A BANKER'S VIEWPOINT OF OUR ECONOMIC POSITION TODAY

14 December 1951

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INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

Mr. Robert Vedder Fleming, President and Chairman of the Board, Riggs National Bank, Washington, D. C., was born in Washington, D. C., 3 November 1890. He attended George Washington University and received his LL.D. in 1939. He began his career with Riggs National Bank in 1907 and became President in 1925 and Chairman of the Board in 1935. He is Chairman of the American Bankers Association Committee on Government Borrowing which advises the Secretary of the Treasury; Vice-President of the Federal Advisory Council to the Board of Governors, Federal Reserve System, and represents Fifth Federal Reserve District; member of the Business Advisory Council for the Department of Commerce. He is a member of the Board of Trustees of the following: Banking Research Fund and Committee on Federal Relationships, Association of Research City Bankers, American Red Cross Retirement System, National Geographic System, and Chairman of the Board of Trustees of George Washington University. Member of the following: Industrial Advisory Committee to the Secretary of the Treasury, Finance Committee U. S. Chamber of Commerce, Smithsonian Institution. Treasurer and founder of the Air Force Aid Society and active member in many other civic enterprises such as Boys' Club, Boy Scouts of America, and the Washington Cathedral. Directorships include: Chesapeake and Potomac Telephone Company, Hotel Waldorf Astoria Corporation, Metropolitan Life Insurance Company, Pan American World Airways, Potomac Electric Power Company, and Southern Railway Company. Currently holds the rank of Commander, U. S. Naval Reserve. Awarded Cosmopolitan Club Medal and citation as citizen of Washington "who performed the most outstanding civic service in 1935." He is a member of the following clubs and organizations: Alfalfa; Burning Tree; Chevy Chase; Metropolitan; National Press, Rotary (honorary).

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COLONEL WILLIAMS: This morning we are privileged to hear from one of the country's leading and most respected bankers. We have asked him to talk about our economic position today. Inasmuch as he likewise officially advises the Secretary of the Treasury in his capacity as Chairman of the American Bankers Committee on Government Borrowing, and as the Vice-President of the Federal Advisory Council to the Board of Governors of the Federal Reserve System, and also on the Council of Business Advisers to the Secretary of Commerce, we have intentionally billed this lecture as "A Banker's Viewpoint of our Economic Position Today," to allow him to free himself from his pseudo-governmental capacity and speak to us frankly in his private capacity and from his broad experience. We have also asked him to give some basic information, which you haven't heard from this platform, concerning the fiscal policy of the Government, particularly the activities of the Federal banking system.

We have assured him that he will not be quoted outside the college if he does give us some of the frank opinions that we brought him here to give, some of which I had the privilege of hearing under informal circumstances. So get his personal views too, if you will.

Although I don't like long introductions, I think it is impossible to introduce Mr. Fleming as President and Chairman of Riggs Bank of Washington without bringing up a few points that may not meet the eye in his biographical sketch you have already seen.

You probably noted he became president of one of the largest banking institutions of the country at 35 years of age, that he is a director of many leading corporations, trustee of many organizations of importance to the country, and that he is engaged in a great number of civic activities and has held innumerable positions in financial organizations, including the presidency of the American Bankers Association. What cannot be read in the biographical sketch, among other things, is the fact that at least three Presidents have sought his personal opinion and advice, and that most top governmental officials and top men of finance consult him regularly. I happen to know that at one time he turned down one of the highest appointive offices in the country that might have led to the top, because he felt he could serve better in his present private capacity; that he has more friends and admirers than anyone could count.

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Dr. Murphy alluded to another attribute when asked if we could show a copy of his speech to Mr. Fleming prior to his speaking here. He said he would be honored and went on to say most earnestly that Mr. Fleming not only is one of our greatest bankers and greatest Americans, but that from observation he believed him to be potentially one of our greatest diplomats. He said: "I would like to see his diplomacy tried on the Russians. I think he could do better than anyone we have had on that mission."

So, gentlemen, I present to you Mr. Robert V. Fleming, banker, businessman, governmental adviser, civil leader, and diplomat.

MR. FLEMING: General Holman, Colonel Williams, and gentlemen of the armed forces: After that very flowery introduction I think the best thing I could do would be to say: "Gentlemen, it is a privilege to have been here" and ask to leave. I hate to destroy such an illusion as Colonel Williams has given you with respect to me.

I am very happy to be here this morning because I recognize the importance to you and to the armed forces in the present times to have a thorough understanding, as much as a layman is able to give you, of some of the problems that we have in the machinery of certain parts of government work, particularly on the fiscal front, because under present conditions the financial aspects cover everything.

Colonel Hardenbergh and Colonel Williams have been good enough to outline to me the subjects discussed here by other gentlemen and have given me a pretty large order--"A Banker's Viewpoint of our Economic Position Today." They have also asked me to give my views on the trend of government fiscal policy, attempts being made to combat inflation, what can still be done, and the outlook for the future. I could keep you here, if I covered all that, for maybe a week.

I want to make it clear that I am not an economist. What my observations are or what I tell you is based simply on my long practical experience in the banking world.

I think first we should consider the Treasury Department of the United States and its relation to the Federal Reserve System in regard to fiscal matters; and then the problems which, it appears to me, are facing us that have a direct bearing upon our economy.

