STATEMENT ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM BEFORE THE JOINT COMMITTEE ON THE ECONOMIC REPORT, FEBRUARY 14, 1949*

Mr. Chairman and Members of the Joint Committee on the Economic Report:

I want to thank you for this opportunity to appear here today to testify on behalf of the Board of Governors of the Federal Reserve System in regard to the recommendations contained in the Economic Report of the President with respect to bank reserve requirements and regulation of consumer instalment credit. The Board of Governors unanimously favors both recommendations.

Inasmuch as I have just returned from an 8000-mile trip on which I visited the offices of the System in Seattle, Portland, San Francisco, Los Angeles, El Paso, Dallas, and Houston, it may be of interest to this Committee if I preface what I have to say on credit policy by summarizing the impressions I brought back from this trip.

You are aware, I think, of the unique nature of this Reserve System, with its 12 Banks and their 24 branches spread throughout this country, a system tailor-made for the economic expansion of our country. I have often referred to it as a great pyramid with its base in the grass roots of our economy and its apex in the Board of Governors. The breadth and strength is in the base, with the member banks and the Reserve Banks as elevations in the slope toward the top. There are more than 250 directors, who serve without compensation and represent not only banking but most of the widely diversified industrial, commercial, agricultural, educational, and other occupations of this country. I submit here a list of the directors and their business or professional affiliations.

The Board in Washington has the very great advantage of close contact with the vast fabric of the entire economy, by direct communication with these men, with the presidents, other officers and staffs of the 36 System offices, through periodic meetings with the presidents, with the chairmen of the Banks, with the Federal Advisory Council consisting of representative bankers from each Federal Reserve district, and through frequent System staff meetings. The System has constantly available current information, factual and statistical, drawn from this great network. This is in addition to the masses of economic data regularly compiled and analyzed by the Board's staff. I am sure that all members of the Board in Washington feel as I do, that the accumulation of facts, figures, as well as opinions, which we are thus able to assemble is invaluable. It is supplemented from time to time by visits such as the one I have just made, which gave me an opportunity for frank, face-to-face discussions with informed men in business, banking, agriculture, and the many different interests linked together in this Reserve System. Since I took office less than a year ago I have visited ten Federal Reserve Banks and seven of their branches, primarily for this purpose. In addition I have talked in different cities with scores of business and professional men not directly connected with the Federal Reserve.

Partly because of the shift in emphasis brought about by reappearance of conditions of a buyers' market since my previous trips, I found businessmen more alert and sensitive to the major external influences—international, legislative, and monetary—which bear upon the activity, profitability and soundness of the enterprises with which they are connected. For instance, most all of them when commenting on business prospects spoke about the dangers in the international situation, the implications of a Federal surplus or deficit, their concern about future Congressional legislation, and the importance of credit and monetary policies.

I found a very general opinion of optimism that we are in the midst of a healthy leveling off adjustment and that the inflation may have run its course. Quite naturally those engaged in agriculture or the manufacture of items which have suffered the greatest price decline were not happy about their positions in relation to other producers whose prices

* Presented by Chairman Thomas B. McCabe.

have not declined and in some instances have risen. It is the rapid change in price relationship in the over-all picture that causes concern to so many people. I found few who excluded the possibility of a renewal of inflation. Among factors mentioned that might bring this about were (1) deficit financing, (2) reappearance of critical shortages, (3) further substantial wage increases, (4) excessive spending by State and local governments, and (5) resumption of rapid credit expansion.

I have found an increasingly better understanding and appreciation of the actions of the Federal Reserve in the field of credit, of the importance of arming it at all times with the authority to deal with changing economic conditions, and of its record, particularly in maintaining an orderly market for Government securities in which all classes of our people have such great interest. I have emphasized and re-emphasized to various groups who have been subject to the System's regulations that our primary objective is to work for a stabilized economy, and that in doing so we must serve the broader interests of industry, agriculture, and commerce and not the limited interests of any particular groups. This purpose is fully in accord with the objectives of the Employment Act of 1946, namely, to promote maximum production, employment and purchasing power.

