

July 5, 1945.

Honorable Robert A. Taft,
United States Senate,
Washington, D. C.

Dear Bob:

You have so many far more important things to deal with that I am not suggesting you take the time to plow through the enclosed memorandum at this point, but I thought you might like to have it in hand for your own information in case the subject should come up.

A month or so ago, I received a copy of a confidential memorandum prepared by Benjamin M. Anderson on "The Control of Inflation, and the Treasury's Borrowing Policy". In it he indicated that he had sent the memorandum to a selected list and you are the only one on it so far as I can tell, who is a member of the Banking and Currency Committee of the Senate. While I don't imagine that you or others who are informed would be misled by Dr. Anderson's argument, it occurred to me that it might be well to have a statement prepared by our research people to point out the flaws in his reasoning and proposals. Accordingly, Dr. Goldenweizer, in consultation with our economic staff, wrote a memorandum which is also marked "confidential" to give the other side of the picture, and I thought you might wish to have it should the matter receive any public attention or come up in some way in the Senate or in the Committee.

With kindest personal regards, I am,

Sincerely yours,

M. S. Eccles,
Chairman.

Enclosure
ET:mla

June 15, 1945

B. M. ANDERSON'S FISCAL PROPOSALS

by

E. A. Goldenweiser, Economic Adviser,
Board of Governors of the Federal Reserve System

Mr. B. M. Anderson has written and circulated a paper on the Control of Inflation and the Treasury's Borrowing Policy. In this paper he compares our present position with that of France after the First World War and suggests that they are very similar. Secondly, he indicates that the First World War was financed very much better in respect to avoiding inflationary pressures than the present war. Thirdly, he emphasizes the danger in the present large volume of liquid assets and ascribes it to wrong financing and open-market policies by the Treasury and the System. As a program to save the situation he proposes a funding of the Government debt into long-term bonds at a rate of interest that would attract investors' money. Just what rate this would be is not indicated, but Dr. Anderson appears not to be too much disturbed by the idea of the rate rising to 4 or 5 per cent. He wants this accompanied by a sale of Government securities by the Federal Reserve Banks in order to tighten the money market. In order to protect the banks from the large loss of principal that would result from the rise in bond rates, he proposes to give them an opportunity to exchange their bond holdings for the higher interest securities with some slight loss of principal -- perhaps 2 per cent of the face value.

Dr. Anderson's diagnosis and program deal with the immediate situation and the immediate future, possibly the next 1 1/2 or 2 years, and the following discussion should be viewed with this time element in mind.

Comparison with France and with First World War

Dr. Anderson's comparison with France after the last war is quite irrelevant. The differences between our situation and the situation of France are far greater than the similarities. Our debt and debt service are much smaller in relation to national income than was the case in France. We have financed 40 per cent of the cost of the war by taxation, while France had so financed only about 12 per cent. France had a very large foreign debt, while we are still on balance a creditor in our international accounts. Furthermore, the difficulties of France after the last war were seriously aggravated by a flight of capital from the country, a development that it is difficult to conceive for the United States in existing circumstances. For these reasons it serves very little purpose to compare our situation with that of France.

In the second place, Dr. Anderson thinks that the last war was financed very much better than the present war, because the rate of interest was higher and was rising. What he seems to have forgotten is that at that time the entire monetary situation was different. Rates of interest were

much higher before the last war than they were before this war, because we had a great demand for capital and limited reserves. Even so the war was financed on a lower basis of rates than prevailed in the market and this was criticized at that time by persons of Dr. Anderson's general convictions as being unsound and inflationary. The Federal Reserve Banks had a differential rate on war paper which was used to a substantial degree.

The rate advanced as the war progressed and the Federal Reserve was not used to stabilize the market through open-market operations. This is generally considered now as having been poor policy, since it increased rather than decreased the difficulty of selling Government bonds outside of the banking system, and since it is widely recognized that a great national need should not be met at a rising cost to the Government. The fact that after the war rates advanced sharply, with the consequence that the buyers of bonds took substantial losses, is not mentioned by Dr. Anderson, but this surely should not be permitted to occur again. Also we had an inflation and a deflation after the last war notwithstanding methods of financing that meet with Dr. Anderson's approval. Distant pastures are greener.

Dr. Anderson stresses the large amount of liquid funds that has been created by financing the present war and the danger that they constitute for the economy. There is no doubt about the facts, but it might be mentioned that the ratio of deposits and currency to total national product has changed very little. In fact, what Dr. Anderson forgets is that the principal reason for the greater growth in liquid assets is that this war was on an immensely larger scale than the First World War. As a matter of fact, less than one-third of the First World War was financed by taxes as against 40 per cent of the cost of this war, so that the record is better this time than it was last time.

Dr. Anderson's apprehensions about the size of our unfunded, or short-term, debt does not appear to be justified. An unfunded, or short-term debt presents difficulty to a Treasury only when there is difficulty in obtaining funds to finance the Government's needs. This country faces no such difficulty unless indeed it should adopt the sort of policy as that recommended by Dr. Anderson.

Would higher rates prevent inflation?