In respect to the Treasury, we must recognize that the Secretary of the Treasury has a very heavy burden on his shoulders in managing the public debt. That is only one phase of that heavy burden. This involves the money market, and it entails plans and decisions for issuance of securities which will tap sources of available money for refundings as well as to supply new money as needed.

One of the problems which always confronts the Treasury is the very large cost of debt service in the budget. On account of the change in interest rates, which I shall explain later, and the fact that the interest return on savings bonds increases year by year--I am referring now to those outstanding increments of increase--the cost of debt service increases even during the period when the public debt is being reduced. At the moment, to give you an idea of the magnitude of this matter, I might tell you that the cost of the debt service is about 5.8 billion dollars. Therefore, the Treasury must finance its refundings and fill its needs for new money with one horn of the dilemma, the ever-increasing cost of debt service; and the other horn, the necessity of ultimately spreading the debt into longer maturities, which, obviously, further increases the debt-service cost.

I am frank to say that one of the problems we have today is the fact that the average maturity of our debt is getting shorter and shorter. But the situation as it exists today does not seem to lend itself to the spreading of the present debt.

I might say in connection with the debt service that the Treasury also has another problem, and that is the problem of the gentlemen on the Hill. And I say this without any disrespect. They, of course, do not, many of them, understand the mechanics of the operation of budgets, and so forth. A few years ago a very prominent Member of Congress called at my house early one morning. This gentleman is now a distinguished Senator. He said: "Bob, I think you know something about the fiscal position of the United States and the Treasury. They sent a budget up here and put in 5 billion dollars for debt service." He said: "Now, what kind of funny business are they doing? It just can't be that it costs them 5 billion." "Well," I said to this gentleman, "there are many other places that you might try to explore in the budgets in the different departments; but, first of all, the interest on the public debt has to be paid, and I happen to know the exact figure on it. It is 4 billion 995 million, estimated. That is just for the debt. So they put 5 million more in, in case they should run short at some point because of a change in the interest rate." "Oh," he said, "I just am not used to those round figures of 5 billion and so on."

The Treasury is always under that pressure of holding down the cost of the debt service. On the other hand this concentration of debt is getting to be a very serious situation. To illustrate, during the calendar year 1951--I am always getting into trouble on that, because most of the government figures are on the fiscal year basis, while other figures are on the calendar year basis--including Treasury bills, there were 55 billion 262 million dollars in refundings alone, and on top of that 2.5 billion more in deficit financing which had just taken place. That brought up to nearly 58 billion dollars the account that will have to be handled in one year. That shouldn't occur. The debt should be spread as and when it can be, so that you don't have such heavy maturities in any one given year, because it is just like with an individual. Every time you let your debts accumulate, that is the time you do not have the money and you cannot get a loan.

I have suggested to the Treasury that instead of financing the debt for six months at a time through refundings, its people ought to have a chart spreading this debt out. Not that they are going to be able to do it at this moment, but so that the maturities in any one year are not going to be too heavy. Even if it costs s little more now, it is going to be safer in the long run; because if they had a chart or something to guide them, there will be times when money to buy long-term securities is available--there have been such times--where that opportunity will be missed; I say that without criticism. That occurred in the first four months of 1950. There was an opportunity then to extend the debt. But if you don't have a chart to work with, when the technicians come in and say, "Here is some money where you can move out here," it will never be done.

In the first four months of 1950, the portfolio of the Federal Reserve banking system went down 2.6 billion dollars. The purchase of securities by individuals, corporations, and others went up 3.3 billion during that four-month period, so that it was evident that there was money available for the purchase of government securities at that time.

I think that I should dramatize or bring out, if I can, the difference in the economic effect on the money supply when government securities are purchased by the commercial banking system and when they are purchased by nonbank investors. I first used this illustration that I am going to give you now many years ago, when I made a nation-wide radio address at the request of Secretary Morgenthau at a time when we were talking about the defense effort on 1 July 1941, when he started to sell Defense bonds.

I said that when a commercial bank buys securities from the Government, the asset position of the bank does not change but its cash position does, as the cash goes down by the amount of these securities purchased. The cash then goes to the Treasury and when the Treasury spends that for the supply of goods, materiel, and so on, the money goes back into the banking system, increasing deposits of the banks in proportion to the amount of securities purchased by the banks.

Now, when a nonbank investor buys government securities, you have a different effect. The process of the money going to the Treasury and then being spent is the same, but when the purchase is made, a check is drawn on a commercial bank whose deposits go down at that time. The bank's deposits are only restored to the level previous to the purchase when the money is spent and comes back into the system. Therefore, you do not increase the money supply when purchases are made by nonbank investors.

I think that is a very important factor for you always to hold in mind. Every effort should be made to have government securities, particularly when we have deficit financing, owned by others than commercial banks. The more we do increase the money supply the more pressure we have on the price structure.

I think all of you would be interested to know what we did in World War II in connection with financing. We learned a lot from the lessons of World War I, where the miserable mistake was made of increasing the rate on every issue of bonds coming out, with the result that you had a near-collapse at the close of the war, when government bonds went down to about 81. It also retarded purchases by nonbank investors, because everybody said: "Well, the next issue the rate will go up. I will wait for that."

The costs of World War II, beginning with the defense period in 1940 and running to 1946, were 391 billion dollars. Where did we get that 391 billion? We got it from receipts from taxes of 176 billion, which represented 45 percent; from sales of securities to noncommercial bank investors representing 34 percent or 134 billion; sales of securities to commercial banks representing 21 percent or 81 billion. So to that extent we inflated our economy--just by 81 billion dollars.

