term interest rates.

At this point the necessity for teamwork between the Treasury and the Federal Reserve becomes apparent. The capacity of the Federal Reserve System to absorb reserves is limited only by the size of its holdings and its willingness to part with them at prices the market will offer. The theoretical limitation imposed upon us by the size of the portfolio is of no current practical importance. We have ample ammunition. Our freedom to use it is another matter since that may involve a rise in short-term rates. 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 relevent factors. I know that the Treasury Department is equally sensitive to the responsibilities of the Federal Reserve in the field of monetary and credit policy. I am confident that problems of mutual concern to the Treasury and the Reserve System in their respective fields will be approached and solved in a continued spirit of cooperation and that each, respecting the responsibilities of the other, will seek to unify their efforts in the public interest.

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 to increase the discount rate. This action would prevent the market from reacquiring 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 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 <u>volume</u> of reserves of member banks. The third general instrument--reserve requirements--is designed to influence the amount of deposits 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. An increase in requirements is a powerful weapon for influencing the volume of deposits provided the total volume of reserves is not correspondingly increased and banks have little or no excess reserves when the action is taken. Changes in reserve requirements can not, however, be considered in isolation. In practice they are closely related to open market operations. One method that banks use to adjust themselves 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. Even when this happens, however, some restraint has been exercised because the increase in requirements reduces the multiple credit expansion ratio as well as the liquidity of banks; and in addition the System 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.

4. <u>Maintain orderly conditions in the Government securities market</u>. I have discussed reserves and the relation of reserves to deposits because that is the heart of the System's statutory responsibilities. The control over reserves, however, is not an end in itself. It is

the means by which the volume of money and the flow of expenditures is influenced. The ultimate goal is to contribute to the maintenance of high levels of production and employment at reasonably stable prices. In view of the huge size of the public debt resulting from the war and its preponderant position in the credit structure the Federal Reserve System must place the maintenance of an orderly market for U. S. Government securities among its primary obligations. We feel confident that we will be able to continue to maintain orderly conditions without detriment to the pursuit of broader objectives.

I assumed the grave responsibilities of my job with the firm conviction that they could be discharged. I am still of that conviction. Of course no one knows the strength of the forces that we must hold in check. Naturally the Board of Governors would be in a more comfortable position if it had greater authority over reserve requirements. Any public body charged with such a grave responsibility desires all the authority that may be necessary to cope with adverse developments. Opposition to granting additional authority has been so widespread, however, that I accepted appointment to the Board, resigned to the probability that no additional authority would be granted at this session of the Congress. I appreciate also that an increase in reserve requirements, of itself, is not the sole answer, especially if it resulted only in transferring Government securities from commercial banks to the Reserve Banks. An increase in the rates on short-term Government securities might still be necessary if the restraint is to be really effective.

Should the flow of funds into the market be stimulated beyond our ability to absorb them in the ways that have been described, we shall, of course, need to ask for such remedial measures as may be required. There is no other course but to go forward operating in the expectation that Congress will deal promptly and appropriately with any emergency that may develop.

Thus far I have spoken mainly of the role of the Federal Reserve System, one member of the team that must work together to achieve our goal.

The cooperation of the public is likewise essential. All of us must be educated to realize that each of us must exercise real restraint in the use of money already in existence. All reasonable means should be utilized to discourage consumer borrowing and consumer spending for non-essentials or for purposes which, even though at some sacrifice, can be deferred until inflationary forces have subsided. Likewise capital expenditures of businesses should also be deferred except in the most urgent cases, such as investment necessary to eliminate bottlenecks in essentials. The purchase of Savings Bonds should be encouraged by all possible means. Local governmental expenditures are on the increase. States, municipalities, and political subdivisions can join in the fight against inflation by postponing expenditures for public improvements where the health and safety of their communities will not be jeopardized. We have seen the restraining effect of Treasury cash surpluses. Every effort should be made to continue them and to that end the greatest possible economy should be practiced by the Government, not only in direct spending but also in the extension of credit by or under guaranties of Government agencies. We can not afford to forget that what we can do is limited by our real resources. The hard fact is that we simply do not have enough real resources to provide all the things we would like to have. If we insist on trying to acquire them anyway, we shall end by dissipating our resources through higher prices. The gospel of restraint in the spending of money should be taken to heart by every individual and by every organized group, public or private.

Commercial banks have embarked on a program of voluntary restraint in the extension of credit, under the auspices of the American Bankers Association. This is an excellent example of team work and sets a pattern for cooperative effort which might be copied with profit by many other enterprises and organizations. The guiding principle of such an effort should be to avoid every deferable use of money or credit. It should be emphasized again and again that the more effective such voluntary policies are the less need there will be for stronger and more direct controls.