SPEECHES OF

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CREDIT CONTROL BY THE FEDERAL RESERVE SYSTEM

There are five principal means by which credit control may be exercised in the Federal Reserve System. These are:

Discount Rates
Open Market Operations
Direct Action
Reserve Requirements
Margin Requirements

Discount Rates

Under the original terms of the Federal Reserve Act two principal instruments of credit control were used. One of these was the discount rate; the other was the rate on bills, or as they are called in the Act, "Acceptances". The Act specifically provided that each Federal Reserve bank "establish from time to time, subject to review and determination of the Board of Governors of the Federal Reserve System, rates of discount to be charged by the Federal Reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business". To this the Banking Act of 1935 added the provision that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board". This does not mean that the rates have to be changed every time, but that they must be regularly and frequently reviewed. The Reserve banks usually take the initiative in any action on rates.

The discount rates of the Federal Reserve banks are usually somewhere between bill rates, which are usually lower, and other short-term rates in the open market, which are usually higher. They are also lower than rates which banks charge their customers for loans. They differ, therefore, from the discount rate of foreign central banks, such as the Bank of England, for example, whose discount rate is higher than the market rate. Since the Federal Reserve bank discount rate is lower than the rates charged by member banks it has usually been possible for member banks to borrow from the Reserve bank and relend at a profit. It has not been the practice for them to do so, however, probably because they are averse to having borrowings show up in their published statements. Consequently, member banks as a usual thing borrow of the Reserve bank only when they have to in order to replenish their reserves and avoid the penalty for deficiencies in their reserve accounts.

Although each Federal Reserve bank's rate is determined largely with reference to local conditions, it is important, of course, not to fix rates at any one Reserve bank without reference to the conditions to which other Reserve banks are subject. The member banks in one district cannot go to the Federal Reserve bank of another district, but nevertheless if rediscount rates in one district were noticeably lower than in another it would be possible for funds to find their way through indirect channels (such as correspondent banks, for example) from the district where rates were low to the district where rates were high. Consequently, general conditions as well as local have to be taken into account in determining what the rediscount rate will be and what changes should be made.

The Federal Reserve Act formerly limited the classes of paper which Federal Reserve banks could discount for member banks, on the principle that a definite preference should be maintained for short-term credit based on self-liquidating commercial transactions. The Reserve banks were, therefore, given the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or backed by United States Government obligations. It was a narrowly defined classification. Advances on a wide range of other assets which made up an important part of the total earning assets of banks were not authorized. These included advances on securities other than those of the United States Government, on real estate loans, and on other loans of considerable importance in the portfolios of banks.

As a result of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged to dump them on a falling market, suffering severe loss thereby and contributing to the deflation in values, or to close their doors.

The new banking act increases the powers of the Federal Reserve banks so that they may meet this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the highest discount rate in effect at the particular Reserve bank. This amendment modifies and makes permanent the emergency legislation which was passed in 1932.

In addition to the foregoing general powers of discount and purchase the Federal Reserve banks have special powers with respect to loans to commerce and industry for working capital purposes. These powers are granted by Section 13b of the Act. Under this section the Reserve banks are authorized to discount loans made by member banks and other financing institutions to established industrial and commercial businesses for the purpose of supplying working capital.

These changes made by recent legislation enlarge very greatly the kind of credit which the Federal Reserve banks may deal in directly, and give the Reserve banks greater freedom of action in meeting requirements of the money market.

Open Market Operations

In addition to the discount rate and the bill rate, two other important means of credit control have been developed from Reserve System experience, although they were not specifically contemplated in the original Federal Reserve Act. These are open market operations and direct action. Open market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. They have the effect of increasing or decreasing the supply of credit available in the money market as a whole. They do not leave control of the money market dependent upon the voluntary action of member banks in seeking funds for the replenishment of their reserves, but give to the Federal Reserve banks the initiative in influencing the market. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. By purchasing securities they put funds into the market and tend to ease credit conditions. If securities are sold they must be paid for, and in the process of paying for them the reserves of member banks are diminished, for every payment means a debit sooner or later to some member bank's reserve account. If the program is carried far enough the member banks will be forced to restrict their extensions of credit or dispose of some of their assets to the Federal Reserve banks either by sale or rediscount in order to replenish their reserves. When this happens, the member banks have been forced by the initiative of the Reserve banks to take action which they would otherwise not have had to take. If, on the contrary, market conditions are such that member banks have gone into debt to the Federal Reserve banks in order to replenish depleted reserves, the Federal Reserve banks may relieve the situation and the tightness which exists in the money market generally by buying securities on a large scale. The funds which they release in payment for the securities which they buy flow one way or another into the reserve accounts of the member banks and enable the latter to pay off their obligations. If the purchases continue beyond this point, they create excess reserves which it is likely the member banks will try to put to some use.