In his Economic Report, the President said:

> "On previous occasions I have recommended that adequate means be provided in order that monetary authorities may at all times be in a position to carry out their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures. The temporary authority to increase reserve requirements of member banks of the Federal Reserve System, granted by the Congress last August, will expire on June 30, 1949. The expiration of this authority without further action of the Congress would automatically release a substantial volume of bank reserves irrespective of credit needs at the time. The Congress should promptly provide continuing authority to the Board of Governors of the Federal Reserve System to require banks to hold supplemental reserves up to the limit requested last August, 10 per cent against demand deposits and 4 per cent against time deposits. This authority to the Board of Governors should not be confined to member banks of the Federal Reserve System but should be applicable to all banks insured by the Federal Deposit Insurance Corporation.
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> "Authority for the regulation of consumer installment credit, which likewise expires under present law on June 30, 1949, should be continued in order to exert a stabilizing influence on the economy."

The credit measures proposed at this time are a form of insurance against the possible renewal of the upward spiral. Let me say a word, however, about the downside of the business cycle. It should be very reassuring to member banks and to the entire banking community to recall that the Reserve System is far better equipped now than ever before to combat deflationary forces. Through open market operations, that is, by purchase of Government securities, the System has virtually unlimited means of supplying the money market with additional reserves if the situation should call for such action. The Reserve Banks have about 23 billion dollars of gold certificate reserves, only half of which are needed at this time to meet gold reserve requirements. Accordingly, the System could more than double its note and deposit liabilities. Furthermore, the Banking Act of 1935, by freeing Reserve Banks from some of the technical limitations on their lending functions, placed the Reserve Banks in a position to lend to member banks on any assets that the Reserve Banks are willing to accept as security for advances. This is an important assurance of a liberal lending policy on the part of the Reserve Banks.

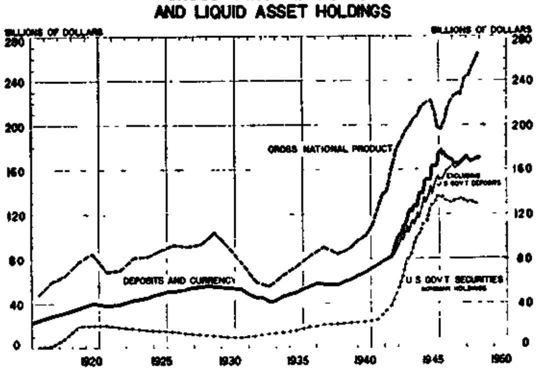
Also the Reserve Banks have authority to make so-called Section 13b loans for working capital purposes to business and industry when other credit is unavailable to the borrowers. And, of course, in a downswing the Reserve Board would lower reserve requirements and similarly adjust regulations on instalment and stock market credit in accordance with the needs of business and finance.

I have referred to the System's ability to deal effectively with credit problems on the downswing in order to emphasize and make clear why we say that if we are equipped with the proposed authority to deal with the problems of a further possible upswing, we will be in a better position to perform *at* *all times* the functions that are the primary responsibility of monetary authorities.

Why is it necessary to ask Congress at this time for the monetary and credit measures to which the President refers? I shall not take your time to go over familiar ground which has been well covered by other witnesses before this Committee, but I should like to summarize, as we see it, the situation which calls for these protective measures.

War finance resulted in a huge and rapid expansion in the amount of liquid assets—bank deposits, currency, and Government securities—held by the public. This expansion represented the accumulation of savings made possible and necessary by the excess of wartime incomes over the supplies of goods and services available for purchase. The result, as shown in the chart, is that deposits and currency increased from about 60 billion dollars in 1940 to 170 billion dollars at present. Nonbank holdings of Government securities, which can be readily converted into money, increased from about 20 billion dollars to 130 billion dollars. The expansion in the combined total is more than three and a half times. Today physical volume of production of all goods and services, including output of farms, mines, and factories and various other activities, so far as such a total can be measured, is only about half again as large as in the maximum prewar year.

