

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

September 8, 1943

Chairman Eccles:

A few weeks ago you mentioned that it might be useful to have a discussion of some of the post-war implications of current war finance which might serve as a supplement to your previous statement to Mr. Paul and Mr. Stam.

Attached is a draft which Mr. Bach and I have prepared jointly.

R. A. Musgrave
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Current Financing Methods and the Danger of Post-War Inflation

A more vigorous fiscal policy is needed in order to relieve inflationary pressures during the war. It is needed equally in order to avoid an economic fiasco after the war is over. The post-war implications of current financing methods deserve much more attention than they have thus far been given.

Already the volume of liquid assets in the hands of the public has reached unprecedented levels. If present methods of war finance are continued, liquid assets will be so vast that we may face an explosive increase in consumers' and business' outlays shortly after the war. The same process through which this threat is created--the huge volume of Treasury borrowing--is simultaneously undermining the effectiveness of monetary and fiscal controls in curbing any inflationary situation which may develop. Every effort should be made now to forestall this dilemma by placing current war finance on a sounder basis.

Increase in Liquidity During the War

The current increase in liquidity is a result of extensive Treasury borrowing, in particular of borrowing from the commercial banks but also from the public. There has been an enormous increase in liquid holdings of businesses and individuals, both in the form of cash and deposits and in the form of highly liquid Government securities.

Holdings of liquid assets--in the form of deposits, currency and Government securities--by businesses other than insurance companies have already soared to over 50 billion dollars from 15 billion in 1930, while individual holdings have risen from 44 to nearly 90 billion, at the same time as private

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debts have been substantially reduced. With present Treasury financing practices, the total of these assets in the hands of the public may well reach 250 billion by June 1945, a possible war-end date, of which some 160 billion might be held by individuals and 90 billion by businesses. Estimated liquid holdings for 1930, the present, and two years in the future are shown in the attached table.

The larger the portion of securities which we sell to the banks, the more of these holdings will take the form of demand deposits and currency, and in fact much of the increase to this point has been in this most liquid form. Business demand deposits and currency (again excluding insurance companies) are already 32 billion dollars compared to only 13 billion in 1930, while individual holdings have soared from 10 billion to 28 billion. If we continue to sell about the present portion of the debt to the banks, these cash holdings may well be around 45 to 50 billion for businesses and 60 billion for individuals by 1945. In addition, time deposits of individuals, though increasing only slowly, are nearly 30 billion dollars.

Beyond the increase in the form of deposits and currency created by large-scale Treasury borrowing from the banks, the drastic increase in United States securities held by the non-banking public must also be recognized as an accumulation of highly liquid assets. Individual holdings of Government securities, which amounted to less than 10 billion in 1930, are now around 30 billion and may well reach 70 billion by 1945. Business holdings, only about 1 billion dollars in 1930, have reached around 20 billion, and may double in another two years. Many of these securities are demand obligations and are thus obviously convertible into cash at any time. The marketable issues, though maturing only at some future date, will in fact also be convertible into cash

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Estimated Liquid Holdings of Individuals and Businesses

	(In billions of dollars)			
	<u>1930</u>	<u>1943</u>	<u>1944</u>	<u>1945</u>
Businesses (except insurance) - total	15	55	(71)	(90)
Demand deposits & currency	13	32		
Time deposits	1	1		
U. S. Government securities	1	20		
Individuals - total	44	86	(122)	(158)
Demand deposits & currency	10	28		
Time deposits	26	28		
U. S. Government securities	8	30		

Note: Figures for 1930 are as of December 31, for other years as of June 30. Figures for business include both incorporated and unincorporated enterprises. Estimates for 1944 and 1945 assume 55 billion dollars borrowed each fiscal year from individuals, non-insurance businesses, and banks. On the basis of the past year's experience, one-third of resulting growth in liquid assets is allocated to businesses and two-thirds to individuals.

at any time should non-banking holders as a group decide to reduce their holdings. As indicated below, Federal Reserve policy acting through the banking system will be left no real alternative but to absorb the excess offering of securities in order to maintain the level of security prices. This will involve the automatic creation of new deposits. Government securities held by the public, therefore, constitute a very real form of potential purchasing power.

The enormous increase in the economy's liquidity in the form of cash or security holdings is an inevitable result of present financing methods, and as is emphasized in a later paragraph the future expenditures of funds by business or individual holders will not reduce the aggregate of liquid assets held in the economy but will only transfer them from one holder to another.