By selling securities, therefore, the Federal Reserve banks may enable themselves to give an effectiveness to a discount rate which it would not have otherwise until such time as market conditions had stiffened and individual banks were forced by those conditions to go to the Reserve banks for funds. Open market operations, therefore, enable the Reserve banks to accelerate corrective action. They are especially useful in view of the tradition which makes banks refrain as much as possible from borrowing from the Federal Reserve banks. If member banks felt no inhibitions about being in debt, and built up their reserves by borrowings so that they might make more loans, they would more generally be amenable to control through the discount rate. As it is, however, the discount rate must depend for much of its effectiveness upon open market operations.

The powers of the Reserve banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act, but at the time were not generally considered to be of very great importance. It was not until 1922 that open market operations were conducted on a large enough scale to affect the money market. The first operations were carried on by the Federal Reserve banks independently of one another, but it was soon found that action had to be coordinated, for otherwise the banks would be buying or selling in competition with one another and following different, and perhaps conflicting, policies. Consequently, a committee representing several of the reserve banks was formed for the purpose of coordinating their operations. About the same time the purpose of the operations was clarified. For some time there had been a tendency to allow purchases and sales to be influenced by the objective of profit, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned. This is in line with the general policy of central banks in conducting open market operations; they do so quite definitely with the idea of correcting credit conditions and not for the purpose of making earnings.

The Banking Act of 1933 gave specific recognition to open market operations and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. The statute provides that open market operations "shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made further change by providing that the Federal Open Market Committee should comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve banks. The law also makes the decisions of this committee obligatory upon the Federal Reserve banks and provides that the record of the committee's actions shall be included in the annual report of the Board submitted to Congress. Thus an activity which was barely recognized in the original Federal Reserve Act, and which was gradually developed in the process of administration of the System, has come to be emphasized in the law as one of the System's most important activities.

Direct Action

I also mentioned direct action as a means of credit control. Direct action means individual effort by the Federal Reserve banks to discourage credit policies of given member banks in given circumstances. For the correction of specific conditions, it is to be regularly resorted to by the Reserve banks in their relations with member banks. Opportunity for it occurs on various occasions, but particularly when the member bank is being examined, and when it is seeking to rediscount some of its paper. In this sense, direct action is largely an individual matter and the form taken by it in any case may have little or no reference to general credit conditions. It may also have reference either to regional or country wide conditions, however, and may then be resorted to for the purpose of enforcing general credit policy. The power to exercise direct action against member banks lies partly with the Federal Reserve banks and partly with the Board of Governors.

The effectiveness of direct action was specifically strengthened by the Banking Act of 1933 in several particulars. When it appears that undue use of bank credit is being made for the purpose of speculation in securities, real estate, or commodities, or for any other purpose inconsistent with sound credit conditions, the facts should be reported by the Federal Reserve banks to the Board of Governors of the

Federal Reserve System. The Board may in its discretion suspend any member bank making such use of credit from recourse to credit facilities of the System. Furthermore, authority has been given to the Board to remove from office any officer or director of a member bank who has violated the law governing the bank's operation or who has persisted in unsafe and unsound practices in conducting the bank's business. The Board also has power to limit for each Federal Reserve district the individual bank capital and surplus which may be represented by loans secured by stock or bond collateral.

It is to be presumed that these special powers will not often have to be used, in view of other broad powers designed for control of credit conditions, but in principle they are nevertheless significant, for they indicate that the law definitely contemplates the exercise of considerable responsibility by the Federal Reserve banks and the Board.

