98

CREDIT POLICIES

HEARINGS

BEFORE THE

JOINT COMMITTEE ON THE ECONOMIC REPORT

CONGRESS OF THE UNITED STATES

EIGHTIETH CONGRESS

SECOND SESSION

PURSUANT TO

SEC. 5 (A) OF PUBLIC LAW 304, 79TH CONGRESS

APRIL 13, 16, MAY 12, 13, 27, 1948

Printed for the use of the Joint Committee on the Economic Report

77099

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1948

98

JOINT COMMITTEE ON THE ECONOMIC REPORT

UNITED STATES SENATE

ROBERT A TAFT, Ohio, *Chairman*
JOSEPH H. BALL, Minnesota
RALPH E. FLANDERS, Vermont
ARTHUR V. WATKINS, Utah
JOSEPH C. O'MAHONEY, Wyoming
FRANCIS J. MYERS, Pennsylvania
JOHN J. SPARKMAN, Alabama

HOUSE OF REPRESENTATIVES

JESSE P. WOLCOTT, Michigan, *Vice Chairman*
GEORGE H. BENDER, Ohio
ROBERT F. RICH, Pennsylvania
CHRISTIAN A. HERTER, Massachusetts
EDWARD J. HART, New Jersey
WRIGHT PATMAN, Texas
WALTER B. HUBER, Ohio

CHARLES O. HARDY, *Staff Director*
FRED E. BERQUIST, *Assistant Staff Director*
JOHN W. LEHMAN, *Clerk*
WILLIAM H. MOORE, *Economist*

CONTENTS

CREDIT POLICIES

TUESDAY, APRIL 13, 1948

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The committee met at 10 a. m., pursuant to call, in the main caucus room, Senate Office Building, Senator Robert A. Taft (chairman), presiding.

Present: Senators Taft (chairman), Flanders, and Watkins; Representatives Rich, Herter, Patman, and Huber.

The CHAIRMAN. The committee will come to order.

This is the opening of hearings which the committee wishes to conduct to study the whole question of credit control, particularly the control of bank credit, the maintenance of the interest rate, and the maintenance of the price of Government bonds. We also intend to ask the witnesses something regarding the question of the availability of money for investment, and whether there is a sufficient supply of equity capital as opposed to bank credit.

Mr. Eccles, you are the first witness, and we will be glad to have you proceed.

STATEMENT OF MARRINER S. ECCLES ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, D. C.

Mr. ECCLES. Mr. Chairman and members of the committee, when I testified before this committee last November 25, I emphasized that I was speaking only for the Board of Governors of the Federal Reserve System. In presenting a further statement today covering the monetary and credit situation as it has developed in the intervening 4 months, I am again speaking only on behalf of the Board.

We, of course, do not participate in the Government's military or rearmament planning or in the formulation of programs for foreign relief. Accordingly, what the Board has authorized me to say with regard to the impact on our economy of military and relief expenditures is said solely from the standpoint of the implications so far as monetary and credit policies are concerned. We feel that in any effort to deal with monetary and credit problems under the situation now existing, we should clearly recognize the alternatives before us and the economic consequences of expanding military outlays superimposed upon the present large budgets for military purposes and for our program of world aid.

Never in our memories has the world been pervaded by greater fears, confusion, and discouragement, arising chiefly because of the disappointments of the past and the uncertainties of the future. The great hopes we had during the war for achieving a lasting peace in a prosperous world have been steadily diminished because a few ruthless and despotic men hold a sword of Damocles over the heads of free peoples throughout the world. It is difficult, if not impossible, to plan for a rational economic future either at home or abroad while that sword hangs over us.

We think that the prospect of removing the threat by peaceful means will be immeasurably enhanced the sooner we assert our moral and physical power to establish the foundations for peace before we are engulfed by the economic and social problems which grow more menacing the longer the establishment of a firm basis for permanent peace is delayed.

Monetary situation in November: When I last appeared before this committee, the country was faced with rapidly mounting inflationary pressures. The issue then was how to curb inflationary forces by striking directly at the basic cause, namely, an effective demand—composed of spending out of past savings, current income and new credit—in excess of the over-all supply of goods and services. As pointed out in the Board's statement to this committee, correction of inflation at its advanced stand had to be on a broad front; fiscal policy had to be our main reliance; and monetary and credit policy was supplementary to other fundamental actions. The Board felt then, as it feels now, that effective monetary and credit policy would require legislation to provide the Federal Reserve System with new powers that would serve as a partial substitute for those traditional powers which had become largely unusable in view of the huge public debt.

I would like to emphasize there that we say "new powers," and not "increased or greater powers." We speak of new powers, which are only a partial substitution for powers that have formerly been used, those which we call the traditional powers.

The essential monetary fact in the inflationary situation at that time was the amount of liquid purchasing power in the hands of the public, that is, currency, bank deposits and Government securities, aggregating in all about $254,000,000,000, or more than three times the amount held in 1940. This amount of cash or cash equivalent was in large part inherited from the financing of the enormous Federal deficits incurred in preparation for and prosecution of global war. Not only did we have this huge volume of cash or cash equivalent already available last November, but at that time, despite the anti-inflationary influence of the Government's large budgetary surplus, the amount of liquid funds was being rapidly increased as a result of bank credit expansion to finance businesses and individuals as well as state and local governments.

Because of the necessity for protecting the Government's fiscal and debt management position by maintaining an orderly and stable market for Government securities, the Federal Reserve System was then and still is unable to restrain effectively further monetary expansion. The commercial banking system held nearly $70,000,000,000 of Government securities, which were being converted into additional bank reserves through sales to Federal Reserve. In addition, the System was providing reserves to banks by purchasing Government securities sold by nonbank investors. That, of course, was in support of the Government bond market.

The CHAIRMAN. Will you spell out how that works, Mr. Eccles? That is, how banks are provided with reserves by the purchase of

Government securities held by nonbank investors? Will you spell it out so that it is clearer?

Mr. ECCLES. Yes.

If a corporation, or an individual, anyone other than banks, sells securities in the market, and the residual market is the Reserve System, they of course are paid for those securities in Federal Reserve funds. The recipient of the funds puts the money into the bank, and the bank therefore has excess reserves on one side and deposits on the other.

In other words, the Federal Reserve creates the money, that is, reserve money, whenever we purchase securities. When you purchase the securities from other than banks, the seller gets deposits, and the bank of course has excess reserves on the assets side of its ledger to offset the deposits it receives on the liabilities side.

The CHAIRMAN. That assumes that they do not reinvest in other securities.

Mr. ECCLES. Who?

The CHAIRMAN. The people who sell the bonds.

Mr. ECCLES. Well, if they do, then somebody else gets the money and that goes back into the banks in the same way. The only way that you can extinguish additional bank reserves, once created by the Reserve System, is for the Reserve System to sell an amount of Government securities to offset the amount which they purchased or to have the Government, through a budgetary surplus, retire Government securities which the Reserve System holds.

Senator FLANDERS. Is the result the same if the Treasury pays off securities?

Mr. ECCLES. Well, if the Treasury pays off securities out of its surplus funds, that is generally deflationary. Where the Federal Reserve buys securities, that is generally inflationary. It is exactly the opposite.

Senator FLANDERS. Is it deflationary or neutral if the Treasury receives funds from taxation and then pays off its securities? I do not see how that is deflationary. Is that not neutral?

Mr. ECCLES. No, it isn't neutral at all; because as the money goes out of the bank into the Treasury——

Senator FLANDERS. I am not talking about what is bank held, although we will come to that later. I was thinking of what is privately held.

Mr. ECCLES. But the Government doesn't pay off the privately held securities. What the Government does with its surplus funds is to retire the securities that the Federal Reserve owns, so that the money does not return to the banking system. If the Government took tax money that it receives and paid off securities held by taxpayers, then the same amount of money would be returned to the spending stream that was taken away in taxation.

Senator FLANDERS. That is neutral.

Mr. ECCLES. That is neutral.

Senator FLANDERS. What happens, however, if it takes tax money, reducing deposits thereby, and pays off bank-held securities?

Mr. ECCLES. Well, that would be neutral. Because the money that the bank held on deposit for the taxpayer goes to the Government, and the Government, of course, would return that money to the bank. What would happen is that the bank's deposit would be diminished when the tax was paid. An asset equal to that amount, of course, would be reacquired when the money is returned.

But what really happens as a practical matter when the tax money is drawn out of the banks? The banks are put under pressure to meet that withdrawal, and therefore they have to sell Government securities at the time the tax money is drawn out. If money is not returned to them by the Government as fast as it is being drawn out, then the banking system has to sell securities to meet the withdrawal of tax money. The Federal Reserve, of course, buys those securities from the banking system. Then the Government pays off securities held by the Federal Reserve.

The CHAIRMAN. Is not the net result, though, of the whole business more or less neutral? That is to say, you take a certain amount of taxes out of the banks. You thereby reduce their deposits. After the process is finished, they have replaced their bonds with cash. They have paid off their deposits.

Mr. ECCLES. That is not quite correct. The process is a reversal of war financing.

During the war period the banks bought Governments and created deposits. That is what is called deficit financing, done through the banking system. When there is a budgetary surplus and the funds are used to pay off the banks, then you have reversed the process. You extinguish the money created, and you likewise extinguish a like amount of the assets that the banks hold in the form of Government bonds. So that it is a reversal of deficit financing, which is inflationary. Therefore, it is equally as deflationary on the money system as it is inflationary during——

The CHAIRMAN. I do not see why it is deflationary at all. I could see why the drawing of deposits out is deflationary. But when you get all through, the bank has 100,000 less assets, we will say, and 100 less deposits.

Mr. ECCLES. That is deflationary. There is that much less money in the money system, just the same as budgetary financing is inflationary, because you create new money through the banking system when you finance the deficit, and you extinguish that money when you have a budgetary surplus.

The CHAIRMAN. Do they not actually have more money that you lend by reason of the fact that, although the assets are not turned into cash, you can turn them into cash?

Mr. ECCLES. But the point is that the banks are less willing to expand credit when they are deficient in their required reserve and find it necessary to sell or liquidate some of their earning assets. When the banks have a deficiency in their reserves, which they do as their deposits are drawn out in taxes, they must either collect loans or sell Governments or borrow from the Federal Reserve. Therefore, they are under pressure.

The CHAIRMAN. Now, they can sell Governments. In fact, the very hypothesis is that the Federal Government is paying the Governments off, so they replace their Governments with cash.

Mr. ECCLES. No; they do not replace them, because the Government uses its surplus cash to retire securities held by the Reserve System.

Representative HERTER. In one case the bank had both the bond and the cash; in the second case, it had only the cash. When it had both the bond and the cash, the bond becomes then an asset that they can discount at the bank, and again re-create credit. If you retire the bond, it becomes a deflationary operation.

Mr. ECCLES. But you see what happens: As the money is drawn out of the banks, in order to meet the withdrawal, the banks must sell something or collect a loan or borrow in order to meet the tax withdrawal.

The CHAIRMAN. Having done that, are they not just where they were when they began?

Mr. ECCLES. That is right. But when you do that, it is strongly deflationary. If you kept the process up long enough, instead of having, as you have today, 170 billions of cash and deposits, you would go back to the 66 billions we had before the war.

The CHAIRMAN. But as long as they have 70 billions of bonds, I do not see why it is deflationary. They turn it into cash, and they are exactly where they were before.

Mr. ECCLES. That is exactly why we proposed the special reserve before, and why we talk about reserve requirements; because of the ease with which the banks can meet current credit demands.

There is no problem at all of the banks meeting the withdrawal demands or the credit demands, because of the fact that they have this large amount of Government bonds that is readily convertible into reserves, upon which a multiple credit expansion can take place.

Senator FLANDERS. Mr. Eccles, as a project of adult education for the junior Senator from Vermont, I wish it were possible to put in balance-sheet form at the end of each transaction what happens in a bank statement when, in the process of deficit financing, banks acquire bonds, what happens when they let them go, how it affects reserves, how it affects loan capacity, and so on.

Now, my reason for wanting to see this in a single sheet that I can hold in my hand and look at the figures, instead of listening to dissertations, is this:

Out at the meeting of the American Economic Association in Chicago last December, I listened to dissertations. And I came out very much confused.

Just as an onlooker, not knowing all of the rules of the game, I judged at the time that the decision, perhaps on points, lay with those who felt that there was no automatic deflationary effect to the retirement of bank-held bonds; which completely reversed the automatic inflationary effect of acquirement by the banks of bonds in the process of deficit financing.

In other words, it was not completely the reverse.

And I wonder if it would not be possible for you to prepare and insert in the record at a later date these processes of acquiring and disacquiring Government bonds by the banks and its effect on the bank statement, on its ability to loan; its effect on reserves, and its ability to loan. I would rather see it in figures than in a mass of words.

Mr. ECCLES. I think that it possibly can be done.

Or course, to understand the process of creating money through the banking system, one first must understand the principles of accounting and likewise the principles of central banking. That becomes basic. And it really isn't simple. One can be very easily misled. It is a subject that requires study and concentration, and especially when you think in terms of 15,000 banks.

If you would think in terms of 1 bank with 15,000 branches, then the process becomes more easily understood. But it becomes extremely confused when you consider it from the standpoint of the State nonmember banks which carry reserves with Reserve city banks. And when you consider, in addition, in connection with the three types of member banks, it becomes quite confusing because of the different reserve requirements and the effects of different reserve requirements of member and nonmember banks.

If I may proceed with my statement, perhaps some clarification will come out of later discussion.

The CHAIRMAN. I would like to have the same thing Mr. Flanders does. But I think I understand the inflationary process, although it seems to me there is quite a difference of opinion in the reports I have read on this deflationary effect, the paying off of bonds in the hands of the banks.

I would like to see just what does happen when the taxes are drawn out and then when the bonds are sold or paid off. I think such a thing might be helpful.

Mr. ECCLES. Of course, how do you reverse the inflationary process? Certainly we know that financing of budgetary deficits through the banking system creates new deposits, just like any other form of credit creates deposits. If loans are being paid by one group of our citizens as fast as loans are being made by another group, there is no change in the total deposits.

But to the extent that all credit, including Government credit, is expanded by the banking system, you create new deposits. And just to the extent that credit is contracted, public as well as private credit, by the banking system, you are reversing the process and you are extinguishing deposits.

The CHAIRMAN. On the other hand, the bank has loaned a lot of money to the Government. The Government comes in and pays it off, and they take the money and loan it to somebody else. I don't see anything deflationary about that.

Mr. ECCLES. But they don't pay it to somebody else when the Government retires debt held by the Reserve banks. The money disappears. It never gets back.

The CHAIRMAN. But I am suggesting that, as to the mere fact that they have the additional money, and the Government pays off and turns around and lends to somebody else, there is not anything particularly deflationary about that.

Mr. ECCLES. What happens when the Government collects more money in taxes than it spends; that is, when it has a budgetary surplus? That money, that surplus money, actually, to the extent that it is used to pay off the Government bonds that the Federal Reserve System has acquired, is not returned to the spending stream, and it actually extinguishes an amount of deposits equal to the liquidation of that credit. The exact opposite would be the case if there was a budgetary deficit and the banks financed the deficit.

A budget surplus with retirement of Federal Reserve-held debt is a direct and complete reversal of deficit financing through the banks, and it extinguishes the same amount of money.

Representative HERTER. Following that same line of reasoning you mentioned a moment ago, the support of the bonds by the Federal Reserve; if the Federal Reserve has to support the bond market and has to go in and buy in order to hold the levels up, that becomes in itself an inflationary process, does it not?

Mr. ECCLES. That is correct. It makes it very easy for the banks, as long as they have the large volume of Government bonds which they acquired during their war financing operation, to get Federal funds or Reserve funds. They can get them with great ease. Therefore, it is difficult to put pressures upon the banks to hold down expansion of private bank credit.

Representative HERTER. Well, recently, when the bond market was dropping, did not the Federal Reserve have to put in a good deal to hold the bond market up?

Mr. ECCLES. The Federal Reserve dropped the bond market substantially in December, because we felt that there was no justification for supporting the market at the premium prices which had prevailed. In other words, we felt that there was too much of an inducement, both to the banks and to the nonbank investors who had market bonds to sell those bonds while they could not only get the return of their money, but could get a premium upon them, than would be the case if the premium disappeared.

And in many cases banks had bought Government bonds at a substantial premium. Then, when the Government bond market was permitted to drop, book value actually exceeded market value, because these banks had purchased Governments at considerably higher prices than the support level that we dropped to.

Now, that action deterred to some extent, and I think a very considerable extent, bank selling of Government bonds.

The CHAIRMAN. Will you proceed, then, Mr. Eccles?

Mr. ECCLES. If I may, to get this in the record—I believe I stopped at this point. In addition, the System was providing reserves to banks by purchasing Government securities sold by nonbank investors. Finally, bank reserves were being substantially augmented by a heavy inflow of gold.

In brief, the banks at that time were in a position to supply unlimited amounts of additional credit, and, in the face of strong demands for additional credit from all sources, further rapid monetary expansion was occurring, intensifying existing inflationary pressures. This situation was potentially explosive because production and employment were close to the maximum then possible.

In other words, to merely add to the supply of money when you were using your production and employment to practical capacity only forced up prices. And, of course, that is the difficulty in the various foreign countries today, where the amount of their bank deposits in currency so far exceeds the supply of goods, and where many of them are still operating on unbalanced budgets and creating more money, because the Government deficits that they are running are being financed by the banking system. And that is why you see the terrific inflationary situations that exist in other countries. It is the same process that proceeded here to a very limited extent. But it is exactly the same principle.

Changes since November: Last November we expected some abatement of inflationary pressures in the first quarter of this year. Such a situation developed. It was recognized that there would be a large volume of funds drawn from the banks by business and individuals in order to pay taxes, which would result in a large cash surplus available to reduce the public debt.

It was also recognized that the existing and contemplated program of monetary and credit policy would have some restrictive effect. The program—that is, this contemplated program, which was carried out—included the statement by the bank supervisory agencies urging the banks to be more restrictive, the lowering of Federal Reserve support levels for Government securities late in December, a slight rise in rediscount rates early in January, and some increase in reserve requirements for banks in New York and Chicago in February.

The banking fraternity, recognizing the dangers in rapidly expanding bank credit and the need for restraint, undertook a Nation-wide educational program to bring about restriction by voluntary means. Finally, there was a widespread belief that the supply of goods in many fields was gradually catching up with deferred demands and that favorable crop developments would combine to lessen inflationary pressures by the spring of this year. That is what you would call a psychological effect.

Monetary developments since November have accorded generally with expectations held at that time. Fiscal and monetary operations together effectively offset factors increasing bank reserves during the period; that is, during this 4 months' period that we had some inflationary factors. And here is what they were: the inflow of gold, the return of currency from circulation—which has amounted to about $1,200,000,000 from its peak in December, and which, of course, adds to deposits of banks and to excess reserves—and purchases by the Federal Reserve of Government securities from nonbank investors.

Representative RICH. May I ask a question right there? Was that paper?

Mr. ECCLES. Yes; that was paper currency. That is the currency in circulation, which decreased about $1,200,000,000 from its peak, in December.

Of course, it always goes up prior to the Christmas holiday season. There is always a seasonal drop in the volume of currency in the first quarter of the year, but the seasonal drop this year has been considerably more than normal.

Representative RICH. Was there any part of that, any great part of that, in coin?

Mr. ECCLES. No; that wouldn't amount to much. The coin in circulation is a very small factor. It is bills.

To continue with my statement, these inflationary factors include the inflow of gold, return of currency from circulation, and purchase by the Federal Reserve of Government securities from nonbank investors. These factors all added to the reserves of the bank. However, they were more than offset by the fiscal and monetary operations during that same quarter. Here is what they were.

During the 4-month period December through March the Federal Reserve purchased 8.6 billion dollars of Government securities—which will give you some idea of the size of our operations—largely bonds, and sold in the market 6.3 billion dollars of securities, chiefly bills and certificates. That was because we dropped the Government bond market, and there was for a time fear that the price of longer term securities would go lower, therefore, they were being sold and replaced to some extent with short securities.

The Government retired $3,900,000,000 of its securities held by the Federal Reserve. That was the budgetary surplus. The net result of these operations was to reduce the Federal Reserve holdings by $1,600,000,000, and thus to keep the bank reserve positions under pressure during this period.

Now, $1,600,000,000 for that period as a reduction in total Federal Reserve holdings during that period was a very large amount. In other words, if we bought $1,600,000,000 more securities from the banks than we sold, that would give the banks $1,600,000,000 of reserves, upon which you could expand $10,000,000,000 of credit. We contracted enough Federal Reserve funds in that 4-month period to support the $10,000,000,000 of bank credit. That is what $1,600,000,000 amounts to.

The combined effect on the money supply of Treasury and Federal Reserve operations, which were only made possible by the large budgetary surplus, was strongly anti-inflationary. The money supply was contracted by nearly $4,000,000,000. Commercial bank loan expansion was sharply curtailed, partly reflecting fiscal and monetary developments, and partly reflecting the effectiveness of warnings by banking supervisors and the success of the bankers' own program of voluntary restraint, and partly reflecting the usual seasonal slack in business loan demand during the first quarter. There was an expansion totaling only about $700,000,000 of bank credit during the entire quarter; which, of course, was a very great slackening compared with what was happening last fall when bank credit was expanding at the rate of about a billion and a half a month.

Concurrently with these developments, the world crop outlook has become more promising, and prices of farm products and foods have declined. In addition, productive activity generally has held close to maximum levels. These developments have exerted an anti-inflationary influence.

Prospective monetary and credit situation: Notwithstanding these salutary developments, it cannot be said that inflationary dangers have been removed. Farm prices, though lower than they were, still continue firm, even though at present levels they are much higher relatively than prices of most other commodities.

Current and backlog demands for many goods continue to be very strong. Prices of industrial products, wages, rents, transportation, and some other services, are still advancing. The money supply, though contracted by an estimated $4,000,000,000, remains excessive in relation to the total product. Public holdings of cash or cash equivalent available for spending are nearly as large as last fall—$250,000,000,000, compared with $254,000,000,000—and continue to be broadly distributed among holders.

The cash equivalent, of course, is the Government securities held outside of the banks. Commercial banks, though obliged to sell some securities to offset shrinking deposits during this last quarter period, still hold $66,000,000,000 of Government securities, which are readily convertible at the bank's discretion into reserves. Upon these reserves, a 6 to 1 expansion of bank credit and deposits can be built. To the extent that the monetary gold stock is increased and Government securities are sold to the Federal Reserve by nonbank investors, still more reserves would be created. These additional reserves could also support an inflationary 6 to 1 expansion of bank credit.

On the basis of the monetary situation alone, there would still be a dangerous inflationary potential, even if no further impetus were given to inflationary pressures by other forces. However, upward pressures are now in prospect as a result of several important new factors. One of these is the tax reduction bill. This bill will add about $5,000,000,000 to the purchasing power of the public and take away a like amount from Federal revenues in the next fiscal year.

The international financial obligations which we have now accepted are another factor likely to add many billions to Government expenditures in the future. The expanding program of military preparedness will further increase the budget burden for next year and future years by still more billions. Stemming from these developments, on top of existing inflationary conditions, is a rapidly changing public psychology with respect to the inflationary outlook.

Businesses and consumers will be more disposed to use existing liquid resources, and to expand their borrowings to finance current expenditures. The prospect is that the demand for new financing, aside from Government requirements, will exceed the supply of available savings. This would mean that many in need of financing will turn to the banks for credit. A growth in the total volume of bank credit and money under such a situation can only add to inflationary pressures. Moreover, these pressures would be aggravated if the demands of the defense and foreign-aid programs for goods which are already in short supply further reduce the quantities available to the public.

The Government's fiscal operations for the balance of the calendar year 1948—that is, the last three quarters—are likely to show a budgetary deficit, which would eliminate the only remaining important anti-inflationary influence. During the last three quarters of the year, it is estimated that the budgetary deficit may exceed $3,000,000,000. You will note, in parentheses, in the statement, this observation:

> In view of large tax receipts in the first quarter of 1949, however, there may be a small budgetary surplus for the 12-month period beginning with April 1 of this year.

The CHAIRMAN. This, of course, is highly conjectural on a lot of things.

Mr. ECCLES. Of course, you can't do other than make your estimates based on the known factors. It is, we admit, difficult to see very far into the future under these conditions. But we feel that the conditions are not likely to be more favorable than we anticipate. They could be less favorable. I think that the statement here is a conservative one, and does not undertake to exaggerate the possibilities.

Representative RICH. Is not the great question just what Congress is going to do between now and the end of the fiscal year in making commitments?

Mr. ECCLES. That, of course, is the basic question insofar as the budget picture is concerned.

Representative RICH. And you have already figured now that with the commitments that have already been made and passed into law, you are going to be three billions in the red.

Mr. ECCLES. Well, that is with some military expansion.

Representative RICH. You have given credit for some?

Mr. ECCLES. That is right.

Representative RICH. But you do not know what the ultimate amount is going to be. I guess nobody does.

Mr. ECCLES. That is right. We have the estimate for the next fiscal year, the 1949 fiscal year, of revenues, based on full production at approximately these price levels, and the tax revenues on that basis, together with the estimated expenditures.

The CHAIRMAN. Mr. Eccles, the first 9 months of this fiscal year there was a budget surplus of up to $8,000,000,000.

Mr. ECCLES. Or thereabouts.

The CHAIRMAN. Somewhere near eight. Now, of that eight billion dollars or so, practically all but $1,000,000,000 came in the first quarter of the year. Is that not correct?

Mr. ECCLES. I think most of it certainly did. There may have been more than a billion in the other quarters.

The CHAIRMAN. And in your estimate here, about a deficit of $3,000-000,000, you are taking the 9 months beginning the first of April, to the end of the year, and leaving out the first quarter, which was the lucrative quarter?

Mr. ECCLES. But, you see, the inflationary impact comes during the next 9 months. And that is a period in which the banks will be under no pressure whatever, but it will be a period when the Government may actually have to give reserves to the banking system. So the point that I will make here is to show what we have ahead of us for the next 9 months.

Now, it is true that the following 3 months, in the first of the year, will be likely mildly deflationary, if you get the budget surplus during that period that is contemplated.

But in the interim period, the next 9 months, during the period when we need some restraint, we will not have any. That is the point that I am making, because I am going to argue why we should get some more credit controls here in the picture, and that is the immediate problem.

The CHAIRMAN. I just wanted to make it clear that when you are talking about a deficit, you are talking about the 9 months which may produce a deficit even this year, and which consisted this year of a surplus of eight billion.

Mr. ECCLES. Yes; but I also pointed out what would happen for the year.

The CHAIRMAN. I did not question the accuracy, Mr. Eccles. I merely wanted to be sure that the newspapers understood what the basis of it was.

Mr. ECCLES. That is why we we put in parentheses here that for the year as a whole there would likely be a small budgetary surplus. It was to emphasize the 9 months that we were speaking about, where there would be the deficit. During that period, you will not have the anti-inflationary effect of a budgetary surplus.

The CHAIRMAN. Can you give us for the whole year your estimate of receipts? You said you had those estimated. I would just be interested to know what they were. Is that from April 1 to April 1, or the fiscal year?

Mr. ECCLES. The fiscal year.

The CHAIRMAN. The next fiscal year?

Mr. ECCLES. Yes. These are cash budget receipts; 42½.

The CHAIRMAN. Forty-two and a half after the tax reduction?

Mr. ECCLES. Yes.

The CHAIRMAN. Now, in all of these estimates, you, of course, have not taken account of $3,000,000,000 of cash surplus, of money which is taken into the trust funds of the Government and not paid out; so that from an inflationary-deflationary standpoint, you have got to add $3,000,000,000 to any surplus you have, or deduct that from any deficit that you are talking about.

Mr. ECCLES. Well, we estimate, however, as I will show in this statement, that we recognize what that is. The effect of that is covered.

The CHAIRMAN. In other words, the Government's cash position is about $3,000,000,000 better than the budget position.

Mr. ECCLES. No, we estimate that it will take those receipts, plus the receipts from the sale of savings bonds, to pay off the redemption of savings bonds and to likewise pay for the redemption of other securities held by holders that will not accept refunding. I refer to maturing marketable Government securities. On these, as they mature and refunding issues are offered, there is always a substantial amount that has to be paid in cash.

The CHAIRMAN. I understand. That is what you do with it. But that does not change the Government cash position. If you wish to take the Government's cash budget as against its book budget, you still have to add about $3,000,000,000 for the cash budget; do you not?

Mr. ECCLES. But you see, we take into account the receipts from social-security taxes, and that is largely where the cash surplus comes from. It will take that cash, plus the estimated cash they get from the sale of savings bonds, to pay off the savings bonds that are being redeemed and other securities that fall due that will not be refunded. Therefore, those funds are not available for other expenditures, as I will bring out here.

Now, here it is: It is also estimated that combined sales of savings bonds and other public debt receipts will approximately cover voluntary redemptions of public debt by holders of maturing issues. Well, that is just what I said. That is what our statement means.

The current deficit will need to be financed by drawing on Treasury deposits which have been built up by tax receipts during recent weeks, or by borrowing in the market. Under these circumstances there can be no net retirement of Government securities held by the Federal Reserve System; that is, during this 9-month period. To the extent that the Treasury may need to borrow new money, it probably will have to be obtained largely from the banking system.

Representative HERTER. Is there not a drive being started very shortly in that connection?

Mr. ECCLES. It is already under way. But we do not estimate that that drive is going to bring in more than enough revenue to offset the redemptions.

Representative PATMAN. I notice an effort is being made to reduce the interest on postal savings from 2 to 1 percent. That will not be helpful in your savings drive; will it, Mr. Eccles?

Mr. ECCLES. Well, I do not think that the savings drive is for postal savings. The savings drive, of course, is largely for the sale of E bonds, which yield 2.9; and the postal savings mechanism, I think, is not a comparable or a competitive savings operation with the sale of Government bonds.

The bankers, of course, feel that the Government pays 2 percent, which is what they paid when savings money was worth 4; that is, when the banks used to pay 4 on savings money. The Government still pays 2. Now, the banking system pays anywhere from 1 to 1½.

Very few banks can pay 2 for savings funds. The banks feel, therefore, that the Government is in competition, and paying for savings funds more than the banks can afford to pay; and that the Government should reduce the rate that it pays on savings payable on demand.

Postal savings are really demand money.

Representative PATMAN. I understand the arguments for it. But the fact remains that if you put your money into postal savings, it has the same effect as putting it in bonds; does it not?

Mr. ECCLES. Oh, sure. The Government puts the postal savings in bonds.

Representative PATMAN. Well, why discourage the people about that? A lot of people will put their money in postal savings that will not put it in banks, as evidenced by the fact that postal savings have increased up to about $3,000,000,000; have they not?

Mr. ECCLES. I don't know what the postal savings amount to.

Representative PATMAN. I think it is proabbly near three. That being true, if you reduced the interest rate to 1 percent, you will probably encourage a lot of people to take that money out and put it in a spending stream, which would be inflationary.

Mr. ECCLES. It is just a question of the competition of Government with private interests. That is what the issue is.

Representative PATMAN. But that has nothing to do with the savings, the way I view it. Of course, that is a good argument for the banks.

Mr. ECCLES. Of course, if the Government wants more savings, they could pay 3 percent on postal savings.

Representative PATMAN. I am not talking about increasing them, of course.

Mr. ECCLES. I think it would have very little effect. I think that you would find that people put money in postal savings, not because of the 2 percent interest. I think, for example, that there are a great many foreigners who have put their money with the Government, because they just feel that is the safe place to put it. And I think it is the principal they are interested in more than the return.

I don't believe that the rate would really be as effective in changing the amount of savings as a lot of people think. I don't believe the banks would get much of that money, even if the rate were less. I think they might get a little, but I do not believe it would affect it. Because certainly 2 percent for savings that can be drawn out on demand is a very high rate under present conditions, and you would think that postal savings would have grown far beyond anything that they have.

Representative PATMAN. But the Federal Reserve Board made the conditions, did it not? Did not the Federal Reserve Board fix the rate of interest that the banks can pay on time deposits?

Mr. ECCLES. All we do is to fix the maximum.

Representative PATMAN. And you fixed it low, did you not?

Mr. ECCLES. No.

Representative PATMAN. How low is it?

Mr. ECCLES. Two and a half.

Representative PATMAN. Two and a half percent.

Mr. ECCLES. But nobody is paying it. The rate that the Federal Reserve has fixed is possibly higher than any bank in this country pays.

Now, one of the reasons that we did not put it lower—I think we would have put it down to 2 percent some time ago—was because the Federal Deposit Insurance, which had the fixing of the rate on the nonmember banks, would not go below 2½ percent, and therefore, because of that situation, the Federal Reserve felt they were in no position to reduce the rate below two and a half.

I think it is an academic rate. It is entirely meaningless in relationship to the rate that could safely be paid.

Representative RICH. You stated that the banks, for savings, were unable to pay more than one or one and a half percent?

Mr. ECCLES. That is right; the commercial banks.

Representative RICH. The commercial banks?

Mr. ECCLES. That is right.

Representative RICH. If the Government pays 2 percent, how can they afford to pay 2 percent, if the banks are unable to pay more than 1½ percent?

Mr. ECCLES. The banks pay taxes and have a lot of expense to absorb, and the Government does not.

Representative RICH. The Government has no expense?

Mr. ECCLES. Not in postal savings. The postal savings money is immediately invested in Governments.

Representative RICH. The Government pays the clerk for looking after that.

Mr. ECCLES. Well, it is paid by the Post Office.

Representative RICH. And the Post Office is $400,000,000 in debt. So the Government is paying for that, and they are going in the red.

Mr. ECCLES. Well, but the Government is paying a lot of money too for war bond drives, in order to sell money to the public.

Representative RICH. I still contend that the Government has expense in handling the postal savings.

Mr. ECCLES. I suppose they do. I suppose they have some expense, of course. But the fact that it is done through the Post Office is important. They don't have the rent to pay. They don't have the same expenses that the banks have to pay.

Representative RICH. I think they do. I think they have the same expense. In fact, I think the Federal Government has a whole lot more expense than the banks when it comes right down to it.

Mr. ECCLES. Yes, but not for operating the postal savings system,

Representative RICH. Well, that is the Government's way of keeping books, and they have been used to that, and the public pays the bill.

Mr. ECCLES. All I am saying is the no bank can pay 2 percent, certainly the way the money market has been over a long period of years, for savings funds. Because when they get 1 percent on Treasury bills, and they get one and an eighth, on Treasury certificates, the highest rate they get is the 2 percent on the Treasury eligible bonds. There are a few prewar bonds that were issued at 2½ percent, but they are selling at such premium that the return is possibly around 2 percent for very long-term bonds. And for commercial paper, the rate is 1¾.

True, there are some loans and investments that banks can get that are above two, but I would say that the average rate, certainly of the commercial banks in the reserve cities would not average 2 percent on their entire portfolio.

Representative PATMAN. But that is on a basis of 6 to 1 expansion too, is it not, Mr. Eccles?

Mr. ECCLES. Yes, but why would they want to pay 2 percent for money in order to be loaned it at 2 percent? They have to carry a reserve against those deposits.

Representative PATMAN. They would loan it six times.

Mr. ECCLES. No, they don't. Not that bank. It is the banking system.

Representative PATMAN. I mean the banking system.

Mr. ECCLES. But the banking system isn't one bank.

Representative RICH. I quite agree with you that the banks cannot pay more than 1½ percent on their savings under present-day conditions, and, for the same reason, the Federal Government cannot afford to do it. Because it shows from the handling of it under the Post Office Department, that all branches of the Post Office Department except the first-class mail have gone into the red.

Mr. ECCLES. I think it is contended that the Government should pay less on postal savings. That is the point that Congressman Patman is making here.

Representative RICH. What do you think?

Mr. ECCLES. I think there is some merit in reducing that rate. I think that the 2 percent has been paid over a long period of years, and there has been a very great change in the interest rate on money over that period. But I think that is a little aside from our subject today.

The CHAIRMAN. All right, then. Will you proceed with your statement?

Mr. ECCLES. I said here that to the extent that the Treasury may need to borrow new money, it probably will have to be obtained largely from the banking system.

During the next few months, Treasury use of accumulated balances with the Federal Reserve banks will add to bank reserves.

Now, let me explain that.

Some of the tax money beyond what the Government has spent has been deposited with the Reserve banks and the balances of the Government with the Federal Reserve banks have been built up. Therefore it is unavailable as reserves to the private banks. If the Treasury was not going to need those balances, it would use that money to pay off its Government securities held by the Reserve banks.

But the Treasury is going to need all of those balances, and they will be drawn down. They are not very large; I think at this time they are a little over a billion dollars. They were large earlier, but the Treasury has been using the balances as they came into the Federal Reserve to pay off the securities held by the Reserve banks. That is why there was the reduction of securities held by the Reserve banks that I spoke of earlier. From this point on, the balances will no longer be used to retire Government debt held by the Reserve banks, but will be disbursed into the spending stream, and will become excess reserves to the banking system. That is the point I want to make here: that these balances will add to bank reserves as they are spent. The bank reserves will also continue to be augmented by the inflow of gold, and possibly by further Federal Reserve purchases of Government securities from holders wanting funds for other uses. These last two factors may operate for a long time in the future. As long as we have to support the Government market and nonbank investors find other markets for their funds, which, under inflationary conditions they do——

Representative HERTER. When you say you have to, is that not a matter of decision with you?

Mr. ECCLES. It is a matter of decision by the Government, too. It is a matter of decision by the Federal Reserve and also the Treasury. We feel, if we are going to have to manage the public debt, you have to manage the market, and the failure to support the Government market would make it, we feel, practically impossible to do the necessary refunding that the Treasury has to do currently.

Representative HERTER. May I ask you there: You speak of its being inflationary when you buy all of these long-term Government bonds in order to support the market.

Mr. ECCLES. That is right. That is the dilemma.

Representative HERTER. And you bought 4 or 5 billions of them. On the other hand, the market is falling off.

Mr. ECCLES. If you raise the interest rate, then you drop the market, and it raises all kinds of serious questions. Of course, that is quite a debate all in itself.

Representative HERTER. But that is a discretionary matter with you. There is nothing statutory as far as that is concerned.

Mr. ECCLES. That is right. It isn't statutory at all. I raised the question before that I wished Congress would indicate that, if they felt we should no longer support the Government market. I felt that Congress should take some responsibility for that.

Representative PATMAN. Suppose you should not support the market, what would happen to these banks, if the bonds were to go below par?

Mr. ECCLES. The difficulty is that you do not know the support price. That is one of the problems you are confronted with. And that raises the critical problems of refunding operations in connection with public debt. It has implications that are very far reaching. We have given lots of thought to the problem, and we have studied it from various angles.

The people in the Reserve System, not only the Board, but the Reserve bank people, as well as the Board people, are unanimous, I think, in feeling that, taking the matter on balance—with the public debt the size that it is, so much larger than the entire private debt, in fact equal to about 60 percent of all the debt—we must maintain stability of Government securities market and confidence in it. The public have taken quite a drubbing already on the decrease in the purchasing power of the dollar that they put in bonds, and now, to make them take a further decrease, by letting the bonds drop below par would be a very serious step.

I want to make another matter clear: We have never made the statement that we should support all Government securities at par. What we have said is that we should maintain the 2½ percent rate on the long-term bonds. That should be the basic long-term rate.

The short rate should be permitted to fluctuate to the extent that it can be useful. And if the short rate should go up, certainly the very short securities may drop below par. And they have. The Federal Reserve System has never taken the position that every issue of Government bonds should always be redeemable at par; we have taken the position that the 2½ percent rate should be maintained, and shorter term issues could fluctuate as the shorter term rate might fluctuate.

Representative RICH. Let me ask you this: The stability of bonds created by the purchase of them by the Federal Reserve is not any more likely to make for a stable and economic Government than it is if the Congress does not stop the spending because we will be just as bad off in the future, because there will come a time when you cannot stabilize the bonds if they increase the size of our national debt.

Mr. ECCLES. You can stabilize the bonds, but you do not stabilize the purchasing power of the dollar. A dollar could be worth far less than it now is, and the bond could still be supported at par.

Representative RICH. The point is that we are not making for a stable government as long as we keep on with the spending.

Mr. ECCLES. That is right; especially deficit spending.

The CHAIRMAN. Can we get along now?

Mr. ECCLES. I would like to finish this, if I can, without any interruption.

The CHAIRMAN. Fine.

Mr. ECCLES. As I said, these last two factor may operate for a long time in the future; that is, the gold imports adding to the reserves, and the purchase of Government securities from nonbank investors. If the international outlook does not improve, Government deficits may continue, and even increase substantially, and banks may be called upon to purchase additional Government securities. Under these conditions, the Federal Reserve would find it difficult, and perhaps impossible to sell Government securities in order to absorb the bank reserves without seriously unsettling the market for such securities.

Where you have a deficit, and if the banks are required to buy, then, of course, the Federal Reserve is more likely to have to support the market, in other words, to have to buy. Under those circumstances you certainly cannot sell in the market and thus absorb the reserves that gold imports create, or the reserves that are created when the Federal Reserve buys bonds from nonbank investors. That is the point that we make here, namely, that it is very difficult to absorb excess bank reserves in these conditions by reversing our action by selling in the market.

Prospects are, therefore, that in the future gold inflow and Federal Reserve purchases of securities in maintaining an orderly market for long-term Treasury bonds, will further increase bank reserves. Banks would thus be in a position to expand loans and investments for private purposes, and this would mean still more inflationary expansion of the money supply. To restrain such potential expansion, the Federal Reserve would have to take action to absorb an excessive volume of reserves. Two type of measures should be considered:

First, interest rates on short-term Treasury securities and discount rates—that is, the discount rates of the Reserve banks—should be permitted to rise to the extent possible without raising rates on long-term bonds; that is, without raising the long-term 2½ rate; and, second, to the extent that this action is not adequately restrictive, the Federal Reserve should have the power to increase Federal Reserve requirements substantially to cover at least any growth in the total supply of reserves.

The first of these measures which could be adopted by the Federal Reserve and the Treasury without new legislation would be designed to induce banks to purchase short-term Government securities, and to discourage the extension of credit to private borrowers. Policies during the past year have moved in that direction about as fast as is feasible without unduly upsetting the market. There are limits, however, to such a course. Short-term rates probably cannot be raised much more without unsettling the 2½ percent rate for long-term Treasury bonds.

When I say "cannot be raised much more," I am thinking in terms of an eighth of 1 percent, to a maximum, say, of one-quarter. If you made the certificate rate 1¼ that would be raising it an eighth. If you raised it a full quarter, ultimately that would be 1⅜. There may be, under certain conditions, a possibility of going as far as 1½ in a short-term rate, but I certainly can't foresee that now.

Such an action, of course, would tend to induce the banks, when they got reserves, to buy securities from the Federal Reserve; whereas at 1 percent for bills, and 1⅛ for certificates, there is a good deal of pressure on the banks to go out into the market and make loans at higher rates. That creates new money, whereas, if they bought the short-term Governments from us, it wouldn't do so.

Clearly, you can't let the short rate go up to a point where pressure on the long-term rates result, so you have to support the long-term market. The problem is one of maintaining a balance, depending upon the conditions. However, it is doubtful how much any rate that is feasible will deter banks from making loans to private borrowers or purchasing higher-rate securities. In other words, there is a question, even if you went up an eighth or a quarter, as to just what extent that might deter the credit extension. We think it would have some effect, but we can't say that it would be very anti-inflationary, or very restrictive.

Representative HUBER. At that point, Mr. Eccles—during consideration of the tax bill, it was often said that the legislation would provide an incentive for risk capital. Are not the banks bulging now with money? Would you feel that that statement was true?

Mr. ECCLES. You mean the money of their depositors?

Representative HUBER. Well, it would provide an incentive for risk capital.

Mr. ECCLES. What would?

Representative HUBER. The tax reduction bill.

Now, is there not a surplus of money throughout the banks of the nation?

Mr. ECCLES. Yes. I think Senator Taft said he wanted to discuss that a little later. If I can finish this, I would like to say something on that subject in relation to budgetary deficits.

Representative HUBER. I would like to hear you.

The CHAIRMAN. The lack of risk capital is more the unwillingness of people to put their money into that kind of thing. It has nothing to do with the amount of money. They have the money, apparently.

Mr. ECCLES. As to the need for additional powers, I have tried to build up the case here, to show what has happened in the last quarter. And now I point out what may well be the need for additional powers.

NEED FOR ADDITIONAL POWERS

Accordingly, the Board believes that the System should be given authority to increase the reserve requirements of all commercial banks. For the present, this authority should make it possible for the System to require all commercial banks to maintain primary reserves with the Federal Reserve System, amounting to 10 percent of the aggregate demand deposits, and 4 percent of the time deposits, in addition to present requirements. This would give to the Reserve System power to increase bank reserves in the aggregate by a maximum of about $12,000,000,000.

An authority of this amount would enable the System to absorb the reserves that are likely to arise from gold acquisitions, or from necessary System purchases of Government securities sold by non-bank investors over the next few years. In other words, it would enable the System to sterilize the gold imports and reserves created by our support of the Government bond market.

In case banks should persistently follow the practice of selling Government securities to the Federal Reserve in order to expand private credits, notwithstanding higher short-term interest rates and increased primary reserves, as indicated, then the system should be granted supplementary authority to impose a special reserve requirement along the lines proposed by the Board last November. This type of authority may be described as an optional reserve requirement, because it could be held at the option of the individual bank, in specified cash assets, or in short-term Government securities.

The maximum requirement under this plan could properly be limited to 25 percent of the aggregate demand deposits, and 10 percent of the time deposits. To be effective and equitable, it should apply to all commercial banks; that is, the nonmembers, as well as the members. A detailed description and analysis of the Board's special or optional reserve proposal—I say optional because that is a more accurate description of it than special—was submitted to the House Committee on Banking and Currency, and has been published in the Federal Reserve Bulletin.

The CHAIRMAN. I do not quite understand.

Does this 25 percent include the 10 percent?

Mr. ECCLES. No; that is entirely another item. It would have different use, different application.

The CHAIRMAN. You are proposing 10 percent plus 25 percent?

Mr. ECCLES. We are saying that the 10 percent would be the cash reserve requirement, in case the bank should persistently follow the practice of selling Government securities, and so forth, in order to do this, notwithstanding the raising of the short rate, and notwithstanding the increase in the primary reserve requirements.

The CHAIRMAN. Is not your total 10 percent higher than last fall? Last fall I thought you had the 25 percent.

Mr. ECCLES. Now we are suggesting deferring the 25 percent special reserve until we see if the 10 percent primary reserve is adequate.

The CHAIRMAN. So that when you came along with the 25 later, you could absorb, and would not necessarily have to put the whole 25 on top of the 10.