The fundamental question is whether the remedy that Dr. Anderson proposes would be in the public interest. He would like to see the rate of interest on Government bonds go up to the point where they would be an attractive investment and would find their way into firm hands where they would be held. He offers some protection from the depreciation of outstanding bonds to the banks, but he says nothing about other institutions and private individuals who have bought Government bonds in good faith. He thinks that by his method inflation would be avoided.

First, the question should be asked whether higher rates on Government bonds would result in larger purchases by investors, or whether, on the contrary, the falling market on outstanding bonds might not result in a

loss of confidence in Government bonds as an investment and a flight from Government bonds by many holders. It would seem that the latter is more likely than the former. And if such a flight did occur, the Government would have no choice but to create money in one way or another and thus to fan the flames of inflation. Also, a drastic rise in interest rates on long-term bonds would disrupt the financial fabric of the country. It would also constitute a breach of faith to persons who have placed their resources at the disposal of the Government to fight the war.

A narrowing of the spread between short-and long-term rates may develop when the pressure of war finance diminishes, but this narrowing may be expected to be achieved by a gradual rise in short-term rates, with long-term rates near the present level remaining as a firm anchor of the rate structure.

Dr. Anderson thinks that rates will go up anyway, when the inflation, which he visualizes as the inevitable result of the present fiscal policy, takes place. To him it is a choice between what he considers a moderate advance in rates now or a much greater rise later. This point turns on one's views as to the inevitability of inflation and on methods of preventing it. When one believes, as is stated in this comment, that Dr. Anderson's proposals would aggravate rather than reduce the inflationary danger -- one cannot view the matter in terms of the alternative he presents.

Other social and economic consequences of high rates

It should be asked also whether a concentration of high-interest bonds in firm hands would be the best economic and social policy. It would seem that the opposite is the case. Firm hands, in plain English, means wealthy investors. The people of the United States, most of whom will have veterans of the war in their families, are not likely to welcome high taxation for many years for the purpose of paying interest to wealthy holders of Government bonds.

It seems apparent that the best condition of a large public debt is the present wide distribution of low-rate securities among all groups of people. The low rate will diminish the cost of the service of the debt and the wide distribution will reduce the amount of diversion of income from tax-payers to bondholders. The tax rates will be lower and since taxes are levied roughly in proportion to ability to pay recipients of interest on the public debt will to a considerable extent pay the interest on the debt to themselves. This is a sounder economic position and more in accordance with equity. To have rich bondholders, because they were able to buy war bonds in large amounts with profit to themselves, collect indefinitely a heavy tribute from the rest of the population is not an objective to be desired.

Furthermore, a high interest rate structure would be a severe handicap to business enterprise in the reconstruction period and thereafter. It would discourage new undertakings, because the cost of acquiring capital would be too high. The country has become adjusted to a rate of interest on riskless long-time investment of 2 1/2 per cent and the maintenance of that

rate would help greatly in facilitating productive enterprise. A policy of maintaining the low rates established during the war has been adopted in England and in Canada on grounds that are similar to those presented here for the United States. Governor Towers, of the Bank of Canada, stated the matter very pungently in his annual report for 1943, in which he said: "A policy aimed at higher interest rates would only become intelligible if, after war shortages are over, consumers' expenditures in capital developments were to proceed at a rate which would overstrain our productive capacity. I see no prospect of such a situation arising in a form which would call for a policy of raising interest rates."

In view of the enormous productive capacity of this country, which has been built up and demonstrated by this war, it is incredible that a situation should develop in the foreseeable future in which consumer demands will exceed our productive capacity. This, of course, has reference to a period after the country's industries have been reconverted to civilian use. Acute shortages of goods exist now and are likely to exist for some time to come, but the remedy for that is not in higher interest rates, which would retard conversion, but in facilitating the conversion process in every way.

Summary

To summarize, Dr. Anderson's comparisons with France and with the First World War are not enlightening, his belief in the magic of higher rates in attracting investment funds and preventing inflation is not realistic in existing circumstances, and his program of overcoming the dangers of inflation by a radical advance in rates is a proposal that might easily make inflation inevitable by undermining the public's faith in United States securities and that would play havoc with our entire financial structure. It would also retard reconversion and hinder expansion of business activity. Even if Dr. Anderson's expectations about attracting investors' money were realized, the proposal would result in a highly inequitable and politically dangerous situation, where a greatly increased burden of debt service would be borne by the broad masses for the benefit of wealthy holders of war bonds.

Of all financial programs that have been proposed this is the most irresponsible.

CONFIDENTIAL

Copy No. 4

For *Chairman Marion S. Eccles*

May 10, 1945

Memorandum on

THE CONTROL OF INFLATION, AND THE TREASURY'S BORROWING POLICY

by Benjamin M. Anderson, Ph. D.

