

MONETARY, CREDIT, AND FISCAL POLICIES

REPORT

OF THE

SUBCOMMITTEE ON MONETARY, CREDIT, AND FISCAL POLICIES

OF THE

JOINT COMMITTEE ON THE ECONOMIC REPORT

CONGRESS OF THE UNITED STATES

PURSUANT TO

S. Con. Res. 26



PRESENTED BY MR. O'MAHONEY

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LETTERS OF TRANSMITTAL

HON. JOSEPH C. O'MAHONEY,
*Chairman, Joint Committee on the Economic Report,
United States Senate, Washington, D. C.*

DEAR SENATOR O'MAHONEY: Transmitted herewith is the report of the Subcommittee on Monetary, Credit, and Fiscal Policies. This subcommittee was appointed by you in the early summer of 1949, pursuant to Senate Concurrent Resolution 26, for the purpose of "conducting a full and complete study and investigation into the problem of the effectiveness and coordination of monetary, credit, and fiscal policies in dealing with general economic policy." In making our studies, we have conformed to this directive, centering our attention on the coordination of these policies and on their effectiveness as methods of attaining economic objectives, especially those objectives related to high and stable levels of employment and production. Within this area we have made our study as thorough and complete as time permitted.

The subcommittee has gathered information and points of view in many ways. (1) Its members and staff have made a continuous study of existing materials and of the materials especially gathered for them by the staffs of various Government agencies. (2) It sent questionnaires to a large number of people qualified to add to our understanding of these subjects. A comprehensive questionnaire covering the most important aspects of the problems in this field was sent to nearly 500 bankers, economists, and others. Though by no means all of these people replied, the answers received by us did provide a large amount of valuable information and did indicate the range of views on many of the questions. Special questionnaires were sent to the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the presidents of the twelve Federal Reserve banks, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Board of Directors of the Reconstruction Finance Corporation, the Administrator of the Housing and Home Finance Agency, the Governor of the Farm Credit Administration, and the Director of the Bureau of the Budget. The official replies, together with a digest of the answers to the general questionnaire and a statement on Federal expenditure and revenue policies which was drawn up and unanimously approved by 15 economists, were published in a 443-page joint-committee print entitled "Monetary, Credit, and Fiscal Policies." Without necessarily agreeing with the points of view expressed in it, we believe that this volume constitutes a valuable contribution to an understanding of the issues in these fields. (3) During 9 days of open hearings, the subcommittee received testimony from Government officials, bankers, economists, and representatives of various agricultural, labor, and

business groups. (4) It met in executive session with the Council of Economic Advisers and with officials from the Treasury, the Bureau of the Budget, and the Federal Reserve. And (5) it met with a group of economists for a round-table discussion of some of the most important issues encountered during the investigation.

In transmitting this report we wish to express our appreciation to the numerous people, both in and outside the Government, who so generously assisted the subcommittee. We are especially indebted to Dr. Lester V. Chandler, of Amherst College, the economist for the subcommittee, for his excellent services. His knowledge, energy, and judgment have been of immeasurable aid.

Sincerely,

PAUL H. DOUGLAS,

Chairman, Subcommittee on Monetary, Credit, and Fiscal Policies.

JANUARY 13, 1950.

To the Congress:

Transmitted herewith is a report of the Monetary, Credit, and Fiscal Policies Subcommittee of the Joint Committee on the Economic Report. This report is one of four studies which have been prepared under Senate Concurrent Resolution 26 (81st Cong., 1st sess.), and represents the views of the subcommittee conducting the investigation. It is to be regarded solely as the presentation of a point of view by the subcommittee and does not in any sense represent a point of view or recommendations by the full committee. The subcommittee's findings will be given consideration by the full committee when it assembles to review the reports of the four studies authorized under Senate Concurrent Resolution 26 (81st Cong., 1st sess.).

JOSEPH C. O'MAHONEY,

Chairman, Joint Committee on the Economic Report.

JANUARY 23, 1950.

MONETARY, CREDIT, AND FISCAL POLICIES

PART A. SUMMARY OF RECOMMENDATIONS

I. THE ROLE OF MONETARY, CREDIT, AND FISCAL POLICIES IN ACHIEVING THE PURPOSES OF THE EMPLOYMENT ACT

We recommend not only that appropriate, vigorous, and coordinated monetary, credit, and fiscal policies be employed to promote the purposes of the Employment Act, but also that such policies constitute the Government's primary and principal method of promoting those purposes.

II. FEDERAL FISCAL POLICIES

1. We recommend that Federal fiscal policies be such as not only to avoid aggravating economic instability but also to make a positive and important contribution to stabilization, at the same time promoting equity and incentives in taxation and economy in expenditures. A policy based on the principle of an annually balanced budget regardless of fluctuations in the national income does not meet these tests; for, if actually followed, it would require drastic increases of tax rates or drastic reductions of Government expenditures during periods of deflation and unemployment, thereby aggravating the decline, and marked reductions of tax rates or increases of expenditures during periods of inflationary boom, thereby accentuating the inflation. A policy that will contribute to stability must produce a surplus of revenues over expenditures in periods of high prosperity and comparatively full employment and a surplus of expenditures over revenues in periods of deflation and abnormally high unemployment. Such a policy must, however, be based on a recognition that there are limits to the effectiveness of fiscal policy because economic forecasting is highly imperfect at present and tax and expenditure policies under present procedures are very inflexible.

2. We recommend that the Joint Committee on the Economic Report make an intensive study of the various possible methods of increasing the flexibility of tax and expenditure policies in order to discover whether and to what extent it is feasible to make these instruments more effective for stabilization purposes.

III. MONETARY AND DEBT-MANAGEMENT POLICIES¹

1. We recommend that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes

¹ Mr. Patman believes that these proposals do not make the Federal Reserve System sufficiently responsible to the executive department of the Federal Government. In creating money and regulating the supply and cost of money and credit, the Federal Reserve is performing a governmental function; it even issues Federal Reserve notes which become obligations of the United States. Moreover, it is now possible for the Federal Reserve to follow policies that would conflict with, and perhaps defeat, the Government's economic program. He believes, therefore, that steps should be taken to increase the responsibility of the Federal Reserve System to the executive department. Though he favors, as proposed in this report, the establishment of a Monetary and Credit Council to be headed by the Chairman of the Council of Economic Advisers, he does not believe that it will make the Federal Reserve sufficiently responsible to the Executive.

of the Employment Act. Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long-run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.

2. We recommend as means of promoting monetary and debt-management policies that will contribute most to the purposes of the Employment Act:

(a) That every effort be made to build up the quality and prestige of Federal Reserve officials; among these measures should be a reduction in the number of members of the Board of Governors from seven to not more than five and an increase in their compensation.

(b) That Congress by joint resolution issue general instructions to the Federal Reserve and the Treasury regarding the objectives of monetary and debt-management policies and the division of authority over those policies. These instructions need not, and in our judgment should not, be detailed: they should accomplish their purpose if they provide, in effect, that, (i) in determining and administering policies relative to money, credit, and management of the Federal debt, the Treasury and the Federal Reserve shall be guided primarily by considerations relating to their effects on employment, production, purchasing power, and price levels, and such policies shall be consistent with and shall promote the purposes of the Employment Act of 1946; and (ii) it is the will of Congress that the primary power and responsibility for regulating the supply, availability, and cost of credit in general shall be vested in the duly constituted authorities of the Federal Reserve System, and that Treasury actions relative to money, credit, and transactions in the Federal debt shall be made consistent with the policies of the Federal Reserve.

(c) That the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System be made members of the National Monetary and Credit Council recommended elsewhere in this report.

IV. RESERVE REQUIREMENTS OF COMMERCIAL BANKS ²

1. We recommend that all banks which accept demand deposits, including both member and nonmember banks, be made subject to

² Mr. Wolcott dissents from this recommendation. It is his opinion that the so-called dual banking system should be preserved in order that possible checks and balances may be maintained to prevent unwise concentration of credit and economic controls. He contends that any such centralization of banking authority might well be interpreted as a step toward the nationalization of all banking and credit. That, instead, there should be full cooperation between the State banking authorities and the Federal Reserve Board to remove any discriminations which might seem to give advantage or disadvantage to either the Federal or State systems.

the same set of reserve requirements and that all such banks be given access to loans at the Federal Reserve banks.

2. Without endorsing any particular plan, we recommend that serious consideration be given to the Federal Reserve proposal that the present system of member-bank reserve requirements based partly on the size of the city in which a bank is located be replaced by a new system of requirements that would be geographically uniform but that might require different percentages of reserves against different types of deposits.

V. FEDERAL CHARTERING, SUPERVISION, AND EXAMINATION OF COMMERCIAL BANKS

We recommend a thorough and complete study of the broad question of Federal chartering, supervision, and examination of commercial banks, including not only the organization and coordination of the Federal agencies performing these functions but also the substance and applicability of the relevant Federal laws and regulations.

VI. MONETARY POLICY RELATIVE TO SILVER

We recommend that the United States Government cease buying silver for monetary purposes.

VII. THE RESTORATION OF A GOLD-COIN STANDARD IN THE UNITED STATES

We believe that to restore the free domestic convertibility of money into gold coin or gold bullion at this time would militate against, rather than promote, the purposes of the Employment Act, and we recommend that no action in this direction be taken. We also recommend a thorough congressional review of existing legislation relating to the power to change the price of gold with a view to repealing any legislation that might be so construed as to permit a change in the price of gold by other than congressional action.

VIII. DEPOSIT INSURANCE

We recommend that Congress, while considering questions relating to the base and rate for deposit-insurance premiums, also study thoroughly the advantages and disadvantages of increasing the coverage of deposit insurance for the primary purpose of protecting the economy against the adverse deflationary pressures that would accompany cash withdrawals from the banking system during any depression period that may occur, and that no changes in deposit-insurance premiums be made until after the completion of the study.

IX. OTHER FEDERAL CREDIT AGENCIES

1. We recommend that Congress review the programs and policies of the various Federal credit agencies to find out to what extent if at all they can be made to contribute more to the purposes of the Employment Act without an undue sacrifice of the substantive programs to which they are related.

2. We recommend that the head official of each of the most important agencies in this group be included on the National Monetary and Credit Council, which we recommend elsewhere in this report.

X. A NATIONAL MONETARY AND CREDIT COUNCIL ³

We recommend the creation of a National Monetary and Credit Council which would include the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the heads of the other principal Federal agencies that lend and guarantee loans. This Council should be established by legislative action, should be required to make periodic reports to Congress, and should be headed by the Chairman of the Council of Economic Advisers. Its purpose should be purely consultative and advisory, and it should not have directive power over its members.

XI. A COMPREHENSIVE STUDY OF MONEY AND CREDIT

1. We recommend that the Joint Committee on the Economic Report, as well as the Banking and Currency Committees of the Senate and of the House of Representatives, continue a thorough and complete study of the monetary and credit systems and policies of the United States, and that they be provided with funds adequate for the purpose.

2. We recommend that S. 1559, which would provide for the establishment of a National Monetary Commission, be not enacted.

XII. A CONTINUING STUDY OF FISCAL POLICY BY THE JOINT COMMITTEE ON THE ECONOMIC REPORT

We recommend that the joint committee, while carrying out its general duties "to make a continuing study of matters relating to the Economic Report" and "to study means of coordinating programs in order to further the policy of the [Employment] Act," make a special intensive study of the various possible methods of increasing the flexibility of Federal tax and expenditure policies in order to discover how and to what extent it may be feasible to make these instruments more effective for stabilization purposes.

XIII. EARNINGS OF THE FEDERAL RESERVE IN EXCESS OF DIVIDEND REQUIREMENTS

We recommend that Congress enact a franchise tax on the net earnings of the Federal Reserve System to replace the voluntary contributions now being made to the Treasury by the Board of Governors. In view of recommendation III, 2, any franchise tax must take into account the necessity for an ample reserve for losses in open-market operations as compared with the present situation in which earnings are automatic.

³ Mr. Wolcott joins in recommending the creation of a National Monetary and Credit Council, but disagrees with the recommendation that it should be headed by the Chairman of the Council of Economic Advisers. In his opinion, this would concentrate too much power in the Executive over the volume and cost of credit. He recommends, instead, that the Chairman of the Credit Council be a person of neutral interests removed as much as possible from the direct influence of either the Executive or the Federal Reserve Board. He also agrees that periodic reports should be made to Congress by the Council.

PART B. TEXT OF THE REPORT

I. THE ROLE OF MONETARY, CREDIT, AND FISCAL POLICIES IN ACHIEVING THE PURPOSES OF THE EMPLOYMENT ACT

We recommend not only that appropriate, vigorous, and coordinated monetary, credit, and fiscal policies be employed to promote the purposes of the Employment Act, but also that such policies constitute the Government's primary and principal method of promoting those purposes.

In the Employment Act of 1946 Congress declared:

* * * it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.

It is clear that, in addition to describing purposes, this statement also indicates some of the characteristics of the methods to be used in achieving them. In the first place, it indicates that the Federal Government is not to rely on one method alone but is "to use all practicable means * * * to coordinate and utilize all its plans, functions, and resources * * *." In the second place, it is not to rely solely on its own actions but is to seek the assistance and cooperation of other governmental units, industry, agriculture, and labor. And in the third place, it is to achieve these objectives "in a manner calculated to foster and promote free competitive enterprise * * *"

We believe that these stipulations as to both purposes and methods indicate not only that appropriate, vigorous, and coordinated monetary, credit, and fiscal policies should be employed, but also that they should constitute our primary and principal defense against instability. This conclusion rests on several considerations: (1) It will be practically impossible to attain the purposes of the Employment Act without a deliberate use of these policies; (2) these policies can exert a powerful influence toward stability without necessarily expanding the scope of Government activity, and (3) these measures are much more compatible with the maintenance of democracy and free competitive enterprise than would be the only alternative—a complex harness of direct controls.

It must be recognized that the Federal Government has for a long time been engaged in a very large number of activities in the fields of money, credit, and fiscal operations and that in the very process of carrying out these activities it must formulate policies of some sort. Whether the Government plans it or not, these policies exert a powerful influence on the functioning of the economy and may work toward either stability or instability. Table I, though highly simplified, indicates the scope and combined importance of these activities.

In many ways, but especially through the monetary and debt-management policies of the Federal Reserve and the Treasury, the Federal Government determines the total supply and cost of money for both private and public spending. Ours is and has been for a long time a partially managed monetary system, and the Government cannot escape responsibility for its behavior. The tremendous growth of the Federal debt during World War II has increased rather than diminished the influence of the Federal Reserve and the Treasury on the supply and cost of credit and money. Nor is this power of the Federal Government over money and credit limited to its chartering, supervision, and examination of banks and the general monetary and credit controls administered by the Federal Reserve and the Treasury. It also includes the activities of a very large number of other credit institutions. In 1916 the Federal Government founded the Federal land-bank system to provide an ample supply of low-cost credit to meet the long-term needs of farmers. In 1923 it added the Federal intermediate-credit banks to enhance the supply of short-term and intermediate-term credit for agricultural purposes. Then, beginning in 1932, it established, or promoted the establishment of, numerous other credit institutions of many types. As a result, institutions established or promoted by the Federal Government and still regulated and financed in varying degrees by it provide complete facilities for long-term, intermediate-term, and short-term credit for farmers and their cooperatives; insure billions of dollars' worth of urban real-estate mortgages and regulate the interest rates, maturities, and other terms of these mortgages; provide a secondary market for these mortgages, lend to and purchase assets from financial institutions; regulate the policies of many financial institutions in the real-estate-mortgage field; lend and grant subsidies to local public-housing authorities; lend to and guarantee private loans to business borrowers, States and their subdivisions, purchasers and builders of ships, and foreign borrowers; and insure billions of dollars in bank deposits and accounts at savings and loan associations.

With an annual budget in excess of \$40,000,000,000, Federal fiscal policy cannot fail to have a marked influence on the behavior of the economy. Both directly and indirectly, Federal spendings are one of the principal determinants of national money income and of the total volume of spendings for output, and taxation—which is essentially an extraction of money from private incomes—influences markedly both the ability and willingness of the private sectors of the economy to save and to spend for consumption and investment purposes. Federal deficits, which reflect the fact that Government spendings are in excess of current extractions from private money incomes, exert an antideflationary or inflationary effect. To the extent that these Federal deficits are financed by borrowing from banks, new credit is created for the purchase of Government securities. There is thus a creation of additional monetary purchasing power which is then used by the Government to buy goods and pay for services. In a depression period, when production, prices, and employment are declining and when there is a considerable amount of unutilized capital and labor, a Government deficit financed by bank-created credit will therefore help to offset the decline in the total volume of private purchasing power. It will thereby make a de-

pression less severe and can help to further a revival of production and employment. Conversely, in a period of high employment, when both the labor force and the capital structure are being utilized, a governmental deficit financed by the creation of additional monetary purchasing power does not increase real national income, which is the output of goods and services. It merely adds more money and credit with which to buy the existing supply of goods. The effect of deficits at such times is to raise the price level, and to divert to governmental uses resources which would otherwise be used for private purposes.