Mr. ECCLES. No; the 10 is strictly a cash reserve, largely for the purpose of sterilizing gold imports and reserves that we would create by the purchase of securities from nonbank investors. But if banks, in spite of that, continued to sell Governments to get reserves for the purpose of making credit expansion, we would need the optional reserve. You see, it depends upon inflationary developments, especially upon the budget picture. As I will bring out later, the possibility of needing the special reserve as an additional authority depends upon conditions, and all we are doing now is pointing out what would seem to be a maximum possibility in the field of monetary and credit policy, to deal with an emergency.

The CHAIRMAN. I was only trying to get clear as to what your proposal was. It is now 14, 20, and 26; and if you add 20 percent, it will be 24, 30, and 36. And then your suggestion is that in some events, you would add 25 percent on top of that?

Mr. ECCLES. Yes, but we would give the banks the option of holding the special reserve in cash or in Government securities.

The CHAIRMAN. That would hardly be in bonds, I take it.

Mr. ECCLES. It could all be in securities, that is, short-term securities, if they wanted to hold it. The whole thing would be in bills and certificates. As a matter of fact, of course, the 25 could include the 10. That is a question of action by the Congress. In other words, if you wanted to give authority to increase the reserve from the 10 to the 25, making it optional to put those reserves in short-term governments, that could be done. That would be a modification.

The CHAIRMAN. All right. Proceed.

Mr. ECCLES. To the extent that it may become necessary to rely upon the banks for any new Government financing operations, the optional reserve requirements would be an especially valuable instrument. And in the case of large-scale deficit financing, it would be essential. In such financing, it would be advisable to make available to banks only short-term securities. Application of the optional reserve requirement would have the effect of immobilizing these securities, so that they could not be used to obtain reserves to pyramid new bank assets upon them on a 6 to 1 ratio. In other words, securities issued in new Treasury financing through banks would be tied to the deposits created by their purchase.

If we had done that in the financing of the last war, we would have avoided a lot of the trouble with which we are now confronted. In other words, if the banks had been limited in their purchase of securities, to short-term securities, and then those securities, at least a portion of them had been required to be held against the deposts they had, you wouldn't have had this freedom which the banks now have to create a multiple credit expansion, leaving the central banking system unable to deal with the situation, so long as it is obliged to support the market. What we are trying to do now, when we propose that requirement, is to go back and to correct some of the mistakes that were made in the form of Government war financing.

Representative RICH. Under those conditions, would you not expect the banks to stabilize the market, then, instead of the Federal Reserve?

Mr. ECCLES. We can only stabilize it through the banks, we have no way of doing it except through the banking system. We have to operate through them.

Representative RICH. You would not expect them, as individuals, to go out and do what you are supposed to do, as the Federal Reserve, would you?

Mr. ECCLES. No. But we stablized the market by buying securities in the market. And we have no way of stopping the banks from selling the securities that they have, and thus creating reserves upon which they can expand $6 worth of credit. That is the point.

Representative RICH. If you had that power, you could do what the banks could.

Mr. ECCLES. We have always had more power than the banks. We have no power now to control the bank credit expansion, and that is the point I want to make.

The special reserve plan would assure a ready market for short-term Governments, and the Treasury would be helped in successfully carrying out both its refunding operations and its deficit financing. These are the important aspects of the proposal, if we get into substantial deficit financing. At the same time, the Federal Reserve would be enabled to exercise some restraint on the money market for private credit. This is the basic merit of the optional reserve plan.

The dominance of public debt in the present credit situation has rendered the system's traditional powers generally unusable for purposes of restraining further inflationary credit expansion. The Reserve Board is not seeking additional power beyond what it formerly possessed; it is merely pointing out that the system has little or no authority to deal with the credit situation as it currently exists, and seems likely to develop.

If the Congress wants the Federal Reserve System to perform the functions for which it was established, the System must have a substitute, or at least a partial substitute for those powers that have become unusable. The Board feels that it would be remiss if it failed to bring this matter to the attention of the Congress.

There is no simple way of holding in check bank credit expansion in excess of essential public and private needs. The problem should be met in a combination of ways—by general credit controls, and in particular areas by selective controls, such, for example, as the reimposition of consumer installment credit regulation, and the continuation of existing margin requirements on stock market credit.

OTHER ANTI-INFLATIONARY ACTIONS

The Congress is currently considering the continuance of easy mortgage credit for housing. Easy mortgage credit is one of the most inflationary factors in the domestic credit picture. At the very most, Government mortgage credit programs at this time should be limited to relatively low-cost housing, particularly for rental housing, and should be accompanied by some restriction on other less essential types of housing. The housing shortage cannot be overcome by increasing the competitive pressures on scarce supplies of materials and manpower. They are the limiting factors on the volume of construction. It is one thing to provide easy credit facilities to encourage special types of residential construction activity under a system of allocations and permits. It is quite another thing to provide such encouragement in a free market already characterized by heavy accumulated demands and by strategic shortages in supply that are likely to be intensified by the defense and world-aid programs.

In restraining inflationary pressures under present and prospective conditions, monetary and credit policies must be combined with fiscal and other governmental policies. The public should be given every possible assurance that the Government will protect the purchasing power of the dollar so that the public would be more willing to defer the satisfaction of wants, particularly for houses and durable goods.

Wherever possible, Government expenditures that will add to pressures on the labor and capital goods markets should be deferred, and State and local governments should be requested likewise to defer nonessential expenditures of this type. There should be early action to close loopholes in our tax laws, and to strengthen the tax collection machinery. If the stage is reached at which Government expenditures again threaten to create large budgetary deficits, then a reimposition of wartime levels of taxation and direct economic controls along the lines proposed by Mr. Baruch, for example, should be undertaken.

Now, you notice, I have said, "If the stage is reached at which Government expenditures again threaten to create large budgetary deficits, then a reimposition of wartime levels of taxation and direct economic controls along the lines proposed by Mr. Baruch, for example, should be undertaken.

If young men are to be drafted into the military forces, then a way should be found to keep men at work in essential industries, and thus prevent the serious inflationary effects brought about by strikes.

The situation now and in 1940: I want to bring out that this reversal of our program, which indicates a substantial expansion, looking to the future of our military, as well as a foreign aid program that we can't see the end of, is a much more difficult program to carry out than would be the case if the situation now was comparable with that of 1940.

The Board believes that any realistic appraisal of the economic outlook from the standpoint of monetary and credit policy must take account of the underlying facts of the international situation.

During the war, there was no doubt about the ultimate victory. the country looked forward confidently to an era of stability and peace following the hostilities. Nearly 3 years after the end of the fighting, however, we seem to be further away from these goals than ever. Our national debt still exceeds $250,000,000,000, or more than five times the prewar levels. Federal budgets have never fell under $37,000,000,000 a year, and we are confronted now with the prospects of an expanding debt and budgets. During the war, we expected the peace to bring an end to these enormous drains on our resources.

Today there is no end point in sight. Threatening as the inflationary potential was at the end of the war, it is worse today. When we embarked upon the defense program in 1940, we had a tremendous slack in the labor force with nearly 12 millions fewer employed than now. We had surpluses of most raw materials, of unused industrial capacity, of housing, of foodstuffs and of countless other things. The impact of our heavy armament expenditures was not inflationary so long as the total demand on our resources did not exceed our capacity. It rapidly became inflationary as civilian purchasing power created by the war expenditures, through deficit financing, began to exceed the available supplies of goods and services.

We held the excess purchasing power fairly well in check while the was was on. We have now seen the consequences of premature removal of the harness of wartime controls. Even the one remaining anti-inflationary force, that is, a large budgetary surplus used to reduce our money supply, is no longer in prospect.

Over-all policy alternatives: On the basis of present trends, we believe that the country, sooner or later, has to choose between three broad alternatives.

First, we can continue on the present course of providing essential foreign aid, and of carrying out a military program on a scale of as yet undetermined size and cost, while at the same time we have no effective checks on the free play of economic forces. That is the certain road, if followed long enough, to a ruinous inflation. Surely no one would seriously contend that we can go on adding more and more pressure in the boiler of inflation without an ultimate explosion. Those who view us with a hostile eye no doubt hope that we will wreck our economy on the shoals of inflation. It would be a cheap way to defeat us.

Secondly, the country could be subjected to a full harness of direct economic controls—for example, allocations, construction permits, rationing, price and wage controls, as well as taxation at higher levels.

Without such a harness, amounting to a regimentation of the economy in peacetime, there is no sure protection against inflationary dangers that may lie ahead. They cannot be successfully combatted by any single means, or on any single front. There is no power that the Board now possesses, or that Congress can give us in the monetary and credit field that would be adequately effective by itself—and I should add there, "under the conditions of large budgetary deficits."

Beyond that, we must ask ourselves whether the public would be willing in peacetime to submit to the sacrifices and rigid restraints of a wartime economy. If our preparedness program calls for a military draft upon our young men, should it not call also for control of the profits arising from that program?

We may well ask for how many years must we maintain enormous and probably expanding military expenditures—and I could add "and world aid." The question is: how long? to what end? and at what consequences to our economy? We do not have the inexhaustible supplies of manpower and resources to support indefinitely, with no end point in sight, programs of the magnitude which we now are shouldering or contemplating.

The CHAIRMAN. "Contemplating" might do. But why the "shouldering"? Your own figures show that you get 42½ billion from present taxes, and you are not going to spend that much.

What is the burden of shouldering, that you cannot go on shouldering if you have to? I would like to cut it down, but what threat is there contained in it?

Mr. ECCLES. I do not think you can do it indefinitely, sir. You have inflationary pressures, as we have pointed out, with what you are already doing, and you have plenty of inflationary dangers even with some budgetary surpluses. With practically no budgetary surpluses, inflationary dangers are very much greater than would otherwise be the case.

The CHAIRMAN. We are no better and no worse off. Maybe it is the exceptional condition, but we are no worse off from an inflationary standpoint than we were in November, when you were here before.

Mr. ECCLES. We do not think that you can go on indefinitely.

The CHAIRMAN. You cannot go on increasing, but when you say "those that you now have," I do not see why you cannot go on indefinitely.

Mr. ECCLES. I don't see how you can, without getting an inflationary development. I think you have got to have some budgetary surpluses in this situation.

Representative RICH. Mr. Eccles, you made this statement in your previous paragraph:

"If our preparedness program calls for a military draft upon our young men, should it not call also for control of the profits arising from that program?"

Then should we not have controls on everything? And then we would have just exactly what Russia has.

Mr. ECCLES. Well, what I am saying is that if you get into a budgetary deficit, if you get into an expanding Military Establishment, due to a world situation, then you certainly do not want an uncontrolled inflation here, which could well result. Therefore, the next thing to do is, as I indicated, have Baruch plan of such controls.

Certainly that would be most difficult in peacetime, and certainly, if we should develop what we call a preparedness program on a scale that would create such deficits—and some people talk of such a program—such controls would become necessary. A preparedness program of that sort means an armament race, and an indefinite expansion, if you are going to be prepared. Preparedness is a relative thing. To be prepared, you have got to be better prepared than the people you are preparing to deal with. That, I think, is one of the discouraging things in the picture today, so far as the American public is concerned.

Representative RICH. When a bill was set up for universal military training, and selective service, and those things were put into effect, then, according to your statement, we have to put regulation on everything.

Mr. ECCLES. I did not mean that by my statement. If that is the way it is interpreted, that is not the way it is meant.

Representative PATMAN. It refers to profits, does it not, Mr. Eccles?

Mr. ECCLES. Yes. Certainly if we are going to carry out a program here, of armament expenditure, and you are going to draft men—I don't know whether you are going to get universal military training or not, but I mean if you do that—certainly there will be substantial profits created or maintained, or that are likely, as a result of large Government expenditures. The question arises as to whether you wouldn't be justified in recapturing some of those profits, as a result of armaments expenditures, and thus improve the budget picture and lessen the inflationary pressures.

Now, that is something for the future. I am not talking about that for the present. I am merely saying that in this statement we are trying to review briefly the past. We are trying to consider the immediate present over the next 9 months. And then we are trying to look beyond the uncertain future as to what some of the problems indicated may well be.

The CHAIRMAN. Mr. Eccles, do you want to finish this morning?

Mr. ECCLES. If I could finish this statement, I would like to do that.

The CHAIRMAN. Then, after that, does the committee want Mr. Eccles to come back for questioning? And if so, when?

Mr. ECCLES. I am available at the pleasure of the committee, either this afternoon or tomorrow, or whenever the committee wants to interrogate me.

Representative PATMAN. He only lacks a page and a half, to finish.

The CHAIRMAN. Yes. But for me, tomorrow morning would be more favorable. However, the House is not in session today so I guess this afternoon would be better.

Mr. ECCLES. That would suit me fine.

The CHAIRMAN. Then when we recess, we will recess until 2:30.

Mr. ECCLES. Thank you.

The CHAIRMAN. One thing, Mr. Eccles, on the question of inflation: These things seem to be so difficult to predict. People are so likely to be wrong. I never have any great confidence about future things, until at least there is an indication of what is happening?

One thing that everybody seemed to agree on was that the price of meat was going up. I admitted it. But it does not seem to have gone up.

Senator FLANDERS. Mr. Chairman, may I make some remarks about that?

The CHAIRMAN. Certainly.

Senator FLANDERS. In the first place, I think that the proposed legislation and the discussion had a great deal to do with consumer resistence, which helped to keep the price down.

It did another thing. It filled up every freeze locker, both private and public in the hands of the packers and in the hands of the chain stores, full of meat. That is now coming out, and again helping to keep the price down. And maybe we will have it in the fall, but I think our little crusade worked out very nicely.

The CHAIRMAN. Oh, very well. But I was just talking about these predictions.

I was out West, and I find that today nearly half of the packing houses have been shut down by strike, and still the price has not gone up. And a great deal of meat is being held back on the farms, because they do not want to send it in when there is a strike, so when the strike is settled, you are likely to get a large amount of meat in addition.

I see no immediate prospect for the carrying out of these predictions on meat, which was the key food practically.

So I do not know whether these inflationary threats are quite justified or not.

Mr. ECCLES. You have to anticipate. If you don't, it is too late after you get it. And it seems to me that you have got to take into account the matter of what are the potentials. You have to be prepared to deal with those potentials if inflation really begins to develop. Because if you are not prepared, it develops, and it is too late to deal with them.

Of course, we have had, without any question, a very serious inflation already. We talk about inflation as something in the future. We already have got it. And the purchasing power of the money that our people have saved and put into bonds and put into fixed income-bearing securities, has already been almost cut in half in its purchasing power.

Therefore, we cannot afford, it seems to me, to jeopardize the possibility of a further devaluation in the purchasing power of our money.

We must be prepared to deal with it vigorously; and to do so, we must anticipate it.

The CHAIRMAN. I agree with you. I think there are likely to be some further increase. I am not claiming that there will not be. I just wonder if it is quite as direful as you seem to predict.

Mr. ECCLES. Well, I am not trying to throw any fear into this. I am merely pointing out what the real possibilities are today. And certainly if the world situation should improve, if we got a basis of peace, if our Government expenditures can be curtailed, if the world recovery is rapid, and we are relieved from a lot of the foreign aid, such as we are now undertaking, if our military expenditures, instead of expanding into the further billions can be held within the range where they are, then, of course, that could change the situation.

On the other hand, the world situation, we must admit, is ominous. And we have got to anticipate what may be the responsibilities of the Government, the burden of the budget, and the inflationary effects if conditions do not improve. We cannot go on year after year bearing these crushing costs without jeopardizing what we seek to save. If we were confident of the early establishment of peace, we could tolerate a tightly controlled economy. We believe that the time element is the very essence of this grave problem.

Our Nation sought neither territory nor reparations in either World War. We seek neither now. We ask only for the earliest possible establishment of the foundations for enduring peace. To that end, our third and best course may be to choose a combination of alternatives; that is to say, acceptance of such controls as may become necessary to prevent inflation at home, while abroad we lay at the earliest possible moment the foundations for peace. And by that I mean: by doing whatever is called for to assure an establishment of peace, rather than an indefinite program of increasing military expenditures for a preparedness program that may end in an armament race.

We simply cannot afford an indefinite armament race that calls for an expanding of Government expenditures, without, of course, either having inflation, or an imposition of all of the restraints that our people do not want and should not have. Rather, we must relieve our budget load, and in that way we get away from risking these Government controls, high levels of taxation, or inflation. Only in that way can we do it.

Representative RICH. Mr. Eccles, from what we were doing now, you would think we had lost the war. We are paying to everybody.

But you made a statement here a moment ago. You said "our foreign expenditures which we cannot see the end of."

Now, what do you mean by that? Have you something in your mind that these Members of Congress have not been told yet?

Mr. ECCLES. That is all I have to say on that, Mr. Congressman.

Representative RICH. Do you not think it is about time that we stopped this foreign spending?

Mr. ECCLES. I have nothing to say on that. I merely say that I do not see the end of them, and I do not know that you do, or anyone else.

Representative RICH. I thought from that statement that you probably knew something that has not been conveyed to us yet, as Members of Congress.

Mr. ECCLES. I said in the beginning of the statement that we had nothing to do whatever with either the preparations for war, or the foreign expenditures. I made that very clear in the beginning. And in what I am saying here, a lot of these remarks are aside.

This statement is the Board's statement.

Representative RICH. Do you not think we have already spent too much on foreign countries?

Mr. ECCLES. A discussion of that subject is not appropriate at this time.

Representative RICH. I am trying to keep a sound financial structure here in this country. That is what I thought we were going to discuss.

Mr. ECCLES. An answer to that question would not help you in establishing a sound financial structure.

Representative RICH. Surely it does. The more we spend, the more trouble you get into.

Mr. ECCLES. An answer to your question will hot help, in my opinion, to clarify the matters under discussion.

Surely an informed public would be ready to accept even burdensome controls and taxation if convinced they are essential to safeguard our economy against a ruinous inflation, and that there is an early endpoint in sight which will enable us to maintain our system and our institutions in a peaceful world.

To sum up the situation as the Board sees it, we are faced with the possibility that still further upward pressures will be added to the tremendous inflationary potential generated by war financing and intensified by subsequent developments. We should do everything possible within the existing authority of the Government to moderate and counteract these forces. Federal, State, and local governments should practice the strictest economy and defer all public works and similar expenditures that can be postponed until there is a surplus of manpower and materials instead of the shortages that now exist. Every effort should be made not onoy to preach, but to practice economy and savings at this time. The need still is urgent to spend less and save more, and to invest in Government savings bonds. Every assurance should be given that the purchasing power of these savings will be protected.

Representative RICH. I will say that that is a fine statement.

Mr. ECCLES. So far as the monetary and the credit field is concerned, we have tried to make clear that action on these fronts alone cannot guarantee stability. Nevertheless, we believe that the Reserve System should be armed with requisite powers, first, to increase basic reserve requirements of all commercial banks and, later on, if the situation requires it, to provide that all such banks hold an additional special or optional reserve. Both of these would be protective measures.

The first could be used to offset gold acquisitions and purchases of Government securities by the Federal Reserve, and thereby restrict the continued expansion of our already excessive money supply. The second would be essential in case banks embark upon an inflationary credit expansion through the sale of Government securities to the Federal Reserve, or to assist the Government in case of large-scale deficit financing.

We believe it is the part of prudence to recognize clearly that the underlying cause of continuing inflationary dangers arises from the disappointment of our great hopes for the early establishment of world peace. Surely we must summon all of our human and material resources needed to assure that peace. If necessary to protect our economy at home, so that we shall not lose by inflation what we seek most of all to save, we should be willing and prepared to reimpose in the future to whatever extent the situation demands a harness of controls, including higher levels of taxation. Nobody wants such regimentation, but in the hard choices before us, it is infinitely preferable to economic chaos and possible collapse of our system, to which all freemen look to deliverance from the evils of war and misery that feed on economic distress.

We are aware that the questions of policy designed to achieve the cardinal purpose of assuring an enduring world peace are outside the domain of those charged with responsibilities in the monetary and credit field, but we feel that such responsibilities have to be exercised in the light of the burdens which the economy must bear. The earliest attainable settlement of the issues that now stand in the way of lasting peace offers the best hope for the preservation of our institutions, and our freedoms. Meanwhile, they must not be jeopardized either by uncontrolled inflation or long-continued regimentation at home.

The CHAIRMAN. The specific recommendation for legislation, I take it, boils down at the moment to a 10-percent increase in reserves; maintaining the ratio, from 14–20–26 up to 24–30–36. Is that the same relationship between the different types of banks?

Mr. ECCLES. I would simplify the statement. We said 10 percent. I think if legislation was to be considered, we would make some slight modification, and make it a little simpler by saying: As to the non-reserve-city banks, which are 14, make that 25; as to the reserve city banks, which are 20, make that 30; and as to the central reserve city banks, which are 26, make that 35.

The CHAIRMAN. 25–30–35.

Mr. ECCLES. That is right. I think that would be a little fairer. The credit expansion is just as great, if not greater with the non-reserve-city banks, and they are, I think, even more liquid from the standpoint of short-term Governments and reserves than are the city or the larger banks.

The CHAIRMAN. Of course, the increase in reserves, the straight increase in reserves, is not a difficult legislative task. But I take it it involves an increase of 10 percent, or a new reserve of 10 percent on all banks, whether they are part of the Federal Reserve System or not.

Mr. ECCLES. Yes; that is correct.

The CHAIRMAN. And that does present, I concede, legislative problems.

Mr. ECCLES. It does. We would not advocate any increase whatever, unless it covered all banks. I think that to try to cover only member banks would be certainly a terrific discrimination. Even when we doubled reserve requirements on member banks, it was quite an imposition, and it makes it practically impossible to increase the membership of the System.

I think that if you increased reserve requirements of member banks only, membership would be too much of a penalty, and certainly further increases in reserves would likely drive a good many banks out of the System. And to the extent that banks are out of the System, your whole monetary control is weakened.

The CHAIRMAN. Is there any doubt about our power, our constitutional power, to do that, do you think?

Mr. ECCLES. You mean increasing the 10?

The CHAIRMAN. The reserve on non-member banks and State banks who are not members.

Mr. ECCLES. There is no question about it. The question of whether banks are engaged in interstate commerce has already been decided in the Wage-Hour Act. And the Board has administered regulations on consumer credit that covered all non-member banks.

The CHAIRMAN. But the question is that that might have been a war power.

Representative PATMAN. Maximum interest rates, too.

Mr. ECCLES. Well, no interest can be paid on demand deposits. We administer that only for all member banks.

The CHAIRMAN. The committee will recess until 2:30.

(Whereupon, at 12:30 p. m., a recess was taken to reconvene at 2:30 p. m., of the same day.)

AFTER RECESS

(The hearing resumed at 2:30 p. m.)

The CHAIRMAN. The committee will come to order.

STATEMENT OF MARRINER S. ECCLES, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ACCOMPANIED BY WOODLIEF THOMAS, DIRECTOR OF THE DIVISION OF RESEARCH AND STATISTICS; AND RALPH A. YOUNG, ASSOCIATE DIRECTOR OF THE DIVISION OF RESEARCH AND STATISTICS, FEDERAL RESERVE SYSTEM—Resumed

The CHAIRMAN. Mr. Eccles, I think I remember going over with you some tables showing the effect on bank reserves of different inflationary elements. Have you anything of that sort on the next 3 months or the next 9 months, or whatever period you choose? It seemed to me that I remember estimates of gold imports and things of that kind that might throw a little light on the subject.

Mr. ECCLES. I have not seen any tables, and I do not know whether the economists in our research department have anything on that. You do not mean charts, you mean tables?

The CHAIRMAN. I meant tables; yes, of what the effect on the bank reserves is going to be in terms of actual figures; what they are now and what they are likely to be. To interpret your statement with actual figures, I mean.

You are asking for a 10-percent increase in reserves which I say will take up the estimated increase in reserves during some period. I wanted to see why you estimate those and what the figures will show.

Mr. ECCLES. What we say here, Senator, is the potential which would be available from gold imports and would be available from the purchase of nonbank securities. We suggested that there were two things that might be done in order to deal with that situation. The first one was that the interest rates on short-term securities and the discount rates should be permitted to rise to the extent possible.

The CHAIRMAN. As far as you could and maintain 2½ percent long-term rate?

Mr. ECCLES. That is right; and that was the one thing. The other, of course, was that to the extent that this action is not adequately restrictive, that is, that it would not divert the reserves that the banks got into those short securities held by the Federal Reserve, then the Federal Reserve should have the power to increase reserve requirements substantially to cover at least any growth in the supply of such reserves.

Then we went on to say later that if we got this power up to the 10 percent, it would equal in the aggregate $12,000,000,000, and that should be sufficient under the present situation for several years. Now, we go on to say that if the budgetary situation should be such as to create substantial deficits, and we go on to say further that if, in spite of the rise in short rates or the increase in reserve requirements, that the banks continued an expansion of private credit on a dangerous basis, or an inflationary basis, then the other power should be added.

The CHAIRMAN. I understand that, but what I want to know is why 10 percent; why the $12,000,000,000; what is it that supports that figure that is necessary for the increase in reserves?

Mr. ECCLES. I suppose we could get along with a less amount and then request additional authority if it was needed. Congress could do that. The only thing is the very fact that the Board had that much power I think psychologically would be effective and desirable. I think the fact that the Board could increase the reserve requirements would tend to keep the banks in a much more liquid position than if they felt they had no further power; that they would be inclined to keep their governments and particularly their short-term governments to be able to meet an increase in the reserve requirements.

If, on the other hand, the authority was of a lesser amount than that, I think it would be much less effective as an anti-inflationary influence.

The CHAIRMAN. Breaking down these deposits, how do you get the $12,000,000,000 as between demand and time?

Mr. ECCLES. I think that we can supply the figures.

Mr. YOUNG. That would be about $10,000,000,000 against demand deposits and nearly $2,000,000,000 against time deposits, breaking that $12,000,000,000 down.

The CHAIRMAN. That is about $10,000,000,000 more than now or more than you can do if you increase requirements at central reserve city banks to the limit allowed.

Mr. YOUNG. Yes.

The CHAIRMAN. You could increase it some without any additional authority.

Mr. THOMAS. Reserves could be increased about $1,000,000,000 now.

The CHAIRMAN. I am wondering where the 12 comes from. It seems to be $8,000,000,000 on demand and 1.4 billion dollars on time, and that is 9.4 billion dollars, and what is the rest of it? Does that include only the Federal Reserve System or what?

Mr. THOMAS. It would be around $10,000,000,000 on demand, because you have to include the interbank deposits. The $82,000,-000,000 of demand excludes interbank deposits. We will insert a table which shows the break-down by class of bank, using deposit figures for a recent date.

Existing and requested potential increases in commercial bank required reserves (estimates as of Feb. 29, 1948)

[In billions of dollars]

Potential increase in required primary reserves under—	All banks	Member: Central reserve city	Member: Reserve city	Member: Country	Nonmember banks
Present authority of the system	1.0	1.0	None	None	None
Demand deposits	1.0	1.0	None	None	None
Time deposits	None	None	None	None	None
Additional requested authority	11.9	2.6	3.8	3.8	1.7
Demand deposits [1]	10.4	2.5	3.3	3.2	1.4
Time deposits [2]	1.5	.1	.5	9.6	.3

[1] Figured on the basis of 9 percent for central Reserve city banks, 10 percent for Reserve city and nonmember banks, and 11 percent for country member banks.
[2] 4 percent of time deposits for each class of bank.

The CHAIRMAN. How do you figure that? Do you have any estimates on the import of gold? What are they running since the first of the year?

Mr. THOMAS. It is $400,000,000 since the first of the year.

Mr. ECCLES. We figured from 1.5 to 2 billion dollars, and we figured not less than 1.5 billion dollars and not more than 2 billion dollars. That is about as near as the amount can be estimated.

The CHAIRMAN. For the year, per annum?

Mr. ECCLES. That is right, for the year. There may be further contractions of currency.

The CHAIRMAN. How far does that affect the reserves, is that dollar for dollar?

Mr. ECCLES. Dollar for dollar, and it also affects deposits dollar for dollar.

The CHAIRMAN. And the other element is what?

Mr. ECCLES. That is the purchase of nonbank holdings of Government securities by the Reserve banks. Supporting the market, buying securities from corporations and individuals selling on the market increases bank reserves and deposits dollar for dollar.

The CHAIRMAN. If you have just a break-even budget, what is the situation then?

Mr. ECCLES. That, of course, would mean that the Treasury would not have to offer any new securities to the banks. But depending upon the amount of demand for municipal financing and long-term corporate financing, what we find has happened is that insurance companies, savings banks, and various institutional investors have sold their Governments, substantial amounts of them, to make other investments that are more remunerative.

You see, during the war they had no outlet for the funds they accumulated. The insurance companies and savings banks, as well as many institutional investors, purchased billions of dollars of the marketable Government securities, which meant, of course, that the savings of the people in those institutions were already spent. They were spent for war. Those institutions are now selling off those bonds that were bought out of savings. They are being sold faster than other savers in the market will buy them. To hold the market the Federal Reserve has to buy them, and that creates reserves.

The factors that cause that sale and that determine the extent to which they will sell depend somewhat on inflationary developments. If there should be no inflationary developments, there would be much less likelihood, and possibly, I think, little likelihood of those market bonds held by nonbank investors being sold on balance.

The CHAIRMAN. Do you not have the same situation with nonbank investors exactly like banks? As long as you have large amounts of Government bonds out, and the Federal Reserve bank will buy them at par, whenever another good investment comes along they sell them to you and put the money into the new investment.

Mr. ECCLES. That is much less true of the banks, very much less true of the banks than it is of the other institutions.

The CHAIRMAN. They make loans, but I am talking about the insurance companies. Somebody comes along with 3 or 4 percent mortgage to build a new building, and since you are willing to buy the bond at par and they can get 3½ instead of 2½, they sell them to you. That raises the whole question that we are raising, the question that some people, that whether or not the policy of always maintaining Government bonds at par is not necessarily inflationary and whether as long as you maintain it you can in any way prevent the lending of money by banks and insurance companies or anybody else who has invested in Government bonds to any degree they want to invest.

Mr. ECCLES. Of course, we recognize the difficulty that that problem raises, and we have recognized it all along, that to hold a rate for an indefinite period on a Government security does raise the very question that you have mentioned here. But it is a question of alternatives. It is a dilemma that we are confronted with. We have recognized that and pointed it out to the committee last fall.

Now, we are not proposing to hold all Government securities necessarily at par. What we have said is that we maintain the long-term 2½ rate, letting the short-term rate fluctuate. Of course that depends upon the Treasury's willingness, I think, because we have tried to cooperate fully with the Treasury, and at no time have we tried to force a rate on to the Treasury that they are unwilling to accept. I do not think that it would be practical to do so. I think the central bank has certainly got to recognize the responsibility of the Treasury and to advise and work with Treasury officials in that regard; and I will say this, that in that connection the Treasury and the Federal Reserve have cooperated pretty fully in connection with the management of the public debt. But the short-term rate is the rate that should be permitted to fluctuate, depending upon the market demand or the market situation so far as it would fluctuate while you are maintaining a 2½ rate.

Now, it is not going to fluctuate so much as long as you have a peg on a 2½ long-term rate, as I indicated this morning.

The CHAIRMAN. My question goes to the 2½ long-term rate.

Mr. ECCLES. It has got to go to that point. That is the basic question.

The CHAIRMAN. How many of these 2½'s do the insurance companies hold altogether?

Mr. ECCLES. They hold a very large amount of them.

The CHAIRMAN. And necessarily to get more return as fast as 3½ or 4 percent mortgages come along, they are going to sell the Governments, because here is a bond you are bound to get par for, and you turn around and you can increase your interest.

Mr. ECCLES. The point is the Government itself has helped that more than the insurance companies. For instance, the title 6 mortgages for housing and what we call the GI guaranteed housing program has been a tremendous stimulation. In other words, the Government has competed somewhat against itself for this rate by its policy in connection with the ease with which it has made very long-term mortgage money available.

However, I will say that only comparatively recently was the 2½ rate reached. You see, the long-term yield last year was down to 2¼, with the 2½ bonds selling at a substantial premium. The short-term yield was permitted to rise last year from ⅞'s to 1⅛. We also raised the rediscount rate a little. The effect was to tend to bring down, or at least one of the effects was to bring down, the price of long-term Governments. In other words, to raise the rate to 2½. Rates on other bonds which were selling almost at a 2½ percent rate, gilt-edged industrial and municipal securities, went up to 3 percent.

Many of the municipals which are entirely tax-exempt and do attract the funds of wealthy people were selling at 1½ percent. Now, they are the same ones that are selling at around 2½. Now, the 4 percent mortgage, 20 or 25 year mortgages, which involve monthly payments and a lot of work and a lot of trouble, are no longer attractive. So the Government is now proposing that the Congress appropriate another $500,000,000 to provide a secondary market so that the Government itself can buy a guaranteed mortgage, that the Government, in effect, guarantees.

Now, that is competing with itself for the 2½ rate, and that certainly is a policy that is diametrically opposed to an anti-inflationary policy. I think that should be recognized.

The CHAIRMAN. On the other hand, it is quite possible that banks might get more money for mortgages for lending on housing if there were no FHA and that they might be more willing to sell their Governments.

Mr. ECCLES. I am not arguing against the FHA, but I am arguing against the Government appropriating money which cuts into the budget picture for the purpose of providing a secondary market. Now, the reason that it needs a secondary market, if it needs one, is because the insurance companies and others are not willing to sell 2½ percent Governments today as they were. There is very little sold on balance any more. That is the way this situation at the mement is at least. Although there was a lot sold last December and in January, of the long-term 2½'s, the effect of our dropping them to par and the fact that they have confidence that the market is going to be maintained, tended to make them hold on to long-terms. The whole long-term market is stabilized around that 2½ rate. Today, there is not as much housing mortgage money available at 4 percent as there was because the holders of Government bonds are no longer as willing to sell them to make mortgage loans.

The CHAIRMAN. If it is supposed to be a Government guarantee, they are a little shy of having too much of one type of security like that, I think. Many of the smaller banks are filled up to their limit, what they think is their limit, for that kind of paper.

Mr. ECCLES. They are not as readily marketable. A guaranteed FHA mortgage, title 6 mortgage, does not have the ready market today that it did have.

The CHAIRMAN. Do you think the Government can maintain Government bonds at par?

Mr. ECCLES. Yes; I think so. I do not think that that is going to be any problem. But it is inflationary certainly to the extent that you create reserves in the banking system unless we have an opportunity to sterilize the effect. There would be no problem at all if you could do that. You could maintain the long-term 2½ rate indefinitely.

The CHAIRMAN. Would you get concerned if the Federal Reserve banks got completely filled up with these Government bonds?

Mr. ECCLES. The question is what is being filled up? When?

The CHAIRMAN. You have got $20,000,000,000 now.

Mr. ECCLES. We have got over $20,000,000,000 now, that is everything, short and long, and the whole portfolio.

The CHAIRMAN. If it runs up to $60,000,000,000, suppose that happens?

Mr. ECCLES. The total volume of marketable long-term bonds held by nonbank investors is, I think, about $50,000,000,000. That is the marketable ones. You see, we have over $50,000,000,000 of the E, F, and G bonds. These savings bonds are not marketable but of course are cashable at par. The long-term marketable are not eligible to the banks, and they amount to something around $50,000,000,000.

The CHAIRMAN. And the banks hold how much?

Mr. ECCLES. The banks own $67,000,000,000 of the total Governments, but they are not the restricted type; they are another type.

The CHAIRMAN. Who has the rest? There are $50,000,000,000 E, F, and G and $50,000,000,000 2½'s outside and $67,000,000,000 to banks, and that leaves about $83,000,000,000.

Mr. ECCLES. You have got $13,000,000,000 of weekly bills that fall due every week, a billion a week.

The CHAIRMAN. Those are the banks?

Mr. ECCLAS. They are held by corporations, some of them, just in anticipation of taxes, and the Federal Reserve is a very large holder of bills, most of our portfolio of $20,000,000,000 is bills and certificates. You see there is something like twenty-odd-billion dollars of certificates, 1⅛ percent certificates. Then, of course, there are these securities that are held by the trust funds, too; the Government itself has a substantial amount of that debt held in the social security and other funds.

I have a table here which shows estimated holdings by investor classes as of March 24, 1948.

Estimated ownership of interest-bearing Federal securities,[1] Mar. 24, 1948[2]

[Par values in billions of dollars]

Type of security	Investor classes						
	Total all investors	Federal Reserve banks	Commercial banks	U.S. Government agencies and trust funds	Insurance companies	Mutual savings banks	All other investors
Marketable securities:							
1. Bills, certificates, and Treasury notes	45.7	15.0	16.5	0.1	1.1	0.6	12.4
2. Treasury bonds, due or callable:							
(a) Within 1 year	4.1	.1	2.7	(4)	.1	.1	1.1
(b) 1-5 years	46.4	2.0	34.0	.3	3.0	1.9	5.2
(c) After 5 years	65.0	3.5	11.4	5.0	18.8	9.1	17.2
3. Miscellaneous [3]	.2		(4)	(4)	(4)	(4)	.1
4. Total marketable	161.5	20.6	64.6	5.6	23.0	11.7	36.0
Nonmarketable securities:							
1. Savings bonds	52.9		1.2	(4)	.4	.3	51.0
2. Savings notes	5.1		.1	(4)	(4)		5.0
3. Depositary bonds	.3		.3				
4. Special issues	29.3			29.3			
5. Armed forces leave bonds	.7						.7
6. CCC demand obligations	(4)		(4)				
7. Treasury bonds, investment series	1.0		.3	.1	.3	.1	.2
8. Total nonmarketable	89.2		1.8	29.4	.8	.4	56.8
Total all securities	250.7	20.6	66.4	35.0	23.8	12.1	92.8

[1] Consists of all interest-bearing securities, issued or guaranteed by the U. S. Government.
[2] Preliminary.
[3] Federal Housing Administration debentures, postal savings and Panama Canal bonds.
[4] Less than $50,000,000.

The CHAIRMAN. How many bonds would the 25-percent special reserve immobilize?

Mr. THOMAS. About $16,000,000,000.

The CHAIRMAN. That is only 16 out of the 67.

Mr. THOMAS. That is short-term.

Mr. ECCLES. I think it is more than that. I think that we can insert a table on the figures. Last November we had all of those figured out as of the figures available at that time. It would need to be brought up to date, making use of the latest call-report figures; namely, those for December 31, 1947. I will also insert into the record a table showing the estimated distribution of bank holdings of Government securities, by call date and class of bank.

Potential requirement for holdings in short-term Government securities under the special or optional reserve plan

[Estimates as of Dec. 31, 1947, in billions of dollars]

	Class of bank				
	All banks	Member banks: Central Reserve, city	Member banks: Reserve, city	Member banks: Country	Nonmember banks
Maximum special reserve requirement	30.2	7.5	9.9	8.9	3.9
Less holdings of excess cash assets	9.7	2.7	3.2	2.9	.9
Maximum requirement for holdings in short-term Government securities	20.5	4.8	6.7	6.0	3.0

[1] Based on aggregate figures by classes of banks.

Estimated distribution of United States Government securities held by all commercial banks Mar. 24, 1948, by call date and by class of bank

[Book value, in billions of dollars]

	U. S. Government securities call class						
	Total	Within 1 year	1 to 5 years	5 to 10 years	10 to 15 years	15 to 20 years	Over 20 years
All commercial banks	67.0	20.7	34.5	6.7	2.2	2.9	---------
Member banks, total	55.9	16.9	29.0	5.9	1.9	2.2	---------
Central Reserve city:							
New York City	11.1	3.4	6.1	1.2	.3	.1	---------
Chicago	2.8	.8	1.2	.5	.2	.1	---------
Reserve city	19.5	6.2	9.1	2.1	.7	.6	---------
Country	22.5	6.5	11.8	2.1	.7	1.4	---------
Insured nonmember banks	9.9	3.4	4.9	.7	.3	.6	---------
Noninsured banks	1.2	.4	.6	.1	[1]	.1	---------

[1] Less than $50,000,000.

Mr. THOMAS. That would be about $30,000,000,000, and you would have about $10,000,000,000 of other assets.

Mr. ECCLES. That is more like it. That is $30,000,000,000 of short-term Government securities.

The CHAIRMAN. That $30,000,000,000 would be immobilized.

Mr. ECCLES. Yes; except that you permit them to use other assets in lieu of that. That is any assets that they have above 20 percent of the demand deposits, and the reason for that is, for instance, that a bank that is a member of the Federal Reserve System has its reserve requirements with the Reserve bank, and they have cash on hand, and they have items in process of collection that they call transit items, and they have balances with city banks.

Now, they may have as much as 30 percent reserve in all of those factors, and it would be unfair to impose the 25 percent on any bank, no matter what reserve they had. Therefore, you start with 20 percent as the basis, and any bank which is carrying reserves and cash of more than a 20 percent figure, it would apply that against the 25 percent special reserve. In other words, the special reserve is composed of short-term securities or other cash items, balances in other banks, which is above 20 percent.

Now, if you did not do that, then you would practically destroy the correspondent bank relationships. There are a lot of nonmember banks as well as member banks that would maintain substantial balances with the correspondent bank; and if those balances, plus cash on hand, plus excess reserves with the Federal Reserve, in the case of a member, are above 20 percent of demand deposits, they would be permitted to count that as part of the special reserve.

In other words, you have got to start on a base point of 20 percent. Now, some banks carry as high as 40 and 50 percent of demand deposits in interbank balances and cash and currency, in which case they would practically have no requirement under the 20 percent because they already are in that position. So now to explain the application of the 25 percent, if banks had nothing above the 25 percent, then to apply the 25 percent would immobilize $30,000,000,000 of short-term Governments; but taking the picture as it now is, there is about $10,000,000,000 of the cash items and balances such as I have mentioned above the 20 percent of demand deposits. So that that would mean if this were applied, it would only immobilize about $20,000,000,000 of short-term Governments.

The CHAIRMAN. In effect, if you exercise full power, they could not put in loans and investments of more than half of their deposits?

Mr. ECCLES. That is about right. And what is more, that fractional reserve of 6 to 1 is cut down to about 2½ or 3 to 1, and not more than 3, I would say closer to 2½. Therefore, you get away from that large multiple deposit expansion. So that even if banks then did sell Governments to the Reserve banks, the ability of the banking system to expand on the basis of the reserves thus obtained would be reduced.

In suggesting the use of the optional reserve power, as you well know, we have indicated here that it would be applied only in case the credit expansion and inflation is continuing, in spite of the use of the powers we might get under the increasing of reserve requirements also, if a substantial budgetary deficit is incurred, we would be unable to increase reserve requirements because either a substantial part of it or all of it would have to be financed by the banks. Deficit financing would mean that you actually wanted the banks to buy Government securities. Therefore you would not increase the cash reserve because that would force them to sell Government securities. Consequently, if you run into large budgetary deficit financing, this special reserve requirement seems to us essential, if you are going to do that financing on the basis of selling short-term Governments to the banks.

We feel that that is the way to do unavoidable bank financing of a Government deficit. We should not want again to see long-term Government securities sold to the banks and have the trouble that we have had in the past. By this special reserve requirement, you would immobilize the securities sold to the banks as you put them out. If you made the special requirement higher, that would be an inducement for the banks to buy more Governmnet securities. The special reserve would also be of great assistance in refunding maturing issues, because the banks then would not be inclined to sell the securities to make loans, in fact, they would probably be obliged to hold some securities as a part of the optional reserve.

The CHAIRMAN. I have one thing, Mr. ECCLES. I might have to go over to make a quorum, and Mr. Patman has some questions to ask.

Will you put in the record the figures that we referred to, that is, the figures showing the effect of this thing on the reserves, and also I think any other figures dealing with the total outstanding bonds and whether held by banks or private individuals, and so forth. There is a table here in the Treasury Bulletin of March 1948, but I think it would be desirable to have those figures in the record, whatever you think is material to the committee.

Mr. Eccles. We will put them in at the appropriate places.

I would like to say one thing, Senator, on this question of interest rates, because I think that I may have made a wrong impression in my remarks this morning. I come to that conclusion by reason of a report over the Dow-Jones ticker that I saw when I went back to the office. The report is that Eccles told the committee that the Reserve Board is considering raising interest rates on short-term securities and discount rates. That is, I think, a misinterpretation of my statement. What I certainly meant to say, and what I think my statement implied is that restrain such potential expansion—and that is the expansion that would be created or possibly could be created by the reserves that would come into the banks from the sources that have been enumerated—I said the Federal Reserve would have to take action to absorb any excessive volume of reserves. To restrain credit expansion, we would have to take some action. I said that there are two types of measures which should be adopted. It might have been better to have said two types of measures should be considered, but certainly to deal with a potentially inflationary situation, I am sure that it is the view of the Board that they should be adopted.

One of these measures is some further rise in short-term interest rates and in discount rates. The question of raising the interest rates is not a matter for the Board. The question of raising the interest rates on short-term Government securities is a matter for the Treasury, in consultation with the Open Market Committee, and in the light of the advice of the Open Market Committee.

Now, the question of raising the discount rates is a matter for Board approval. The Board does exercise control over the discount rates. We can approve of the rates submitted by the banks, or if we disapprove of them then they have to submit a rate that we will approve, so the practical effect is that we can control the discount rates.

I went on further to say that the first of these measures, namely, that of increasing the interest rate on short-term Government securities, was the matter that could be adopted or considered by the Federal Reserve and the Treasury without any new legislation. I also said that the action would be designed to induce banks to purchase short-term Government securities.

It would look from the reporting of this morning's testimony that the Reserve Board, if they decided you should raise short-term rates, would just proceed to raise them. As I stated, that is not a power which the Reserve Board has. The Treasury fixes the rates on the short-term securities that they are going to offer, and it is done in consultation with, and on the advice of, the Open Market Committee, of which all of the Board are members. In addition to the Board members, there are five Reserve bank presidents; so that the Board, of course, exercises a very considerable influence in advising on the question of interest rates.

But this reporting gives the impression that interest rates might be raised tomorrow because we favor doing it, and therefore we can do it. I just wanted to have the press get the correct picture here, namely, that although we favored, under the conditions which are indicated, dealing with them by raising the rates to the extent that we can do it without raising the rates on long-term bonds—and that may be a very limited amount—the raising of interest rates is not a power which is within the Board's prerogative.

Representative PATMAN. I understood you to say this morning that the 2½ percent interest rate on government securities should be maintained.

Mr. ECCLES. That is right.

Representative PATMAN. You mean to say the 2½ percent rate on Treasury bonds; in other words, the bonds will be taken at par, so that the rate will not go down or will not go up; is that right?

Mr. ECCLES. Well, if the 2½ percent rate on the longest term Government securities is maintained, that means that longest term bond would be supported at par.

Representative PATMAN. Do you expect to do that?

