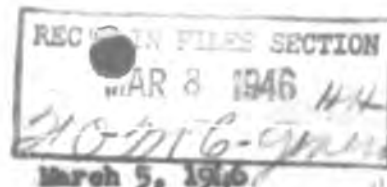
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INFLATION, BANK CREDIT, AND THE GOVERNMENT DEBT

Policies to finance the war. On the day after Pearl Harbor, the Board of Governors announced that the Federal Reserve System was prepared to exert its influence toward maintaining conditions in the Government security market that were satisfactory from the standpoint of the Government's requirements. During the war the joint policy of the Treasury and the Federal Reserve was to facilitate the financing of the huge necessary increase in the public debt and to do so at a steady and low interest cost and with as little inflationary effect as possible. The Federal Reserve supported Administration policy in fields outside of the responsibilities of the Federal Reserve. These included various direct controls, such as price ceilings, allocation of production, and rationing, and also the general policy of paying as much as possible of the cost of the war from taxation.

The Federal Reserve and the Treasury jointly sought to reduce inflationary trends by directing their policies toward selling the largest practicable amount of new Government securities to investors other than commercial banks and the Reserve Banks and toward inducing these nonbank investors to hold their securities. It was recognized that it would be both impossible and undesirable to place all of the increased debt with nonbank investors, because some increase in bank holdings was necessary in order to provide the public with the larger amount of deposits needed in an expanding and abnormal war economy. With this exception, however, the policy was to place all of the increased debt with nonbank investors. This policy resulted in channeling current income and idle funds of nonbank investors from the purchase of scarce goods and services to investment in Government securities. It also retarded the increase in bank deposits and thereby limited the amount of funds that were in readily spendable form for purchasing goods and services either during the war or afterward. This policy was implemented by eight war loan drives and by payroll savings plans.

The Federal Reserve during the war directed its open market operations toward stabilizing within a relatively narrow range the prices and yields on marketable Government securities. This policy was recommended to the Treasury by the Federal Reserve, and the recommendation was accepted by the Treasury. The purpose of the policy was to avoid financing the war on a rising level of interest rates, which had been the experience in the first World War. Yields were stabilized in accordance with a pattern of rates on outstanding marketable Government issues having various maturities. This pattern ranged between 3/8 per cent on three-month Treasury bills and 2 1/2 per cent on long-term Treasury bonds.

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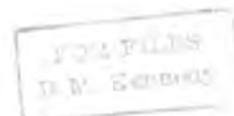

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Individual issues with maturities between these two terminal points had yields that were graduated between 3/8 and 2 1/2 per cent on the basis of a general pattern. The policy of stabilizing prices and yields was implemented by open market purchases and sales of Government securities by the Federal Reserve.

The stability that was maintained in the Government security market facilitated Treasury financing by assuring investors that, since the market value of their holdings of Government securities would not decline as new issues were offered, they had nothing to gain by delaying purchases in the hope of obtaining higher rates at a later time. This stability also assured the Treasury of a low interest cost on the debt and of a satisfactory market in which to sell the unprecedented amount of securities that it issued in financing the war. The Federal Reserve, by freely purchasing securities at stable prices and yields, also provided commercial banks with reserves as reserves were needed to meet wartime monetary demands.

During the course of war financing, the Federal Reserve made several recommendations that were designed to retard the expansion of bank credit without increasing the interest cost of the debt to the Treasury. The Federal Reserve proposed a long-term non-negotiable security which would have been ineligible for purchase by commercial banks. The security would have carried rates graduated on a sliding scale up to 2 1/2 per cent, depending on the period held. This feature would have prevented short-term money from being invested in long-term securities at higher rates, a practice which later developed on a large scale as investors became convinced that the Federal Reserve would maintain rates on Government securities for the duration of the war. The Treasury later issued in lieu of this proposal, long-term marketable issues which were restricted for a period of years against purchase by commercial banks. To provide an investment outlet for temporarily idle corporate funds at low rates to the Treasury, the Federal Reserve proposed a short-term non-negotiable security. This security also carried graduated rates depending on the period held, which would encourage holding to maturity. To accomplish most of the objectives of the proposed security, the Treasury later issued tax savings notes.

