

Subject: Inflation and Interest Rates on Government Securities

I do not believe it is useful to discuss the problem of interest rates except in terms of the two major problems facing us under present conditions. On the one hand, we must make available to the Government the goods and services needed to carry out our mobilization program, and these goods and services will reduce the amount available for civilian purposes. At the same time, we are endeavoring to avoid an inflationary rise in prices and wages for reasons which it is unnecessary to elaborate.

The Treasury is directly concerned with both of these two great problems. We must find the funds which the Government requires to finance its greatly expanded needs for men, materials, equipment and all the manifold activities connected with the defense program. This is our financing problem, which we must deal with through taxes and through appropriate issues of government securities. The Treasury is equally concerned with the second front, that of controlling the inflationary pressures in the economy created by the defense program. To this end the Treasury has submitted to the Congress programs for increases of taxes which, when adopted, will effectively contribute to reducing the inflationary pressure, as well as finding the necessary funds. We are equally concerned, in our borrowing operations with both aspects of the problems before us. We must borrow the funds which we need, and we wish to do so with the minimum of inflationary results from our borrowing.

Broadly speaking, we face the inflationary situation before us primarily because of growing shortages of civilian goods. The public

knows that we are going to have these shortages, and there is always a tendency for prices to rise and for inflationary movements to get under way whenever it is anticipated that a government must undertake a large scale defense program. Inflationary pressure is inevitable and has always been present in such a situation. We have to do our best to deal with and control those inflationary pressures.

Inflation means over-spending. It means that everyone is trying to acquire more goods or services than he can acquire at present prices. It is this tendency to over-spend which brings about inflation. Hence, it is basically necessary to find ways and means of avoiding or preventing this over-spending.

How is this over-spending made possible? From what sources does it spring? Broadly speaking, it can come in three ways. First, people can stop saving the normal proportion of their current income and try to spend this amount. Second, they can go further, and draw upon their past savings in the form of bank deposits, savings bonds, and similar holdings. Third, they can borrow against their credit or against capital assets, or sell their capital assets.

In the United States our people were saving at an annual rate of approximately \$15 billions per annum in the first quarter of 1950. If they stopped this saving and spent that money, this could add ^{more than} \$2 billion a month to the spending throughout the country and put an inflationary pressure on prices if additional goods were not being produced to meet the increased rate of expenditure. In fact, the supply of goods was tending

to be restricted as the government went forward with its defense program. In the second place, there was outstanding at the time of Korea, a very large volume of liquid savings in the hands of the public, amounting to about \$200 billion. Drawing upon these savings may be made at any time and constitutes a continuous potential inflationary pressure of very large magnitude. In fact, during the third quarter of 1950 the rate of personal consumption expenditure by the public grew to \$198 billion per annum, as compared with \$182 billion per annum in the first quarter of the year. The rate of savings, by comparison, fell off from \$15 billion in the first quarter to \$6 billion in the third quarter, despite the higher incomes resulting from the inflationary rises in wages, farm prices and other incomes during the period.

The third source of funds for over-spending is borrowing or realization of capital assets. Most typical, perhaps, of the two classes are loans from banks and sales of securities on security exchanges. A great deal of attention has been given to the effect on the inflationary picture of the upward trend in bank loans. These loans in fact rose by about \$ billion in the third quarter of the year. There can be little or no question that the full purchasing power provided by many of these loans has contributed to over-spending. What is important to remember is that this is only one source from which funds have been obtained for over-spending. It is not the largest or the most significant source. It would be difficult to prove that expenditures which have been made during this period would have been impossible if these loans had not been made. Nevertheless it is certainly true that there might have been a slightly smaller amount

of what I have called over-spending if there had been no expansion in bank loans during this period. Personally, I believe that even if there had been an absolute freeze on the total outstanding loans of every bank in this country during recent months, so that there could have been no net expansion in bank loans by the banks, that we would ^{merely} have seen a heavier rate of drawing on private savings, some greater liquidation of securities and other capital assets, so that there might have been only a very limited and perhaps hardly noticeable diminution of the upward pressure of wages and prices caused by over-spending.

