STATEMENT OF

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OF THE

FEDERAL RESERVE SYSTEM

BEFORE THE

SUBCOMMITTEE ON MONETARY, CREDIT, AND FISCAL POLICIES

OF THE

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Now that the hearings before this subcommittee of the Joint Committee on the Economic Report are coming to a close, I wish to commend most enthusiastically the objective manner in which you have addressed yourselves to your important task. I am sure that the witnesses who have appeared before you all appreciate, as I do, the earnestness, impartiality and diligence which you and your staff have shown in your search for light on some of the most complex problems of our times. You have been concerned, not with any specific legislative proposal, but rather with the more fundamental questions of the principles which should guide future legislation. The report of this committee, composed as it is of members of both Houses who are well versed in money and banking, can not fail to have great influence upon the direction of monetary, credit and fiscal policies in the future.

The searching nature of the questionnaire sent out to qualified and interested individuals, and the way in which you have brought out disinterested professional opinion have contributed to the sustained high level of discussion that has prevailed during the past three weeks of these hearings. The printed record with the testimony of men of broad experience from business, finance, and public life, together with the answers to the questionnaire, constitute a most important and constructive volume -- one that will be a "must" in every library dealing with problems of money in the world today.

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You are probing into a very delicate and very crucial problem. It is no exaggeration to say that nothing more vitally affects the welfare and destiny of this nation than the integrity of its money and credit. The American dollar commands the highest confidence throughout the world. To maintain that confidence demands no less vigilance than liberty itself. The problems you have been exploring are at the base of that integrity and confidence. A free enterprise economy can not exist without appropriate central banking institutions to influence the availability and cost of credit. Unfortunately this point is not generally understood and lack of background is not confined to the general public. The attitude of many business and financial leaders, and of some of our banking leaders and supervisory officials, whose devotion to the public welfare can not be doubted, is explainable on no other grounds. Much of the diversity in the testimony before you reflects not so much basic disagreement as it does differences in appreciation of the importance of the problem.

I shall address myself directly to the role to be expected of central banking procedures in the functioning of the American economy. Central banking institutions have always been considered the necessary and essential complement of a free enterprise economy. Money does not manage itself. Once commercial banking institutions holding demand deposits become important, central banking institutions must be organized to avert money panics and to mitigate booms and depressions. Although they have necessarily been given wide discretionary powers, they should in no sense be regarded as an invention of or an adjunct to a "managed economy" or an "administered state". Instead they are part and parcel of a free enterprise economy, designed to maintain full and continuous use of its human and

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material resources. In modern terms this means that they are expected to help maintain a high and stable level of employment in a free enterprise economy. They endeavor to do this by the prompt and flexible use of adequate discretionary authority over the cost and availability of money and credit. As in the case of the Courts, they must be operated purely in the interests of the public but at the same time they should be immune from political bias and control.

That is the traditional, the conservative, the classic position. It is the issue that was dealt with by Carter Glass, among others, when the Federal Reserve System was established. Misunderstanding about it underlies much of the criticism of our actions. I can not emphasize too strongly the difficulties we are placed under when many of the most vociferous supporters of free enterprise, businessmen and bankers, and their organizations criticize the possession and use by the Federal Reserve System of necessary authority over the cost and availability of credit as if the delegation of this authority to the System were characteristic of a "managed economy" or an "administered state". It is exactly the opposite. Otherwise I would not have been considered for my present post. Nor would I have been disposed to hold it.

Our main problems today have arisen as an inevitable result of the huge volume of war financing. They raise anew the question, "How should central bank procedures be related to the fiscal function of the state?" The traditional position was developed in a world where public expenditures constituted a low percentage of the national income, where budgets were expected to be balanced annually, where the public debt,

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though it might have seemed large at the time, was very low in comparison with anything we face today, and where, incidentally, the widespread use of credit by consumers had yet to take root. It is clear that this is very far from the situation which confronts us today. In this country public expenditures, including Federal, State, and local, are of a magnitude that approaches one-fourth of the gross national product. Since the war, our Federal public debt has been considerably in excess of our entire annual national income, even though the national income is at record peacetime levels. Public debt now far exceeds the total of all private debt. The variety of new considerations that have to be taken into account in the modern formulation of fiscal policy is indicated in the report of the economists at their conference on fiscal policies held at Princeton. Their report is included in the record of your committee.