Toward the close of the period we were doing much better, because in the fiscal year ending 30 June 1946, we had receipts from taxes totaling 66 percent, securities sold to nonbank investors 14 percent, securities sold to banks 20 percent. We got more from taxation.

But also, once the war was over, the sales to noncommercial-bank investors went down to 14 percent, whereas the bank holdings were about the same, about 21 percent. They were 21 percent during that whole period and went to 20 percent in that last period.

Let us see what weapons the Treasury has. It has about 42 billion dollars of invested funds in various trusts, social security pensions, and other funds. Most of those funds are invested in special issues of governments which are nonmarketable. But the Treasury has about 6 billion dollars of marketable bonds, that could be used for open market operations. I will touch on that later. In addition to that, it has about one billion dollars in free gold.

I would like to talk a little bit about the budget situation, a subject that I think you will hear a great deal about in the next couple of months.

You must always hold in mind that actually there are two budgets: the over-all budget, including all expenditures and receipts; and the cash budget, which reflects only the cash outlays. As a matter of fact, the noncash disbursements, which really are bookkeeping entries and affect total budgetary expenditures, amount to about 3 billion dollars. In other words, if for a given fiscal year, say the fiscal year ending 30 June 1952--these are not the right figures, but I am just using that as an example--there was a deficit in the over-all budget of 3 billion dollars, then the Treasury would have no need for deficit financing because of the noncash disbursements. While the total debt would rise by 3 billion, the Treasury would not have to pay out that 3 billion dollars in cash.

That is always a factor to bear in mind. The over-all budget would show a deficit, but the Treasury would not need to go to deficit financing. That is merely a bookkeeping entry representing the increase in interest on savings bonds. Also, interest on social security funds, and on special issues, such as the various pension trusts of the Government, all are represented in that 42 billion dollar figure.

Now, regarding the forthcoming budget, which no doubt you will hear a lot about, I think we are going to have a deficit and possibly a sizable one. Even with gross national product and national income running at ever-increasing totals, the tax bill passed by the Congress will not fill the gap between the appropriations made, the funds spent, and receipts from various sources of taxation or revenue. Hence we will be in deficit financing then, as we are in it at this particular moment.

Let me illustrate it this way: Let us take the fiscal year 1951 and the fiscal year 1952 as far as we can. In 1951, in the first quarter, the Treasury had a surplus of 5.7 billion dollars. Hold this figure in mind--5.7 billion. When we came over to the June quarter, we had a deficit of 1.6 billion. Then we get to fiscal 1952. In the period July to September--these figures are actual--the Treasury had a deficit of 3 billion dollars. In the period October to December, the period we are now in, the deficit is estimated at about 5.6 billion. That is the kind of Treasury deficit financing we are engaged in at the moment.

Now, when we come to January to March, next to the last quarter of 1952, which comes right after the first of the year, the Treasury will have again a surplus of income over expenditures. That is very understandable, because the tax rate was raised and is now much higher. Corporations this year will have to pay 35 percent of their 1951 taxes on the higher base, with some excess profits on 15 March then that balance on 15 June. I will touch on that in a minute. Then the Treasury will not only get a final payment from individuals in the higher bracket groups on the estimates that they have made, but a ballooning to over 5 billion dollars of surplus in the first quarter of 1952.

I think from the June quarter or the last quarter of fiscal year 1952, the Treasury will be running a deficit of about 2 billion dollars.

But I think from the over-all picture that it will probably not need any more deficit financing, barring some emergency that we don't anticipate.

The Government at this particular time has been financing by tax anticipation notes, Treasury bills, called Treasury tax anticipation bills. The first issue was in October for 144 days, due on 15 March 1952. The second was issued in November, maturing on 15 June 1952. These two issues amount to 2.5 billion, and I think that is about all the deficit we will need during this fiscal year, as far as we can see. When you get beyond that, it is another story.

I will explain the reason the Treasury had to go short. Most of the issues were taken by the banking system, which I regret. The corporations under this so-called Mills plan, the amendment to the tax bill, did not have money to invest in anything except short-term securities. This was due to the expansion programs and because of the accelerated amounts of taxes the corporations have to pay right off.

As to the wisdom of this Mills amendment, that is another story. The impact will be heavier this year than last year. It provides that this year 35 percent will be paid in March and 35 percent in June. That makes 70 percent of the 1951 tax must be paid in cash in the first six months. Then, of course, the other 30 percent will be spread from September to March.

The following year it accelerates by 10 percent more, so that 80 percent will be payable, if the law is still the same, in the first half of 1953. When you get to 1954, it will be 90 percent; and when you get to 1955, it will be 100 percent in the first six-month period.

If you examine some charts that I have seen of the corporate cash position, the working capital position, you will find that this is having a very marked effect on corporations. I expect that corporations will be in the market for many bank loans for working capital purposes as this trend continues, because in the past they always used part of the tax reserve for working capital purposes or placed it in short-term governments.