Individual and Business Expenditures after the War

A fairly even rate of spending out of accumulated balances or a reduced rate of savings out of current income might provide a welcome antidote to deflationary forces in the post-war economy. But this happy result will occur only if these expenditures are made at the right rate and at the right time. There is no assurance of this.

There is a particular danger, in fact, that individuals may go on a "spending spree" shortly after the war, when desirable civilian goods first begin to appear on the market but the economy is still far short of achieving peace-time capacity output. The threat of the ill-timed liquidation is particularly strong with respect to currency and demand deposits and to war savings bonds, which are redeemable on demand and have been widely sold under slogans encouraging the investor to ask for immediate redemption after the war to finance purchases of consumers' durable goods. A patriotic appeal for con-

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tinued holding of securities will carry much less weight after the war than now, and the post-war spending argument, which once appeared a happy safeguard against deflation, may well boomerang into a major inflationary pressure in the early post-war period.

The volume of liquid assets held by businesses is also approaching proportions where outlays on inventory accumulation and new capital formation may reach explosive levels with little or no need for the business community to rely on "outside" funds. If in the 1920's around 15 billion was an adequate supply of liquid assets, it seems doubtful indeed that legitimate business needs for liquidity at the war's end will approach even present holdings of 53 billion, much less the soaring figures which a continuation of present financing methods would involve.

(a) Working capital: It is altogether unlikely that post-war working capital needs will exceed peak war-time levels. Overall production will surely fall; inventories, goods in process and net receivables can hardly be expected to increase. If, as seems likely, provision is made for prompt payment on cancelled war contracts, these payments will free funds otherwise tied up in frozen war inventories, and together with post-war tax refunds will go far to keep businesses well supplied with working capital. On balance, working capital needs in the years immediately following the war will probably decline; at most any overall increase must be small relative to liquid accumulations on hand.

(b) Plant and equipment: For plant and equipment outlays, an estimate of 10 to 15 billion dollars for the first two or three post-war years appears liberal. If total public and privately financed outlay on business plant and equipment since 1940 has run between 20 and 25 billion, corresponding reconversion outlays will surely be substantially less. The post-war expansion of

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peace goods output will certainly be less dramatic than the war expansion of 1940-43, and much pre-war and war period plant and equipment will be usable.

Thus it is evident that if present Government financing methods continue, businesses, as well as individuals, will have on hand after the war liquid assets far beyond the requirements for a desirable rate of reconversion and output expansion. While there will undoubtedly be numerous particular exceptions, business in general will be in a position to finance for itself an unprecedented inventory boom and a destructively concentrated burst of capital formation.

Implications for Post-war Fiscal and Monetary Policy

The accumulation of liquid balances in the hands of businesses and individuals simultaneously increases the inflation potential and undermines the fiscal and monetary powers available to check inflation should it develop.

Monetary policy

Holdings of currency and deposits after the war will have become so large as to make businesses and individuals largely independent of the banks or the open market for funds. Beyond this the public will be in a position to finance additional expenditures by liquidating security holdings. War savings bonds are demand obligations which the Treasury must pay at the option of the holders. With respect to marketable securities, it is doubtful that the public and Congress would be willing to tolerate decreases in security prices comparable even to those after the last war. But perhaps more important, the tremendous volume of refunding which the Treasury must accomplish due to the present pattern of maturities (33 billion next year and an increasing amount as the debt rises) means that the confidence of the market in the value of Treasury issues must be maintained. If Government security prices were permitted to fall, this decline,

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with its attendant uncertainty, would necessitate such an increase in rates to obtain the required huge volume of funds for the Treasury on a competitive market basis that it can hardly be envisaged as a practical course of action. Probably, therefore, we shall have to maintain the market for Government securities at or around par for some time after the war. If, in an inflationary period, the public wishes to liquidate its Governments we shall have little option but to provide the funds desired through direct or indirect support of the market by the Federal Reserve. And the more inflationary public psychology becomes, now or after the war, the larger the volume of securities the Federal Reserve may have to take with a corresponding increase in cash available to the public.

As a result, the powers of the Federal Reserve to check inflationary credit expansion are being largely neutralized. When individuals and businesses reach a position where they do not have to resort to the banks or the market for funds to finance an explosive increase in expenditures, it is evident that such a development cannot be checked by tightening of credit. Neither general nor selective credit controls can be applied effectively. Moreover, if the bulk of individuals and businesses are in a position to finance their outlays unhampered by credit restrictions, considerations of equity may preclude application of stringent controls against even such marginal and smaller firms as may be still dependent upon bank credit.