Professor of Economics, University of California,
Los Angeles, since 1939
Economist, Chase National Bank, 1920-39
Economist, National Bank of Commerce in New York,
1918-20
Assistant Professor of Economics, Harvard
University, 1913-18
Instructor in Economics, Columbia University,
1911-13
Head of Department of History and Economics,
State Teachers College, Springfield, Missouri,
1907-11

Author of

The Value of Money, New York, 1917 and 1936
The Effects of the War on Money, Credit and Banking
in France and the United States, Carnegie Endowment
for International Peace, 1919
The Chase Economic Bulletin, 1920-37
The Economic Bulletin, issued by the Capital
Research Company, Los Angeles, since 1939

This document is confidential in the sense that I do not wish it published. I am sending it only to highly responsible men. A great war loan is impending, the success of which no one would wish to jeopardize. The situation with respect to our public debt, our banking system and our currency has grown extremely dangerous, as a result of the unsound policy which the Treasury has been pursuing. It is essential that there be the frenkest kind of discussion regarding the matter while there is still time to reverse the policy and to avoid a ruinous inflation.

I am, therefore, sending this memorandum, each copy of which is numbered, to the President of the United States, to the Secretary of the Treasury, to the members of the Board of Governors of the Federal Reserve System, to the twelve Presidents of the Federal Reserve banks, to the twelve members of the Federal Advisory Council, to the Chairmen of the Senate Committee on Finance, to the Chairman of the House Committee on Ways and Means, and to certain other highly responsible men, some members of Congress, some leaders in the banking profession, some economists, and others, whose names will appear at the end of the document.

We can avoid a ruinous inflation if we act promptly, but not, I believe, unless we do act promptly.

The public debt has already grown to a gigantic figure and promises to be much bigger before the war is over.

The ease with which the Treasury has been borrowing money at fantastically low rates of interest from the banks and the Federal Reserve banks has generated a false sense of financial omnipotence which is encouraging the demand for great postwar extravagances, both for governmental financing of exports to foreign countries and for unbearable governmental expenditures at home.

France in World War I and the United States in World War II

How dangerous our position is may best be revealed by a comparison of our war financing in World War II with that of France in World War I. It will be recalled that France greatly weakened her position during the war by heavy reliance upon the Bank of France and by a great increase in her bank note issue. She failed to pull up at the end of the war. In 1919 and 1920 the franc broke to low levels in the foreign exchanges. At the end of 1926 France made a de facto stabilization of the franc with a gold content of approximately 20% of the old par, and with commodity prices at 641% of 1913 prices.

With respect to most points we are now a great deal further along the road of inflation than France was at the end of the first world war.

(1) The relation of government debt to national wealth is now worse with us. France ended the war with a national debt of 147,000,000,000 francs as against a prewar national wealth estimated at 300,000,000,000 gold francs. The debt at par was 49% of the national wealth. By 1926, when France pulled up, she had a public debt of 287,000,000,000 paper francs (internal), and 23,000,000,000 gold francs (external, including debts to United States and British governments). (See Chase Economic Bulletin, February, 1927). We had at the end of 1944, long before the war is over, a national debt of \$230,000,000,000, as against a prewar national wealth not exceeding \$387,000,000,000¹. Our national debt December 31, 1944, was thus 59.5% of the national wealth.

(2) The growth of money in circulation in the United States since 1939 is greater in percentage than the growth of money in circulation in France between June 1, 1914, and August 29, 1918. France had about

1 - This is the top figure suggested by the National Resources Committee in "The Structure of American Economy", June, 1939, Part I, Pages 374-376. Their top "probable" figure is \$360,000,000,000 and their lower "probable" figure is \$350,000,000,000. I cannot find an estimate sponsored by the Department of Commerce later than 1922, when the figure was placed at \$321,000,000,000. Estimates both of national wealth and of national income, of course, involve assumptions, as well as facts, and the estimates for France in 1913 are, of course, less dependable than American estimates today.

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9,000,000,000 francs in circulation, including about 3,000,000,000 francs of gold, on June 4, 1914. 2,000,000,000 francs of this gold was turned into the Bank of France in the three years that followed, and 1,000,000,000 francs of gold disappeared from circulation. By August 29, 1918, French circulation, chiefly Bank of France notes, had risen roughly to 30,000,000,000 francs, an increase of 233%. This grew to 53,000,000,000 francs by June, 1926. In the United States money in circulation at the end of June, 1939, stood at \$7,000,000,000, and it now stands at \$26,000,000,000, an increase of 271%.

(3) The percentage of national debt carried by the banks is far greater with us than with France. On December 31, 1917, the French public debt stood at 123,000,000,000 francs, of which 12,200,000,000, or almost exactly 10%, was held by the Bank of France. But the commercial banks in France took very little of the public debt. The great banks, The Credit Lyonnais, the Comptoir d'Escompte and the Societe Generale, were badly shaken when the war broke out, and taken together, by the spring of 1918, had made virtually no expansion in their balance sheets. To some extent they had substituted government paper for commercial bills in their portfolios, but the amount was small. The only commercial bank that really expanded greatly in France during the last war was a bank of second rank, the Banque Nationale de Credit, which expanded a few hundred millions of francs, lending both to the government and to business. At the beginning of 1918 I should estimate that not more than 12% of the public debt was in French banks, including both Bank of France and commercial banks.
French figures

In the United States, on the other hand, at the end of 1944, 42% of the whole interest bearing public debt was in the commercial banks and the Federal Reserve banks combined. Leaving out that part of the public debt held by government agencies and trust funds, 46% of our interest bearing public debt was in the Federal Reserve banks and the commercial banks. Finally, looking only at the marketable public debt, and omitting that part held by government agencies and trust funds, 58% was in the commercial banks and the Federal Reserve banks.