Power to Change Reserve Requirements

Recent legislation has also established two other new forms of general credit control which previously did not exist. The first of these is the power given the Board to change the reserve requirements imposed upon member banks by the statute. For most banks the requirement is and has been for years that they have reserves on deposit with the Federal Reserve bank equal to at least 7 percent of their demand deposits, and 3 percent of their time deposits. The power to alter these reserve requirements was first given the Board by an amendment to the Federal Reserve Act May 12, 1933, but under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the present requirements nor increase them to more than twice the present requirements. The effect of raising them, which is the only action that could now be taken, because the reserves are now at the point of legal requirement, would be to decrease the lending power of member banks and consequently the available credit. The effect of subsequently lowering them would be, of course, to enlarge the lending power and the amount of available credit. This means of credit control is one of the most powerful and direct that the law has bestowed.

Margin Requirements

The second new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying listed securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934. This grant of authority was in line with various provisions of the Federal Reserve Act, such as I have already referred to, aimed at restricting the use of credit for speculative purposes. In the language of the Securities Exchange Act, the authority it bestows is to be exercised with the object of preventing "the excessive use of credit for the purchase or carrying of securities". The standard established in the Act and adopted by the Board as an initial regulation limits the loans which a broker or dealer may make on a security to whichever is higher of the two following ratios:

(a) Fifty-five percent of the current market price of the security, or

(b) One hundred percent of the lowest market price of the security since July 1, 1933, but not more than seventy-five percent of the current market price.

This standard permitted the extension of credit up to seventy-five per cent of current market value on securities that had made little or no advance from the lows of recent years, and up to fifty-five percent on securities that had made considerable advance. The Board, however, was given authority to alter this initial standard, making it either higher or lower as conditions might warrant, and it has recently changed the fifty-five per cent limitation to forty-five per cent. The reason for this action was realization of the possibility that recent increases of stock market values might lead to such excesses as the law sought to prevent.

The determination of margin requirements is designed to exert a restraining influence on speculative trading. By imposing higher margin requirements on securities that have had a rapid rise, credit is made less freely available for trading in speculative stocks. A limitation is also imposed on the extent to which speculative profits on securities can be used as margins for further speculation, a practice that is known as pyramiding.

The power of the Board to raise margin requirements provides an instrument for controlling the demand for credit from speculators in the stock market without restricting the supply available for other borrowers. It differs from other means of credit control in that it affects directly the demand for credit rather than the available supply or cost. Through the use of this instrument it may be possible for the Board to exert a restraining influence on the use of credit for speculation in the stock market before it has reached a stage at which the general business and credit situation is unfavorably affected. The use of the instrument exercises a restraint on speculation without limiting the supply or raising the cost of credit to agriculture, trade, and industry.

The Securities Exchange Act specifically exempts from its provisions all obligations of the United States Government, of any state, municipal, or other political subdivision, and of agencies or instrumentalities of a State or local government. Additional exemptions of a similar nature are provided for.

Brokers and securities dealers subject to the Act are not permitted by the Act to borrow from banks which are not members of the Federal Reserve System, unless such banks agree to comply with the same conditions relating to the use of credit to finance transactions in securities as are imposed on member banks.

The foregoing provisions governing the credit activities of brokers and dealers are covered in Regulation T of the Board of Governors.

Insofar as banks are concerned, the Board's authority relates to loans made for the purpose of purchasing or carrying securities registered on national securities exchanges. It does not apply, therefore, to loans made solely for industrial, agricultural, or commercial purposes, regardless of the question whether these loans are secured or unsecured, and, if secured, regardless of the character of the collateral. The determining factor is the purpose of the loan and not the nature of the security offered. If a loan is made for the purpose of purchasing or carrying securities registered on a national securities exchange, it comes under this section of the act; if it is made for any other purpose -- industrial, agricultural, or commercial -- then it is exempt. It is also exempt if it is secured by certain types of collateral other than stocks, such as bonds and government obligations. In general, the law, insofar as it applies to control over banks, is intended to prevent the banks from being used for the purpose of circumventing the margin requirements prescribed for loans extended by brokers to their customers, and to prevent undue expansion of bank credit in the securities markets.