GROSS NATIONAL PRODUCT AND LIQUID ASSET HOLDINGS



Partly as a consequence of an excessive money supply relative to production, we have already experienced a large degree of inflation. Consumers' prices for all items as measured by the indexes of the Bureau of Labor Statistics rose by 75 per cent above prewar and are still close to that peak. The dollar value of the annual gross national product, as shown on the chart, has increased from about 100 billion dollars in 1940 to an annual rate of over 260 billion dollars in the last quarter of 1948, an expansion of over two and a half times. The existing and potential money supply could still generate strong inflationary pressures.

Some easing of inflationary pressures has been indicated recently by marked declines in prices of various commodities, principally those that had risen most sharply. This easing was brought about in part by the record volume of production of both agriculture and industry in the past year.

Over-all consumers' incomes and holdings of liquid assets, nevertheless, have continued at high levels and are fairly widely distributed. Expenditures by businesses for capital investment, by State and local governments for public works, and by home owners and builders for new housing have continued large. Resistance to high prices and some abatement in the urgency of demands have been evident, however, in the case of housing and of many durable goods, now that the more pressing shortages have been overcome.

As for credit, the increase in bank loans, which had been very large in previous years, slackened considerably in the last quarter of 1948. Also there was an almost complete cessation late in the year of sales of Government bonds to the Federal Reserve System by nonbank investors to obtain funds for other uses, a factor that had previously been an important inflationary influence. Taking the year as a whole there was a small decline, amounting to a billion dollars, in the total volume of bank deposits last year, due to the Federal Government surplus early in the year and the use of part of that surplus to retire bank-held securities.

It is possible but it is by no means certain that postwar inflation has run its course and that additional restraints for anti-inflation purposes will not have to be applied. However, no one can be sure that inflationary dangers are over rather than merely interrupted. We have had a number of readjustments since the end of the war. Each was hailed by some as the end of the postwar boom. Each was succeeded, in turn, by renewal of the inflationary spiral. I recall so vividly the strong statements made to me by financial and business leaders just before I took office last spring that they were confident that the break in the commodity markets in early 1948 was the beginning of the long anticipated recession. You will recall that there was a similar feeling in the spring of 1947.

In view of the uncertainties in the outlook at this time, the temptation is strong to assume that inflationary forces have been dissipated. This may prove to be an unwarranted assumption.

The needs for enlarged defense expenditures, particularly if they involve the purchase of materials in short supply and if they lead to a budgetary deficit, are a continuing force making for inflation. Unless total production can be expanded—and the ability to expand in any short period is limited by available resources of materials, manpower and equipment—additions to the goods and services devoted to defense must be diverted from those going into private consumption and investment. If private demands for goods and services are not correspondingly adjusted, then higher prices will result. With such strains on the economy it is important that governmental expenditures be fully covered by revenues.

Not only is the surplus or deficit in financial operations of the Government important, the economy is also affected by cash surplus or deficit operations of the private sector. In a fully-employed capitalistic economy, business and other investment should be financed largely from current savings of the public. If, however, over-all expenditures for consumption and investment exceed current receipts —which is possible if they are financed from accumulations of past savings or from bank credit expansion—then the result is likely to be inflationary.

In view of the general liquidity of the economy, one cannot be complacent about the possibility of renewed or continued deficit financing by businesses and individuals in the aggregate. We still have a tremendous potential for a further increase in deposits and bank reserves as well as for a more rapid use of existing money. Commercial banks alone hold over 60 billion dollars of marketable Government securities, which they could convert at will into reserves capable of supporting an enormous deposit expansion. The turnover of bank deposits is currently much less than it has been in many previous periods of high economic activity, and spending for all purposes could be considerably expanded without any further increase in the amount of the outstanding money supply. Under these circumstances, we must be prepared *at all times* to cope with inflationary possibilities that may develop just as we must be prepared to move in the opposite direction by relaxing restraints when deflationary influences are dominant.