It is clear that we can no longer expect the wise exercise of traditional central banking powers, unsupplemented by other public policies, to maintain high level stability in a free enterprise economy to the same extent as was thought possible a generation ago. The impact of other public policies on the whole economy has grown too large in the interval. Does this mean that an "administered economy" is inescapable and that we must frankly accept the habitual resort to widespread controls in the form of price-fixing, allocations, rationing, etc., in order to maintain high level stability? These are incompatible with all of our conceptions of a free enterprise economy in peacetime. To this question the answer is unequivocally no. We can and we must retain the dynamic stimulus of free enterprise institutions. The course of postwar experience, both here and abroad, has demonstrated anew that these institutions need to be protected through the

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exercise of central banking functions affecting the cost and availability of credit. These are still powerful instruments in the promotion of high level economic stability. They must operate, however, in close conjunction with appropriate fiscal, debt management, and other governmental policies. The Committee for Economic Development has submitted to you a most thoughtful document addressed directly to this problem. It deserves careful consideration.

When I joined the Board of Governors in the spring of 1948, the economy was still undergoing the trials of the postwar inflation. Money and liquid assets resulting from war financing were in over-supply relative to available goods and services. This vastly expanded money supply was supplemented by an increasing volume of commercial credit and consumer credit. Total loans at all commercial banks increased by more than $16,000,000,000 between the end of 1945 and the end of 1948. There was full employment, possibly over full employment, scarcities prevailed in the markets, our people were becoming restive under the impact of continuous increases in the cost of living, and the operation of the wage-price spiral that is characteristic of mounting inflation was everywhere in evidence. Inflation is a form of intoxication in which some groups gain at the expense of the rest of the population, particularly people of fixed incomes. Frequently it accentuates selfish interests. Many in these groups think that their financial progress has been due solely to personal merit. They are blind to the fact that the great impersonal forces of inflation "greased the way." It was our unpopular task, together with the Treasury, to counteract these forces by monetary and fiscal measures under our respective or joint influences or control.

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Let me enumerate the measures that were adopted and comment briefly on each. By far the most powerful measure of restraint was the use of surplus Treasury funds to retire bank-held debt, particularly Federal Reserve held debt. The power of decision with respect to this measure lay wholly with the Treasury. I doubt whether the public in general appreciates how important this was and the credit that must be given Congress and the Administration for making it possible during that period. There is no antidote to inflation equal to the development of a budget surplus and the use of that surplus to retire debt at the central bank. It was endorsed and indeed recommended by the Federal Reserve System.

The policy of restraint was also fortified by the campaign undertaken by the American Bankers Association to encourage voluntary restraint in the extension of credit. I have repeatedly commended this action in both public and private statements. This cooperation on the part of the commercial bankers exemplifies the fact that we can all pull together in this country to achieve public ends when leadership has understanding and conviction.

Another restraining measure was the reimposition of Regulation W, establishing limits to the extension of instalment credit to consumers. It was reinstated and administered by the Board of Governors of the Federal Reserve System when Congress granted a temporary authority in the summer of 1948. During the period of the lapse of this authority, the total volume of this credit outstanding increased by two and a half billion dollars.

Another measure, and one of the more controversial, was the decision of the Board of Governors, after receiving temporary authority

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from Congress, to increase reserve requirements of all member banks by 2 per cent on demand deposits and 1-1/2 per cent on time deposits in the early autumn of 1948. The Treasury was informed of this decision and offered no objection.

During all of the period of strong inflationary pressures, there were related and highly controversial questions in regard to raising the cost of credit in the money markets. These involved, on the positive side, increases in discount rates made in 1946 and in 1948 by the Federal Reserve, the decisions by the Treasury in 1947 and 1948 to raise its rates on new issues of certificates, and the accompanying restrictive actions in the open market by the Federal Reserve authorities to increase the rates at which Treasury bills and certificates were traded in the market. They involved, on the negative side, supporting actions in the open market by the Federal Reserve authorities to maintain the 2-1/2 per cent rate on the long-term Treasury bonds, after permitting prices of these bonds to decline from high premiums they had reached.