The law imposes upon the Board no duties in connection with supervision of stock exchanges or prevention of undesirable practices among members of such exchanges. Responsibility for these matters rests upon the Securities and Exchange Commission.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discount rates, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special. Let me mention a few things that complicate the task of credit control.

In the first place, if there were a clear connection between given extensions of credit and the uses to which the credit is ultimately put, the control of credit would be simplified. This connection was formerly assumed to exist and to afford an important means of control. The thought was that the Reserve bank could shut off speculation by refusing to discount the notes of speculators. That, of course, is far from the facts. A bank may borrow from the reserve bank on bills of lading covering the sale of merchandise and at the same moment it may buy the mortgage of a man who is speculating in industrial stocks. The extension of credit on bills of lading was specifically favored by the original Federal Reserve Act, yet in such an instance as I mention, it might make possible a speculative activity directly opposed to the purposes of the Act.

Another important fact is that more than half the banks of the United States are not members of the Federal Reserve System. The system has consequently only a partial and indirect influence on their credit activities.

For another thing, there is always the important consideration that United States Treasury activities must be taken into account.

These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve such large sums and so intimately affect the banking and credit situation that Federal Reserve policy and Treasury policy must always be coordinated with one another.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks.

These factors, among others, necessarily limit and modify the exercise of credit control.

Speech delivered before
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THE FEDERAL RESERVE SYSTEM AND CREDIT CONTROL

It is now nearly three years since I left Chicago to take up my present duties in Washington. In those three years the administrative organization and functions of the Federal Reserve System have undergone important and interesting changes, mainly brought about by the Banking Acts of 1933 and 1935.

In general terms, I think the most important accomplishment of recent legislation so far as the Federal Reserve System in concerned is that it strengthened and clarified the lines of credit control. A few changes affecting the organization and functions of the Federal Reserve banks were made, but they were not changes in essentials. The most conspicuous of these changes was that the title of President was given to the principal executive officer. Formerly his title was Governor. The title of Vice President now replaces the former title of Deputy Governor. As you know, the former titles, Governor and Deputy Governor, were not mentioned in the Federal Reserve Act. The office of Governor was originally created under the general authority which the Federal Reserve Act gave the directors of the Federal Reserve banks to arrange for such officers as were necessary for the administrative work of the banks. Originally, the only office specifically mentioned by the Act, other than that of director, was that of Federal Reserve Agent and Chairman, with assistant agents and deputy chairmen. The Banking Act of 1935 in designating the President of the Federal Reserve bank as its chief executive officer merely recognized an arrangement that had developed under general authority and that had proved itself desirable from the point of view of Federal Reserve bank administration.

The organization of the governing board of the System was changed considerably by the Banking Act of 1935. In the first place, the old name "Federal Reserve Board" was changed to "Board of Governors of the Federal Reserve System". At the same time, the chief executive officer of the Board was designated as Chairman. Furthermore, the number of members of the Board was changed from eight to seven and all of these members were made appointive. Formerly, as you know, the Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Board.

The term of office of the members of the Board was formerly 12 years. Under the new law, the terms of members now in office range from 2 to 14 years and their successors in office will have terms of 14 years so arranged that the term of one member will expire every 2 years. Since a member who has served a full term of 14 years is not eligible for reappointment, there will be a regularly recurring change in membership; one member leaving the Board and a new one being appointed every 2 years, unless more frequent changes occur from deaths or resignations.

The most important changes effected by the 1935 Act, however, have not to do with these matters of organization so much as with the function and authority of the governing Board in the field of credit.

In the course of the twenty-two years that have elapsed since the Federal Reserve banks were established much experience and knowledge have been accumulated. Some problems which the System was devised to remedy have now been settled and others have taken their place. At the same time the conception of central banking functions has changed in many respects. The net result is that the System presents in certain ways a different aspect from what it did formerly.

Twenty-two years ago the ideas prevailed that the important functions of the Federal Reserve banks were to furnish an elastic currency, to lend to member banks which were short of money some of the reserve funds accumulated by other member banks, and to curb the speculative use of credit by rediscounting only paper representing self-liquidating commercial transactions. These ideas now appear quite inaccurate, or at least inadequate. Furnishing currency is seen to be less important than it was thought to be, because currency cuts a very small figure in the total of payments that are made by people in their dealings with one another. What they use for the most part is bank credit in the form of deposits. The control of bank credit as a whole is, therefore, of greater importance than the control merely of the currency supply; it is also incomparably more difficult.