Mr. ECCLES. As a matter of fact, the support price is 100$^{2}/_{32}$. The reason for this support price is to enable the ultimate seller to get par, because when he sells his bond he cannot bring it right in to the Federal Reserve bank. He sells his bond to a security dealer, and by the time it gets to the Reserve System there is some cost in handling it. We wanted to be sure that the seller would get par. And to do that, we had to allow $^{2}/_{32}$ above par to allow for the commissions and costs in between.

Representative PATMAN. That is about what they are selling for now; is that not right?

Mr. ECCLES. I think they are slightly above that. They have fluctuated. They have been up eight-thirty-seconds above that.

Representative PATMAN. It is the intention of the Board to maintain at least that rate?

Mr. ECCLES. It is the announced purpose of the Open Market Committee, and also the announced purpose of the Treasury, to maintain that rate on the longest term Government bonds. There is no commitment, so far at least as the Open Market Committee is concerned, to maintain securities, all securities, at par.

Representative PATMAN. I did not mean to say all securities. I meant the 2½ percent securities.

Mr. ECCLES. That is the basis.

Representative PATMAN. You expect to keep them at par?

Mr. ECCLES. Yes, and that means, of course, as long as you do that, the shorter, medium-term securities will sell at a premium. Therefore, there is not much likelihood of any of the securities going below par except if the short-term rate is raised. If the short-term rate is permitted to rise as much as a quarter, then the securities falling due within a year or maybe 2 years might fall slightly below par.

Representative PATMAN. What is the average going interest rate now for the Government bonds, or the Government securities?

Mr. ECCLES. I think around 2 percent.

Representative PATMAN. Is it not a little higher than that?

Mr. ECCLES. It fluctuates, depending upon the amount of savings bonds out, because that is a fairly high rate. Of course, you have to take the average rate into account, in raising the short-term rate I should point out that a good portion of the increase in the short-term rate would go to the Federal Reserve, which in turn would return the lion's share to the Treasury as a tax.

Representative PATMAN. Because the Federal Reserve owns most of the securities?

Mr. ECCLES. It owns a large amount of bills and certificates.

Representative PATMAN. I notice they were increased from about three-eighths in January of 1947 to about ninety-seven one-hundredths.

Mr. ECCLES. That was done practically all at once, because that three-eights was an unreal and unnatural rate. That three-eights rate then prevailing represented the rate on securities owned by the Federal Reserve. There was no market for bills outside the Federal. What we felt should be done was to make the bills a market instrument; in other words, to put them on a real bid basis instead of the existing artificial basis. That is to say, we felt that we should let the market determine what a 1-year bill should pay or yield.

Representative PATMAN. I notice, though, Mr. Eccles, that the bankers' acceptances, 90-day bankers' acceptances, went up from about eighty-one one-hundredths in January of 1947 to about 1.08 in 1948. They went up considerably, too, along with those securities.

Mr. ECCLES. That is right, because the yield on bills and certificates went up.

Representative PATMAN. Which one pulled the other up?

Mr. ECCLES. The Governments pulled up the others, I think.

Representative PATMAN. Pulled up the private ones?

Mr. ECCLES. The Governments dominate the whole market.

Representative PATMAN. Now you take the corporations, the interest rate increased from 3.13 in January of 1947 to 3.53 in January of 1948.

Mr. ECCLES. That is right.

Representative PATMAN. You say the Governments pulled them up?

Mr. ECCLES. Entirely.

Representative PATMAN. Why should the Governments do that?

Mr. ECCLES. Because, with a marketable public debt of 165 billion dollars, Government securities dominate the market.

Representative PATMAN. It occurs to me that that is interfering with the market.

Mr. ECCLES. It was not interfering at all, because we were supporting an artifically low level. We were the ones that were pegging the short-term rate at seven-eighths for certificates and three-eighths for bills, and therefore there was no market for bills and practically all bills went to the Federal Reserve, and a great many of the certificates at seven-eighths went to the Federal Reserve.

Because we were paying such a low rate on the short-term paper, the 2½ percent Governments went up to a premium of nearly 107, and the municipals dropped down to a 1½ percent rate. It was all due to the fact that we're permitting the banking system to create money at a very, very rapid rate.

What the banks were doing was this: Because the rate was so low on the short-term paper, they were selling the short-term paper to the Federal Reserve and buying the longer-term paper in the market. And a 2-percent bond that was eligible for the banks to purchase went down as low as 1¼ percent yield, and to a very high premium.

In other words, we forced the rate down and prices up through pegging the market at seven-eighths on the short term.

Now, we have shifted the emphasis of our support program to the 2½ long-term rate. What we were doing—the fact that we were pegging seven-eighths short-term rate—drove the long-term rate down. Under these conditions, the refunding which was being done by private corporations and others was at lower and lower rates. We were getting into a position where it was increasingly difficult to ever let the short-term rate go up without also raising the long-term rate and causing insurance companies and many others to incur very large losses on the securities that they had purchased at the low rates.

We felt that there is some obligation, certainly, to investors as well as there is to borrowers; that there was no justification in maintaining that short rate and forcing the long rate up. You can make a pretty good case for holding the long-term rate at 2½, while the public debt is as large as it it. If it were not for the fact that the public debt is so large that there is a very big job of refunding to be done constantly, and that these securities are held so widely by banks and many other institutions, then certainly in a situation today where the total volume of savings in the country possibly does not equal the demand, you should let the savings rate really go up. We are tending to keep the savings rate down as long as we hold the 2½-percent rate, and we are criticized for it.

But as I said to Senator Taft, you have a problem of alternatives here. It is the judgment of the Board that even though the demand for savings might temporarily justify a higher rate because the savings today are possibly less than the demand for money, we should continue to hold the 2½-percent long-term rate. However, we also agree that the long-term rate should reflect the actual volume of savings that is taking place in the country in relation to the sustainable demand.

Representative PATMAN. But there is plenty of money or credit available.

Mr. ECCLES. The trouble is, it is bank credit. Borrowers go into the banks and obtain bank credit. That expands the total volume of money, and because you cannot expand the supply of goods and labor, it reflects itself in higher prices.

Representative PATMAN. Really, there is about three times as much money and credit available now as ever before in history.

Mr. ECCLES. But you have also the fact that the national product has pretty largely absorbed that inflation of money. The national product has gone up since 1940 from $100,000,000,000 to $240,000,000,000. Now, that is an increase of one and two-fifths; whereas, the supply of money has increased nearly one and two-thirds. The supply of money is still more than adequate; there is an excess of it.

Representative PATMAN. That is what worries me. I cannot understand, Mr. Eccles, this fact: It occurs to me that the law of supply and demand would cause interest rates to go down instead of going up, since you say there is adequate credit, more than we have ever had before.

Mr. ECCLES. But there is a question of who wants to borrow the money and who wants to lend it. You cannot assume that a person who owns money is necessarily going to be willing loan it at these rates. That is, one of the reasons that the money may not be flowing, to even though you have got a lot of it, as freely and readily as otherwise it would flow, is because there are some who feel that the rates do not justify the risk. What you have today is an abnormally low velocity of money.

Representative PATMAN. Here is the danger that I see in this increase in the interest rates. You take the cities and counties and States—they will have to pay more.

Mr. ECCLES. They ought to pay more. Why shouldn't the investor get more interest when the purchasing power of the dollar is diminishing?

Representative PATMAN. And that, of course, causes an increase in taxes, too.

Mr. ECCLES. Possibly so, that is right. But why shouldn't people pay more taxes, or why shouldn't the farmer pay more taxes when he gets three times as much for his wheat? Why shouldn't the laborer who gets two or three times as much for his wages pay more taxes, and why should the entire cost of the inflation be borne by the saver, the person who has got money to rent?

Representative PATMAN. Utilities will have to pay more interest, and they will want an increase in rates, and it increases everything. That is inflationary.

Mr. ECCLES. The rates are still excessively low. Money rates are the one part of the economic situation that is still deflated. The person who has been hurt the worst is the pensioner, the saver, and the person who depends upon a return from a fixed investment. There are two reasons for this.

Representative PATMAN. Or fixed salaries and wages.

Mr. ECCLES. That is right, too. The saver not only gets a much smaller return on his dollars, on his loans or investments, than he ever got in the 1920's or in previous years, but the dollar will likewise purchase a lot less, so that if it were not for the problem that the management of the public debt would create, and the huge size of the public debt, and what it would do to the value of the securities held by banks, insurance companies, and institutions generally, there is a very good case on the grounds of equity today to make for raising of the rate.

Representative PATMAN. You are raising the rate.

Mr. ECCLES. I am speaking of the long-term investment rate. The short-term rate is not the investment rate; the short-term rate is the bank rate.

Representative PATMAN. But something has caused the corporate rate to go up considerably.

Mr. ECCLES. It is because the short-term rate went up, and that reflected itself in the long-term rate until the support price of the 2½ bonds was reached.

Representative PATMAN. It occurs to me that, although I am sure the Board did not intend it that way, it is going to practically stop the housing program based on 4 percent equity. It will not be long before the people will not take these 4 percent mortgage loans.

Mr. ECCLES. I think that they will take the 4 percent mortgage loans; that is not so much the problem. If the loans were better loans than they are, they could be sold. One of the troubles with these loans is that there is no down payment. And certainly it would be a good thing if there was a smaller market for mortgage loans. In that case there would possibly be fewer people trying to build houses, and if there were, then the cost of building labor and materials would not go higher. The trouble in the housing field has been that you have an inflation here since the war ended of practically 100 percent in the cost of houses, and you are getting people in debt at excessively high-priced housing today. If we should at some time get a change in these values, and get any recession, it is going to put a real burden on these people that we want to help. You do not help a person by getting them in debt to buy property on a long-term basis at an inflated price, and it seems to me that one of the reasons that construction costs are so greatly inflated is because the amount of money made available for construction, and particularly in the housing field, has exceeded the supply of building labor and material. Because there has been practically no down payment required, it has taken practically no capital to get into the industry, and we have found literally thousands of speculative builders go into the business with practically nothing on their own. The net result is that there is a highly speculative situation in the housing field. If that has slowed up and if there is not the mortgage money available, I think that that is one of the most wholesome situations that can happen as an anti-inflationary development at this time. One of the best things that could happen at this particular stage—as an anti-inflationary measure—would be to have the cost of housing come down, particularly the cost of the materials and the labor that goes into the housing.

Representative PATMAN. Construction costs you only pay one time, and interest you pay every year until it is paid off.

Mr. ECCLES. That is right.

Representative PATMAN. Do you not think it is easier now to pay $10,000 for a home with a low interest rate over a period of 30 or 40 years, than before the war to pay $5,000 with a high rate of interest, may be with three mortgages?

Mr. ECCLES. What I am advocating—and I am not saying that even the 4 percent rate should necessarily change—is that there should be some down payment required; that people should not go into the business without any money or capital of their own, and that people should not buy houses without any equity of their own. That is what I am largely contending here.

Now, it may well be that an increase in the rate on housing mortgages of one-half of 1 percent would be all that would ever be required, so long as the 2½ percent rate is maintained on long-term Governments. It is that close a margin. The margin between the desirability of a 4 percent housing mortgage and a 3 or a 3½ percent bond is just about one percentage point.

Representative PATMAN. I know, but one-half of 1 percent every year for 40 years runs into money, you know; that is paid every year.

Mr. ECCLES. If they paid it in 20, it would be half as much.

Representative PATMAN. We have a bill over in the House, and of course I am in favor of Senator Taft's bill, the Taft-Ellender-Wagner bill, because it has some public housing in it, too, and I am for that.

Mr. ECCLES. We ought to wait for a period when it is favorable to do that.

Representative PATMAN. Are you not going to consider the people who are out of homes?

Mr. ECCLES. But you are not going to get more homes. All you are doing is inflating the price of homes. If by reducing the rate from 4 to 3 that was actually going to build more homes, at less money, then I would be for it. If you had idle men and idle material, and the thing that was short was money, then we ought to do everything for the Government to help to stimulate the construction industry in order to use up the idle labor and the idle facilities.

Representative PATMAN. Do you not think that there are certain things that we have to do, although possibly inflationary, in order to give homes to people?

Mr. ECCLES. I think if you were getting more homes, that is one thing. But merely by making more favorable terms you do not get more homes. It is like I said in the installment credit field: Merely by making installment credit terms more favorable to buy an automobile is not going to produce more automobiles.

The CHAIRMAN. I think it does produce more homes, though.

Mr. ECCLES. I doubt it.

Representative PATMAN. I think so, definitely.

The CHAIRMAN. I think we have gotten beyond the bottleneck stage in homes, pretty nearly.

Mr. ECCLES. I hope so, but so long as you have the shortages that you have in the basic materials and building labor, I cannot see how more credit will produce more housing. Lumber is a terrifically inflated item; it is still up. I know something about it. Lumber is up from the OPA ceiling price by more than 100 percent.

The CHAIRMAN. Why should we send $300,000,000 worth abroad, then?

Mr. ECCLES. That is another question, but certainly lumber is fantastically high. It is higher than any farm product, I think. And on top of that, you have building labor that is extremely high and very inefficient, generally speaking.

Representative PATMAN. And on top of that, you know what the steel situation is. I know people in the building business, and they do not verify the fact that it is easy to get deliveries on materials at all. They are still very tight, and there are still gray markets in many items.

Representative PATMAN. I want to ask you a few questions bearing directly on your testimony, Mr. Eccles, please.

Now, you want these reserve requirements raised. At least you want the Board to have the power and the authority to raise them if necessary. You believe that will make credit harder to get; and credit being harder to get will stabilize the economy just a little bit better and keep prices down.

Mr. ECCLES. Let me put it this way: We feel it would sterilize the inflationary effects of the excess reserves that gold imports create, and it would tend to sterilize the effect of the reserves that would be created in our support of the 2½ market if insurance companies and others sell 2½ bonds.

Representative PATMAN. You made that very plain in your testimony.

Mr. ECCLES. Otherwise, the banks would have these reserves and they would be out under pressure to be making loans, under an inflationary condition. If we had that condition in deflation, it would be fine. But in a condition now where the supply of money is already excessive in relation to the total product, to be inducing the banks to seek loans and to be putting in a condition where it is in their interest so to do, because they have idle funds, idle reserves, that we have created for thm, or our gold policy has, is something that we do not want to do.

Now, last year they were doing just that.

Representative PATMAN. If you had this power, Mr. Eccles, and you exercised it, which, of course, you would do under the circumstances——

Mr. ECCLES. Well, we would if bank credit expanded, and if it didn't we wouldn't be justified in doing it.

Representative PATMAN. If you did, do you think that would have a tendency to keep prices down?

Mr. ECCLES. Yes. It would have a tendency to keep credit expansion down. And to the extent that credit expansion was kept down the money supply would be kept down. Certainly you can't get inflation without money. Inflation is a reflection of the expansion of the money supply; not directly, because velocity must be taken into account, too; but certainly, without an expansion of the volume of money on a given supply of goods and services, you are not going to get a dangerous inflationary situation.

Representative PATMAN. Suppose the Board had the power today. Would you want the Board to exercise that power to lower the present prices?

Mr. ECCLES. Well, we couldn't. There is no power today under which we could do that.

Representative PATMAN. I say if you had the power you are asking to be given to you, had that power now, would you use it to lower prices and wages?

Mr. ECCLES. You couldn't lower prices and wages by doing it. If we undertook to lower prices and wages, it would have to be done by withdrawing support from the Government market and raising the discount rate.

Now, we could actually make credit so tight if we refused to buy Governments and raised the discount rates accordingly that it would be just like it was after World War I. You certainly could create that kind of a situation with that kind of a policy. But so long as you support the 2½ percent Government rate you really can't make bank credit tight. And that is something to which we are committed for the foreseeable future.

Nobody wants to say forever, but certainly so far as the Federal Reserve people can see things at the present time, we have an unavoidable responsibility to the support of the 2½ percent rate.

As I stated, while you are doing that, you really can't make bank credit tight. If you increased the reserve requirements to the full extent that is indicated here, that is a total amount of $12,000,000,000, and the banks have $67,000,000,000 of Governments, they could easily meet that requirement. They could meet it simply by selling $12,000,000,000 of Governments, and they would still have $57,000,-000,000 left.

Representative PATMAN. Now, I want you to apply that from a practical standpoint by using a Reserve city bank as an illustration.

How could a Reserve city bank increase its reserves to make additional loans? And how much could they increase them?

Mr. ECCLES. How do you mean?

Representative PATMAN. How could a Reserve city bank, in selling bonds to the Federal Reserve bank of that district, increase its ability to expand its loans?

Mr. ECCLES. Well, if a bank hasn't got any excess reserves, or, that is, has no money to lend—then, let us say they wanted a million dollars of reserves. They would sell a million dollars' worth of their Governments. Those Governments would be purchased by the Federal Open Market Committee from the dealers to whom they were sold, and funds would be credited to that bank that sold the bonds.

Now, assume that bank makes a loan, and this is the way it makes a loan. It gives credit to the borrower in the form of a deposit account. Then, in place of the bond that is held, the bank has a note of the borrower.

Representative PATMAN. They could have an aggregate of how much in notes?

Mr. ECCLES. Well, just one for one; that bank.

Representative PATMAN. I know; that particular bank. But in the entire Reserve System, it would be about 10 to 1.

Mr. ECCLES. When the customer draws down that deposit, it is transferred to another bank. That other bank must lay 20 percent against its new deposit and then has 80 percent of that money to loan. It doesn't know where the deposit came from. It doesn't know anything about it. It is the reserve funds that were created in the first instance which are important. And when these reserve funds once get into the spending stream, then the effect of their use is to create at least six times that amount of money, which in turn becomes part of the spending stream.

Representative PATMAN. That is the average.

Mr. ECCLES. Yes; that is minimum. You have to take savings into account and also nonmember banks. Nonmember banks are not now subject to Federal Reserve requirements. Under State banking laws, nonmember reserve requirements can be met by holding deposits with member banks.

Representative PATMAN. How large a national income do you think we should try to maintain in order to pay our national debt, Mr. Eccles, with the least discomfort and inconvenience?

Mr. ECCLES. I think if we are going to have reasonably full employment at current price levels we have to maintain a national income, certainly, with the present population, of around $200,000,000,000.

Representative PATMAN. $200,000,000,000?

Mr. ECCLES. I think so.

Representative PATMAN. I would just like to know that the Federal Reserve Board certainly has nothing in mind like what happened in 1920.

Mr. ECCLES. Well, you can be perfectly sure of that. As far as the present Board is constituted, I am perfectly certain of it.

Representative PATMAN. That is the reason I wanted you to say "about $200,000,000,000," because if you keep it about $200,000,000,000, you cannot go to far on that.

Mr. ECCLES. The idea that the Federal Reserve can——

Representative PATMAN. Yes; but to encourage it, Mr. Eccles; not to do anything to stop it. That is what I have reference to.

Mr. ECCLES. Of course, it is a very difficult thing to stop inflationary pressures at this stage without, maybe, getting some deflation.

In this connection, I would like to make another observation. With reference to the matter of some rise in the short-term rate, we have already had some. In other words, the rate has gone up from ⅜ to 1⅛. Now, if you were to get some little further rise in the short-term rate, when the situation is reversed, you can drop it. But you cannot drop it if it is already on the floor.

And the same thing is true in the financing of housing. In this sort of a situation, if you get a little higher rate, and if then you get a deflation, you can lower the rate. It is a good thing to have some backlog of housing at lower prices rather than filling up the entire backlog at these inflated prices, so that if you do get a slump you have absolutely no backlog available.

Representative PATMAN. I think those of us who are looking at this housing problem are not looking at this from that standpoint solely. We are looking at it from the standpoint that although it might cause some inflation, it is justified by reason of the necessity of getting decent housing for people.

Mr. ECCLES. It is justified up to the point that there are labor and materials available without inflating further the price of labor and materials. I would like to qualify that. I would say that it would even be desirable if there was a little surplus labor and material in the housing field, so that you might get the cost down a little. Housing construction is so badly inflated that it would not hurt any if they had a little deflation.

Representative PATMAN. You would not try to adopt any policy that would cause that, would you, Mr. Eccles?

Mr. ECCLES. I would, if the question of supplying a secondary market was all that was involved. I would say if there was likely to be some easing in the price of housing, some increased efficiency in the building of housing, some slightly reduced cost in housing, if there was no secondary market provided, and hence if there was a little less housing taken for the time being, I would be all for it. I would be for it especially in view of the other inflationary pressures, due to the foreign aid, and our military, and our tax-reduction program.

Representative PATMAN. Mr. Eccles, suppose that, after you get those powers, lumber should go up 25 percent, for a known reason, and other basic materials like steel and cotton and wheat and things like that should also go up. Would the Board take any action calculated to reverse that trend?

Mr. ECCLES. If that was based on a further bank credit expansion; yes. I do not think that could happen without further bank credit expansion.

I think these prices that you indicate are going up will immediately reflect in increased bank credit.

Representative PATMAN. Then, if you deny them credit, that will have a tendency to keep the prices back.

Mr. ECCLES. That will keep them in line.

Representative PATMAN. That is a lot of power, Mr. Eccles.

Mr. ECCLES. That is right.

Representative PATMAN. Of course, in an exaggerated case such as I mentioned, it certainly would be justified.

Mr. Eccles. But as I told the committee before, we certainly are not seeking any additional power, and what is proposed here is less power than the System has always had, but which it now is unable to use if it supports indefinitely the 2½ percent rate.

Representative Patman. All I want you to do is to make it plain and continue to make it plain that you are not contemplating anything that happened in 1920.

Mr. Eccles. Well, I am perfectly sure that everybody in the Board is conscious that if the Board were to use any power that would tend to stop the boom, or interfere with the boom, it would be an unpopular thing to do. Booms are always popular, and it isn't possible for the Reserve System to ever win. They just don't have a chance to win. Because any action that they take is sure to be unpopular with a lot of people.

Whenever you try to curb any use of credit or expansion of credit, you can be perfectly sure it is a very unpopular thing to do. But after all, that is one of the jobs of the Board that the Congress meant to give them, and I think that the Board should have the courage to do something about it, or the power should be given to somebody else. Because certainly if you are going to have any stability in the economy, you have got to deal with it either by direct means, which is contrary to the American way of doing it—and I mean direct controls, allocations, and everything—or you have got to try to get it in an indirect way, in a functional way, through fiscal and monetary and credit policy.

Now, that, it seems to me, is the only alternative.

And I, for one, prefer to have some freedom, and fluctuation and try to get at it through fiscal, monetary, and credit policy, rather than a completely regimented and controlled economy, which we have to adopt in emergencies, in war. And if, for military or other causes, due to developments, we have to run a large budgetary deficit, then certainly we will have to put those controls in again, or we will have to have an inflationary development.

That is the point I tried to make.

The Chairman. Mr. Eccles, earlier today you suggested you might have some ideas on the question of whether under present conditions there is enough inducement for people to invest in equities as against loans.

One of the reasons that has been suggested for the excessive pressure for loans, is the inability to get equity money. If that is so, what has caused it, and what is the remedy?

Mr. Eccles. There is certainly no shortage of equity or other money today. That isn't the problem. The problem today is the shortage of material. And if there was more equity money, there would be more demand for goods that are in short supply. The problem is not a shortage of money.

The Chairman. Now, we have had some cases brought to my attention. One was the company that wanted to sell stock and could not, and wanted to withdraw stock issues; and there were several stock issues withdrawn here some months ago. They could not sell more bonds, because the Public Utilities Commission said that would be an improper balance; that what they needed was more equity money.

Mr. Eccles. That is right.

The CHAIRMAN. Would you think that that was a special case? Or do you think that situation has changed?

Mr. ECCLES. I think that there are a lot of such situations; and I think if the equity market was open, you would have more inflation than you have got. Because, if it was easier for corporations to get money than it is today, you certainly would have more of it spent. You would have more of them trying to expand the capital-goods market. There seem to be enough corporations with enough money already on hand or with Government bonds.

The CHAIRMAN. It is suggested, however, that most of that money comes from profits. Profits are very ephemeral and likely to disappear from the exchange; and they cannot get outside money, outside new money.

Mr. ECCLES. It is because they are trying to expand faster than savings are accumulating. And that is undesirable, because when you are expanding new investments, either by corporations or individuals, faster than the community as a whole saves the money, you have inflation again.

The CHAIRMAN. Well, of course, this is more of a long-term problem than it is an immediate problem; because, as you say, you do not need at the moment more money. But there is a study by Professor Kuznets, I think, simply to show that there was no net saving in the thirties; practically no new investment. We were not moving ahead as we had before.

Mr. ECCLES. Because you had a lot of unused capital facilities, and consumer purchasing was not in the then deflated conditions adequate to use what new investments had already been created in the twenties. You had idle capacity, and that is why in the thirties you didn't have a lot of new investment going forward; because there was too much idle capacity in almost every field.

The CHAIRMAN. Well, I mean, that is the cart before the horse. If you had had more investment, if you had had more willingness to put money into capital goods, you might have started up an industry that would have really pulled us out of the depression. In fact, that is the way we have gotten out of depressions before. In the thirties there was no such money. Except for a brief period in 1937, it collapsed overnight.

Mr. ECCLES. If we had had more consumption that might not have been true. As you survey the situation, we had an excess of office buildings and hotels and apartments and factory production of all kinds. We had idle railroads. We had an excess of utilities. We had an excess of automobiles. In almost any field you looked at in the thirties there was excess capacity. What was lacking at that time was consumer purchasing power.

Today you have a complete reversal of that situation. You have a situation where the general public's demand for saving has exceeded the total volume of savings. In order to carry forward the housing and other new investment, there has been a heavy reliance on the use of bank credit. When the bank credit starts to tighten up slightly, then the Government wants to step in and to supply it in one way or another.

The CHAIRMAN. Apparently nobody is willing to put any equity money into housing. That may be because nobody wants to put it into equities, or maybe they do not want to put it into housing. I do not know which. But very little is going in.

Mr. ECCLES. It is because of the inflated price, and people have no confidence in buying. When you put equity money in housing, it means that you have made an investment in housing at these prices. Few enterprisers want to do that. They are perfectly willing to have the little fellow come along and put his equity in and go in debt for the housing at these prices. The builder is unwilling to put his equity money in housing because he just does not have confidence that it is a good investment at these prices.

I think that is one of your major troubles in the housing field. That certainly would be my feeling. And I would feel the same way about putting money into an office building, or into a hotel.

The CHAIRMAN. It is suggested that with the present tax rates nobody with very much income can long afford to put money into equities.

Mr. ECCLES. Into what?

The CHAIRMAN. Put money into equities, and take a chance; when he can get 2½ percent on a Government bond.

Mr. ECCLES. What present tax rates do is to induce the people to put money into municipals. The wealthy people today put their money into municipals. The municipal rate will give them 4 or 5 percent, when you take into account the fully tax-free feature. There is no Government bond or comparable security that will pay them anything like that.

The CHAIRMAN. Do you not have the dilemma that the very wealthy man will not put money into equities and the poor man should not? The poor man puts it necessarily into insurance or savings banks, which have to put their money into loans. So the more you shift savings to the lower-income groups, the less equity money you have.

Mr. ECCLES. Of course, I know the argument of the brokers. They say if we would reduce margins, then, of course, the equity market would go forward. Well, that is merely a case of expanding credit largely for speculation, because that is how the margin trading would be financed. And that means bank loans to brokers or to others for the purpose of buying securities.

They would be better off to have the bank loan to the corporation in the first instance than to have the money loaned to individuals through the brokers, or directly for the purpose of buying the securities. You do not accomplish anything by that route. And the only way you can help the equity market is where you have more savings available, and then there is a chance for those funds to go into equities.

The CHAIRMAN. I would say, off-hand, just from having contact with a few securities, that there is very little interest in buying stocks today. I am not talking about margins. I mean investing in stocks. I do not know just why.

Mr. ECCLES. Well, it is because people have no confidence in the future. It is the whole uncertainty. People are feeling today that they do not know whether you are going to have a deflation or an inflation. The whole question of what is going to happen in the world picture is causing people to be very, very hesitant. If there was some assurance that you were going to have more of an inflation, it would improve your equity market tremendously. On the other hand, if there was a feeling that you were not going to have any further inflation, then, of course——

The CHAIRMAN. As of November, everybody was rushing in here saying there was going to be an inflation surely, inevitably. It did not produce anybody rushing out to buy stocks that I ever discovered.

Mr. ECCLES. We didn't come in and say there was going to be an inflation. We have pointed out definitely that so far as the monetary front was concerned, there would be no inflation on that front until after the first quarter. During the first quarter, we said that there would be a deflationary situation, due to taxation. You will recall that we said, as to the proposal that we discussed at that time before the committee, the special reserve plan, that there was no pressure for it at the time; that it could be considered after the first quarter.

The CHAIRMAN. That was not the general tone during the special session in the fall. Yours was the most conservative view we had on it.

Mr. ECCLES. I was dealing with it, of course, only on the credit and the monetary front. And with reference to the question of equities, this argument has been raised: that a reduction of taxes in the higher brackets would induce the well-to-do people to use the savings that they would get as a result of the tax reductions to buy equities; and thus, it would not be necessary for the corporations to use bank credit to the same extent. It may be that some of the tax savings of the well-to-do would go into equities, and corporations would carry out their expansion as a result of getting that money, instead of using bank credit. Or they might carry out an expansion which they would not carry out if they could not sell their equity; and that expansion might might be inflationary and undesirable.

Again, they may already have the bank credit, and if they could sell equities, they would pay off the bank loan. That would be deflationary. But to the extent that the Government would lose revenue in taxes, and just to that extent, the Government would be less able to pay off its debt at the banks.

You have got to remember that the Government has debts as well as corporations, and the question of taxation is a question of whether or not the taxpayer pays it to the Government and the Government applies that on its debt, or whether the individual keeps the money and provides the equity money to the corporation, so that the corporation can pay it on its debt.

Now, in an inflationary situation such as you have now, I think it is more constructive for the Government to collect it and apply it on its debt. I certainly think if you had a reversal of business conditions, that is, a deflationary situation, then you would want to reverse that.

If we try to do everything in an inflationary situation that we ought to do in a deflationary situation, we will have nothing to do, if we ever get a deflationary situation to counter it. The principal hope of a capitalistic democracy, it seems to me, is to be able to use its fiscal and monetary policy both against deflation and against inflation. Flexible fiscal and monetary policy is essential to stability.

I recognize that that is not an easy thing to do. And the opposite to that is to let nature take its course on the boom-bust theory that private capital, and individuals left to their own devices without Government doing anything, will work their own way out better. That is the other side of it.

The CHAIRMAN. Your theory sound like a theory of mine. I always refused to have my tonsils taken out, on the ground that if I ever got sick I wanted to have something left to do to cure it.

Mr. ECCLES. I would not say that, if we didn't already have a continuing inflation.

The CHAIRMAN. I agree.

This question that we are raising is a long-term question. I mean I am not trying to apply it to the immediate problem. I don't think there is any concern about it at this moment. But I do think there is a good deal of doubt whether, as we have the high tax rate, which I think we are bound to keep on high incomes, and more of savings in the lower income groups, we are going to get equity money.

It does seem to me that that presents a long-term problem that somebody is going to have to consider.

Mr. ECCLES. Of course, the community-property tax has gone a long way to help very substantially the people in the higher brackets. Certainly from $25,000 to $100,000 they have had real relief as a result of that community-property tax; that is, those who were not already in community-property States, and I happen to be one of them.

The CHAIRMAN. And those who had not already divided their property with their wives.

Mr. ECCLES. I was all in favor of the community-property provision.

The CHAIRMAN. In any event, you do not think that there is any concern immediately regarding the question of getting more equity money?

Mr. ECCLES. No, I don't think there is any concern at all. I think that concern would come and would possibly be met, if you had a deflationary situation.

Certainly at that time, I think the Board, Senator, would be justified in reducing margins very substantially on security. If you had a deflationary situation, where bank credit was rapidly contracting and unemployment developing, we certainly would not hesitate to encourage bank credit.

Representative PATMAN. On the question of equity capital, Mr. Eccles, is it not a fact that most investors can get the benefit of the capital-gains tax and not be out over 25 percent in taxes anyway?

Mr. ECCLES. Yes; they can get it on real estate. They can get it on any asset.

Representative PATMAN. Is not most equity capital in that category?

Mr. ECCLES. It is all in that category. If you buy it and it goes up, and you sell it while it is up, after a 6-months' period.

Representative PATMAN. That is what I mean; for a profit.

Of course, if it goes down, you are at a disadvantage taxwise.

Mr. ECCLES. That is true.

Representative PATMAN. You can only deduct how much, as a maximum amount, on a long-term capital loss?

Mr. ECCLES. Over a 6 months' period you get the benefit of a capital gain.

Representative PATMAN. That is where it increases.

Mr. ECCLES. If you have a capital gain, it means 25 percent. That is really where the tax is.

Representative PATMAN. That is when it increases. But suppose it goes down? There is a limit to what you can charge off, is there not?

Mr. ECCLES. That is right. I think you can charge off not more than a thousand in any one year, unless you charge if off against the capital gain. You can charge off the capital loss on one security against a capital gain on another, but if you do not have a capital gain, and take the capital loss, then you can only charge off a thousand, I think it is, a year.

Representative PATMAN. It is not cumulative.

Mr. ECCLES. Up to 5 years; $1,000 a year up to 5 years.

The CHAIRMAN. Of course, in that kind of equity investment, you only bring that result about by selling out. You put the money into a business, and then you have to figure on selling it out and putting it in another business.

Mr. ECCLES. I will tell you one of the principal reasons that corporations have a disadvantage in selling equities against bonds: that in the case of financing by bonds or mortgages, they can deduct the interest against their income tax. If they finance on an equity basis they of course cannot deduct their dividends against the earnings.

Corporations prefer debt up to a point of safety. Naturally they do not want to get to a dangerous point, but they actually prefer debt, because there is such a tax advantage. The stockholder of the corporation pays his share, in effect, of the corporation tax, which is about 40 percent, out of earnings. Then, on the earnings that are left, to the extent that they are paid in dividends, he pays surtax on the dividends.

So, you see, there is quite a premium on the use of equity capital as against debt. And that is one of the principal deterrents to the use of financing by equity capital. That is a much more important factor in the picture than any other: the tax disadvantage of equity capital as against using the debt form.

Representative PATMAN. I have no other questions.

The CHAIRMAN. We thank you very much, Mr. Eccles.

The committee will recess until Friday at 10 o'clock, and will meet in room 138 at that time.

(Whereupon, at 4:20 p. m., an adjournment was taken, to reconvene at 10 a. m., Friday, April 16, 1948.)

CREDIT POLICIES

FRIDAY, APRIL 16, 1948

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The committee met at 10 a. m., pursuant to adjournment, in room 138, Senate Office Building, Senator Robert A. Taft (chairman), presiding.

Present: Senators Taft (chairman), Watkins, and O'Mahoney; Representatives Rich, Patman, and Huber.

The CHAIRMAN. The committee will come to order.

Do you want to read your statement through, Mr. Rowe, or do you want questions as you go along?

STATEMENT OF JOHN J. ROWE, PRESIDENT, THE FIFTH THIRD UNION TRUST COMPANY, CINCINNATI, OHIO

Mr. ROWE. I will be very happy to have questions as I go along. However, whatever you want will be satisfactory.

I want first to state that I have been a amateur student of the Federal Reserve System for a great many years. It just happened that in 1929 I was president of the Cincinnati Clearing House Association; and, as president of that association, I had the opportunity of looking over very, very carefully, the assets of several banks that were more or less in trouble.

The CHAIRMAN. You had, then, been in banking all your life?

Mr. ROWE. Since just before the panic of 1907.

I arrived in banking just before the panic of 1907 and have been in banking ever since; not theoretical banking, but practical banking.

The CHAIRMAN. And you were with the First National Bank of Cincinnati up until when?

Mr. ROWE. I was with the First National Bank from 1907, was president of it from 1929 to 1934, and then accepted the presidency of the Fifth Third Union Trust Company in 1934, where I have been since.

The CHAIRMAN. And those are the two largest banks in Cincinnati?

Mr. ROWE. Yes.

I should like to speak of the adequacy of present powers of the Federal Reserve System and other Federal agencies to prevent undue expansion and contraction of bank credit, and current proposals for increasing those powers, as has been recommended in the economic report of the President.

The preamble to the Federal Reserve Act is as follows:

> An act to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

The origin of the Federal Reserve System stemmed, in my opinion, from the panic of 1907 when the actual supply of available currency ran out. The public, in great numbers, insisted upon asking for cash—in many ways as unexplainable as when cattle stampede.

Panic, in its worst sense implies blind, black, unreasoning fear; often is psychological, and sometimes causes are not unreasonable. Inelasticity of currency was the first hurdle to jump; hence, that portion of the Federal Reserve Act.

The second aim, namely, to afford means of rediscounting commercial paper, has worked fairly well. The intent is thoroughly covered by the wording, but in the panic of 1929–33 there were banks who had to pay heavy penalties for what was deemed to be excess rediscounting at the very time when they needed a low interest rate—at the very time when they needed to reduce expenses to regain solvency. Instead, they had to pay a higher rate.

It is somewhat like medieval days, when a desperately sick man was bled, when the reverse was needed for recovery.

Today, borrowing by member banks at the Federal is practically wholly against Government bonds which the banks, very rightly, in my opinion, consider their most liquid asset.

The third preamble proposed—a more effective supervision of banking in the United States—was believed to mean an improvement in bank examinations, but a steady and persistent growth in the idea of Government management with the conviction that thousands and thousands of member banks should not think for themselves but need more and more all-wise and omniscient regulations by the few, produced a steady broadening of the definition of this word "supervision." More and more power was given to the Federal Reserve Board to issue regulation after regulation, so that today men active in the bank have to constantly refer to long series of operating letters by number and regulations by letters, which now run through all of the letters of the alphabet, from A to Z.

If this is what the word "supervision" means, it seems to me that the adequacy of the present powers of the Federal Reserve System are fully adequate and, in fact, more than adequate.

The thinking back of requests for greater powers seems to revolve about so-called inflation, the necessity to prevent further rise in price levels, and a desire to put a flood under the price of Government bonds.

Economists seem to differ amazingly as to the causes of increasing prices, and unless there be an agreement among competent-thinking people as to causes, it is impossible to gage the adequacy of remedies.

The general thought seems to be that if one adds up total deposits in banks, and the total of E bonds in the hands of the public, which are payable on demand, plus paper money in circulation, the magnitude of the total is a self-evident cause of inflation, due to the size of this potential spending power. To my mind, it is almost completely incorrect thinking. As Charles Lamb put it, "The world is divided into two classes of people—the spender and the lender." In other words, the spender and the saver, and I think it is obvious that this is true.

Moneys awaiting investment, saved to provide for the long range future, in an amount which obviously is unascertainable, should be deducted from the total "inflationary" money as being noninflationary. This includes most E bonds and practically all savings deposits and currency in safe deposit boxes and the matresses. It is not circulating.

Next, there is a direct relationship between a person's bank account and his current normal expenses, and as living expenses have mounted and quarterly tax payments to be made have mounted, it is my experience that the average individual's personal checking account averages much more than it used to. Accounts of this nature should be deducted.

We then come to corporation accounts, and there, there is a direct relationship of needed cash in bank, pretty much based upon the annual volume of business of each company or partnership. The rule of thumb figure is that business enterprises keep 10 percent of their annual volume of sales in cash, largely in the bank. With sales volume at present levels, it is obvious that business bank balances are larger, perforce.

In my opinion, bank deposits have gone up as business volume and living costs went up, and it is very much like the old question of which came first—the chicken or the egg. It is therefore unfair to say that the increase in bank deposits increased prices, as it seems almost obvious that increased prices and volume of business demanded increased deposits.

This happening is exactly in accord with the preamble to the Federal Reserve Act, namely, elasticity of the money supply. How otherwise would it have been possible to increase industrial production as we did as is shown on this chart. (Chart inserted at the end of Mr. Rowe's statement, p. 85.)

The increases in wages cannot be overlooked as the prime factor in so-called inflation.

Consider the changes in industrial production with the growth of national personal income, and it seems to me obvious that bank deposits had to go up to make the facts possible. The fact that national personal income continued to go up after the war, while industrial production dropped sharply, demonstrates clearly that this is a major reason for the rise in prices; namely, that income has continued to go up while industrial production went down—the old-old law of supply and demand:

Demand—ability to purchase—namely, personal income, continued to rise while the supply of goods went down.

During the war the people were glad to postpone their buying. After the war they very naturally and very humanly wanted that they could get and were willing to pay for it.

In my opinion, cures rest with a variety of necessary factors: increased production calls for bank credit or new capital for new tools. In other words don't stifle bank credit if you want to get production up and prices down.

And the man-hours involved require lengthening of working hours rather than limitation of hours per week.

Wages are the overwhelming cost in production and the services, and round after round of increased wages can only mean increased costs; hence, increased prices. To think that prices can be held down by restricting credit seems to me utterly absurd.

It is my firm conviction that effective supervision of banking means progressively better and better bank examinations.

The job has been done far better, in my opinion, since the bank holiday than before, but no matter how good it has been, it still can be better.

The divergence in the performance of the banks of the country in keeping themselves strong and sound with carefully valued assets, measured risks in proportion to each bank's net worth, demonstrate clearly that the private management of banks differs greatly in this regard, and that such remedy as is needed lies in the present powers of supervision and examination, not in regulation.

I offer the following chart of changes in net worth of a selected group of banks, which tells the story. (Chart inserted at the end of Mr. Rowe's statement, p. 85.)

Here you have merely a selection of banks that performed very well after the bank holiday and before, and others that didn't show as well. Names are not given. They are simply chosen more or less at random.

We start with 1929 net worth. Whether it be big net worth or little, that is the par of their net worth, par for that golf course. And, of course, since 1929, their deposits have gained tremendously, so that the net worth of the banks today should be far more than it was in 1929 in relation to their debts.

The CHAIRMAN. You knew that Mr. Rich was a very fine golf player, did you not? He is one of the best.

Mr. ROWE. That is fine. I will continue with the "par" idea.

Now, the net worth of these fellows at the bottom is almost a 70-percent decline, and these others are comparable. Two of them never dipped below their 1929 total.

And here [indicating] you see the result of their gain in net worth: careful about their dividends, plowing it in, building up to keep this country on a firm foundation. And it comes from business to keep on a firm foundation; not through ukase.

It is perfectly clear that bank examinations could be better. I have never yet seen a bank examiner come in and, with his letter to the Board of Directors, say, "Your bank is grade A when it comes to carefully valuing your assets," or "Your bank is grade Z," or just make it, broadly, "good," "medium," and "poor." And that goes for all of the mechanisms, not the individual loans, but the mechanisms, as to whether your assets are soundly and carefully valued, and whether you will rate good, bad, or indifferent.

That is what the bank directors should be told. Particularly the country bankers think their banks are fine.

Representative RICH. Well, the country banker who wants to do a good job is just the same as the city banker.

Mr. ROWE. Just the same. And your country banker is probably smarter than the city banker on the average, but there are probably many more of them.

Representative RICH. I have been a president of a country bank for 35 years, and I know what it is, and I wish I was not in the banking business today. It is a tough responsible job.

The CHAIRMAN. What the chart really shows is that a large number of those banks were valued as to their assets; with the consent of the examiners, way above what they were in 1929.

Mr. ROWE. Of course, the examiners had a strong alibi: that nobody could dream that the quotations could go down as far as they did.

But there was one group of loans, one class of security, that could have been shown to be vulnerable. And the reasons, I don't think have ever been studied the way they should be.

Representative RICH. Lots of these bank examiners go around and examine the portfolio, and when it comes to local individuals and business they do not know anything about them, and they tell you that you have to write them off; when the banker himself oftentimes knows very well that they are worth 100 cents on the dollar. They ask you to put your money in something else that is listed; and the country bankers have been told many times to do the thing that has not in my judgment been the right thing to do.

Mr. ROWE. I agree with that.

Representative RICH. The examiners are just as human as the bankers, and they go by a rule of thumb, or a rule laid down for them by somebody higher up. They are told to place their value of assets as to whether it is listed on the big board. You know what happens to things on the big board. That goes up and down as much or more than many local securities that are not listed on the big board.

Mr. ROWE. But there are certain securities that have very heavy debts, heavy preferreds, ahead of them; others that have none.

Representative RICH. The majority of people in the banking business today, or a great many of them, I will say, put the great amount of their assets in Government bonds.

Mr. ROWE. It is overwhelming.

Representative RICH. And then here in Washington we say Government bonds have to be stabilized. And where are you? The first thing you know, if anything should happen to them, what is going to happen to banks?

Mr. ROWE. Now I would like to show the totals of selected assets of banks, if I may. (See chart at end of Mr. Rowe's testimony, p. 85.)

Here are all of the commercial banks [indicating]. And from 1935 to 1947, of course, their deposits have gone up tremendously, as we all know. That is their total. This is their demand [indicating].

And as to their loans, there is a great deal said about how fast the loans are climbing. Mind you, the deposits bear a direct relationship to the volume of business. You see, this line is almost at the same angle as the volume of business, and when business is at that volume, you have to have money, and the bank is merely a tool of industry.

These loans are going to have to go a great deal higher. And they ought to be encouraged rather than discouraged, in my humble opinion. And as to the total capital accounts, if you are going to have a strong nation, those accounts have to be bigger. The relationship there, as to debts—and that is what deposits are; that is what the banks owe—is all out of line. And they need earnings. Things should be done to help them rather than to hold them back. Don't take blood from a dying man when he needs a blood transfusion. Now, the same thing applies as to your Federal Reserve banks, which I will come to in just a minute.

Representative RICH. That same thing not only happens to banks, but applies to business as well.

Mr. ROWE. Everything.

Representative RICH. And business today is getting in bad shape because of the fact that you have the high prices of commodities.

You think you are increasing your capital and your earnings, and the fact of the matter is that you have inflated prices and you have not nearly as much assets as you had a year ago. You have inflated assets.

Mr. ROWE. I may add to that. Business is simply production, distribution, transportation, power; and the banks are the fiscal department of business. We are all partners. When any one of them is in bad, the others are hurt.

This chart on the right emphasizes the need for better bank earnings, largely retained in order to safeguard properly the public. It is an interesting point, looking over some of the larger banks, to note that the 3.3 percent at one end of the spectrum goes up to 20.7 percent for net worth at the top.

Think of the divergence; and the opportunity for bank examiners to press the ones who have a poor ratio of net worth to deposits to pay low dividends and build up their net worth. Instead of that, I find one here that has a 3.9 ratio of net worth to deposits, paying out 57 percent of its earnings in dividends; while one with 17.7 percent of capital funds to gross deposits only paid out 49.2 percent.

I think bank examiners could comment on that.