TABLE I.—Federal activities in the fields of money, credit and fiscal operations, and the controlling Government agencies

<i>Activity</i>	<i>Federal Agency</i>
I. Provision of a legislative framework for the monetary, credit, and fiscal system:	
1. Legislation defining the monetary unit; determining the roles of gold, silver, and paper money; determining the powers of administrative and executive agencies in the field; regulating the establishment and operations of private monetary and credit institutions, levying taxes, and determining Government expenditures.	Congress.
II. The issue of coin and paper money:	
1. Issue of Federal Reserve notes.....	Federal Reserve.
2. Issue of Treasury coin and paper money.	Treasury.
III. Commercial bank chartering, supervision, and examination:	
1. Chartering of national banks.....	Comptroller of the Currency.
2. Bank supervision and examination....	Comptroller of the Currency, Federal Reserve, and the Federal Deposit Insurance Corporation.
IV. General monetary and credit management:	
1. Regulation of the total supply and cost of money and credit.	Treasury and the Federal Reserve.
2. Selective credit control.....	Federal Reserve.
V. Insurance of bank deposits.....	Federal Deposit Insurance Corporation.
VI. Agriculture credit.....	General regulation by the Farm Credit Administration.
1. Loans for rural electrification.....	Rural Electrification Administration.
2. Loans to farm cooperatives.....	13 banks for cooperatives.
3. Promotion and regulation of production credit associations.	12 production-credit corporations.
4. Loans to, and discounts of paper for, various institutions that extend short- and intermediate-term loans to farmers and their cooperatives.	12 Federal intermediate-credit banks.
5. Loans to and regulation of national farm-loan associations.	12 Federal land banks.
6. Loans and guaranties of private loans to small farmers unable to secure adequate credit elsewhere.	Farmers Home Administration.
7. Nonrecourse loans and guaranty of private loans on agricultural products.	Commodity Credit Corporation.

TABLE I.—*Federal activities in the fields of money, credit and fiscal operations, and the controlling Government agencies—Continued*

<i>Activity</i>	<i>Federal Agency</i>
VII. Housing credit-----	Over-all supervision by the Housing and Home Finance Agency.
1. Guaranty of mortgages on residential real estate and home modernization.	Federal Housing Administration.
2. Chartering of Federal savings and loan associations and supervision of institutions of this type.	Home Loan Bank Board.
3. Loans to savings and loan associations and to certain other institutions of this type.	11 Federal home-loan banks.
4. Provision of a secondary market for certain insured mortgages.	Federal National Mortgage Association.
5. Insurance of savings accounts at savings and loan associations.	Federal Savings and Loan Insurance Corporation.
6. Loans and subsidies to local public-housing agencies for low-rent housing and slum clearance.	Public Housing Administration.
VIII. Insurance of home, farm, and business loans to veterans.	Veterans' Administration (also other agencies in the performance of their functions).
IX. Other loans and insurance of loans:	
1. Loans to financial institutions-----	Reconstruction Finance Corporation, the Federal Reserve, and certain other agencies listed above.
2. Loans to States and their subdivisions.	Reconstruction Finance Corporation and certain other agencies listed above.
3. Loans and guarantee of private loans--	Reconstruction Finance Corporation and the Federal Reserve.
4. Guarantee of loans for the construction and reconstruction of shipping.	Maritime Commission.
5. Loans to foreign borrowers-----	Export-Import Bank and certain other agencies.
X. Fiscal policy:	
1. Taxation, including determination of types, bases, and rates of taxes.	Congress.
2. Spending, including determination of the timing, amounts, and purposes of expenditures.	Congress and the agencies granted discretion as to the timing, rate, and purposes of their expenditures.
3. Debt management-----	Treasury and the Federal Reserve.

On the other hand, Federal surpluses represent subtractions from private incomes which are greater than the total of Government spending. Government surpluses therefore exert an anti-inflationary or an outright deflationary effect. In periods of depression, they withdraw from private incomes sums of which a major part would probably have been spent for consumption or capital purposes. If the surpluses are then used to retire a part of the public debt, the banks and private holders would be reluctant to invest these sums in new capital, since at such times investment, because of fear about the future, falls off. The sums thus received by people for their Government bonds will largely be hoarded. The net effect of Government surpluses in

periods of depression is, therefore, to worsen conditions and intensify unemployment.

But in a period of prosperity and rising prices, when labor and capital are comparatively fully employed, a governmental surplus has a healthful effect in checking inflation. The collection of taxes in excess of Government's spendings tends to reduce private spendable incomes, thereby reducing the pressure of spendings, and at the same time it provides the Treasury with a weapon which can be used to restrict the creation of money and credit. By using the money representing the surplus to build up its deposits at the Federal Reserve banks or to pay off securities held by the Federal Reserve banks, the Treasury can reduce the volume of bank reserves and contract the lending power of the banking system. This is the most powerful anti-inflationary way in which the Treasury can use its surplus. The use of a surplus to retire securities held by the commercial banks exerts a smaller anti-inflationary effect, and the anti-inflationary effect of using a surplus to retire debt held by nonbank investors is the least anti-inflationary of all.

Thus the mere existence of governmental deficits or surpluses inevitably affects the economy whether they are planned or not. They may tend toward greater or less stability, according to their timing, their magnitude, and other economic conditions. At their worst, they could make it impossible to achieve economic stability and growth. For example, a very easy monetary policy, liberal Government loans and loan guaranties, and a large deficit-spending program during a boom period could enhance the process of inflation. A tight monetary policy, a contraction of Government loans and loan guaranties, and a policy of taxing in excess of Government spendings during a recession could seriously aggravate and prolong deflation and unemployment. Such policies should clearly be avoided. And, since it is unlikely that these policies could ever be so precisely managed as to be "neutral" in their effects on the economy, they should be employed in such a way as to make a positive contribution to economic stability and growth.

Another reason for preferring reliance on monetary, credit, and fiscal policies as the major method of general economic stabilization is that they are more consistent with the maintenance of our democratic system and with the fostering and promotion of free competitive enterprise. These instruments do not involve the Government in detailed control of the particulars of the economy; they do not require the Government to intervene in individual transactions between buyer and seller, in dealings between employer and employee, and in the determination of the prices and production of particular commodities. These millions of intricate decisions are left to the operation of the market mechanism while general monetary, credit, and fiscal policies work toward stabilization by influencing the total supply and cost of money and the total amount of money income at the disposal of the private sectors of the economy. There is every difference between the effects of general over-all monetary, credit, and fiscal policies which indirectly influence the economy toward stabilization and the effects of an elaborate system of direct controls. This point was made very strongly in testimony before the subcommittee by J. Cameron Thomson, president of the Northwest Bancorporation and chairman of the monetary and fiscal policy subcommittee of the

research and policy committee of the Committee for Economic Development.

I want to draw a sharp distinction between fiscal, monetary, and debt-management policies on the one hand and direct controls on the other hand. By direct controls, I mean such measures as Government price controls, wage controls, rationing, allocations, and controls over the direction of investment. Failure to distinguish between these two kinds of measures is responsible for much confusion in public discussion and could lead to serious error in public policy. Two kinds of confusion are common. One is to reject the attempt to achieve greater stability by fiscal, monetary, and debt-management policies by putting these policies in the same class with direct controls over the details of private economic activity. The other is to accept and justify all manner of direct controls by putting them in the same class with indirect financial measures for stability.

Fiscal, monetary, and debt policies are appropriate means for attacking the problem of instability in a free society. The problem of instability is essentially a problem of broad forces affecting the over-all magnitudes of the economy. The problem arises when millions of workers are simultaneously unemployed, or when there is a general, although probably uneven, rise of most prices. The advantage of fiscal, monetary, and debt policies is that they allow the Government to influence the over-all forces—especially the level of aggregate demand—that determine the stability of the economy without necessarily involving the Government in detailed control of the particulars of the economy. These over-all measures will, of course, affect different individuals and businesses differently. But the differences are determined by the market process, not by Government decisions. The Government does not have to make decisions that are with rare exceptions better left to the market—the price of shoes relative to the price of automobiles, whether the ABC company or the XYZ company should prosper, what kind of a job John Jones or Robert Smith should have.

Direct controls do involve Government decisions about the particular interrelationships of the parts of the economy. One virtue claimed for them by their advocates is that they are "selective." But adding together a very large number of selective controls is surely a clumsy, expensive, inefficient, and politically dangerous way to get the over-all effect needed to deal with the stability problem. While the market process is not perfect, any general substitution of Government decisions for it would result in serious loss of efficiency, progress, and stability.

But more than efficiency, progress, and stability are at stake. Freedom is also at stake. Any widespread system of direct controls would necessarily involve widespread power of Government to affect the economic fortunes of particular individuals, businesses, industries, and regions "selectively"; that is, discriminately. This power would have to be exercised by the Executive subject to only the most general statutory limitations. It would be the power to reward or punish, to coerce, by administrative action. The existence of such a power would ominously threaten the survival of our free society, for so long as the free society might endure.

We hear the concepts of "freedom" and "statism" used so much and so loosely that we become callous and impatient with them. But, on the specific problem of this subcommittee, I am convinced that the importance of fiscal, monetary, and debt policy will not be sufficiently appreciated until we learn to make the distinction between power to coerce individuals and power to affect the general behavior of the economy. A precise line cannot be drawn between appropriate and inappropriate powers; yet, we must recognize that there is a direction in which we should not move except in cases of clearest necessity and even then only with utmost caution.

Chairman McCabe, of the Board of Governors of the Federal Reserve System, made a similar point with respect to monetary management by central banks.

* * * Central banking institutions have always been considered the necessary and essential complement of a free-enterprise economy. Money does not manage itself. Once commercial banking institutions holding demand deposits become important, central banking institutions must be organized to avert money panics and to mitigate booms and depressions. Although they have necessarily been given wide discretionary powers, they should in no sense be regarded as an invention of or an adjunct to a "managed economy" or an "administered state." Instead, they are part and parcel of a free-enterprise economy,

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

That is the traditional, the conservative, the classic position. It is the issue that was dealt with by Carter Glass, among others, when the Federal Reserve System was established. Misunderstanding about it underlies much of the criticism of our actions. I cannot emphasize too strongly the difficulties we are placed under when many of the most vociferous supporters of free enterprise, businessmen and bankers, and their organizations criticize the possession and use by the Federal Reserve System of necessary authority over the cost and availability of credit as if the delegation of this authority to the System were characteristic of a "managed economy" or an "administered state." It is exactly the opposite.⁴

Those who would oppose using monetary, credit, and fiscal policies for stabilization purposes, either by refusing to give the Government adequate powers or by obstructing its use of these powers, must therefore either oppose the purposes of the Employment Act or find other methods of equal effectiveness and of equal compatibility with our democratic, free-enterprise system.

We do not know precisely how much effectiveness as a stabilizing device we can expect from appropriate, vigorous, and coordinated monetary, credit, and fiscal policies. Our past experience is of little help in making such an estimate, for a timely, vigorous, and coordinated use of all these policies for stabilization purposes has never been seriously attempted in this country. Fortunately, however, the validity of our recommendations does not need such a precise estimate; it is enough to know that these methods can be very powerful and that they are preferable to other methods for promoting general economic stability. We do, however, wish to make two points with respect to the effectiveness of these instruments: (1) They are not a panacea for all economic ills, nor do they make it unnecessary for us to employ wise economic policies of other types. There are many kinds of economic problems—for example, those relating to the maintenance of competition—that they cannot solve, and they are even likely to lose a large part of their effectiveness as stabilization measures if other policies are unfriendly. And (2), if not used in a coordinated and supplementary manner, the various components of monetary, credit, and fiscal policies are likely to prove insufficient to cope with strong cumulative forces which at times create depressions and at other times inflation. In fact, these policies may completely defeat each other. They can be much more effective if they are employed as integrated parts of an appropriate over-all monetary, credit, and fiscal program. We cannot afford, therefore, to rely solely on a few of these measures and to neglect the others.

II. FEDERAL FISCAL POLICIES

1. We recommend that Federal fiscal policies be such as not only to avoid aggravating economic instability but also to make a positive and important contribution to stabilization, at the same time promoting equity and incentives in taxation and economy in expenditures. A policy

⁴ See also the testimony of W. Randolph Burgess and of Alfred H. Williams.

based on the principle of an annually balanced budget regardless of fluctuations in the national income does not meet these tests, for if actually followed it would require drastic increases of tax rates or drastic reductions of Government expenditures during periods of deflation and unemployment, thereby aggravating the decline, and marked reductions of tax rates or increases of expenditures during periods of inflationary boom, thereby accentuating the inflation. A policy that will contribute to stability must produce a surplus of revenues over expenditures in periods of high prosperity and comparatively full employment and a surplus of expenditures over revenues in periods of deflation and abnormally high unemployment. Such a policy must, however, be based on a recognition that there are limits to the effectiveness of fiscal policy because economic forecasting is highly imperfect at present and tax and expenditure policies under present procedures are very inflexible.

2. We recommend that the Joint Committee on the Economic Report make an intensive study of the various possible methods of increasing the flexibility of tax and expenditure policies in order to discover whether and to what extent it is feasible to make these instruments more effective for stabilization purposes.

Fifty years ago, when the Federal budget amounted to only about half a billion dollars a year, it was not a very important influence on the behavior of the economy. But the situation is now completely changed since the annual Federal budget has grown to about \$43,500,000,000, which amounts to about 19 percent of national income and 17.5 percent of gross national product. Federal expenditure and revenue policies now constitute one of the most important determinants of production and employment, and depending on the nature of these policies their influence may help to create either stability or instability.

The Government exerts its influence on total spendings, production, employment, and prices through both sides of its budget.⁵ Its purchases of goods and services add directly to the demand for output and create money income for persons and business firms, while its expenditures for interest, veterans' and social-security benefits, and various other transfer payments also add to private incomes and spending power. Taken by themselves, therefore, Government expenditures tend to expand money incomes and the market for business output. On the other side of the budget, tax collections extract from personal and business incomes large amounts of money that might have been spent for consumption purposes or for capital improvements. Taken by itself, therefore, the collection of taxes tends to shrink the spendable money incomes of persons and business firms, to reduce the private demand for output, and to diminish employment. Thus, the Government exerts a net antideflationary or an inflationary effect on the economy by spending in excess of its current revenues, and a net anti-

⁵ In dealing with the effects of fiscal policies on general economic conditions, we shall refer to the "cash budget" rather than to the "conventional budget." The former more accurately measures the impact of Federal financial operations on the economy, for it reflects all Federal receipts of money from the public, including social-security contributions, and all Federal payments to the public, including social-security benefits; it does not include "receipts" or "expenditures" which are merely bookkeeping transfers within the Government. The "conventional budget," though highly useful for evaluating and controlling the various governmental programs, fails to measure accurately the impact of Federal revenues and expenditures on the economy, for it does not include all payments between the Government and the public, and it does include some items that merely represent transfers on the books of the Government itself. In neither case, of course, do "receipts" include proceeds from borrowing nor "expenditures" the amounts used to retire debt.

inflationary or a deflationary effect by collecting revenues in excess of its current spendings. Whether such policies contribute to stability or instability depends on their timing and magnitude. Deficit spending in a period of high employment tends to induce or aggravate inflation; the same policy in a period of serious underemployment tends to retard deflation and recession and cannot constitute an inflationary threat so long as there exists a considerable amount of unemployed labor and other productive resources. A surplus of tax collections over spendings in periods of recession and depression tends to aggravate the decline by accentuating the fall of demand for business output, but the same policy in a period of actual or imminent inflation promotes stability.

We recommend that the Federal Government employ a revenue-expenditure policy that will not only avoid aggravating instability but will actively contribute to the maintenance of general economic stability. A policy of balancing the budget annually despite fluctuations in production and employment does not meet this test; such a policy, if actually followed, would magnify economic fluctuations. Only a fiscal policy that will yield a surplus of revenues over expenditures at high levels of national income and an excess of expenditures over revenues when there is more than a moderate amount of unemployment can at once avoid contributing to instability and make a positive contribution to stabilization.

We want to make it perfectly clear at the outset that our proposed revenue-expenditure policy for the Federal Government is thoroughly consistent with two other important objectives of fiscal policy—the preservation of incentives and the promotion of equity in the tax system and the promotion of economy in Government expenditures. The tax system should be under constant scrutiny to find ways of increasing the equity in the distribution of the tax burden and to preserve the incentives of industry toward constantly greater production. The adoption of a flexible fiscal policy will promote rather than make more difficult the attainment of these objectives. The achievement of economy in Government expenditures is essential. We are strongly and unalterably opposed to waste in Government. No project should be undertaken that cannot be justified on its merits, and the Government, no less than private industry, should get the most for every dollar spent. We are not rich enough to afford waste in our homes, in our industries, or in our Government. The quest for economy must be continuing and unrelenting; it must not be limited to any one phase of the business cycle. Economy cannot be turned on and off at will. While recommending a flexible fiscal policy, we also recommend a continuous promotion of efficiency in Government.

