STATEMENT ON BEHALF OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM BEFORE THE JOINT COMMITTEE ON THE ECONOMIC REPORT, APRIL 13, 1948 *

Mr. Chairman and Members of the Committee:

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

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

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

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

Monetary Situation in November

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

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

Because of the necessity for protecting the Government's fiscal and debt management position by

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maintaining an orderly and stable market for Government securities, the Federal Reserve System was then and still is unable to restrain effectively further monetary expansion. The commercial banking system held nearly 70 billion dollars of Government securities, which were being converted into additional bank reserves through sales to the Federal Reserve. In addition, the System was providing reserves to banks by purchasing Government securities sold by nonbank investors. Finally, bank reserves were being substantially augmented by a heavy inflow of gold.

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

Changes since November

Last November we expected some abatement of inflationary pressures in the first quarter of this year. Such a situation developed. It was recognized that there would be a large volume of funds drawn from the banks by business and individuals in order to pay taxes which would result in a large cash surplus available to reduce the public debt. It was also recognized that the existing and contemplated program of monetary and credit policy would have some restrictive effect. The program, which was carried out, included the statement by the bank supervisory agencies, urging the banks to be more restrictive, the lowering of Federal Reserve support levels for Government securities late in December, a slight rise in rediscount rates early in January, and some increase in reserve requirements for banks in New York and Chicago in February. The banking fraternity, recognizing the dangers in rapidly expanding bank credit and the need for restraint, undertook a nation-wide educational program to bring about restriction by voluntary means. Finally, there was a widespread belief that the supply of goods in many fields was gradually catching up with deferred demands and that favorable crop developments would combine to lessen inflationary pressures by the spring of this years.

Monetary developments since November have accorded generally with expectations held at that time. Fiscal and monetary operations together effectively offset factors increasing bank reserves during the period, such as the inflow of gold, return of currency from circulation and purchase by the Federal Reserve of Government securities from nonbank investors. During the four-month period, December through March, the Federal Reserve purchased 8.6 billion dollars of Government securities, largely bonds, and sold in the market 6.3 billion of securities, chiefly bills and certificates. The Government retired 3.9 billion dollars of its securities held by the Reserve System. The net result of these operations was to reduce Federal Reserve holdings by 1.6 billion dollars and thus to keep the bank reserve positions under pressure during this period.

The combined effect on the money supply of Treasury and Federal Reserve operations, which were only made possible by the large budgetary surplus, was strongly anti-inflationary. The money supply was contracted by nearly 4 billion dollars. Commercial bank loan expansion was sharply curtailed, partly reflecting fiscal and monetary developments, partly reflecting the effectiveness of warnings by banking supervisors and the success of the bankers' own program of voluntary restraint, and partly reflecting the usual seasonal slack in business loan demand during the first quarter.

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

Prospective Monetary and Credit Situation

Notwithstanding these salutary developments, it cannot be said that inflationary dangers have been removed. Farm prices, though lower than they were, still continue firm, even though at present levels they are much higher relatively than prices of most other commodities. Current and backlog demands for many goods continue to be very strong. Prices of industrial products, wages, rents, transportation and some other services are still advancing. The money supply, though contracted by an estimated 4 billion dollars, remains excessive in relation to total product. Public holdings of cash or cash equivalent available for spending are nearly as large as last fall—250 billion dollars compared with 254 billions

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—and continue to be broadly distributed among holders. Commercial banks, though obliged to sell some securities to offset shrinking deposits, still hold 66 billions of Government securities, which are readily convertible at the banks' discretion into reserves. Upon these reserves a six-to-one expansion of bank credit and deposits can be built. To the extent that the monetary gold stock is increased and Government securities are sold to the Federal Reserve by nonbank investors, still more reserves would be created. These additional reserves could also support an inflationary six-to-one expansion of bank credit.

On the basis of the monetary situation alone, there would still be a dangerous inflationary potential, even if no further impetus were given to inflationary pressures by other forces. However, upward pressures are now in prospect as a result of several important new factors. One of these is the tax reduction bill. This bill will add about 5 billion dollars to the purchasing power of the public and take away a like amount from Federal revenues in the next fiscal year. The international financial obligations which we have now accepted are another factor likely to add many billions to Government expenditures in the future. The expanding program of military preparedness will further increase the budget burden for next year and future years by still more billions. Stemming from these developments, on top of existing inflationary conditions, is a rapidly changing public psychology with respect to the inflationary outlook.