In the second place, the reserve banks do not depend on the deposits which member banks maintain with them for the ability to make loans and buy securities. They pay for such assets by entering deposit credits on their books in favor of the member banks whose paper they discount or whose investments they buy. If a member bank's reserves are deficient, it can turn over some of its assets to the Reserve Bank and receive a credit to its reserve account. The Reserve Bank in such a transaction is not lending to one bank what it owes to another; it is exercising the familiar banking power of paying for assets by the entry of deposit credit.

In the third place, it is recognized that there is no necessary connection between the form in which credit is procured from a bank and the form in which it is used. Money may be borrowed on acceptances and yet be used in the stock market. It may be borrowed on a real estate mortgage and yet be used to buy merchandise. It may be borrowed on the security of speculative stocks and yet be used to finance the production and shipment of commodities. Consequently, any discrimination for or against a certain type of paper offered for discount does not mean that speculation is being controlled or that credit is being supplied for the needs of commerce. The task of controlling the use of credit is far more difficult than such a supposition would imply.

Under various provisions of federal law there are five principal means of credit control which the Federal Reserve banks or the Board of Governors may use. These are:

Discounts
Open Market Operations
Direct Action
Reserve Requirements
Margin Requirements

<u>Discounts</u>

The Federal Reserve Act has from the beginning provided that each

Federal Reserve bank establish from time to time rates of discount to be charged by it on various classes of paper; these rates to be subject to review and determination by the Board of Governors of the Federal Reserve System, and to be fixed with a view of accommodating commerce and business. To this the Banking Act of 1935 added the new requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board". This does not mean that the rates must be changed every time, but that they must be regularly and frequently reviewed. In general the initiative in making changes in discount rates rests with the Federal Reserve banks, but the Board has authority to make changes on its own initiative if the public interest demands.

When the Federal Reserve Act was adopted the prevailing idea seems to have been that discount rates were not only the most definite means of credit control but the most important. This idea was apparently based upon a belief that member banks would seize the opportunity to borrow funds from the Reserve banks at a low rate of interest, in order to relend them to their own customers at a higher rate. This was a logical supposition and it appears to be widely held even at the present time. As a matter of fact, it has not worked out that way in practice at all. Member banks rarely show a disposition to borrow from the Reserve banks for the purpose of relending. They do not like to borrow and as a general thing they will not borrow unless they have to, no matter how low the rediscount rate is. Custom appears to exercise a very imperious control over them in this respect. As a consequence, they borrow from the Reserve banks as a usual thing only when they have to augment depleted reserves.

The Federal Reserve Act formerly limited the classes of paper which Federal Reserve banks could discount for member banks, but the Banking Act of 1935 eased these limitations. The principle followed in the original provisions was that a definite preference should be maintained for short-term credit based on self-liquidating commercial transactions. The Reserve banks were, therefore, given the power to discount only such paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, or paper backed by United States Government obligations. These were narrowly defined classifications. Advances on a wide range of other assets which made up an important part of the total earning assets of banks were not authorized.

Moreover, as a result of various financial and economic developments the classes of paper which could be used as a basis for borrowing from the Reserve banks had for many years constituted a decreasing proportion of the assets of member banks. In 1929 it was only about twelve percent of their total loans and investments, and in 1934 it was only eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks whose assets as a whole were good nevertheless had very little that was technically eligible for use in borrowing at the Reserve bank. They therefore had to dump their assets on a falling market in order to raise the funds they needed.

The new banking act increases the powers of the Federal Reserve banks so that such a necessity may be avoided. It authorizes advances to be made to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank. This amendment modifies and makes permanent the emergency legislation which was adopted in 1932.

Beside the foregoing general powers of discount and purchase, special authority was given the Reserve banks in 1934 to discount loans which member banks and other financing institutions may make to established industrial and commercial businesses for the purpose of supplying them with working capital.

These changes made by recent legislation enlarge very greatly the kind of credit which the Federal Reserve banks may deal in directly, and allow greater freedom of action in meeting the requirements of the money market.