Now, looking at the question of where the Treasury is going to get its money, I have said that the Treasury should have spread its debt out. Unfortunately, we have a situation where the insurance companies, who have always been holders and purchasers of long-term government securities, are not in a position to purchase them. That has come about as a result of the tremendous pressure on insurance companies for loans due to the greatly increased number of housing starts. One million four hundred thousand housing units were built in 1951. There probably will be more than a million this year. Furthermore, industry is going to the insurance companies for long-term loans in huge amounts. You may have seen in the papers recently that the Union Carbide Company has obtained 300 million dollars--150 million from the Metropolitan Life and 150 million from the Prudential Life. That is just one illustration of what is happening. And the insurance companies, generally speaking, are trying to play ball with the Government and are not selling their government securities unless they know it is a bona fide purchase and not being bought by the Federal Reserve System. In effect a purchase by the Federal Reserve System is just the same as the effect I described for purchases by the commercial banking system. It has an inflationary effect. Most of those sales are made in order to meet the insurance companies demands over and above their premium incomes, which are going into pension trusts and various trusts of the various states.

There has been a savings trend in the last three or four months, which is encouraging. Ultimately, the mutual savings banks will have some money, but not at the present time.

I have described the position of the corporations. That leads you right down to the wealthy individuals. Those in the higher income brackets are not interested in what they can keep out of the interest return from government securities, even if the Government should raise the interest rate a little. They are investing in stock equities or municipal securities.

That leads you right down to the lower income groups where most of the money is available--those with incomes up to around 7,500 dollars. That leads us into the Series E Bond program. That program is improving. Redemptions in the last few months went down considerably. In the past year and a half redemptions have been exceeding purchases. It is very important that we take advantage of this mass purchasing power.

What I am saying now is no secret. I have said this to the Treasury. But I feel that the philosophy of the savings bond program must change. The philosophy has been to encourage all the sales you can get. But we tend to have penalties in the redemption prior to maturity. Take, for instance, the present program which provides on bonds 2.5 percent for the first seven and a half years and 2.9 percent compounded for the last two and a half years. You have to figure out what that means. It means that if you hold them for 10 years, it is actually 3 1/3 percent simple interest, because a 100-dollar bond that I bought for 75 dollars goes to 100 dollars after 10 years, and if automatically extended at the end of 10 years, that 100-dollar bond is worth 133 dollars and 34 cents.

I may be totally wrong and the Treasury may disagree with me, but I believe that the philosophy of salesmanship in America is to give people something that they think is good--and if they think it is good, they are going to hold on to it--rather than trying to force them to hold it by penalties.

I am hoping that some improvement in that situation may be effected whereby we can stimulate sales of savings bonds and have people hold them and own them even more widely. I am sure that those who are in the banking business want very clearly to see GI loans and real estate loans such that the GI's of tomorrow will have the cash that they will be able to put down on the barrelhead when they purchase a home. They won't have it if they don't buy savings bonds. Buying savings bonds is what does it.

So much for the Treasury. Let us turn to the Federal Reserve System. I believe it is the responsibility of the Treasury to manage the Federal debt; but once the securities have been sold, it is the responsibility of the Federal Reserve System, through its open-market committee, to maintain an orderly market; in fact, it had to maintain a pegged market during the war period, and in the postwar period until February 1951, when an accord with the Treasury was reached.

I assume that in your studies here you are familiar with the structure of the Federal Reserve System, but I doubt if you know very much about the Federal Advisory Council, of which, as Colonel Williams said, I am the Vice-President.

This body is not new to the Federal Reserve System. The Federal Advisory Council was Woodrow Wilson's compromise at the time of the enactment of the Federal Reserve Act. He did not want bankers on the Board of Governors but he felt bankers should have representation and serve on the Federal Advisory Council, being elected by the Boards of Directors of the Federal Reserve Banks in each Reserve District, making it a body of 12 men. They have the right to elect their own officers. They also have an executive committee consisting of the president, the vice-president, and three other members of the Council. The members serve for two or three years; sometimes they may serve a little longer.

Now, the Council has the power, by itself or through its officers, to confer directly with the Board of Governors of the Federal Reserve System on general business conditions; to make oral or written representations concerning matters within the jurisdiction of the Board; to call for information and to make recommendations in regard to discount rates, rediscount business, note issues, reserve conditions in the various districts, the purchase and sale of gold or securities by Reserve banks, open-market operations by said banks, and the general affairs of the Reserve banking system. In addition to that, they have the right to make reports to Congress if they so desire.

Now, this body meets by law four times a year with the Board of Governors in Washington. It can meet oftener. During the war period the executive committee met monthly with the Board to assist in the deliberations on open-market operations. I mention that because the body has more effect than people realize. But even in the Congress very little is known about the activities of the Council. I was testifying before the Banking and Currency Committee of the Senate representing the Federal Advisory Council on a particular matter. Senator Bricker, of Ohio, said: "What is the Federal Advisory Council? I would like to know." So I told him in some detail. When I finished, he said: "As long as I am a member of this committee, I intend to see that every time the Board of Governors is called up here, a representative of the Council is called also, because I want both sides of the picture."

Let us look now at the Federal Reserve's powers. Let us see what really is the mandate of the Federal Reserve System. It has a bearing on something that I will touch on in a minute.

Section 12a of the Federal Reserve Act says with respect to the Open-Market Committee: "The time, character, and volume of all purchases and sales of paper described in Section 14 of this act"--that is government securities and other things--"as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

This general mandate on open-market operations gives the Federal Reserve System the right to regulate the percentage that can be borrowed on stock exchange securities, under what is known as Regulation U, as affects individual investors, and Regulation T, as regards brokers. They have operated that pretty well, and so there isn't very much inflation in stock exchange credit regardless of the volume of purchases and sales.

