Statement by Chairman Thomas B. McCabe
on behalf of the
Board of Governors of the Federal Reserve System
before the Senate Banking and Currency Committee
May 11, 1949

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Mr. Chairman and Members of the Committee:

I deeply appreciate the opportunity to appear before you today on behalf of the Board of Governors of the Federal Reserve System. We share a great responsibility. You as the representatives of the people have laid down the broad monetary and banking policies of the nation. We as your instrumentality are charged with the administration of these policies in such a way as to contribute to the maintenance of a high level of employment, stable values, and a rising standard of living. That is the goal set by the Employment Act of 1946. It is the basic guide for Federal Reserve System policy.

We are emerging from eight years of mounting inflationary pressures. During these eight years the public's total holdings of liquid assets nearly quadrupled. The physical volume of production, as nearly as it can be measured, expanded by only about half again as much as the pre-war maximum. It was this great disparity between demand and supply which drove consumers' prices up to 75 per cent above pre-war. When I testified before the Joint Committee on the Economic Report in mid-February I said, "Some easing of inflationary pressures has been indicated recently by marked declines in prices of various commodities, principally those that have risen most sharply," and I called attention to the fact that "over-all consumers' incomes and holdings of liquid assets, nevertheless, have continued at high levels and are fairly widely distributed." That is still the case today.

Last August when inflationary pressures were still mounting, you granted us certain supplementary powers to help cope with the situation. After Congress acted at the special session, the Board of Governors put to use the authorities which it had received. Regulation W was reissued establishing down payments and terms on consumer instalment credit more lenient than those that prevailed when the power lapsed the preceding November, but sufficient to exercise a wholesome restraint on the rapid growth of this volatile credit. At the same time, the Board increased reserve requirements of all member banks by two per cent on demand deposits and by 1-1/2 per cent on time deposits.

Later in the year the economic situation turned. In the interim, however, the Treasury and Federal Reserve System underwent one more severe test of their resolve to maintain stability in the market for government securities. From September 1 to November 1 bonds in the amount of 3-1/4 billion dollars were purchased to carry out this policy of stability.

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.

Since the peak of inflation in November, there has been a significant readjustment in the economic situation. You are familiar with the general features of this readjustment, but I should like to review them briefly.

(Discussion of accompanying chartbook.)

With the passing of the inflationary crest we acted promptly to relax credit restraints. Four major steps were taken:

1. On March 2, the Board announced a relaxation of the consumer instalment credit regulation.

2. On March 28, the Board reduced margin requirements from 75 to 50 per cent.

3. On April 22, the Board further relaxed Regulation W, making the maximum maturity 24 instead of 21 months across the board, reducing the down payments on all articles of furniture, appliances, etc., covered by the regulation from 15 to 10 per cent, while retaining the one-third down payment on automobiles. All articles costing less than $100 were exempted. Previous exemptions had applied to articles costing less than $50.

4. On April 28, the Board reduced reserve requirements for all member banks, the effect being to release approximately 1-1/4 billion dollars of required reserves.

It has been of great help to us to have the benefit of close cooperation with this Committee, and with the Banking and Currency

Committee of the House.

Before coming to decisions on all matters of policy, the Reserve Board has the inestimable advantage of being able to communicate with and obtain factual information, as well as opinions, from the twelve Federal Reserve Banks and their twenty-four branches throughout the country, on whose boards are more than 250 directors, drawn not only from banking but from the widely diversified industrial, commercial, agricultural and professional pursuits of the nation. The directors, the officers and staffs of the Reserve Banks and the Board, the Federal Advisory Council, and the member banks comprise the Reserve System which, as I have often said, is like a vast pyramid, whose breadth and strength is in its base. The Board has constantly available current information, drawn from this great System to supplement the vast mass of factual and statistical data gathered through other governmental sources. Moreover, the System sponsors special studies as occasion demands. In addition, we are always at pains to consult with representative businessmen, the small as well as the larger ones, with trade associations and, in fact, with all who are affected by System operations. We try to weigh carefully their views and to distinguish broad national considerations from those reflecting narrower interests. I mention these myriad sources of information to emphasize that we do not function in a vacuum.

We do not wish to exaggerate the role which monetary and credit policy has played in the period from which we are now emerging. It is fair to say, however, that in the last year of upsurge especially, it exerted some restraining influence. We think we may fairly say that we used the powers which Congress entrusted to us flexibly, and that we have made an earnest effort to take into account every relevant fact and circumstance, including the hardships or inconveniences imposed on those subject to regulations and requirements.