I do not say the above in order to imply that the bank loan problem should not be dealt with, even though I am convinced the present situation would not be appreciably different even if it had been dealt with very drastically. Although it may be a relatively small element in the entire picture of the inflationary pressures, it clearly requires attention. What I do wish to emphasize is that it must not be given disproportionate attention in terms of all the efforts which we must make to deal with the inflationary problem.

Those efforts take two general forms, which tend to be called the direct and indirect anti-inflationary programs. The direct approach is exemplified by price and wage ceilings. By imposing these ceilings, we are trying to stabilize incomes and we are trying to decrease the speculative pressures resulting from anticipation of future increases in prices. We are trying to maintain the general level of the cost of living, so that our workers will be satisfied that their real incomes are stabilized. These are the direct controls and they are very important because they touch directly at the foundations of an inflationary movement. The real basis

for nearly every inflationary movement is anticipation of higher prices and higher incomes. Our efforts have to be directed toward dealing with that basic factor. The direct measures are also of great help in preventing the tendency for the movements of prices and wages to interact on each other in a sort of upward spiral, one following the other and no tendency to settled readjustment being apparent.

We must remember that all these measures are taken against the background of a situation in which many items are going to be in short supply, and have to be in short supply if we are to carry out our defense effort satisfactorily. We do not want any more shortages than necessary. But we do want the necessary shortages, because they mean we are getting the job done. We must not, however, let these necessary shortages become distorted into widespread and general inflationary pressures, with people vainly attempting to get the goods which are not going to be there by continually bidding-up prices and then asking for higher wages, when they find that prices have gone up.

One of the important series of direct controls consists of the restrictions which have been imposed on consumer credit and on real estate credit. These have a direct impact in dampening down over-spending in these two important areas, and help to release goods, labor, materials, and other resources for the production of more necessary items. They have been, in a sense, forerunners of the commodity allocation arrangements which we are having to introduce, and they assist in the enforcement of those allocation programs.

In addition to these direct controls, we have undertaken to act against the inflationary menace by the so-called indirect controls. These are measures which do not deal specifically with particular prices, incomes,

or categories of credit, but apply more generally to the objective of reducing over-spending. They are of three general types: first, we increase taxes to reduce the amount that people can spend out of current income; second, we intensify our efforts to ask them to make^a contribution to our national survival by saving and lending their money to the government at reasonable rates; third, we try to reduce reserves of the banking system, so that it will have less potential power to expand credit.

I am sure you will agree that we have vigorously and conscientiously pursued the policy of increasing our taxes. The inflation which we have had to date has not been due to any significant budget deficit, and in fact we have been taking in more money than we have been paying out thus far. But we do not have in prospect a continuation of this happy situation. We will have to increase our taxes ~~x~~ so as to pay as we go to the utmost extent. But, unfortunately, we would have to go much further than this to avoid any possibility of over-spending. We would have to tax our people heavily enough to meet all the expenses of our defense effort, and also to take away most of their saving, if we relied solely on the tax measures.

Instead of this, we are endeavoring in every possible way to supplement our tax policy with a vigorous effort to ask people to save and provide their savings to the government. Let us be quite frank. The success of our anti-inflationary measures in general contribute to the success of our saving campaign, and our savings campaign contributes to the success of our anti-inflationary program in general. In a situation like the present everything works together. The better we do in any direction, the better we shall do in all directions, and vice versa. It is a gigantic campaign like a military campaign, in which every part of the operation must contribute

its share to the campaign. And likewise, the better everyone does, the easier it is for everyone in the campaign.