We have two principal reasons for rejecting the principle of an annually balanced Federal budget in the face of serious fluctuations in our national money income: (1) Adherence to this principle would aggravate economic instability. With a given structure of tax rates, the aggregate yield of the Federal revenue system is highly responsive to changes in the level of national income. Yields of the two taxes that provide the major part of Federal revenues—the personal-income and corporate-income taxes—fluctuate more widely, percentagewise, than national money income, and the yields of social-security taxes and of excises on alcoholic beverages, tobacco, and many other prod-

ucts are also sensitive to changes in income levels. Thus, with a given structure of tax rates, increases or decreases in the national income automatically produce increases or decreases in total Federal revenues. To apply the principle of an annually balanced budget in the face of these facts would necessitate perverse variations in Federal tax rates, or expenditures, or both. When total Federal revenues rose in response to an inflationary rise of national income, the Government would have to cut tax rates, which would increase the spendable incomes of people and business, or increase Government expenditures, which would still further increase spendings for output and add still more to private incomes, or do both. Such a policy could only aggravate inflation. And when Federal revenues fell in response to a deflationary decline of national income and employment the principle of an annually balanced budget would require an increase of tax rates, which would further shrink the already-declining private spending power, or decrease Government expenditures, which would reduce still further the demand for business output and further shrink private incomes, or do both. These policies would inevitably accentuate the decline of production, employment, and prices.

(2) In actual practice the principle of an annually balanced budget in the face of fluctuations in the national income will not be accepted by the American people, and by continuing to pay lip service to it we would probably promote inflation in the long run. It is unrealistic to expect that the Federal budget could actually be balanced in periods of serious deflation and unemployment; the Nation would not approve or even condone the marked increase of tax rates or decrease of expenditures that would be required for the purpose. But the annual-budget-balance principle would be seized upon in an inflationary boom period as a justification for decreasing tax rates or increasing expenditures. A frank recognition of the fact that the budget neither should, nor as a practical matter can, be balanced in a period of depression would bolster our ability to resist inflationary reductions of tax rates and undue increases of Government expenditures during boom periods.

Our recommendations for a flexible fiscal policy have been strongly influenced by the following considerations: (1) The unreliability of economic forecasting. If we could accurately predict future economic conditions it might be possible to anticipate turning points in business activity and to use revenue-expenditure policies promptly enough to hold fluctuations within very narrow limits. The poor record of the forecasters in the past warns us as to the danger of this course. Thus in the fall of 1945 virtually all of the economic forecasters predicted that there would be a tremendous postwar slump which would create from 8 to 12 million unemployed by the spring of 1946. This did not occur; and, instead, we had rising production and even more rapidly rising prices with substantially full employment. For us to have embarked on a tremendous program of public works at this time, as the forecasters had urged, would not only have been unnecessary but it would have intensified and heightened the inflation. In fact, the accumulation of a surplus and the retiring of a portion of the public debt beginning in the latter part of 1946 helped to dampen down inflation and prevented matters from becoming still worse. Again in the winter of 1949 the official economic forecasters stated that the real problem was inflation, to prevent which they wanted further restrictive controls. Since it then developed that we were

in a recession which continued for some time, the putting into effect of these recommendations could only have deepened the recession. We mention these errors not to single out those who committed them for blame but rather to show how unsafe it is to base fiscal policy upon predictions of what it is alleged will happen in the future. Under our recommended policy, therefore, decisions as to changes in revenue and expenditure programs are not made to depend on forecasts of future levels and changes in business activity but, instead, on current economic conditions and developments in the recent past. Deviations from this rule should occur only when there are clear and convincing reasons to believe that present conditions are not indicative of those to be expected in the future. (2) The long period required to enact revenue laws and the inflexibility of expenditure programs. To change our tax laws under present procedures is a long and time-consuming process. Moreover, many expenditure programs are not suitable for countercyclical variations, and some others cannot be quickly started, stopped, speeded up, and slowed down. There are some projects, however, such as the building of roads and houses, which can be varied in volume without too great loss or delay. We recommend that the Joint Committee on the Economic Report study the problem of how the rate of expenditures can be made more flexible. But until this greater flexibility is actually achieved it will be well to recognize this limitation on the effectiveness of fiscal policy as a stabilization device, and not to discard or weaken monetary policy, which, despite its other shortcomings, does have the great merit of flexibility.

The nature of our recommended fiscal policy has already been indicated in broad terms; it may be outlined as follows: (1) The tax system should be equitable and should preserve and even create incentives toward an ever-increasing level of production. But, when the tax system is changed in the interests of equity or incentives, the effects on total revenue-expenditure relationships and on general economic stability should also be considered. For example, if in the interest of equity or incentives some taxes are eliminated or reduced at a time when economic conditions are not such as to warrant a reduction of total revenues relative to expenditures, the loss of revenues should then be offset by the increase in other taxes or by a reduction of expenditures. Remedying an inequity for one group of people should not be allowed to create inequities for many others by encouraging inflation. (2) Efficiency in Government should be promoted at all times; every expenditure should be justified on its merits, and the Government should strive to get the most for every dollar spent. (3) The revenue-expenditure system should be so designed that in normal periods—periods when unemployment is at or near its practical minimum, when price levels are relatively stable, and when there is no clear-cut and convincing reason to expect a change in any particular direction—then Federal revenues should not only equal expenditures but should show a small surplus to permit a slow reduction of the national debt. Moreover, newly planned increases or decreases in expenditures should be matched with equivalent changes in planned revenue receipts. This rule has a double advantage. In the first place, it leads to economy in Government, for every proposed increase in expenditures has to be compared with its cost in taxes. And in the second place, it leads to stability. for at such times the

Government should not seek to inject either a net expansionary or net contractionary influence into the economy.

The only exceptions to the general principle that planned changes in expenditures should be matched by offsetting changes in planned revenues are (a) a decrease in planned expenditures should not be balanced by an offsetting reduction of planned revenues if there is clear and convincing evidence that such a reduction would initiate or enhance inflation, and (b) a planned increase of expenditures should not be offset by a planned increase of revenues if there is clear and convincing evidence that the near future will be characterized by deflation and unemployment so that an injection of a net expansionary influence would be desirable. But, because of the natural human tendency to favor tax reductions and to oppose tax increases, the presumption should be strongly in favor of abiding by the general principle. (4) The maintenance of unchanged tax rates and expenditure programs will produce, as a response to fluctuations in the national income, an "automatic flexibility" of revenues and actual expenditures, which will exert a stabilizing effect on the economy. For example, with a decline in the national income, Federal revenues will automatically fall while expenditures under certain Government programs, such as unemployment benefits and assistance to farmers, will automatically rise. The decline will be somewhat cushioned as the Government automatically taxes less money away from the public and pays out more to it. On the other hand, with an inflationary rise of national money income, Federal revenues will automatically rise while certain types of expenditures, such as those mentioned above, will automatically fall; the rise would be dampened down as the Government taxed larger amounts from private incomes and paid less into them. We believe that this automatic flexibility is a valuable contribution to stability, and that the degree of automatic flexibility in our fiscal system should, if possible, be increased. But its limitations should also be recognized. In the first place, though it can retard or perhaps even stop a decline of business activity or a rise of prices and can provide time for recovery forces to come into play, it cannot by itself reestablish full-employment conditions or push prices back to a preinflation level. In the second place, though automatic flexibility probably represents the maximum extent to which fiscal policy should be employed to combat moderate economic fluctuations, it is almost certain to be inadequate in the face of a serious depression or inflation. (5) In the event of such a serious depression or inflation, automatic flexibility should be supplemented by countercyclical changes in tax rates, expenditure programs, or both. The considerations which should underlie such measures, as well as some of the problems involved, were pointed out in a unanimous report presented to the subcommittee by 15 economists:

In the event of severe recession, it is not only politically necessary but economically desirable to provide additional employment projects that can be started and ended quickly. Temporary tax relief should be given in order to stimulate private spending and employment. Other incentives for private investment, such as guaranties, should be considered. There can be no social or economic justification for allowing mass unemployment to persist for extended periods at a time when there is abundant need for roads, schools, hospitals, and other useful objects of public expenditures. However, we recognize that there are difficult questions of extent and timing connected with any such program. An overambitious Government program may impede the course of recovery in the private sectors of the economy by dislocating resources and delaying needed price adjustments. On

the other hand, a program that was overcautious could needlessly fail to advance recovery by not stimulating the demand for the products of private industry. Much skill and judgment are required to move from depression to stable prosperity. We must not rely on the private economy, unaided by Government action, to perform that task. The Government must not shirk the responsibility placed upon it by the Employment Act, and fiscal policy is one of the most promising instruments it possesses.

On any occasion when serious inflation is in prospect, emergency measures would be needed to curtail expenditures and increase taxation. Wartime and postwar experience provides convincing evidence that the political obstacles to a fiscal policy adequate to combat inflation are so great that there is little practical danger of going too far. The survival of a relatively free and stable price system depends heavily on our willingness to fight inflation by fiscal methods.⁶

As we have stated, one of the greatest limitations on the effectiveness of fiscal policy as a stabilization device is to be found in its inflexibility—the long period typically required to formulate, enact, and put into operation tax changes and the time required to start, stop, slow down, and speed up expenditure programs. Many possible methods for improving this situation have been suggested, but time did not permit us to study them thoroughly enough to make recommendations concerning them. We do, however, recommend that the joint committee make an intensive study of the various possible methods of increasing the flexibility of fiscal policy in order to discover how and to what extent it is feasible to increase the effectiveness of this instrument for stabilization purposes.

III. MONETARY AND DEBT MANAGEMENT POLICIES ⁷

1. We recommend that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act. Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long-run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.

⁶ See Monetary, Credit, and Fiscal Policies, a print of the Joint Committee on the Economic Report, 81st Cong., 1st sess., 1949, p. 438. This volume will hereafter be referred to as Monetary, Credit and Fiscal Policies. It contains a large amount of materials on fiscal policies that were submitted to the subcommittee. Some of the most informative of these are two statements that were drawn up and unaniously approved by 15 university economists (pp. 435-443), a digest of replies to a questionnaire sent to bankers, economists, and others (pp. 395-424), a statement by the Secretary of the Treasury (p. 14), and a statement by the Director of the Bureau of the Budget (pp. 285-287). Among the witnesses who testified at some length on fiscal policy were J. Cameron Thomson and Beardsley Ruml of the Committee for Economic Development, W. Randolph Burgess of the National City Bank of New York, William J. Grede and Harley Lutz of the National Association of Manufacturers, Allan B. Kline of the American Farm Bureau Federation, and Russell Smith of the National Farmers Union.

⁷ For the further views of Mr. Patman, see footnote 1, p. 1.

2. *We recommend as means of promoting monetary and debt-management policies that will contribute most to the purposes of the Employment Act—*

(a) *That every effort be made to build up the quality and prestige of Federal Reserve officials; among these measures should be a reduction in the number of members of the Board of Governors from seven to not more than five and an increase in their compensation.*

(b) *That Congress by joint resolution issue general instructions to the Federal Reserve and the Treasury regarding the objectives of monetary and debt-management policies and the division of authority over those policies. These instructions need not, and in our judgment should not, be detailed; they should accomplish their purpose if they provide, in effect, that, (i) in determining and administering policies relative to money, credit, and management of the Federal debt, the Treasury and the Federal Reserve shall be guided primarily by considerations relating to their effects on employment, production, purchasing power, and price levels, and such policies shall be consistent with and shall promote the purposes of the Employment Act of 1946; and (ii) it is the will of Congress that the primary power and responsibility for regulating the supply, availability, and cost of credit in general shall be vested in the duly constituted authorities of the Federal Reserve System, and that Treasury actions relative to money, credit, and transactions in the Federal debt shall be made consistent with the policies of the Federal Reserve.*

(c) *That the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System be made members of the National Monetary and Credit Council recommended elsewhere in this report.*

As indicated earlier, we believe that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of our principal instruments for achieving and maintaining economic stability. For several reasons we reject the idea, held by a few economists and others, that for stabilization purposes little or no reliance should be placed on monetary policy and that we should rely exclusively on other measures, such as fiscal policies. (1) It is highly doubtful that fiscal policy would be powerful enough to maintain stability in the face of strong destabilizing forces even if monetary policy were neutral, and a conflicting monetary policy could lessen still further the effectiveness of fiscal policy. (2) Monetary policy is strong precisely where fiscal policy is weakest; it is capable of being highly flexible. It can be altered with changes in economic conditions on a monthly, daily, or even hourly basis. (3) It is a familiar instrument of control and thoroughly consistent with the maintenance of our democratic government and our competitive free-enterprise system. It is certainly much to be preferred over a harness of direct controls. (4) Our monetary history gives little indication as to how effectively we can expect appropriate and vigorous monetary policies to promote stability, for we have never really tried them.

For example, the effectiveness of these policies during the late 1920's was seriously reduced by the Federal Reserve's lack of powers for the selective control of security loans. After 1929, a vigorous easy-money policy was not adopted until bank reserves had been allowed to shrink for more than 2 years, thousands of banks had

failed, and general business confidence had dwindled; and after World War II its use as a restrictive measure with which to combat inflation was very seriously hampered by considerations relating to the management of the Federal debt. With our improved banking structure and the benefit of our past experience, we should be able to look forward to more effective monetary management characterized by timely, vigorous, and flexible actions.

The essential characteristic of a monetary policy that will promote general economic stability is its timely flexibility. To combat deflation and promote recovery, the monetary authorities must liberally provide the banking system with enhanced lending power, thereby tending to lower interest rates and increase the availability of credit. To retard and stop inflation they must restrict the lending power of banks, thereby tending to raise interest rates and to limit the availability of credit for private and Government spending. And these actions must be taken promptly if they are to be most effective. The Federal Reserve has three principal weapons which it can use to control the over-all supply and cost of money and credit: (1) Altering the discount rate at which it will lend to member banks, (2) open-market operations in Government securities, and (3) altering the reserve ratios which the member banks must keep against their deposits.

The first method, that of altering discount rates, was the one chiefly relied upon during the early period of the Federal Reserve. It was said that by raising the discount rate in periods of inflation the member banks would not present so much paper to the Federal Reserve for rediscount and consequently would not build up their reserves and lending power as much as they would otherwise. Moreover, the rise in the discount rate would lead the member banks to increase the interest rates which they in turn charged private borrowers, and this higher rate would curtail the amount of credit taken and would curb the inflation. Conversely, in a period of recession, it was said that the Federal Reserve by lowering its discount rate would stimulate banks to present paper to build up their reserves. This would give them abundant supplies of potential credit which they would loan out to business at relatively cheap rates. This it was said would induce private industry to borrow and would stimulate trade and investment and, consequently, production and employment.

For many years, however, the importance of the discount rate has been far less than was originally intended. In the first place, commercial paper has become much less important. These loans from banks were originally designed to help manufacturers finance the costs of purchasing and fabricating raw materials prior to their final sale and to finance the successive steps of consumers' goods as they moved through the hands of wholesalers and retailers on their way to final purchase and consumption. As business units have grown larger, however, they have tended to finance themselves to a much greater extent out of earnings or from the sale of longer-term securities and have issued much less commercial paper. In the second place, and more important in explaining the decline in the significance of the discount rate, the vast increase in the public debt and the readiness of the Open Market Committee of the Federal Reserve System to purchase these securities in virtually unlimited quantities and to give the banks additional reserves in return has meant that the banks

depend almost exclusively on sales of Governments rather than on borrowings from the Federal Reserve as a means of replenishing their reserve accounts. Outstanding Federal Reserve loans have recently averaged only about 1 percent as large as Federal Reserve holdings of Government securities. The significance of the discount rate has declined correspondingly. The discount rate of the System is not, therefore, a very effective instrument with which to stabilize the economy.

There is more hope in the second weapon of the Reserve System, namely, open-market operations. Under this operation the Federal Reserve will sell Government securities, which it holds in abundant quantities, when it wishes to check an inflationary movement. When the banks buy these securities, they pay for them by giving their checks to the Federal Reserve, which then draws down the reserve accounts of the member banks. This reduces the lending capacity of the banking system by about six times the amount of shrinkage in the reserve. The same result follows if the Government securities are sold to nonbank purchasers, such as insurance companies. The checks given to the Federal Reserve by these purchasers are drawn on banks, and the Federal Reserve collects by drawing down the reserve accounts of those banks. By thus curtailing the supply of available reserves, the Reserve System can curtail the growth of credit or force an actual contraction.