France had very little increase in demand deposits during the war and almost all was in the Bank of France itself, where there was an increase of about 2,712,000,000 francs between June 4, 1914, and August 29, 1918. Our commercial bank demand deposits ("adjusted") plus United States government deposits stood on June 30, 1939, at \$28,147,000,000. On December 31, 1944, the figure stood at \$87,500,000,000, an increase of 210%. We have, therefore, enormously outdone France in the increase of a circulating medium, money plus demand deposits, during the war.

(4) The Bank of France steadily resisted inflationary developments, urging upon the Treasury constantly that it should borrow as much as possible from the people, and its resistance had real results. Our own Federal Reserve System seems to have surrendered its money market policy completely to the borrowing policy of the Treasury.

1 - I cannot, with the data at hand as I write, give all my French figures as of the same dates. Figures showing the classification and distribution of our own public debt at the end of 1944 will be found in the Federal Reserve Bulletin, March, 1945, pages 257-58.

But we must now take account of favorable factors in our situation as compared with the French situation in the last war.

(1) We are now doing very much better than France did in taxation. ✓

(2) Although France had a strong gold position throughout, we have what appears to be a world dominating gold position. But the outside world is gaining gold from us, and we are now apparently net debtor to the world on current account. (See National City Bank letter of April, 1945). ✓

(3) The relation of our national debt to our national income is more favorable by a good deal than it was in France. The estimate for national wealth in France in 1913 was 300,000,000,000 francs, and that for national income was 50,000,000,000 francs, giving a ratio of 10 to 1. Real estate is the biggest factor in national wealth and the French capitalized their real estate on a very low yield basis in 1913. The ratio of national wealth to national income in the United States was only $5\frac{1}{2}$ to 1 in 1912. It was again $5\frac{1}{2}$ to 1 in 1939 if we take the figure of \$387,000,000,000 given above for national wealth and compare it with the Department of Commerce estimate for national income for 1939, which was \$71,800,000,000. ✓

We do not know what our national income will be in the postwar period and we are uncertain what our national debt will be.

Our Debt Largely Unfunded

In the last war we placed the debt with the people primarily and in long-term form. The government did spend for a few months funds borrowed on short-term from the banks, and then issued great funding loans, in which bonds were placed with the people and out of which this short-term debt to the banks was paid down. The curve for short-term debt rose to peaks just before each funding loan, and then moved sharply down again. The banks always held some of the government debt. At the peak of the public debt they held about \$4,000,000,000, but this included nearly \$1,000,000,000 that they had held before the war to secure national bank notes and for other purposes. Of the war debt they held little more than \$3,000,000,000 at the peak in direct ownership, and much of this was short, and they had also another \$3,000,000,000 or \$3,500,000,000 of loans secured by government bonds which they had made to their customers to help them buy government bonds.

The Federal Reserve banks owned almost no government securities during the last war, except for a few days at a time when each of the great Liberty Loans was being floated.

When the war was over, the debt was largely funded. The Treasury knew where it stood.

Our Treasury today cannot know where it will stand when the war is over. The debt is very badly distributed. Of the part held outside the banks, there is a great part in the hands of corporations which are carrying depreciation reserves, maintenance reserves and liquid funds for reconversion purposes in government securities, but which must turn the government

securities into cash to accomplish their purposes when the war is over.

A great deal is in the form of tax anticipation certificates which will come back to the Treasury instead of cash.

The so-called war savings bonds, gigantic in volume, are in effect demand deposits. The holders can get their money at any time. These bonds have been sold in a high percentage of cases with the argument that in buying them the purchaser is buying a postwar automobile or a postwar home or a postwar washing machine. The behavior of the sales and redemptions of these bonds in the fiscal year 1945, as compared with the fiscal year 1944, is disquieting. The Treasury Daily Statement of April 20, 1945, shows that in the fiscal year 1945 to date the Treasury has sold only \$10,757,000,000 of these bonds, as against \$12,612,000,000 in the corresponding period of the fiscal year 1944. It shows also that in the current fiscal year the Treasury has had to redeem \$3,357,000,000 of these bonds, whereas in the preceding fiscal year it redeemed only \$1,774,000,000. The net intake of the Treasury on these bonds in the fiscal year 1945 is thus only \$7,400,000,000, whereas in the corresponding period of the preceding fiscal year it was nearly \$11,000,000,000. (Since March 1, 1945, these redemptions have included redemptions of matured savings bonds, but the tendencies indicated above were strongly in evidence before March 1). The Treasury may have a very grave problem with these demand deposits when the war is over. It is unfunded debt. The total of these savings bonds was \$40,361,000,000 at the end of December, 1944, and the total of the Treasury tax and savings notes was \$9,843,000,000.