The proposal to increase reserves of member banks with the Federal, simply adds up to the fact that member banks will have to sell Governments, and the Federal Reserve banks will have to buy them, in order to provide the funds to deposit with the Federal, should reserve requirements be increased.

If those commercial banks have to put more deposit idle money with the Federal, the only thing that they have got to deposit with the Federal—they haven't got currency; in the aggregate, they can't give a check on each other. We haven't the gold to put in which we had originally, which was the concept. The concept was that we would deposit gold, and we had the reserve. But the increase means that the Federal owns more Governments, and we own less. Therefore, our earnings will be down, because we have that additional completely idle sterilized money in our balance sheet.

The Federal Reserve bank is a completely separate solar system—if one may use the word—than the solar system of the member banks considered as a consolidated balance sheet. We member banks have no gold to deposit. To borrow the needed increased Federal Reserve balances, and to continue to owe that money would be obviously disastrous. We have no gold to deposit nor have we currency. The currency demand has been made by the public. It is something over which we, nor the Federal Reserve banks, have no control whatsoever; hence, we have no idea when there will be a flow-back of currency which would increase our reserves and which, if and when it occurs, will give the bank funds with which to buy Government bonds from the Federal.

None of us know when that will occur, and the probabilities are that it will be a long and slow process; hence, not part of this discussion.

To my mind, this process, that of the three ways to increase member bank balances at the Federal due to increased reserves, the only practical one is to have the Federal own more United States bonds and the banks less.

Representative RICH. Now, let me ask this:

Supposing the banks all want to sell their Governments, and the Federal Reserve is not able to take them over.

Representative PATMAN. You do not mean to say the Federal Reserve would not be able to take them over?

Representative RICH. Supposing they were not able to.

Representative PATMAN. But the fact is that they are, is it not, Mr. Rich?

Mr. ROWE. Take this net worth picture.

In the first place, their net worth is just negligible. And I left off anything here that was less than 2 percent of the balance sheet as being unimportant. That means that in these year-end figures, at no time did the Federal borrowings even show on the chart. They were just negligible from 1935 to date. Their assets are gold and their Governments.

One this chart, one line reperesents the Governments, and the gold line represents the gold. And their total assets have to equal their total liabilities. Their total liabilities are their deposits.

It is just like a thermometer. When one of them goes up, another has to go down; and when the other goes up, the first has to come down. If both assets lines go up, then both liabilities lines have to move accordingly.

Their charge, by the preamble of the Federal Reserve Act—which is just exactly what has happened—is to provide elasticity to money the public demands. At no time was it paid out because the Government wanted to pay pay rolls with Federal money, and so they took it. It wasn't put out the way it was in the Revolution, where they put paper money out because they didn't have any credit. It was put out because the public wanted it and needed it; for higher pay rolls and every other reason. The gold just happened to flow into this country, naturally. It was the one safe haven in the world. Let us hope we keep it that way. And the deposits are the net result. They bought that many Governments.

If we need more deposits, if they require us to keep more deposits, they are going to have to own more Governments. It is just as simple as that, and there is no possible way out of it. And I am coming to that a little later.

It is so obvious that the public may feel that the Government bond market needs and must have that support. And there is a limit beyond which you can't go. And then where are you?

It is like committing a murder. If you commit one, it leads to other ones. It is dangerous ground.

To my mind, as I said, this proves that of the three ways to increase member bank balances at the Federal, due to increased reserves, the only practical one is to have the Federal own more United States bonds and the banks less.

The effect of this is lower earnings for the member banks, when they need the exact opposite, namely, higher earnings to protect their deposits and to get back to a better than 10 percent ratio of net worth to debt—and mind you—deposits are bank debt, and a 10 percent margin against bank debt, namely, net worth, seems to me on the low side, not on the high side.

When, as and if the public realizes that the result of increasing reserves is to reduce the Government bonds owned by banks and increase the Government bonds owned by the Federal, there could easily be a growing apprehension lest the Government bonds have to be artificially supported in price, and that the case is so desperate that this action had to be taken.

Now, up to date all the Federal has been doing is to buy longs, and sell shorts. They haven't gone up any. They have merely shifted their portfolio.

There is another point. As we banks, as these reserves are increased, own less Governments earning money, what are we going to do? We are going to have to start raising rates on commercial loans, to get it back. And that will put further pressure on the Government bond market, because the interest comparison will be more out of line again.

Representative RICH. That is right. As the rates for commercial paper go up, naturally the bankers are going to get rid of their Governments, because they have the low rate.

Mr. ROWE. If we can get higher rates on paper, short of 1, 2, or 3 years, we will take it, as against something else.

Representative RICH. As the demand increases all over the country by business for bank loans, naturally, the pressure is going to be to dispose of the Governments.

Mr. ROWE. And I say that our loan total in relation to the curve of industrial production is very low. It will be much higher. It will have to be and should be.

Now, mind you, up to date, they have not increased their holdings of Governments, so the public does not see it. The general public does not care much about shifting maturities.

Credit is as delicate as a gossamer thread, and the slightest breath of suspicion could cause a panic on the part of holders of Government bonds to get out of them. The result of this form of panic could accomplish the exact opposite of what we all desire, namely, to steadily and persistently increase private ownership of Government bonds.

In the parlance of the investment banking profession, the digestion of a new issue of securities takes time to accomplish.

It is not easy to offer a large corporate bond issue, and get them in the hands of permanent investors at once, and the digestion process goes on until—again in the parlance of the investment banker—a specific bond issue has been well digested, well placed, and necessitous selling can be easily matched by new investor demand.

The size of the Federal debt naturally takes longer for this digestive process. In my opinion, they are moving from the hands of the weak holder to the hands of the strong holder better than any of us could dream when we contemplated, early in the period of increased Federal debt, how it would be possible to achieve this imperative digestion.

Efforts to interfere with the natural process of this digestion can easily work in the opposite direction. People are prone to mass psychology, and no changes should be taken whatsoever.

As to the suggestion that banks either may or must own a percentage of Governments against deposits as an additional reserve, the arguments mentioned immediately before this hold to an even greater degree. The moment there is a requirement to own Governments, there is the risk of engendering fear as to the credit of the Government.

Government bonds in the hands of the banks are constantly referred to as monetization of the debt. Isn't the same thing true of every single loan that banks make unless money is borrowed at one bank in order to pay debts at another?

The double-entry system of bookkeeping means that for every debit there is a credit, and on consolidated balance sheets of all the banks, when one bank makes a loan, the proceeds are promptly deposited in other banks as the borrower pays the bills, to pay which he borrowed the money.

When people and companies have their bills paid, they are apt to pay bills promptly that they owe, so that obviously in due course, the immediate monetization of debt results in larger payments of pre-existing debts—so the double entry growth on both sides of the ledger of the consolidated banks becomes a slow process.

In periods of great expansion in business activity, obviously bank loans go up and bank deposits go up.

During the war the banks loaned money to the Government, and created the deposits imperatively needed to take care of mounting volume of production.

As long as production and prices call for high totals in dollars of industrial production, bank deposits will remain up, and bank loans and bank holding of governments will remain up.

The judgment as to what is too much credit has to be made by each bank.

The Federal Reserve examining authorities have plenty to do in challenging the ability to pay of every borrower as they examine banks, and take what they deem to be appropriate action in citicism or in ordering charge-offs.

Now, as to the question of the necessity or responsibility of continuing support of the Government bond market and ways in which this might be done with a minimum stimulus to undue expansion of credit:

It strikes me that the fundamental question is, whether the 12 Federal Reserve banks should be operated for and on behalf of the member banks, who are, after all, the shareholders, or whether they should be hand in glove with the Treasury Department to assist in the mechanical handling of renewals as Government securities mature, or as new and additional borrowing takes place, and by supporting the market on long maturities.

To my mind, this is an extremely serious question. We believe in across-the-table bargaining for private business, and it strikes me that the same rule should apply to the Government.

In other words, when the Federal is buying bonds from the Government, they ought to be on one side of the table, and the Treasury Department on the other.

As a people, we Americans revolted from the age-old tradition of divine right of kings; we built up this great country after the Revolution, having achieved independence, and steadily and persistently have endeavored to eliminate special privilege, et cetera, and most of us, I believe, have felt that we had accomplished a democratic government made up of elected representatives of the people, and that they were not imbued with divine powers or divine rights, but were accountable to the people.

Based upon this, should it not be obvious that the prime obligation of the Federal Reserve banks is to carry out the Federal Reserve law as written and amended, and not take unto themselves the additional task of serving the United States Treasury except insofar as the actual law provides?

Section 14, paragraph 3 of the law gives the following powers to the Federal Reserve banks:

PURCHASE AND SALE OF OBLIGATIONS OF UNITED STATES, STATES, COUNTIES, ET CETERA

(*b*) To buy and sell, at home or abroad, bonds and securities of the United States, bonds of the Federal Farm Mortgage Corporation having maturities from date of purchase of not exceeding six months, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipalities in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Board of Governors of the Federal Reserve System: *Provided,* That any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities either in the open market or directly from or to the United States; but all such purchases and sales shall be made in accordance with the provisions of section 12A of this Act and the aggregate amount of such obligations acquired directly from the United States which is held at any one time by the twelve Federal Reserve banks shall not exceed $5,000,000,000.

You will note from this that great stress is placed upon not extending maturities beyond 6 months, except in the case of United States securities. This makes abundantly clear the recognition on the part of the lawmakers that there are great market hazards in securities with maturities longer than 6 months should going interest rates change.

Well-run banks, particularly since the panic of 1929, have as deep a fear of market risk, and the necessity of carrying securities in their portfolio at the market, as they have of credit risks, and as one reads published statements of banks and studies composite balance sheets of banks, it is made abundantly clear that banks having more than their net work in securities other than Governments are few, and further, that they are, almost universally, afraid of having more than a fraction of those other bonds in maturities of over 5 years.

It would seem to me obvious that what is sound policy for member banks is sound policy for the Federal Reserve banks. In fact, inasmuch as they are the final place of recourse, should any member bank's deposits shrink faster than they can liquidate assets, it behooves the Federal Reserve banks to be even more careful in owning any substantial totals of bonds maturing in more than five years.

If the 12 banks which have the supervising and examining powers over the member banks violate this principle of being careful about market risk, will not their powers as an examining authority and the looked-up-to adviser of member banks be seriously impaired?

For the Federal Reserve banks to own approximately five times their net worth in Government bonds maturing over 5 years strikes me as being packed full of inherent danger.

And that has gone up to almost six times since I wrote this paper.

The fear that United States bonds of longer maturities could sell with any permanence at heavy discounts is based upon the thinking that should general interest rates go up a great deal the market price of United States Governments could go down severely. On the other side of this picture is the fact that if the United States finances are handled wisely, the fundamental credit of the Government will be unimpaired.

United States Government bonds are unquestionably the most riskless security in the world today. They have unquestioned value as collateral. If a customer comes into the bank to borrow money on United States Government bonds, there can and should be no question about his being able to get the money against a reasonable margin, depending upon the maturity of the bonds.

There is an implicit belief that Government bonds are completely acceptable collateral at the Federal Reserve banks without question when member banks wish to borrow on them. This unquestioned factor of complete eligibility as collateral bears a close resemblance to Government bonds which had a circulation privilege when the national banks were permitted to issue national bank notes secured by Government bonds plus a 5 percent redemption fund or, in other words, a 5 percent margin.

The market record of the old circulation bonds shows clearly the premium value which this circulation privilege gave them. Government 2 percent bonds, with no maturity at all, merely a call price on and after 1930, sold constantly through the panic of 1907 above par. In fact, their quotation in 1907, was 106¼ high, low 104⅛, for a 2 percent Government bond with no maturity at all, and with panic raging and securities selling on a 6 percent basis. In 1914, they sold at a high of 99 and a low of 97, when corporate bonds were at a substantial discount.

The general belief that interest rates during the war were inordinately low and due entirely to the "management of the public debt" can be severely questioned. Historically, money rates reach a peak as a depression starts, and work lower following a panic.

A study of the open market money rates in England from 1683 to 1939 proves this point without question. Following the unsettled conditions in the very early 1800's, open market money rates there declined from 4.9 percent to a low of 2.3 percent by 1824. My own belief is that the panic of 1819 in this country was worse than the panic of 1929.

Shortly after the upset of 1837, they dropped from 6.5 percent to 2.2 percent; advanced to 7.7 percent in 1847, and declined to 2 percent by 1852; back to 7½ percent by 1857, and down to 2½ percent by 1859; up to 7 percent in 1865, and down to a low of 1.75 percent in 1867, a fractional interest rate. And people say we have never seen a fractional interest rate, until just latterly, accomplished by money management. But it dropped sharply in England following the panic of 1907.

After the 1929 panic and the bank holiday in this country, there was a clear indication that few people or companies wished to borrow and the lending officers in banks, in my opinion, were in many cases afraid to lend. There is an old adage that when money is cheap, credit is hard to obtain—another way of saying that a burnt child dreads the fire, and when there is little demand for money, rates go down.

Many people think that money rates are a state of mind. Sometimes the fish bite, and sometimes they don't.

This fear of private debt has to a great degree remained with us through the depression and through the war. With the end of the war, people felt that they wanted to go places. They could not buy automobiles, refrigerators, et cetera, during the war, so that when they could get them, they wanted them.

For many reasons it was a logical thing for interest rates to continue to get easier and easier during that long period dating from the bank holiday and through the war.

Government bonds should have a substantial premium value; in other words, sell at a lower interest rate due to their availability as collateral, and the fact that they are practically the only riskless investment in the world; and I feel that much too great weight is being given on what is called the imperative necessity to sustain a market price of par for long Government bonds.

It seems quite possible to me that an average price of par or better for these bonds can be a natural market. In the long run, due to the size of the total amount of the Government debt, outstanding bonds have to take their market risk depending upon comparable prices for other securities, and when allowance is made for the outstanding advantages to the holder of Government bonds, when seeking credit, they should and will sell at a much lower yield than any other security in the world.

Representative RICH. The rates of money are based upon the same thing as commodities, the law of supply and demand.

Mr. ROWE. It is very similar.

Representative RICH. And the rates for money are dependent upon the law of supply and demand for loans and volume of cash in the banks.

Mr. ROWE. Well, money isn't quite the law of supply and demand, because by double entry bookkeeping you can supply all the money in the world under our present system. You don't get to the bottom of the barrel.

But the demand side is psychological, and when they want it they pay a higher rate, and when they don't want it, is goes down.

Representative RICH. That is right.

Now, here is one thing. In that last paragraph, you say:

> It seems quite possible to me that an average price of par or better for these bonds can be a natural market.

You are figuring, then, from that standpoint, that we should not guarantee the price of Government bonds?

Mr. ROWE. Certainly. I say we should not. Unquestionably.

Representative RICH. That is right. Then, if we do not, Government bonds can, and may possibly, go below par.

Mr. ROWE. Certainly. What of it? But they may not.

Representative RICH. It might make an awful furor, but in the end it eventually has to come to that, and it will create a little fear in the Members of Congress.

Mr. ROWE. It will hold them down on their spending.

Representative RICH. Yes; the people are going to tell Congress that "the first thing you people have to do is to stop your spending, or Government bonds may go down still further."

Mr. ROWE. Here we have the greatest borrower in history, the United States Government. And when they attempt to restore the price of par, all they are doing is saying, "We are going to endorse that note."

The maker offering to endorse the note! It is ridiculous.

Representative PATMAN. That argument about the law of supply and demand applying in the case of money and credit and interest rates is disturbing to me, in view of the fact that we have more credit now available than ever before in history. And yet interest rates are going up. Why would not interest rates be going down?

Mr. ROWE. Why wouldn't they?

Representative PATMAN. Yes.

Mr. ROWE. Well, the reason is that the borrower has to pay the interest, and the borrower has to be willing to come in.

Representative PATMAN. Yes, I know. But if the law of supply and demand operates in the case of banks and interest rates, why should interest rates be going down now instead of the reverse? We have three times as much volume as we ever had before, including credit.

Mr. ROWE. Total loans at the banks, all the commercial banks of the country, have only gone up that much [indicating], while their total deposits have gone up that much. Percentage of borrowing to requirements is very, very low. Loans are roughly one-third of our earning assets, and the other two-thirds are Governments.

Representative PATMAN. What is the potential borrowing power of the country now, unused?

Mr. ROWE. Under the Federal Reserve Act, it is practically limitless. The present ratio of gold is so liberal that we don't have to think anything about the ceiling of the amount of available money, should the credit require it.

Representative PATMAN. And the point that the gentleman from Pennsylvania raised a while ago can be answered by the statement that the Federal Reserve banks can purchase all Government bonds now, if it were necessary.

Mr. ROWE. Yes, but there is the other point which is very valid, made by the gentleman from Pennsylvania, the other side to that; that while we have this elasticity of both money and credit in our Federal system, there is no doubt about it—and you have that elasticity, terrific elasticity—but as loans start to turn up, the lender charges a little more interest.

Representative PATMAN. I know, but if the law of supply and demand operates and you have more money than you ever had before, why should they not charge more? The law of supply and demand would necessarily cause interest rates to go down.

Mr. ROWE. Because there is a ceiling to the amount that these banks will lend, self-imposed. They know that they can go ahead and hit the ceiling.

Representative PATMAN. But you have not approached it.

Mr. ROWE. I want to show that we are approaching it. I would like to show that.

Here is your net worth of all the banks [indicating]. Now, very few banks want to go over five times their net worth on loans. They do not care about how much they go on short Governments because there is no market risk, and they think they know there is no credit risk. But a careful banker doesn't like to get his loans over five times his net worth, or maybe six.

Representative PATMAN. Just one minute, in order to educate me. What do you construe to be his net worth? His capital undivided profits? Surplus?

Mr. ROWE. Yes.

Representative PATMAN. What is the total net worth of banks now in the Nation? About 3½ billion dollars? I haven't looked it up in some time. Last time it was a little over $3,000,000,000.

Mr. ROWE. The total net worth of the commercial banks of the country is about $10,000,000,000.

Representative PATMAN. You say capital and surplus and undivided profits, amount to $10,000,000,000?

Mr. ROWE. Yes.

Representative PATMAN. They certainly have gone up enormously in the past 3 years then.

Mr. ROWE. They have gone up that much [indicating on chart]. But look at what has happened to that.

Representative PATMAN. How much is the capital by itself?

Mr. ROWE. I haven't got that separated. I don't see any reason to separate it.

Representative RICH. Capital is the surplus and undivided profits, plus reserve for depreciation, plus capital stock paid in.

Mr. ROWE. Net worth is their margin, the margin for their depositors. And come a black panic, most of them feel that they would like to have a 20 percent margin of their own net worth against those loans. A 20 percent margin is five times your loans, five times your net worth.

Representative PATMAN. You have about 10 percent margin now, do you not?

Mr. ROWE. No; in the aggregate I imagine we have better than 10 percent; toward 15.

Representative PATMAN. Of course, I do not dispute your figures. I am sure you know exactly what you are talking about, and I do not. But that seems awfully large to me for capital and surplus and undivided profits, just those three items, of the commercial banks.

Mr. ROWE. Well, they have total deposits of $144,000,000,000.

Representative PATMAN. I am not talking about deposits.

Mr. ROWE. But they owe $144,000,000,000, and they haven't got a 10 per cent margin on it, of their own net worth. And I say that they should have at least 10 percent of their debts.

Representative PATMAN. I will thoroughly agree with you on that.

Mr. ROWE. They should have at least 10 percent of their debts on their net worth. And they only have 10. It ought to be another 4 at least.

Representative PATMAN. Do you have the amount of capital of all of the commercial banks available?

Mr. C. O. HARDY (staff director). I do not have it here. I can check it.

Representative PATMAN. Excuse me for interrupting. But I still cannot understand why we have three times as much money, and yet the interest rates are going up.

Mr. ROWE. Well, they have gone up so very little.

Representative PATMAN. Why should they go up at all? It looks to me like they should go down a little bit.

Mr. ROWE. Money is to a great extent a psychological thing. There used to be an old adage that when the borrower came in to borrow money with his hat on his head and a cigar in his mouth, rates were very low. When he came in with his hat off and threw his cigar away before he came in, rates were very high.

That merely emphasizes that there is a psychology in it, a state of mind.

Representative PATMAN. In other words, psychology enters into it more than the law of supply and demand.

Mr. ROWE. They are both factors. The law of supply and demand affects the psychology, so you can't say which is paramount, because one affects the other. But to my mind, in the first place, all the banks have had to raise their wages to keep in line with everybody else. Costs are up. And we have so far accomplished the magnificent achievement, many banks have, of raising from 1½ percent on 6 months paper to 1¾. That is the extent of it on the short paper. But the very minute these loans creep up, so that they approach, or are more than five times your capital account, the banks are not going to be quite so ready to lend, and will charge more money.

REPRESENTATIVE RICH. The demand in business today is for more money from the banks.

Mr. ROWE. No question of it.

Mr. RICH. And the banks are asking higher interest rates for the use of that money. And as they are doing that, they are getting rid of their Government securities, because they have invested heavily in them. And it is up to the Federal Reserve now to take them. If the Federal Reserve does not take them, I do not know who will.

Representative PATMAN. I think we should say, then, that the law of supply and demand does not operate in the banking system.

Representative RICH. Were you ever in a bank?

Representative PATMAN. I have been a borrower. I have been on the other end.

Representative RICH. Then you do not know anything about it.

Representative PATMAN. The law of supply and demand cannot operate, then, if you have three times as much money with interest rates going up.

What would you think about having three times as much wheat, and wheat going up?

Representative RICH. Well, I never took wheat for collateral.

Representative PATMAN. I will ask the gentleman if he was ever in a wheat field.

Mr. ROWE. Income is up three times, or a little more, and so is industrial production, though not quite so much. And the requirements for loans, we know, will be very much higher. We have been held down so, with wages and low interest, that the capital accounts have not increased the way they should have.

In other words, your net worth, your base of your business, ought to grow with your deposits. And we have these huge deposits. We still remember 1929. And we are going to keep our assets liquid, we banks. That is the firm conviction of every banker. And his feeling is that the most liquid asset he has got are his Government bonds.

Now, the statistics on the Government bonds are clouded by the fact that the Government borrowed a great deal more than they needed in the final war loan drive, left the money on deposit with banks, and later retired other debt. So that statistically, the great height of the Federal debt, and this magnificient lowering of it is a fact, and is statistically accurate.

But actually, the last 20 billions, or whatever it was, should not have been counted. Because they did not use it, and they repaid it promptly.

Representative PATMAN. That is when we had a balance in the Treasury of about $20,000,000,000-odd, was it not?

Mr. ROWE. Yes; in the final bond drive the public bought the long bonds, to a much greater degree than everybody expected. They felt the war was over and this was the last drive, and they could buy those bonds, and a 2½-percent market was assured. They were pleased with the market level. They had been careful of the long bonds before that.

The bankers and the Treasury Department, in my opinion, were just as much amazed when those bonds jumped up to a 104-point premium a few weeks after the end of the final bond drive as they could be. The public took hold of that bait, and ran for it, and ran them up to 104.

Representative RICH. And the reason today that the short-term bonds are selling at a premium, and the long-term bonds can be bought at par, is that the bankers now are waiting for commercial loans to come in, so that they can pick up a higher interest rate to increase their capital and surplus. They will sell governments.

Mr. ROWE. I do not know that the banks are delaying on their holdings of Governments.

Representative RICH. Well, they are trying to have short-term Governments rather than long-term Governments.

Mr. ROWE. Yes; because they appreciate, again, that the market risk on their Governments has been demonstrated by the rapid decline in quotation, and the terrific decline in municipal bonds.

Representative RICH. The reason the bankers want short-term Governments is so that he can turn them into cash and get rid of his obligation, and get increased interest rates from commercial borrowers. I know that is what we are trying to do in our bank, and I am sure that we are only taught by some of you bigger bankers that that is the way to do business.

Mr. ROWE. You want liquidity.

Representative HUBER. Are you a banker, Mr. Rich?

Representative RICH. Oh, in a small way.

Representative PATMAN. If you had complete liquidity, you would not have much of a banking system, would you?

Mr. ROWE. Our deposits are payable on demand. Our reserve in the Federal Reserve Bank cannot be withdrawn. We must keep a certain fixed amount. We can dip below for a day or so, but it is necessary to pay a penalty if it lasts for any length of time. So it is absolutely frozen. Our real reserves for all of us are our accounts we keep with larger banks. That is what we check on, and that is what has a flexibility. And we have to hold, in addition to our reserve balance with the Federal Reserve, I think it is fair to say, at least half again as much on deposit with larger banks.

So that we have a large amount of nonearning assets. That is our first line of defense for liquidity, for fluctuation in deposits.

Representative PATMAN. But you do not hope to obtain complete liquidity, do you?

Mr. ROWE. Certainly not.

Representative PATMAN. That was the question that was raised here a while ago.

Mr. ROWE. Certainly not.

Representative PATMAN. That would destroy you.

Mr. ROWE. It is my judgment that the Federal Reserve banks should let the market take care of itself slowly and persistently over the years, reduce the total of long bonds they own and replace them with shorter maturities, in order to keep the reserve balances of their member banks on an even keel.

The underlying purpose of the Federal Reserve Act was to provide both elasticity to currency and elasticity to credit, and the mechanism of the Federal Reserve bank, simple as it is, under existing laws can easily accomplish that result. They merely have to have in their assets a total of gold, Governments and bank borrowings against the required total of currency in circulation and required reserves for their members, with their net worth total included in these liabilities. Now as to the net worth total, recently the earnings above dividends have been withdrawn from the banks and paid to the United States Government.

Representative PATMAN. Let me ask you a question there, Mr. Rowe. You state that the Federal Reserve banks have, as a part of their assets, gold. You mean gold certificates, do you not?

Mr. ROWE. Oh, yes. But after all the public think they own that gold, so I call it gold just for the sake of brevity.

Representative PATMAN. Excuse me.

Mr. ROWE. Section 7, paragraph 3 of the Federal Reserve Act is as follows:

EXEMPTION FROM TAXATION

Federal Reserve banks, including the capital stock and surplus therein, and the income derived therefrom shall be exempt from Federal, State, and local taxation, except taxes upon real estate.

Section 7, paragraph 1, of the Federal Reserve Act is as follows:

DIVIDENDS AND SURPLUS FUND OF RESERVE BANKS

After all necessary expenses of a Federal Reserve bank shall have been paid or provided for, the stockholders shall be entitled to receive an annual dividend of 6 per centum on the paid-in capital stock, which dividend shall be cumulative. After the aforesaid dividend claims have been fully met, the net earnings shall be paid into the surplus fund of the Federal Reserve bank.

These two paragraph seem to me to say that the Federal Reserve banks were expected to build up their capital and surplus over and above the limited dividends authorized to member bank stockholders, and that they should do just what the member banks should do, namely, keep their net worth in proper and suitable proportion to their total balance sheet.

Representative PATMAN. What is the net worth of the 12 Federal Reserve banks?

Mr. ROWE. About a billion dollars, $750,000,000 to a billion dollars.

Representative RICH. Has the Federal Reserve paid into the Federal Treasury any part of its earnings?

Mr. ROWE. The Federal Treasury took its earnings for last year.

Representative PATMAN. There is no law requiring it now. That law was repealed.

Mr. ROWE. Then, what right did the directors of the Federal Reserve bank have to pay that money over?

Representative PATMAN. Because in the original act, the purpose as there set forth is to render certain services and accommodations; and the rest of it is intended for compensation for the Government.

Originally the law specifically provided a certain amount, and it was provided that when the capital reached a certain amount, it would overflow back into the Treasury. Later that law was repealed. I think that was in 1935. And although it has been repealed, the earnings of the banks have been so large that they have voluntarily relinquished their earnings, or have paid them over into the Treasury of the United States; I mean, in excess of a certain amount.

Mr. ROWE. May I ask you a question? How do you reconcile that with this statement in the law that after the aforesaid dividend claims have been fully met, the net earnings should be paid into the surplus fund of the Federal Reserve bank?

Representative PATMAN. The law provides that above a certain point it would go over into the Treasury. At one time the law was that 40 percent should be paid over, and then it was increased to 100 percent.

Mr. ROWE. This clause, section 7, paragraph 1, of the Federal Reserve Act, says:

> After all necessary expenses of a Federal Reserve bank shall have been paid or provided for, the stockholders shall be entitled to receive an annual dividend of 6 percent on the paid-in capital stock, which dividend shall be cumulative. After the aforesaid dividend claims have been fully met, the net earnings shall be paid into the surplus fund of the Federal Reserve bank.

Representative PATMAN. That is right.

Mr. ROWE. It does not say anything about taking it out.

Representative PATMAN. I think you will find a limitation there.

Mr. ROWE. Let me go on for just a minute. There is a double liability on the shares of the Federal Reserve bank.

Representative PATMAN. They have not paid but half of it so far, though.

Mr. ROWE. They have paid half of it; so that they could be called upon for the other half. They could be called upon for the full amount, the old half plus the new half.

Representative PATMAN. You do not expect that to be done, do you, in view of the fact that the Government credit is behind those banks?

Mr. ROWE. I most certainly do anticipate it if we continue to go along with as reckless spending on the part of the Government as we have been having over the next decade or so.

Representative PATMAN. The credit of the Nation is behind those banks.

Mr. ROWE. All I am saying is that the credit of the Nation is something that has to be guarded. And we have taken plenty of risks with that credit.

Representative PATMAN. I will agree with you. That is the reason I voted against that tax bill.

Mr. ROWE. Personally, I can find nothing in that law that leads me to believe thay have the moral right to pay those earnings out instead of leaving them in the surplus fund of the Federal Reserve banks, particularly due to the double liability clause on us stockholders.

Representative RICH. You might ask some of these Members of Congress about their voting for all of this spending.

Representative HUBER. Is there any reckless spending today?

Representative RICH. Certainly. Lots of it in Government.

Representative HUBER. I am asking Mr. Rowe.

Mr. ROWE. I cannot help but feel that the growth in the total number of people in the Federal pay roll today, versus 1940, or any year you want to take, is to me simply unexplainable, and unbelievable.

Representative HUBER. We will call that to the attention of Mr. Taber and Mr. Bridges, who have been going over these things with a fine-tooth comb.

Representative RICH. I might tell you that Mr. Taber is doing a great and yeoman job. The only trouble with Mr. Taber is that he is unable to do the thing that the executive department of the Government is supposed to do. And he has no control over that. And you are not going to get any relief until you change the executive branch of the Government and those who are supporting it.

Representative HUBER. Of course, the executive branch is spending the money appropriated by Congress.

Senator WATKINS (presiding). Shall we let the witness finish his statement?

Senator O'MAHONEY. May I ask the witness if he has made any study of spending by State governments?

Mr. ROWE. Only broadly.

Senator O'MAHONEY. I think that is one of our great oversights.

Now, the fact of the matter is that the budgets of the States have been growing more rapidly, even, proportionately, I think, than the budgets of the Federal Government.

For example, the State of New York this year presented the largest budget in history, and it happens that that budget was presented by a gentleman who is one of the leading and outstanding members of the party which denounces spending in the Federal Government.

I find that the budget of the State of California for this year is the largest budget in history. And again, the gentleman who presented that budget is an outstanding and a very efficient member of the same political party that denounces Federal spending. And if I am not mistaken, an examination of the budget of the State of Minnesota also indicates that it is the biggest in history.

Representative HUBER. Will the Senator yield there; and include Pennsylvania?

Senator O'MAHONEY. I have no doubt. And Ohio.

Representative RICH. Will the gentleman yield?

Senator O'MAHONEY. Certainly.

Representative RICH. Do you not know that every State in the Union is in better financial condition than the Federal Government? And do you not realize that all of the spending that is to be done ought to go back to the States and be dropped here in Washington? You ought to study that a little.

Senator O'MAHONEY. That is one of the reasons, Congressman Rich, why I also, like Congressman Patman, was against throwing away the surplus which the Federal Government had, and which it might have applied on the reduction of the national debt.

Representative RICH. You have never voted as you talk now.

Representative PATMAN. Of course, the Federal Government bailed out the States a few years ago, too.

Senator WATKINS. Let us let the witness finish his statement.

You may proceed.

Mr. ROWE. I again call your attention to the charts which show the growth of member banks net worth from 1935 to 1947, and ask you to contrast it with the totals for the Federal Reserve System as to net worth in proportion to its balance sheet. The withdrawal of earnings from the Federal Reserve bank to the United States Treasury seems to me of more than doubtful propriety. Federal Reserve banks are the keystone of the credit position of the banks of this Nation.

In my opinion, great stress should be placed upon building up the net worth of the member banks and of the Federal Reserve banks, and that is an essential and the objective we all have, namely, to keep our whole financial structure in this country on a completely sound basis so that the risk of the impairment of credit is reduced, so far as possible, to a minimum.

Representative PATMAN. I would like to ask a question or two, on that last paragraph.

Senator WATKINS. You may.

Representative PATMAN. The money that is issued, about seven-eighths of it now, is Federal Reserve notes, is it not, Mr. Rowe?

Mr. ROWE. Yes, sir.

Representative PATMAN. That is the circulating medium of exchange. Now, these Federal Reserve notes are issued by the 12 Federal Reserve banks, are they not?

Mr. ROWE. I think they gave that up.

Representative PATMAN. Well, look at one of them and read it.

That Federal Reserve note does not say it is an obligation of the Federal Reserve bank. It says the "United States of America" promises to pay to the bearer. And since that is, you might say, a blanket mortgage against all the property of all the people, including their incomes, do you not think that the Government is entitled to just a little compensation for the use of that privilege?

Mr. ROWE. This says "Federal Reserve note."

Representative PATMAN. Now, read the rest of it.

Mr. ROWE. They are all alike, except that they have an imprint of Cleveland or Jackson, or what have you, on them. This says:

> This note is legal tender for all debts, public and private, and is redeemable in lawful money at the United States Treasury, or at any Federal Reserve bank.

Representative PATMAN. Read all of it. Read where it says, "The United States of America will pay to the bearer."

Mr. ROWE. It says, "Federal Reserve note, United States of America."

Representative PATMAN. Read it just like it is, unbroken, if you please.

Mr. ROWE. Well, it is broken on the note: "The United States of America," is the fancy part at the top.

Representative PATMAN. That is right. That is the first of it.

Mr. ROWE. And down here, it says, "Will pay to the bearer on demand twenty dollars."

Representative PATMAN. Now, you see, that is an obligation not of the Federal Reserve bank that issued that, but an obligation of the people, of the United States Government.

Now, since the United States Government is permitting that great privilege to be used by the banks, do you not think the United States Government should at least collect just a small bit of compensation for its use?

Mr. ROWE. I most certainly do not, for this reason: The Federal Reserve banks have gold in their vaults.

Representative PATMAN. How did they get that gold? They passed laws to make people turn it in.

Senator WATKINS. Let him finish, please.

Mr. ROWE. The people turned in their gold and were given paper money.

Representative PATMAN. But they were compelled to by law. Do you think the law should compel people to help the private banks?

Mr. ROWE. How is the Federal Reserve bank making any money whatsoever on converting the gold, which used to be in the hands of the public into paper money?

Representative PATMAN. That is the basis of credit, and the Federal Reserve banks are privileged to use that basis of credit.

Now, criminal laws were passed compelling people to turn that gold in. And certainly you could not insist that was turned in for the exclusive benefit of the private banks, Mr. Rowe. That is going too far.

Mr. ROWE. You are speaking as though the Federal was given a specific privilege, when all they did was to supply the public with paper money and be a warehouse for the gold. Later, the warehousing was taken away from them, and the gold was put in a safer place, or so it was deemed.

But there is nothing in the law that contemplated the withdrawal of earnings from the banks to the Federal Government.

Representative PATMAN. Nothing in the law that does what?

Mr. ROWE. That contemplated the withdrawal of earnings from the Federal Reserve banks.

Representative PATMAN. In the original act, Mr. Rowe, it was very plain.

Mr. ROWE. But it is not, as amended now. I am talking of the act as amended.

Representative PATMAN. But the very act itself contemplates it. Otherwise it would be wrong for Members of Congress to vote for laws putting people in the penitentiary if necessary, to compel them to turn in their gold to private banking institutions, or for their use. You know, that would be a terrible position to put Members of Congress in. They voted for that law on the theory that it was helping the United States Government.

And when the Federal Reserve banks make this issue on the credit of the Nation, the Nation is entitled to some compensation.

Representative RICH. Mr. Rowe, if I remember correctly, this gold that was taken, was taken by Executive order, and the power was turned over to the Chief Executive, and you know who that was. And he took all the gold from everybody.

Representative PATMAN. I know, but laws were passed later which doubtless the gentleman voted for.

Representative RICH. That was when you gave that power. I voted against the President having such power.

Representative PATMAN. But that was recognizing the Executive order, showing it was right. And that required people to turn their gold in.

Mr. ROWE. It doesn't seem to me very logical for the Federal Reserve banks to think that they are making any money on having replaced the gold that was the circulating medium of the country, with paper money. They did not make a dime on the transaction. They make no money on that. They are making their money on their deposits, with which they can have earning assets.

Representative PATMAN. You mean the Federal Reserve banks?

Mr. ROWE. Federal Reserve banks.

Representative PATMAN. They do double duty, do they not? You use them, and the Federal Reserve banks use them——

Mr. ROWE. We don't use them.

Representative PATMAN. You can use them. They are double-duty reserves. The deposits you put into the Federal Reserve System, you get credit for. You can use them.

Mr. ROWE. How do we use them?

Representative PATMAN. Well, by expanding your loans; by having the reserves in your local Federal Reserve bank. You know more about that than I do.

But this is what I cannot understand. I believe in the private banks. I believe in the commercial banks of this country. I am proud that we have a wonderful banking system. We want to encourage it. We do not want to do anything against it. What I cannot understand is why you insist that the Government cannot have anything out of the Federal Reserve System when the banks themselves only have an investment of about $150,000,000, about 3 percent.

They paid 3 percent out of six. Well, let us say you have $200,000,000. How can you say you own the Federal Reserve Banking System, that issues money upon the credit of the Nation, and has already outstanding liabilities of $47,000,000,000; which shows that the amount the banks have in certainly is insignificant by comparison.

It is certainly not enough to support $47,000,000,000. It is insignificant. It is practically nothing. And I cannot understand why you would say that the banks should run the Federal Reserve System and should own it, with that very small ownership.

Mr. ROWE. Here is the balance sheet, the way the member banks make up theirs. You see here this $197,000,000 of capital.

Representative PATMAN. That is all the commercial banks have invested?

Mr. ROWE. That is all we have invested. And if we were called upon to put in the other——

Representative PATMAN. But you will never be called upon. The Federal Reserve banks have to pay 6 percent on that. Why should they be asking for more to pay 6 percent on? You will never be called upon for it.

Mr. ROWE. That may be. I do not know whether we will be or not. But it is an obligation of ours to pay that in.

Representative PATMAN. But you are not shuddering under that obligation, because there is no danger. The Government is behind you.

Mr. ROWE. I am concerned about the attitude that the Government can do no wrong, and the Government's credit will remain unimpaired forever.

Representative PATMAN. I am concerned with anyone having that attitude, too.

Mr. ROWE. I am terribly bothered by it. Now, the total net worth of this balance sheet would have as low as $700,000,000 of net worth. As compared with the $48,000,000,000, that, to my mind, is too small a margin for any operation.

Representative RICH. May I ask you this question: Suppose the Federal Reserve bank carries all of the bonds that the banks present for them to carry, and they take them over. And then, supposing the Government bonds go below par. Of course, naturally, everybody says that you carry them at par whether they are below par or not. That way, they could keep solvent.

But if anything happened, and they were supposed to carry them at market value, the Federal Reserve would be wiped out almost overnight.

Mr. ROWE. Careful banks certainly expect to carry their Governments at cost, or market, whichever is lower, and continue to be able to do that.

Representative PATMAN. That is where it is above par. But, of course, at one time during the depression they were allowed to carry them at par, although they were below par, were they not, Mr. Rowe.

Mr. ROWE. They were allowed to.

Representative PATMAN. That is what I mean; yes.

Mr. ROWE. But the depositor, who chooses which bank he is going to keep a very large sum of money in, is going to a bank that is able to carry his securities at the market. In other words, we do not care what the Government lets us do in the way of appraising assets above market value. Competition is going to drive the deposits to the banks that were strong enough to mark down the market.

Representative PATMAN. Especially when you go above $5,000?

Representative RICH. Anybody in the banking or mercantile or any other kind of business carries them at cost or lower, whichever is the lower.

Mr. ROWE. Certainly.

Representative RICH. Always. That is only sound business.

Mr. ROWE. But the point I am trying to make is that in my judgment, rather than use this capital surplus, it should grow and grow and get into this column [indicating].

Representative PATMAN. But you wanted to grow, Mr. Rowe, on the earnings of the Government. The banks are not proposing to increase that amount. You are not proposing to put any more money in it.

Mr. ROWE. We are perfectly willing, if we are asked to.

I am perfectly certain they do not want to ask us, because they don't want to pay the 6 percent.

Representative PATMAN. But the point I make is that your investment there is so small that it is insignificant. It is practically nothing. And you are not operating on that capital. You are operating on the credit of the Nation. That is what you are operating on. You are operating on the ability of the people to pay taxes.

Mr. ROWE. Why, it seems to me that you are saying that after the Federal Reserve buys Government bonds, and has earnings, then, over and above its normal operating expenses, that money, derived practically solely from Government coupons, has to be paid back to the Government.

Representative PATMAN. Why certainly, and for this reason: a government obligation for a government obligation. In other words, the Government bond is put over into the Federal Reserve bank. The money that is paid out on it is also an obligation of the Government, and not the Federal Reserve bank.

Mr. ROWE. Do you want me to carry on for a minute?

Representative PATMAN. Certainly. It is all right with me.

Mr. ROWE. It seems to me that you are putting your finger on the fundamental difference of opinion. This country feared a central bank. The row over the renewal of the charter of the First Bank of the United States, and then the terrific row under President Jackson on the renewal of the charter of the Second National Bank is sufficient to indicate that the people were afraid of a crushing monopoly in the banking business, and they would not renew those charters.

When the Federal Reserve Act came along, the whole talk was as to 12 Federal Reserve banks; not one single word about a central bank. The growth of the thought of turning it into a central bank has all come since the New Deal era.

The conception in this country was one of 12 separate banks, with a Central Federal Reserve Board; but always 12 separate banks. It was not until long afterward that the power and authority of each separate bank to invest its own money as it saw fit was taken away, and the open market committee created.

If anybody feels that the central banks of the world have done a great job, look at the Bank of England and look at the Bank of Germany. And look at the Bank of France. The moment the banking and the emission of currency become the complete creature of the Government and the Government takes to wasteful spending, your whole credit structure will go down, and go down like a plummet.

Representative PATMAN. But Mr. Rowe, you seem to think it is all right for the Government to issue money on the credit of the Nation, but let the banks have the benefit of it.

Take this district here, which is in the Richmond Federal Reserve area. All right. Suppose the Government sells the Richmond bank a million dollars in Government bonds. The Richmond bank pays the Treasury, up here, a million dollars. In what? In other Government obligations.

Mr. ROWE. No. I beg your pardon. They give them a check.

Representative PATMAN. I know. But they could get the money if they wanted it. The check is as good as money. And if you carried it to its logical conclusion, the money they use is Federal Reserve notes. And that Federal Reserve note is a Government obligation.

If that was an obligation of the bank, your argument would be logical and reasonable, but since the Government's own money, and the Government's own obligation are being used, why should not that money flow back into the Treasury, as to any excess?

Mr. ROWE. I don't see how you can say this is an obligation of the Federal Reserve banks.

Representative PATMAN. No, it is an obligation of the United States Government. Just read that at the top of the bill. It says "The United States of America," and not "The Federal Reserve Banks."

Mr. ROWE. Then why is it on their balance sheets as a liability?

Senator WATKINS. It is a joint obligation, is it not?

Mr. ROWE. I don't think it is a joint obligation at all. I think "The United States of America," on there is pure scenery.

Representative RICH. I have listened to them for 10 years, and I have not been able to understand them yet.

Representative HUBER. I am surprised that a banker would complain of the New Deal banking program, because as I remember the bankers were not getting along so well up until the New Deal.

Representative PATMAN. And they have not had a failure in the last 10 years.

Representative HUBER. And I believe you were one of the proposers of that.

Representative PATMAN. I was one of the proposers of the Federal Deposit Insurance Law.

Mr. ROWE. I was one of those who felt that that was a great mistake and we should not have it.

Representative HUBER. Again, we have two philosophies.

Representative RICH. Just a difference of opinion.

Senator WATKINS. If this debate has been going on for 10 years, I am sure we are not going to finish it today.

Are there any other questions?

Representative HUBER. I have one brief question.

As I see it, the commodity in which a bank deals is dollars. In effect, you rent out dollars to those who return them in good shape, plus some interest. Why, if you reduce the price of borrowing these dollars, would not that line change a little bit? There would be some more incentive for people to borrow money at a lower interest rate, and would not those lines come closer together on your chart?

Mr. ROWE. I doubt very much whether the interest rate affects the amount, or the desire to borrow at all. Companies borrow because they need the money.

Representative PATMAN. And they cannot sell bonds or stocks.

Mr. ROWE. And the markets for equity money are not favorable.

Representative PATMAN. Yes. That is right.

Mr. ROWE. The individual fears debt, but when he has to borrow, he borrows to have a home, and what have you. The corporation treasurer wants to get the lowest going rate. He wants to do as good a job for his company as the corporation of the same size and same quality does. So that when the borrowers borrow, they pay what they have to pay. And the costs of banks have gone up very sharply. We all realize that our net worth in proportion to our total deposits isn't as big as it should be.

Also, competition holds the rates down too. We can't raise them. If a man can borrow at another bank cheaper than he can borrow at the first bank, he will go where he can get it cheaper.

It isn't as though there were any super group fixing the rates. The rates are fixed by every bank separately. There are some country banks that lend nothing under 5 percent.

That is a fair statement, is it not?

Representative RICH. That is right, many of them 6 percent.

Mr. ROWE. Many of them 6 percent.

In the early days, money could be 3 percent, or 2½ in New York, and 7 or 8 in San Francisco, before the Federal Reserve System came along, and helped to unify and make a better clearance for money.

Representative PATMAN. You favor the Federal Reserve System, do you not?

Mr. ROWE. Oh, definitely. I want it lived up to; not given more powers. I want the powers they have exercised better. I am not criticizing them. I say they have done a much better bank examining job, but that I hope it will continue to get better.

The strength of this Nation is inevitably bound up with this. The bank panic of 1929 shows that we are terribly intertwined. I am speaking for a stronger Federal Reserve bank, with a building up of capital. There should be no extension of powers. There is no necessity for member banks to keep a larger idle balance with the Federal Reserve bank. There is no need for it. It will simply mean we will then own less Governments, and they will own more, and we will then have to fight for higher rates of interest, because we have to make up for that loss of earning power that will have happened by losing some earning assets, Governments, which is the only thing we can move into the Federal stream to create the additional reserves that they are talking about.