We are also still confronted with the necessity of balancing our several objectives, one of the most important of which is maintenance of stability in the Government securities market. To accomplish this, the Federal Open Market Committee stands ready to buy such securities when there are no other buyers at established prices and also to sell securities when demand is heavy. I think the System's support of the Government securities market has been wise and necessary. It is one of the outstanding accomplishments of the postwar period. As the President pointed out in his Economic Report, such stability in the Government bond market "contributes to the underlying strength of the financial structure of the country."

At the same time we want to prevent any excess reserves supplied to banks by our stabilizing operations in the securities markets from becoming the basis for manifold expansion of credit and of deposits. We also need to absorb reserves made available from other sources, notably gold inflow. It would of course be possible to curb expansion of reserves by failing to support Government securities in the market. Although I fully realize that the support program limits the System's ability to restrain credit expansion, I am convinced that the consequences which might result from abandoning the program could be disastrous. The measures we are recommending are designed to deal with this situation.

The heart of the problem is bank reserves. If we are to deal at all effectively with the problems of inflation we must devote ourselves to the subject of bank reserves. There are other lenders in the market who compete with banks for loans, but banking is unique because bank deposits are the largest part of our money supply.

Let me emphasize as I have before that I am not singling out bankers for criticism. In my opinion this nation owes a debt of gratitude to commercial bankers generally for their service in the task of financing the war, and reconversion from war. I also feel that the bankers are indebted to the Federal Reserve System for the part it has played in this period of strain. Never before in the history of this nation has the banking system been in a stronger position.

Action by monetary authorities to prevent newly-created reserves from becoming the basis for further deposit and bank credit expansion is in no sense a reflection on the banking community. If effective restraint is to be exercised over the money supply and the credit situation, the Federal Reserve System must be concerned with changes in the volume of bank reserves, which have a direct bearing on the volume of bank credit and bank deposits. Responsibility for the over-all volume of bank deposits and, to some extent, for the general quality of bank credit rests primarily upon the monetary and banking authorities rather than upon individual bankers.

The banking system today acquires reserves in three major ways: (1) imports of gold, (2) return of currency from circulation, and (3) purchases of Government securities by the Federal Reserve Banks. If the volume of deposits is to be held in check additional reserves arising principally from these sources have to be absorbed or immobilized. Monetary policy has been directed to this end.

During the year ending last October large amounts of reserves were supplied to banks as a result of Federal Reserve purchases of bonds, largely from nonbank investors. These purchases amounted to about 10 billion dollars. In addition, gold inflow and return of currency from circulation supplied banks with over 2 billion dollars of reserve funds.

These additional reserves were largely absorbed or offset through fiscal and monetary measures. The most important of these was the large excess of cash receipts over expenditures by the Federal Government during the early part of 1948. The transfer of these funds to Treasury account at the Reserve Banks reduced privately-held deposits and also absorbed bank reserves. The Treasury used a large part of these funds to retire public debt held by the Reserve Banks. Banks in turn maintained their reserve positions by selling Government securities to the Federal Reserve. The necessity to make these sales exerted a degree of restraint on the lending activities of banks.

The cash surplus of 6 billion dollars in 1947 and 8 billion dollars in 1948, used in the way I have described, was the largest single restraining force on the money supply. But at best the prospects for this calendar year, in view of our enlarged defense expenditures, are for a cash surplus of less than 2 billion dollars, which is more than accounted for by the excess of receipts in the first quarter, leaving a deficit for the rest of the year. Thus this element of restraint is no longer available.

Another important means of absorbing reserves was the sale of short-term Government securities by the Reserve Banks. Since the middle of 1947 interest rates on such securities have been allowed to rise somewhat from the very low levels that were reached in the depression and that had been maintained during the war and early postwar period. Investors were encouraged by these higher rates to purchase and hold short-term issues. Federal Reserve sales of short-term securities in the market, together with retirements by the Treasury, reduced the System's holdings of such securities by fully as much as System holdings of bonds were increased through the support program. It would be unwise, however, to rely on this means of absorbing additional reserves that might be made available from System purchases of bonds or from other sources, particularly if there should be a substantial demand for loans.