Of the marketable issues, a very dangerously high proportion is in unfunded form. The total of marketable issues was \$162,843,000,000 as of the end of December, 1944. We may break this up as follows: Treasury bills, certificates and Treasury notes, total \$69,868,000,000. To this we ought to add the Treasury bonds maturing within five years, which stood at \$7,824,000,000, making a grand total of short marketable debt of \$77,692,000,000. To this we should add the war savings bonds and the tax and savings notes mentioned above, making \$127,906,000,000 of unfunded debt, out of a total of \$230,000,000,000 of interest bearing public debt, or 56%.

Of funded debt in the form of bonds maturing after five years the total is \$83,761,000,000, but this funded debt of over five years maturity is very badly held. \$31,672,000,000 of this is in the commercial banks. The part that is clearly well-placed consists of \$7,567,000,000 in the mutual savings banks, and \$17,303,000,000 in the insurance companies, a total of \$24,870,000,000, in these two classes of institutions.

The part that is held by individual investors is pathetically small. The great bulk of the public debt ought to be in the hands of the individual investors and it ought to be in funded long-term form. I cannot give the figure. It is part of \$21,321,000,000 listed under the category "other", which includes business corporations, states and municipalities, educational and charitable organizations, trust funds, investment banks, brokers, and investment companies, as well as individual investors. The rates of 2% on ten-year bonds, and 2½% on twenty-year bonds are simply too low to attract investors. The man who knows how to look at a bond table can see to what prices they would go if the rate of interest should rise, and he can look back over the history of government bond yields for the past twenty-five years, and see yields exceeding 5%.

Diagnosis

The symptoms of pathology in the handling of the public debt are very clear in the figures given above. What is the explanation, what is the cause of the pathology? The explanation is to be found in the fantastically low rates of interest at which the Treasury has been borrowing, made possible by the artificial manipulation of interest rates by the Federal Reserve System.

The lowest interest rates in all history, at a time when the world is destroying capital on a colossal scale, and when the government of the United States is borrowing many tens of billions of dollars a year, are obviously an anomaly. Normal interest rates reflect supply and demand of capital, and rise as supply diminishes or as demand increases. There are four normal sources of capital: (1) consumer's thrift; (2) business thrift, particularly the building up of corporate surpluses out of profits; (3) direct capitalization, as where the farmer uses his spare time in building fences and barns, or allows his flocks and herds to increase; (4) governmental thrift, where taxes exceed public expenditure and the government is paying down public debt.

New bank credit constitutes a fifth source of capital, safe enough when cautiously used and kept in reasonable relation to the growth of the four normal sources of capital and the growth of production in the country, but dangerous in the extreme when used to excess, as we saw in the period 1924-33.

Bank credit as a substitute for savings is particularly dangerous in war time. It has been the typical breeder of war and postwar inflation. The classical case is, of course, that where the government leans directly upon credit from the state bank of issue, as Germany and France both did in World War I. The great expansion of bank notes is obvious. But an expansion of bank deposits is in economic essence almost identical with an expansion of bank notes. Notes and deposits alike are demand liabilities, are both media of exchange. Psychologically, the note issue is the more dangerous. We are, however, increasing both now on a colossal scale.

In World War I, between April, 1917, and December 30, 1918, we expanded bank deposits by \$5,800,000,000 and bank loans and investment by \$7,000,000,000. In the period from June of 1922 to April 11, 1928, we expanded bank credit by \$13,500,000,000 in deposits and by \$14,500,000,000 in loans and investments. This generated our wild stock market and stock market crash of 1929, and the resulting troubles of 1930-33. In the present war, as we have seen above, as a result of the Federal Reserve cheap money policy and the policy of the Treasury of borrowing at low rates of interest from the banks, we have generated an expansion of bank credit in the United States of incredibly greater magnitude, and have increased our money in circulation from \$7,000,000,000 at the end of June, 1939, to \$26,000,000,000.

We had already very greatly overdone cheap money and bank expansion, and government security purchases by the banks, between March of 1933 and June of 1939. The Federal Reserve authorities had been greatly concerned, and had raised the reserve requirements of the member banks in late 1936 and early 1937 to double the minimum reserve requirements. The Treasury

was concerned, and created a "sterilization" fund. But Presidential action compelled both the Treasury and the Federal Reserve authorities to retreat with respect to these matters in early 1938.

The Warning of the Federal Reserve Authorities

But the Federal Reserve authorities remained concerned. In a report to Congress on January 1, 1941, there was a unanimous recommendation by the Board of Governors of the Federal Reserve System, the Presidents of the twelve Federal Reserve banks and the twelve members of the Federal Advisory Council urging the Congress to forestall inflationary tendencies (1) by increasing the power of the Board of Governors to raise reserve requirements of the member banks; (2) by ending the President's power to devalue the currency; (3) by repealing the power to issue three billion dollars of greenbacks; and (4) by selling government securities directly to investors, rather than to the banks. The first and fourth of these recommendations looked directly toward firmer rates of interest.

Belatedly, and by action originating in Congress, recommendations (2) and (3) of this report have been adopted or appear to be in process of adoption, but nothing has been done about recommendations (1) and (4). They seem to meet no favor in the Treasury. The Federal Reserve System, having made its protest, today lies supine. It imposes no brakes. It feeds the inflation of bank credit and currency.