I am pleading for a strong Federal Reserve System with adequate net worth shown on its books in proportion to its liabilities, and for a strong banking system, with the member banks of this great Federal Reserve System given an opportunity to build up their own net worth and value their own assets more and more conservatively in the next depression.

Representative RICH. So that in the time when the banks of the country need the bonds, the Federal Reserve will not tighten up on member banks, but open up and pour the money back into the banks for the assets which they hold, if they want to deposit them with the Federal Reserve for additional capital. That only makes for strong banks as well as a strong Federal Reserve.

Mr. ROWE. If I may add just one thing. The Federal Reserve System has republished the booklet, The Federal Reserve System, Its Purposes and Functions, and they start out with a foreword: "Central banking is essential to the economic stability and progress of any modern country."

That is a flat statement. I doesn't seem to me that the Central Bank of France, or the Central Bank of Germany, or the Bank of England has done any outstanding job. To say that that is essential to the economic stability and progress of any modern country, I think, is laughable.

Representative RICH. It does not look that way, when they are all coming over here and asking us to pour the money back into these countries. And we have been nuts enough to pour it into those countries and tax our people as we do.

Mr. ROWE. And I don't think that we are a central bank, actually, as the British would call it.

Representative PATMAN. I think you are just playing on words. I say that with all due respect, Mr. Rowe, but I do not think it means exactly what they had in England, or in France, or in Germany. We do have a central banking system, not one bank, but a coordinated banking system. We have 12 Federal banks serving different areas of the country, and there is coordination through a Federal Reserve Board. And to that extent you could call it a central banking system, because the money comes from one central place, that money that you read was owing a while ago. That comes from one place, the Bureau of Engraving and Printing; and to that extent it is a Federal banking system.

Mr. ROWE. Give me one further minute here.

Chapter 1 is entitled "Purpose of the Federal Reserve System."

This follows, in italics:

> The principal purpose of the Federal Reserve is to regulate the supply, availability and cost of money with a view to contributing to the maintenance of a high level of employment, stable values, and a rising standard of living.

Contrast that with the preamble to the Federal Reserve Act.

Representative PATMAN. You are in a dispute with the Federal Reserve Board now, and not with this committee. Because the language that they used, the phrases they used——

Mr. ROWE. I am simply urging that there be a better knowledge on the part of the public of what our Federal Reserve System really is, rather than what somebody thinks it is.

Representative HUBER. The public generally think that the Federal Reserve System is a Government agency.

Mr. ROWE. They generally do.

Now, I just want to read the preamble of the act:

> An act to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

Representative PATMAN. Pretty well expressed, is it not?

Mr. ROWE. Very well expressed; and quite different from this opening preamble of this pamphlet.

Representative PATMAN. You could enlarge upon it by saying that these 12 Federal Reserve banks will have a coordinating agency here in Washington; which they have. And they get their money from one source.

Senator O'MAHONEY. I read with very much interest the paper which you have presented here; and I have listened too, to your answers to various questions.

I gather that your position is that the Government should allow the banks to run the banking business; that the separate Federal Reserve banks should have the largest possible amount of autonomy, without direction by the Reserve Board; that the System should not be used to support Government bonds; and that the operations of the Federal Government should be reduced to a minimum. Is that right?

Mr. ROWE. The operations of the Federal Government?

Senator O'MAHONEY. The operations of the Federal Government. When you speak of reckless spending, and of sound financing, do you not mean the abandonment by the Federal Government of various enterprises of various kinds into which it has entered in recent years?

Mr. ROWE. I certainly do; a trend downward, instead of constantly broadening the sphere.

Senator O'MAHONEY. So that it boils down to this: You would like to see the Government get out of banking as far as is possible and get out of all forms of business as far as possible, and allow this matter to be handled by the people.

Mr. ROWE. That is right.

Senator O'MAHONEY. Now, I ask if that does not involve an assumption that the people themselves, in their individual capacities, could do this? When you speak of the several Federal Reserve banks handling the banking business without too much direction from the Reserve Board, you are thinking of decentralization, are you not?

Mr. ROWE. Yes.

Senator O'MAHONEY. And you feel that the largest amount of decentralization would be good for the country, do you not?

Mr. ROWE. Yes.

Senator O'MAHONEY. I agree with you in that. But I ask you how it is possible for us to decentralize the Government when we are confronted with a stupendous concentration of economic control over the business of the country, and of the people.

Mr. ROWE. Through existing Government agencies?

Senator O'MAHONEY. No; concentration through private management. That, I think, Mr. Rowe, is the cause of all this concentration that you speak of.

Now, let me give you an example, or let me ask one or two questions.

When you speak as you do here on page 12, I want to tell you my understanding of your language. And let me read for you the paragraph at the top of page 12:

> The fear that United States bonds of longer maturities could sell with any permanence at heavy discounts, is based upon the thinking that should general interest rates go up a great deal, the market price of United States Governments could go down severly. On the other side of this picture is the fact that if the United States finances are handled wisely, the fundamental credit of the Government will be unimpaired.

Now, I take that to mean that you acknowledge that if bonds of long maturities were selling at heavy discounts for any length of time, the market price of those bonds would go down severely. And therefore, you say the way to prevent that is to have Government finances handled wisely.

And that I take to mean that you would like to have the Government abandon the activities which were undertaken, from your point of view, when the New Deal began. Is that right?

Mr. ROWE. Well, I don't mean for a minute to say that there haven't been some very real advances in Government thinking. I do feel that the total amount of Government bureaus, and the right to rule, to make laws by proclamation, the giving or powers to make rules and regulations which become law, have gone very much too far.

Senator O'MAHONEY. I agree with that. I have said that on numerous occasions.

But when we talk about Government spending, let me ask you, for example:

Do you believe that the Federal Government should undertake Federal aid to education in the States?

Mr. ROWE. I think, of course, States' rights should be preserved much more than they have been, and that there are certain fields where the States could take care of themselves, given ability to get their fair share of taxes.

Senator O'MAHONEY. Yes. But I am talking now about the terms of your statement here, about wise Government financing.

Now, this is the picture which we have. Up here in the Senate today, sir, the Senate has passed a bill for Federal aid to education, which will provide for an outlay of at least $300,000,000 a year, to aid the States to maintain education. And that aid is based upon a payment of not less than $5 per head, even to the States which have such good credit that they can maintain their educational systems without aid.

Now, that bill was passed by this Senate.

Up on the floor now, we have the Taft-Wagner-Ellender bill, which provides for public housing, and the investment of Federal funds in housing.

Now, that bill is supported, as the names of the sponsors indicate, by members of both parties. It is Government spending.

Mr. ROWE. All I can say to that is that I do not feel I am at all confident that the study I have made would permit me to say how I would vote on half a dozen bills that are pending.

Senator O'MAHONEY. Then you would say to Senator Watkins and myself that you would not undertake to pledge yourself now to vote against Federal legislation for, say, the irrigation of arid lands in the West.

Mr. ROWE. My inclination would be to vote against any extension of Federal powers. In any matter of that kind, I would have to fight with myself to keep an open mind on the merits of the case.

Senator O'MAHONEY. And what would you say with respect to the recommendations for Federal spending to control floods? And what particularly would you say to the residents and the businessmen and the bankers of West Virginia and Ohio and Kentucky who are suffering now because of the fact that the floodwaters of the Ohio River are destroying commercial values?

Should the Federal Government have no obligation in that respect?

Mr. ROWE. They most certainly should. Now, that, of course, stems back over the years.

Senator O'MAHONEY. Very good.

Mr. ROWE. The problem of your waterways and, to my mind, your ports of entry into these United States, are clearly in the province of the Federal Government, because that is over State lines.

Senator O'MAHONEY. Then we are in agreement, Mr. Rowe, that Federal spending for flood control in your opinion is not reckless spending.

Mr. ROWE. Certainly. There must be several that are not reckless spending. I am simply saying that for a Government to carry the size of budget it is now carrying, against an absolute peak gross income of individuals, is to set up a situation in which they cannot sustain that total taxation, come a terrific decline in total income.

Senator O'MAHONEY. I think you are quite right about it. But I want to call your attention to the fact, Mr. Rowe, that four-fifths of the present Federal budget is due to war and preparation for war. I want to call your attention to the fact that the interest upon the national debt alone, $5,000,000,000 a year, is more than half of what the national budget was, the total national budget, at the height of New Deal spending in 1939, when the total budget for military spending and for civilian spending was only $9,000,000,000.

Now, it has become a very easy thing to denounce so-called New Deal spending, and to overlook the fact, which is the fact, that in 1940, before we became involved in the events leading to World War II, the national debt was only $49,000,000,000, of which only $22,000,000,000 had been inherited from the Hoover administration.

Mr. ROWE. World War I?

Senator O'MAHONEY. From World War II, and from deficit spending during the last 2 years of the Hoover administration.

Mr. ROWE. A small sum.

Senator O'MAHONEY. A small sum? It amounted to about $6,000,000,000.

Mr. ROWE. They had reduced the debt $9,000,000,000.

Senator O'MAHONEY. Yes, but then they put it up again. They reduced it about $8,000,000,000.

But may I say, since you suggest it, that five times during that period they reduced the taxes. If they had not reduced the taxes, we probably could have paid off the whole debt. But that is neither here nor there. The fact is that deficit spending, which began in 1930, added $6,000,000,000 to the debt.

And then, because the country was in a terrific dilemma, and there was no possibility of independent Federal Reserve banks or any banking houses coming to the aid of national credit, the Government had to step in.

Senator WATKINS. Do you have any further questions, Senator?

Senator O'MAHONEY. I am trying to determine just to what degree the witness would advise this Congress to curtail Federal spending and where he would do it.

Mr. ROWE. Oh, I would just like to answer that in this way: That the only conception I can have of it is that the Government has a right to spend what it can properly take in in taxes without jeopardizing the economy of this country—just like a business—and that the Federal Reserve System ought to build up a larger net worth and not have its earnings taken out by the Treasury, so that it has a strong balance sheet; that the member banks should be encouraged to sound banking, and to build up their net worth over the period; and that an increase in reserves hampers their ability to build up and remain strong.

Senator O'MAHONEY. Well, now, if we could apply the surplus which we shall have on the 30th of June upon the national debt, that would have tended, would it not, to have built up the net worth, or contributed to the net worth of the Government of the United States?

Mr. ROWE. The Government of the United States has naturally every right to pay down on its debt wherever it can.

Senator O'MAHONEY. Not only the right; but would you not say it has the duty?

Mr. ROWE. The duty. It is better for everybody.

Senator O'MAHONEY. And would you not call it sound financial policy for the Congress, in order to reduce taxes, to shift $3,000,000,000 of its surplus in the present fiscal year over to the next fiscal year, in order to cover up a deficit which would be occasioned by the reduction of Federal receipts following the reduction of taxes?

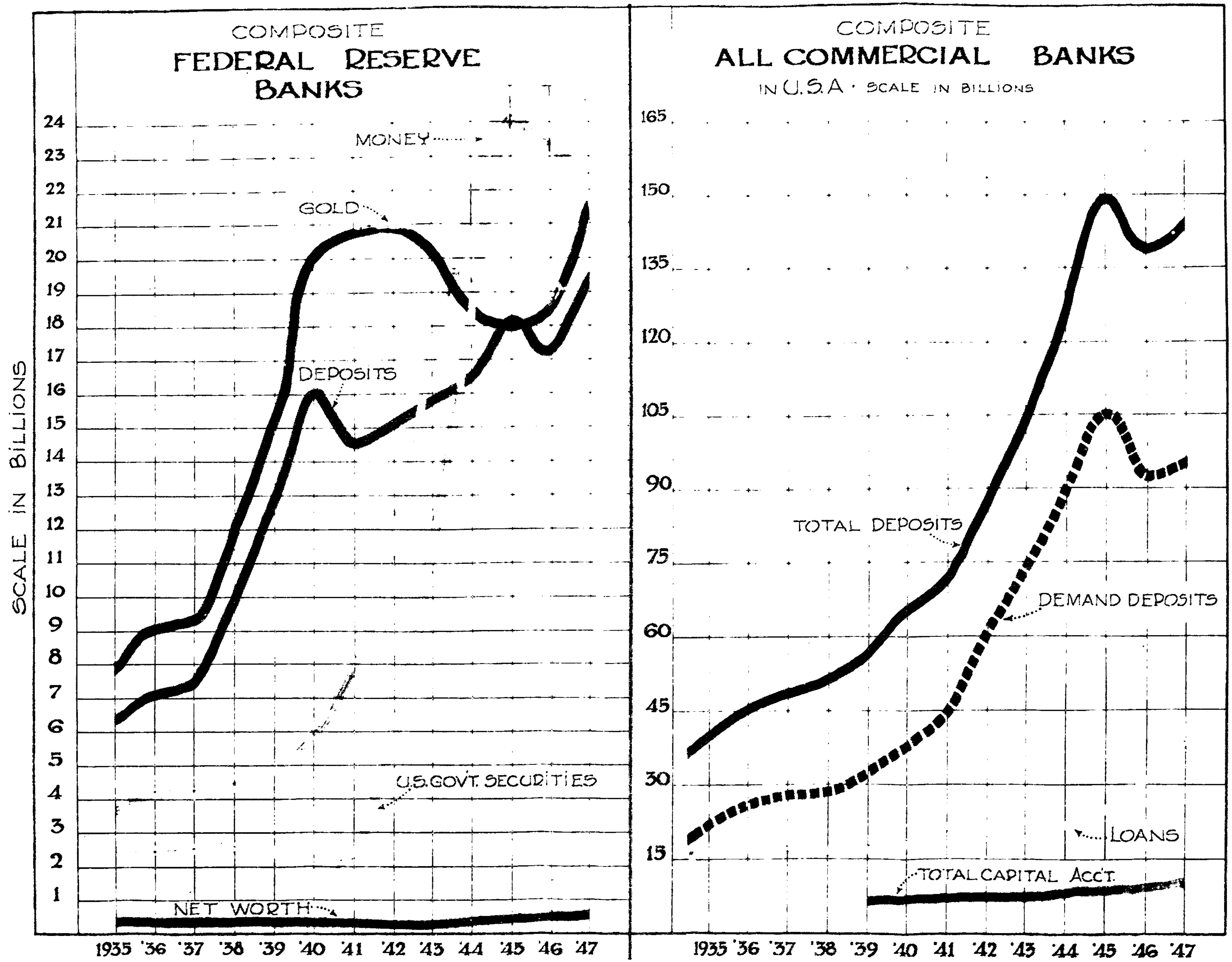
Mr. ROWE. I am no authority on that.

Senator O'MAHONEY. All right, Mr. Chairman.

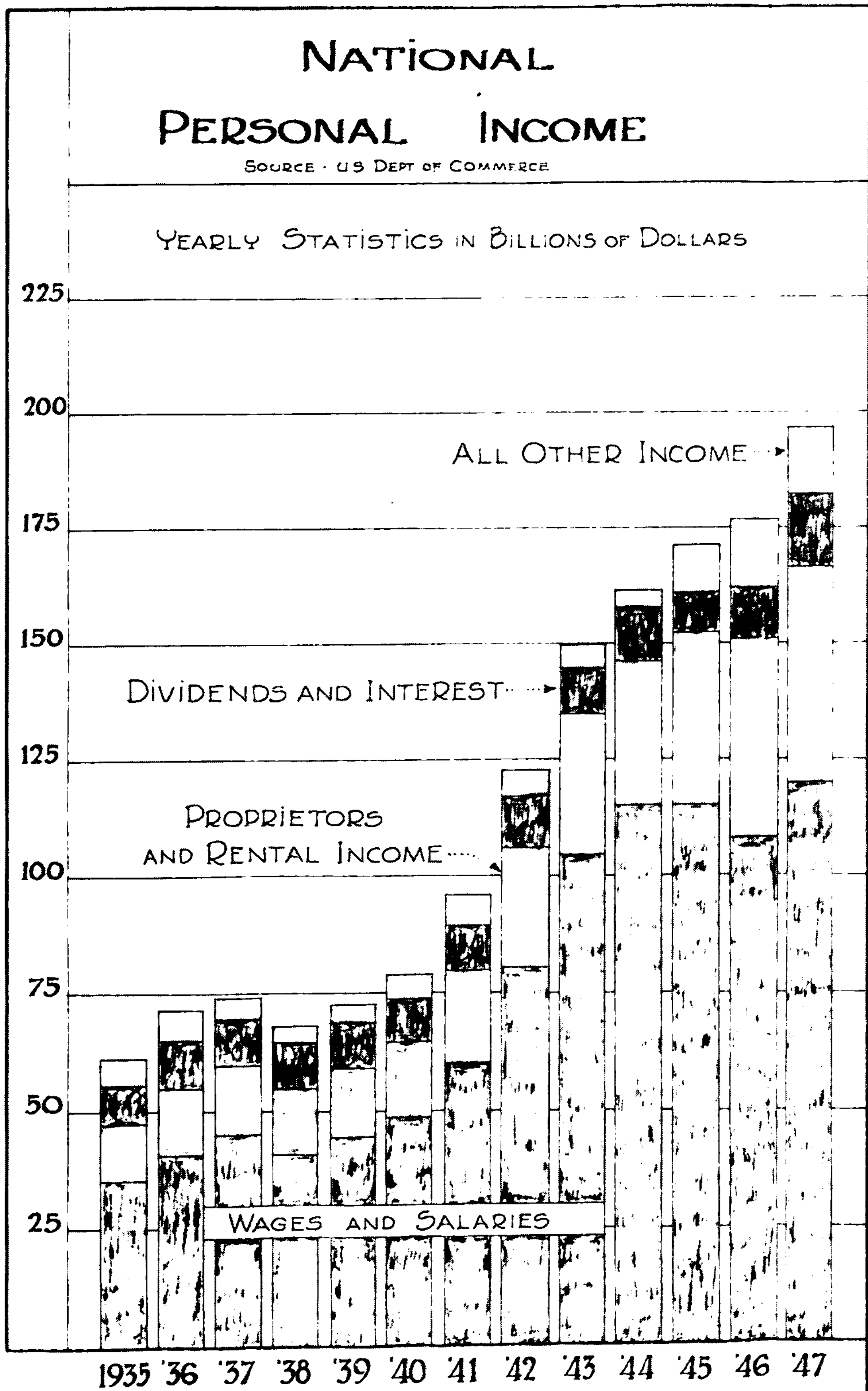
Representative HUBER. Mr. Rowe, Senator O'Mahoney says that the interest on the national debt is $5,000,000,000. Then, in effect, are we not borrowing money and paying interest on money by voting the tax reduction, and is that sound Government practice?

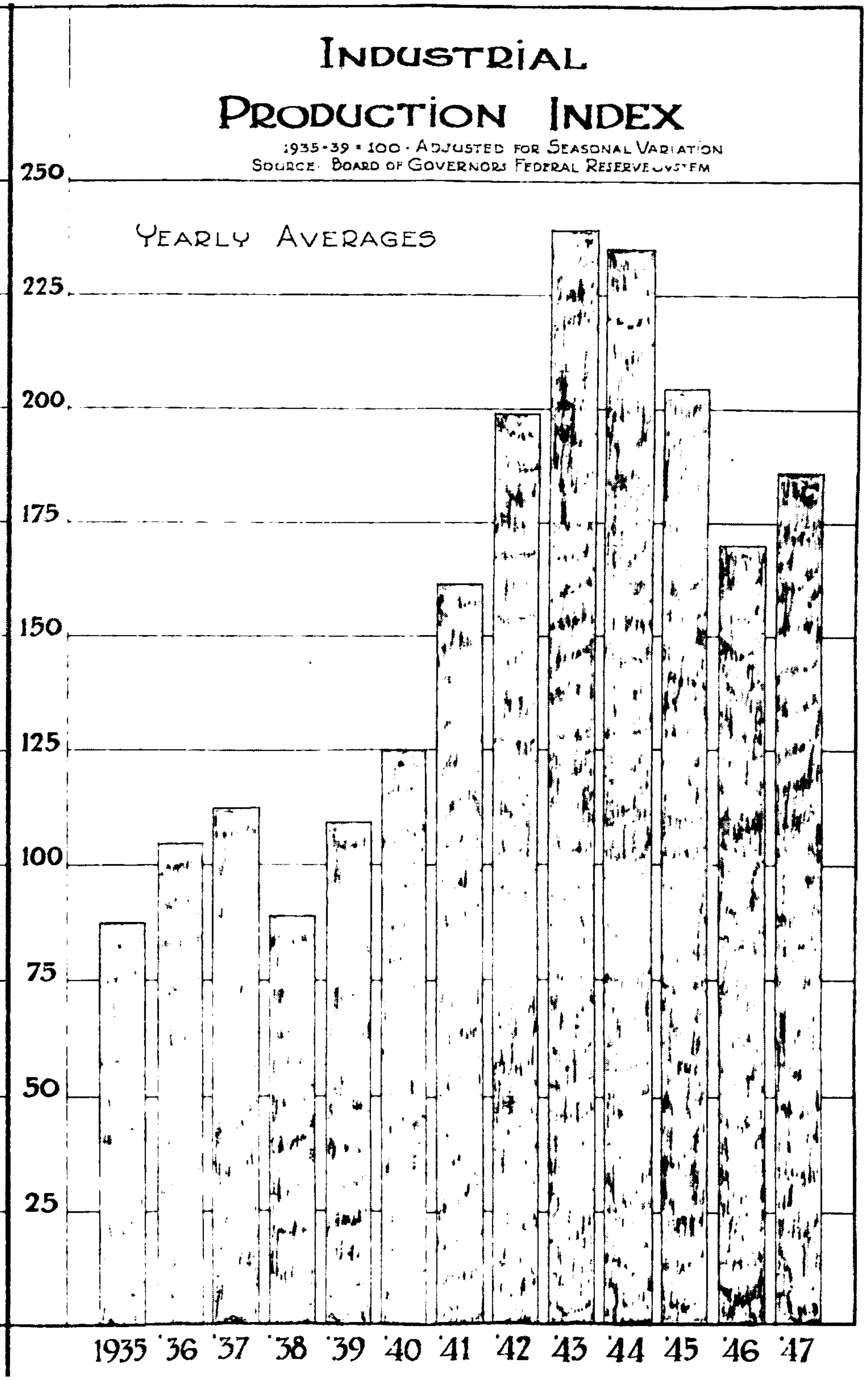
I would like to ask you that, because I realize you are an authority on interest and banking matters.

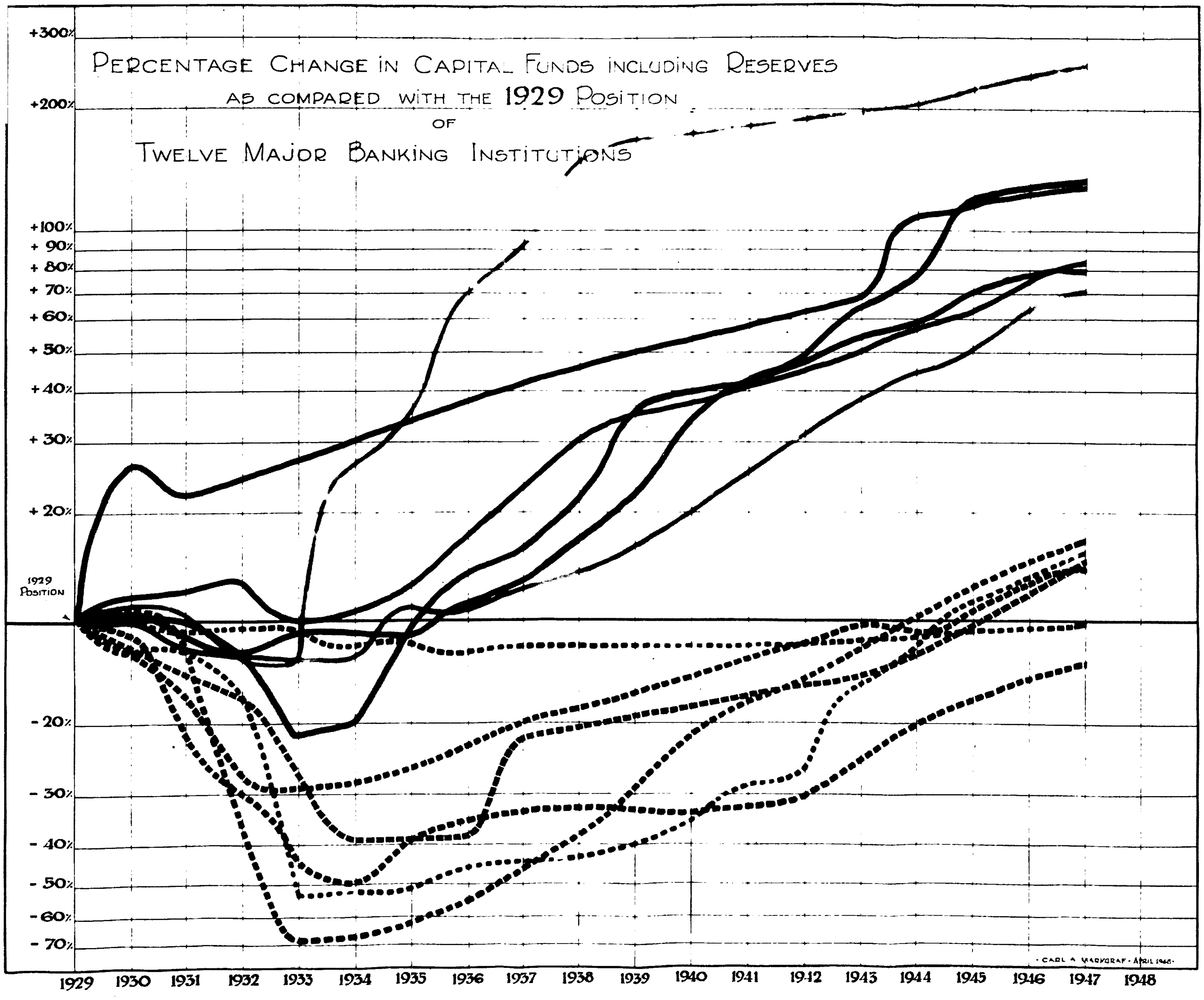
Mr. ROWE. It seems to me that the imperative need for venture capital in this country, the imperative need for equity capital in this



COMPOSITE
FEDERAL RESERVE BANKS
SCALE IN BILLIONS
24
23
22
21
20
19
18
17
16
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
MONEY
GOLD
DEPOSITS
U.S. GOVT. SECURITIES
NET WORTH
1935
'36
'37
'38
'39
'40
'41
'42
'43
'44
'45
'46
'47
COMPOSITE
ALL COMMERCIAL BANKS
IN U.S.A · SCALE IN BILLIONS
165
150
135
120
105
90
75
60
45
30
15
TOTAL DEPOSITS
DEMAND DEPOSITS
LOANS
TOTAL CAPITAL ACCT.
1935
'36
'37
'38
'39
'40
'41
'42
'43
'44
'45
'46
'47


NATIONAL
PERSONAL INCOME
SOURCE · US DEPT OF COMMERCE
YEARLY STATISTICS IN BILLIONS OF DOLLARS
ALL OTHER INCOME
DIVIDENDS AND INTEREST
PROPRIETORS AND RENTAL INCOME
WAGES AND SALARIES
225
200
175
150
125
100
75
50
25
1935 '36 '37 '38 '39 '40 '41 '42 '43 '44 '45 '46 '47


INDUSTRIAL
PRODUCTION INDEX
1935-39 = 100 · ADJUSTED FOR SEASONAL VARIATION
SOURCE · BOARD OF GOVERNORS FEDERAL RESERVE SYSTEM
YEARLY AVERAGES
250
225
200
175
150
125
100
75
50
25
1935 '36 '37 '38 '39 '40 '41 '42 '43 '44 '45 '46 '47



PERCENTAGE CHANGE IN CAPITAL FUNDS INCLUDING RESERVES
AS COMPARED WITH THE 1929 POSITION
OF
TWELVE MAJOR BANKING INSTITUTIONS
+300%
+200%
+100%
+90%
+80%
+70%
+60%
+50%
+40%
+30%
+20%
1929 POSITION
-20%
-30%
-40%
-50%
-60%
-70%
1929
1930
1931
1932
1933
1934
1935
1936
1937
1938
1939
1940
1941
1942
1943
1944
1945
1946
1947
1948

country, by strong, good, going companies, who need more common stock to sustain their base of debt and preferred, is clear. And as long as taxes remained at the high level they were before this tax reduction came along, you were stifling your source of income and the future.

I say it is good business to lower the taxes, thereby reducing the amount which you can pay off on your debt. Because in the long run you will get more taxes by having done so, sir.

Representative Huber. As to this risk capital today, with maximum production and almost a severe allocation of materials, is there any possibility of new enterprises right now?

Mr. Rowe. I have them offered to me, two or three a week; people with an idea, who want to go places, with no money, no proven earning power, and just a beautiful idea.

Representative Huber. Do you have to turn them down?

Mr. Rowe. We can't find the risk capital. I go to people, and they say, "Why, don't be silly. After March 15 I haven't got a dime. In fact, I had to sell principal in order to pay my final adjusted tax."

Representative Huber. That is all I have.

Senator Watkins. Thank you, Mr. Rowe.

The committee will now be in recess, subject to the call of the Chair.

(Whereupon, at 12:20 p. m., the hearing was adjourned, subject to the call of the Chair.)

STATEMENT OF CONDITION, THE FEDERAL RESERVE BANKS, WEEK ENDING FEB. 25, 1948

[Figures in thousands]

Resources:		
Gold certificates		$21, 776, 219
Other cash		367, 880
U. S. Government securities		21, 033, 836
Discounts and advances		279, 149
Industrial loans		4, 353
Federal Reserve notes of other banks		126, 905
Bank premises		32, 891
Uncollected items		2, 796, 358
Other assets		150, 232
Due foreign banks		95
Total resources		46, 567, 918
Liabilities:		
Capital stock		197, 384
Surplus:		
Sec. 7	$448, 189	
Sec. 13b	27, 543	
		475, 732
Other capital accounts		50, 905
Federal Reserve notes		24, 065, 495
Deposits:		
Member banks	$16, 799, 290	
U. S. Treasury	1, 655, 975	
Foreign	448, 761	
Other	452, 355	
		19, 356, 381
Liability for accrued dividend		15, 647
Deferred liabilities		2, 406, 374
Total liabilities		46, 567, 918

CREDIT POLICIES

WEDNESDAY, MAY 12, 1948

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The committee met at 10 a. m., pursuant to call, in room 312, Senate Office Building, Senator Robert A. Taft (chairman), presiding.

Present: Senators Taft and Flanders.

The CHAIRMAN. The committee will come to order.

You may proceed, Mr. Sproul.

STATEMENT OF ALLAN SPROUL, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. SPROUL. In your invitation to me to appear before this committee you posed four questions which, among others, you hoped might be discussed. They were:

1. Adequacy of present powers of the Federal Reserve System and other Federal agencies to prevent undue expansion and contraction of bank credit, and current proposals for increasing those powers, as has been recommended in the Economic Report of the President.

2. Extent to which existing powers should be utilized in dealing with current credit situation.

3. The necessity or desirability of continuing support of the Government bond market and ways in which this might be done with a minimum stimulus to undue expansion of credit.

4. Justification of current complaints about difficulty in securing adequate funds for modernizing and expanding business facilities, especially for small business; effectiveness of current methods of channeling savings into investment.

My statement will concern itself with these questions, or at least with the first three, although not necessarily in the order given nor as direct answers, since they all relate to the general problem of inflation and bank credit. I shall also want to lay some stress on the longer range problem involved, although not neglecting our immediate situation. Perhaps I can best present my views in a series of propositions or paragraphs, with a minimum of argument, leaving to subsequent discussion the elaboration of those points in which you are particularly interested. Or, if you prefer, I could submit more detailed memoranda on any points which you wish to have covered more fully in the record.

1. First it is essential that we try to put the problem in proper perspective. It has become a commonplace to say that our difficulty lies in the existence of an enormous volume of purchasing power, which has meant an effective demand in excess of the existing supply of goods and services—and that this is inflation. Stated thus baldly, attention is focused on the monetary aspect of our problem and many are led

to the conclusion that only by monetary action can we really cope with it. The figures most usually quoted are the increase in the money supply—adjusted demand deposits plus currency outside banks—from 33.8 billion dollars in 1939 to 113.7 billion dollars in December 1947, and the inflation potential in such a tremendous increase is emphasized. These figures, however, are not very illuminating taken by themselves; they must be related to changes in the gross national product—or to some other measure of over-all production—before we can see where we are and where we may be going. Money does not exist in a vacuum; it has work to do. The facts are that the gross national product is estimated to have increased from 90 billion in 1939 to an annual rate of 241 billion in December 1947, and that the ratio of our money supply to the gross national product has, therefore, only increased from 37.4 to 47.2 percent during that period. That puts a very different light on the inflationary potential still resident in the existing volume of money. We have already gone a considerable way in growing up to our increased money supply, and adjusting our general price level to it. And if there has been a substantial and more than passing reduction in the velocity of money—the velocity of money is believed to have dropped substantially in the 100 years before the Second World War—it might be argued that we have gone most of the way in closing the gap—that the price level has come near adjustment to the money supply. I would not want to press this argument too far, but it does help, I think, to put our problem in proper perspective.

2. This is not a surprising development. It is really a continuance of the record of progress of our industrial civilization, distorted by the incidence of war. The progress of the United States in terms of increase in the national income during the present century has been phenomenal. From 1899 to 1947 there was a fivefold expansion, and even when account is taken of the increase in population, and the decline in purchasing power of the dollar, the average real income per capita appears to have increased about 2½ times in less than 50 years. If it were not for the waste of wars and of periods of unemployment, and if it were not for the inequitable distribution of the gains of productivity, as one group or another—farmers, management, owners, organized labor—found itself in a position to receive or to grab a bigger hunk of the pie, we should have had declining prices commensurate with declining real costs, and a lesser need for growth in the money supply. In that sense we have had a more or less continually inflationary economy, interrupted by depressions, but accentuated periodically by wartime wastes of resources and expansion of money supply. The record, however, is one of growing up to the increased money supply—plus declining velocity of money—with intervening shake-outs as in 1920–21 and 1930–32. We have never substantially reduced the money supply without concurrent serious declines in production and employment, which, I believe, no one would wish to contemplate now in the light of the domestic and international situation. In other words, our main hope is not in a get tough monetary policy on the theory that a bust now is better than more boom and more bust later. Our hope lies in gradual adjustments in various parts of the economy, staggered in incidence, while the money supply and the general price level achieve an approximate balance somewhere near the present relationship.

3. This does not relieve us of the responsibility of trying to prevent a further increase in the money supply while inflationary pressures are still strong in our economy, and that is what we have been doing. It is not true that we have had no effective policy and could have none because our existing powers were inhibited by considerations involved in the management of the national debt. By means of a coordinated program of debt management and credit policy, both relying on fiscal policy and on the maintenance of some uncertainty as to the next move, for their main strength, we have held back the further expansion of bank credit. The voluntary program of the commercial banks has worked toward the same end. There is reason to believe that this program has been cumulative in effect, even though it is obvious that credit has not been made either very tight or very costly. As you know, there was an expansion of bank credit in 1947, which we would have liked to prevent, at least in part, since it is difficult to see how the whole of the expansion could have contributed to increased production, but during the first 3 months of 1948 we regained much of the ground we lost during the preceding 12. Adjusted demand deposits plus money in circulation totaled about $109,400,000,000 at the end of March 1948, compared with $113,700,000,000 in December 1947 and $110,000,000,000 in December 1946. That is taking advantage of the very favorable situation which existed during the first quarter of 1948, in which most of the Treasury's surplus for the fiscal year 1948 was concentrated, in which a sharp break in agricultural prices shook the easy optimism of business and and consumers, and in which business borrowing is not ordinarily large in any case. Nevertheless, I should say that we could take considerable satisfaction in our performance with our existing powers, if it were not for recent events which have aggravated the problem ahead.

The CHAIRMAN. Mr. Sproul, my recollection is that Mr. Eccles presented figures showing the increase in bank loans. You are dealing here only with deposits. It is my recollection that the increase in bank loans during the year 1947 was somewhere between five and seven billions.

Mr. SPROUL. I think seven billion perhaps was the figure used, offset perhaps to some extent by a decline in investment; so that the total of bank deposits did not increase by the amount of the increase in bank loans.

The CHAIRMAN. Now, for the last 3 months, the first quarter of this year, have you any figures showing whether bank loans have increased again, or whether they have stood still, or whether they have gone backwards?

Mr. SPROUL. In the first 3 months, the bank loans in the country are estimated to have increased perhaps $500,000,000.

The CHAIRMAN. In the first quarter?

Mr. SPROUL. Yes.

The CHAIRMAN. I think the National City Bank Review made the general statement that the increase in bank loans had been stopped, or checked; or there was some such statement. But they did not give the figures either.

Mr. SPROUL. The reporting member bank figures, which are the ones which are generally made public, do show that the increase has been checked. But I think the figures for all banks of the country, those outside the larger cities as well as those in the largest cities, when they are available, will show that there was some increase during the first quarter.

The CHAIRMAN. Do you think this American bankers campaign has had an influence in holding down bank loans?

Mr. SPROUL. I think it has had an influence. I think you will have to give it some credit for the results.

The CHAIRMAN. With prices still rising slightly, you would have to increase bank loans somewhat, would you not?

Mr. SPROUL. Yes. That is the chicken-and-egg situation; a rise in prices requires some increase in bank loans, and some increase in bank loans results in some rise in prices. They chase one another.

I was dealing here with the supply of money, which is simply deposits plus currency, which represents the amount of purchasing power in the hands of the public.

The CHAIRMAN. The volume of money never has had any impression on me at all. I do not think the volume of money makes any difference. It seems to me it is a result; not a cause. That is as contrasted to additional purchasing power, the creation of current purchasing power, where there seems to be an inflationary element.

Mr. SPROUL. That, I think, is what we have been restraining: the further increase of current purchasing power.

4. It is clear, I think, that proposed increases in our military expenditures and tax reduction (plus continued foreign aid) taken together have created a new situation with respect to the coordinated program of credit policy and debt management which we have been pursuing to restrain the expansion of bank credit. A main reliance of that program, a whacking surplus in the cash budget, has been taken away from us. There are various extimates of what the fiscal results of the year 1948–49 will now be but, with the possible exception of some congressional committee estimates, they do not leave us much fiscal ammunition. A great deal depends, of course, on how rapidly increased appropriations for preparedness are translated into actual expenditures. Our figures indicate that, barring a possible business recession which would cut down Treasury receipts, there will be a cash surplus of between 1 and 3 billion dollars. This amount is probably no more than enough to take care of voluntary public redemptions of maturing Treasury securities, leaving nothing for redemption of securities held by Federal Reserve Banks; which has been the way in which we have cut down the supply of credit available during the past quarter.

Senator FLANDERS. Excuse me a moment. "This amount" you say, "is probably no more than enough to take care of voluntary public redemptions of maturing Treasury securities." By that do you mean a net redemption—the difference between new purchases and redemptions?

Mr. SPROUL. Yes.

Senator FLANDERS. You are expecting a considerable net redemption in the publicly held securities?

Mr. SPROUL. With each new issue which is exchanged for a maturing issue, there is a substantial amount of cash redemption. It is a natural part of the whole exchange operation.

The CHAIRMAN. You are not talking about E bonds, particularly?

Mr. SPROUL. I am talking about current market obligations. Because on E bonds, and F and G bonds, there have been net sales rather than net redemptions.

Senator FLANDERS. Does this sentence, however, mean that publicly held bonds of all sorts will not be sold as fast as they mature; that new issues will not be sold as fast as the bonds mature?

Mr. SPROUL. The sale of E, F, and G bonds, to the public for instance, or the sale of special issues to Government accounts, would provide the funds with which these market issues would be redeemed, market issues which are not exchanged for new offerings.

Senator FLANDERS. I was just trying to see why a cash surplus of 1 to 3 billions could not be used for redemption of reserve bank securities. It would seem to me if it cannot be used for that redemption it would be because there is a net loss in refinancing.

Mr. SPROUL. A net loss in connection with market obligations; although that loss is made up in other ways in the Treasury's cash position. Now to proceed with my argument.

Because of the uneven distribution of Treasury receipts and expenditures, the Government might conceivably be a temporary borrower of small amounts for short periods during the latter part of the calendar year 1948—that is, during the first half of fiscal 1949. Our existing program of credit control will not be in working order much longer without some adjustment.

5. It is uncertain, of course, whether there will be a revival of strong inflationary pressures during the second half of this calendar year, or later, and it is still debatable what and how much should be done to try to curb such pressures by over-all monetary action if they still persist. It has seemed likely, as a consequence of approaching completion of postwar plans for plant construction, expansion, and improvement in a number of industries, that there would be a falling off in business capital expenditures during the latter half of 1948 or the first half of 1949. If Government expenditures (and deficits) do not pick up rapidly, it is conceivable that the inflationary effects of renewed spending may be offset by this decline in private capital expenditures. There are other elements in our economy—that is, supply of some goods overtaking demand and the prospect of better world crops this year than last year—which would also mean a relaxation of inflationary pressures or even the introduction of deflationary forces. These can be set off against tax reduction, a sustaining influence on the demand side, increased military expenditures which will give a fillip to domestic production, European and other foreign aid expenditures which will help maintain a high level of foreign demand, and a third round of wage increases, all of which singly or taken together have inflationary implications. It cannot be too easily assumed, however, that we are definitely headed into another inflationary upsurge, nor, if we are, that it will be of the kind to demand drastic over-all monetary measures. Let me quote from the official press:

Release concerning the memorandum to the President by the Council of Economic Advisers, dated April 9, 1948:

Appraisal of the combined impact of these two plans [foreign and preparedness programs] may be undertaken by an examination, first, of their general impact upon the economy, and, second, of their impact upon specific situations of shortage. Viewing first the general impact, we concluded in our October foreign aid report that the export surplus in 1948 under an aid program of the size then contemplated would not inject a new inflationary influence because it would not exceed the export surplus already felt in 1947. As finally adopted, the European recovery plan will involve an export surplus in 1948 at least $2,000,000,000 below the level that the October report contemplated and found to be safe. This leaves room for the safe absorption of a defense program of considerable magnitude. The defense program, as now formulated, implies at 3 to 4 billion dollar commitment for the fiscal year 1949. In the President's letter of April 1, transmitting an additional budget request, there was outlined a program involving additional expenditures for the armed services of only 1.7 billion dollars in fiscal 1949. Of this amount, not more than half will represent actual payments to the public in 1948, and only a part of this will represent a demand for additional goods. Thus, in terms of its general impact upon the economy, the defense plan would seem to be something the country could readily take in its stride.

With increasing appreciation of these facts, the tendency for business to react to the defense program in terms of an incipient new boom has abated, and there has been an increasing disposition to assess the plan as an offset to softening tendencies which might be developing during 1948 rather than as a further stimulus to an already strongly inflationary situation.

But while a 3 to 4 billion dollar program may not seem disturbing to a $240,000,000,000 economy when viewed generally, the conclusion is different when we turn to its specific impact upon particular production and market situations. Just as in the case of the European recovery program, to which it is now added, the real issue as to whether additional economic controls are needed grows out of the concentration of both programs on certain classes of goods and areas of production where shortages have been most severe and persistent. These areas include products of farm origin, particularly livestock products and textiles, steel and other metals, and the sources of power and heat, including coal, petroleum, gas and electricity.

This may be an argument, say, for allocation of certain materials where specific bottlenecks develop or shortages appear, or for some other kind of direct controls, but I certainly do not think it is an argument for drastic over-all monetary controls.

6. Nevertheless, if we take account of the possibility that we may be faced with the necessity of resisting strong inflationary pressures during the second half of this year, or the first half of next year or later, we must also take account of the possibility that these pressures will give rise to increased and inflationary demands for bank credit, even though they are primarily due to nonmonetary causes. Fiscal policy, debt management and credit control should then be ready to make their contribution to the renewed struggle against inflation. The choices before us have been classified (assuming for the present that we shall not quickly reverse ourselves and increase taxes) as trying to cut down (*a*) military expenditures, (*b*) other Government expenditures, (*c*) private or public investment, (*d*) personal consumption.

Here I express rough opinions. Although there should be room for some paring of previously planned military expenditures now having a lower order of priority, and every effort should be made to this end, it is unlikely that much will be accomplished. Similarly, in the field of other Federal Government expenditures, every effort should be made to hold them to a minimum, but the prospect for substantial economies is doubtful. Federal investment expenditures may be curtailed, but State and municipal expenditures are expanding rapidly. As I have suggested a gradual decline in private capital expenditures seems likely, unless the contemplated effects of increased military spending are exaggerated or actual expenditures prove to be greater than presently estimated, and pressure for private capital expenditures again increases.

The CHAIRMAN. I do not see much evidence of any increased military spending that would require a capital expenditure outside of the airplane industry; and even there, as I understand it, the industry is oversupplied with capital already, and it will only be a question of tools.

Mr. SPROUL. That seems to be the place where the largest immediate influence will be felt, and where working capital rather than investment capital is a primary need. I think you are right.

An invigorated campaign to sell savings bonds can help sop up loose dollars. And, finally, by means of action in the monetary and credit field we can attempt to prevent or restrain a further expansion of consumer and business purchasing power based on bank credit, but we can not do much, if anything, about purchasing power already in existence, unless we want to take measures so drastic as to risk a serious over-all decline in production and employment.

7. Does this leave us entirely helpless with our present powers? I think not. With fiscal policy inhibited and debt management reduced in scope, monetary policy may be able to play a relatively more important role than in the recent past when it has been leaning heavily on Treasury surpluses. If there is a decrease in the demand for private capital funds the pressure on long-term rates which asserted itself last fall will be relieved. Maintenance of the 2½ percent long-term rate on Government securities should not then require us to put large sums into the market if, in fact, support by us is necessary. Meanwhile, we could proceed further with increases in short-term rates, so as to maintain a healthy degree of uncertainty as to future action, so as to keep the banks liquidity conscious, and so as to encourage them to use whatever reserve funds come into their possession (through gold imports, return flow of currency, Treasury expenditures, or otherwise) to purchase short Governments from us. While I do not believe that a public hearing of this sort is the place to try to give details of the immediate moves which the Treasury and the appropriate groups in the Federal Reserve System may be considering, I can say that I do not agree that we have necessarily approached the limit of increase in rates on short-term Government securities which might be permitted without endangering the long-term market. The pattern of interest rates, in which rates follow a smooth downward curve toward the short-term end of the rate structure, has now prevailed for so long that we tend to regard it as normal. In fact, however, the present rate pattern was an outgrowth of quite abnormal circumstances—namely, the accumulation, before the war, of a huge volume of excess reserves in our banking system. Prior to 1930 short-term interest rates were more commonly above long-term rates than the reverse. And even if we admit that other things are no longer equal, we need not be too concerned about the long-term market. In theory at least, so long as we are firm in our support of the 2½ percent rate for long Government bonds, we have made that a demand rate and there is no reason why rates on shorter term obligations could not approach this figure. The facts, as distinguished from the theory, of course, might suggest or require that we stop at a lower figure.