Conversely, Federal Reserve purchases of Government securities in the open market add to the volume of bank reserves, increase the total lending power of the banking system, and tend to make credit both cheaper and more available. This is true whether the purchases are from banks or from nonbank sellers. In both cases the Federal Reserve pays for the securities with checks drawn on itself, and when these checks are presented for collection the Federal Reserve adds their amounts to the reserve accounts of the banks.

Both the discount rate and the open-market operations of the Federal Reserve operate primarily through their effect on the dollar volume of reserves available to the banking system. Reductions in discount rates and purchases of securities in the open market tend to increase the availability of reserves to banks, while increases in discount rates and sales of securities in the open market tend to reduce the availability of bank reserves. But changes in the required reserve ratios of the member banks influence the supply and cost of credit not through their effect on the dollar volume of bank reserves but through their effect on the number of dollars of credit that the banking system can extend on the basis of each dollar of its reserves. For example, when the reserves required against deposits average 10 percent, the banking system can create and have outstanding deposits equal to 10 times the volume of its reserves, but when the reserves required against deposits average 20 percent the banking system can create and have outstanding deposits equal to only 5 times the volume of its reserves. Thus, when the Board of Governors of the Federal Reserve as a restrictive measure increases the percentage of reserves that banks are required to hold against deposits, it tends to decrease or at least to curtail a rise of their lending power and of the total supply of money and credit. Conversely, by lowering the percentage of reserves required against deposits, the Federal Reserve tends to increase or at least to retard a decline in their lending power

of the banking system and in the total potential supply of money and credit.

At various points it will be noted that a restrictive monetary policy usually produces higher interest rates and a liberal policy lower interest rates. It must be emphasized, however, that the effectiveness of general monetary and credit policy does not depend solely on the movement of interest rates. Typically, the Federal Reserve does not operate directly on interest rates but on the total lending power of the banking system and thereby on the total supply of credit. Its actions in reducing the volume of bank reserves or increasing the percentages of reserves required against deposits decreases the total lending power of banks. To some extent the banks curtail their lending by raising interest rates, but they are likely to rely to a greater extent on various kinds of credit rationing. A relatively small rise in interest rates may be accomplished by a marked reduction in the availability of credit. On the other hand, when the Federal Reserve increases the total lending power of the banks, the latter use lower interest rates to some extent to increase the amount of credit that they can sell, but they tend also to rely on a relaxation of credit-rationing restrictions. A relatively small decline in interest rates may be accompanied by a considerable increase in the availability of credit.

As noted earlier, flexibility is an essential characteristic of a monetary policy that will promote general economic stability. To combat deflation, it must make money and credit more available at lower cost; and, to curb inflation, it must restrict the availability and raise the cost of money and credit. During World War II and the postwar period, however, the Federal Reserve and the Treasury did not vigorously restrict credit in order to fight the current inflation. Instead, monetary policy became virtually fused with Federal borrowing and debt-management policies and was used to prevent or limit increases in the yields and decreases in the prices of Federal securities. General credit restriction could not be vigorously tried out because of the strong desire to maintain low interest rates and yields on Government securities and to prevent or at least to hold within very narrow limits any decline in the prices of Governments. This raises, we believe, the most important current question in the field of monetary policy: "To what extent should the use of a restrictive monetary policy to curb inflation be inhibited by the desire to hold down the yields and to hold up the prices of Federal securities?" A short sketch of the development of this policy will help bring out the issues involved.⁸

Between early 1937 and our entrance into World War II, the Federal Reserve on several occasions bought and sold Federal securities not for the primary purpose of affecting the volume of bank reserves and aggregate lending power but for the express purpose of influencing the prices of Governments, and especially the longer-term issues, in order "to maintain an orderly market" for them. In justifying these actions the Federal Reserve did not mention the needs of the Treasury, but stressed that its principal purposes were: (1) To "exert a steady influence on the capital market, which is an essential part of the country's economic machinery, and disorganization in which would

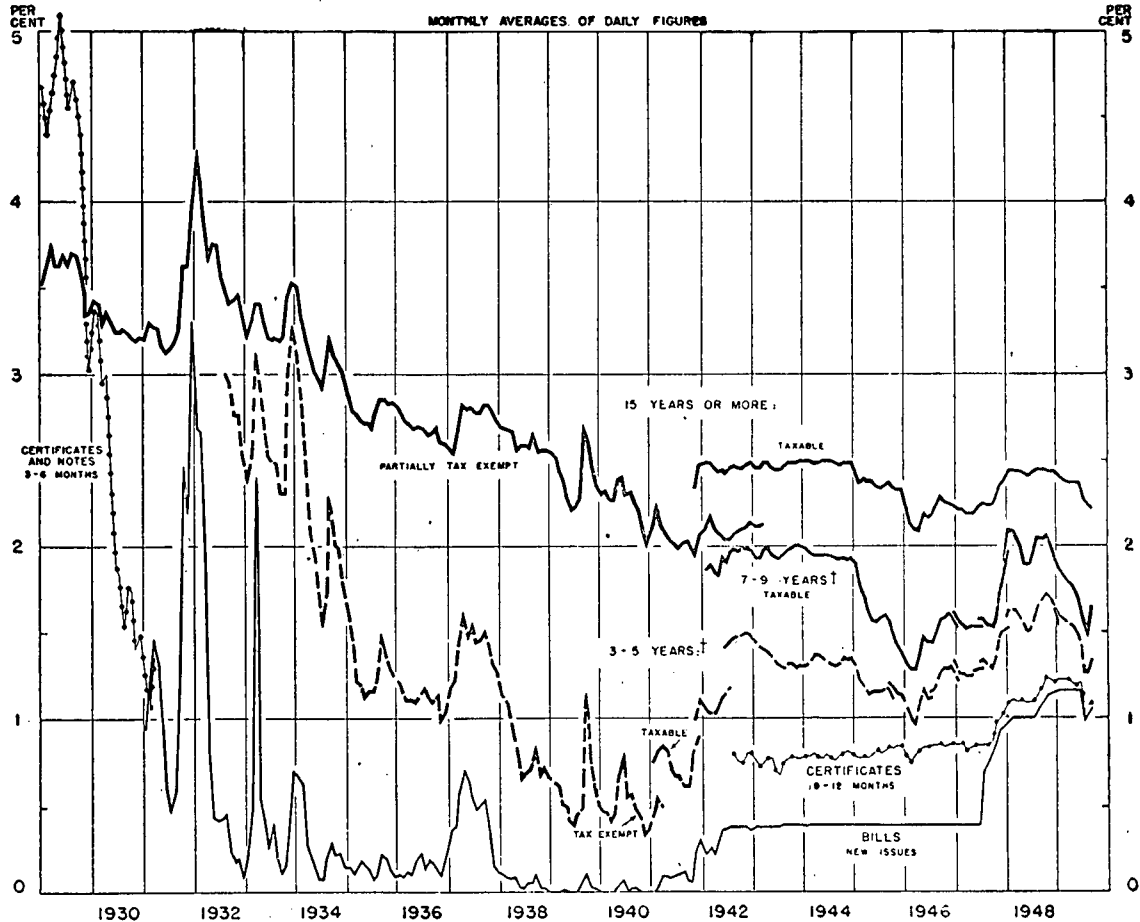
⁸ A large amount of materials on the relationship between monetary and debt-management policies was presented to the subcommittee. The committee print on Monetary, Credit, and Fiscal Policies contains statements by the Secretary of the Treasury (pp. 4-11), the Chairman of the Board of Governors of the Federal Reserve System (pp. 24-44), the presidents of the 12 Federal Reserve banks (pp. 102-124), and a number of bankers, economists, and others (pp. 299-308). Moreover, practically all of the witnesses who appeared at the hearings presented testimony on this subject.

be a serious obstacle to the progress of economic recovery" and (2) to safeguard the large Government portfolios of member banks against "unnecessarily wide and violent fluctuations in price."⁹ In short, by the time we entered World War II, "the maintenance of an orderly market for Government securities" had already become an important objective of Federal Reserve policy. But not yet had the Federal Reserve reached the point of "pegging" Government prices at stated levels and standing ready to buy all securities offered to it at the pegged prices. It was "maintaining an orderly market for Governments" in the sense of preventing "disorderly" changes in their prices and yields, but it was not yet maintaining a rigid yield pattern.

The next phase was entered at the time of Pearl Harbor. The Federal Reserve assured the Nation that it could and would see that the Treasury was supplied with all the money that it needed for war finance, and in March 1942 its Open Market Committee agreed with the Treasury to maintain for the duration of the war approximately the then-existing structure of yields on Governments. These promises were completely fulfilled. Two facts about the frozen-yield structure are very significant. The first, as shown in figure I, was the very low level of the entire yield structure. Partly because of the depressed demand for credit and partly because of the huge volume of excess bank reserves all interest rates, but especially those on short-term safe paper, had fallen greatly since 1929 and the early 1930's. The second fact, which is also shown in figure I, but which stands out more clearly in figure II, was the very low level of yields on short-term paper relative to yields on the longer maturities. The pattern above which yields were not to be allowed to rise ranged from three-eighths of 1 percent on 90-day Treasury bills, through seven-eighths of 1 percent on 9-12-month certificates of indebtedness, through about 2 percent on 10-year bonds, and up to a maximum of 2½ percent on the longest-term marketable issues.

Though several measures were employed to prevent a rise of these yields above the agreed-upon pattern, by far the most important one, and the only one that needs to be mentioned here, was the agreement of the Federal Reserve to buy all the Governments that others were unwilling to hold at yields not in excess of those agreed upon with the Treasury. In effect, therefore, the Treasury and the Federal Reserve fixed the pattern of prices and yields at which the Federal Reserve would be a passive buyer, and the Federal Reserve relinquished control over the volume of its Government holdings to the Treasury as issuer and to others as buyers and sellers. And, of course, its purchases of these securities both added directly to the money supply and supplied the commercial banks with additional reserves on the basis of which they could create money. What happened to Federal Reserve holdings of Governments as a result of this passive policy is shown in figure III. Total holdings rose from a little more than \$2,000,000,000 at the beginning of 1942 to about \$24,000,000,000 at the end of 1945, and virtually all of this increase represented the rise in Federal Reserve holdings of bills, certificates, and other short-term Governments on which the yields were very low. Private investors were "playing the pattern of the rates"; with the safety and liquidity of the longer issues greatly enhanced by the Federal Reserve price

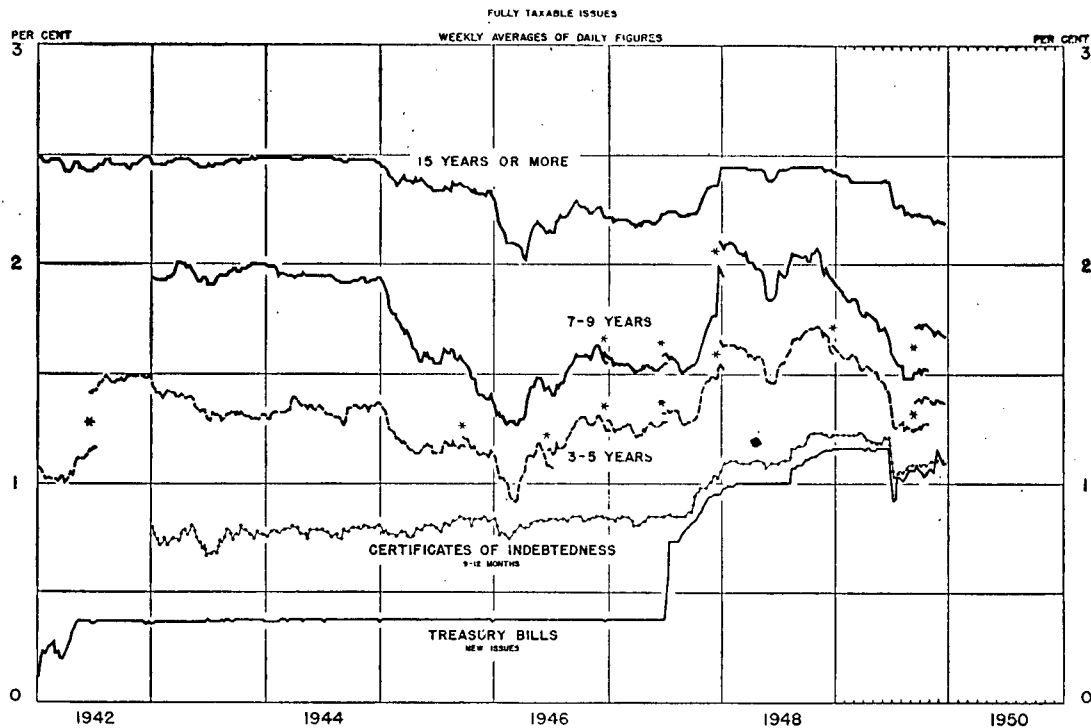
⁹ For a short history of the development of this policy, see *Monetary, Credit, and Fiscal Policies*, pp. 29-42



Source: Board of Governors of the Federal Reserve System.

† BREAKS IN LINES REPRESENT CHANGES IN ISSUES INCLUDED.

FIGURE II
 YIELDS ON U. S. GOVERNMENT SECURITIES



Source: Board of Governors of the Federal Reserve System.

support program private buyers tended to concentrate on the purchase of them and to leave to the Federal Reserve the purchase of the short-term, lower-yield maturities. In fact, during 1945 and 1946 the great private demand for the longer-maturities bid down markedly their yields.

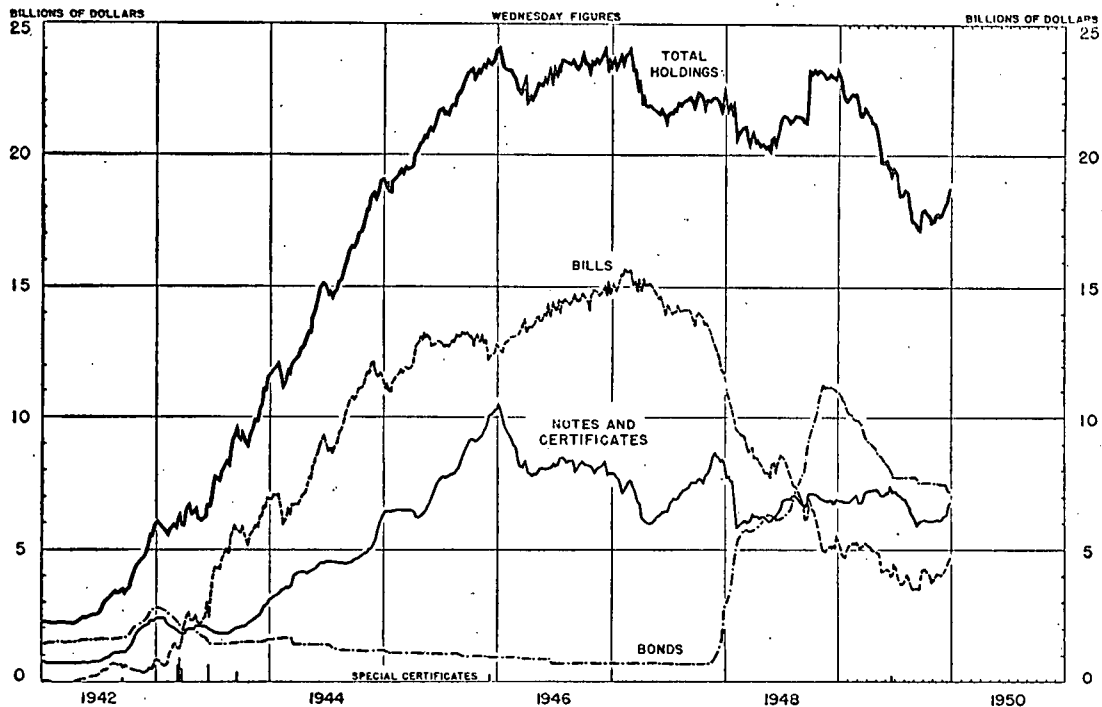
As the war ended, therefore, the Federal Reserve was following a rigid policy of preventing the yields on Governments from rising above the agreed-upon pattern, and it was accomplishing this by passively purchasing—and monetizing—all of these securities that others were unwilling to hold at yields not above those on the pattern. In effect the Federal Reserve had relinquished control over the amount of the Federal debt that it would monetize in order to prevent yield increases. Having committed itself to this policy, it could not refuse to buy and monetize Governments at the agreed-upon price, for to do so would have been to let the price of the security fall and the yield rise. This policy was continued without significant change until July 1947, nearly 2 years after VJ-day. (See fig. II.) But in mid-1947 some upward flexibility began to be introduced; in a series of steps the yield on bills was increased to about 1.76 percent by late 1948, the yield on certificates to 1.25 percent, and long-term yields by lesser amounts. In 1949, as inflationary pressures abated and the private demand for credit declined, yields were allowed to fall somewhat.