It is in the third sector of the anti-inflationary campaign that we have run into difficulties. There is a conflict between the objective of reducing the potential power of the banking system to extend credit and the objective of maintaining a stable market for government securities which form such an important part of our financial structure at the present time. There is some difference of opinion as to how this conflict should be resolved. The difficulty arises because the banking system now holds a large volume of government securities purchased at par or better, which are the assets which it holds against the deposits of the public. The savings of the public, in effect, are invested in these government bonds indirectly through the banking system. The banks have not hesitated to sell these government securities to the Reserve System and make additional loans on the basis of the reserves thus established. One way of dealing with this problem of expanding loans by the banks would be, it is argued, to allow the price of government bonds to fall so that banks would not sell them to make loans of inflationary character. That is to say, if the Federal Reserve System should no longer be prepared to buy the bonds at or above par, the banks would not sell them to the Reserve System because they would take a loss, and hence would be reluctant to establish the reserves necessary to make the additional loans. Against this point of view, it is the Treasury opinion that there are ^{more effective} other ways of limiting the expansion of loans by the banking system, and that this particular method has the serious disadvantage of hampering the efforts of our government to raise the necessary funds through tapping the savings of the public. It hampers

this operation in two ways. First, it increases the cost to the Treasury of borrowing money, and makes the Treasury pay to the banks and other financial institutions larger amounts in the form of interest on the public debt, thus adding to the overall expenditures of the government and the over-all deficit to be financed by appropriations and taxes. Secondly, by disturbing the confidence of depositors, insurance policy holders, and other savers, it may accelerate a flight from government securities into commodities and other forms of wealth.

The Treasury believes that, at this critical juncture, the overall fiscal advantages of maintaining the level of interest rates is more important to the country, than the limited contribution which would be made to the bank loan problem by allowing interest rates to rise fractionally and the prices of government to fall. There are a number of reasons why we do not feel that, under prevailing circumstances, a rise in bank loans would be effectively prevented by unsettling the government bond market. The banks today can replenish their cash reserves and go on making loans, without needing to sell any long-term government securities to the Federal Reserve System. They have in their portfolios short term bills and notes some of which mature every day, week or month. To make new loans all that is necessary is that they fail to renew some of the maturing short term securities which they now hold. It is for this reason that we do not believe that banks will forego opportunities to make profitable loans even if their long term government securities are made unmarketable except at a loss. The fact that in recent months they have preferred to sell long-term government securities rather than let the short-term holdings run down as

a means of replenishing their reserves, I believe is to a substantial extent due to the desire to reduce their portfolios because of the threat that prices of these securities might be allowed to decline.

It would not, in my opinion, have been easy to stop the loans that the banks have been ^{making} during the past few months by any of the indirect measures which affect primarily the prices and the interest rates on government securities. I strongly suspect, as I have indicated before, that nothing short of a definite ceiling on the loans permitted to any bank, in the form of a quota for total loans fixed by the Federal Reserve Board would really have achieved the result of preventing an expansion in bank loans during recent months.

While I remain rather skeptical as to the effect of indirect measures in holding down the level of bank loans when the bank's customers are vigorously demanding credit, there are other ways of applying indirect pressure to the level of bank loans without at the same time incurring the risks of unsettling the government security market or adding to the cost of the defense effort and the size of the budget. These might take several forms: a general increase in reserve requirements, the addition of special emergency reserve requirements during the emergency period, and an extension of selective controls on credit in the form of directives to the banking system. Though I do not place any ways near as great emphasis on the significance of bank credit in the total inflationary picture as some others do, I fully agree that no objection should be made to any attempt to deal with this aspect of the inflationary problem unless it involves dangers to other objectives we have before us. Consequently, I would

support the adoption of legislation authorizing the Board of Governors of the Federal Reserve System to increase reserve requirements above present levels. I would also endorse the proposals which the Board of Governors has made at previous dates, as a special emergency period device only, the requirement of a special reserve, over and above regular reserves, to be held in the form of eligible securities of a short time character. I believe this should be a special emergency measure rather than a permanent authority.

In the third place, I would be glad to see the powers of the Federal Reserve System extended to enable them to provide limits as to the amount of business inventories as well as consumer credit, which may be financed for a given borrower. I would also be glad to see them given powers to direct the banking system to refuse credits for particular types of activities. In fact, I am prepared to accede to any request of the Federal Reserve System for powers to control bank loans directly, so long as these powers are not exercised in such a way as to make more difficult the problem this country faces in financing this gigantic effort of national survival and maintaining a steady and confident market for the billions of government securities which ~~I~~ must eventually be placed with the public and with the financial system, at rates which are reasonable but which do not add unnecessarily to the heavy burden of expenditures which we must write into our forthcoming budgets.