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

The Government's fiscal operations for the balance of the calendar year 1948 are likely to show a budgetary deficit which would eliminate the only remaining important anti-inflationary influence. During the last three quarters of the year, it is estimated that the budgetary deficit may exceed 3 billion dollars. (In view of large tax receipts in the first quarter of 1949, however, there may be a small budgetary surplus for the twelve-month period beginning with April 1 of this year.) It is also estimated that continued sales of savings bonds and other public debt receipts will approximately cover voluntary redemptions of public debt by holders of maturing issues. The current deficit will need to be financed by drawing on Treasury deposits which have been built up by tax receipts during recent weeks, or by borrowing in the market. Under these circumstances, there can be no net retirement of Government securities held by the Federal Reserve System. To the extent that the Treasury may need to borrow new money, it probably will have to be obtained largely from the banking system.

During the next few months Treasury use of accumulated balances with Federal Reserve Banks will add to bank reserves, which will also continue to be augmented by the inflow of gold and possibly by further Federal Reserve purchases of Government securities from holders wanting funds for other uses. These last two factors may operate for a long time in the future. If the international outlook does not improve, Government deficits may continue and even increase substantially, and banks may be called upon to purchase additional Government securities. Under these conditions, the Federal Reserve would find it difficult, and perhaps impossible, to sell Government securities in order to absorb bank reserves without seriously upsetting the market for such securities.

Prospects are, therefore, that in the future gold inflow and Federal Reserve purchases of securities in maintaining an orderly market for long-term Treasury bonds will further increase bank reserves. Banks would thus be in a position to expand loans and investments for private purposes and this would mean still more inflationary expansion of the money supply. To restrain such potential expansion, the Federal Reserve would have to take action to absorb any excessive volume of reserves. Two types of measures should be adopted: (1) Interest rates on short-term Treasury securities and discount rates should be permitted to rise to the extent possible without raising rates on long-term bonds; and (2) To the extent that this action is not adequately

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restrictive, the Federal Reserve should have the power to increase reserve requirements substantially to cover at least any growth in the total supply of reserves.

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

Need for Additional Powers

Accordingly, the Board believes that the System should be given authority to increase the reserve requirements of all commercial banks. For the present this authority should make it possible for the System to require all commercial banks to maintain primary reserves with the Reserve System amounting to 10 per cent of aggregate demand deposits and 4 per cent of time deposits *in addition to present requirements*. This would give to the Reserve System power to increase bank reserves in the aggregate by a maximum of about 12 billion dollars. An authority of this amount would enable the System to absorb the reserves that are likely to arise from gold acquisitions or from necessary System purchases of Government securities sold by nonbank investors over the next few years.

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

The maximum requirement under this plan could properly be limited to 25 per cent of aggregate demand deposits and 10 per cent of time deposits. To be effective and equitable, it should apply to all commercial banks. A detailed description and analysis of the Board's special or optional reserve proposal was submitted to the House Committee on Banking and Currency and has been published in the Federal Reserve BULLETIN.

To the extent that it may become necessary to rely upon the banks for any new Government financing operations, the optional reserve requirement would be an especially valuable instrument. And in the case of large-scale deficit financing, it would be essential. In such financing, it would be advisable to make available to banks only short-term securities. Application of the optional reserve requirement would have the effect of immobilizing these securities so that they could not be used to obtain reserves to pyramid new bank assets upon them on a six-to-one ratio. In other words, securities issued in new Treasury financing through banks would be tied to the deposits created by their purchase. A ready market for short-term Governments would be assured and the Treasury would be helped in successfully carrying out both its refunding operations and its deficit financing. At the same time, the Federal Reserve would be enabled to exercise some restraint upon the money market for private credit.

The dominance of public debt in the present credit situation has rendered the System's traditional powers generally unusable for purposes of restraining further inflationary credit expansion. The Reserve Board is not now seeking additional power beyond what it formerly possessed; it is merely pointing out that the System has little or no authority to deal with the credit situation as it currently exists and seems likely to develop. If the Congress wants the Federal Reserve System to perform the functions for which it was established, the System must have a substitute or at least a partial substitute for those powers that have become unusable. The Board feels that it would be remiss if it failed to bring this matter to the attention of Congress.

There is no simple way of holding in check bank credit expansion in excess of essential public and private need. The problem should be met in a combination of ways—by general credit controls and in particular areas by selective controls, such, for

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example, as reimposition of consumer instalment credit regulation, and the continuation of existing margin requirements on stock market credit.