Though the policy from July 1947 until late 1948 did indicate an ability of the Federal Reserve and the Treasury to agree upon a re-introduction of some upward flexibility in yields and interest rates, it does not by any means indicate that the concern for "maintaining an orderly market in Governments" has been abandoned and that the use of a restrictive monetary policy to combat future inflations will not be seriously hindered by a concern for preventing or limiting decreases in the prices and increases in the yields on Governments. In fact, throughout this period the Federal Reserve made it clear that it was continuing its policy of maintaining an orderly market for Governments, the rise of even short-term rates was never allowed to proceed very far, and in no case was the price of a Government security allowed to decline below par. The following press release by the Federal Reserve on June 28, 1949, indicates, according to Chairman McCabe, that policy in the future will be flexible:

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

But in interpreting this statement, two facts are important: (1) The June 1949 decision had the effect of lowering interest rates, thereby facilitating Treasury finance. The Treasury might not have assented so readily had the policy been toward higher interest rates. And (2) the statement did not, and of course could not, indicate the extent of flexibility that will be employed in the future. The range of flexibility may prove to be so narrow as to limit very seriously the effectiveness of a restrictive monetary policy.

FIGURE III
RESERVE BANK HOLDINGS OF U. S. GOVERNMENT SECURITIES



Source: Board of Governors of the Federal Reserve System.

Treasury and Federal Reserve officials have advanced a number of reasons for the policy of holding down the yields and supporting the prices of Governments in the face of inflation. (1) Such a policy holds down service charges on the Federal debt. The Secretary of the Treasury stated to the subcommittee:

The interest cost of the debt to taxpayers is another of the many considerations which must be taken into account in debt-management policies. It is estimated that the interest charge on the public debt during the fiscal year 1950 will be \$5,450,000,000. This item represents over 13 percent of the Federal budget for the year. The interest cost is likely to grow over a period of time—in the absence of substantial debt reduction—because the rate of interest on savings bonds increases as the bonds are held to maturity, and because an increasingly large proportion of the debt represents the accumulation of trust funds invested at rates set forth in the law which are higher than the present average interest rate on the debt.

A general rise in interest rates would bring about a further rise in the budget charge for interest payments. An increase of as little as one-half of 1 percent in the average interest paid on the debt would add about \$1,250,000,000 to this charge. The Treasury was able to finance the last war at an average borrowing cost of less than one-half the borrowing cost of World War I. If this had not been done, the interest charge at the present time would be more than \$10,000,000,000 a year instead of \$5,000,000,000 a year. It is clearly evident that this \$5,000,000,000 annual saving in the taxpayer's money is a highly important factor in the budget picture of the Federal Government.¹⁰

(2) The maintenance of relatively stable prices on Governments helps to maintain confidence in the public credit and facilitates Treasury sales of securities for both new financing and refunding purposes. This looms important to the Treasury, with about \$50,000,000,000 of its marketable debt maturing within a year and with large volumes of outstanding nonmarketable issues, especially savings bonds, payable on demand. (3) The maintenance of stable security prices protects investors against capital depreciation and prevents any loss of public confidence in financial institutions, including banks, that might result from a serious decline of these prices. (4) Any marked decline in the price of Governments would be communicated to other parts of the credit market and might bring about unemployment and deflation by interfering with the flotation of new private securities. And (5) any feasible rise of the yields on Governments would be so ineffective as an anti-inflationary measure as not to be worth its cost. Though Federal Reserve and Treasury officials, and especially the latter, seem to have been greatly influenced by the objectives of holding down the service charges on the Federal debt and of facilitating Treasury security flotations it is well to remember that there were also other considerations behind the postwar policy, such as those relating to protecting individual and institutional investors against capital depreciation, prevention of a financial panic, and avoidance of restrictive policies that would be so vigorous as to reduce employment and production.

The principal argument against a monetary policy of preventing or narrowly limiting the increase of yields on Governments is that it seriously limits, if it does not completely prevent, the use of restrictive monetary policy as an instrument for combating inflation. It is no hindrance to the use of a liberal monetary policy to fight deflation and unemployment; the very same low-interest, easy-money policy that will be conducive to business recovery also holds down service charges on the Federal debt and facilitates security sales by the Treasury.

¹⁰ Monetary, Credit, and Fiscal Policies, p. 9.

But in periods of inflation the objective of preventing or narrowly limiting increases of yields on Governments may conflict directly with that of combating inflation; the former objective requires a policy of continued easy credit and low interest rates while the latter requires a lessened availability of credit accompanied by higher interest rates.

That the Federal Reserve is powerless to restrict credit in general while maintaining low yields on Governments is brought out by two facts: (1) All holders of Governments, both individual and institutional, retain complete freedom to buy or to sell at will any or all of these securities, of which their holdings are tremendous. At their own option they may sell these securities to acquire money to spend for consumption, to finance capital purchases, or to lend to others. Any tendency for interest rates on private obligations to rise relative to those on Governments tends to induce investors to sell Governments in order to make funds available to private users. And (2) in order to prevent yields on Governments from rising above any given level the Federal Reserve must stand ready to buy at those yields all the Government securities that others do not wish to hold. In this way all holders of Governments, not merely member banks, are given access to new money from the Federal Reserve. They get this money by selling Governments, and the cost of the money to them is the yield that they sacrifice on the securities sold. Thus for the Federal Reserve to maintain low yields on Governments by passively purchasing them in unlimited quantities is to assure that money for other uses will continue to be cheaply available in large amounts.

Such a policy of maintaining low yields on Governments negates or seriously reduces the effectiveness of every Federal Reserve instrument for general credit restriction. (1) Open market operations are likely to be useless; the Federal Reserve is not free to refuse to buy or actually to sell Governments in order to restrict credit in general but must purchase these securities in such amounts as are required to prevent undesired rises in their yields. Even if the Federal Reserve should sell Governments in an attempt to restrict credit it would be compelled, under this policy, to buy them back again to prevent a rise of yields. (2) Increases in Federal Reserve discount rates are likely to be largely ineffective as positive restrictive measures, for banks will not need to borrow so long as they can secure funds at will by selling Governments to the Federal Reserve. Even the psychological effects of increases in discount rates are much reduced by the fact that banks are largely out of debt to the Federal Reserve and know that they can remain so. (3) The restrictive effects of increases in member-bank reserve requirements are greatly reduced by the fact that the banks can easily repair their reserve positions and restore and even expand their lending power through the sale, at their own option, of Governments to the Federal Reserve.

It appears to us impossible to prescribe by legislation highly specific rules to guide the determination of monetary and debt management policies, for it is impossible to foresee all situations that may arise in the future. The wisest course for Congress to follow in this case is to lay down general objectives, to indicate the general order of importance to be attached to these various objectives, and to leave more specific decisions and actions to the judgment of the monetary and debt management officials. We believe that specific policies should

conform to the following broad principles: (1) They should prevent "disorderly" movements in the prices and yields of Governments while avoiding the maintenance of such inflexibly low yields as to reduce seriously the effectiveness of monetary policy for anti-inflation purposes. A few people, but apparently only a very small minority, have argued that the Federal Reserve ought never to enter the market to influence the behavior of prices and yields on Governments. This position is, we believe, untenable. It is a central function of the Federal Reserve to influence the behavior of yields in general, and the behavior of yields on more than \$250,000,000,000 of securities, making up more than half of all public and private debt in this country, can hardly be ignored. The Federal Reserve should prevent not only panicky declines in the prices of these securities but also other disorderly, erratic, and overly rapid changes. A part of the technique of central banking is to avoid excessively harsh restrictive measures. Declines of the magnitude that occurred after World War I, when long-term Governments fell to about 80, serve no useful purpose. On the other hand, the Federal Reserve and the Treasury should not allow their concern for holding down yields and supporting the prices of Governments to prevent a vigorous use of restrictive monetary policy to combat inflation. To continue to maintain an easy availability of credit at low interest rates in the face of inflation is not to be neutral; it is to feed the fires of inflation. (2) The advantages of avoiding inflation are so great that they should be pursued even if the cost is a significant increase in the service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes. In general, the Government ought not to use its monetary policy to maintain easy credit and to facilitate the management of its own debt if that monetary policy is not conducive to the maintenance of general economic stability. Exceptions to these principles should occur only at times of serious national emergency. In emphasizing the desirability of using a restrictive monetary policy, which must entail some rise of interest rates, to combat future inflations we are not arguing for a secularly higher interest rate structure. There is good reason to believe that secularly low interest rates will be in the national interest for they will stimulate private capital construction. We favor interest rates as low as they can be without inducing inflationary pressures. But flexibility of interest rates, without which a flexible monetary policy is impossible, should be restored.

Also involved in this broad problem of the relationship between monetary and debt management are questions relating to the division of authority. Who should determine and administer these policies? The traditional position in this country has been that power and responsibility for monetary policy should be lodged in the "independent" Federal Reserve System, which though accountable to Congress should not be responsible to the executive branch. To assure the maintenance of this independence the members of the Board of Governors were given 14-year terms, the Secretary of the Treasury and the Comptroller of the Currency were removed from the Board, and a certain amount of decentralization of authority within the Federal Reserve System was continued. On the other hand, power and responsibility for debt management within very broad limitations laid down by Congress is delegated to the Treasury Department. In

theory, therefore, the Federal Reserve exercises the powers of monetary management while the Treasury exercises the powers of debt management. But this is hardly a realistic description of the actual location of these powers. The Federal Reserve has always exercised an influence on debt management policies through its general monetary policies and in recent years, as noted above, monetary management has been an integral part of debt management. Moreover, the Treasury has monetary control powers; it can tend to ease or tighten the money market by shifting its general balance from the Federal Reserve banks to commercial banks and vice versa, its purchases and sales of securities for the account of its trust funds have general effects similar to those of Federal Reserve open-market operations, and at times in the past it has had discretionary powers relative to gold and silver. But in recent years the Treasury has exercised its greatest influence on monetary policy through its debt management policies, and especially through its power to fix the various terms, including interest rates, on its new issues.

As a practical matter there will be at any time an approximate equality between the yields fixed by the Treasury on its new offerings and to market yields on comparable outstanding Treasury issues, the latter reflecting the general monetary policy being followed by the Federal Reserve. The Treasury will not be able to sell its new issues at yields below the market yields on comparable issues already outstanding, and it is not likely to offer significantly higher yields on the new issues. But who determines the levels at which the yields on the outstanding and new issues will be equalized—the Federal Reserve or the Treasury? Do Federal Reserve officials determine the general level of interest rates, including yields on Governments, that they will establish so that the Treasury in fixing rates on new issues must conform to the decisions of the Federal Reserve? Or do Federal Reserve officials conform their general credit policies, including their support levels for Governments, to the pattern desired by the Treasury? The evidence presented to the subcommittee indicates that there is no simple answer to these questions. Federal Reserve and Treasury officials and staff members are in frequent consultation, and many decisions are agreed upon by the two agencies without marked differences of opinion. On some occasions when there were originally differences of opinion the Treasury has "gone along" with Federal Reserve requests for higher interest rates. But the evidence indicates that in a majority of the cases where the judgments of the two agencies differed it was the judgment of the Treasury that prevailed; the Federal Reserve was not willing to assert its independence and force market yields to rise above the yields that the Treasury wished to set on its new issues, thereby embarrassing the Treasury. It appears that in the absence of strong Treasury influence the Federal Reserve would have initiated a tighter monetary policy somewhat earlier and that this policy would have been carried further. Allan Sproul, who as president of the Federal Reserve Bank of New York and vice chairman of the Federal Open Market Committee participated in negotiations with the Treasury, offered this testimony at our hearings:

It is important that better means be found, if possible, for reconciling potential differences between the Treasury and the Federal Reserve System, so that action in the credit sphere may be taken promptly, as needed, in reasonable harmony with the action being taken by the Treasury in the sphere of debt management.

The record of cooperation in the postwar years has been better than might have been expected, and so has the record of our economy, whatever connection there may be between the two. But agreed action, in my opinion, has most often been too little and too late, so far as the aims of an effective monetary program were concerned.

For example, the System wanted to discontinue its preferential discount rate on Government securities maturing within 1 year, before the end of 1945; Treasury acquiescence, and the action, did not come until April 1946.

From the closing months of 1945 through all of 1946, the System was pressing for discontinuance of its artificially low buying rate—three-eighths of 1 percent—on Treasury bills; the action finally came, with Treasury agreement, in July 1947.

From that point on, as inflationary pressures increased, the System wished to follow a program of credit restraint which would have necessitated small but, perhaps, frequent increases in short-term interest rates which would have meant similar increases in rates on Treasury bills and certificates, and some increase in the yield of other short and intermediate Government securities.

The Treasury did a large part of the job, of course, by devoting its substantial cash surpluses to the retirement of debt in such a manner as greatly to aid in achieving the common objective; but the Treasury was generally several months behind in accepting the implications of a tightening policy for the interest rates on its short-term securities.

The general thesis of the following statement to the subcommittee by Marriner Eccles, a member of the Board of Governors and formerly its Chairman, appears to be justified.

The Treasury * * * is not responsible to Congress for monetary and credit policy and has had for a long time general easy-money bias under almost any and all circumstances. As long as the Federal Reserve policy must be based upon this criterion, it could not pursue a restrictive money policy to combat inflationary pressures.

Decisions regarding management of the public debt set the framework within which monetary and credit action can be taken. As the size of the debt grew through the period of deficit finance in the thirties and particularly over the war period, Treasury needs came to overshadow and finally to dominate completely Federal Reserve monetary and credit policy. When the Treasury announces the issue of securities at a very low-rate pattern during a period of credit expansion, as it did last Wednesday, the Federal Reserve is forced to defend these terms unless the System is prepared to let the financing fail, which it could not very well do. To maintain a very low-rate pattern when there is a strong demand for credit, the System cannot avoid supplying Federal Reserve credit at the will of the market.

Under these conditions it can hardly be said that the Federal Reserve System retains any effective influence in its own right over the supply of money in the country or over the availability and cost of credit, although these are the major duties for which the System has statutory responsibility. Nor can it be said that the discount rate and open-market operations of the System are determined by Federal Reserve authorities, except in form. They are predetermined by debt-management decisions made by the Treasury. This will be true as long as the System is not in a position to pursue an independent policy but must support in the market any program of financing adopted by the Treasury, even though the program may be inconsistent with the monetary and credit policies the System considers appropriate in the public interest.

There have been many proposals for altering the division of authority and responsibility for monetary and debt management in the interest of securing more appropriate policies. These range all the way from proposals that all monetary and debt-management powers be lodged in the Treasury or in a newly created department of money and finance directly responsible to the Government to proposals that all these powers should be lodged in the Federal Reserve. We do not favor either of these extreme proposals. We oppose the concentration of all these powers in the Federal Reserve primarily because we doubt the wisdom of placing one authority in the position of borrower and of determiner of the monetary and credit conditions under which

its borrowing will be done, but also because it seems inappropriate to entrust the technical details of managing the debt to an independent agency. We oppose concentration of all these powers in the Treasury, or in a new department responsible to the President, because we fear that considerations relating to service charges on the Federal debt and to the ease of refunding would be weighed too heavily and would create a bias toward inflexibly low interest rates and continuously easy money. Moreover, we see only a limited value in proposals designed merely to bring Federal Reserve and Treasury officials into frequent consultations; such consultations already occur.

We recommend that three general methods be employed to secure more appropriate monetary and debt-management policies. In the first place, every effort should be made to build up the quality and prestige of Federal Reserve officials. Measures for this purpose should include (a) decreasing the number of members of the Board of Governors from seven to not more than five in order to make the position attractive to more capable men and to lessen the temptation to appoint men of lesser stature, and (b) raising the salary of the Chairman of the Board of Governors to the same level as the salaries of Cabinet members—namely, \$22,500—and raising the salaries of other Board members to \$20,000 a year. Inability to extend such salary increases to certain other officials engaged in bank supervision and examination should not be allowed to prevent Board members from receiving salaries more commensurate with the importance of their functions.

In the second place, we recommend that Congress by joint resolution issue general instructions to the Federal Reserve and the Treasury regarding the objectives of monetary and debt-management policies and the division of authority over these policies. These instructions need not, and in our judgment should not, be detailed; they should accomplish their purpose if they provide, in effect, that, (a) in determining and administering policies relative to money, credit, and management of the Federal debt, the Treasury and the Federal Reserve shall be guided primarily by considerations relating to their effects on employment, production, purchasing power, and price levels, and such policies shall be consistent with and shall promote the purposes of the Employment Act of 1946; and (b) it is the will of Congress that the primary power and responsibility for regulating the supply, availability, and cost of credit in general shall be vested in the duly constituted authorities of the Federal Reserve System, and that Treasury action relative to money, credit, and transactions in the Federal debt shall be made consistent with the policies of the Federal Reserve. We believe that the issues involved here are of such great importance to the people of the United States that Congress should at this time give these further instructions to the Federal Reserve and the Treasury to guide them in the performance of their functions.