One fact that must be taken into account, but must not be allowed to outweigh more important considerations, is the cost of servicing the public debt. It is easy, if one does not stop to make an actual calculation, to exaggerate the effects of a rise in short-term rates on the positive and immediate cost to the taxpayer of interest payments on the public debt. The fact of the matter is that a rather considerable rise in short-term rates could occur without too much positive effect on the budget during the next few years. The major factor in the rise in the budgetary item of interest payable on the public debt that has already occurred is not the small advance in short-term interest rates to date, but rather the increasing rate of interest accruals on savings bonds, due to the practice of accruing interest on the basis of the the increments in redemption values, rather than at the rate of interest payable from issue date to maturity date. This practice has had the effect of reducing the budgetary provision for interest payments on the debt in the earlier years of the life of the bonds, at the expense of substantial increases in the later years. But, of course, no increase in actual cash outlays is involved until the bonds are redeemed. Once the facts of this situation are understood, the argument that we cannot follow an appropriate monetary policy, because of its effects on the burden of servicing the public debt, loses some of its force.

8. This latter discussion may suggest a subsidiary question which I know is in some of your minds. Why should we support the Government security market, and to that extent circumscribe our powers and our actions to control the volume of credit? Obviously, there is a conflict between our desire to restrain credit expansion and our acceptance of the obligation to maintain stability in the Government security market, although this conflict has been exaggerated in some current discussion. The facts are that the System's purchases of Government securities have been exceeded by the System's sales and redemptions, by more than 1½ billion dollars since market support purchases were begun last November. The total amount of Federal Reserve credit outstanding has been reduced by approximately 3 billion dollars since the end of 1946 and by about 4 billion dollars since the end of 1945. We have moved to offset the effect of gold inflows and other factors tending to expand commercial bank credit, despite our concern about the Government security market. Our policy has been actively anti-inflationary, if it has not been deflationary. If this had not been so, there would have been no need for us to support the Government security market. Banks would have been swimming in reserve funds, and Government securities (and probably other securities) would have had a more or less continuous bull market. I suggest, therefore, that it has been possible to support the Government security market, as we have been supporting it, without stimulating an undue expansion of bank credit.

I justify the policy we have followed, not on the basis of cheap money or low interest rates so far as the Government debt is concerned, although that has its important aspects, but because I question what good could have been accomplished by a vigorous aggressive policy of over-all credit contraction—such sales of Government securities from our portfolio as might have broken the market. As I said, in my testimony before the Banking and Currency Committee of the Senate last December, in view of the large involvement of our whole economy with a Federal Government debt of over $250,000,000,000, in view of the continuing need for refinancing parts of that debt, and in the face of an imperative demand for maximum production, if we are to solve our domestic problems and meet our commitments abroad, it seems to me that those who suggest raising the discount rate sharply and selling Government securities out of System account, without regard to the effect on the price and yield of such securities, are talking in terms of a situation which does not presently exist. Such action would probably be effective in checking the further expansion of bank credit, but at a cost in fiscal and financial disorder, and in terms of reduced production and employment which no one would want to contemplate now.

The CHAIRMAN. It would seem to me that that could be approached from a different standpoint, not selling Government securities, but of buying Government securities. I do not know that anybody has suggested that the Government would go out and flood the market with Federal securities, but the question is whether they are going to support the market by buying securities.

Mr. SPROUL. In a real sense we have not been buying them, because, as I said, net we have sold and redeemed substantially more than we have bought.

The CHAIRMAN. That may have happened in the last few months, but that is not what is going to happen from now on.

Mr. SPROUL. That has happened since 1945.

The CHAIRMAN. 1945? You mean you have fewer bonds in the Federal Reserve System now than you had in 1945?

Mr. SPROUL. Yes. We have taken 3 to 4 billion dollars out of the market, 4 billion I believe, since the end of 1945.

The CHAIRMAN. That resulted from that big sale of bonds, from the big redemption of bonds after the last bond drive, from the accumulation of cash and the paying off of those bonds, did it not? I mean, you claim that you have not been supporting that.

Mr. SPROUL. No; but we have been supporting in a way that has resulted in a net reduction in the amount of Federal Reserve credit in use. We have not put Federal Reserve funds into the market net over this whole period.

The CHAIRMAN. That certainly is contrary to what I have been thinking; if you take out the effect of that last bond drive.

Mr. SPROUL. It all comes down to whether we have put funds into the market or taken them out, which is the basis for expanding or contracting bank credit. And we have taken them out, net.

The CHAIRMAN. Well, I just do not think the figures will support that statement, if you take out the figures on this last bond drive.

Mr. SPROUL. The Victory loan drive?

The CHAIRMAN. Yes, the Victory loan drive; if you take out the effect of that. Well, those figures can be obtained anyway.

Mr. SPROUL. A general monetary control, if used drastically enough works through a restriction of production. The steps in the process are restriction of money supply, rise of interest rates, contraction of employment and production, contraction of income. I know of no monetary device which would enable us to avoid these consequences, and I think it is an illusion to think that some painless way of avoiding the consequences of making credit really tight, can be found. To use our existing powers without regard to interest rates and the Government security market, in order to get the effect our critics suggest, would mean that our action would have to be drastic enough to lower the money income of a large segment of the consuming public. To accomplish this by over-all monetary or credit action would mean a serious decline in production and employment. Such action could only be justified if we were faced with a runaway inflation due solely or primarily to monetary causes. That is not our present situation and that cannot be the right policy now.

9. To sum up this section of my testimony, we are in difficult but not impossible circumstances. We may be faced with another upsurge of inflationary pressures, but that is not certain, and insofar as the remedy is to be found in monetary action—and in most circumstances it will be supplementary at best—we still have a few shots in our locker. In other words, we should neither magnify the dangers we face nor minimize the effectiveness of the weapons we have to combat those dangers.

10. It has been suggested, however, that our situation may become much more critical, that we may be faced at some future time with an accelerating price rise, that our present powers may run out or prove ineffective, and that we should arm ourselves with additional powers as a necessary precaution. It has been proposed, first, that the Federal Reserve System be given authority to increase the primary reserve requirements of all commercial banks, and, second, that if still further powers are needed the System be granted supplementary authority to impose a special reserve requirement permitting banks to hold, at their option, an additional reserve in specified cash assets or in short-term Government securities. I do not think that either of these proposals would be particularly effective in checking the kind of inflation we are supposed to be worrying about—that is, a real runaway inflation with a monetary background—while constantly seeking their imposition does run a considerable risk of seriously interfering with our present program, and their actual application could not help but be upsetting to the securities market as deficient banks adjusted their positions to meet the new requirements.

It is true, of course, that an increase in reserve requirements, either primary or special or both, would put pressure on the banks and would reduce the ratio of possible expansion of bank loans and investments based on a given volume of reserves. But so long as we maintain our present policy of support of the Government securities market, banks would still be able to obtain additional reserves (and some multiple expansion of credit would still be possible), if the alternative were to deny funds to a borrower they wished to accommodate, or to pass up an attractive investment. Commercial bank policy, individual customer relationships, the incidence of possible capital losses, and relative interest rates, would still be the sanctions in such cases, and our influence could be brought to bear just about as effectively by increasing short term interest rates, as by the more clumsy method of increasing reserve requirements. As an instrument of short-run credit policy, increases in existing reserve requirements, which must be applied in jerks and in chunks to large groups of banks regardless of their individual policies and positions, are not very useful. And if we should, in the future, get into a situation in which it is imperative that additional emergency powers be available and used, in which aggressive monetary action must be taken to check a runaway inflation, regardless of the risks of such action, the powers would have to be stronger than any yet proposed. It would not be enough merely to reduce the possible ratio of expansion of bank credit; we should probably need powers that would enable us to stop the further expansion of bank credit in its tracks. I would rather try to meet that situation when and if we come closer to it, than try to anticipate its requirements now.

The CHAIRMAN. Mr. Sproul, you have emphasized that the fear is of a runaway inflation. Most of the fears presented to us have not been as to a runaway inflation but as to a creeping inflation, one which steadily increases prices and wages and is accelerated by more bank loans, which are produced in turn by the wages and prices, and do forth. I do not think anyone really fears a runaway inflation particularly.

Mr. SPROUL. Then I say the powers we have are adequate to cope with the creeping inflation. We do not need new powers; in fact, we should not use the new powers, if we had them, to cope with the creeping inflation.

The CHAIRMAN. You have not coped with it in the last 15 months.

Mr. SPROUL. I think we have had considerable influence in coping with the increase in bank credit during that period; and I bring to my support the figures that you do not believe, which indicate that the volume of purchasing power has been held steady.

The CHAIRMAN. You yourself say you have had an increase in bank loans of $7,000,000,000 in a year, which has added that much to the purchasing power of the people.

Mr. SPROUL. It was offset by decreases in other items of the bank's accounts, so that the total volume of purchasing power—that is, deposits and currency—is no larger at the end of the first quarter of this year than it was at the end of 1946.

The CHAIRMAN. I do not see any balance against that $7,000,000,000 except the Government surplus. I do not see any control on the part of the banks or the Federal Reserve Board that had an effect on it.

Mr. SPROUL. There was a decline in bank investments; growing, to be sure, out of the Government's reduction in its outstanding debt. But the means and methods of using that surplus to retire Government debt held by the Federal Reserve banks in large part, has meant that to a considerable extent the funds taken out by taxes did not go back into the market in the redemption of securities held by the public, or by the banks.

The CHAIRMAN. You are saying that the Government fiscal policy as to the surplus has balanced that increase in purchasing power. But I do not see just what effect the policy of the Federal bank has had on it, or how it in any way has restrained it particularly. You have raised your rates of interest a little, perhaps, and you have raised the short-term stuff, and you have increased the reserves a little bit; or the Board has.

Mr. SPROUL. The major influence was the Treasury cash surplus and the method used in disposing of that cash surplus. There is no question about that. That is what we have been leaning on. But we have geared our debt management policy, or the Treasury has, to the Treasury cash surplus in such a way as to make it all work together. The Treasury cash surplus could have been used to retire the credit held by others than the Federal Reserve banks, without having this restraining effect.

The CHAIRMAN. That is right. There would have been more inflation.

Mr. SPROUL. 11. Going beyond such temporary emergency action which might be considered, in the future, as a way of meeting an urgent and critical (but still hypothetical) situation, a more fruitful long-term approach to the whole problem of reserves would seem to be to attack the problem at its base. First, there is the method of fixing reserve requirements. I think the present method is based too much on geography and too little on existing banking facts. It is time to give serious consideration to a system of reserves related to the character of deposits rather than to their location. I think we shall find that, in the words of a recent study, we are now at a point where we could device a uniform system of reserve requirements, uniform as to banks wherever located, and distinguishing only inter-bank deposits, demand deposits, and time (savings) deposits which would be economically defensible, administratively feasible, equitable as between banks, and adapted to our banking system as it has evolved through the years.

Second, there is the question of the leverage factor in our present system of proportionate reserves. There may well be reasons, taking the long view, for an increase in the reserve requirements of the commercial banks of the country, and of the limits within which those requirements can be varied by the Federal Reserve System. I am inclined to believe that this could be a progressive step in our monetary-banking organization, especially if there should continue to be a persistent and substantial inflow of gold. With a modern central-banking system operating in a highly developed deposit-banking system, and with a decreasing reliance upon gold, much of the need for low reserve requirements and consequent economizing in the provision of money by commercial banks has disappeared. In these circumstances there may well be a balance of advantage in higher reserve requirements, as a means of reducing the dangerous expansibility and, at times, destructive contractability of a money supply based on a low reserve ratios of commercial banks. There may be too great an element of leverage in our present system to be left at the disposal of 14,000 banks. We should try to discover whether there is some practical way, as a long-term improvement and not as an emergency device, to increase reserve requirements so that the ratio of expansion on a given base would be less than it is now. Perhaps the answer could be found in a modified ceiling reserve plan, which would authorize an increase in reserve requirements—whether primary or special—on any increase in deposits after the effective date. Not an increase to 100 percent or anywhere near it but to some figure which, on the average, would bring total reserve requirements nearer to the desired ration, whatever it might be determined to be, than the ratios which now exist. These are the directions in which I believe Federal Reserve study and the consideration of congressional committees should be taking us.

12. There are other things to be considered if we are going to take the long view rather than the short view. There is the integration of monetary and credit policy and powers which have been given to the Federal Reserve System, with related powers exercised by the Treasury and other agencies of the Government. These diverse authorities wield overlapping powers which have been granted over a period of years—frequently with a view to strengthening some weak spot in our economy—without much regard for their accommodation to an

over-all economic policy. Action taken in one place may accentuate inflationary or deflationary tendencies while we are fighting them in another. Then there is the organization and functioning of the Federal Reserve System itself. I have always believed and still believe that we have in the Federal Reserve System a wise blend of national authority and regional responsibility, of Government control and private participation. But it is some time since the Congress gave us its mandate and various interpretations of its intent have gained currency. More and more it seems to have become the habit to think of the System as a head office in Washington with 12 branches or subsidiaries in the 12 Federal Reserve districts, and even to forget that the Board of Governors is a Board and not a chairman with deputies, great though the powers of the Chairman may be. More and more it has become the habit to minimize the value or deny the propriety of any private participation in the affairs of the System. I oppose these tendencies.

I think we shall do well to retain the regional characteristics of the System, both in the matter of decentralized operation and, more important, in the matter of System national policy. No one would deny the need for coordination of general credit policy, but we now have, in the Federal Open Market Committee, the statutory means of achieving this while retaining some regional participation and responsibility. This committee is composed, as you know, of the seven members of the Board of Governors and five of the presidents of the Federal Reserve banks. Here are brought together, under statutory auspices and with statutory responsibilities, men who are devoting their full time to the problems of the Federal Reserve System and who are in touch with governmental policies and private views and opinions, in Washington and throughout the country. The Federal Open Market Committee now controls the principal weapon of credit policy—open market operations in Government securities. It is time, I think, for the Congress to consider whether it would not be a foward and constructive step to charge the Federal Open Market Committee with the related credit powers now exercised solely by the Board of Governors, and to consider this committee as the body to which any additional powers should be granted.

I also think we shall do well to retain the modest measure of private participation in the affairs of the System which we now have, and to make effective use of those public spirited men who are willing to serve as directors of the Federal Reserve banks. It has been argued that the only way to insure the place of the Federal Reserve System in our financial affairs is to deprive it of all taint of private participation. The Government, so the argument runs, would be willing to place full reliance on the System's existing powers, or to give it additional powers, only if the remaining vestiges of private participation are removed. This seems to me to be a misreading of the longer term future and a miscalculation of the policy which will serve us best now. Rather than seek powers by trying to make ourselves just another Government agency, we can claim powers because we are a successful working example of Government functioning in the economic field, with the aid and support of private business. Our experience in Government-business cooperation—Government having the dominant voice, as it should have in the field of monetary and credit policy—might be a sign-post along the way to solution of one of the major economic problems of the postwar years: The relation between Government and business in our whole economy.

It may be that these are not matters within the immediate purview of your committee. They are matters, however, which affect any long range consideration of credit powers and credit policy. There has been no general review of our whole monetary and credit organization and its workings since the studies of the National Monetary Commission which preceded the establishment of the Federal Reserve System in 1913. It is time, I submit, to review all of our legislative authorities in the light of our experience and our existing economic environment.

The CHAIRMAN. Mr. Sproul, it seems to me there is still a dilemma. I still do not see how you can restrain bank credit if the rates of interest tend to rise. You say the 2½ percent will not rise. But suppose it does. Is there any restraint on bank credit, as long as you have the obligation to maintain the 2½'s at par?

Mr. SPROUL. Yes, I think there is.

The CHAIRMAN. And let us take the normal condition of a Government fiscal policy, where you have a small surplus, a couple of billion, $2,500,000,000, or so, a year, which, as you point out, is likely to be used up in different ways. Do you think that you can exercise any real restraint on bank credit while those bonds are maintained at par?

Mr. SPROUL. Yes, I think we can prevent an indiscriminate and loose extension of bank credit. I do not think we can stop all expansion of bank credit. But a certain amount of bank credit expansion may be necessary, in a full employment, or high employment, high production economy.

The CHAIRMAN. I think so, too. I do not mean to say that you want to stop the expansion of bank credit; but to restrain it from being an undue influence. You say yourself that in effect the increase in reserves is more or less useless, because as long as you maintain Government bonds at par the banks can sell their bonds to the Government and replenish their reserves and loan the money. So that method is not very useful, I suppose, unless you tied it up to the whole extent, as Mr. Eccles thinks of, in taking 25 percent or so in Government bonds. It might deprive them of the Government bonds they need to sell to the Government. I do not know.

Mr. SPROUL. You would have to freeze the whole of the Government bond portfolio of the banks in order to plug that leak.

The CHAIRMAN. Yes.

Mr. SPROUL. But I do not think that is necessary to put restraint upon the expansion of bank credit. I think uncertainty as to what is going to be the future course of interest rates, uncertaintly as to what the banking authorities are going to do, plus the desire on the part of the banks themselves, not to go wild on this situation, can be a sufficient restraining influence insofar as bank credit is a factor. And, as I have said, I think it is only a minor factor. It is not the major factor. And we cannot deal with the situation solely by means of bank credit. In other words, we cannot do all the wrong things every place else and then expect to correct the situation with bank controls.

The CHAIRMAN. Well, you have your housing credit and the spending of Government money in different programs. You have a great many things that join in this situation.

Mr. Sproul. And you cannot do everything else wrong and then come to bank credit and say, "Correct this for us."

The Chairman. It would be one of the elements of a possible inflation. It has been in the past at times.

Mr. Sproul. Yes.

The Chairman. You have not expressed direction your opinion as to the necessity for maintaining the Government bonds at par. You think that probably should be continued?

Mr. Sproul. I think that probably should be continued.

The Chairman. You do not think it is necessary, but you think it should be continued?

Mr. Sproul. I think it should be continued for the foreseeable future, and under existing circumstances and conditions, yes.

The Chairman. As to only the 2½'s?

Mr. Sproul. The 2½ is the anchor rate. I do not think we can, should, or want to commit ourselves to maintaining all Government securities of all maturities at any rate. But I think for the present we have pretty well committed ourselves and should commit ourselves to the 2½ percent rate.

The Chairman. What would happen if you did not maintain it, and the bonds fell below par? What do you think would happen?

Mr. Sproul. Well, I have a list of things I think might happen:

1. A decline in prices of long-term Treasury bonds more than fractionally below par, under existing conditions, would throw the whole market for long-term securities—corporate and municipal, as well as Federal—into confusion, as it would raise questions, which no one could answer with confidence, as to how far long-term rates might rise, and how great might be the loss in market value of Government securities bought at or below a 2½ percent basis and of other securities bought at proportionate yields.

2. Potential buyers would tend to stand aside until they became convinced that bond prices were down to levels at which the chances of a recovery definitely outweighed the chances of a further decline—that yields were above what they regarded as the "natural" levels.

3. Conversely, present holders who are in a position to act quickly on either side of the market would probably offer their securities for sale until prices fell approximately to levels corresponding with their ideas of the "natural" interest rate, in the expectation that they would be able to repurchase the securities at lower prices. Many present holders who anticipated other needs for their funds would probably try to sell their securities, regardless of whether or not they had any definite idea as to the level at which equilibrium might be restored in the market, in the effort to assure the availability of the funds in liquid form when they were needed.

4. An attempt to reestablish stability in the market, for example at a level only moderately below par, would encounter serious difficulties, as it would be hard to restore the confidence that was destroyed by failure to make good on all the assurances that have been given in recent months that the 2½ percent rate would be maintained.

5. Under these conditions, flotations of long-term securities would be made very difficult if not impossible, until the market became stabilized at a new level, and even then could proceed only on a limited scale until confidence developed in the new level. There is no telling how long that would take.

6. The resulting interference with business and other financing would tend to have a depressing effect on business and employment. The effects would extend beyond industries dependent upon business capital expenditures, State and local government public works, and so forth. For example, the mortgage market would be affected and therefore residential building. Curtailment in these industries would quickly affect the markets for consumers' goods and extend the area of contraction.

7. There is no reason to expect that savings would be stimulated materially unless the rise in rates was substantial, and even then there would be little incentive to invest so long as the security markets remained in an unsettled condition.

8. If the decline in prices of marketable Government bonds went very far, holders of savings bonds might become frightened and redeem their bonds, even though yields to maturity remained above yields on marketable securities. And well before redemptions increased materially, sales (especially of F and G bonds, but also of E bonds) would be likely to diminish sharply. Consequently a considerable shift in the relative volume of redemptions and sales might be expected, which might go to the point of involving sizable net redemptions, with effects on the Treasury's cash position that would be likely to have further adverse repercussions on the bond market.

9. Finally, maintenance of the 2½ percent long-term rate will facilitate a moderate credit policy designed to discourage bank loan expansion, since it will permit execution of a program involving some rise in short-term rates without throwing the whole bond market into confusion and risking the whole train of consequences outlined above.

In other words, I see no great gain to be achieved by letting that 2½ percent rate go now, and I see serious difficulties in the securities market, and, beyond that, in the whole field of financing business and industry.

The CHAIRMAN. It would undoubtedly start a tremendous confusion for a while. There is no doubt about that.

But the difficulty that I see is the fact that the elements which have restrained bank credit, that is, in the Government surplus, are going to continue. Reduction of the Government debt is not going to go on at the rate in which it has gone on for the last few years. Your position really is that the 2½ percent rate is a pretty natural rate?

Mr. SPROUL. I think it probably is.

The CHAIRMAN. And probably in the long run it might maintain itself?

Mr. SPROUL. I think it will.

The CHAIRMAN. But we probably ought not to take a chance on it.

Mr. SPROUL. I think we have a very sensitive market, a very sensitive banking situation. Everybody is an economist and sees depressions and inflations and recessions under the bed. And very minor moves by the monetary authorities can have major effects. Because everybody reads the services and the reports and gets alarmed if a mouse appears.

The CHAIRMAN. Senator Flanders?

Senator FLANDERS. I have one or two questions here, Mr. Sproul, that have been accumulating.

I would like to ask you about the limitations of fiscal and monetary policy. Senator Taft expressed his fears of a creeping inflation rather than a runaway inflation. Is there anything that can be done in the fiscal monetary field with relation to an expanding wage and price structure? Is there anything that can be done that is not catastrophic?

Mr. SPROUL. Yes, I think there is. I think clearly capital expenditures by the Government should be kept at the absolute minimum, and whatever pressure can be brought on the States and the municipalities to do the same thing under the existing circumstances—I do not think that pressure is much, but some can be exerted—would be desirable. I think, as I indicated, any place along the line where ordinary governmental expenditures can be reduced, cut down, that would be effective. I think military expenditures should have an order of priority, and those of lower priority perhaps sacrificed. In those areas of expenditure, both capital and current, fiscal policy in the broad sense can be used, certainly without catastrophic effects; in fact, with beneficial effects. Also you may come to the time, if our rearmament expenditures increase substantially, that you will want to reconsider your action on taxes.

Senator FLANDERS. Just avoid for a moment that unpleasant subject, and thinking of the present danger of this third turn of the wage-price spiral, when you were asked whether there is anything that can be done about that in the monetary and fiscal field, you instanced various cases in which it would be possible to defer actions. But those deferments are going to pile up on you and become unmanageable. You cannot indefinitely defer needed expenditures; cities, municipalities, the Government cannot do that. They keep piling up on you until you have to do something about them.

Then this creeping inflation requires decisions as to bank credits and industrial credits. They require increased sums for carrying inventory. They require increased working capital. They result in increased accounts receivable. All of that requires more credit. They all appear on the books as profit and so stimulate the wage demands. And if they eat up liquid resources and lead directly into further credit expansion.

Now, can you do anything really, in the long run, in fiscal monetary policy, about that situation? You can, of course, end prosperity.

Mr. SPROUL. Yes. We can take very drastic action and send the whole thing tumbling down, which I do not think we want to do. Or we can restrain it, so that while you need more credit to carry inventories you do not get into the business of speculating in inventories, or, as to expansion of capital equipment, you do not anticipate the continuance of a bull market in your products indefinitely over the years. In terms of Federal Government expenditures, those that cannot be deferred or avoided, you nevertheless try to gear in with a decline in capital expenditures by the private economy, which I think is a likely development within the next year or so, unless rearmament expenditures increase very greatly, and more rapidly than is now estimated.

Senator FLANDERS. What you are saying leads to a further question, as to the advisability of applying qualitative controls to credit. You just described some qualitative credit controls; or they are more in the nature of credit qualities, maybe, than credit controls. Would you feel, distinguishing one example you have just given, our credit needed for carrying a given volume of inventory that is higher priced from buying ahead and speculating in your inventory, that there is any field there for definite controls on the credit qualities of the banking system?

Mr. SPROUL. I think that particular form of selective credit control is one that would have to be left to the commercial banks themselves. I think there are areas of selective credit control where the terms of the control can be so clearly delineated, and where the restraints can be so general rather than pin point, that the monetary authorities might well have selective credit control powers. One of those areas is consumer credit. Another is margin requirements. And that might be extended into the field of commodity trading, or, conceivably into the field of mortgage credit. But as to general business credit, that is a selective control that has to be left to the commercial banks. Otherwise you get into the area of saying A can have a loan and B cannot. And I do not think that is any business of the central banking system.

Senator FLANDERS. Suppose that distinction has to be made every day in the ordinary run of the banking business, but it is difficult to legislate. I am glad to get that list of possible qualitative credit controls.

Of course, Congress is committed, or the Senate is, to one of them at least.

Now, another question that I wanted to ask was this: We are tol by committees of Congress which have been studying the thing tha we may want to increase our military expenses for the armed services, and I forget whether it is 3 or 4 years, up to $17,000,000,000, in place of the $11,000,000,000 which we have expended this year; and with, so far as I can observe, no results. We are assured by the armed services that we have got nothing from the $11,000,000,000 we spent this year.

That, however, is neither here nor there as far as this committee is concerned.

But with an increased expenditure of $6,000,000,000 more, with a concurrent withdrawal of men from production as the number of men in the armed services is increased, are we or are we not going to face, coming upon a period of relatively full employment, an inflationary situation which cannot be handled by the means we have been discussing this morning.

Mr. SPROUL. Yes. I think we may. And I think you then will have to reconsider your tax policy. You will have to reconsider the question of allocation of materials and other direct controls. We will have to have a much stepped-up and invigorated savings bond program. We will have a return of many of the circumstances of a wartime situation if the expenditures for military preparedness get into the area of and the magnitude of wartime expenditures.

Senator FLANDERS. I do not know that I have any other questions.

The CHAIRMAN. Mr. Sproul, you have, as number four on your opening page:

> Justification of current complaints about difficulty in securing adequate funds for modernizing and expanding business facilities, especially for small business; effectiveness of current methods of channeling savings into investment.

Would you care to say a word about that? We were going to have Mr. Schram here this morning, and I rather assume that is one of the lines that he will follow. And we have a good deal of complaint, and some evidence, I think, that it is very difficult to get new money into equity investment particularly.

Mr. SPROUL. I know less about that question than about bank credit. Perhaps it is more difficult than what I have been discussing and to that extent I may have avoided it.

I think first, however, we want to get our facts clear. In 1947 the figures of the Department of Commerce show that there were $26,500,000,000 raised by corporations, of which $14,500,000,000 were for plant and equipment, $7,000,000,000 for inventory replacement and expansion and $5,000,000,000 to meet an increase in receivables. They got the $26,500,000,000 through retained profits, $10,000,000,000; depreciation reserves, $4,500,000,000; net new capital issues $4,000,000,000 of which 26 percent only were stock issues, bank loans of $3,500,000,000, increased tax liabilities $3,000,000,000, and increased trade accounts payable $1,000,000,000.

The CHAIRMAN. You say 26 percent of the $4,000,000,000 was stocks?

Mr. SPROUL. That is right. The important point is that $10,000,000,000 came from retained profits plus 26 percent of $4,000,000,000 all of which was equity capital. They were getting it out of the present stockholders, you might say, rather than going to the market.

The CHAIRMAN. But those profits may not last forever and also those are the large corporations and it raises the question whether when you get small corporations who cannot raise the money whether they can get any equity money at all.

Mr. SPROUL. In 1946 when we had a rising stock market, a very much larger amount of equity money was obtained through the sale of new stocks and it was obtained by small as well as large corporations. I think the record of 1947, on which much of the current complaint is based is partly due to the fact that the situation has not been conducive to the free offering of stock in the market.

One thing I would like to say about that is that I do not think the way to meet that situation is by pumping more credit into the stock market, by giving us a boom in the stock market, based on credit, in addition to the other booms which we may have.

The Chairman. You mean keep the present 75 percent margin?

Mr. SPROUL. I would have to be convinced that the 75 percent margin requirement was interfering with getting capital for productive purposes, which I do not think it is, before I would want to see that margin requirement lowered.

The CHAIRMAN. Apart from the stock market, what do you think is the difficulty in getting investment capital?

Mr. SPROUL. That is in getting it for small business which is not able to meet its needs by the method of retained profits, a method which has been available to the large and established corporations. I think the difficulty resides more largely in tax policy than it does in credit policy or is the situation in securities market. I think the possibility of gain in the one case where you win is so largely offset by the losses in the many cases when you lose that our tax program ought to be adjusted to give greater rewards for winning.

Senator FLANDERS. And besides that you do not get what you win.

Mr. SPROUL. No; that is the difficulty.

The CHAIRMAN. You cannot get any return on it after you get it.

Mr. SPROUL. No.

In addition to this difficulty of getting adequate funds, either capital or credit, we have found in our experience with loans to business, and particularly to small business, having difficulty in financing itself, that its problems cannot all be solved with credit or with capital. There are difficulties in terms of lack of ability to keep up with improvement in methods and procedures, and lack of ability with respect to accounting and management, which greatly increases the hazards of those businesses. It would be a pretty dangerous game to try to plug it all up with credit or even easier access to capital.

The CHAIRMAN. There was a plan, I have seen some plans of trying to get the investment of smaller savers on the theory that the large people are always going to have high rates. The savings now come in the lower echelon where they ought not to take the same risk and do not ordinarily do so, putting their savings into insurance and so forth. Some plan of setting up companies that would diversify investments in common stocks and perhaps some investment in insurance from the Federal Government for certain percentage of over-all losses.

Have you gone into that?

Mr. SPROUL. There have been a number of such plans studied. I have never yet seen one that looked like a commercially profitable venture and, therefore, they do not develop into working programs.

The CHAIRMAN. I mean the trouble, as I see it, you probably have as much savings as perhaps you ever had but being in lower income groups where they cannot afford to take the risks is your problem.

Mr. SPROUL. That is right.

The savings are being channelled more and more into insurance companies or savings banks or pension plans which by reason of law or policy do not go into equities. Even if these institutional sources relax their requirements they will probably go into established companies and would not go into the risky small business ventures.

The CHAIRMAN. In this small housing, we have a plan for insurance company investment. It is an experiment and it may not work at all. I think it guarantees tow and three-quarters percent and limits them to four and a half or something like that.

Senator FLANDERS. Insurance companies are not particularly excited about that.

The CHAIRMAN. No, but it was an approach toward insuring an equity investment that might be followed in some kind of investment company investing in equities.

Mr. Sproul, going back to this other figure, you refer to a reduction of Federal Reserve bank holdings, taking this from the Federal Reserve bulletin of April 1948, December 1945 Federal Reserve bank holdings were listed at $24,000,000,000 Government bonds, $24,262,000,000, and that has been reduced in January 1948 to $21,925,000,000. Your statement that that reduction has been made is entirely correct.

On the other hand, the point I am trying to make is that the Government bonds, outstanding Government bonds in that period have been reduced from $198,000,000,000 to $164,000,000,000 a reduction of $34,000,000,000 of which only about $2,300,000,000 was a reduction of holdings of Federal Reserve banks, and that we cannot hope to continue that reduction in government bonds. That was partly due to that last sale?

Mr. SPROUL. Yes.

The CHAIRMAN. I still feel that the Federal Reserve is going to be up against a problem of buying more Government bonds unless the interest rates tend to get stronger and that if they do, if they are in that position, they cannot very well restrain bank credit.

Mr. SPROUL. My hope and expectation is that if and as we have to buy long Government bonds we will be able to sell short Government bonds and sell more of them than we buy long or at least sell an equal amount.

The CHAIRMAN. I would suggest that the table on page 432 be placed into the record at this point.

(The table appearing on p. 432 of the Federal Reserve Bulletin is on p. 108.)

Ownership of United States Government securities, direct and fully guaranteed

[Estimates of the Treasury Department. Par value, in millions of dollars]

End of month	Total interest bearing securities	Held by banks			Held by nonbank investors							
		Total	Commercial[1] banks	Federal Reserve Banks	Total	Individuals	Insurance companies	Mutual savings banks	Other corporations and associations	State and local governments	U. S. Government agencies and trust funds	
											Special issues	Public issues
1940–June	47,874	18,566	16,100	2,466	29,308	9,700	6,500	3,100	2,500	400	4,775	2,305
1941–June	54,747	21,884	19,700	2,184	32,863	10,900	7,100	3,400	2,400	600	6,120	2,375
December	63,768	23,654	21,400	2,254	40,114	13,600	8,200	3,700	4,400	700	6,982	2,558
1942–June	76,517	28,645	26,000	2,645	47,872	17,900	9,200	3,900	5,400	900	7,885	2,737
December	111,591	47,289	41,100	6,189	64,302	23,700	11,300	4,500	11,600	1,000	9,032	3,218
1943–June	139,472	59,402	52,200	7,202	80,070	30,300	13,100	5,300	15,500	1,500	10,871	3,451
December	168,732	71,443	59,900	11,543	97,289	37,100	15,100	6,100	20,000	2,100	12,703	4,242
1944–June	201,059	83,301	68,400	14,901	117,758	45,100	17,300	7,300	25,800	3,200	14,287	4,810
December	230,361	96,546	77,700	18,846	133,815	52,200	19,600	8,300	27,600	4,300	16,326	5,348
1945–June	256,766	105,992	84,200	21,792	150,774	58,500	22,700	9,600	29,800	5,300	18,812	6,128
December	276,246	115,062	90,800	24,262	161,184	63,500	24,400	10,700	29,100	6,500	20,000	7,048
1946–June	268,578	108,183	84,400	23,783	160,395	62,900	25,300	11,500	25,200	6,500	22,332	6,798
December	257,980	97,850	74,500	23,350	160,130	63,600	25,300	11,800	22,100	6,300	24,585	6,338
1947—June	255,197	91,872	70,000	21,872	163,325	66,100	25,000	12,100	20,100	7,100	27,366	5,445
1947—August	257,183	91,892	69,700	22,192	165,291	66,600	24,900	12,200	20,700	7,200	29,220	4,496
September	256,177	92,129	69,800	22,329	164,048	65,700	24,700	12,100	20,400	7,100	29,520	4,424
October	256,348	91,968	69,800	22,168	164,380	65,700	24,900	12,200	20,400	7,200	29,447	4,488
November	255,674	91,509	69,300	22,209	164,165	65,600	24,700	12,100	20,300	7,300	29,517	4,675
December	254,281	91,159	68,600	22,559	163,122	65,300	24,300	12,000	19,900	7,300	28,955	5,397
1948—January	254,030	90,825	68,900	21,925	163,205	65,400	24,100	12,000	19,900	7,200	29,148	5,452

[1] Including holdings by banks in territories and insular possessions, amounting to 100 million dollars on June 30, 1942, and 500 million on Dec. 31, 1947.

Summary data from Treasury survey of ownership of securities issued or guaranteed by the United States [1]

[Marketable public securities. In millions of dollars]

End of month	Total outstanding	U. S. Government agencies and trust funds	Federal Reserve Banks	Commercial banks [2]	Mutual savings banks	Insurance companies	Other
TYPE OF SECURITY							
Total: [3]							
1945—Dec.	198,820	7,009	24,262	82,830	10,491	23,183	51,046
1946—June	189,649	6,768	23,783	76,578	11,220	24,285	47,015
Dec.	176,658	6,302	23,350	66,962	11,521	24,346	44,177
1947—June	168,740	5,409	21,872	62,961	11,845	23,969	42,684
Dec.	165,791	5,261	22,559	61,370	11,552	22,895	42,154
1948—Jan.	164,945	5,315	21,925	61,588	11,593	22,657	41,867
Treasury bills:							
1945—Dec.	17,037	5	12,831	2,476		1	1,723
1946—June	17,039	3	14,466	1,142	3	1	1,424
Dec.	17,033	2	14,745	1,187		11	1,088
1947—June	15,775	11	14,496	787	1	1	479
Dec.	15,136	18	11,433	2,052	25	154	1,454
1948—Jan.	14,838	73	9,709	3,092	39	357	1,568
Certificates:							
1945—Dec.	38,155	38	8,364	18,091	91	360	11,211
1946—June	34,804	58	6,813	16,676	243	576	10,439
Dec.	29,987	64	7,496	11,221	257	490	10,459
1947—June	25,296	48	6,280	8,536	249	362	9,821
Dec.	21,220	30	6,797	6,538	200	269	7,386
1948—Jan.	20,677	34	882	6,712	275	351	7,423
Treasury notes:							
1945—Dec.	22,967	8	2,120	15,701	179	576	4,383
1946—June	18,261	9	1,748	11,396	227	623	4,258
Dec.	10,090	6	355	6,120	211	603	2,796
1947—June	8,142	7	369	4,855	183	285	2,443
Dec.	11,375	4	1,477	5,327	98	245	4,224
1948—Jan.	11,375	4	1,543	5,168	129	271	4,260
Treasury bonds:							
1945—Dec.	120,423	6,915	947	46,535	10,217	22,230	33,579
1946—June	119,323	6,655	755	47,335	10,743	23,073	30,764
Dec.	119,323	6,186	753	48,408	11,049	23,226	29,700
1947—June	119,323	5,306	727	48,756	11,407	23,305	29,822
Dec.	117,863	5,173	2,853	47,424	11,226	22,213	28,974
1948—Jan.	117,863	5,168	4,791	46,591	[7] 1,149	21,655	28,499
TREASURY BONDS AND NOTES, DUE OR CALLABLE							
Within 1 year:							
1945—Dec.	15,222	185	2,017	9,956	63	235	2,761
1946—June	10,119	4	1,431	5,655	116	495	2,418
Dec.	7,802	29	72	4,341	181	591	2,591
1947—June	11,255	83	251	6,936	374	420	3,191
Dec.	14,263	69	1,693	8,244	266	316	3,675
1948—Jan.	17,798	69	1,759	9,465	343	423	5,739
1-5 years:							
1945—Dec.	35,376	408	693	25,165	701	1,742	6,673
1946—June	35,055	443	797	25,285	709	1,506	6,319
Dec.	39,570	576	831	28,470	1,047	2,101	6,550
1947—June	42,522	469	698	29,917	1,574	2,671	7,193
Dec.	49,948	344	1,377	33,415	1,876	3,046	9,890
1948—Jan.	46,413	344	1,825	31,454	1,908	2,941	7,941
5-10 years:							
1945—Dec.	33,025	787	210	21,007	2,058	2,902	6,063
1946—June	32,847	716	135	21,933	1,609	2,822	5,632
Dec.	27,283	529	72	16,657	2,042	2,826	5,156
1947—June	18,932	423	40	11,577	1,245	2,002	3,645
Dec.	10,270	370	426	6,090	576	880	1,928
1948—Jan.	10,270	370	494	6,053	570	842	1,941
10-20 years:							
1945—Dec.	34,985	2,779	90	3,691	5,523	10,996	11,905
1946—June	37,189	3,400	83	3,308	6,026	12,547	11,829
Dec.	32,384	2,975	78	2,433	5,303	11,708	9,886
1947—June	40,352	3,374	78	2,587	6,751	15,137	12,425
Dec.	54,757	4,393	834	5,003	8,606	18,211	17,710
1948—Jan.	54,757	4,389	2,255	4,788	8,457	17,730	17,138

See footnotes at end of table, p. 110.

Summary data from Treasury survey of ownership of securities issued or guaranteed by the United States [1]—Continued

[Marketable public securities. In millions of dollars]

End of month	Total outstanding	U. S. Government agencies and trust funds	Federal Reserve Banks	Commercial banks [2]	Mutual savings banks	Insurance companies	Other
TREASURY BONDS AND NOTES, DUE OR CALLABLE—con.							
After 20 years:							
1945—Dec.	24,781	2,764	57	2,418	2,051	6,933	10,559
1946—June	22,372	2,103	57	2,550	2,510	6,325	8,826
Dec.	22,372	2,084	55	2,632	2,687	6,602	8,313
1947—June	14,405	964	29	2,593	1,649	3,358	5,812
Dec.							
1948—Jan.							

[1] Figures include only holdings by institutions or agencies from which reports are received. Data for commercial banks, mutual savings banks, and the residual "other" are not entirely comparable from month to month. Figures in column headed "other" include holdings by nonreporting banks and insurance companies as well as by other investors. Estimates of total holdings (including relatively small amounts of nonmarketable issues) by all banks and all insurance companies for certain dates are shown in the table above.

[2] Including stock savings banks.

[3] Including Postal Savings and prewar bonds, and a small amount of guaranteed securities, not shown separately below.

Source: Federal Reserve Bulletin.

The CHAIRMAN. Are there any further questions, Senator Flanders?

Senator FLANDERS. No.

The CHAIRMAN. Thank you, Mr. Sproul.

Certainly no questions which I have asked are to indicate any opinion on my part. I am like the radio; I want the press to know I am trying to bring out voice, not expressing an opinion myself.

The committee will stand in recess at this time.

(Thereupon, at 11:30 a. m., the committee recessed to reconvene at 10 a. m., May 13, 1948.)

CREDIT POLICIES

THURSDAY, MAY 13, 1948

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The committee met at 10 a. m., pursuant to adjournment, in the Labor and Public Welfare Committee room, United States Capitol, Senator Ralph E. Flanders, presiding.

Present: Senator Flanders (presiding), Representatives Rich, Hart, and Huber.

Senator FLANDERS. The hearing will be in session.

This morning we have Mr. Emil Schram, president of the New York Stock Exchange.

You have, I see, Mr. Schram, a typewritten presentation, which you may proceed with as you wish.

STATEMENT OF EMIL SCHRAM, PRESIDENT, NEW YORK STOCK EXCHANGE, NEW YORK, N. Y.

Mr. SCHRAM. Thank you. I would like to read it, Mr. Chairman, if you will bear with me. It should take about half an hour.

Senator FLANDERS. Go right ahead, sir.

Mr. SCHRAM. Mr. Chairman and gentlemen of the committee, my name is Emil Schram. I am a resident of New York City. My home address is 784 Park Avenue. I am president of the New York Stock Exchange.

I wish to express my sincere thanks for your courtesy in permitting me to set forth my views on inflation, credit controls, the capital markets, and the Government bond market.

It is my understanding that the committee is examining the question of high prices in general as well as various anti-inflationary proposals. These are subjects of encyclopedic proportions on which there is a vast literature with plenty of disagreement among the doctors, and I shall speak from my experience rather than attempt to present an economic dissertation.

Inflation, to put it bluntly, is a state of mind. It cannot be understood solely in monetary or fiscal terms or if attention is paid only to interest rates or commodity prices. I like to think in terms of the future and base my opinions largely on an analysis of present conditions, which are never exactly like those of the past. Reference to experience has value mainly in conditioning our minds to follow the facts no matter where they may lead us.

In the early and midthirties, you will recall, herculean efforts were made by the monetary authorities to generate the forces of recovery by pushing funds out and creating excess reserves so that the commercial banks would add to their loans and investments. Excess reserves piled up but business nevertheless languished and unemployment was large.

Finally the central bank authorities were compelled to admit that while a horse can be led to water, it cannot be forced to drink. We are accustomed to think that periods of a balanced budget necessarily coincide with sound credit conditions and an absence of inflation, yet in the period ending in the 1929 crash, the budget was balanced and, more than that, a large surplus—that is, for those days—made it possible to reduce the Federal Government's debt roughly by $8,000,000,000 between 1921 and 1939.

Again, the deficits in the fiscal years 1934, 1935, and 1936 did not make for anything approaching full employment, let alone inflation. Interest rates in 1936 and 1937 which now seem high, were being condemned as representing the consequences of easy money policies of an unsound nature. We know, from previous periods of business expansion, that businessmen will borrow in one period at relatively high rates and look with a cold eye on financing plans at other times, although the cost of borrowed money is relatively low. As a matter of fact, our building booms always seem to harmonize with a period of increasing and high costs.

If commodity prices were a perfect mirror of inflation, a slightly downward slump in the midtwenties to 1929 could not have occurred. The history of commodity prices in those years would give one a most distorted view of the larger business picture. This is simply by way of comment and I think illustrates why I have stated bodly that inflation is psychological, or a state of mind, hoping that you gentlemen will credit me with some acquaintance withthe economic facts of life.

I would not like to try to define inflation in a way that would stand up against the criticism of monetary experts, but I think that we can best recognize its existence or absence by a homely truth: We have inflation when money is running after goods and deflation when goods are running after money. The great problem, I might add, is to find a way of avoiding both of these conditions and pave the way for more stability so that we do not always appear to be in a period where a large number of people realize that prices are low, but cannot pay even these low prices for goods and services because of lack of income or, having income, find it hard to make both ends meet because prices are high.

By my own definition, in the 2 years after VJ-day and until recently, we were in an inflationary period because certainly money was running after goods and services. A public which had done without many things and had ample funds was determined to do without no longer. More recently, despite developments such as the coal strike which has tended to accentuate shortages in certain fields, the areas of shortages has shrunk. It is my conviction that it will shrink further in coming months as the remaining pipe lines are filled and production and consumption come into greater balance.

According to the latest figures, the monthly production of washing machines has reached 400,000 against approximately 290,000 a year ago and the adequacy of the supply of such consumer durable goods as radios and refrigerators is common knowledge to everyone who reads the newspapers or walks into an electrical appliance store.

For a number of consumer durable goods which were so difficult to get a year ago prices have been reduced—this despite higher wage costs. Shortages that vexed us a few months ago have disappeared. There is no longer any shortage of men's white shirts and the best authority, your wives, will confirm the fact that many food items such as citrus fruits, which a year ago were hard to get, are in ample supply and in several cases, prices have tumbled severely.