I would like the committee, in judging this controversial subject, to be in possession of the facts. It has been said that the Open Market Committee of the Federal Reserve System, which is charged by Congress with responsibility in these matters, did not wish to continue to support the 2-1/2 per cent level on long-term Treasury bonds but was induced to continue this policy by pressure from the Treasury. This is not true. There were widely varying shades of judgment, not only throughout the country and in the Congress but within the Federal Reserve System on the wisest course of action to pursue. It was my view, stated at the time, that the System was obligated to maintain a market

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for government securities and to assure orderly conditions in that market, not primarily because of an implied commitment to wartime investors that their savings would be protected, nor to aid the Treasury in refunding maturing debt, but because of the widespread repercussions that would ensue throughout the economy if the vast holdings of the public debt were felt to be of unstable value.

In any case the decision taken and executed was the decision of the Open Market Committee. It represented their combined best judgment and I was convinced then as I am now, in retrospect, that they were right. They were concerned with the huge size of the Federal debt and with its pervasive influence throughout the financial structure. In view of the pervasive holdings of these securities, of the continued unsettlement that prevailed in the immediate circumstances of the post-war inflation, and of the fact that it had not yet been demonstrated that the great bulk of these securities were solidly held and that the floating supply had been absorbed, the adoption of a support level below par was a risk which the Committee was not prepared to underwrite.

Our most controversial action during this period was to raise the reserve requirements of member banks. This decision was related to, but by no means conditioned solely on, the reluctance of the Treasury to increase short-term rates on bills and certificates as early as was recommended by the Open Market Committee. I propose, therefore, to discuss these two situations together. I have stated above that rightly or wrongly it was the decision of the Open Market Committee on its own responsibility not to risk a lowering of the support level on long-term Treasury bonds.

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This decision, in itself, meant, of course, that funds paid out by the Reserve Banks in support of the long-term bond market added to the bank reserves available for credit expansion. It meant that the System must depend mainly, for whatever restraining influence could be exerted, either on increasing short-term rates or on increasing reserve requirements, or both. Either or both of these actions, restraining in themselves, were bound to be partly negatived to the extent that support of the long-term market resulted in furnishing reserves to the banks.

I think it is true that the reluctance of the Treasury to move as rapidly as the Open Market Committee recommended reinforced the disposition of the Board of Governors to make use of the power to raise reserve requirements. I doubt, however, whether the Board, under the circumstances then prevailing, would have refrained from the use of the power to raise reserve requirements even if the Treasury had agreed earlier to an increase in rates on short-term bills and certificates. It is difficult to be categorical about this point because it involves an interpretation of what official reactions would have been in a hypothetical situation.

There are some who felt that neither of these restraining moves would be effective because they would tend to be offset by the funds that would necessarily be put out in support of the long-term bond market. There are others, particularly among the member banks, who felt that the increase in short-term rates on bills and certificates would be effective but that the increase in reserve requirements would be completely offset by support purchases of bonds. We can now look back and give definite answers to some of these considerations that were highly conjectural at the time. It is a matter of record that the

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combination of these moves did actually exert a net restraint, that short-term money rates did firm, that loan expansion did stop, and that this situation prevailed until the Federal Reserve reversed its policies when the inflation abated.

I do not personally subscribe to the view held by some that this actual result reflected solely the increase in rates on short-term bills and certificates supported by the voluntary campaign of the American Bankers Association to restrict credit advances to essential productive credits. Personally I believe it also reflected the increase in reserve requirements, for one reason because this increase diminished the liquidity of the member banks. In retrospect, however, I would also say that my reluctance to resort to changes in reserve requirements as a method of dealing with an inflationary situation has been increased, not diminished, by the experience.