In addition to that the System has open-market powers. It has the power to change rediscount rates, which serves as a guide to rates that will be charged in the open market, and at which member banks can borrow; and the power to change reserve requirements. Then, of course, under special authority granted by the Defense Production Act, as revised by the Congress, powers have been delegated to the system to regulate consumer credit under what is known as Regulation W and real estate credit under Regulation X.

With respect to open-market operations and maintaining an orderly market, which is the present policy, the Open-Market Committee consists of the Board of Governors (the full membership being seven)--there is one vacancy--and 5 representatives of the 12 Federal Reserve banks. The president of the Federal Reserve Bank of New York is always represented on the Open-Market Committee, so that the committee consists of 12 members. Our Federal Reserve System consists of 12 regional banks and branches. Because of its size and the fact that New York City is the place where most financial transactions of great moment are negotiated, as well as foreign transactions, the Federal Reserve

Bank of New York actually acts as the agent for the Open-Market Committee in executing purchases or sales of government securities. It is the duty and responsibility of the Federal Reserve System to handle the purchase or sale of securities in the open market, depending upon whether it desires the price to fluctuate upward or downward. This is one of the means by which the Federal Reserve System can either expand or contract credit. When it buys securities, it makes credit easier, because individuals, corporations, and banks which sell the securities to the Federal Reserve System receive cash. That cash goes back into the banks and causes much more money to circulate. When the Open-Market Committee operation results in the sale of securities out of the portfolios of the several Federal Reserve banks, the deposits of the banks are reduced, and credit is tightened. That is one of their weapons--the fact that they can make money easier or tighter, which usually is used in collaboration with or in connection with the rediscount rate.

With respect to the rediscount rates, the Open-Market Committee cannot change those rates. That is not one of its powers under the law. Any one of the Federal Reserve banks can apply for a change in the rediscount rate, which at the present time is 1.75 percent; but any change must be approved by the Board of Governors. This is another instrument of either tightening or easing credit. The higher the rediscount rate, the more the cost of money to private borrowers; and, therefore, there is a tempering effect on those seeking credit. Where the rediscount rate is lowered, it results from a policy to make money easier. Usually it is considered as a signal that money is going to be easier.

Reserve requirements also are changed upward or downward by the Board of Governors. At the present time reserve requirements are up to the statutory limit except in the two central reserve cities of New York and Chicago. Reserve requirements are fixed as regards these classes of banks--banks in central reserve cities (New York and Chicago) where the statutory requirement is 26 percent of demand deposits and 6 percent of time deposits; reserve cities (about 63 in number, Washington being one of them, being banks in the principal cities of the Nation other than New York and Chicago) where the requirement is 20 percent of demand deposits and 6 percent of time deposits; and all other banks (classified as "country banks"), which are required to reserve 14 percent of demand deposits and 6 percent of time deposits.

These are the maximum limits and they may be reduced to just one-half of that, to 3 percent for time and 7 percent for country bank demand deposits; reserve city banks down to 10 percent on demand and 3 percent on time, and in New York and Chicago to 13 percent on demand and 3 percent on time.

As you see the system has very little leeway for raising reserve requirements at this time, because all banks are up to the top limit, except New York and Chicago, where reserve requirements could be increased 2 percent on demand deposits. Raising or lowering reserve requirements again serves as an instrument for controlling the volume of available credit.

But it must be borne in mind that, in addition to these reserves which member banks of the Federal Reserve System must carry, they also must carry till cash. If they are not located in a city where there is a Federal Reserve bank or the Treasury of the United States, as is the case here in Washington, they have to carry even more till cash. In addition to what they must carry to meet withdrawals, they must carry balances with correspondent banks in order to transact business.

At the present time any increase in reserve requirements in New York or Chicago would simply force the banks to borrow from the Federal Reserve System or sell government securities, because excess reserves in the member banks of the whole System are very low. That is due to the existing great demand for credit. There were approximately only 400 million dollars excess reserves as of the close of November and at the present time about 800 million. Of course, these excess reserves are spread out through all the member banks of the System.

Now, let me say that this is going to be one of the problems. Unless loans for industry, for construction purposes, to help in the defense effort, and the other loans for purposes not essential to the defense effort go down sufficiently by the second half of 1952 (the first half of the fiscal year 1953, using the government term)--unless they go down to make room for, and take the strain off, the demand for credit from the insurance companies, the mutual savings banks, and from corporations, to meet the deficits, then (with excess reserves of only 400 to 800 million dollars) the Federal Reserve System will have to go into open-market operations in order to make available to the banks the reserves with which they can buy new government securities.

But that will have a further inflationary effect. If in open-market operations the Federal Reserve buys securities from the member banks, the money that the banks receive will be used to buy new securities. You will get an increase in the monetary supply, unless the Congress of the United States, or the Administration, trims down, particularly, nondefense expenditures, and defers everything that is deferrable, and the military holds down its expenditures to what is considered a prudent level. We have a substantial gap between the new budget and taxes, and, in my opinion, no Congress in a Presidential election year is going to raise taxes again this year. The Congressmen just won't do it. The people won't stand it again. Yet, there simply will be that gap if the budget is not trimmed down.

It is very hard to think about again raising the reserve requirements. As I pointed out the reserves cannot be raised with the deficit as it is. The reserves could be produced through open-market operations. Open-market operations are probably the way that would be desired. But reducing the reserves would mean continuing this dangerous cycle and lead to more inflation.