The Federal Reserve recommended that the rate on three-month Treasury bills be increased from 3/8 to 1/2 per cent. The purpose of this recommendation was to make three-month bills more attractive to commercial banks and to corporations and thereby to widen the distribution of bills. It had become evident that banks and nonbank investors would not hold any large amount of bills at 3/8 per cent when they could purchase certificates at 7/8 per cent. It was the belief of the Federal Reserve that the Treasury would be able to issue a larger amount of bills at 1/2 than at 3/8 per cent and consequently would be able to reduce the

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issuance of higher-rate securities, and thereby would reduce the interest cost of the debt.

Subsequently the Federal Reserve recommended that both the 3/8 per cent bills and the 7/8 per cent certificates be refunded into 3/4 per cent bills. The principal purpose of this recommendation was to reduce the profit that could be made by purchasing certificates at par and selling them as their yields declined. This new security also would probably have reduced the interest cost of the debt.

The Federal Reserve recommended as early as November 1941 that securities offered for commercial bank subscription should have maturities not exceeding 10 years. This recommendation was accepted by the Treasury in October 1942, with the result that the interest cost of the debt was reduced considerably. For a time the Treasury continued to issue 2 per cent bonds in the drives, and large amounts of these bonds subsequently were purchased by commercial banks. In view of this fact, the Federal Reserve recommended that the Treasury discontinue the issuance of 2 per cent bonds. As a result the yields on outstanding issues in this range of maturities declined sharply. In the Seventh War Loan, the Treasury issued 1 1/2 per cent bonds, which reduced further the interest cost of the debt, and in the Victory Loan the only securities that commercial banks generally could purchase were 7/8 per cent certificates. These changes also were recommended by the Federal Reserve.

<u>Expansion of bank credit.</u> Although the wartime nature of open market operations facilitated Treasury financing, it in effect transferred from the Federal Reserve to the holders of Government securities the power to determine the amount of reserves that is supplied to commercial banks and consequently to determine the level of bank credit. As long as the Federal Reserve is committed to preventing the prices of Government securities from declining, the Federal Reserve must purchase all Government securities that are offered at or near the current level of prices and yields. This provides a ready source of funds both to commercial banks and to nonbank investors. It increases reserve balances and thereby encourages commercial banks to expand credit further.

The pattern of rates that is now in existence is particularly conducive to the expansion of bank credit. This arises from the wide spread between the yields on short-term securities and the yields on long-term bonds. A pattern of rates that is stabilized over such a wide range affords an inducement to investors to purchase only the higher-yielding long-term bonds. By this means they obtain not only the higher yield but also a profit. This profit accrues because of the fact that individual issues, as they approach maturity, decline in yield and consequently increase in price. Investors are encouraged thereby to purchase marketable securities, to sell them at a profit after holding them for a short time, and to repeat the process.

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Commercial banks have shown an increasing tendency to shift from the lowest-yielding shortest-term issues to higher-yielding medium-term issues. They generally purchase the medium-term issues from non-bank investors and sell the short-term issues to the Federal Reserve. These purchases by the Federal Reserve increase the member banks' reserve balance and enable the banking system as a whole to expand credit by several times the amount purchased by the Federal Reserve. As long as the yields on short-term securities cannot rise, bidding by banks for medium-term issues increases the prices and reduces the yields on these issues. This will continue until the yields on medium-term securities have declined to the point where commercial banks consider the spread to be unattractive. The only other limit to the possible expansion of bank credit is (1) the amount of loans that commercial banks are willing to make and (2) the amount of other assets that are eligible for commercial banks to purchase and that they are able and willing to bid away from nonbank investors or to purchase on issue.

The expansion of bank credit is occurring at a time of increasing inflationary pressure. A large demand for goods and services is backed by huge purchasing power in the form of liquid assets accumulated during the war, as well as by the high level of current income. The ever-increasing supply of funds is spilling over into speculation in lower-grade bonds, common stocks, real estate, and commodities, which the purchasers expect will increase in price.