Other Anti-Inflationary Actions

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

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

Wherever possible, Government expenditures that will add to pressures on the labor and capital goods markets should be deferred, and State and local governments should be requested likewise to defer nonessential expenditures of this type. There should be early action to close loopholes in our tax laws and to strengthen the tax collection machinery. If the stage is reached at which Government expenditures again threaten to create large budgetary deficits, then a reimposition of wartime levels of taxation and direct economic controls along the lines proposed by Mr. Baruch, for example, should be undertaken. If young men are to be drafted into the military forces, then a way should be found to keep men at work in essential industries, and thus prevent the serious inflationary effects brought about by strikes.

Situation Now and in 1940

The Board believes that any realistic appraisal of the economic outlook from the standpoint of monetary and credit policy must take account of the underlying facts of the international situation. During the war there was no doubt about the ultimate victory. The country looked forward confidently to an era of stability and peace following the hostilities. Nearly three years after the end of fighting, however, we seem to be farther away from these goals than ever. Our national debt still exceeds 250 billions, or more than five times the prewar total. Federal budgets have never fallen under 37 billions a year and we are confronted now with the prospect of an expanding debt and budgets. During the war we expected the peace to bring an end to these enormous drains on our resources.

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

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

Over-All Policy Alternatives

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

First, we can continue on the present course of providing essential foreign aid and of carrying out a military program on a scale of, as yet, undeter-

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mined size and cost, while at the same time we have no effective checks on the free play of economic forces. This is the certain road, if followed long enough, to a ruinous inflation. Surely no one would seriously contend that we can go on adding more and more pressure in the boiler of inflation without an ultimate explosion. Those who view us with a hostile eye no doubt hope that we will wreck our economy on the shoals of inflation. It would be a cheap way to defeat us.

Secondly, the country could be subjected to a full harness of direct economic controls—for example, allocations, construction permits, rationing, price and wage controls, as well as taxation at higher levels. Without such a harness, amounting to a regimentation of the economy in peacetime, there is no sure protection against inflationary dangers that may lie ahead. They cannot be successfully combated by any single means or on any single front. There is no power that the Board now possesses or that the Congress could give us in the monetary and credit field that would be adequately effective by itself.

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

We may well ask for how many years must we maintain enormous and probably expanding military expenditures. The question is, how long, to what end, and at what consequences to our economy? We do not have the inexhaustible supplies of manpower and resources to support indefinitely, with no end point in sight, programs of the magnitude which we now are shouldering or contemplating. We cannot go on year after year bearing these crushing costs without jeopardizing what we seek to save. If we were confident of the early establishment of peace, we could tolerate a tightly controlled economy. We believe that the time element is the very essence of this grave problem.

Our nation sought neither territory nor reparations in either World War. We seek neither now. We ask only for the earliest possible establishment of the foundations for enduring peace. To that end, our third and best course may be to choose a combination of alternatives; that is to say, acceptance of such controls as may become necessary to prevent inflation at home while abroad we lay at the earliest possible moment the foundations for peace. Surely an informed public would be ready to accept even burdensome controls and taxation if convinced they are essential to safeguard our economy against a ruinous inflation, and that there is an early end point in sight which will enable us to maintain our system and our institutions in a peaceful world.

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

So far as the monetary and credit field is concerned, we have tried to make clear that action on these fronts alone cannot guarantee stability. Nevertheless, we believe that the Reserve System should be armed with requisite powers, first to increase basic reserve requirements of all commercial banks and, later on, if the situation requires it, to provide that all such banks hold an additional special reserve. Both of these would be protective measures. The first could be used to offset gold acquisitions and purchases of Government securities by the Federal Reserve, and thereby restrict continued expansion of our already excessive money supply. The second would be essential in case banks embark upon an inflationary credit expansion through the sale of Government securities to the Federal Reserve or to assist the Government in case of large-scale deficit financing.

We believe it is the part of prudence to recognize clearly that the underlying cause of the continuing inflationary dangers arises from the disappointment of our great hopes for the early establishment of

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world peace. Surely we must summon all our human and material resources needed to assure that peace. If necessary to protect our economy at home so that we shall not lose by inflation what we seek most of all to save, we should be willing and prepared to reimpose to whatever extent the situation demands a harness of controls, including higher levels of taxation. Nobody wants such regimentation but in the hard choices before us it is infinitely preferable to economic chaos and possible collapse of our system, to which all free men look for deliverance from the evils of war and misery that feed on economic distress.

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

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