Alleged Safety in New Techniques

We are told that new techniques have arisen which make the policy safe. I see very little in the way of new techniques, and rather, a very exaggerated use of old techniques.

We have, first, the purchases of government securities by the Federal Reserve banks, replenishing the reserves of the member banks. In the first world war, the Federal Reserve banks did this in connection with each of the four great Liberty Loans, reducing the strain in the money market for a few days, while the loans were being floated, and then promptly selling the government securities again. The magnitudes were small--for the first three Liberty Loans a few tens of millions, and in the Fourth Liberty Loan, something over two hundred millions--but only for a few days.

In 1924 and 1927, the Federal Reserve banks bought several hundred millions of government securities and held them for a good many months, in each case generating a very dangerous expansion of bank credit, and in the second case precipitating almost unmanageable difficulties.

In the present war, the Federal Reserve banks have bought government securities in terms, not of tens of millions or of hundreds of millions, but of many billions. The figure stood at \$2,184,000,000 on December 31, 1940, and at \$20,153,000,000 on April 18, 1945. This is no new technique, but the vast scale of its use makes one ponder.

Rediscount Rates Below the Market

In the last war, Federal Reserve Bank rediscount rates were placed below the market rates to facilitate war financing. But they followed the market up as the war went on. The New York Federal Reserve Bank rediscount rate was placed at 3% in 1917, moved up to $3\frac{1}{2}\%$ at the end of the year, and to 4% early in 1918, remaining, however, below market rates. At the present time, the Federal Reserve bank rediscount rate is $\frac{1}{2}\%$ for advances secured by government obligations maturing in one year or less. Here again there is no new technique, but merely an extreme application of an old one.

Reducing Reserve Requirements

The Federal Reserve authorities now have power to reduce the reserve requirements of the member banks, and they have already done this as far as New York and Chicago banks are concerned. But in the last war we reduced member bank reserve requirements by act of Congress in 1917--to levels that made us great trouble in the period of the 1920's.

Unlimited Access to Federal Reserve Banks at 3/8%

Finally, the Federal Reserve banks buy government bills without limit from the member banks at a fixed rate, 3/8 of 1% discount, with a repurchase agreement. This is designed to make the member banks look upon government bills as ready cash, and to make them feel that it is not necessary to carry excess reserves. It may be granted that we have here a new technique. It is obviously a highly dangerous technique, and a highly inflationary one.

Using Up Ammunition Rapidly

In the process of this immense bank expansion, we have used up ammunition very fast. The reserve ratio of the Federal Reserve banks to notes and deposits combined stood at 90% in April, 1942, and at 47% on April 18, 1945. Excess reserves, which stood at nearly \$7,000,000,000 in early 1941, dropped below \$1,000,000,000 in 1944.

Inflation Policy in Last War

During our own participation in the last war, we held down inflation admirably. The great rise in prices in the last war came between December of 1915 and July of 1917, before our government war policy got into operation. Commodity prices at wholesale in July of 1917 stood at 187% of 1913 prices. Under our war policy these prices receded to 182% in October of 1917, and then rose slowly, under the extreme pressure of the war, to 207% in November of 1918, after which they receded again to 197% in March of 1919.

Our war policy in the first world war with respect to prices contained four elements: (1) the sudden, very heavy application of war taxation; (2) great concern that bonds be sold to investors rather than to banks; (3) a firm money market to hold down bank expansion. Commercial paper rates in 1918 stood at 6%, though the government borrowed more cheaply. Rates were made, however, which would attract investors, and which could look reasonable over a long period of time. The First Liberty Loan was issued at $3\frac{1}{2}\%$, fully tax free, the Second Liberty Loan at 4%, the Fourth Liberty Loan at 4%, the last three Liberty Loans being partially tax exempt. (4) We had a limited amount of price fixing, applying to scarce essentials, and accompanied always by commodity control. We had retail price fixing only in the matter of scarce foods and fuels, and here not until after wholesale price fixing had been well established. We relied in the last war primarily on functional controls, rather than direct controls, as far as commodity prices were concerned.

Primary Reliance on Price Fixing in World War II

In the present war, building up an immense inflationary flood by the expansion of bank credit and money in circulation, we have used as our primary device for controlling inflation, price fixing, covering virtually all wholesale and retail prices and industrial wages.

Price Fixing Must End with the War

It is quite clear that these price controls cannot be tolerated if we are to have a free postwar economy. Prices have work to do. Prices are to guide and direct the economic activities of the people. Prices are to tell them what to do. Prices must be free to tell the truth.

Something may be said for the temporary continuation of price fixing, with rationing, in the case of very scarce essential commodities, but each case should be scrutinized carefully. The general idea that price fixing should be continued after the war for the purpose of preventing inflation must be absolutely vetoed. Inflation must be controlled, if it is controlled, by budget balancing and control of money and credit.