I want to touch on one other thing. It is something that is going to come shortly in connection with a questionnaire which the Patman Committee sent out. The committee is sending it to the Federal Reserve System and to the Treasury, to a selected list of banks, and to some insurance companies. The questionnaire asks many questions on money and credit and whether the accord that was reached last March should have been reached more quickly. It asks whether the Treasury should handle securities as it is today, or whether the Federal Reserve System should become subservient to the Treasury, or whether the Treasury should become subservient to the Federal Reserve.

The committee is trying to ascertain from the questionnaires the information to be used in hearings expected to be held some time in January. I don't think it can be done by any human beings. Dr. Murphy, the chief technician to the Patman Committee, knows that it is not humanly possible for the staff, in my opinion, to wade through all of those questionnaires and prepare for those hearings in that time. I understand it is now talking about March. I think it will be nearer the end of April.

The committee is asking many questions. The questions, in my opinion, are very honestly prepared, very frank. They are not to my mind slanted too much toward what might be called trick questions. The Federal Reserve System has about 61 to answer. The questionnaires were sent to a list of selected banks. We had the honor of being selected as one. We received only 10 questions. I can assure you, however, that if the answers are carefully prepared, it will take a good deal of time. The Treasury, I think, has 49 questions.

I am going to follow this with one thing. I am going to go into the question of this accord. I think it is important to hold this in mind, because it has a very marked bearing upon our economy in subsequent years as to how this matter comes out.

In my opinion our forefathers felt that our democratic form of government could be preserved only by maintaining a system of checks and balances. If we get down to the question of no checks and balances, no matter if with a democratic system things are dragged out a little bit, nevertheless I think you should hold in mind the fundamental principle that we must have some checks and balances. Otherwise the freedom of the people, even through their elected representatives, disappears.

I read to you the mandate on open-market operations, which could deal with the question of support or nonsupport of government securities by open-market operations. There is nothing in that mandate other than a statement about how those operations shall be conducted and as to their bearing upon the general credit situation of the country. There is nothing in there that says the Federal Reserve System shall issue securities or that it shall have the right to interfere with Treasury financing.

From previous pronouncements by Mr. Patman, it is apparent that he wants to see the Federal Reserve System subservient to the Treasury. It would then follow the route--in your studies you are probably familiar with it--which has been followed in the history of the central banks in other countries of the world. It has been that when the Government was in difficulty and needed money, for deficit financing or anything else, and the central bank said "No," those countries have taken over the central bank. When that has occurred, it has led the country right down the road to uncontrolled inflation and to socialism. That is exactly what has happened.

Mr. Patman was made Chairman of the committee. It is a joint committee of the House and Senate, a joint cooperative committee of both houses. Senator O'Mahoney is the Chairman of the full committee. They cannot, except as individuals, propose legislation. All this committee can do is to refer its report to the full committee, and all that committee can do is just to recommend that certain legislation be enacted. The committee cannot introduce the legislation, but an individual Senator or Congressman on the committee could introduce it. But the joint committee as a committee would have to go to the two banking committees of both houses and they would have to examine the legislation and hold hearings to study it.

Now, Representative Patman takes the view, according to the dissent in what is known as the Douglas Report (by Senator Douglas, of Illinois, a member of the committee), that the whole Federal Reserve System should be subservient to the Treasury of the United States.

Senator Douglas takes the opposite view. He introduced a resolution early in 1951, after the making of this report and the accord between the Treasury and the Federal Reserve, which states: "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." If that resolution had been enacted, the Treasury would have become completely subservient to the Federal Reserve.

On the other hand I do not feel that Mr. Patman's views should prevail either. I cannot conceive of any government that would allow the fixing of rates at which securities are issued and refundings made and the managing of the Federal debt to be transferred to a quasi-independent agency. I don't believe that will happen. So, frankly, gentlemen, this may sound like a funny answer, but I think this problem between the two parties must be handled with sanity and reason, with a constructive approach, without personalities. As a matter of fact, I think the Treasury and the Board of Governors almost have to become Siamese twins. That is the way it has to work. Otherwise, you don't write it into legislation without completely making the Federal Reserve subservient which, as I tried to point out, would be a very dangerous thing.

I might mention that we have undertaken a very constructive and widespread credit restraint program. That was done under a provision which the Board of Governors requested be inserted into the Defense Production Act, and the powers to administer these provisions were delegated by the President of the United States to the Board of Governors of the Federal Reserve System. Since they got that power, they have done a magnificent job. It is known as the Voluntary Credit Restraint Program.

In this connection I might add that in 1948 the American Bankers Association, under the leadership of President Joseph M. Dodge, inaugurated a voluntary credit restraint program with the approval of the Secretary of the Treasury, the President of the United States, and leaders of Congress. President Dodge had served as financial adviser to General Marshall in Europe and subsequently served in a similar capacity to General MacArthur in Japan. Mr. Dodge, who is President of the Detroit Bank of Detroit, Michigan, was returning to America from Europe when this voluntary credit restraint program was being planned by certain members of the American Bankers Association, including myself. Although he was pretty well worn out, as a good soldier he immediately undertook furtherance of the program and headed up 13 pilot meetings, which were held in strategic cities in the United States, and fanned out to State Bankers Association meetings and county banking groups throughout the country. It was very effective and, as a matter of fact, this program was the forerunner of the present Voluntary Credit Restraint Program which, as I will now explain, carries the authority of law by coming under the provisions of the Defense Production Act and encompasses all types of lenders. Therefore, it should be even more effective in tempering down speculative credit, or credit for purposes not essential to our defense economy, than the program carried out voluntarily by members of the American Bankers Association in 1948.