If inflation is permitted to continue unchecked, it will lead to a collapse, which will jeopardize the achievement of the long-run objective of maintaining high levels of production and employment. The most effective means of fighting inflation is through taxation and budgetary surpluses. Taxes should be maintained at a high level, Government expenditures should be kept down, and the public debt should be reduced as much as possible. In addition controls should be maintained until the danger of inflation has passed. At the same time, monetary policies should be directed toward preventing any further expansion of credit. While monetary policies taken alone cannot stop inflationary tendencies, they can influence important elements in the situation, and they should be among the weapons employed.

Decline in long-term yields. Present policies result not only in a dangerous expansion of bank credit but also in increases in the prices of long-term bonds and declines in their yields. Commercial banks purchase medium-term bonds from nonbank investors, who in turn bid against each other for long-term bonds not available for bank purchase. This trend has been accentuated since the Victory Loan by the knowledge that the Treasury will not need to raise any new funds for a considerable period of time.

A further decline in long-term yields would tend to decrease savings and to cause the public to rely to an increasing extent on the Government for protection formerly supplied through savings deposits,

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insurance policies, and the like. In addition it would decrease the earnings of insurance companies, savings banks, and endowed institutions which invest principally in long-term bonds. These institutions hold the savings of the public and perform important services that are essential to the public.

A substantial decline in their earnings might make it necessary for the Government to subsidize them or possibly even to socialize them. We do not want to adopt socialism indirectly by permitting long-term yields to decline to too low a level. If we want to adopt socialism, the people should have a chance to determine that question, and they should not be forced into it by the indirect means of declining long-term yields. The Congress should study this problem carefully to determine whether some modification of present policies is not desirable.

Solution by customary means. Further expansion of bank holdings of Government securities could be stopped if the Federal Reserve would discontinue buying all securities offered. Nonbank investors consequently would not be able, by selling Government securities, to obtain at will new deposits for spending, and they might find it both more difficult and more costly to raise funds by borrowing from banks or by the issuance of new securities. This policy, however, would probably result in some rise in short-term interest rates. This in turn would increase both the interest cost of the debt to the Treasury and the already large earnings by commercial banks as maturing and called issues were refunded.

The importance of interest charges is shown by the fact that, as a result of the wartime expansion of the debt, the interest cost of the debt has increased from an annual rate of a billion dollars to 5 billion. The importance of commercial bank earnings is shown by the fact that, as a result of wartime purchases of Government securities, they have more than doubled and now equal 10.9 per cent of their capital accounts. This increase has occurred despite the fact that the Treasury has limited commercial bank purchases of the highest-rate bonds that it has offered. Although most of these earnings have been wisely used to increase capital accounts rather than to increase dividend payments, it is questionable whether capital accounts of banks should be built up at the expense of the taxpayer.

Commercial banks did an excellent job in aiding the financing of the war. They were an important factor in selling Government securities to nonbank investors. They handled a tremendous volume of ration coupons. They purchased the Government securities that the Treasury offered and was unable to sell to nonbank investors. The interest rate on Government securities held by commercial banks should be fair to commercial banks and should give them a reasonable profit for the services

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that they render. On the other hand, it is necessary for the Treasury to be fair to taxpayers and to pay to the banking system a rate of interest that will not give to banks unduly large profits.

Federal Reserve program. Since present policies are resulting in a dangerous expansion of bank credit and a dangerous decline in long-term yields, the Federal Reserve hereby submits a four-point program that should go a long way toward meeting this problem and should do so without increasing the interest cost of the debt and without increasing further the already large earnings by commercial banks.

First, the Treasury should use some of its large cash balance to reduce the public debt. The Treasury already has announced that it will redeem for cash the bonds and notes that have been called for payment and mature on March 15 as well as a billion dollars of the certificates that mature on March 1. Continuation of this policy will further reduce the interest cost of the debt to the Treasury. In addition, to the extent that the securities redeemed for cash are held by commercial banks, both bank credit and bank earnings will be reduced.