As everyone knows, that particular episode in our economic history, the hangover of postwar inflation, had come to an end by early 1949. We can now look back on the postwar period as a whole, consequently, with some perspective and some of the advantages of hindsight. It is my personal evaluation that this country, all things considered, came through that period of trial amazingly well, better than any other major country and with less social and economic distortion. The amount of inflation that actually occurred was less than there was reason to fear. By this I do not mean in any sense that no mistakes were made, or that the inflation and distortions we have suffered were unavoidable. Some inflation was inevitable, probably a considerable inflation, but it could undoubtedly have been held within narrower limits. Nevertheless, taking all the complexities and perplexities of the problem into consideration and also the necessary coordination of millions of individual

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wills I feel that it will be the verdict of history that our combination of democracy and free enterprise which we enjoy in this country gave a good account of itself during this period.

The monetary and credit measures which we adopted played no small part in that overall result. Let me cite two specific instances. One of our controversial actions was the decision to reimpose restrictions on the extension of instalment credit to consumers. When we reissued Regulation W in the autumn of 1948, the automobile industry was producing cars to the full extent permitted by the avilability of materials. This production was insufficient to meet the demand, however, with the result that so-called used cars commanded bonuses or premiums of as much as $500 or more in the "grey" market. It was part of our objective to defer some of this excess demand until materials became more freely available, that is to a period when the demand so deferred would sustain employment and buttress high level stability rather than augment the inflation and the wage-price spiral. I think the record shows that these expectations were on the whole borne out by the subsequent course of events. Of course, many factors played on the scene and subsequent events cannot be explained in terms of any one factor alone. Nevertheless, it remains true that the premium in the grey market for automobiles disappeared shortly after the reissuance of our regulation, that we were able in March of 1949 to relax the regulation, and that the automobile industry since that time has been a bulwark to employment during the transition period of inventory readjustment that has prevailed in 1949. With materials more freely available, the automobile industry has been able to set new high records in production and sales at a time when this production was most effective and most needed as a contribution to high level stability.

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My second illustration is from the field of mortgage financing in its relationship to home building activity. You are all aware of the spiralling costs of housing construction during the postwar period when what seemed like an almost unlimited demand for shelter impinged on the limited resources of the home building industry. You are also aware of the turndown in new housing starts that occurred in the autumn of 1948, the subsequent reduction in costs of new homes by 5 per cent to 10 per cent, and the renewed and sustained home building activity at new record levels that made itself felt during the past summer. Performance of the home building industry was a powerful factor in the maintenance of employment at high levels and without renewed inflation of costs during this past year. It is my personal judgment that monetary and credit factors played a significant role in these developments. The slowing up of new starts that made itself evident in the autumn and winter of 1948 was not unrelated to the decreased availability of credit at that time. The subsequent upsurge of activity during this summer was related in part to the effect on mortgage financing of our moves to ease credit during the spring of 1949, as well as to other actions by government to ease mortgage credits.

So much for the postwar inflationary situation from which we have now emerged, and the lessons that the experience has brought to us. I wish to turn now to the current position of the Federal Reserve System in its policy operations in the money markets.

That position was announced by the Open Market Committee on June 28. I will quote that announcement in full so that you all may be familiar with it:

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

I regard the announcement as a significant milestone because it reflected the joint judgment of the Treasury and of the Federal Open Market Committee that the postwar economic and financial situation had evolved to a point where open market operations could safely be permitted to play a more orthodox role in our policies. Such operations will, of course, continue to be affected by concern for the stability of the Federal debt and its repercussions upon the entire debt structure. The public debt is now a dominant part of the financial structure. No one informed on money market operations expects that open market policies will ignore this fact. The public debt, however, huge as it still is, has become sufficiently settled in the hands of stable holders to permit open market policy to be formulated on a more flexible basis than formerly. I regard June 28, 1949, as a most important date. It signified removal of the "strait jacket" in which monetary policy had been operating for nearly a decade, that is, since the beginning of the war.

The record that I have cited illustrates how we have been compelled to operate under utterly new conditions, unprecedented in modern times. What is their significance with respect to fiscal policies, to the relationships required between central banking authorities and fiscal

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authorities, and to the adequacy of traditional central banking powers? These questions are implicit in your inquiry. They demand the attention of thoughtful men everywhere. Unless we find the solution to these problems, our way of life, which is the way of the free world, will be in jeopardy. Having spent thirty-three years of my life as a private enterpriser, I want above all to avoid anything that either weakens our economy or puts the fiscal structure of our government in peril.