Still another means of dealing with the problem of reserves was to increase reserve requirements. Under authority of permanent law, the Board of Governors increased reserve requirements at central reserve city banks in New York and Chicago in February and again in June. Then in the third quarter, when nonbank investors were selling bonds in large volume and the demand for bank credit was active, the Board used part of its newly-acquired temporary authority to increase reserve requirements for all member banks. Let me emphasize that we have not used the temporary authority merely because we were given it. We have used only a part of it, cautiously and with discretion, to meet a specific development.

We should be prepared for whatever may develop. No one can know how the volume of reserves will change in the future. We should be prepared to deal with the problems that would arise if reserves increase significantly. That is why adequate continuing authority is needed to require banks to hold supplemental reserves in the form of balances at the Reserve Banks.

We are again asking, as we did last summer, for authorization to require supplemental reserves up to a maximum of 10 per cent against demand deposits and 4 per cent against time deposits. Congress granted authority up to 4 per cent on demand deposits and 1½ per cent on time deposits, applicable to member banks only, and expiring June 30, 1949. The present request would replace this temporary authority.

Since the temporary authority has been used in part to require member banks to hold additional reserves, expiration of the power on June 30 would immediately release about 2 billion dollars of reserves that could be used as a basis for a manifold credit expansion.

It is vitally important that the requirements be made applicable to all insured banks, and not exclusively to member banks of the Federal Reserve System. Banks now subject to Federal supervision and enjoying the protection of Federal insurance of their deposits comprise 95 per cent of all commercial banks and hold 98 per cent of all deposits in commercial banks, while member banks of the Federal Reserve System include slightly less than half of the total number and hold about 85 per cent of the deposits.

It would be grossly inequitable to limit the requirements to member banks alone. Member banks already carry higher effective reserves than nonmembers, while nonmember banks benefit by the strength which the very existence of the Federal Reserve System gives to the credit structure. It is unfair to have member banks bear the entire burden of actions in the monetary field undertaken in the public interest. I have found member banks, particularly small member banks, becoming restive because of the inequitable application of reserve requirements. Failure to include all insured banks would seriously impair the effectiveness of national monetary policy.

It is not suggested that the proposed supplemental reserve requirement is the perfect or final solution of the problem of arming the monetary authorities with adequate means of performing their primary function. The pending proposal, however, is a necessary step in the right direction. Together with other powers now available, it would equip our monetary mechanism with authority to cope with overexpansion of the money supply in case that danger again threatens us. As I have already indicated, we are amply forearmed to deal with the credit needs of the opposite swing of the business cycle.

The additional authority would only be used to absorb future additions to reserves. It would not be used to force banks to liquidate outstanding loans. At present most of the banks of the country hold short-term Government securities in amounts more than adequate to meet their needs for liquidity, as well as to accommodate their customers or to set aside additional reserves. Moreover, it should be borne in mind that monetary policy is not a one-way street. It has always been flexible, adapted to changing requirements of the economy. Bank reserves immobilized in a period of inflationary pressure would be released when business needs require.

In addition to the authority with respect to bank reserves, we urge you to continue consumer instalment credit regulation.

Instalment credit is the volatile and dynamic element in consumer financing. It is subject to wide fluctuations and exerts a pervasive effect on consumer demand and prices. During the past year, for example, nearly 80 per cent of the 2.5 billion dollar increase in total consumer credit was accounted for by instalment credit. The instalment credit portion has increased in the past two years from about one-third to one-half of the total of all consumer credit.

Consumer instalment credit, furthermore, is directly associated with the distribution and financing of durable goods. In an advanced and rich economy such as ours, the standard of living of the great mass of the people takes more and more the form of possession and enjoyment of a variety of durable goods. Thus instalment financing is subject to a growth force that is basic and persisting and is becoming a more important element in the economy.