Even if businesses or individuals should go to the banks for funds, the growing volume of Government securities held by the banks will make it impracticable to tighten credit during a period of inflationary spending. Under boom conditions traditional credit policy would dictate a restriction of credit and sharply rising interest rates. But maintenance of the security market is

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incompatible with this policy. In fact, commercial banks themselves may desire to liquidate security holdings, and such banks now hold over 50 billion dollars of Government securities. In two more years holdings may be nearly doubled. If excess reserves are lacking when private demands for credit arise, low-yield Governments will be liquidated to obtain funds for higher yield loans. Since the Federal Reserve will have to assure the maintenance of the market at stable or only slowly declining prices, the huge Government security holdings of the banks become in essence excess reserves, a liquid basis for further credit expansion.

Under the present Treasury financing program we are thus forcing ourselves continually deeper into a situation where after the war the central bank, due to public pressure and the needs of the Treasury, not only will be effectively barred from its major credit control function but will in essence have no option but to absorb large volumes of Government securities at exactly the wrong times and thereby to provide precisely the easy money conditions most conducive to further inflation.

Fiscal policy

Although fiscal policy is a more potent weapon against inflation than credit control, the present growth in liquidity throws serious doubts on the possibility of effective fiscal action against post-war inflation. Every dollar of new liquid holdings increases the force of the fiscal measures required to check a spending boom, should one develop. In the absence of a spending tax--which will hardly be acceptable to Congress in the post-war period--very high rates of income taxation would be required to check the expenditure of liquid balances in a period dominated by inflation psychology of spending to "beat" rising prices. But in fact it seems clear that strong pressure will be brought / to bear

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immediately after the war both to reduce taxes and to eliminate such direct controls as the allocation of materials, rationing, and price fixing. At the same time, substantial relief expenditures may be necessary. Under these circumstances, development of a full-fledged spending boom could easily lead to serious price inflation and business maledjustments laying the basis for ensuing deflation and instability.

While the most critical inflationary danger is likely to arise within a year or two after the war, it must be recognized that the powers of control lost through the creation of huge liquid balances will not be automatically restored once the public has had its "spending spree". Expenditures will merely transfer existing liquid balances to be spent again--not use them up. It is likely, in fact, that deposits and currency will even increase further in an inflationary period, because the public will sell off Governments for which the banking system, supported by the Federal Reserve, will be the only large-scale taker. The total volume of money will decline substantially only when the Government can retire its debt by obtaining current receipts in excess of current expenditures or when the banks can sell assets net to the public. Large-scale debt retirement can surely not be counted on in the immediate post-war years; at most a small portion of the huge total at the war's end could be retired each year. A large-scale shift of security holdings from the commercial banks to the public is even less likely, especially in an inflationary period. Yet only through such a reduction in liquid assets or through a drastic post-war inflation which wipes out the value of the holdings can consumer and business expenditure policies again be effectively subjected to traditional credit and fiscal controls.

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Implications for Current Policy

The potential dangers of a vast increase in liquid assets held by the public are alarming. It is essential that every effort be made now to keep the problem within manageable proportions by adjustments in our current methods of war finance. In particular, the following steps are required:

(1) By far the safest method of financing the war is by taxation. Every effort should be made to obtain the largest possible amount in the form of tax revenue. However, there are some obvious limitations to the tax approach, and it is not feasible to cover the entire cost of the war by taxes.

(2) Insofar as outright taxes are not feasible, refundable taxes should be utilized, with the post-war claims redeemable at the option of the Government. Although assets would be placed in the hands of the public under this arrangement, the Treasury would retain control over the timing of redemption payments. This constitutes a critical difference from the present types of borrowing which place liquidation at the option of the security holder, either through legal provision or the necessity of market price maintenance. Use of refundable taxes is especially attractive because the need for controlling the pressure of inflationary buying during the war is centered more heavily in the lower income groups than might appear desirable on equity grounds. If part of the revenue is collected in the form of refundable taxes, the refundable portion of the total contribution should be made greater for lower than for higher income groups.

(3) Insofar as marketable issues must be sold on a voluntary basis, every effort should be made to place the largest possible amount outside the banking system. Although the increase in security holdings by non-bank buyers constitutes a very real addition to post-war liquidity, this is a less dangerous addition than the expansion of deposits and currency which results from bank purchases.

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(4) Lastly, since we have already gone far in piling up liquid accumulations and since we will, as a practical matter, inevitably go considerably farther, every possible effort should be made to assure the maintenance of such direct controls as rationing, price fixing, and even possibly the allocation of some materials. The need for such controls should be over within a space of two years or so after the war. But over that period the need will be critical indeed.