I approach these problems with a feeling of humility which I am sure you and many of the thoughtful men who have appeared before you share. It is this feeling that makes me so sympathetic to the study which you are conducting. Out of all of the discussions, we can, perhaps, achieve better understanding for our future guidance.

I would be less than frank if I left you with the impression that the new position which was initiated on June 28 had ended the need for coordination between debt management and money market policies. That need will, of course, continue. Many suggestions have been advanced in the answers to your questionnaire and in the testimony, suggesting formal procedures to assure a result that is in the long run public interest of our democracy. Personally I am skeptical of the value of formalized procedures in a situation of this kind. The truth is that our problems arise out of the different character of the very serious responsibilities that are borne by the Treasury on the one hand and the Federal Reserve System on the other. The record of history is clear, that the institutions charged with these responsibilities should be mutually independent of each other, for the subordination of either might lead to unfortunate results. This seems to me to imply that we must rely on the men who carry these

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respective responsibilities, on their good will, constructive vision, and spirit of cooperation. There is no danger that Treasury officials and Federal Reserve officials will lack personal contact. The nature of their duties insures and will continue to insure that they face these problems together. I took pains to point out in my answer to the questionnaire that a splendid degree of cooperation exists between the Treasury and the Federal Reserve.

Reserve Requirements

I propose now to clarify several specific, but not necessarily related, points where the record indicates confusion. First of these is the general problem of reserve requirements. Three relatively distinct types of problems that fall under this heading have been dealt with in the record, and I want to distinguish them and comment briefly on each.

(1) To what extent should the Federal Reserve authorities have the power to raise or lower reserve requirements and under what conditions should this instrument be used?

I am somewhat embarrassed in answering this question. The Congress has not seen fit in the past to delegate as broad authority with respect to this instrument as it has with respect to other instruments. Only six months ago Congress refused extension of the temporary authority that then existed. I am hopeful that as a result of this committee's interest the subject might be reviewed in broad perspective in a study under authority of Congress.

The Board has heretofore proposed that additional authority be granted so that it would be in a position to absorb additional reserves

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that might be made available in excess of the current needs of the economy. It has been recognized, and so stated, that reserve requirements are not a flexible instrument, in other words that frequent "jiggling" of the requirements should be avoided. The principal possible sources of additional reserve funds are (1) inflow of gold, (2) return of currency from circulation, and (3) Federal Reserve purchases of government securities.

It should be recognized that from a long-run standpoint basic adjustments in reserve requirements may be needed from time to time to allow for fundamental changes in the reserve structure. An inflow of gold of a billion dollars a year for five or ten years, together with a return flow of a moderate portion of the very large wartime increase of currency in circulation, could deplete the Federal Reserve Banks' open market portfolio below a reasonable operating level. It may also be essential at times for the Federal Reserve to purchase government bonds in maintaining orderly markets for these securities. An increase in reserve requirements might be needed in order to immobilize any large amount of reserves created in this manner.

As I stated in my answer to your questionnaire, the Federal Reserve should have authority broad enough to meet its responsibilities under different situations. We have learned from experience that if we should again be confronted with the problem of dealing with a dangerous expansion of bank credit, flexible open market and discount policies would be more effective instruments than increasing reserve requirements.

(2) <u>Is the existing system of reserve requirements for member banks effective and equitable?</u>

It is not necessary on this occasion for me to discuss at length existing methods of computing reserve requirements or why we believe a

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change in the methods is worthy of consideration. These matters are treated at some length in the answers which the Reserve Bank Presidents and I have submitted in answer to your questionnaire. The problem has been studied by various groups in the Federal Reserve System almost from the time of its organization and many proposals have been made for its solution.

We are convinced that the existing system should and can be greatly improved. We are not, however, committed to any particular proposal for change. Our staffs after years of study have worked out a method which is believed to be workable and equitable and may be the best that can be devised; it has already been presented informally to your committee.