The unregulated use of instalment credit financing tends to accentuate instability of demand for durable goods. Credit spending is stimulated during periods of business expansion when consumers are more inclined to make commitments for the future and lenders are more willing to extend credits. New instalment credits exceed repayments on old credits and outstanding credit volume grows. When economic recession sets in, accumulated credit remains to be paid off in the period of contraction. The drain on consumer income for debt repayment curtails current purchasing of consumer goods and services generally. The over-all effect is to amplify fluctuations in consumer expenditures, directly for durable goods and indirectly for all types of goods. This makes for greater instability of the entire economy.

We are interested in stability as well as growth in our economy. Regulation of instalment credit is designed to help maintain stability without preventing sustainable long-term growth in such credit.

Consumer instalment credit has risen since the end of the war from 2 billion dollars to 8 billion dollars at present. This is an impressive increase and has contributed to the heavy pressures of demand against available supplies of goods for purchase, which in turn have contributed to rising consumer prices. If these rates of increase in consumer debt were to continue, we would eventually, and perhaps before long, exhaust the cushion of consumer borrowing power and thus endanger economic stability.

Regulation W in its present form, which some have criticized as too stringent, has not prevented expansion of instalment credit. But it has operated to restrain excessive instalment spending and lending especially for consumer durable goods. It has tended to make quality and price more important factors than terms in the sale of such goods. The restraint has served as a useful brake on further advances in retail prices in the consumer areas affected by regulation, as well as on the excessive expansion of instalment credit volume.

The all-important thing is that the authority to restrain be in hand when the need to restrain arises. Appropriate instruments to meet possible inflationary or deflationary developments should be constantly available for use as circumstances warrant.

In adapting Regulation W to changing economic conditions, the Board of Governors by statutory direction would have in view the prevention of excessive expansion or contraction of consumer instalment credit as well as the maintenance of sound credit conditions in this credit area and in the economy generally. The regulation would thus help to carry out the objectives of the Employment Act of 1946.

Consumer instalment financing has played an important part in the development of the American system of mass distribution of consumer goods. It should continue to play this important role by being used but not abused. Sound credit conditions should be maintained at all times for the protection of the entire economy. It should not be overlooked that the users of instalment credit are primarily low and middle income households. These economic units suffer most from the hardships of instability. By helping to maintain sound credit conditions and also to moderate excessive fluctuations in instalment financing Regulation W can serve well the public interest. Also, smaller business enterprises can compete more equitably and safely when terms conform to reasonable standards.

The Board has consistently been mindful of the problems that confront those who have the job of carrying on a business. We have tried to achieve the purposes of Regulation W with the least possible interference with usual business operations. I believe we have achieved reasonable success in that endeavor.

I want to say at this point that we have received strong and friendly cooperation from an overwhelming majority of those subject to the regulation. We have a sympathetic interest in their problems and we believe that in most cases they have made an honest effort to understand ours.

The Board is fully aware of the problems which consumer instalment credit regulation presents to retailers, as well as to sales finance companies, banks, and other credit-granting agencies. We are very conscious of the problems that increased reserve requirements raise for any bank that may have to obtain the additional reserves by liquidating other assets. We earnestly hope that the need will not again arise for use of further restraints. We would only use them if it became necessary to do so in order to protect the economy. I can assure you that these restraints will be modified as economic conditions warrant, and the Board will not hesitate to relax them when they have served their purpose. In the world of today the United States, occupying as it does a place of world leadership, should be equipped *at all times* with flexible, effective means of carrying out appropriate monetary and credit policies, adapted to changing economic circumstances.

Most of my business life has been spent in private industry. I would be the last to want Government to have power and authority merely for the sake of having power and authority. In the complex and fluid monetary field, however, the timeliness of policy moves is of critical import. That is why the Board believes that in the interest of a stabilized, progressive economy, it is essential that our monetary machinery be prepared in advance to adapt itself to changing economic needs.