We can all take satisfaction from the fact that the many banks of the country are on a more secure foundation now than ever before in our history. The bankers themselves, as a result of their voluntary efforts to restrict loans in the face of strong inflationary pressures, deserve a great deal of the credit for this condition. At the same time, we must recognize that our existing banking strength is in part the product of national economic and financial developments since the mid-thirties. Today our commercial banks, with about 50 per cent of their total loans and investments in government securities largely acquired as a result of war finance, enjoy an exceptional unprecedented liquidity. Their capital accounts, while not yet at a desired level in relation to deposit growth since pre-war years, are over 50 per cent greater than before the war, representing in large part a steady plowing back of earnings.

Not only do our many unit banks possess unusual strength, but the Federal Reserve System, as a result of the Banking Act of 1935, is in far better position than ever before to assist member banks, and through them all banks. Its greater experience enhances its ability to meet the credit needs of a time when surpluses rather than scarcities prevail and private enterprise requires encouragements rather than restraints.

In his Economic Report to the Congress last January the President pointed out that the monetary authorities should 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. He asked that Congress provide continuing authority to the Board to require banks to hold supplemental reserves up to the limit we had requested in August, 10 per cent against demand deposits and 4 per cent against time deposits. He stated that this authority should not be confined to member banks, but should be applicable to all insured banks. The President asked that the authority for the regulation of consumer instalment credit be continued in order to exert a stabilizing influence on the economy. The President made these requests after a most careful and exhaustive survey of the situation with the Board and the requests had the unanimous approval of the Board.

That report was prepared and submitted nearly four months ago, four months in which inflationary pressures have abruptly abated and the economic situation generally has changed in many respects. In view of these developments I come here today with somewhat changed recommendations. We now feel that we will have adequate powers for the period immediately ahead if the Congress will extend the two temporarily granted authorities voted by the special session last August and make the authority to increase reserve requirements applicable to all insured commercial banks.

Elbow room is essential to an institution such as the Federal Reserve System performing central banking functions. Congress has made the System responsible for the maintenance of sound credit conditions in this country in the interest of high-level economic stability. To carry out that responsibility we must always be in a position to operate flexibly, counteracting trends as they set in, either toward inflation or deflation. We must take into account how much latitude exists to move in either direction from the position that seems correct for the near future. Viewed in this perspective, the present powers of the Federal Reserve System are ample for our needs during a downward trend. Our powers in the other direction, however, are limited. So long as we have the huge Federal debt to support we cannot count on use either of the discount rate or operations in the open market to exert the same degree of influence that they did before the war. To an extent hitherto not contemplated, we are forced to place greater reliance on reserve requirements as a defense against inflationary trends. We are at the moment, however, very close to the limits of that power.

We come before you, therefore, to ask you to maintain what we regard as the minimum operating leeway that is needed in view of our responsibilities. We do not plan to use those powers now. In fact, reserve requirements may be further reduced if present trends continue. But we do want the powers in case an emergency situation should arise. The basic concept underlying the Federal Reserve System is that it should have at all times residual power to deal flexibly with changing situations, not that it should come to Congress whenever an emergency exists. Looking backward at the situation, I feel it would have been better for the economy if we had been in a position earlier to restrain consumer installment credit expansion and to increase reserve requirements.

You understand, I am sure, that the ability of the Federal Reserve System to influence credit developments is always subject to limitations, even when our residual authorities give us much greater elbow room than we have at present. In large part these limitations arise out of the complex organization of finance in a highly developed country such as ours. In part they reflect the many different types of financial activities that are carried on within the Government itself.

As members of this Committee realize, the existence of our huge public debt and the need to assure orderly conditions in the government bond market have greatly complicated the problems faced by the System in adapting policies to adjust the supply of money and credit to the needs of a stable, high-employment economy. At the present time our commercial banks hold about 60 billion dollars of marketable government debt securities. Non-bank public investors hold an additional 70 billion. Whenever any security which is a part of this 130 billion is bought by the Federal Reserve there is an increase in bank reserves, and the reserve so created then becomes the potential basis of a multiple credit expansion.

Of course, the Federal Reserve is not always involved. There may be a balance of buyers and sellers in the market and orderly conditions may exist without Federal Reserve participation. But if there are more sellers than buyers at any time, the Federal Reserve must enter the market. It thereby makes reserves available to the banking system regardless of whether such reserves are needed for the stability of the economy. If the money supply (deposits plus currency) is already ample in relation to the goods and services for which it can be exchanged, the further increase through bank credit expansion on the basis of the new bank reserves serves mainly to exert inflationary pressures. The initiative in all such operations rests with the market and not with the Federal Reserve. Thus the System cannot always control the availability of bank reserves. It should accordingly be equipped to vary the required amount of reserves so as to neutralize the indirect effects of its government security transactions.