The problem is a continuing one and inequities increase the longer it remains unsolved. It is my view that the problem should be studied by the appropriate committees of Congress, by banking groups, and others, as well as by the Federal Reserve. We will be prepared to present a definite recommendation at the appropriate time. If a National Monetary Commission is set up to study such questions, this would be one of the most important for it to consider.

(3) Should banks which are not members of the Federal Reserve System be required to maintain reserve requirements essentially the same as those required of member banks?

I have discussed at some length, in the answers submitted to your questions, the difficult problem of the limitations that the existence of nonmember banks place on the effectiveness of Federal Reserve actions. The Reserve Bank Presidents, who are intimately concerned with

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this problem, have also given you their views and so have many others. Differences in reserve requirements are one of the most important aspects of the effect of nonmember banks on the Federal Reserve System.

Reserve requirements for State banks which are not members of the Federal Reserve System vary from no statutory requirements whatever in the State of Illinois to requirements which, in percentages, are higher than those of member banks in a number of States. The essential difference between reserve requirements of member and nonmember banks, however, is not in percentages but in the composition of reserves. Even where the percentages of deposits required to be held as reserves are the same as, or higher than those for member banks, the nonmember bank still has an important advantage. Nonmember banks can meet their reserve requirements through holdings of vault cash and balances with correspondent banks, while member banks can count only their balances with the Federal Reserve as required reserves, and in addition must hold for working purposes a certain amount of vault cash and balances with correspondents. Member banks not in reserve cities, the so-called "country" banks, as a group have recently been maintaining holdings of vault cash and balances with other banks amounting to about 15 per cent of their gross demand deposits, in addition to balances with Federal Reserve Banks of 12 per cent against net demand deposits* and 5 per cent against time deposits.

*Net demand deposits are computed by deducting holdings of balances with correspondent banks and other cash items from gross demand deposits.

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The practice of holding balances with correspondents is characteristic of our system of unit banks. In any inquiry of needed monetary and banking legislation, consideration should be given to the possibility of evolving a system of reserve requirements that would make allowance for holdings of vault cash and balances with other banks in such a way as to minimize the effect of differences between member and nonmember banks. In my answer to your questionnaire, I have submitted some alternatives that might be considered to deal with this problem.

The Problem of a Divided Banking Structure

It has been intimated to the committee that we in the Federal Reserve are unduly alarmed by the problems presented by a divided banking structure since nonmember banks hold only 15 per cent of the total commercial bank deposits in the country. I want to point out that this is an overall figure and can be very misleading if not viewed on a geographical basis. The percentage of deposits varies between 4.5 per cent and 62 per cent from the lowest State to the highest. Correspondingly, the number of nonmember banks varies between 13 per cent and 85 per cent of all commercial banks. I need hardly point out to members of Congress the actual influence of these 7,000 nonmember banks representing 50 per cent of the banking constituency.

I emphasized strongly in my answer to your questionnaire my fundamental faith in the dual banking system. The great commercial expansion of this country was ventured under that system, and I would be the last to advocate any policy that supplants it. I also emphasized my great concern lest our dual banking system degenerate into a hopelessly divided banking structure, and I gave you what I consider some constructive

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alternatives to deal with it.

My primary aim is to consolidate the efforts of all forces concerned with our financial integrity to the greatest extent possible in order to have this country adequately armed, so far as our money mechanism can accomplish that, to prevent credit excesses in an upswing and to make Federal Reserve resources universally available to banks if they need help in stormy weather.

Our banking and credit economy consists of an incredibly complex structure of interlocked assets and liabilities. No bank can operate that can not convert its assets quickly into cash when depositors' use of funds results in a drain. In periods of financial strain there is no alternative but recourse to the Reserve System. This recourse to funds is always available to a member bank, with full assurance that the Federal Reserve will be in a position to meet its requirements, whatever they may be. I would like to see this recourse open also to nonmember banks who carry their reserves in the Federal Reserve Banks.

Objections raised against inclusion of all commercial banks in common protective action against inflationary excesses, do not of course arise when we talk of making the resources of the Reserve System available to all banks, regardless of membership, when the going gets rough. Whether it is more vital to restrain a boom or cushion a depression, in either case I have felt that the Reserve System should be in a position to use all its influence.