This program is being carried out by authority of the Defense Production Act, with the approval of the Federal Trade Commission under the supervision of the Federal Reserve System, with the cooperation of not only banks but insurance companies, investment bankers, and now even municipal and state offices. It is a more elastic program and one with less rigidity than raising or lowering reserves. It is doing a fine job.

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I might say this in connection with that program: I think you will find that there is no estimate of how much credit might have been granted that has never been asked for because of the dramatization of the program in the press, which made borrowers who like to buy for speculative purposes refrain from asking for credit. It has been very effective. Under the leadership of the Federal Reserve, a good job has been done.

Just a word about the outlook--I believe we can generally expect business to be good and run at high levels in this coming year. Employment no doubt will be very full. There will be some spotty situations and shortages in civilian goods, particularly those requiring metals. But I believe that it will be a good year, barring some catastrophe.

One of the dangers that I see, which appears to be coming to a head shortly, is the demand of the steel unions. This demand set the pattern for another round of increases and another "leap-frogging" of wages first and then prices rising, which will, of course, add to the inflationary spiral.

QUESTION: I wonder if you would give your opinion as to the outlook beyond 1952.

MR. FLEMING: I will answer that by just giving my best guess. I haven't any crystal ball.

We have had the present conditions for a very long time. The country can stand deficit financing for a certain length of time. I tried to dramatize what happened in World War II, when 81 billion dollars out of 391 billion came from the commercial banking system buying securities and adding that amount to the money supply. You could carry that on for a while; but the more you add to the money supply, the greater pressure you have on the price structure and the greater the inflationary pressures that exist.

Somewhere along the line there is a limit, without a Pearl Harbor, to what people in a democracy will stand in the way of taxation. You are pretty close to that now. There might be some more acceptable types of taxation that might be tried to bring in some more money. But, unless the gap is closed between the particular cash budget and revenues in dollars, it can't go on for any great period without causing very definite distortions of the price structure and greater and greater inflation to the point where people want things more than they want money.

That is the danger in looking beyond 1952, because if the present proposed budget is not trimmed severely, you will have heavy deficit financing start in the last months of 1952.

I don't know if that answers your question, but I just can't be too philosophical in saying what would happen. We haven't had peace in Korea as yet. If the present defense program is continued, if we go on for a period of some time with deficit financing like we did in World War II, then I fear that we cannot control the inflationary spiral.

QUESTION: I have two unrelated questions. First, you say that the sale of government bonds to commercial banks, if I understand your point, increases the level of the money supply directly by that amount. Is that right?

MR. FLEMING: That is correct. It causes an increase in deposits.

QUESTION: We have been reading some reference works in which I believe the figure was mentioned that the increase is six or seven times the amount of bonds sold. Is that about right?

The second question is this: As I understand it, there have been tremendous amounts appropriated for the fiscal year 1952 which cannot be expended until, say, fiscal 1953. Is that money which cannot be expended in that fiscal year raised by the Government during the fiscal year for which it was appropriated?

MR. FLEMING: No. I will answer as to 1953. The Treasury endeavors to carry a working cash balance. During this period the Secretary has been trying to carry a balance between 4 and 5 billion dollars as working cash. A Federal Reserve official said to me that you can handle the present situation with maybe 2.5 or 3 billion dollars.

My answer to that question is that I think that is correct. But, after all, the checks are drawn on the Treasury; and I would think that this would provide a safe margin for the present.

Now, to answer your question specifically--the Treasury always tries to keep a working balance based on its best estimate of revenues and outgo. But I think that is dangerous for the Treasury during this defense period, because we might have a change in the war which forces a change in design of tanks to a certain pattern of tank or a certain type of plane, making those in production obsolete. Then your job would be a bit difficult. That would certainly put pressure on you. You don't get money just because they appropriate it.

The other question is a technical one. Theoretically, we could predict an increase of about six times. I have never seen it actually happen in practice. Theoretically, it could.

QUESTION: On a television program the other evening a well-known Presidential adviser played down the idea of the national debt being anything to worry about, because it was all owed to ourselves. I can see that there is a relative advantage to owing it to ourselves rather than having it owed abroad, but I don't share his optimism. What do you think?

MR. FLEMING: Neither do I. But I think I can answer that question by telling you about the spot I found myself in when I was president of the American Bankers Association in 1935.

President Roosevelt made the statement that bankers had told him the country could stand an 80 billion dollar debt. Being president of the American Bankers Association then, I thought I would become exhibit "A" and be called on for a statement. So I called together economists and discussed the problem with them. They came to the conclusion that no one could say whether 80, 90, or 100 billion dollars of debt was too large, that it all depended upon the gross national product which generates gross national income. This income creates the ability to meet the debt service.

QUESTION: Doesn't any increase in the debt generate inflation?

MR. FLEMING: Oh, yes, certainly. But the ability to carry a debt of that size was what Roosevelt was referring to. He said that depends upon the gross national product and the personal income level or the income level. In other words if you can get from taxation sufficient money to meet the debt service, it is all right.