I come now to our most controversial request. The nature of the problem compels us to plead that the authority in respect to supplemental reserves be made applicable to all insured commercial banks, rather than only to members of the Federal Reserve System. Failure to include all such banks will seriously impair the effectiveness of national monetary policy in a critical period. It will work to the detriment of our whole banking structure at a time when the situation calls for consistency and uniformity in national monetary policy. No category of commercial banking should be exempt to that call.

We are not suggesting that the nonmember insured commercial banks carry the same reserves as the member banks. In normal periods they would be unaffected by this legislation. We are proposing only that to the extent <u>supplemental</u> or <u>increased</u> reserves may be required under the provisions of this act the percentage amounts would be the same for both member and nonmember insured commercial banks. Under our proposal this would mean at the very maximum an increase over existing State requirements of no more than 4 per cent on demand deposits and 1-1/2 per cent on time deposits.

With a huge public debt it would be wholly unrealistic to have no means of steadying or supporting the market. We have that means in the Federal Open Market Committee. Without it no one could be sure of a ready market or of the rates that might prevail.

The vital point to bear in mind is that this function and operation is a protection for all banks of the country -- not merely member banks. All commercial banks have in their portfolios relatively large amounts of government securities. Every bank, member or nonmember, can have confidence in its ability to find a market if necessary for those securities without exposure to the risks that would prevail if there were no residual purchaser. It should be emphasized as strongly as possible that nonmember banks have benefited and profited from all of these operations and actions, yet they have not had to bear their proportionate share of the burden. That is why we say it is only fair and equitable to ask all insured banks to shoulder their proportionate share of a load which is imposed for the benefit of the entire banking community and for the country.

As I have sometimes put it, to be a member in the Federal Reserve System is like being a contributing member to a local volunteer fire company. So long as enough neighbors contribute, the protection will be adequate. In case of a conflagration, however, noncontributors also receive help. This is inequitable, but it is humane and necessary to prevent spreading of the danger to the whole community. Nevertheless in the existence and majority support of the institution there is great security for all.

We are not asking that nonmember insured commercial banks be required to become members or to become subject to all of the other requirements and obligations which member banks have to meet. Membership of State banks in the Federal Reserve System is voluntary and our membership will be endangered if the competitive relationship is too glaring.

We are aware, as you are, that there is strong opposition to the proposal to include nonmember insured banks under the supplemental reserve authority. It will be said that it is simply the attempt of another Government agency to grasp for more power; that it trespasses upon States' rights; and that it is a step toward ultimate destruction of the dual banking system.

I can only assure you that the Board does not seek power for the sake of power; in fact, we would prefer, as a matter of personal choice and convenience, to have less formidable responsibilities. At best, the administration of regulatory powers is a headache. Certainly we would be remiss if we failed to explain to the best of our ability the situation as we see it and the way in which we feel the responsibilities entailed can best be met.

I do not feel there is a relevant objection on the score of States' rights. Insured banks are all under the aegis of Federal legislation and for many years member and nonmember banks alike have been subject to Federal law providing for stock market margin requirements.

The dual banking system, which I have long upheld and will continue to support vigorously, is not jeopardized by this proposal. It is specifically drawn to leave with the State bank supervisory officials full discretion and authority to apply and enforce. It seems to me the test must be national needs and not groundless fears that State chartering and supervision are threatened. Clearly they are not. Moreover, we contend that what we propose will fortify and strengthen the dual banking system by arming all banking in this country against a danger that would undermine private banking.

A few States have cooperated to the fullest extent possible under their laws to parallel or approach the reserve requirements of the System. It would be desirable, of course, if there were greater uniformity and effectiveness under State reserve requirements, combined with a disposition by all State authorities to pursue policies of parallel action. We cannot safely hope, however, for separate and parallel action by most of the States.

In addition to authority with respect to bank reserves, we request you to continue authority to regulate consumer instalment credit.

As you know, this type of credit is associated particularly with the sale of what are known as consumer durable goods, including automobiles, refrigerators, radio and television sets, washing machines, furniture and similar articles which have become so much a part of our American standard of living that very large sections of our economy depend on their production and sale. Because the prospective buyer of these articles can exercise so much latitude in both the selection and time of his purchase, sales are subject to wide fluctuation. The credit related directly or indirectly to their ownership is consequently extremely volatile.