In the third place, we recommend that the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System be made members of the National Monetary and Credit Council which we recommend elsewhere in this report.

The "independence" of the Federal Reserve does, of course, create the possibility that the Federal Reserve System might follow policies which were directly at variance with important policies of the execu-

tive department and which might tend to defeat an over-all economic program that met the approval of a majority of the American people. In practice, however, this is not a real danger, and seriously adverse effects from any such development can be guarded against without making the Federal Reserve System more directly responsible to the executive department. Federal Reserve officials are kept fully informed as to the Government's policies; the executive department is perfectly free to make its views and wishes known to the Federal Reserve, and Congress can always use its investigatory and legislative powers to bring about a change in Federal Reserve policies if these should at any time prove to be seriously at variance with important national policies.

The effectiveness of monetary and debt-management policies in simultaneously maintaining relatively stable price levels and maximum production and employment is greatly influenced by the appropriateness of other economic policies, and especially those relating to prices and wages. For example, widespread monopolistic increases in prices and a widespread insistence upon unduly large increases in money wage rates could make it impossible for the monetary authority both to maintain relatively stable price levels and maximum production and employment. If in the face of such price and wage policies it refused to supply more money and credit to finance a rise of price levels, it might produce unemployment. And if it supplied the additional money and credit needed to maintain maximum employment and production it might be financing an upward spiral of prices. The monetary authorities may face such a dilemma in the future unless the attitudes of employers and employees are such that wage and price bargains can be arrived at within the framework of a relatively stable general price level.

IV. RESERVE REQUIREMENTS OF COMMERCIAL BANKS ¹¹

1. *We recommend that all banks which accept demand deposits, including both member and nonmember banks, be made subject to the same set of reserve requirements and that all such banks be given access to loans at the Federal Reserve banks.*

2. *Without endorsing any particular plan, we recommend that serious consideration be given to the Federal Reserve proposal that the present system of member-bank reserve requirements based partly on the size of the city in which a bank is located be replaced by a new system of requirements that would be geographically uniform but that might require different percentages of reserves against different types of deposits.*

Reserve requirements of commercial banks are an essential part of the monetary-management mechanism. The volume of deposits that the banks can create and have outstanding at any time is limited by the dollar volume of legal reserves that they can command and by the height of their legal-reserve requirements. The monetary authorities influence the general monetary and credit situation both by regulating the dollar volume of bank reserves and the terms on which these reserves are made available and by regulating reserve requirements. There are, however, two aspects of the present system of reserve

¹¹ For the further views of Mr. Wolcott, see footnote 2, p. 2.

requirements to which we wish to draw attention: (1) Banks that are nonmembers of the Federal Reserve do not operate under federally determined reserve requirements, and (2) the present reserve requirements against demand deposits at member banks are made to depend on the location of the bank rather than on the type of deposit.¹²

The minimum legal-reserve requirements of banks that are members of the Federal Reserve System, which include all national banks and those State banks that elect to join and can meet the entrance requirements, are fixed by the Board of Governors within limits set by Congress. The reserve requirements of the nonmember banks are fixed by the laws of the 48 States. Thus, as shown by table II, the Federal Government determines the reserve requirements of about 49 percent of the banks holding about 85 percent of all deposits, while the 48 States control the reserve requirements of about 51 percent of the banks holding about 15 percent of all deposits.

TABLE II.—Commercial banks in the United States: Percentage of nonmember banks, by States, June 30, 1949¹³

State	Number of banks	Percent non-member	Percent total deposits held by non-member banks	State	Number of banks	Percent non-member	Percent total deposits held by non-member banks
Mississippi.....	203	84.7	62.0	Utah.....	55	43.6	16.5
Georgia.....	394	83.5	28.9	California.....	204	43.6	8.5
South Carolina.....	150	78.0	32.5	Illinois.....	891	43.2	9.6
North Carolina.....	226	76.1	45.4	Vermont.....	70	42.9	48.1
Iowa.....	665	75.5	48.1	Connecticut.....	114	42.1	31.4
Tennessee.....	295	72.2	22.9	Oklahoma.....	387	41.9	14.0
North Dakota.....	150	72.0	57.4	Maine.....	64	40.6	31.4
Louisiana.....	161	71.4	23.0	West Virginia.....	179	40.2	23.0
Kentucky.....	285	70.9	37.6	Idaho.....	45	40.0	13.5
Arkansas.....	230	70.9	32.1	Colorado.....	147	37.4	11.0
Wisconsin.....	551	70.2	34.0	Texas.....	898	36.6	11.1
Missouri.....	599	69.9	21.6	Ohio.....	662	36.0	11.6
Minnesota.....	682	69.6	28.9	Virginia.....	314	35.0	19.3
Nebraska.....	416	65.6	28.4	New Mexico.....	50	32.0	20.5
Kansas.....	610	64.8	36.0	New Hampshire.....	75	30.7	32.3
South Dakota.....	170	63.5	33.8	Wyoming.....	55	25.5	16.3
Florida.....	190	61.6	23.0	Nevada.....	8	25.0	8.4
Alabama.....	226	59.7	18.1	Montana.....	111	24.3	13.3
Washington.....	122	56.6	7.9	Pennsylvania.....	979	24.0	13.5
Oregon.....	89	56.5	8.2	Massachusetts.....	183	21.9	8.8
Delaware.....	39	56.4	33.7	District of Columbia.....	19	15.8	6.1
Arizona.....	11	54.5	16.5	New Jersey.....	334	15.3	12.5
Maryland.....	163	52.8	26.2	New York.....	648	12.8	4.5
Indiana.....	486	51.8	27.3				
Michigan.....	446	48.2	13.7				
Rhode Island.....	19	47.4	20.0	Total.....	14,150	51.2	15.0

The percentages of reserves that may be required against deposits in member banks under present laws are shown in table III. All of these legal reserves must be in the form of deposits at the Federal Reserve banks; no other assets may be counted for this purpose.

¹² For information and points of view relative to the reserve requirements of commercial banks, see the testimony offered at the open hearings by almost all the witnesses; also see Monetary, Credit, and Fiscal Policies for statements by the Chairman of the Board of Governors of the Federal Reserve System (pp. 54-56, 58-66), by the presidents of the twelve Federal Reserve banks (pp. 134-142, 154-161), and by bankers, economists, and others (pp. 313-321, 327-342).

¹³ This table was included in the testimony of Thomas B. McCabe, Chairman of the Board of Governors.

TABLE III.—*Reserve requirements of member banks*

	Minimum percentage requirement that may be set by the Board of Governors	Maximum percentage requirement that may be set by the Board of Governors
Demand deposits—		
At central Reserve city banks.....	13	26
At Reserve city banks.....	10	20
At other banks (country banks).....	7	14
Time deposits at all member banks.....	3	6

The reserve requirements of the nonmember banks, being determined by the widely varied laws of the 48 States, are very difficult to summarize. In one State there is no legal requirement at all; at the other extreme are States with percentage requirements at least as high as those of member banks. The types of assets that may be counted as reserves also vary widely among the different States, but in general the nonmember banks may count their cash in vault, their deposits with correspondent banks, and in some cases even earning assets such as Government securities. When all these factors are taken into consideration, member-bank reserve requirements are on the average significantly more onerous than those of nonmember banks. In addition to their legally required reserves, all of which must be in the form of nonearning deposits at the Federal Reserve, business necessity requires member banks to hold other nonearning assets in the form of cash in vault, balances with other banks, and cash items in process of collection. But the nonmember banks are permitted to count all of these toward their legal-reserve requirements. As a result, as is shown in table IV, the actual requirements of nonmember banks are, on the average, significantly lower than those of member banks.

TABLE IV.—*Ratio of cash assets to deposits of all insured commercial banks, by class of bank, June 30, 1949—Ratios to total deposits*¹⁴

	Member banks					Insured non-member banks
	Total	Central Reserve city banks		Reserve city banks	Country banks	
		New York	Chicago			
Cash in vault.....	1.3	0.5	0.4	1.1	2.1	2.6
Balances due from banks.....	4.4	.3	2.5	4.0	7.2	14.7
Cash items in process of collection.....	8.1	9.3	5.8	5.9	1.9	.6
Subtotal.....	10.8	10.1	8.7	11.1	11.2	17.9
Reserves with Federal Reserve banks.....	15.2	20.0	19.3	15.5	11.8	-----
Total, cash assets.....	26.0	30.1	28.0	26.5	23.0	17.9

Many have proposed that the existing discrepancies between the reserve requirements of member banks and those of nonmember banks should be ended, either by requiring all banks that hold demand deposits, or at least all such insured banks, to become members of the

¹⁴ This table was submitted at the hearings by the Chairman of the Board of Governors of the Federal Reserve System.

Federal Reserve System or by requiring all of these banks, even the nonmembers, to hold the same reserves as member banks. Several arguments are used to support this proposal that all commercial banks, or at least all insured commercial banks, should be governed by the same set of reserve requirements: (1) The fact that more than half of all the banks and about 15 percent of all deposits are outside the Federal Reserve System and not subject to its reserve requirements or to changes in these requirements directly decreases the effectiveness of Federal Reserve policies. (2) The present arrangement is inequitable in that the nonmember banks bear less than their fair share of the cost of monetary management. The holding of nonearning reserves is in a sense a necessary cost of monetary control, but at the present time the member banks have to carry more than their fair share. (3) The lower reserve requirements of nonmember banks in addition to other less onerous provisions may lead to withdrawals of banks from the Federal Reserve System; they create ill will and discontent among member banks, and fear of these adverse reactions may deter Federal Reserve officials from raising reserve requirements when this should be done. Among the evidence presented to the subcommittee by Chairman McCabe to show that there is a real basis for these contentions was the following letter from H. G. Leedy, president of the Federal Reserve Bank of Kansas City:

It is sometimes said that the effectiveness of the Federal Reserve System is not reduced significantly by the presence of nonmember banks, as member banks hold 85 percent of all bank deposits in this country, leaving only 15 percent not directly subject to Federal Reserve influence. This statement greatly understates the problem.

Recently, one of our officers visited with a banker in a small town who is operating a national bank, and therefore a member bank. His competitor across the street is a State nonmember bank. The national banker indicated that there was serious question in his mind as to whether he should carry or could afford to carry the cost of being a member bank when he was trying to compete with an institution across the street that did not have to meet those particular costs. He not only thought that it was not fair and equitable, but he indicated serious doubt as to whether it was good judgment on his part to operate his bank as a member bank in that kind of competitive situation. This conversation is only one example of a host of similar conversations that we have had.

Repeatedly, we hear our member bankers raising serious question as to whether it is either equitable or good judgment for them to incur the additional dollar cost that is involved in being a member bank, and we hear nonmember banks commonly giving that increased cost as a reason for not joining the Federal Reserve System. Recently, a member bank withdrew from the Federal Reserve System, and in a letter to this bank made the following statement: "In this action we want to assure you that there is absolutely no ill feeling, as our association and business dealings have all been most pleasant, but it was thought that keeping such a large reserve with the Federal Reserve worked quite a hardship on us, and precluded our investing State and county funds in bonds, as we are required to keep the reserve with you on such deposits."

We also must recognize that part of the effectiveness of Federal Reserve credit action stems from the indication it gives of the viewpoint of the monetary authorities with respect to credit developments. An increase in member-bank reserve requirements, for example, not only immobilizes part of a member bank's reserves but it also makes the member bank acutely conscious of the fact that the Federal Reserve officials think that credit expansion should be restrained. This in itself, I am convinced, tends to make member banks more selective in their extension of credit to customers. On the other hand, nonmember banks not only do not have that additional part of their reserve immobilized, but the Federal Reserve's expression of its attitude with respect to further credit expansion has little effect upon the nonmember banks' lending policy. In our Federal Reserve district, with 1,009 nonmember banks as compared with 759 member banks, this means that the lending policy of the vast majority of banks, and in some areas of the district nearly all banks, are affected little, if at all, by Federal Reserve credit actions.

The proposal to bring all commercial banks, or at least all of these banks that are insured, under the same set of reserve requirements is opposed on several grounds: (1) It is not necessary for effective monetary control; the Federal Reserve already has control over the reserve requirements of banks holding 85 percent of total deposits. (2) For the Federal Government to impose such requirements on State banks that do not elect to join the Federal Reserve would be a violation of States' rights and a threat to the dual banking system. (3) In fact, very few banks have withdrawn from the Federal Reserve because of its higher reserve requirements. (4) The imposition of such reserve requirements on nonmember banks would injure the large city banks by reducing interbank deposits. And (5) the present arrangement is a check on the imposition of "excessively high" reserve requirements on member banks, for Federal Reserve officials will be deterred from such a course by their fear of losing members and their feeling that such action would be inequitable to their members.

Without taking any position as to what the ultimate decision should be, we do not at this time recommend that all commercial banks, or even all insured commercial banks, should be required by law to become members of the Federal Reserve System. This question is part of a much broader one that we recommend for thorough study. We do, however, recommend that all banks that accept demand deposits, including both member and nonmember banks, be made subject to the same set of reserve requirements and that all such banks be given access to loans at the Federal Reserve banks. We do not believe that such a requirement would in any way threaten either States' rights or the continuance of the dual banking system. The States would retain their right to charter and supervise banks, and the banks would be able to meet the reserve requirements and still prosper, just as State-chartered banks that elected to join the Federal Reserve have done in the past. The extension of these requirements would enhance the effectiveness of Federal Reserve policies and would remove unwarranted limitations on the justified use of Federal Reserve powers. The granting of access to Federal Reserve credit, which is the ultimate source of liquidity in time of strain, to nonmember as well as member banks would serve a very useful purpose not only in periods of crisis but also during periods of recession. This would be useful to the economy as a whole as well as to nonmember banks.

Another aspect of reserve requirements to which we wish to call attention is the geographical basis of member bank reserve requirements against demand deposits (see table III above). The height of the requirement depends not on the type of deposit but on the size of the city in which the bank is located. This basis for graduating reserve requirements was carried over from the pre-1914 laws governing national banks, and the original justification was that country banks held few deposits for other banks, that many banks located in larger cities held deposits of country banks, and that a big majority of the banks in the largest cities held deposits of both country banks and banks located in reserve cities. The present reserve provisions are subject to criticism on two counts. In the first place, net movements of deposits between banks with different levels of reserve requirements can produce an unwanted tightening or loosening of credit.

And in the second place, banks of similar size and doing similar types of business may be subject to quite different reserve requirements. For example, a small bank located in New York or Chicago and holding no deposits of other banks must hold reserves almost twice as large, percentagewise, as a similar bank located in any city that has not been designated as a central reserve or reserve city bank. And a country bank which does hold deposits of other banks is required to hold only about half as large reserves as are required of a similar bank located in a central reserve city. For some time the Federal Reserve has been studying proposals that would abolish the present system of reserve requirements based on the geographic location of banks and substitute a system of geographically uniform requirements based on the type of depositors. For example, there might be one requirement against interbank deposits, another against other demand deposits, and another against time deposits. Without endorsing any particular plan, we believe that the general idea behind the proposal has merit and that it should be given serious consideration.

V. FEDERAL CHARTERING, SUPERVISION, AND EXAMINATION OF COMMERCIAL BANKS

We recommend a thorough and complete study of the broad question of Federal chartering, supervision, and examination of commercial banks, including not only the organization and coordination of the Federal agencies performing these functions but also the substance and applicability of the relevant Federal laws and regulations.

Federal activities in the chartering, supervision, and examination of commercial banks are divided among three Federal agencies with overlapping jurisdiction—the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation. Owing to voluntary agreements among these agencies and the 48 State supervisory authorities there is less confusion and duplication of effort than might be expected from such overlapping jurisdictions; nevertheless, there is evidence that a thorough study is needed. The present arrangement, though not without its merits, involves an undetermined amount of waste because of duplication of facilities and supervisory personnel; it does not promote the development of uniform supervision and examination policies, and there is evidence that on some occasions the different agencies have been guided by different concepts as to the purpose of bank supervision and examination; it does not facilitate coordination of policies; and there is evidence of interagency rivalry of types that do not contribute to the development of a better banking system.

The study should also cover the substance and applicability of the relevant Federal laws and regulations. The substance of these laws and regulations have long needed an over-all review, and the method of determining their applicability should also be studied at length. Under the present plan, only a relatively small number of Federal banking laws and regulations apply to all classes of banks regardless of their classification. (See IV in table V.)