Eliminate Inflationary Money and Credit Policies Now

The existing low interest rates are made possible only by the substitution of bank credit for investors' savings. If bank expansion were to stop today, interest rates would forthwith rise. If, on the other hand, bank expansion is not stopped, we shall have a tremendous inflation. And then we shall see an immense rise of interest rates, the inevitable accompaniment of a great inflation. The choice is not between continuing low interest rates and not continuing. The choice is rather between a moderate and manageable reversal of policy in the near future, and an involuntary submission to very high interest rates at a later date.

Prescription: Fund the Public Debt
Now and Reduce Money and Deposits Now

I believe we should act promptly while the war is still on, while we still have controlled commodity markets, and while we still have wartime motives to work with, in funding the government debt into long-term bonds at rates of interest which will attract investors' money. The vast scale of the funding operations required means that we should have to supplement the attractive yield with effective bond-selling, including neighborhood pressure. I believe that if we act promptly, these rates can be intermediate between those we paid in the last war, and those we are now paying.

We now have outstanding, as a result of the previous abuse of bank credit, an immense volume of idle money in circulation and an immense volume of idle deposits in the banks. If these grew active, we should have an inflation that would blow us sky-high. The thing to do is to pull them in and get them invested in government bonds before they begin to work actively in other fields.

I cannot, of course, set exact figures at which investors will take long-term government bonds. Only the market can do that. But this idle cash is a market factor of first importance, tending to hold interest rates down. I think the thing to do is to increase the interest rates on new government securities forthwith to levels at which investors' money will be forthcoming. This should be accompanied by a sale of government securities by the Federal Reserve banks to tighten up the money market correspondingly.

Existing Excess of Money and Credit Tend to
Hold Down Interest Rates for Refunding Purposes

Now a rise in interest rates would set in motion powerful counter-forces which would tend to hold the interest rates down. With rising interest rates, savings banks and other banks would find it worth-while to offer attractive rates on savings accounts to the people, pulling in actual cash from circulation. And commercial banks would be interested in reducing or even dispensing with service charges on demand deposits, which would pull in a great deal of money from circulation. But this money coming in from circulation would ease the bank reserve situation and tend to hold interest rates down. Moreover, investors, attracted by higher yields on government bonds, would make a market for very many of the government securities now held by the banks. As the banks sold these securities to investors, investors would pay for them by checking against deposit accounts, canceling a great deal of the inflated deposits, and once more easing the money market situation by reducing the reserve requirements of the banks. *not much*

Protecting the Banks When Government Bond Yields Rise

There are two main objections to the policy which I propose:

- 1 - For an analogous situation, see my account of the money market in 1928, in The Chase Economic Bulletin, "Brokers' Loans and Bank Credit", October 31, 1928.

(1) that it would involve dangers to the capital structures of those banks now too heavily loaded with long-term government securities; (2) that it would increase the tax money required to meet the debt service on the Government's already enormous debt.

Let me say with respect to both these points that the problems grow progressively worse the longer we refrain from facing them.

To protect the banks in this change of policy, I have proposed that the banks holding long-term government bonds be allowed to exchange them for new issues at the higher rates of interest, at a discount of, say, 2% as compared with cash subscribers, leaving them with some loss but not with losses that would ruin their depositors. The F.D.I.C., whose solvency and liquidity are of highest importance, should have the same protection as the banks. Both banks and F.D.I.C. should be expected to take shorter maturities in making these exchanges. I have seen no other proposal for dealing with this that looks at all adequate. It cannot be solved by allowing the banks to carry these bonds at par on their books, regardless of the market. Informed depositors would simply withdraw their funds from banks whose capital structures were impaired, and put them into banks whose holdings of government securities were predominantly short-term. Nor do you solve any inflation problem by forcing the Federal Reserve banks to take long-term bonds from the member banks at par.

*local
area*

The present artificiality in the interest structure runs far beyond the regulation of member bank reserves and short-term money rates. The Federal Reserve authorities are also undertaking to regulate the long-term interest rates, by buying and selling government securities of different maturities. For an exposition of Federal Reserve policy with respect to this matter, see the Federal Reserve Bulletin of July, 1943, pages 590-91. A good many bankers have come to expect a sure market for their long-term government bonds in the Federal Reserve banks themselves. This is an ominous delusion. The holders of the ultimate reserves of the country must not be investment institutions and must not be looked to, to supply long-term capital or to manipulate the bond market. When the Federal Reserve authorities are finally driven to tighten the money market in resisting a great inflation, they will not be able to protect the prices of long-term government bonds without feeding the very inflation they are trying to control.

*problem
versus*

The Interest Burden of the Public Debt

With respect to the interest burden on the government debt, let me say that this problem becomes progressively worse if we delay it. We can now fund the government debt at moderate rates of interest, as above indicated. If, however, we wait for inflation to come, interest rates will rise rapidly and the Secretary of the Treasury will sweat blood as Treasury bills and certificates fall due, as people cash in their war savings bonds, and as he has to borrow money on the rapidly rising money market--or else print, which would not help the inflation.