The development of consumer instalment financing has come largely during the period since World War I. By the mid-twenties, consumer instalment credit outstandings probably did not exceed a billion and a quarter dollars. Today the figure is nearly 8.5 billion. Since the mid-twenties fluctuations in credit volume have been wide, swelling consumer spending power in expansion periods and reducing it during contractions. Because instalment credit has become so important a factor in the main distribution of durable goods, its wide swings have contributed to instability in the production and marketing of these goods. We are fully cognizant of the usefulness of these credits to the durable goods industries, to consumers, and to the entire economy, and we earnestly desire to see this usefulness continued and extended. We are naturally apprehensive, however, lest this credit grow too fast under the pressure of unsound credit practices and terms and thus at some point contribute to serious instability of markets and purchasing power. We believe that a further period of trial under more normal conditions for the regulation of this credit can well serve the public interest.

Appropriate regulation of instalment credit can be especially helpful during times when more purchasing power serves only to bid up prices. In periods when production and demand approach a balance, such regulation can be relaxed considerably. This the Board has done twice recently in respect to its present authority, and the Board will have no hesitancy in suspending any part or all of the regulation should conditions make such action desirable. The important thing is that the power be at hand to exercise restraint when necessary to maintain sound credit conditions.

Regulation W is of course not in itself the answer to the problem of instability which our high standard of living presents. The problem is far more fundamental. But we are convinced that proper regulation of this volatile type of credit, in conjunction with other credit restraints, constitutes a substantial contribution to stability.

In summary, then, we are suggesting extension of the authorities which you delegated to us last summer but with the application of the reserve requirement authority equally to the nonmember insured banks as well as to the member banks. We are suggesting the extension of these authorities in the hope that the Congress will in the meantime survey the entire framework and functioning of our financial system and of the role of banking and Government therein. It is evident from the resolutions which members of this Committee have sponsored to create a National Monetary Commission that you are well aware of the need for a thorough and painstaking study of this whole complicated and difficult subject. We hope that you will press ahead to authorize such a review and reappraisal in all its ramifications of the function of the entire banking system and its role in contributing to national economic stability through the financing of individuals, business enterprise, and Government.

We in the Federal Reserve System are naturally concerned over the areas of controversy that surround the System's functioning and responsibilities as a central banking, monetary, regulatory, and supervisory authority. We trust that Congress will review its delegation of authority and responsibility to the System to be sure that they are commensurate with each other and with the objectives established by Congress. Such a review would include consideration: (1) of the System's open-market powers and their relation to Federal financing and the administration of the public debt; (2) of the use of selective credit controls such as those over security loans and consumer instalment loans and of the proper sphere for the application of such types of control; (3) of the distribution of regulatory and supervisory power among the various Government agencies; (4) of the need for some mechanism of policy coordination on the domestic financial front as we have available through the N.A.C. on the international financial front; (5) of the objectives of central banking and supervisory policies; and (6) of the relation of the Federal Reserve System as a central banking organization to the banks of the nation, both member and nonmember.

In any such review the role and function of reserves will inevitably receive prominent consideration. As you know, the System has been conducting extensive studies of this subject and believes that a more scientific formula for establishing reserves can be determined by the Congress. I feel confident that solutions to these problems can be found without impairment of our long established institutions, or encroachment upon either State or national prerogatives. Indeed, it is imperative to find solutions that avoid, on the one hand, extremes of centralization which would threaten the dual banking system, or, on the other hand, jeopardize the effectiveness of national policy by disunity, discrimination, and divided counsels.

I hope the Committee will include in its review of our financial system an inquiry into the adequacy of our supply of equity capital. I do not need to remind members of this Committee of the fundamental, vital importance of this subject. This nation grew great and strong on the enterprise of its citizens. It used to be possible for a man with a good idea to get capital together, start a business, and market that idea. It is still possible, but it is becoming much more difficult to do so, and I tell you, as a businessman, that when our alert and up and coming young men of ideas are unable to get the venture capital to start and grow, then the American way of life is on its way out.

In conclusion, I would like to give the Committee my ideas on the present business situation. Naturally I am optimistic about the future of American business, and although many of my business friends are pessimistic about the present situation, I feel strongly that we are in a healthy readjustment period. There must of necessity have been a transition from inflationary prices to more normal ones and a transition from the concept of mass production to one of merchandised production. I feel strongly that we have let our merchandising skills get rusty in the past eight years. The pressure was on production. First we were engaged in all-out production of the materials and machines of war. Then came these past three lush years when pent-up demand beat on the doors of our factories for almost every type of consumer article. There was no need to exercise merchandising skills. The more urgent deferred demands of consumers have now been satisfied and most goods are in plentiful supply. When sales are a little disappointing, as compared to the abnormal years, there seems to be an inclination to look for excuses rather than get down to fundamentals of product price and quality, and consumer services. It is primarily by that constant improvement in quality, accompanied by lower prices, that our competitive system has functioned so phenomenally in improving the American standard of living. I, for one, am glad to see the return of the competitive conditions which are so vital a factor in our enterprise system.