I realize, of course, that some shortages in the heavy goods industries still exist and it does not seem possible for the automobile industry to catch up on the demand for some time. Only a few months ago, this committee heard testimony on the alleged shortage of meat. If there was one subject on which everyone agreed, it was that in April and May meat prices would soar. The fact is that recently hogs in Chicago, as a result of heavy receipts, slumped to $21.75 against $23.50 only a month ago and were at the lowest prices since OPA days. It is common knowledge, however, that luxury businesses have suffered sharp curtailment.

One field that is so important as to deserve special comment is the housing shortage and real estate. In a very thoughtful survey published by the Federal Reserve Bank of Cleveland as a supplement to the April Monthly Business Review, it is pointed out that since early 1947 the rate of family formation appears to have declined substantially.

For the first time in recent years the increase in dwelling units appears to have exceeded the increase in family formation. The survey concludes that while demand for the present is still in excess of the ability of the construction industry to produce, there is some evidence that the intensity of the demand for housing will gradually taper off. To quote:

> The gradual prospective reduction in the housing deficit, coupled with increasing pressure of those costs on income, and coupled with evidences of tightening of the mortgage market, should all contribute to progressive lessening of the intensity of demand.

In the field of small housing, we find an area in the economy where it seems the Government must continue to lend a helping hand. The Congress has been mindful of its responsibilities to the country in this regard in its constant and careful study of the problem. There is pending a long-term housing measure known as the Taft-Ellender-Wagner Act which is concrete evidence of further consciousness of the housing problem on the part of Congress. The FHA mortgage guaranty authority (title 6) lapsed as of April 30, and I understand that Congress is presently reviewing the advisability of extending this authority for 1 year. In other words, small and mass housing continues to require a form of subsidy from the Federal Government.

In the broad objective of such legislation, I concur; as to the methods of assistance, I prefer to leave that decision to those in the Congress who have given real study to the question, as in the case of your distinguished chairman, Senator Taft.

I do point to the fact that the former Chairman of the Federal Reserve System, Marriner Eccles, disputed the soundness of provisions of the Housing Act which made credit available on excessively easy terms in that buyers were encouraged to go deeply into debt, adding to inflationary pressure.

I understand the approximate carrying charge on a small home under the GI bill of rights to be about 1 percent of the purchase price per month. A builder informed me the other day that in the outlying areas of New York a $19,500 home may be mortgaged for $14,500 through private channels; that the GI can obtain an additional loan of $3,000 for a total of $17,500 and the additional $3,000 is guaranteed as to payment by the Federal Government. The carrying charge in this particular case is about $150 a month, or $1,800 a year.

In the bracket of a $10,000 home, the carrying charge is approximately $80 per month. It seems to me that at this rate of monthly outlay we must expect that some purchasers will find it difficult to maintain their payments. This will be especially true should we find employment and prices at lower levels in the coming years.

I am a firm believer in the rights and advantages of ownership on the part of all of our citizens, whether they be well off or of moderate means. There is a certain something, by way of better citizenship, that accrues to the Nation from the privilege of ownership. That is why it is the duty and responsibility of every public official and of the Congress to safeguard and protect property rights and the rights of ownership if enterprise as we know it is to endure. The reward is in the pleasure of living in freedom and liberty. I heartily endorse Government planning and assistance in the field of small and mass housing throughout the Nation.

It is a healthy sign for a nation to be critical of itself, but I sometimes think that we have overdone criticism of our performance since the end of the war. On the one hand, 60 million employees were regarded by Government economists as a goal to be reached in the fifties and by many business economists as an example of wishful thinking, to the discredit of neither view.

The fact remains that practically 60 million have been employed and production has been rolling for months. According to the most widely used index of production, that published by the Federal Reserve Board, industrial production in January and February of this year was at the rate of 192 and 194 percent of the 1935–39 average and in March was back to 192 only because of the coal strike. As a matter of fact, in no month since last September has this index been under 190. This is a record of which both labor and business management should be proud. The consuming public, too, has exercised discrimination. I am told that merchandise which moves today has to have appeal both with reference to quality and price. The large volume of liquid savings accumulated mainly during the war period seems to be either dedicated to specific purposes such as the purchase of a home or automobile or to some other special need.

I do not believe there is any evidence to support the idea that a large percentage of the accumulations will suddenly appear as a broad-scale demand for commodities. If this has not already happened in the face of all sorts of inflationary scares, I am inclined to dismiss it as a future source of concern. Two important bits of economic evidence are:

One, the continued decline in money in circulation which now amounts to approximately 27.7 billion dollars, a reduction of 400 million dollars since the comparable date a year ago. The total is now about the smallest since August 1945.

Two, the annual rate of turn-over of demand deposits outside of New York City is almost exactly the same as in 1941 prior to our entry into the war. In my judgment, this is strong proof of intelligence on the part of the public in refusing to become panicky or to be stampeded into a rash, indiscriminate preference for goods over money.

The timely price reductions recently announced by United States Steel Corp., General Electric Co., and Westinghouse Electric Corp. signal wise business statesmanship. Undoubtedly the 21 billion dollars which will have been spent in the years 1946 through 1948 by manufacturing companies on new plant and equipment are also beginning to show up in cost sheets, and if a third round of wage increases is of minor proportions, additional price cuts will herald the return of a competitive era.

Credit controls, I admit, have charm. I can well recall when all of us, including the Federal Reserve System, were much younger and thought the Federal Reserve authorities could regulate the business cycle in the same way that an engineer regulates the speed of a train. No one would be happier than I if the matter were as simple.

In a study by Dr. Charles O. Hardy, economic adviser to your committee, entitled "Credit Policies of the Federal Reserve System," the author set forth the theory of central bank control of the business cycle. Abbreviating this lucid description somewhat, the basic idea is that commercial banks cannot afford to hold surplus or excess reserves, and the public cannot afford to hold surplus cash and bank balances.

Dr. Hardy then wrote this commentary on the various methods of pursuing a liberal central bank policy which, according to theory willy-nilly translates itself into increased willingness and ability to buy on the part of the public, and so stimulates business revival. He stated:

> The difficulty with this program is in the assumption that the response of the banks and that of the public to easy money in times of depression will be the same as it would be in times of prosperity. Depression psychology is ignored. But this is to ignore the central element in the problem. A depression exists precisely because there is a general preference for cash, and for safe short-time investments expressed in cash terms, over commodities and securities. To increase the supply does no good unless the preference decreases.

More recently, the experience of 1936–37 is illuminating. Federal Reserve authorities disclaim responsibility for the precipitate decline in business—the decline in industrial production between September 1937 and June 1937 was one third and employment in manufacturing industries fell almost 25 percent—and are inclined to point to the drop in net Government contribution to income following upon the collection of new social-security taxes.

It cannot be questioned that the Federal Reserve was aware of this fact and would not have taken its series of steps to cut excess reserves by raising reserve requirements had the subsequent decline in business been envisaged.

Even after the three increases between August 1936 and May 1937 had doubled reserve requirements to 26 percent for central Reserve city banks, 20 percent for Reserve city banks and 14 percent for country banks, excess reserves amounted to some $770,000,000.

As I see it, this case illustrates the danger of a restrictive policy and the rapidity with which psychology can change, for business expenditures dwindled and in retrospect psychology probably had more to do with the change than actual stringency in the money market.

Frankly, I do not want to pose as a monetary expert and feel much closer to the capital market. From this vantage point, I am astonished at the continued attempt to draw an iron curtain around the separate parts of the capital and money markets, all of which are inseparably interwoven. The current issue of the Cleveland Trust Co.'s economic bulletin contains a chart of common stock yields and the return on bonds which is so striking that I have attached a copy to my remarks. The explanation as set forth is also worthy of your attention.

Senator FLANDERS. That will be received for the record.

(The chart referred to, with accompanying explanation, follows in the record at this point.)

THE CLEVELAND TRUST COMPANY BUSINESS BULLETIN

STOCK AND BOND YIELDS

Yields on common stocks are now relatively high, while those on bonds are not much above their all-time low of 1946. Over the past 48 years, the average yield on common stocks was 5.85 percent. In March of 1948 it was 6.81 percent. Corporate bond yields averaged 4.97 percent during the same period, and were 3.10 percent in March.

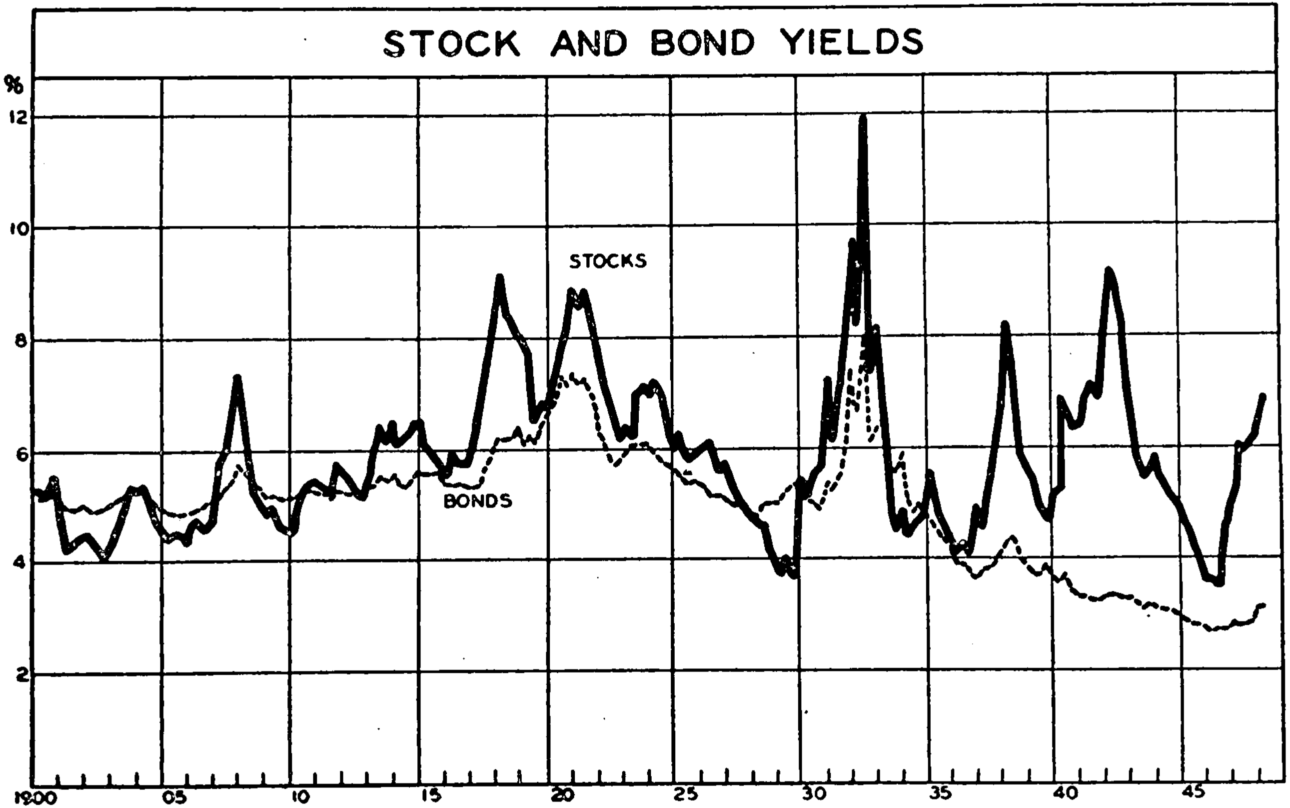
The diagram shows the changes in stock and bond yields beginning with 1900. For stocks, the curve represents the average yield of all common stocks regularly traded in on the New York Stock Exchange. The yield for any given month is obtained by dividing the sum of all the dividends paid per share during the previous 12 months, by the sum of all the prices. The curve for bonds shows the average yields to maturity of high- and medium-grade corporate bonds. It is based on the index of Standard & Poor's Corp. from 1900 through 1918, and on the Moody index from 1919 to date.

On the diagram the yields are plotted for the last month in each quarter during the 48 years from 1900 to 1947, inclusive, making 192 quarters represented in all. In addition, the yields for March 1948, are shown. A comparison of the March stock yield of 6.81 percent with all those which preceded it discloses two points of particular interest. First, the March figure has been exceeded in only 45, or less than one-fourth, of all the 192 earlier dates. Second, that figure was nearly 2.2 times the March yield of 3.10 percent on bonds a ratio exceeded in only 14 of the 192 prior quarters.

If a curve of general business activity were also drawn on the diagram, it would show that an average stock yield as high as that in March is very unusual when business is above normal.

The foregoing facts illustrate the lack of response by investors to the large increase in corporate profits, and a relatively more moderate incresae in dividends, over the past 18 months. During this period the spread between stock and bond yields has become steadily greater despite the very low return available on bonds. Corporate bond yields will probably not attain much higher levels as long as the Federal authorities continue to influence long-term interest rates by supporting the Government bond market, through purchases at fixed prices when the occasion arises. A reduction in the spread between stock and bond yields would thus depend mainly on lower stock yields, either by way of rising stock prices or smaller dividends.

There have been several reasons for the relative lack of enthusiasm toward common stocks. Among them are the double taxation of dividends; the doubt that current dividends could be maintained if business should slacken, because of the high break-even point in corporate operations; and the effect of high taxes in reducing venture capital. Influenced by these and other factors, many indiviaual investors have preferred the greater security of bonds, or even idle cash, in these times of perplexing uncertainties.



April 15, 1948

The Cleveland Trust Co.

Mr. SCHRAM. The present margin requirements are clearly discriminatory in the one market that is noninflated. As I stated in my testimony before the Senate Finance Committee a few months ago, this is a matter that transcends Wall Street and La Salle Street. It reaches into every town, mining district, and rural area—wherever America is engaged in wealth-creating activities.

I am convinced that a healthy, dynamic stock market would also help the bond market, especially Government bonds. This may seem contradictory. Yet, it follows that a considerable part of the financing consummated last year through bank loans, term loans, and long-term debt issues went to the insurance companies and banks because the companies issuing securities could not finance through the sale of equity securities.

The economic bulletins have noted the fact that weakness in Government bonds and the sales by financial institutions which brought pegging operations to the forefront coincided with the expansion of the corporate investments of these institutions. An improved stock market as a result of a reduction in margin requirements and capital gains taxes would have a twofold result: One, financial institutions could replace with Government bonds the loans paid off through stock financing; two, and stocks which are not sold because of the onerous tax burden would in many cases be liquidated and the proceeds put into Government obligations, assisting in the private placement of the Government debt.

Since the end of the war, the Revenue Acts of 1945 and 1948 have been steps in the right direction, renewing the flow of risk savings, made impossible under the burden of wartime taxation. The return flow of risk savings must be accompanied by incentives putting capital to work, as an integral part of our production and employment mechanism.

The relief I have called for will enable the capital accumulating groups whose function it is to take the risks of ownership to perform their proper office. The larger body of small savers whose savings are channeled into institutions, principally life insurance companies, savings banks, building and loan associations, who invest solely or largely in debt securities, would continue to contribute to the national savings, undisturbed by the ups and downs in risk investment. I might add that I would prefer to have it this way, and would not advocate a policy encouraging our life insurance companies to provide risk capital through the purchase of common stocks, except as a last resort.

Senator FLANDERS. In that sentence, you are departing from the manuscript as we have it. You say here:

> and would advocate a policy encouraging our life insurance companies to provide risk capital through the purchase of common stocks, only after careful study.

Mr. SCHRAM. The meaning is the same. For emphasis, I changed the wording just a little, Senator.

When the economic historian sets forth the financial development since VJ-day, he will have to explain how it was that the interest rates were kept at unprecedentedly low levels while the national debt and deficit were soaring and how it came about that almost simultaneously with the end of deficit financing and the beginning of debt retirement, substantial changes took place in the bond market. It would seem that as the supply of Government securities declined their value also declined.

The explanation is that the Government bond market which now dominates the interest rate pattern of the country has become a managed market, and probably must continue so, but we should not permit monetary policy that has turned out to be mistaken to place us in an economic strait-jacket determined by the past.

Even a 2.5 percent long-term rate may be subject to change without the catastrophic effects feared by some. The country's economic and financial system has adapted itself in the last 20 years to more fundamental changes. To insist on a 2.5 percent rate and at the same time express deep concern over alleged inflationary tendencies, to say the least, is inconsistent.

Leaving the narrower field of the Government bond market for the broader concepts of central bank policy, what is the object of the renewed efforts of credit control? If it is in effect to hold down prices, I point out that the Federal Reserve Board itself in the past has turned down any mandate that it use commodity prices as the guide for its policies. It did this in the 1920's and again in the prewar period. With a $40,000,000,000 budget and $250,000,000,000 debt, it is folly to expect a return to the prewar price level. As yet no Federal Reserve or Treasury official has expressed his opinion on where the price level should be—we may ask what is the happy price level?

Until that question is answered, I would hesitate about giving the Federal Reserve Board additional powers. The means of bringing about the natural answer is to permit the forces of supply and demand to work themselves out through budgetary controls so as to avoid a renewal of deficit financing, and by making saving more attractive. An economy operating at almost 200 percent the prewar level cannot exist on a prewar credit diet. Practically every severe period of business depression and unemployment has been preceded by a contraction of the monetary supply.

Consequently, it seems reasonable to ask that other methods be used first and the need for such drastic action be established beyond a reasonable doubt. I must say that we seem to be obsessed with the monetary side of the price equation and seem to have forgotten that there is another side—the supply of goods and commodities.

For this reason, I find the observations of the Federal Reserve Bank of New York in its current annual report of special interest. In the section of Federal Reserve credit and credit policy, it is stated:

> The growth in the money supply in the form of demand deposits and currency amounted during 1947 to about 3 percent. This was, no doubt, a contributing influence in the rise of commodity prices, but that rise was induced primarily by other factors, such as crop failures in Europe, rising costs of industrial production in this country, and the existing excessive money supply, a heritage of the war and its financing. It is doubtful whether, in the circumstances of the year 1947, credit expansion could have been prevented entirely (it is even more doubtful that purchasing power placed in the hands of the public during the war could have been substantially reduced), except by such drastic measures as would have interfered seriously with production—production urgently needed to meet domestic and foreign demands.

I am glad that we are again thinking about production, supply, and costs rather than in exclusively monetary and fiscal terms.

In conclusion, I believe that if we have our eye on the big fundamentals, like the football player who always follows the ball, we shall be doing our best job. I keep my eye on employment and underlying all my views is the goal of continued high employment, the great challenge to our society.

The times call for acute thinking and appraisal of the basic forces in the economic process rather than snap judgment. My thinking is along lines of stability. Provided we keep our heads, I do not fear runaway inflation nor do I look for the great depression whose failure to appear has so chagrined the Marxian economists and statesmen. We cannot hope to attain absolute stability—it is not part of a dynamic economy. However, if we do not depress business psychology unnecessarily, and adopt voluntary restraints such as the American Bankers Association has advocated, I see no reason why a large volume of goods and services cannot continue to be produced and taken off the market. Over the longer term, a return of the upward trend of greater productivity per man-hour will enable us to resume the improvement in living standards that is the most noteworthy feature of the romance of American economic history.

We have emerged from the period of shortages and unless the Congress permits the budget to become unbalanced again, I firmly believe we have already entered the postwar period of stabilization.

Senator FLANDERS. Thank you, Mr. Schram.

I would like to ask you a few questions which I have noted down in the course of your reading.

On page 4, you mentioned the tightening of the mortgage market. Why should that insured mortgage market tighten?

Mr. SCHRAM. Why should an insured-mortgage market tighten?

Senator FLANDERS. Yes.

Mr. SCHRAM. Well, I don't think that it should, really. I think that those mortgages have proved to be very good investments for banks.

Senator FLANDERS. I ask the question because we get complaint from those endeavoring to purchase homes at this time that it is being made more difficult for them to get FHA accommodations at banks than was the case a year ago. That, perhaps, is a little outside of your field of experience.

I was wondering what the reasons for that would be.

Mr. SCHRAM. I would assume that the cost factor would enter into that a great deal. But with the mortgages insured, it seems to me that the banks would be willing to continue to make those loans.

Senator FLANDERS. I have not gone further than that point in my questioning of those more directly concerned.

I have before me the transcript of yesterday's hearing. And yesterday, the chairman, Mr. Taft, questioned Mr. Sproul with respect to justification of current complaints about difficulty in securing adequate funds for modernizing and expanding business facilities, especially for small business. That is another question, though. I will come to that a little bit later.

On page 9 of your manuscript, you read points one and two there a little more rapidly than my mind moved. You are explaining, apparently, why the weakness in Government bonds coincided with the expansion of the corporate investments of these institutions and an improved stock market, as a result of the reduction in margin requirements, would have a twofold result. First, you say, "financial institutions could replace with Government bonds the loans paid off through stock financing."

What financial institutions are you referring to? The banks?

Mr. SCHRAM. I am talking about both banks and insurance companies, particularly insurance companies, life insurance companies, Senator. I think life insurance companies are making loans today that banks ought to be making, and I think banks are making loans from funds where the money should be secured in the equity market.

Senator FLANDERS. But if the present 75 percent margin were reduced to 50 percent, do you think that equities would have a far better market? Is that what you are saying?

Mr. SCHRAM. It would have a much broader market, Senator. I feel quite strongly about that. I disagree with the Federal Reserve most heartily in that particular point.

Senator FLANDERS. Mr. Sproul apparently followed Federal Reserve thinking in his testimony yesterday on that point.

Mr. SCHRAM. I understand that he did.

Senator FLANDERS. He saw no difficulty with the present 75 percent margin requirement.

Mr. SCHRAM. When you analyze the loans that are being made, you find that there is a decided trend toward debt financing, which I think is a very dangerous trend.

Now, the Federal Reserve on several occasions has said the stock market is one of the healthiest spots in our economy today. But still they say that you have to put up $100 worth of collateral to borrow $25. I think they are very inconsistent. I think that the securities market has been inspiring all of the business activity and operating at a very high level. The stock market has been the one depressed industry in the country.

Senator FLANDERS. Now, this diagram which accompanies your testimony, this diagram of the Cleveland Trust Co.'s bulletin, shows the stock yield as being much above the bond yield.

Mr. SCHRAM. That is correct.

Senator FLANDERS. Do you lay that largely to the sluggishness of the market, due to the high reserve requirements? Is that the only thing which brings those yields so much higher?

Mr. SCHRAM. I think there are two factors there. One is the margins, and the other is the lack of incentive, due to the tax structure, and with particular reference to capital gains.

Now, there is not much incentive to purchase risk securities today.

Senator FLANDERS. You might review the present capital gains situation. I remember it is 25 percent. And after how many months?

Mr. SCHRAM. Six months.

Senator FLANDERS. That would seem, on the face of it, to be fairly liberal purchasing except for quick turn-over.

Mr. SCHRAM. The quick turn-over ,of course, is taxed at the income rate.

Senator FLANDERS. Yes.

Mr. SCHRAM. But the capital gains tax for the long period, 25 percent, is a very high rate.

Senator FLANDERS. It is now in comparison with the straight income tax as to most of those who are in the market.

Mr. SCHRAM. Senator, I think that is one of the great mistakes that we make. We confuse a capital levy with income. I think it is unfair to think of a capital gains tax as an income tax.

Senator FLANDERS. I was not thinking of it from the standpoint of theory. Because the point you are just making can be maintained.

Mr. SCHRAM. Oh, yes.

Senator FLANDERS. But I was thinking of it more from the standpoint of the individual investor, who, it would seem to me, forgetting theory and just facing the facts, would say: "Here is the stock which gives a good yield and it seems as though its present price, considering everything, is lower than it should be. It gives a good income at the present price, and it seems as though its price ought to be higher later on."

Forgetting theory, as to whether it is a capital levy or whether it is an income-tax proposition, why should I not take a chance on this, after reviewing all the information I have at hand in connection with this stock?

Mr. SCHRAM. Senator, you know, the capital-gains tax is one tax where you have a choice of whether you pay it or whether you do not pay it.

Now, capital has aged tremendously in this country. It is now owned by people who really should dispose of those securities—or their capital assets; they are not all securities. We usually think of capital-gains tax in terms of securities.

Senator FLANDERS. It is physical properties of all sorts.

Mr. SCHRAM. That is right.

Now, an elderly person has a low acquisition cost. He takes his profit, pays the 25 percent, and he dies a week or a month later. His estate is really cut down tremendously.

Now, in that he cannot afford to take that chance. We need to broaden our markets. If we could lower that tax, it would encourage people to divest themselves of those holdings.

Senator FLANDERS. You are speaking of lowering the estate tax?

Mr. SCHRAM. No, I am speaking of lowering the capital gains tax.

If we could encourage those securities, those assets, to be sold, and get them into newer channels, a great deal of money would normally go into Government bonds. It would make revenue for the Government. It would actually be a revenue producer; and of course, the capital gains tax has never been considered a revenue producer. It would be of tremendous help if we could get those securities out of those old ownerships and into younger hands, and diffused.

Senator FLANDERS. I get the point you are trying to make there.

Again referring to this Cleveland Trust Co. chart, I presume charts have been made which indicate earnings as well as dividends on stocks. These relate to yields. That is the personally available yield. I imagine that that stock line would go out of sight off the chart if it were plotted on company earnings against stock market prices.

Mr. SCHRAM. Yes; it would be much higher.

I think perhaps right at the moment some of them might be coming down quite rapidly.

Senator FLANDERS. I can understand the disparity between company earnings and market price, because so much of the company profit is not available profit at all. It is the cost of carrying high-priced inventories, the cost of carrying the increased working capital requirements, which shows on the books a profit but really is not available.

Mr. SCHRAM. And they have to be retained, too, for expansion purposes, because the money is not available in the equity market.

Senator FLANDERS. They have to be retained; yes.

Mr. SCHRAM. Of course, these high profits, given time, adjust themselves. They do not remain out of line very long.

Senator FLANDERS. It was Mr. Sproul's contention yesterday that the money supply and the supply of goods and services, and consequently the price level, were tending toward stability. They were coming together.

Mr. SCHRAM. I think that is definitely true.

Senator FLANDERS. That is a hopeful sign if that is true.

Now, again referring to Mr. Sproul's testimony of yesterday on page 10 you say:

> Even a 2.5-percent long-term rate may be subject to change without the catastrophic effects feared by some.

He made the statement that he felt it should be kept at 2.5 percent, and he used some such words as these: "For any foreseeable future." He left the small knothole to creep out through in some distance.

But do you share his feeling that under any conditions foreseen at present it would be a serious thing if the Government securities, the long-term securities, were not pegged?

Mr. SCHRAM. I am afraid that for a while they will have to be pegged, especially because of the condition of the equity market. With your flow of savings—and the flow of savings, of course, has been from the low income brackets—going into insurance companies, and the insurance companies persisting in selling governments and going into the making of these industrial loans, then of course you have to have some support from the Government bond market. My contention is: do something for the equity market. Broaden that out. Permit these companies to do what historically they have always done: finance through equity financing rather than debt financing. Then I think you will have funds that will give you support in the Government bond market. But at the present time I think the Government bond market is going to have to be supported, and should be.

They seem to insist on drawing an iron curtain, as I have said, between our equities and the bond market, and the Government bond market. You just can't do it. They are all wrapped up in the same ball of wax, and they have to be considered as one unit.

That is where the great mistake is being made today by the Federal Reserve Board in my opinion.

Senator FLANDERS. On page 11, at the top of the page, you express your feeling that the prewar price level will remain and should remain, will naturally remain, at a considerably higher level than the prewar level.

Now, I have no figures before me, but I think it is the personal experience of everyone who is as old as you and I are that the price level after the First World War was higher than the price level before the First World War. We went up onto a new plateau then. And we eventually adjusted ourselves to it, I think far too painfully, particularly so far as the agricultural factor of our economy was concerned. But it seems reasonable to expect, on the basis of any previous experience with previous wars, that that result does take place. And that coincides with Mr. Sproul's testimony, as to our gradually coming into a balance at a higher level than the prewar level. And with that you agree.

Mr. SCHRAM. Yes; I do. Of course, I think that in time, if industry is given sufficient funds for expansion and technological improvements, which you must have, you will get some adjustment of price level. I think we have already seen some of that taking place.

Senator FLANDERS. Do you agree that the mechanism by which we have increased the productivity of the manpower has been largely through capital investment in more productive facilities?

Mr. SCHRAM. Yes, sir; I do. And that figure is mounting almost every day, Senator. The dollars invested per man now for a job is going up constantly. And it has to go up.

Senator FLANDERS. I presume you would then feel—while I do not know that you express it directly here, I think I have heard you express it before—that tax policies which encourage investment in more efficient productive facilities are essential to a continued increase in productivity per man-hour, and that is the basis for the continued rise in our standard of living.

Mr. SCHRAM. Unquestionably. And our economy of this country has been financed with private funds, not public funds. That is why our economy is such a dynamic economy.

We seem to think that that is no longer necessary.

For 15 years, Senator, as you will realize, there has been little need for private capital. We have followed another procedure.

Most of the funds, beginning back in 1933, were furnished by the Government. And, as you know, I was part of the agency in Washington, the RFC, that played a great part in furnishing funds to all types of business, insurance companies, railroads, and so on.

We got into the war period, and again the Government financed business. It had to. There has been little need for private capital.

Now we come to a time when there is a tremendous need for capital. And we find the atmosphere such that it is not available.

I just hope that this committee will give very serious thought to that particular question because I think that is the only way we are going to continue to have a dynamic economy in this country.

We must encourage savings and investment in American industry.

Senator FLANDERS. Now I come to two other questions that give me, personally, a great deal of trouble.

One is the question as to whether the inflationary spiral is not one exceedingly difficult to control under the conditions which we wish to maintain, and which we have maintained for a long period, the conditions of practically full employment.

Does that not present new problems in the way of controlling the inflationary spiral?

Does not the fact of full employment present great difficulties in keeping that spiral under control?

Mr. SCHRAM. I think the one thing you have to keep your eye on, as I have tried to point out, is that question of full employment. That, I think , is very important.

Senator FLANDERS. Stability of a sort might be more easily obtained with a pool of unemployed than with full employment, perhaps?

Mr. SCHRAM. Well, I don't know. I have always been afraid of these schemes that seem to call for a "healthy unemployment."

I do not think there is such a thing.

Senator FLANDERS. I agree with you that healthy unemployment is socially exceedingly unhealthy. And we do not want to succumb to such an idea. But I am disturbed at the difficulty of controlling the spiral under long continued full employment, which is our objective.

Mr. SCHRAM. That is right.

Now, of course, you do have a very tight labor market. And you have had. There is some loosening up now.

Senator FLANDERS. There is some loosening here and there.

Mr. SCHRAM. But on the whole, I think we have a tremendous area for expansion. And if industry is able to finance itself in a proper manner—and I say that advisedly—I do not think we have much to fear.

I do not like to see industry being financed with this procedure of increasing the debt structure. Because that money becomes "scared money" awfully fast. And there you get into a psychological situation which I think is exceedingly dangerous.

You get a little bit of a set-back, and they are forced to dump inventories, and you get a psychology there that I think is very dangerous.

Now, if industry is financed as it should be, with equity financing, it is not "scared money." That is, you have better control over it. Management has a greater opportunity. But you have a high concentration of debt in one or two companies, and the first thing you know, the business is going to be run by the fellows they owe the money to, and I think it is a very dangerous procedure.

Senator FLANDERS. Coming to the last sentence now, you say:

> We have emerged from the period of shortages, and unless the Congress permits the budget to become unbalanced again, I firmly believe we have already entered the post-war period of stabilization.

But we are faced with requirements by the armed services which will raise our expenditures in 3 or 4 years' time on the $11,000,000,000 for this fiscal year just ending now, in a gradual rise to $17,000,000,000. Can we absorb that without getting unbalanced again?

Can we have that period of not nearly an increased percentages of production going into something else than consumption, but also a decreased manpower available, due to the manpower being diverted into production into the Army and Navy?

Can we face that without again getting into deficit spending, without getting into money supply that is again chasing a lessened product and without again requiring our entry into a period of controls?

Mr. SCHRAM. Senator, I do not see anything in this present program—that is, the European relief program and the increase in the demand of the armed services—that is dangerous. Because the expenditures are going to be made over a long enough period of time that I think we will be able to keep pace with it.

Senator FLANDERS. Do you think that in 4 years we can absorb that extra $6,000,000,000 which is suggested?

Mr. SCHRAM. Yes. Yes; I think we can.

Now, if we get over on the side of war, then, of course, I don't know. I wouldn't attempt to predict that. Because when you have to go all out, you get along the best you can.

But I don't see anything in the present situation that would allow me to believe we are getting the thing out of balance. You know, I have great faith in the judgment of the American people. You can get prices too high, and they just refuse to buy.

We saw quite a bit of evidence at the peak of this price trend. They developed a buying resistance. And I just have an awful lot of faith in the judgment of the American people.

Senator FLANDERS. Well, I have been worried by this $6,000,000,000 additional, but I am glad to find someone who is not seriously perturbed by it.

Mr. SCHRAM. My observation is that the planning of expenditures for the next fiscal year is not going to be such as to throw us out of balance. I believe we will be able to absorb those expenditures.

Representative HUBER. I feel as you do, Senator. I remember when we thought that $2,000,000,000 were going to upset the applecart.

Now, you mentioned the healthy dynamic stock market. I wonder what steps could be taken to prevent it from becoming too dynamic, with a resultant recurrence of the conditions of 1929.

Mr. SCHRAM. 1929 saw a situation which I do not think can possibly return.

I am very frank to say to you that in 1929, I think we had more or less of a rigged or manipulated market. We had absolutely no control at that time. We got a psychology that was rampant in this country at that time that was very difficult to stop.

Everybody thought that all they had to do was to buy something today and it would be worth a lot tomorrow. They did not use very good judgment.

We have controls today that I think would make another 1929 almost impossible. That was pretty much of a rigged market.

There was permitted at that time these options, these pools, and these manipulated practices that are just unthinkable today, that could not possibly happen.

For example, you had no margin requirements at all in 1929. Banks could lend anything they wanted to, and brokers could lend anything they wanted to.

Now we have a lot of control. We have the SEC Act, which I think has been an excellent piece of legislation. And the stock exchange itself has gone just as far, if not further than the SEC in many respects, in control.

We certainly do not want another 1929, and I would be the first one to come down here if anything like that was in prospect. Because that is the last thing we want.

Representative HUBER. I am glad to have you point that out for the record.

Mr. SCHRAM. But with a 50-percent margin, you could not possibly get enough borrowing.

There is practically no borrowing now on securities. I think it is about $400,000,000 which is practically nothing.

In 1929, I am told that that figure got up to ten or 12 billion dollars, or something like that. It is just unbelievable.

Today there are being loaned on securities, I think, a little less than $500,000,000 or perhaps $500,000,000. I think margins should immediately be put on a 50-percent basis.

It does not make sense to say that the stock market is one of the steps in our economy, but in the same breath say that you could only borrow 25 cents on the dollar on securities of the best industries of this country.

Representative HUBER. You mention the adoption of voluntary restraints. That, is a thing we are all interested in, and everybody talks about it. But we have not achieved it so far.

I wonder what there is in store for us in the future all the way along the line.

Mr. SCHRAM. In what respect?

Mr. HUBER. You mentioned in your statement here, that—

> if we do not depress business psychology unnecessarily, and adopt voluntary restraints such as the American Bankers Association has advocated—

you see no reason why a large volume of business and services cannot continue to be produced and taken off the market.

Mr. SCHRAM. Yes, there I am speaking of the association. And I think they have done an excellent job. Bank loans, I think, have been reduced approximately $500,000,000 since the 1st of January. They are a little more selective.

Then I think with those voluntary controls that we will get over into the area of the individual.

I think I can say when it comes to the price structure, I have great faith in the American people. When prices get too high, people now just will not buy. Then the prices will go down.

Senator FLANDERS. Are there any questions?

Mr. Hart?

Representative HART. No questions, Senator.

Senator FLANDERS. Mr. Rich?

Representative RICH. You spoke about the Federal Reserve stabilizing things in 1929.

Well, did it?

In 1929 the Federal Reserve tightened up on its loans to the banks, and the banks were unable to secure funds, which closed a lot of the banks.

And I do not believe that the Federal Reserve at that time functioned properly, or we would not have had so many banks close.

Mr. SCHRAM. The Federal Reserve, of course, did not have the authority at that time that they have today.

Representative RICH. Well, they were just acting as good bankers would, to save their own institutions. Instead of loaning to the banks and letting the Federal Reserve take the shot, the Federal Reserve put themselves in a good position and let the banks take the shot.

It seems to me that it was not wise to handle it at that time, because I had some experience in it.

Now, you said that you had faith in the American people not overextending themselves, or faith in the Congress, relative to our spending.

We are now spending about 11½ billion dollars for war. And they tell me it is going to cost $25,000,000,000 for 1951 if we put into effect the plan that they are now contemplating for building up the Army.

Well, if we put that into effect, and it costs us $25,000,000,000, that is going to be 11½ billion over what we are spending now. That is going to make our budget over $50,000,000,000.

Do you think we can handle a budget of $50,000,000,000 under our present economy?

Mr. SCHRAM. I think your budget at present levels is about as much as the present economy can stand. I do not think you can get very much above your $40,000,000,000.

Representative RICH. I think you are right on that. And I question whether the Congress, then, should assume these greater responsibilities for spending until we know just definitely how far we can go.

If we get into war, naturally, as you said before, we do not know what the answer is.

But under present-day conditions, we ought to try to maintain—cut it down if possible, but certainly not go over—the $40,000,000,000. I agree with you.

Mr. SCHRAM. I think the $40,000,000,000 is just about the limit that our economy can stand.

Senator FLANDERS. Mr. Schram, to improve the stock market, you made two suggestions:

One was the lowering of the margin requirements, and the other I judge was the elimination of the capital gains tax.

You would eliminate it, would you?

Mr. SCHRAM. I believe it should be eliminated, yes; but I think that is a pretty big step to make at this time.

I think I would advocate at the moment that it be reduced from 25 to 12½ percent. I say that because I think something should be done quickly.

To completely eliminate it, I think, would require considerable study.

Now, I am heartily in favor of the present plan to close these loopholes that exist in the capital gains tax, such as we had in commodity trading.

I do think that this capital gains tax subject should be studied very carefully by a committee of Congress, planning toward the complete elimination of it. Because it is a capital levy, and it is nothing else.

It is an un-American procedure, and it puts a handicap upon the accumulations of savings that is very dangerous to the type of economy that we have always enjoyed in this country.

Senator FLANDERS. Have you any other suggestions then, than these two, to improve the equity market?

Mr. SCHRAM. Well, I am only speaking of those that are immediately available.

Yes; I have another suggestion that I would like the Congress to look into, and that is in the field of double taxation of dividends. I think that is another situation. In fact, I tried, as you know, to encourage the Finance Committee to give a credit in this last tax bill, just 3 percent of the normal tax, which would have cost about $165,000,000, I believe.

But I think the encouragement that corporations would have had at that time would have increased their payments to stockholders, and I think on balances it would again have made money for the Treasury.

Senator FLANDERS. That is one of those things like the weather, that everybody talks about and nobody ever does anything about.

Mr. SCHRAM. I always live in hopes, Senator, I am never pessimistic. I am always going to keep trying.

Senator FLANDERS. Are there any other questions?

Representative RICH. May I ask this question of Mr. Schram: Under section 102 of the Revenue Code, a corporation is supposed to pay out 70 percent of its earnings to its stockholders, or the Government comes along and takes 27½ percent of the amount that they do not pay out.

Now, as the situation is today, with the high prices which are bound up with the inventories of the corporations, it is clear that they have increased their assets not so much in goods as in high prices.

Therefore, many corporations, in order to save that 27½ percent, are going out and constructing things and buying things that they really could get along without, or would get along without. Yes, I had better put it that way. They would get along without these things.

They build new buildings, in order to save the 27½ percent; thus creating a scarcity in the commodity market of the building materials that they use.

They go and buy machinery, and they put that into their plant. Probably they increase the efficiency of their plant; but they are doing it for the purpose of trying to save that 27½ percent.

So with the scarcity of steel and the scarcity of materials like that, it seems to me that that tax is working a hardship on corporations, and it also is working a hardship on the commodity market. I think that should be eliminated.

I, myself, personally, think so.

What is your opinion of it?

Mr. SCHRAM. I was not aware that corporations were deliberately expanding for the sole purpose of trying to avoid the penalties of section 102. I think that it is my general impression that the Treasury has been very lenient in its administration of that particular section.

And in talking to a lot of people that I come into contact with, I have found that they rather indicate that that has not been too troublesome.

I understand, though, that there are some suggestions for a change. I think that corporations have had to retain earnings for the purpose of expansion. And I was not aware, Congressman, that the many corporations were deliberately expanding in order to avoid 102.

Representative RICH. I know to the contrary that there are a lot of them who would like to keep themselves in a good position financially, but because of that section they are going out now and doing a lot of things that they would not do normally.

Mr. SCHRAM. Is that so?

Representative RICH. Because their income and their profits have been reflected in high prices. And they have less merchandise, less goods, than they had a year ago. But they have more value, because of the high prices.

Mr. SCHRAM. I would think that that would be rather an unwise procedure.

Representative RICH. You suggest, then, that the corporations spend the 27½ percent; let it remain in, without doing those things?

Mr. SCHRAM. If they do not need the money, they ought to pay it out to stockholders. They can avoid 102 in that way.

Representative RICH. Yes, they can do it in that way. Then the stockholders will do exactly what you say they should not do.

Mr. SCHRAM. What is that?

Representative RICH. Pay the double tax.

Mr. SCHRAM. Yes, they would have to pay the double tax.

Representive RICH. But you say they ought to have relief from that.

Mr. SCHRAM. That is right.

Representative RICH. So that the corporation would be subjecting the stockholder to double taxation.

Mr. SCHRAM. Yes.

Representative RICH. Is that right?

Mr. SCHRAM. They have to pay the dividends; yes.

Representative RICH. But you say you want that changed. You say it is not right.

Mr. SCHRAM. That is right.

But if they distributed the earnings, they would have to pay the tax.

Representative RICH. But you want them to be relieved from that taxation.

Mr. SCHRAM. I do not say that the tax should be eliminated completely. But certainly they should be relieved to a certain point, because I believe in the graduated tax.

Representative RICH. So do I.

Mr. SCHRAM. And I think those in the higher income brackets should pay a higher rate of tax. But they certainly should be relieved up to the point of double taxation.

Representative RICH. I was trying to find out what your opinion was, from the corporate standpoint, of weakening their financial structure by creating more buildings or more machinery, or something, on which they will be taxed more in local taxes, then they felt they could not do it; because 27½ percent is an awful bite out of the taxes of a corporation.

Mr. SCHRAM. I would not consider that very sound management.

Representative RICH. I consider that it is not a very sound law.

Mr. SCHRAM. I can agree with that too.

Representative RICH. That is the point. I wanted to know whether you agreed with that.

Mr. SCHRAM. Yes, I think that should be corrected.

Senator FLANDERS. If there are no other questions, we will excuse Mr. Schram, and thank you for your testimony, and for your willingness to come down here.

Mr. SCHRAM. I was very glad to come here and testify, Senator.

(Whereupon, the committee adjourned at 11:30 a. m., upon the call of the Chair.)

CREDIT POLICIES

THURSDAY, MAY 27, 1948

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The committee met at 10 a. m., pursuant to call, in room 138, Senate Office Building, Senator Robert A. Taft (chairman) presiding.

Present: Senator Taft (chairman) and Representative Rich.

The CHAIRMAN. The committee will come to order.

You are going to make an opening statement, Mr. Riefler?

STATEMENT OF WINFIELD W. RIEFLER, ASSISTANT TO THE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. RIEFLER. Mr. Chairman, my function here is mostly to introduce the two other gentlemen, who have worked on this plan, and who have presented it to the Federal Reserve Board and the presidents of the Federal Reserve banks.

It was quite interesting to me on the day of my arrival at the Federal Reserve Board a few weeks ago to hear this plan presented. It just happens that when I left the Federal Reserve System in 1933, I was secretary of the previous Federal Reserve System committee, dealing with this same subject.

It is a subject we have been studying in the System for a very long time. This program is still under study. The committee has just presented its report. It is now being considered by the Federal Reserve banks and by the Federal Reserve Board.

The CHAIRMAN. I think perhaps the gentlemen in the room could hear this if you spoke up a little louder.

Mr. RIEFLER. This plan is now being studied by the Federal Reserve banks and the Federal Reserve Board. What we are presenting here this morning is the report of the committee has it as been presented to both of those bodies.

This should not be confused with the special-reserve plan which the Federal Reserve Board has presented to Congress during the last year.

Now, first, I think that Mr. Thomas, Director of the Division of Research of the Federal Reserve Board, will present the general background that makes the subject of reserves important and tell us why it is that the System is studying this subject.

The CHAIRMAN. Mr. Thomas?

STATEMENT OF WOODLIEF THOMAS, DIRECTOR OF RESEARCH, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. THOMAS. Mr. Chairman, just by way of background, I think it is useful to have an understanding of why there are bank reserves.

It is important to recognize that the name of this central banking system that we have in this country is the Federal Reserve System; and it is well named, because reserves are the basis of the System's operations.

Now, "reserves," as used in this sense, are assets that banks hold in certain forms or in certain amounts these may be designated by law, or may be a matter of tradition.

Now, the common conception and the earlier conception of the primary function of bank reserves has really gone through a stage of evolution. Originally it was considered that the principal purpose of requiring banks to hold a certain amount of reserves against their deposits was to assure the convertibility of thsoe deposits into cash. Or else, there were reserves against bank notes; and the purpose of that was to assure the convertibility of those bank notes, that is, to assure the ability of the individual banks to meet their liabilities on demand during any period of strain.

But in the course of time, even before the establishment of the Federal Reserve System, it became evident that reserves alone were not an adequate protection to banks and their depositors. No reasonable amount of reserves could be sufficient to meet a large-scale withdrawal of deposits.

Furthermore, with the organization and establishment of the Federal Reserve System, the convertibility of deposits into cash became assured by the ability of the banks to borrow on their assets from the Federal Reserve. And that was a more important aspect of the safety and convertibility than just the amount of reserves that banks held.

Under the Federal Reserve System, reserves have served primarily not so much as a means of preserving the liquidity of banks or assuring their safety or their ability to convert their deposits on demand, but they have been a medium through which an influence can be exercised on the expansion and contraction of credit.

The CHAIRMAN. Is there not still a function there, in keeping a certain amount of cash or convertibility? If you have everything in loans, your losses would be a much larger percentage of total assets and would endanger the deposits.

Still there is a question of safety of deposits in reserves, is there not?