Drastic Federal Budget Economies Essential

The notion that we can permanently hold the debt service on the public debt to a 2% rate is fantastic. The notion that we can permanently service three hundred billions of public debt with six billions of interest is fantastic. We had best face the facts now. The facts are that our postwar budget is going to be very difficult to balance, and that we face the necessity for drastic economies in the postwar period. The facts are that proposals for expanding Federal expenditures after the war must be fought all along the line. We do not create social security when we endanger the dollar in which social security payments are to be made.

Artificialities Built on Artificialities

I cannot pretend to know with confidence what is going on in the minds of men inside the government who, seeing the dangers, are still afraid to face them. But I have heard some fantastic suggestions.

One of them looks to a compulsory holding by the member banks of fixed quotas of non-negotiable government securities as a permanent matter, at nominal rates of interest with, however, the understanding that in times of necessity they may turn these over to the Federal Reserve banks for cash. Now always in the past our government securities in the commercial banks have been looked upon as secondary reserves. Always in the past we have had a free government bond market. The liquidity of the banks, and their ability to make adequate loans to commercial borrowers and their ability to meet depositors' withdrawals have always been greatly strengthened by their holdings of government securities. To freeze government securities in the banks is to freeze the banks. Moreover, the volume of bank deposits, which ought to be related to the needs of commerce, would then tend to be frozen, governed not by the needs of commerce, but by the Treasury's needs. Money market control with respect to the needs of trade and with respect to the need of checking inflationary tendencies would disappear under a system like this. Again the Federal Reserve banks, trying to tighten up and prevent the inflation from becoming a ruinous thing, would find themselves compelled to expand their credit as they took over government bonds from hard-pressed banks. No such artificiality will help.

I had last Autumn from a man in the government's financial system, whom I do not wish to identify as he was talking with me privately, an alarming suggestion which may or may not represent a considerable body of inside thought. He told me that we had learned many things, which economists had previously not known, which made it safe to proceed along lines that we had formerly regarded as unorthodox. He said that two years ago he had been afraid of the great expansion of bank deposits and money in circulation which the Treasury's borrowing involved, and afraid of the unfunded debt, but that today he had no fear at all of inflation. It will be perfectly possible with modern techniques to control the interest rates and to control inflationary tendencies. When I pressed him regarding methods, he said that the Nazi had developed some very good technical economic ideas. I said, "Yes, if you have enough regimentation,

if you have control of all commodities and all prices, if you have control of every man's pocketbook and every man's bank balance, if you have control of the farmer's consumption of his own production, if you can control all exports and imports and foreign exchange transactions, and if you have a sufficiently powerful and efficient Gestapo, you can take great liberties with money and credit." He said that the trouble with the Nazi is that they do not have consciences.

I may add, however, that without techniques of the Nazi type described in the preceding paragraph, it is not possible to continue our present course and avoid a ruinous inflation.

I know at least one man in the Federal Reserve system who was reconciled to inflation nearly two years ago, who held that inflation always follows a great war, and that it is necessary to cover up the great war debt. To this man I would say, first, that I do not believe it. We can, by sound measures taken promptly, protect our currency from further debasement, and protect our price system from ruinous convulsive movements. Moreover, the accomplishment of the measures which I propose would still leave far more inflationary material lying around than I like to see. For one thing, we have not yet felt the main impact of the 40% cut in the gold content of our dollar in 1934, and we have not yet seen the consequences upon the world of the rise of annual world gold production from \$430,000,000 in old gold dollars in 1930 to roughly three times that figure in new gold dollars in 1939. I would add that in any case the most hopeless pessimist would wish to have some control of the situation.

Inflation is not something that you can turn off and on like water at a faucet. Inflation and deflation are not simple terms, and they are not simple opposites. There is no financial Westinghouse air brake by means of which an inflationary movement can be smoothly tapered off and brought gently to an end without a shock. Rather, inflationary forces engendered in defiance of sound financial policy may seem harmless for a long time, and then suddenly break forth into great violence.

It is far better for the Federal Reserve System to act now when moderate restraining movements will accomplish a great deal, than to wait until the great inflationary movement is under way and when even violent methods of restraint may have limited efficacy. And it is far better for the Treasury to face the financial facts regarding the public debt service now, while it is possible to fund the debt on moderate terms, than to wait to face the violently rising interest rates which a real inflation always creates.

Benjamin M. Anderson

This memorandum is being sent to the officials listed in the second paragraph on Page 1, and also to the following:

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Senator Josiah W. Bailey
Senator Harry F. Byrd
Honorable Clarence Cannon
Honorable Leo T. Crowley
Senator Forrest C. Donnell
Honorable Joseph W. Martin, Jr.
Honorable Frederick C. Smith
Honorable John W. Snyder
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Senator Millard E. Tydings
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BANKERS

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Birmingham

Mr. Oscar Wells, First National Bank

Boston

Mr. Walter S. Bucklin, National Shawmut Bank

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Mr. J. Stewart Baker, Bank of the Manhattan Company
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Mr. W. L. Hemingway, Mercantile-Commerce Trust Company
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Mr. Sidney Maestre, Mississippi Valley Trust Company

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Professor Harold L. Reed, Cornell University
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Professor Walter E. Spahr, Secretary, Economists' National Committee
on Monetary Policy
Professor Marvel M. Stockwell, University of California, Los Angeles
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