I think this should dispel the fog that has spread over the question of whether nonmember banks should be on an equal footing with

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member banks so far as reserve requirements are concerned. This is no new subject. It is as old as the Federal Reserve Act itself. Carter Glass was by no means alone in insisting that logic and simple fairness called for universal membership. I can imagine no more vigorous a champion of States' rights than he was. In the early and mid-thirties, Congress specifically provided that all insured banks, at least, should be members of the Reserve System. True, that decision was subsequently reversed. I mention this only to point out that there is nothing new or novel, there is no reaching for more and more power, when we bring to your attention the fact that nonmembership dilutes our ability to do our job -- and that is all we are concerned with. Carter Glass put it in far stronger terms when he said it makes for competition in laxity.

As a businessman I naturally dislike restrictive government authority and centralization of power. Some of the fog that surrounds the subject of the role of monetary policy arises because of the erroneous belief that the Federal Reserve System seeks to play a far greater part than was intended and that it is reaching for more power. I have tried to bring out in this discussion, on the contrary, that the dilemma we faced until this year could not be resolved adequately because, in our considered judgment, we could not use the open market powers -- undoubtedly very great -- which we already possessed without the likelihood of doing more economic harm than good.

The suggestion has recently been made to me by a very competent observer that one step forward might be taken through strengthening, in some appropriate and acceptable way, the relationships between the Reserve System and the Supervisors of State banks. I have not thought this out

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completely, and I mention it only because this is one of many constructive thoughts that we are exploring to harmonize the policies of all supervisory authorities in attaining our common objective. With your permission, I will introduce in the record a table which shows nonmembership by States, both as to deposits and numbers of banks. I would also like to introduce into the record excerpts from letters I have recently received from the Presidents of the Federal Reserve Banks of Chicago, Minneapolis, and Kansas City, commenting on this subject.

<u>Loans to Business</u>

I wish particularly at this point to clarify my response in the questionnaire that dealt with the authority of the Federal Reserve Banks to extend direct loans to industry. The statement has been misunderstood by some to indicate that I requested new authority to compete with the lending authority of the Reconstruction Finance Corporation. The fact is that the Federal Reserve Banks have long had authority under Section 13b of the Federal Reserve Act to make direct loans to industry. I was seeking in my answer to avoid conflict between the lending activities of the Federal Reserve Banks and those of the RFC. I specifically stated that if Congress did not wish to clarify the position I would prefer that our authority be repealed, and I wish to reemphasize that statement because the Federal Reserve System should not be looking for new worlds to conquer. Furthermore, the very justifiable question can be raised as to the role of a central banking authority in the field of direct lending.

It is part of my basic philosophy to be wary of the growth of

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government loan agencies that in their competition with private lending institutions may weaken these institutions to the point where they no longer play a dynamic role in our economy. At the same time, I recognize that situations have arisen, and may arise again, particularly in periods of emergency, when the availability of public financing is essential to the survival of the economy. I recognize also that in the area of small business there may be financial needs at all times that justify direct government attention and support. In my answer I tried to deal with both of these needs.

The basic problem arises out of the nature of the credit relationship between borrower and lender that is appropriate to a private enterprise economy. Though it may not so appear on the balance sheet, a business credit or business loan is not an isolated transaction that occurs once between a borrower and a lender and is terminated at the time of repayment. What a businessman needs, and what small businessmen need above all else, is a credit connection, a recurrent source of loans to which he can turn periodically to finance his seasonal needs, to tide him over emergencies, to advise him on plans for expansion and to help finance his growth. It is only very large concerns, with direct access to the central money markets, that can afford even to contemplate operations without an established recurrent source of financial accommodation. Most of our successful business enterprises, both large and small, are meticulous to cultivate and maintain customer relationships of long standing with commercial banks and other financial institutions, and vice versa.

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It is this long-term nature of business credit relationships that makes me fearful of government lending activities. The danger is that such financial relationships once established tend by their very nature to be maintained, and that a growing sector of our private business economy may come to depend for its credit advances on the public credit.