Mr. THOMAS. Well, if the reserves are 20 percent, of course, that amount is held as an asset which is definitely 100 percent good, as it were; and to that extent the deposits are safer. If you had a 40 percent requirement, deposits would be that much safer. But if you require banks to hold reserves of 20 percent, and the bank loses a million dollars of deposits, it can only use 200,000 of those reserves to meet that drain on deposits. It has to get the 800,000 somewhere else.

The CHAIRMAN. No; I meant the ultimate safety of the deposits. I did not mean the convertibility.

Mr. THOMAS. The ultimate safety is better, the higher the reserve requirement. That is unquestionably true. The more reserves they have, the more assurance there is of safety. But the other assets make up the larger part of the assets of the bank; so that it is more important that they be safe than it is that they have to depend entirely on their reserves.

I do not want to say that that is not an important part of the function of reserves, but it is not the most important part.

By requiring banks to immobilize, you might say, a certain part of their assets—banks have to hold a certain part in an immobile form—you bring about the result of reducing the part that the banks can re-lend. So therefore, the higher the reserve requirements are, the less tanks can make loans on the basis of new funds that come to them. And that reduces what we call the ratio of multiple credit expansion.

If a certain amount of gold comes in, one bank can sell that gold to the Treasury, and it gets an additional reserve, and it can make a loan of 80 percent of that. When the funds go to another bank, that bank can lend an amount equal to 80 percent, and so, until you get into an expansion of credit of five times the original deposit. Well, the higher the reserve requirement, the less multiple credit expansion there can be.

So that one of the most important functions of reserves, is to limit the ability of banks to expand credit.

Now reserves, in order to perform these functions, have to be of two sorts. I mean, they have to have two characteristics. One is that they have to be assets that are assured, that have assured safety and liquidity; like a deposit with a Federal Reserve bank, a currency obligation of the Government. And the reserve assets have to be limited in amount. If they are readily available, a bank could go out and obtain additional reserves, and it can continue to expand credit on the basis of those additional reserves.

For instance, if you had all Government bonds as satisfying the reserve requirements, a bank could go out and buy Government bonds, and satisfy its requirements, and then the money that is used to buy Government bonds would go to some other bank, and it could expand credit on the basis of it.

So you have to have assets that are limited in amount, in order to be really effective as a limitation on credit expansion.

Now, the purpose of the Federal Reserve System,was, first, to hold the reserves of the commercial banks. The commercial banks are required to hold their reserve balances with the Federal Reserve.

And second, the System must regulate the supply of those reserves.

Really, in a sense, the System was organized for the purpose of providing facilities which could create additional money.

Before the Federal Reserve Act went into operation we had a banking system in which the amount of money the banks could lend was limited. They couldn't obtain additional funds. We had periodic panics where there was a big demand for money, and money couldn't be obtained. The banks all tried to get it out of New York, and you had a panic resulting.

The Reserve System was organized for the purpose of making it possible to supply additional reserves under such circumstances.

At the same time, the System had to operate under certain limitations. They couldn't be in a position of supplying unlimited amounts of reserves.

So the System has to regulate the supply of reserves which the banking systems can obtain, in accordance with the needs of the economy, in order to prevent undue inflation or to prevent undue deflation.

The regulation of the supply of reserves by the Federal Reserve System is operated in part through its lending facilities to the commercial banks, by rediscounting their paper. And that is influenced by raising or lowering the discount rate.

In part, the system can supply reserves through open market operations; that is, by buying and selling securities or bills in the open market on its own account.

And a third means of regulating the supply of reserves is by changing the requirements, the amount of reserves that banks are required to hold. That instrument can be used to regulate the available supply of reserves. If banks have a lot of reserves that they are not using, the System could absorb them, or make them unavailable for use by making banks hold more. The System under other circumstances could raise reserve requirements and make it necessary for banks to sell some of their assets to the Federal Reserve in order to meet those requirements. Although that would increase the supply of reserves, it would at the same time reduce the other assets available to banks for meeting the credit demands of the public.

The System can also increase the supply of reserves by lowering the reserve requirements.

Now, that particular power, which was granted first in 1933 and then, under slightly different process, in 1935, has now all been used up. The Federal Reserve authorities can lower reserve requirements. They cannot raise them, with one minor exception.

Banks obtain reserves also through gold inflow. They also could obtain reserves if currency returned from circulation into the banks, and that currency was turned over to the Federal Reserve System. It would give the banks additional reserves.

On the other hand, if banks have to meet a currency drain, they have to draw on their reserve balances, and that reduces reserves.

Another element which affects temporarily the supplies of reserves, is the fluctuations of the Treasury deposits with the Federal Reserve. They may go up and down, but generally that is only a temporary influence and not a long-term one.

I would like not to leave the impression that this regulation of the supply of reserves is entirely automatic, that you can completely control the money and the supply of credit just through regulation of reserve supply; because a lot of it depends upon the willingness of borrowers and lenders.

We have had periods where banks held large amounts of excess reserves, and did not use them, because either the borrowers were not willing to borrow, or the banks were not willing to lend on the basis of the sorts of loans that they could get, or they were not willing to buy the securities that were available.

We have had other periods where the banks have freely made loans and have borrowed from the Federal Reserve for the purpose; or one bank would borrow, and one would go to another bank, and it would make the loan.

So this is not a fixed and automatic relationship. The banks have a great deal to say about how much reserve bank credit is brought into use, how much they make use of their reserves to expand credit. And the borrowing public also has a great deal to say about it.

Now, there are two aspects to this problem of bank reserves that the Federal Reserve System is concerned with, and one is the changes in the total volume of reserves. That is the one that I have been talking about mostly. At the present time, the possibility of expanding bank reserves is really very large, because for one thing we have the likelihood of continued inflow of gold to this country of maybe a billion or 2 billions a year, that will supply the basis of expansion of 6 to 10 or 15 billions of additional credit. And for another thing, the banks hold very large amounts of Government securities, much larger than they have ever had before, or been accustomed to holding in the past. And they can sell those. With the Federal Reserve policy of supporting the Government bond market, the Federal Reserve would buy them, and that would create additional reserves.

Now that is one aspect of the problem which has been presented to your committee pretty thoroughly by Governor Eccles.

The other aspect, which is the question which we want to discuss somewhat more carefully, is the question of the structure of reserve requirements. And that is how much each bank shall hold and the basis of the requirement that determines how much each bank shall hold.

We have a certain amount of reserves which is related to the total credit structure, but there is a lot of question as to the details of the operation, whether one bank shall hold more reserves than another, and on what basis that shall be worked out.

The present system of reserve requirements is one that is based on the location of banks and the type of deposits. It is a system that was inherited from the National Banking System. It developed at a time when some banks held reserves with other banks. So that was carried over into the Federal Reserve System, and we have operated largely on that basis.

The city banks that used to hold the reserves of the country banks have to carry higher reserves with the Federal Reserve than the country banks have to carry.

For instance, the banks in the central reserve cities of New York and Chicago, under the law, had to carry between 13 and 26 percent of their deposits, their demand deposits, with the Federal Reserve. The banks in what used to be 60 and is now a slightly smaller number of cities, called reserve cities, have to carry in reserves between 10 and 20 percent of their demand deposits, the exact amount being fixed by the Board under the power to change the requirements. The other banks, which for convenience we will call country banks, have to carry reserves of from 7 to 14 percent of their demand deposits. And then, all banks have to carry reserves of between 3 and 6 percent of their time deposits.

All of those requirements are now at the maximum level, except the requirement for central reserve city banks in New York and Chicago.

There has been a lot of discussion throughout the history of the Sytem as to whether this is a particularly equitable method of distributing the reserves among banks, whether it is logical, what is the basis of it, and why should banks in these cities have higher reserve requirements than banks in the country.

It used to be that these city banks carried in bank deposits the reserves of other banks, but they don't any more. They still have a lot of interbank deposits. But should a distinction be made between interbank deposits and any other kind of deposits?

There was a question as to whether the distinction between time deposits and demand deposits was a justifiable one.

Representative RICH. You speak in reference to the country banks making their deposits in the city banks, and with reference to the requirement that they carry a Federal Reserve. Well, are not the reserves that are carried by the city banks the same money that is deposited by the country banks? And if you permit the city banks to load up fully on the reserves that they carry of the country banks, supposing the country banks would recall those loans. The city banks would be in difficulty, would they not?

Mr. THOMAS. Yes. That is one reason why originally those were higher. But at the present time, the city banks can meet the drain if necessary by calling on the Federal Reserve for accommodations. And the present system requires the city bank to hold the reserve against these interbank deposits; so that if the funds are shifted from the country bank to the city bank, if the city banks hold the reserve, why should the country bank hold some?

Representative RICH. In my judgment, the city bank should have a greater reserve than the country bank.

Mr. THOMAS. Well, there is a logical basis for that. But there are other people who think that that is not a necessary distinction now. And it is one of the controversial questions which we shall discuss a little more fully later.

But there has always been this question of the classification of cities. The banks now are classified on the basis of their location and not on the basis of the type of business they do. You have in a city a bank that may have no interbank deposits, but it has to carry just as high reserves against its other deposits as the city bank that has interbank deposits. And the law permits banks in outlying sections of cities, to be classified on a lower basis than the banks in the center of the city. And we have had many studies in the past with respect to that.

Representative RICH. Is that not because of the fact that the ones in the central cities have greater capitalization and greater deposits? And they are always after the deposits of these outlying banks, the country banks. Therefore, you have to be careful that you do not permit them to have the same opportunity to make greater loans, because they are the ones that can get stuck. Because the smaller banks are going to call on them in case of necessity.

Mr. THOMAS. That is the basis of it. But you have the same requirement, though, whether a bank holds interbank deposits or does not. The small bank in the central city has to carry just as much as the big bank, even though it is doing an entirely different kind of business.

The CHAIRMAN. Your suggestion there would be based on the distinction between straight deposits and interbank deposits, rather than where the bank is.

Mr. THOMAS. I am anticipating now Mr. Bopp's discussion. I am trying to indicate some of the problems that have arisen.

Now, the System has studied this whole question of reserve requirements and the structure of reserves, and the classifications of cities for many years. We did some studying back in 1928. A committee made up of representatives of the Federal Reserve banks and the Board, with Mr. Riefler as its secretary, made a report in 1931, which recommended uniform requirements for all deposits wherever located, and of whatever type, except that there would be an additional requirement based on the turnover of those deposits, the amount of checks drawn against them.

Now, that is a logical and sound system. Because if the purpose of reserves is to influence the economic situation of the country, and to influence the banks in their lending activities, the use of this money is just as important as the amount.

So we subsequently made a very careful analysis of how this would apply to different banks, and different cities, and found that the administrative problems involved were very tremendous.

The CHAIRMAN. Was the suggestion that you would have more reserves if you had a more rapid turn-over?

Mr. THOMAS. Yes, that was the suggestion.

The CHAIRMAN. That relates the whole thing rather more to your original idea of liquidity than it does to the expansion of bank loans.

Mr. THOMAS. Something of volatility. But it also relates it to the use that is made of the money as well as to the amount that is there, and the extent to which it is used as well as the amount.

Well, we found that there was a lot of variation in the use of deposits, according to the ways of doing business. In a livestock center, for example, a lot of the banks had money going in and out during the day in tremendous amounts. The same thing is true in a city like Memphis, where there is a lot of cotton money, where there is a lot of cotton business going on.

So it was difficult to apply administratively.

Then, furthermore, it did not meet the problem that has subsequently developed, of the total expansion and the total supply of reserves. Because we had a very low velocity, but a very large volume of reserves.

There have been other system studies. There was at one time a study that suggested that a higher reserve requirement be placed on all further increases in deposits. I think Allan Sproul suggested that in one of his speeches recently as worthy of consideration.

Again, that is a logically defensible method. There may be some way of working it out. It has also administrative difficulties.

Then you have had the proposal that the Board has made, of a reserve to be held in the form of certain types of Government securities, the supply of which is limited.

Recently the System has been faced particularly with this problem of classification of cities. Last year or early this year certain cities were reclassified. And it was faced with the question of: What is the basis of clasification? So a System committee has studied that question. It was a committee made up of the research people from various reserve banks and the Board. It tried to work out a scheme which would meet some of the difficulties in the question of the structure of reserves.

Now, Mr. Bopp, who is the vice president and director of research of the Federal Reserve Board of Philadelphia, served as chairman of that committee. That committee made a report which should be taken as a study and not as a recommendation.

I know members of the committee itself did not recommend it for adoption. They simply presented it as one of the schemes which might solve some of the problems. It has not been adopted by any of the System authorities for recommendation, but it has simply been thrown on the table here for as wide a discussion as it can get by interested people.

If you will, Mr. Chairman, I would like to have Mr. Bopp present that.

The CHAIRMAN. Proceed, Mr. Bopp.

STATEMENT OF KARL R. BOPP, VICE PRESIDENT, FEDERAL RESERVE BANK OF PHILADELPHIA

Mr. Bopp. Mr. Chairman, I am quite willing to assume responsibility for this report. I would like to say, however, that I deserve very little credit for such merits as it may have. It is important to note that it is a study and not a recommendation.

A central bank that is alive to its responsibilities is studying reserves of commercial banks continuously, because, as Mr. Thomas has said, reserves are the principal means by which a central bank influences the supply of money in a country. The inequities and administrative difficulties inherent in our present structure of reserve requirements, have been recognized for a long time.

I was very much intrigued by the proposals of the System Committee in 1931, that Mr. Riefler mentioned. Those proposals were based on, and they contributed to, modern development in monetary principles, in which emphasis has been shifted from the quantity of money as such to the flow of expenditures in the economy. I abandoned this particular application reluctantly only as I saw the administrative and practical difficulties revealed in tests of those proposals as applied to individual banks.

Frankly, I was initially skeptical of the plan that is analyzed in the study before you.

I remember discussing some of the basic features as they were advanced several years ago by some of the people in the System. My concern at that time, however, was that of an interested observer or spectator rather than a participant.

In due course I became a participant by being asked to serve as chairman of a System staff committee to study the general problem of member bank reserve requirements. And I soon learned what President Wilson meant when he said:

> We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon.

There are always the practical difficulties that one runs into.

As the committee worked on its assignment, it developed the general principles on which this report is based; namely, that a structure of reserve requirements could be economically defensible, administratively feasible, equitable, and adapted to the American system of banking as it has developed.

With respect to the specific results of this work, as embodied in this study, I should like to emphasize two things. First, significant contributions have been made by the staff at the Board of Governors and at the Reserve banks. And second, this study is not completed and hence is not presented in the form of specific recommendations by the staff, nor has it been adopted by the responsible authorities in the System.

With that introduction, Mr. Chairman, it may be well to read the study as it is. Please feel free to interrupt at any time with any questions, if you like.

Representative Rich. First let me ask you this question:

Why do you not give us your recommendations? If you are giving us a study, it seems to me if you came here with a concrete proposal we would be better able to judge the merits of it than we would if it is left to us to determine that. You ought to have conclusions, certainly, after you read your report; and we would like to know what your conclusions are.

Mr. Bopp. With respect to that, Representative Rich, I would say only this: that the study is in preliminary form, and there may be bugs in it. We would like to have it for discussion by all interested parties, so that they can find out what the bugs are.

Representative Rich. That is the reason I would like to have your definite conclusions; and then we can pick the bugs out. But if we are left open to find the bugs, it might be pretty difficult, because we may not have the same line of thought that you have.

Mr. Bopp. The particular problems that arise, so far as our present system of requirements is concerned are, I think, analyzed in the study. And I have specific methods of attack—I don't like to call them proposals—on these problems included in it. So I think some of your questions may be answered in the study.

The Chairman. Is this the first time this study has been made public? You say you discussed it with the Board.

Mr. Bopp. This is the first publication of it.

The ability of a commercial banking system to create deposits depends on the volume of reserves available to its members and on the relationship between reserves and deposits. In order for the monetary authorities to exert an effective influence over the volume of deposits, it is necessary that they have adequate influence over the volume of reserves and adequate administrative authority over reserve requirements. This is the first and more important aspect of the current problem of bank reserve requirements. It is this aspect of the problem that proposals for increasing existing primary reserve requirements or requiring a temporary additional reserve in the form of short-term Government securities, or excess cash reserves, are designed to meet. In this memorandum a provision is included which allows for raising or lowering the level of reserve requirements; and whatever reasons justify an increase in existing reserve requirements are equally applicable to the corresponding provision here described.

The second aspect of the current problem of bank reserves—the one to which this memorandum is directed primarily—is the plan or system of distributing reserve requirements among member banks. Such a plan should be economically defensible, administratively feasible, equitable, and adapted to the American system of banking. The desirability of establishing a more logical and effective method of determining the distribution of reserve requirements among member banks has long been recognized. Periodic recommendations have resulted from continuous study of the problem in the light of experience.

This earlier work has been taken into account in the preparation of this report.

II. A plan: This plan contemplates that the Federal Reserve Act be amended to—

(1) Eliminate designations of central reserve cities and reserve cities.

(2) Prescribe basic initial reserve requirements against classes of deposits as follows: (*a*) 30 percent against interbank deposits whether demand or time; (*b*) 20 percent against other demand deposits less cash items in process of collection; (*c*) 6 percent against time deposits, or perhaps 6 percent against savings deposits and 20 percent against other time deposits.

(3) Empower the Federal Open Market Committee to increase or decrease these basic requirements by some suitable proportion—perhaps a maximum of 50 percent—in either direction as to any or all classes of deposits. This would deal with the first aspect of the current reserve problem, namely, raising the level of total reserve requirements; this provision of the plan is merely an alternative to the proposals for increasing existing primary reserve requirements or requiring a special reserve of short-term securities. It would also permit a lowering of total reserve requirements if circumstances should arise in the future which made that desirable.

The CHAIRMAN. Where is the power now to increase or decrease reserves?

Mr. BOPP. The Board of Governors, sir.

The CHAIRMAN. You suggest here the Federal Open Market Committee.

Mr. BOPP. I should think that the report of the committee should have been concerned with system authorities rather than specifying which authority. And this was put in because Governor Eccles proposed that that power be lodged in the Federal Open Market Committee.

Am I correct?

Mr. THOMAS. That is correct. That is again one of the moot questions, as to where it should be lodged.

Representative RICH. They set the rates of reserve. Now, we have the State reserves, who set the reserve of the State banks. And we may have 48 different sets of reserves in those 48 States. Then we have the Federal Reserve banks, which are federally controlled, and they set the reserves there. So you have in the banking system a great number of reserves, dependent upon the location of banks.

Mr. BOPP. That is one of the reasons, Representative Rich, why we have not come forward with this as a recommendation: because of the problem which is mentioned on page 3, which I might read at this point:

> Along with the changing of member bank reserve requirements, consideration should be given to the desirability of prescribing uniform reserve requirements to be observed by all nonmember commercial banks in lieu of or in addition to those prescribed by State law.

That is certainly one of the knotty and difficult problems in this whole area.

Representative RICH. The only thing, as I view it, is that the State banks are always jealous of the National banks and trying to have the Federal Government interfere with the operation of the State banks.

Mr. BOPP. Nonetheless, how many State member banks do we have?

Mr. THOMAS. We have about 1,900 State member banks. But they hold a large part of the deposits of all State banks.

Representative RICH. You have never found any difficulty in reasoning with the State banking system as to the reserves that they should set? I think they are always cooperative, are they not, in trying to set the reserves?

Mr. BOPP. Frequently those State bank reserve requirements are established by law, without any power as to change lodged in any State authority.

Representative RICH. Certainly, however, if you can show the law they now have in those various States is wrong, I think that could be corrected. You know, the State banks are very jealous and very concerned as to the effort to have all the power centered in Washington. And so am I. I do not want it. I think we have too much power here, and the less power we have here the better it will be for this country.

We have to get the power back to the States, rather than bring it to Washington.

So I think we have to be awfully careful in lodging the power with the Federal Reserve or with the Federal Government.

Mr. BOPP. As I say, that is one of the thorny, knotty problems.

Representative RICH. It is a good thing that we have a knotty problem there. Because if we had it in the hands of a few here in Washington, the devil only knows what would happen.

Mr. BOPP. It explains one of the reasons why this is still a study and not a recommendation. Because that is a problem which is involved in specific recommendations.

Representative RICH. Well, I am glad you have no recommendation there.

Mr. BOPP. (4) Permit vault cash to be counted as part of required reserves.

(5) Permit a member bank to deduct from its required reserves a percentage of its balances due from other member banks equal to the percentage of reserves required to be held against interbank deposits. This would replace the present method of allowing a member bank to deduct from its demand deposits the amount of its balances due from other banks before computing its required reserves. It might be better as well as simpler to treat "cash items in process of collection" as the equivalent of "due from banks," instead of as a deduction from demand deposits.

(6) Empower the Board of Governors to waive, by regulation, during a transition period, penalties for deficiencies in reserves resulting from increased requirements on the proposed new basis.

Mr. THOMAS. I may say there, on that point, that the powers in the present act may be adequate.

Mr. BOPP. So that no change would be required.

Mr. THOMAS. That is, again, one of the things that will have to be studied by lawyers and administrators.

Mr. BOPP. Analyzing these specific provisions, then, item by item, and first with respect to the elimination of central reserve city and reserve city designations:

Under existing statutes, the Board of Governors, for purposes of establishing reserve requirements, classifies banks into three categories—central reserve banks, reserve city banks, and banks not in reserve cities. It also determines actual requirements for the three classes of member banks within the limits prescribed by law.

The names attached to the categories of banks reflect their origin. The National Bank Act authorized banks to keep a portion of their reserves in the form of deposits at other banks. Classification of cities was a method of identifying reserve depositary banks or at least banks that were eligible to receive reserve deposits. The obvious intent was to require higher reserves to be carried by banks which held reserves of other banks. However, all eligible banks were subjected to higher reserve requirements, whether or not they actually held deposits of other banks.

Representative RICH. Could they not have a reserve, of the amount of money that was deposited by member banks through the country banks, and then have a reserve on their own deposits in the same depositary bank?

Mr. BOPP. I think that we will come to the problem you have in mind, Representative Rich. You will see that this fifth point attempts to cover exactly that.

Representative RICH. You will come to that later.

Mr. BOPP. Yes.

This method of basing reserve requirements on the location of a bank rather than on the character of its business has resulted in inequities. Inequities are bound to arise when some banks in a city held substantial amounts of interbank deposits and others do not. The only choice before the Board of Governors is to classify the city as a reserve city or as a nonreserve city. If it does the former, it penalizes—relative to banks doing similar business elsewhere—the banks with little or no interbank deposits; if it does the latter, it favors—relative to banks doing similar business elsewhere—the banks with such deposits.

Representative RICH. Now, when you take the State banks, the Banking Commissioner willl grant permission to a small bank our in the country to have as a depositary a bank in a larger town. Or you can have it in Philadelphia or New York; or, we will say, where I live, up in Pennsylvania. Or we will take a small country bank, for instance, like Williamsport. I am speaking of a smaller bank outside of Williamsport. We can use the Williamsport, or we can use the Philadelphia or New York bank. That is permitted in the State of Pennsylvania.

Now, why is it not good business to do that? The bank that they have in Williamsport in turn would use the larger city bank. So that you do not put everything in Philadelphia and New York and Chicago, and a few cities like that.

Mr. BOPP. Again, one of the difficulties that arose in connection with that, which was part of the old national banking system, was that it permitted what technically came to be known as "pyramiding reserves." That, again, is a problem that is dealt with subsequently in the memorandum: the problem of how much cash reserve you actually have if part of your reserve is in the form of deposits.

Representative RICH. What would be the difference if, for instance, a little country bank made its deposit in Williamsport and then in turn the Williamsport bank deposited it in New York? They have to carry the same reserves. And if you put it all in New York, they would have the same amount; would they not?

Mr. BOPP. They would, according to this plan which we have here. But that would not be the case under either the present State system or under the old national banking system, when we had it. Because you would have, let us say, the individual customer depositing his funds in the Williamsport bank; and, just to take a figure arbitrarily, let us say they have a 20 percent reserve against that, which, let us say, they deposit in New York.

The New York bank then keeps a reserve of, we will say, 20 percent against that 20 percent. So that the cash reserve against the $100 deposit is only $4.

To complete that; On the contrary, if the individual had his money in the New York bank, he would have a 20 percent reserve. That is what is technically called pyramiding reserves. And the attempt in this particular plan which we have is to make sure that irrespective of what the particular bank does, the amount of reserve, really, in the banking system——

Representative RICH. All right. Let us make two sets of reserves, one for deposits on deposists. That could be easily arranged, and you would not have it in the large cities, then. You could keep it back in the country where it belongs, and keep it out of the Federal Government, where it does not belong.

Mr. BOPP. That is the purpose of the second provision which we have here.

Such inequities have been mitigated slightly by the qualification that the Board may designate outlying banks in central reserve and reserve cities as country banks; but not all inequities can be eliminated, because the adjective "outlying" also relates to location, not to character of business.

The administrative problems that have arisen from the requirement to designate cities, though not significant with respect to credit control, have been among the most difficult confronting the Board of Governors. Mere reference to the questions, extensive correspondence, and hearings incident to the Board's recent adoption of standards for designating and terminating reserve cities is sufficient to demonstrate the impossibility under present law of dealing with reserve classifications of cities on a basis that is equitable and satisfactory to the System and to member banks.

Representative RICH. Why is it necessary for you to have the power to designate what cities shall be used as depositaries, and what banks? Why do you not give that to the banks in accordance with their financial structure, whether it be in the larger cities or whether it be in some of the smaller cities?

Mr. BOPP. This study asks that question, and can't find an adequate justification for it. And then says that perhaps a more appropriate method can be devised. But the present law requires the Board to do it.

Representative RICH. I think the law is wrong. I think it ought to be changed.

If you think that, why do you not make that recommendation?

Mr. BOPP. The first recommendation—and by "recommendation," I mean the first part of this plan—is to eliminate designations of central reserve cities, and central reserve cities.

Representative RICH. You are not afraid of making a recommendation because you are working for some Federal organization, and afraid you might hit somebody higher up, are you?

Mr. BOPP. No, sir.

Representative RICH. I would make a recommendation, then, if I were you.

Mr. BOPP. (2) Classification of deposits for reserve purposes: A system of reserve requirements should be effective on an over-all basis, administratively feasible, and equitable among commercial banks. In revising a system, consideration should be given also to the impact of the change, so as to create a minimum of hardship cases. Views differ, of course, as to the precise system that best meets these criteria.

One of the bases of the plan discussed in this memorandum is the assumption that as a practical matter it is desirable, at least for a fairly extended transition period, to continue some differentials in reserve requirements in addition to those between demand and time deposits and that experience and studies have demonstrated that interbank deposits, which underlie existing statutory differentials, are the simplest, most practicable, and on the whole the most acceptable basis for such additional differentials in reserve requirements.

At one extreme, it has been argued that deposits should not be classified at all or that requirements should be uniform against all classes. This was the situation under the National Bank Act and is still the situation under the banking laws of some States. At the other extreme, it has been argued that a detailed classification should be made based on such characteristics as turn-over, volatility, size, and economic activitity of depositor—whether an individual or a business, whether local or national.

Both views have been challenged in principle, in practice, or both. The practical objection, of compelling importance, to treating all deposits alike is that the impact of launching such a system would be to cause serious dislocations in the banking system because, depending on the level set, it would create enormous excess reserves in reserve and central reserve cities, enormous deficiencies elsewhere, or both. The principal objection to an elaborate classification is that it is not an appropriate means of achieving the presumed objective. That objective would be to give the monetary authorities selective as well as general influence over the quantity and flow of credit in various segments of the economy.

To accomplish this objective, however, it would be necessary to identify either deposits or debits to deposit accounts, or both, in terms of the economic activities to which selective controls are to be applied. If deposits were chosen, it would be necessary to classify them, not on the basis of present ownership, but on the basis of intended expenditures—a hopeless prospect. If, on the other hand, debits were chosen, discriminatory requirements could be avoided by shifting to cash transactions, by means of "clearing arrangements," and by other devices. It is virtually impossible to devise a comprehensive system of classification which would be administratively feasible.

The suggested threefold classification and the proposed basic initial requirements would minimize disturbances created by initiating a new system while yet retaining effective over-all control. It is recognized, however, that any classification is somewhat arbitrary. In terms of function, for example, some depositors hold savings in the form of demand deposits, others in the form of savings deposits, and still others in the form of other time deposits. By and large, however, the three classes of deposits are used for different purposes. In addition, they are readily identifiable, and difference in treatment is an established part of American banking traditions.

There is substantial agreement that time—or at least savings—deposits should be treated separately. Such deposits are not, strictly speaking, a means of payment, but they perform other functions of money, such as being a store of value. For practical reasons the existing reserve requirements on time deposits ought to be retained as the basic requirements under the proposed plan.

There are also strong reasons for treating interbank deposits differently than other demand deposits. In the first place, interbank deposits are legal reserves for nonmember banks; they underlie the deposits and credit extended by such banks. In determining appropriate reserve requirements for such "deposits," it needs to be emphasized that they are reserves on the basis of which other deposits are built. If nonmember banks were required to carry reserves with the Federal Reserve banks, the fact that their present balances due from banks are their reserves would become very obvious when the nonmember transferred a substantial portion of such balances from their member bank correspondents to the Federal Reserve banks.

Similarly, member banks, taken individually rather than as a group, treat their "due from bank" as something more than secondary reserves. In practice, such balances are often used in preference to reserve balances with Reserve banks to make loans or meet deposit withdrawals. Moreover, they are readily convertible by the owner bank into Reserve bank reserves—and in the event of a substantial increase in requirements undoubtedly would be converted to a considerable extent; they are, in other words, much like additional reserves of the owner bank. The depoistary bank, in turn, performs some quasi-central banking functions, including not only holding of reserves of other banks but also clearing and other services.

Furthermore, to require higher reserves against interbank deposits would be in harmony with current and old Federal and State laws, which contain provisions requiring banks holding reserves of other banks to hold higher reserves. Such treatment would, in fact, accomplish the original intent of those who established present and historical differentials in reserve requirments. It would also be in harmony with the formula or standard only recently adopted by the Board of Governors, after extensive consideration, for the designation of reserve cities, and with the basis on which the Board has in the past granted or refused to grant permission for reduced reserves to be maintained by outlying banks in reserve cities.

Finally, there is a compelling practical reason. Elimination of designation of cities without separate treatment of interbank deposits would result in creation of large excess reserves at central reserve and reserve city banks and of large deficiencies at other banks if over-all requirements were set so as to maintain approximately the current volume of total required reserves.

Even though one held the view that in principle all demand deposits should be subjected to identical requirements, it would be desirable during a transition period to establish different requirements so as to permit a gradual change and thus minimize sudden dislocation; in fact one feature of the plan here outlined is that it would permit this very thing to be brought about at an appropriate time: Uniform requirements on all demand deposits—interbank, individual, partnership, and corporate.

The particular requirements that are suggested have been selected only after considerable discussion and analysis. Many different combinations of requirements were tested for feasibility and effectiveness on an over-all basis. Combinations which satisfied this criterion were then applied to individual banks. On the basis of preliminary tests made thus far, it appears that on the whole the proposed basic combinations meet the criteria satisfactorily. It should be noted, however, that there would be plenty of room for adjustments—in requirements on any one or two or all three classes of deposits.

In general, these new requirements would hit hardest those banks outside reserve and central reserve cities subject to "country" bank reserve requirements, which nevertheless do a type of business similar to that done by most large banks in such cities, including many that hold substantial amounts of interbank deposits. Included also are banks that hold large proportions of demand deposits, are "loaded up," and have relatively small amounts of vault cash and balances due from correspondents. Conversely, banks with relatively large amounts of vault cash and balances due from correspondents and relatively large proportions of time deposits would experience reductions in their required reserves. From the standpoint of more effective control of bank credit, that would appear to be the result desired.

The CHAIRMAN. You increase all country banks from 14 to 20 percent? Is that right?

Mr. BOPP. On demand deposits, yes.

Mr. THOMAS. We give them the privilege of counting as reserves 30 percent of their balances due from member banks and all their vault cash. That pretty much washes out for the country banks as a whole.

Mr. BOPP. Yes, in general; so far as we can see, it would be only the large country banks which have large interbank deposits and relatively small amounts due from other banks, that would be hit, but not the ordinary run of country banks.

The CHAIRMAN. The last proposal was 30, reserve, and 35, central reserve, maximum. And here you give them 20, with a power to raise to 30.

Mr. BOPP. You see, the initial requirements were set, so that the total reserve requirements for the country as a whole—the initial problem that Mr. Thomas discussed—would be the same under this proposal as those presently existing.

(3) System authority to vary requirements: The basic initial reserve requirements mentioned in item 2 were selected so that total reserve requirements for all member banks would equal, approximately, the present maximum level. These initial requirements would not, of course, prevent multiple deposit expansion based on new reserves that member banks may acquire from gold imports, purchases of Government securities by the Federal Reserve System, and a return flow of currency from circulation.

Methods of preparing to neutralize such reserves have been discussed extensively in public hearings and in the press. One method, recommended to Congress by the Board of Governors, would be to authorize the System to require banks for an interval to maintain a special reserve of short-term Government securities. Another, suggested in lieu of a special reserve, would be to authorize a substantial increase in primary reserve requirements.

The desirability of enabling System authorities to change reserve requirements from time to time within prescribed statutory limits, in order to prevent injurious credit expansion and contraction, is an accepted principle. The statutory limits should be set with reference to initial requirements, although it is not essential that the same degree of variability be granted in both directions.

Although the chief purpose of authorizing changes in reserve requirements is to influence total requirements, experience has demonstrated that discretion should be granted as to each requirement as well as the requirements as a whole. In this connection, it should be pointed out that various groups of member banks could be variously affected by selective use of changes in the requirements against different classes of deposits. Thus, combinations of changes in requirements on the three classes of deposits could be utilized to exert differential influence on banks doing different types of business. For example, an increase in the requirement against interbank deposits would result in increases in required reserves of banks with an excess of "due to other banks" over "due from other banks," while at the same time causing increases in excess reserves of banks with an excess of "due from other banks" over "due to other banks." An increase or decrease in the requirement for either nonbank demand deposits or time deposits would, of course, affect all banks alike in proportion to their holdings of such deposits.

(4) Vault cash, reserves, and credit control: The transition to the new system of reserve requirements would be facilitated by permitting banks to count vault cash as legal reserves. Establishment of the suggested uniform requirement against other demand deposits would increase required reserves of country banks. Since, however, such banks hold somewhat larger amounts of vault cash, relatively, the increase in their total requirements would be offset in part by permitting them to count vault cash as legal reserves, as well as by larger credits for their balances with other banks.

The role of vault cash in the banking system has changed fundamentally in the past half century. Before the Federal Reserve System was established, vault cash was the ultimate reserve of the banking system, since it alone was available to "cash" deposits. Inability to create additional reserves or cash when needed or to mobilize and utilize existing vault cash was among the principal weakenesses of the banking structure before the Federal Reserve System was established. The implications of the new System were not understood completely. With the purpose of encouraging the movement of cash, particularly gold, into the Federal Reserve banks, the Federal Reserve Act, as amended in 1917, excluded vault cash from legal reserves of member banks. This purpose no longer has any significance since gold or gold certificates may no longer be held by commercial banks.

The use of vault cash as reserves would not impair the System's influence over the volume of bank credit, provided initial requirements are established at appropriate levels to offset the change. From the point of view of credit control, System authorities need not be concerned as to the form of Federal Reserve bank liability—whether against Federal Reserve notes or reserve deposits—that a member bank prefers to hold as reserves.

To permit vault cash to be counted as legal reserve might also make membership in the Federal Reserve System somewhat more attractive to banks now outside the System, since they are accustomed under State laws and long established traditions to look upon vault cash as their primary reserves.

(5) New treatment of balances due from banks: Correspondent balances ought to be related to reserves in such a way that (*a*) a shift of funds by member banks into or out of "due from banks" would not affect the total volume of excess reserves in the System as a whole;

(*b*) "reserve credit" would be allowed for precisely the portion of "due from banks" that is on deposit in Federal Reserve banks—by way of the reserve requirement imposed on deposits due to banks—and; (*c*) correspondent bank relationships and interbank balances would be recognized as an established part of our banking system but would be neither encouraged nor discouraged.

Item 5 is designed to accomplish these results. So long as the rate at which the "country" bank or the Reserve city bank is allowed reserve credit for its "due from" balances is equal to the rate at which depositary banks are required to maintain reserves on interbank deposits, a given reserve will support the same volume of nonbank deposits irrespective of whether the ownership bank keeps all of its reserve with its Federal Reserve bank, or keeps a portion of it on deposit with a correspondent—and, therefore, indirectly with a Federal Reserve bank. In either case, only vault cash and balances which are directly or indirectly on deposit with Federal Reserve banks would constitute legal reserves.

The relation between correspondent balances and reserves has created some of the knottiest problems of monetary policy. Under the National Bank Act, as has been mentioned, such deposits within limits were legal reserves. Reserves were "pyramided" through re-deposit and the basic cash reserves of the entire banking system were far less than the legal reserves. Furthermore, the decisions of banks to change the form—that is, as between cash and correspondent balances—in which they kept their reserves affected the total volume of deposits that a given case reserve would support.

With the intention of solving the first difficulty, the Federal Reserve Act specified that after a transition period all legal reserves of member banks except prescribed amounts of vault cash would have to be held as deposits in the Federal Reserve banks. Since balances due from banks could no longer be used by member banks as legal reserves, it was no longer possible for member banks to pyramid reserves. The situation which formerly prevailed as to all banks still prevails with respect to nonmember banks, though fortunately the great bulk of nonmember bank balances is deposited in member banks, where the process of pyramiding stops. In some respects banks balances still affect member bank reserves because—

(*a*) Balances due from both member and nonmember banks are deducted from gross demand deposits in computing reserve requirements. The result is that a percentage of such balances is in effect counted as reserves.

(*b*) The percentage of "reserve credit" now depends on the reserve requirements of the owner-bank, rather than on the reserve carried against the interbank deposits by the depositary bank. This results in anomalous situations such as the following: A country bank gets a "reserve credit" of only 14 percent of its "due from" account although its central Reserve city depositary is carrying a 22 percent reserve against the deposit; a Reserve city bank has a 20 percent "reserve credit" for any balance it has on deposit in a country bank, even though the latter carried only a 14 percent reserve against the deposit. The present unsatisfactory situation would be aggravated if reserve requirements on interbank deposits were raised substantially but owner-banks were given no additional credit for the higher reserves carried on such deposits; the only equitable credit for balances due from banks is one that directly reflects the ultimate reserve held against such balances at the Federal Reserve bank.

(c) Member banks—individually, not as a group—can, as a practical matter, readily convert balances due from other banks into reserve balances.

IV. Summary: This analysis may be summarized as follows:

The present system of reserve requirements is frequently inequitable; required reserves of many banks are higher or lower than those of other banks doing a similar business simply because of the classification of the communities in which they are located.

The uniform system of reserve requirements under discussion would eliminate inequities by requiring all member banks, regardless of location, to maintain the same percentages of reserves against the three major classes of deposits. It would eliminate also the long-standing administrative problem incident to reserve city designations and terminations. It would permit, if desired, the bringing about gradually of uniform reserve requirements on all demand deposits, including interbank deposits, if such action should at some future time be considered appropriate and desirable.

Banks whose business requires the holding of disproportionately large amounts of vault cash would no longer be penalized by being required to maintain the same reserves in Federal Reserve banks as other banks doing a similar type and volume of business, but whose cash requirements were less.

Changes in the volume of interbank deposits would no longer affect the volume of other deposits of member banks that could be supported by a given aggregate volume of reserves; city banks would have to maintain larger reserves against balances due to country correspondents, but the latter would be given corresponding credits against their required reserves for such balances. This would be particularly important if interbank deposits were subject to considerably higher requirements than other demand deposits.

This is in contrast to the present system under which the volume of bank credit that can be supported by a given aggregate amount of reserves can increase or decrease as a result of reductions or increases in interbank balances.

The required reserves of some individual banks would be increased, while those of other banks would be reduced, but the changes would be reasonable and in the direction of greater equity.

The CHAIRMAN. That is a very clear report. I suppose there will be people who will object.

Mr. BOPP. I would anticipate that, Senator.

The CHAIRMAN. Some banks, I suppose, will object.

Mr. BOPP. And there may, of course, be difficulties or bugs, as we call them in it. And it is well to have public discussion, so that they can be ironed out. It is an attempt to get at a problem that is a knotty one, and a difficult one.

Representative RICH. I think it is, too, and I think if you had come right out openly and made your recommendations on that, we could then have other people criticize them, and we could come to a conclusion probably as to what was the right thing to do.

But even if you were to do that, I have seen the time when the Federal Reserve System did not function. When we had the last great depression, instead of the Federal Reserve trying to help out the local country banks that had demands thrown upon them, they restricted loans to these country banks. In other words, they saved the Federal Reserve bank, when the time came for really sound action on the part of the Federal Reserve. They were bankers, just the same as in the local country banks, and they saw what was happening, and they were trying to protect the Federal Reserve from being broken down. Thus, the country banks had to stand the shock, and they could not, and many of them had to close. Whereas, if the Federal Reserve, which was set up for the primary purpose of trying to save the banking system, would have functioned as it should have, when Gene Meyers was head of it, we would not have seen the great number of banks close up that were closed up during the depression years.

Mr. BOPP. This report, of course, would not solve what may be termed the policy problems of the System. As I see it, there is no automatic mechanism which would do that.

The CHAIRMAN. How much do the banks rely on the prestige of being Reserve cities? Is the battle to be a Reserve city, or is it not to be a Reserve city?

Mr. THOMAS. That was the problem. The problem was that in setting up standards to reclassify cities, some which are now Reserve cities, or were Reserve cities, would be classified on a lower reserve requirement basis. And the banks objected. They did not want the privilege of carrying lower requirements, because they liked the distinction.

The CHAIRMAN. It made it easier to get the country banks to deposit, perhaps.

Mr. THOMAS. Well, that was their reasoning. Of course, there are some banks in cities that are not Reserve cities, that still get a lot of country bank deposits.

The CHAIRMAN. But this would just abolish it all. There would be no distinction at all between cities.

Mr. THOMAS. No, the distinctions would be between bank deposits on the basis of the type that the particular bank held.

The CHAIRMAN. What is your idea of procedure on this thing? Mr. Rich has asked your recommendation. I suppose you may have some hesitation to recommend until the Federal Reserve Board or some authorities have approved it, and made a recommendation. What is the status of your study? Is this now before the Board?

Mr. THOMAS. It has been presented to the Board, and to the Reserve bank presidents for consideration and study. Whether they will want to make a recommendation on this subject remains to be seen. They certainly will want to look into it and get the benefit of as much discussion and opinion as possible.

The CHAIRMAN. Of course, when it comes to recommendations from the Federal Reserve Board to Congress, it immediately becomes involved with these other plans that have been presented.

Mr. THOMAS. That is right.

The CHAIRMAN. On increasing reserves, or reserves in short-term Government, and so on.

Mr. THOMAS. Yes. I would like to add to what Mr. Bopp has said to Mr. Rich: that our unwillingness to make a definite proposal now, you might call intellectual modesty. We like to get the benefit of other people's views before we make up our minds definitely.

Representative RICH. Are you presenting that to this committee and expecting us to make the recommendations?

Mr. THOMAS. No, sir.

Representative RICH. Of course, we would do it if we thought it would amount to anything.

The CHAIRMAN. We have no intellectual modesty. [Laughter.]

Representative RICH. That was the reason I made the statement I did about the Federal Reserves. I was associated with country banks, and I know a lot of banks that wanted to get loans from the Federal Reserves. But they were bankers, just the same as in the country banks, and they tightened up, and would not give the country banks any assistance. Therefore, they were just like the fellow in the small country bank. They wanted to save the Federal Reserve, which was set up for the purpose of standing the shock on banks. And it was 10 percent of the deposits of the various banks.

Supposing the Federal Reserve had gone broke? It would not have hurt anybody or anything. Whereas, on the other hand, they let a lot of the country banks go broke. I was associated with some of them, but thank God we did not go broke at that time, because we had ability enough or we had cash enough to withstand the shock. And it might have just been the good fortune of some of the bankers.

But the point I am trying to make here now is that the Federal Reserve just acted the same as the local banks, trying to save the Federal Reserve, and they did not do the thing that the Federal Reserve was supposed to do: to take the shock from the other banks and save the local situation.

And that is the reason I criticized them at that time.

Mr. THOMAS. I may say, on that point, although it is not the question we are here to discuss, that at that time the Federal Reserve was operating under an act which limited its ability to extend credit.

Representative RICH. They could have extended credit.

Mr. THOMAS. And since then, we have had the Banking Act of 1935, which makes it possible to extend credit more freely.

Now, I am not saying that in all cases as completely free extension of credit was given as might have been possible, but that is a matter of policy.

Representative RICH. If at any time in the future we get into a bank panic, and the Federal Reserve officers refuse to make loans to country banks, we will get into the same position. It will not do the work that it is set up and intended for. And I hope when the time comes that the Federal Reserve officers, whoever they may be, will realize that it is their duty to try to aid and assist the banks of the country, rather than to try to save the Federal Reserve.

Mr. THOMAS. I think that was the purpose behind the Banking Act of 1935.

The CHAIRMAN. I thank you very much, gentlemen, for this. Our committee will study the question of reserves.

Representative RICH. Will you make the recommendations, then?

The CHAIRMAN. I think, in view of the fact that the Federal Reserve Board is studying the question, and in view of the variety of different proposals that have been made, by Mr. Eccles and others, and Mr. McCabe's unwillingness to appear at all at the present time, we had better study the question of reserves over the summer and wait until——

Representative RICH. After election?

The CHAIRMAN. Until there is at least some more consolidated opinion from the experts as to what they think they would recommend to the Congress.

I understand that you are really just presenting this so that we may undertake study of it.

Mr. THOMAS. It is for your information, and we did not ask to come up and present this as a proposal.

The CHAIRMAN. We asked you to do it, yes.

Representative RICH. I would say further, Mr. Chairman, that if these gentlemen have some recommendations they would like to make, and they would like to have them kept confidential, I would like to receive them. They will be kept confidential; I promise you that.

The CHAIRMAN. I think we could bear that in mind.

We will continue studies during the summer. And I think, on the whole, it is fair to say to the press that as far as any question of change in the present policy as to the maintenance of Government bonds is concerned, I do not think this committee is going to make any recommendation for such change. Certainly it would take a great deal more study, before we would undertake any such proposal, and certainly there will be none such at this session.

Mr. THOMAS. We are at your disposal any time you want assistance in studying these problems.

The CHAIRMAN. These hearings, then, are closed for the present session.

(Whereupon, at 11:40 a. m., hearing in the above-entitled matter was closed.)

×