TABLE V.—*Some of the principal provisions of Federal statutes regulating the principal classes of banks*

- I. Applicable only to national banks:
 1. Restrictions on real-estate loans.
 2. Regulations governing the exercise of trust powers.
 3. Restrictions on acting as insurance agent.
 4. Restrictions on acting as real-estate loan broker.
 5. Requirement that one-tenth of earnings be transferred to surplus until surplus equals common capital.
 6. Prohibition against holding other real estate for more than 5 years.
 7. Restrictions on absorption of another bank.
 8. Limitations on indebtedness which bank may incur.
- II. Applicable only to national banks and to State banks that are members of the Federal Reserve:
 1. Limitations on total loans to one borrower. (State member bank loans to one borrower are not subject to the limitations applicable to national banks, but loans in excess of the limits applicable to national banks are not discountable at the Federal Reserve.)
 2. Regulations governing purchase of investment securities.
 3. Prohibition against purchasing stocks.
 4. Prohibition against engaging in underwriting of investment securities and stocks.
 5. Restrictions on loans to executive officers.
 6. Restrictions on dealings with directors.
 7. Restrictions on interlocking directorates or other interlocking relations with other banks and with securities companies.
 8. Prohibition against bank having less than 5 or more than 25 directors.
 9. Provision authorizing supervisory authority to remove officers and directors for continued violations of law or continued unsafe or unsound practices.
 10. Prohibition against affiliation with securities company.
 11. Restriction on holding companies affiliates.
 12. Restrictions on bank stock representing stock of other corporations.
 13. Limitations on loans to affiliates.
 14. Requirements of reports of affiliates and publication thereof.
 15. Requirements for examination of affiliates.
 16. Limitations on investment in bank premises.
 17. Minimum capital requirements.
 18. Minimum capital requirements for branches.
 19. Prohibitions against loaning on or purchasing own stock.
 20. Restrictions on withdrawal of capital and payment of unearned dividends.
 21. Requirement that reserves specified in the Federal Reserve Act be maintained.
 22. Requirement for specific number of condition reports annually and for publication thereof.
 23. Requirements in connection with the par clearance collection system.
 24. Prohibition against false certification of checks.
 25. Limitations on acceptance powers.
 26. Prohibition against acting as agent for nonbanking institutions in making loans to brokers and dealers in securities.
 27. Limitations on loans to one borrower on stocks or bonds.
 28. Limitations on aggregate loans to all borrowers on stocks or bonds.
 29. Limitations on deposits with nonmember banks.
- III. Applicable to national banks, State member banks, and nonmember banks insuring their deposits with the FDIC:
 1. Requirement for approval of establishment of branches.
 2. Restriction on consolidating or merging with noninsured bank, assuming liability for such bank's deposits, or transferring assets to such bank for assumption of deposits.
 3. Restrictions on payment of interest on deposits.
 4. Restriction on paying time deposits before maturity or waiving notice before payment of savings deposits.

TABLE V.—*Some of the principal provisions of Federal statutes regulating the principal classes of banks—Continued*

- III. Applicable to national banks, State member banks, and nonmember banks insuring their deposits with the FDIC—Continued
5. Prohibition against payment of dividends while delinquent on deposit insurance assessment.
 6. Prohibitions against loans or gratuities to bank examiners.
 7. Provision authorizing supervisory authority to publish examination report if bank does not follow recommendations based thereon.
 8. Provision authorizing supervisory authority to require that banks provide protection and indemnity against burglary, defalcation, and similar insurable losses.
- IV. Applicable to all banks:
1. Provisions regulating loans for the purpose of purchasing or carrying securities registered on national securities exchanges.
 2. Laws granting certain tax advantages in connection with the operation of a common trust fund if operated in conformity with the regulations of the Board of Governors.

Source: Based on a chart in *Banking Studies*, a publication of the Board of Governors of the Federal Reserve System.

Most of them become applicable only if a bank voluntarily elects to submit itself to them. For example, if a bank elects to operate under a national rather than a State charter it subjects itself to all the items under I, II, III, and IV in this table, for a national bank is required to join the Federal Reserve and the Federal Deposit Insurance Corporation. It can, however, escape the Federal rules under I by taking out a State charter and by the same action retain its freedom to determine whether to subject itself to II and III. Likewise, a State-chartered bank can avoid the rules under II by electing not to become a member of the Federal Reserve, and it can avoid the rules under III by electing not to join the Federal Deposit Insurance Corporation. This system under which a bank itself determines which Federal laws and regulations will apply to it merits a review. But even if this general system is found to be desirable, there remain questions regarding the reasonableness of the present applicability of specific Federal laws and regulations. For example, II of this table, which indicates the principal Federal provisions to which a bank subjects itself by electing to join the Federal Reserve, contains many requirements that are only remotely related to general monetary and credit control but which are designed to promote bank safety and liquidity, to assure a fair distribution of credit, and to maintain competition and prevent monopoly in banking. It is not at all clear why these provisions should be attached to membership in the Federal Reserve rather than to membership in the Federal Deposit Insurance Corporation which should have a special interest in promoting bank safety and liquidity. The present arrangement seems to imply that monopoly among banks that are not members of the Federal Reserve is not objectionable, and it gives rise to many cases in which banks have enough capital and are safe enough to have their deposits insured by the Federal Deposit Insurance Corporation but still cannot meet the stricter requirements for membership in the Federal Reserve. There seems to be no justification for this, or for a number of other similar results of the present provisions. We believe, therefore, that a thorough study is needed.

VI. MONETARY POLICY RELATIVE TO SILVER

We recommend that the United States Government cease buying silver for monetary purposes.

Table VI shows that since 1933 the Government has purchased for monetary purposes 2,736,800,000 ounces of silver at a total cost of \$1,509,400,000. Though a major part of this silver was purchased abroad and a small part represents nationalized silver that was being held in this country at the time of the Silver Purchase Act of 1934, nearly a fifth of it by volume and over a quarter of it by cost to the Government represents newly mined domestic silver, and only newly mined domestic silver has been purchased since 1942. At all times the price paid by the Treasury for newly mined domestic silver has been significantly above the price it paid for other silver. The average prices per ounce paid for the nationalized and foreign silver were 50 cents and 50.1 cents, respectively, while the prices paid for newly mined domestic silver have been as follows:

Period:	Price per ounce (cents)
1934-Apr. 9, 1935.....	64.64
Apr. 9-23, 1935.....	71.11
Apr. 23, 1935-Dec. 31, 1937.....	77.57
Dec. 31, 1937-July 1, 1939.....	64.64
July 1, 1939-July 2, 1946.....	71.11
July 2, 1946.....	90.50

It is clear that the Government's silver purchase policy has represented a subsidy to silver producers and that the full amount of the subsidy is not indicated by the difference between the Treasury purchase price for newly mined domestic silver and the price of silver in the market, for in the absence of Treasury purchases the market price itself would have been lower.

TABLE VI.—Silver production in the United States and silver purchases by the Government

[In millions]

Year	Silver production in the United States (ounces)	Silver acquired by U. S. Government						Total	
		Newly mined domestic silver		Nationalized silver		Foreign silver		Ounces	Dollars
		Ounces	Dollars	Ounces	Dollars	Ounces	Dollars		
1934.....	32.5	21.8	14.1	110.6	55.3	172.5	86.5	304.9	155.9
1935.....	45.6	38.0	27.3	2.0	1.0	494.4	318.2	534.3	346.5
1936.....	63.4	61.1	47.3	.4	.2	271.9	150.3	333.4	197.8
1937.....	71.3	70.6	54.6	.....	.....	241.5	108.7	312.2	183.3
1938.....	61.7	61.6	42.4	.....	.....	355.4	156.9	417.1	199.1
1939.....	63.9	60.7	40.1	.....	.....	282.8	120.5	343.3	160.6
1940.....	67.0	68.3	48.5	.....	.....	139.8	60.9	208.0	99.4
1941.....	71.1	70.5	50.1	.....	.....	72.6	27.1	143.1	77.2
1942.....	55.9	47.9	34.0	.....	.....	14.3	6.0	62.1	40.0
1943.....	40.8	5.5	3.9	.....	.....	.....	.....	5.5	3.9
1944.....	35.7	.....	.....	.....	.....	.....	.....	.....	.....
1945.....	29.3	.9	.6	.....	.....	.....	.....	.9	.6
1946.....	21.4	4.9	4.4	.....	.....	.....	.....	4.9	4.4
1947.....	38.1	30.3	27.4	.....	.....	.....	.....	30.3	27.4
1948.....	38.1	36.8	33.3	.....	.....	.....	.....	36.8	33.3
Total.....	731.8	578.9	428.0	113.0	56.5	2,045.2	1,025.1	2,736.8	1,509.4

Source: Treasury bulletins.

Under present laws the Treasury is required to purchase at 90.5 cents an ounce all newly mined domestic silver that is offered to it, and since this price is considerably above the market level of 70-73 cents, practically the entire domestic output is going to the Government. Only a very small part of this purchase silver is used to supply the public's demand for subsidiary silver coins and silver dollars; most of it is used as a basis for issuing additional paper money in the form of silver certificates. In the very process of buying the silver and issuing new money in exchange for it the Treasury tends to add to the volume of bank reserves and to expand credit, for in the absence of a demand on the part of the public for more coin and currency the new paper money will flow to the Federal Reserve banks and be added to member bank reserves.

The present monetary policy relative to silver is objectionable on several grounds. (1) It is unnecessary. The Federal Reserve already has the power to expand the money supply, including both paper money and deposits, far beyond any needs that are now expected to arise. The issue of silver-based money tends to lessen the issue of money by the Federal Reserve, which reduces Federal Reserve bank net earnings and also Federal Reserve payments of net earnings to the Treasury. This indicates the error in the argument of those who defend the silver purchase program by saying: "It doesn't cost the Government anything; actually the Government makes a profit equal to the seigniorage." The fact is, however, that if the silver were not purchased the Government could issue other types of paper money instead of paper money in the form of silver certificates and thereby profit on the entire amount of the issue rather than on only the seigniorage. The silver purchase program is a net expense to the Government. (2) It is continuously expansionary and in practice irreversible. The Treasury must buy all silver offered to it and issue new money at all times, during inflation as well as under other conditions. Not only is the Treasury prevented from selling silver freely in order to exert an anti-inflationary effect, it is not even permitted to cease these expansionary purchases in the midst of inflation. (3) Even as a subsidy program it is defective. It grants aid to producers without any test as to whether aid is needed, it finances the aid during all phases of the business cycle in the most expansionary way possible, and it locks up the subsidized production in the monetary system and makes it unavailable for industrial, artistic, and other uses.¹⁵

VII. THE RESTORATION OF A GOLD-COIN STANDARD IN THE UNITED STATES

We believe that to restore the free domestic convertibility of money into gold coin or gold bullion at this time would militate against, rather than promote, the purposes of the Employment Act, and we recommend that no action in this direction be taken. We also recommend a thorough congressional review of existing legislation relating to the power to change the price of gold with a view to repealing any legislation that might be so construed as to permit a change in the price of gold by other than congressional action.

¹⁵ The committee print, *Monetary, Credit, and Fiscal Policies*, contains statements on silver by the Secretary of the Treasury (p. 12), the Chairman of the Board of Governors of the Federal Reserve (p. 52), the presidents of the 12 Federal Reserve banks (pp. 131-132), and a number of economists, bankers, and others (pp. 353-357).

Since 1934 the United States has been on an international gold bullion standard; gold may be held or dealt in only in accordance with rules prescribed by the Secretary of the Treasury, but in practice the Treasury sells gold freely to meet all bona fide demands for domestic industrial, commercial, and artistic purposes, and it provides gold for export to the extent necessary to prevent the dollar from declining in foreign-exchange markets. It does, however, place some limitations on gold exports and it prohibits the use of gold domestically for monetary or hoarding purposes. Some have proposed the reestablishment of an unlimited gold-coin standard; they would require the Government to provide unlimited redeemability of its money into gold and to remove all limitations on holding and dealing in gold. This proposal is usually supported by the following principal arguments: (1) Only a money that is freely redeemable in gold is an "honest" money. (2) To restore free redeemability would restore to the people of the country an effective method of preventing monetary and fiscal abuses by the Government. In a statement presented to the subcommittee, Prof. Walter E. Saphr put this argument in the following terms:

Redeemability gives every individual with dollars the opportunity, to the extent of his purchasing power, to get the standard metal if he prefers that to the promises to pay it. This enables him to exercise some control over the use by his Government and banks of the people's gold and over the amount of promises these agencies may issue. If either or both issue promises to an extent that invites lack of confidence, every individual, to the extent he has dollars, can express his lack of confidence. His demand for redemption is his right, if the promise means anything. It is his effort to protect his savings against men's uncertain promises. His demand for redemption is a red flag of doubt. If many red flags appear, the banks, the Treasury, and Congress receive warnings and must call a halt or exercise greater restraint in their use of the people's money. In this manner redeemability provides a people with control over the Government's use of their purse.

The gold standard with provision for redemption in effect provides a system of golden wires to every individual with dollars, over which he can send messages of approval or disapproval to the central signal board. When our Government took the people's gold and thrust irredeemable promises to pay on them, it cut all these wires to the central signal box. The people were cut off. The lights went out on the central signal system and the people were left helpless. Thus absolute control of the people's gold and public purse passed to their Government. The latter had freed itself from receipt of signals of disapproval and from any effective check. The spending orgy is the result. Vote buying goes on and can go on without let or hindrance. The people are helpless; the Government is the boss; irresponsibility is in the saddle and it cannot be checked. The understanding, concerned, and responsible men in Congress are in the minority and are helpless. Government spending and bureaucracy are out of control. Apparently this course cannot be brought to a halt except by restoring to our people control over their purse. That can be done only by the institution of redeemability of the promises to pay of the Treasury and banks.¹⁶

And (3) for the United States to return to an unlimited gold coin standard would set a good example for the rest of the world and would hasten the reestablishment of a world-wide gold standard and of a system of free multilateral payments in international trade.

An "honest money" in the sense of a money that maintains a relatively constant purchasing power is essential to the attainment of the purposes of the Employment Act; maximum production, employment, and purchasing power cannot be continuously maintained over a period of time if either serious deflation or serious inflation is allowed to occur. But we do not believe that the restoration of unlimited convertibility of our money into gold would be either an appropriate or an effective method of promoting stability of price levels and of

¹⁶ *Monetary, Credit, and Fiscal Policies*, pp. 361-362.

the purchasing power of the dollar. It probably could not prevent a serious inflation in this country if other pressures were inflationary. This is primarily because of this Nation's extremely strong gold position, the almost chronic tendency for gold to flow to our shores, and the normal unpopularity of gold coin as a medium of payments here. The monetary gold stock of the United States has reached the huge total of about \$24,500,000,000, the Federal Reserve banks could more than double the outstanding volume of their deposits and notes without even suspending their reserve requirements, and the present monetary gold stock could support at least a threefold increase in the money supply. With the present strength of our international economic position, inflation here could probably reach very serious proportions before we began to lose gold reserves to other countries. Nor is it at all certain that an internal drain of gold would occur before the inflation had reached serious proportions. Even before 1933 Americans were not in the habit of using gold coin to any extent as a means of payments. (See table VII.) Any significant demand for gold would be a speculative demand based upon fear or hope that dollars in general would become inconvertible into gold, and such hopes or fears would probably not be generated before a high degree of inflation had already occurred.

TABLE VII.—Gold coin and gold certificates in circulation outside the Treasury and Federal Reserve banks

[In millions of dollars]

June 30	Gold coin	Gold certificates	Total currency plus demand deposits	Gold coin in circulation as a percent of total currency and demand deposits
1914.....	325	1,026	11,615	2.8
1920.....	183	259	23,721	.8
1925.....	111	1,005	24,949	.4
1926.....	105	1,057	25,601	.4
1927.....	98	1,007	25,539	.4
1928.....	90	1,019	25,881	.3
1929.....	81	935	28,179	.3
1930.....	70	995	25,075	.3
1931.....	76	997	23,483	.3
1932.....	166	716	20,241	.8
1933.....	284	649	19,172	1.5

¹ End of February.

In short, the restoration of free convertibility of our money into gold would be neither a reliable nor an effective guard against serious inflation. For this purpose there can be no effective substitute for responsible monetary, credit, and fiscal management. There is no reason to believe that a requirement of redeemability into gold would promote wise monetary and credit policies; in fact, past experience indicates that it would at times endanger such policies, for gold drains can be induced by deflation as well as by inflation. For example, the internal gold drains and gold hoarding in 1932 and 1933 probably contributed somewhat to deflationary pressures in this country. We concur in the following statement by the Chairman of the Board of Governors of the Federal Reserve System:

An overriding reason against making gold coin freely available is that no government should make promises to its citizens and to the world which it would

not be able to keep if the demand should arise. Monetary systems for over a century, in response to the growth in real income, have expanded more rapidly than would be permitted by accretions of gold. In the United States today our gold stock, although large, is only 15 percent of the economy's total holdings of liquid assets. The retention of a gold base is desirable in order to maintain international convertibility, and a gold-standard system has therefore evolved in which the various forms of money and near money in the country are ultimately convertible to gold, where that is necessary to meet the country's international obligations. Return to a gold-coin standard, however, would clearly expose the economy to the risk of drastic and undesirable deflation at times of high speculative demand for gold for hoarding, or else the Government would have to withdraw its promise of gold convertibility. Conjecture as to the possibility of such a withdrawal would stimulate a speculative demand for gold and might precipitate the event feared. The long-run effect would be to weaken rather than to strengthen confidence in the dollar.¹⁷

The restoration by other countries of the free redeemability of their moneys into gold coin for internal hoarding as well as for other purposes would delay and hinder, rather than promote, the abolition of exchange restrictions and the restoration of a system of free multilateral international payments, for it would mean that a part of the gold reserves of those countries would be drained off into private hoards and would not be available to meet adverse balances in international payments.