The suggestions I advanced in my answer represented my best thought on how we in the Federal Reserve System might meet these conflicting objectives constructively, if the Congress placed our authority on a more effective basis. The advantages to the economy, should Congress do so, are that we are very close to banks and are familiar with their operations, that we have adequate resources, and that we have an experienced personnel capable of giving considerate and constructive attention to unusual credit situations, particularly those that are closely associated with the legitimate financial needs of small business. It has been my observation that an important difficulty of small business, particularly of relatively new ventures, to secure financing is due to the fact that it has no established banking connection. It is my thought that if the Congress so directs, we in the Federal Reserve could play a constructive role by devoting ourselves to the establishment of sustained customer connections between small business units and their local banks. Clearly, this would be more welcome to small business than the prospect of continued dependence on public lending agencies.

Frequently, these connections are not automatically established in the marketplace, because a typical small business with no regular

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banking connection represents an unusual credit risk that does not conform to traditional standards. In such cases, the application may be turned down by the local bank because it has not the facilities to make the investigation essential to establish whether or not the risk is bankable. It is these situations where the Federal Reserve Banks could operate most effectively. With their trained personnel and facilities they are in a better position to investigate unusual credit situations than many small local banks. If they found such situations justified the extension of credit, they could make the loan, subject always to the safeguard that the local institution carried at least 10 per cent of the risk. They would always be prepared to sell back to the local bank any or all of their participation and we would consider their job well done when the borrower had acquired an established local banking connection and no longer repaired to the Federal Reserve Bank for assistance.

I am aware that direct loans of a customer nature to industrial business units lie outside the main credit activities of central banking institutions. I would not expect that the dollar volume of such loans at the Reserve Banks would ever be large. I would look on it as a pilot operation designed to establish regular customer relationships between local small businessmen and their local banks. I would judge its success not by the dollar volume of such loans outstanding at any one time but rather by the vitality that it gave to small business and to commercial banking.

If Congress were to request us to do a job like this, I can assure you that the Federal Reserve is organized to do it. As I

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indicated in my answer, I would want our existing authority liberalized and I would also want assurance that the law be amended so that we would not be in a competitive position with the Reconstruction Finance Corporation.

Organization of the System

It is of course vital that the Board of Governors and the Open Market Committee be composed of men of the highest caliber. I wholeheartedly agree with the view which has several times been expressed here that the best assurance that the System will continue to be able to arrive at informed and disinterested judgment on all questions of monetary policy is a strong Board of Governors. Only a Board made up of men of the highest competence can discharge the heavy responsibilities for monetary policy entrusted to it. That is why I feel so strongly that it was a great mistake for the Congress under the recent executive pay legislation to alter the relationship between the salaries of Board members and those of the top executive officers of the government, which was established when the Federal Reserve was founded. It is not the salary level as such so much as the implied disparagement and reduced status of the Board which will make it extremely difficult in the future to induce outstanding men to accept Board membership. The Board is also placed at a disadvantage in its relationship with other agencies.

The accusation has been made that the Board operates in an ivory tower, and that its decisions are surrounded by mystery. This is very far from the fact. I doubt whether there is any institution, public or private, anywhere in the world whose operations are so fully disclosed

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to the public as those of the Federal Reserve System. In the Federal Reserve Bulletin, in the annual reports to Congress - which include all policy actions of the Board and of the Open Market Committee together with the reasons therefor - in regularly issued reports of day-to-day operations, in frequent other publications both of the Board and of the Reserve Banks, and in public discussions, the actions and activities of the entire System are displayed as in an open book. We occupy no ivory tower. We live in a goldfish bowl.

The unique organization of the Federal Reserve enables the System to be extremely close to the pulse of the economy at all times. 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. 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

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operations. We try to weigh carefully their views and to distinguish broad national considerations from those reflecting narrower interests.

The art of central banking is far from simple, nor is it one of the exact sciences. That is why, as I have stated, I feel that your committee is doing such a useful educational job in bringing these monetary, credit and fiscal problems to the attention of the public and grappling with these problems. You can help greatly by such conclusions and recommendations as you may put in your report to chart the future course of monetary and credit policy and enable it to play its full part towards achieving our goal of steady economic progress.

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