Second, the Federal Reserve should discontinue the preferential discount rate of 1/2 per cent on Reserve Bank advances collateraled by short-term Government securities. The preferential rate was established as a war measure at a time when an increase in bank holdings of Government securities was necessary and some encouragement of bank borrowing to obtain reserves or to adjust reserve positions was desired. The establishment of the rate was a temporary measure designed to meet a special situation, and it was felt at the time that the rate should be eliminated when the need for it had passed. Now that war financing has been completed and the Treasury will not need to raise new funds for a considerable period of time, the conditions that prompted the establishment of the preferential rate no longer exist, and the continuance of the rate can no longer be of service to the Treasury's financing program. The elimination of the rate would have no influence on the cost of future Treasury refunding, because that will be determined by Federal Reserve support of the Government security market through open market operations.

The preferential rate not only has passed its period of usefulness, but makes it profitable for banks to borrow at 1/2 per cent to purchase higher-yielding Government securities. The preferential rate also encourages banks to lend on securities at low rates, thus giving substantial profits to borrowers. The magnitude of the possible credit expansion is several times the amount of the borrowings, because the bank reserves created by the additional Reserve Bank credit provide the basis for a multiple expansion in member bank credit.

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Third, the Treasury would reduce the weekly offering of Treasury bills to an amount sufficient only to cover the needs of the banking system in meeting day-to-day fluctuations in reserve funds. The Treasury would refund the remaining bills, which are held by the Federal Reserve, into special certificates at a rate of 1/8 per cent. This would reduce the present large earnings by the Reserve Banks. The Federal Reserve would discontinue the 3/8 per cent bill buying rate and the repurchase option, but would support the market for bills by purchasing any bills not otherwise absorbed at a satisfactory rate. The rate would be permitted to rise gradually until it reached a point where it would be in line with the rate on certificates. It might start at 1/2 per cent and would probably not exceed 3/4 per cent. The Federal Reserve would purchase and sell bills freely at around the market rate for the purpose of assisting banks in making day-to-day adjustments in their reserve positions. The interest cost of the debt would not be increased, because the decreased cost on Federal Reserve holdings of special certificates would offset the increased cost on the bills, and the Treasury might be able to save a little interest by increasing the outstanding amount of bills and reducing the amount of 7/8 per cent certificates, which would be made possible by the likelihood that there would be a larger demand for bills at the higher rate.

Fourth, the Congress would be requested to pass legislation permitting the establishment of a requirement that all commercial banks in the country maintain their holdings of Treasury bills and certificates at or above some percentage of their net demand deposits. This provision would retard the expansion of bank credit and of bank earnings without raising short-term rates. The exact requirement, which should be left to the discretion of the Federal Reserve within limits, could be placed sufficiently high so that commercial banks as a whole would need to purchase bills and certificates on balance. By this means commercial banks, rather than the Federal Reserve, would support the market for certificates, and this might even reduce the rate to 3/4 per cent. Commercial banks as a whole might need to sell some notes and bonds, which would reverse the present tendency for commercial bank purchases to reduce medium-term and long-term yields and would tend to make long-term yields return toward 2 1/2 per cent. The Federal Reserve, however, by making any purchases that might be necessary, would maintain the 7/8 per cent rate on certificates and the 2 1/2 per cent rate on long-term bonds.

The limitation on bank credit expansion would be determined by the bill-certificate requirement and by limiting the outstanding amount of bills and certificates, together with a requirement that any banks not holding the required amount of bills and certificates would make up the shortage by holding reserve balances in addition to those that they are otherwise required to hold. When the banking system, as a result of the requirement, held all of the outstanding bills and certificates or all that could be obtained from nonbank investors, any further expansion in net demand deposits would

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need to be covered by additional reserve balances. This latter provision would also afford some flexibility to commercial banks that were gaining deposits and did not hold an adequate amount of bills and certificates. Some provision might also be necessary to take care of individual banks that hold a small amount of Government securities. In the event that total holdings of any bond were less than the bill-certificate requirement, a bank for a time might be exempted from the requirement, provided that all of its Government security holdings were in reserve securities and provided further that it made no increase in its loans or its holdings of other securities. Although this provision could be used to prevent further expansion of bank credit at the present time, it is sufficiently flexible to encourage an expansion of bank credit at any time that deflationary developments might make such an expansion desirable.

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