COLONEL WILLIAMS: Suppose we are unable to pare the budget. What is our outlook if we don't change our laws on stabilization and price control?

MR. FLEMING: If we can't balance the budget, we can go on for a certain period with an unbalanced budget. Then you would find people demanding controls on new civilian goods to keep the price level stable.

COLONEL WILLIAMS: Congress will have to levy stricter controls?

MR. FLEMING: That is right.

COLONEL WILLIAMS: Then what about the next year or two?

MR. FLEMING: I wouldn't like to guess about that. I still hope that the budget will be balanced; but it is a faint hope, because I haven't too much confidence, regardless of what the Administration may do, in cutting down the appropriations or the budget in a Presidential election year, when one-third of the Senate is up for re-election as well as the entire House of Representatives. I don't think any Senator, if he wants to be re-elected, of either party, is going to be very anxious to increase taxes. I haven't too much hope of that being done.

I don't think any civilian can say what the military should do except to suggest to the military that it use as much prudence as possible. After all, the services are like the Treasury; they have to see that all emergencies are anticipated.

QUESTION: A recent study indicated that the savings bond program had put about a billion of additional dollars into circulation in a recent period of years. Would it be more desirable from all standpoints to eliminate completely the small savings bond operations--the whole range up to 500 dollars? Please comment on that.

MR. FLEMING: I think such limitation would be very unwise; that is one source of purchasing power that can be tapped. Unless you have a pay-roll-deduction plan or a bond-a-month plan to sell these bonds, people have to be sold on them. There must be some program, otherwise you get a tremendous inflationary potential. With the average person, an income up to 7,500 or 8,000 dollars, the tax factor is not so heavy as in the higher brackets; they have more left over after their wants are supplied and have more money in their pockets.

The Treasury has always been able to handle the savings bond program. I don't know what the exact figure is on the cost. The main expense is the printing bill. For instance, the banks all sell these bonds and handle the drives themselves. They don't charge anything for that. There is no charge made by the banking institutions. Mr. Clark gets no salary whatsoever. The staff is not large and, frankly, not very well paid.

So far as the advertising program is concerned, in the main the programs have been donated. I would hate to see the savings bond program discontinued; the money that can be siphoned off would be used to put further pressure on the price level.

QUESTION: Since higher taxes are not politically feasible for next year, what do you think of the idea of forced savings deposits or bonds?

MR. FLEMING: If you get compulsory purchases or capital levies, you are right down the road to socialism and democracy is about over. I hope we never have to do that. We lose everything that we created in this country, that made us the most powerful country and the most prosperous, which is our capitalistic system, our free enterprise system.

QUESTION: What is the relationship of the home loan banking system and the Federal National Mortgage Association in terms of the current mortgage picture and how does this affect the money market and inflation, as against the Federal Reserve banks operations with the rediscount rate?

MR. FLEMING: Of course, the Federal Reserve System had to do something about the amount of government debt held by insurance companies and building and loan associations that they were disposing of. That has a bearing on the penalty rate. That was part of the difficulties in the accord. The accord would have been arrived at much earlier if it hadn't been for the newspaper dramatization of the difference of viewpoints that existed at that time. It would have been reached much earlier and probably less violently, but it was a step that had to be taken.

The first step was taken to increase the rediscount rate, which affected the value of the interest rate structure. The next thing was done through open-market operations to change the price of short-term governments by raising the short-term rate, which produced a condition where these securities were selling below par and if the banking system desired to sell them it would do so at a loss. The average maturity of the securities held by the banking system was between three and one-half and four years at a maximum and, of course, this had a retarding effect upon it selling government securities to make additional loans.

Then the next step--and here we are back in a controversial area--was to drop the supporting price on long-term governments held by the insurance companies, building and loan associations, and the mutual savings banks that had the effect of stopping the insurance companies and others from selling at a profit, taking mortgages, and continuing the flow of available mortgage money in the country. That also had the same effect upon the home loan bank system.

You have also to recognize that we are sometimes too ambitious in turning the spigot on and off, as I described. Just prior to Korea, Congress was worried to death about there was going to be a decline and a spotty situation in regard to banks extending credit. So it passed a law increasing the government guarantee for GI's to 7,500 dollars, which made the purchase of houses much less difficult. Congress was even considering passing a bill to create capital banks under government supervision to make loans to small business. That was all in the atmosphere before Korea.

Then came Korea. As soon as that happened, scare buying started. Congress recognized it had to temper down such buying. That brought about the Defense Production Act, Congress giving powers under Regulations X and W and also voluntary credit restraints. That act has now started to become effective. If it is not, we will have to have more direct controls, which Congress can provide.

It was hoped when the FHA was created that private mortgage associations would be organized to purchase mortgages insured under the FHA Act. None was organized, however, because of a clause in the act that the regulations under which the act was to be administered could be changed from time to time by the FHA. Thus, private money was stopped from going into this field. Because there was need for more credit than was available under FHA, the Federal National Mortgage Association was set up under the RFC; its functions now have been transferred to the National Home and Housing Authority.

Personally, I have some doubts as to the legislative wisdom of having the lending agency in the same bureau where they make the rules for interest rates on housing, and so forth. But that is where it is.

COLONEL WILLIAMS: Our time is up. Your presence here has made our studies this year much more profitable. Thank you very much for coming.

MR. FLEMING: It was a great honor to be asked to come down here.

(21 Apr 1952--100)S/ijk