VIII. DEPOSIT INSURANCE

We recommend that Congress, while considering questions relating to the base and rate for deposit insurance premiums, also study thoroughly the advantages and disadvantages of increasing the coverage of deposit insurance for the primary purpose of protecting the economy against the adverse deflationary pressures that would accompany cash withdrawals from the banking system during any depression period that may occur, and that no changes in deposit insurance premiums be made until after the completion of the study.

The insurance of bank deposits by a Federal agency was first initiated in 1933 at the end of a period in which thousands of banks had failed, billions of dollars of depositors' money had been lost or frozen, huge withdrawals of cash had seriously depleted bank reserves, depositors were afraid to entrust their money to banks, and bankers were afraid to make loans and reduce their liquidity. Deposit insurance therefore had a multiple purpose: (1) To restore confidence so that depositors would not only refrain from resuming their runs on the banks when they reopened but would actually start a return flow of cash, and also so that bankers would again feel safe in making loans; (2) to offer full protection to small depositors who could not be expected to be able to judge the quality of a bank; and (3) to provide better supervision and examination for the thousands of banks that were not members of the Federal Reserve System and that displayed a very high failure rate. Thus the original and continuing purpose of deposit insurance is not only to protect depositors against losses on their accounts but also to improve the quality of banking and to promote general economic stability by preventing runs on banks with the attendant drain of bank reserves.

Though the present plan for deposit insurance has contributed to a strengthening of the banking system it has potentially serious shortcomings as a means of preventing runs on the banking system in times

¹⁷ Monetary, Credit, and Fiscal Policies, p. 51.

of depression. This grows out of the fact that nominally only the first \$5,000 of each deposit account is insured by the FDIC. In actual practice, however, the coverage varies with the procedure followed by the FDIC in handling the affairs of a failed insured bank. The law provides the FDIC with three alternative procedures in such cases. (1) It may secure from the Comptroller of the Currency a charter for a Deposit Insurance National Bank. Such a bank may not operate for more than 2 years, it may only pay out and receive deposits and invest its funds in Governments, and it may not perform other banking functions; in effect, it is only a paying agent for the FDIC. When this method is used, and it has been on only one occasion, only the first \$5,000 of each deposit account is covered by insurance. (2) It may allow the bank to go into receivership. When this method is used the FDIC verifies deposit accounts at the bank, pays each depositor up to a maximum of \$5,000, and shares on a pro rata basis with the unpaid depositors in the amounts realized on the bank's assets. This method has several disadvantages. The first is that realizations on the assets of a failed bank may be small. The costs of receivership are sometimes large, the disposal of assets at "forced sale" frequently leads to only small recoveries, and some borrowers make little effort to meet their obligations when they know that the bank will not exist as a future source of loans. In the second place, the liquidation of a bank may leave the community without any, or with only inadequate banking facilities. And in the third place, the use of this method often means that deposit accounts in excess of \$5,000 are frozen for a considerable period and subject to an eventual loss. A community may suffer seriously when the deposit accounts of its business concerns are frozen and partially lost. This receivership method, though employed during the early period of the FDIC's operations, has not been used for several years. (3) For a number of years the FDIC has relied exclusively on the merger method. Under this power it may make a loan to the bank, or purchase assets from it, or guarantee another insured bank against loss from the assumption of the liabilities and assets of the bank, provided that two conditions are met: (a) Such action will facilitate a merger or consolidation with another insured bank, and (b) in the judgment of the board of directors of the FDIC the risk of loss to the Corporation will be reduced or averted. When this method is employed another insured bank assumes all the liabilities of the bank in difficulty and is protected against loss by the FDIC. All depositors are fully protected against loss, no deposit account is frozen, and the community is not deprived of banking power.

In short, coverage under the present deposit insurance plan depends on the method used by the FDIC to handle the affairs of an insured bank in financial difficulties. The coverage is limited to \$5,000 for each account under the receivership method, but there is unlimited coverage when the merger method is used. And no depositor can predict which method will be employed if his bank fails. Moreover, there is no assurance at all that the 100-percent coverage of bank deposits which has actually been in effect during the past few years can be continued in a period of depression, for under depressed conditions it might be impossible to find other insured banks that were willing to assume the liabilities of failed banks, even with FDIC assistance. A system of deposit insurance with unlimited coverage

during prosperity and a limit of \$5,000 for each account in depression periods cannot promote stability to the maximum. This suggests the desirability of reviewing the methods of payment and the coverage of insurance by the FDIC.

Experience during the early 1930's indicates that a \$5,000 coverage may not be adequate to prevent serious runs on the banks during disturbed periods. The available evidence suggests that large deposit balances were more responsible than small ones for the crippling cash withdrawals during the period. An investigation covering 67 banks which suspended between November 1930 and March 1933 showed:

1. From the time that serious deposit withdrawals began until the date on which they suspended, the banks included in the survey experienced an average reduction of almost 40 percent in their deposits.

2. In most of the banks demand deposits showed somewhat larger percentage reductions than time deposits, and interbank deposits showed much sharper reductions than either demand or time.

3. A decrease of 70 percent took place in the balances of demand deposit accounts of \$100,000 and over. The magnitude of the percentage decline in balances tended to decrease in each successively smaller size class, and became negligible in accounts of less than \$200. Large demand deposits were a very important factor in withdrawals of deposits both because of their proportionate magnitude and because they were reduced much more sharply than smaller deposits. In the sample group of banks as a whole, reductions in the balances of accounts of \$25,000 and over accounted for 43 percent of the total decrease in demand deposits, although demand deposits of this size accounted for only 28 percent of the total demand deposits on the date from which decreases were measured. Accounts of this size were reduced 64 percent, as contrasted with a reduction of 40 percent in total demand deposits, and a reduction of 6 percent of the balances of accounts of less than \$500.

4. The most important factor in explaining differences in the variability of demand deposit balances in time of stress is apparently the size of the balance. The influence of other factors, such as type of deposit (demand or time), residence of holder (local or nonlocal), or type of holder (business or personal), seems to be of comparatively minor importance.¹⁸

There appears to be no reason to believe that similar withdrawals of large deposits in excess of the \$5,000 formal limit may not occur in future disturbed periods in the absence of clear assurances that they will be covered by insurance. Although 96 percent of all deposit accounts are fully covered within the \$5,000 limit, about 54 percent of the total volume of deposits would remain uncovered if the \$5,000 maximum were actually adhered to.

We recommend that Congress, while considering questions relating to the base and rate for insurance premiums, study thoroughly the advantages and disadvantages of increasing the coverage of deposit insurance for the primary purpose of preventing cash withdrawals from the banking system during any future depression periods that may occur, and that no change be made in deposit insurance premiums until after the study is completed.

IX. OTHER FEDERAL CREDIT AGENCIES

1. *We recommend that Congress review the programs and policies of the various Federal credit agencies to find out to what extent if at all they can be made to contribute more to the purposes of the Employment Act without an undue sacrifice of the substantive programs to which they are related.*

¹⁸ Quoted from the March 1939 Federal Reserve Bulletin by the Chairman of the FDIC in a statement to the subcommittee. Monetary, Credit, and Fiscal Policies, pp. 208-209.

2. We recommend that the head official of each of the most important agencies in this group be included on the National Monetary and Credit Council, which we recommend elsewhere in this report.

As indicated earlier, many federally sponsored credit agencies lend and insure loans to private borrowers. (See Table I, pp. 7 and 8.) These include numerous agricultural and housing credit agencies, the Reconstruction Finance Corporation, the Veterans' Administration, the Federal Reserve banks, the Export-Import Bank, the Economic Cooperation Administration, and a few others. In the aggregate, the loans and guaranties of these agencies are very large. According to an estimate of the Bureau of the Budget, the following situation prevailed on June 30, 1949:

Status of major Federal loan, loan guarantee, and loan insurance programs, June 30, 1949

[In millions of dollars]

Loans:		
Outstanding	-----	9, 053
Commitments to lend	-----	2, 192
Total	-----	<u>11, 245</u>
Guaranties and insurance:		
Outstanding	-----	12, 582
Commitments	-----	2, 680
Total	-----	<u>15, 262</u>
Grand total	-----	<u>26, 507</u>

Outstanding loans and loan guaranties amounted to \$21,634,000,000 and commitments to lend or guarantee loans amounted to another \$4,872,000,000, for a grand total of \$26,507,000,000. Those agencies with a stated limit on their activities still had \$8,808,000,000 of uncommitted authority to lend or guarantee loans. Between June 30 and the end of October Congress enlarged this commitment authority by \$3,876,000,000, and the President may at his discretion add still another \$2,000,000,000.

In view of the magnitude of their operations, it is clear that these agencies exert a strong influence on the behavior of the economy, and that this influence can be toward either stability or instability. By lending and guaranteeing loans on liberal terms during depressed periods and by following more restrictive policies in periods of high employment they can be an influence toward general economic stability and can assist flexible monetary and fiscal policies. But by following quite liberal policies at all times they may actually contribute to instability and at least partially defeat appropriate monetary and fiscal policies.

We recommend that Congress review the programs and policies of the various Federal credit agencies to find out to what extent if at all they can be made to contribute more to the purpose of the Employment Act without an undue sacrifice of the substantive programs to which they are related. We also recommend that the head official of each of the most important agencies in this group be included on the National Monetary and Credit Council, which we recommend elsewhere in this report.

X. A NATIONAL MONETARY AND CREDIT COUNCIL¹⁹

We recommend the creation of a National Monetary and Credit Council which would include the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the heads of the other principal Federal agencies that lend and guarantee loans. This Council should be established by legislative action, should be required to make periodic reports to Congress, and should be headed by the Chairman of the Council of Economic Advisers. Its purpose should be purely consultative and advisory and it should not have directive power over its members.

The National Advisory Council on International Monetary and Financial Problems has performed a useful function relative to foreign lending. We believe that a similar Council to deal with domestic monetary, credit, and debt management problems would also serve a useful purpose. It could keep each of the various agencies informed as to the problems and policies of the others, it could provide a forum for the discussion of common problems, it could solve some disagreements by negotiation and serve as a means of bringing others to the attention of the President, and it could call the attention of Congress to the types of legislation needed in order to secure more appropriate and better coordinated policies.

There are two principal reasons for recommending that the Monetary and Credit Council should be headed by the Chairman of the Council of Economic Advisers. The first is that the head of such a Monetary and Credit Council should be free from any bias that might go with being head of an agency which is charged with the primary responsibility for administering a substantive program as are, for example, the Treasury, the Federal Reserve, and the housing finance agencies. The second is that this function is in line with the primary function of the Council of Economic Advisers as economic adviser to the President. The over-all view possessed by the Chairman of the Council of Economic Advisers, his knowledge of the Government's entire economic program, and his study of all the principal monetary and credit policies should make him an effective head of the Monetary and Credit Council, just as his work in the latter capacity should assist the work of the Council of Economic Advisers and enable him to take promptly to the President any problems that merited his attention.

XI. A COMPREHENSIVE STUDY OF MONEY AND CREDIT

1. We recommend that the Joint Committee on the Economic Report, as well as the Banking and Currency Committees of the Senate and of the House of Representatives, continue a thorough and complete study of the monetary and credit systems and policies of the United States, and that they be provided with funds adequate for the purpose.

2. We recommend that S. 1559, which would provide for the establishment of a National Monetary Commission, be not enacted.

This subcommittee believes that its study of monetary, credit, and fiscal policies has been thorough and complete enough to justify the recommendations made in this report. There are, however, a large

¹⁹ For the further views of Mr. Wolcott, see footnote 3, p. 4.

number of important subjects in these general fields which lack of time and resources prevented us from studying thoroughly but which merit further investigation. We therefore recommend that the Banking and Currency Committees of the two Houses of Congress and the Joint Committee on the Economic Report be given adequate funds for the purpose and that they be requested to make a comprehensive study of the monetary and credit systems and policies of the United States. We believe it important that the study be made by a committee composed exclusively of Members of Congress rather than, as proposed in S. 1559, by a mixed commission composed of Members of Congress, members of the executive department, and members drawn from private life. The study should draw upon the information, judgment, and points of view of people both within and outside the Government. For this purpose the investigating committee should engage experts to make thorough studies and reports on various phases of the problem, and it should invite presentations from all who can be helpful. But the committee that receives the information, weighs it, forms judgments about it, and submits reports concerning it to Congress should be composed exclusively of Members of Congress, for only in this way can the study contribute a maximum to congressional understanding of all these complex problems and to the quality of the resulting legislation. Congress should not abandon its function of legislation, and to legislate wisely it must fully understand the reasons for its legislation. It should not be put in a position of accepting on faith the recommendations made by private citizens without knowing thoroughly the facts and reasoning that led to those recommendations. There is no substitute for thorough congressional investigation and hearings.

An illustrative but by no means complete list of the topics that should be studied by these committees would include:

1. The proper role of the Federal Government in chartering, supervising, and examining commercial banks, and the appropriateness and adequacy of its present organization, laws, and policies for these purposes. (See V above.)

2. The adequacy of banking facilities in the various geographic areas of the country and the appropriate means of remedying any inadequacies that are found to exist. As a result of suspensions, mergers, and consolidations prior to 1934 and of continued mergers and consolidations since that time, many towns and cities and even some counties are now without banking facilities. This situation should be studied to see whether or not it has harmful results, and what, if anything, can and should be done about it.

3. Federal and State laws, regulations, and policies relative to branch, chain, and group banking.

4. The appropriate role of Federal agencies that lend and guarantee loans to private borrowers, and the changes in their structures and policies that might make them conform more closely to that role. This should include an investigation of the specific respects in which the private credit system fails to meet all the legitimate needs of private borrowers, as well as a study of the feasibility of altering the structure, powers, and policies of the private credit system in such a way as to reduce, or perhaps even to eliminate, the need for some of these Federal agencies.

5. The requirements for membership in the Federal Reserve System.
6. The location of authority within the Federal Reserve System and the composition and methods of selection of the System's governing authorities.
7. The appropriate role of consumer credit regulation and other selective credit controls in a stabilization program.
8. The need for more effective Government supervision over speculative trading on the commodity exchanges.
9. The appropriateness and adequacy of the monetary and credit control powers in the hands of the Federal Reserve and the Treasury, the division of these powers between the two agencies, and the coordination of their policies.
10. The conditions and limitations that should apply to purchases and sales of United States Government securities by the banking system, including the feasibility and desirability of "sterilizing" or "freezing" a part of the public debt as a means of regulating its monetization, together with any other suggestions which might be made in connection with the relationship of the debt and the money supply.
11. The appropriateness of the present reserve requirements applicable to Federal Reserve banks.

XII. A CONTINUING STUDY OF FISCAL POLICY BY THE JOINT COMMITTEE ON THE ECONOMIC REPORT

We recommend that the joint committee, while carrying out its general duties "to make a continuing study of matters relating to the economic report" and "to study means of coordinating programs in order to further the policy of the [Employment] Act," make a special intensive study of the various possible methods of increasing the flexibility of Federal tax and expenditure policies in order to discover how and to what extent it may be feasible to make these instruments more effective for stabilization purposes.

The serious limitations on the flexibility of both Federal revenue and Federal expenditure policies under existing procedures and the resulting limitations on the effectiveness of fiscal policy for stabilization purposes were noted earlier in this report. (See II above.) There have been many proposals for improving this situation, and the joint committee has already called some of them, notably the desirability of flexibility in the timing of public housing and in grants-in-aid to State and local governments, to the attention of Congress. We believe that the joint committee can perform a useful function by making a special study of the various proposals for improving the flexibility of both revenue and expenditure policies to see which of them, if any, would be both useful and consistent with our democratic processes.

XIII. EARNINGS OF THE FEDERAL RESERVE IN EXCESS OF DIVIDEND REQUIREMENTS

We recommend that Congress enact a franchise tax on the net earnings of the Federal Reserve System to replace the voluntary contributions now being made to the Treasury by the Board of Governors. In view of recommendation III, 2, any franchise tax must take into account the necessity for an ample reserve for losses in open market operations as compared with the present situation in which earnings are automatic.

Signed:

PAUL H. DOUGLAS, *Chairman.*
RALPH E. FLANDERS.
WRIGHT PATMAN.
FRANK BUCHANAN.
JESSE P. WOLCOTT.

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