Open Market Operations

It must be obvious, however, that the power of a Federal Reserve Bank to grant credit at predetermined rates of discount and interest can be exercised only when credit is asked for. Consequently, if the Reserve bank had no other means of credit control than the power to discount the paper of member banks at given rates, it might have to wait passively and idly until individual member banks decided that they would like to borrow. Then only would it have opportunity to act and what it might do then would be far from constituting real credit control. As a consequence of the need of meeting the Federal Reserve System's responsibilities more positively, two other means of credit control have been developed. These are open market operations and direct action. Both are outgrowths of experience, primarily.

Open market operations consist of the purchase and sale by the Reserve banks of certain classes of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. The reason for this is that in the process of paying for the securities that are sold the reserves of member banks become diminished, because every payment means a debit sooner or later to some member bank's reserve account, And as a member bank's reserves decline toward the legal minimum it is less able to make extensions of credit.

On the other hand, by purchasing securities the Reserve banks put funds into the market and more credit becomes available; because the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them. And as their reserves expand, they are in a position to extend more and more credit.

In principle, therefore, the Reserve banks can increase or decrease the funds available for lending, accordingly as they buy or sell securities. Of course, there are in practice many limitations on the effectiveness of open market operations, but their tendency is to enable the Federal Reserve banks to take corrective action with respect to abnormal credit conditions on their own initiative.

The powers of the Reserve banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act, and at the time were not generally considered to be of very great importance. The first operations were carried on by the Federal Reserve banks independently of one another, but it was soon found that action would have to be coordinated; otherwise the banks would be buying or selling in competition with one another and following different, and perhaps conflicting, policies. To avoid this, a committee representing several banks was formed for the purpose of directing the operations. About the same time the purpose of the operations was clarified. For some time purchases had been made with the idea of providing income to meet expenses, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned.

The Banking Act of 1933 gave specific recognition to open market operations as a System matter and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. This was to the effect that they be conducted "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made a further change by providing that the Federal Open Market Committee should comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve banks. The law also makes the decisions of this committee obligatory upon the Federal Reserve banks and provides that the record of the Committee's actions shall be included in the annual report of the Board submitted to Congress. Thus an activity which was barely recognized in the original Federal Reserve Act, and which was gradually developed in the process of administration of the System, has come to be emphasized in the law as one of the System's most important functions.

Direct Action

I also mentioned direct action as a means of credit control. Direct action means efforts by the Federal Reserve banks or the Board to discourage credit policies of given member banks in given circumstances. Opportunity for it occurs on various occasions, but particularly when a member bank is being examined, and when it is seeking to rediscount some of its paper. In this sense, direct action is aimed at the correction of specific conditions in particular banks. It may also be resorted to, however, with reference to general conditions and for the purpose of enforcing general credit policy.

The effectiveness of direct action was specifically strengthened by the Banking Act of 1933 in several particulars. If a member bank makes undue use of bank credit for any purposes inconsistent with sound credit conditions, it may be suspended from recourse to credit facilities of the Federal Reserve System. Furthermore, authority has been given to the governing Board of the System to remove from office any officer or director of a member bank who continues to violate the law governing the bank's operation or who has persisted in unsafe and unsound practices in conducting the bank's business. The Board also has power to limit for each Federal Reserve district the individual bank capital and surplus which may be represented by loans secured by stock or bond collateral.

Power to Change Reserve Requirements

Recent legislation has also established two other new forms of general credit control which previously did not exist. The first of these is the power given the Board to change the reserve requirements now imposed upon member banks by the statute. For most banks (chiefly those outside the larger cities) the requirement is and has been for years that they have reserves on deposit with the Federal Reserve bank equal to at least 7 percent of their demand deposits, and 3 percent of their time deposits. The power to alter these reserve requirements was first given the Board in 1933, but under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the present requirements nor increase them to more than twice the present requirements. The result of raising them - which is the only action that could now be taken, since the minimum is already in effect - would be to decrease the lending power of member banks and consequently the amount of available credit. The effect of lowering them later on would be, of course, to enlarge the lending power and the amount of available credit.

Margin Requirements

The second new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying registered securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934. This grant of authority was in line with various provisions of the Federal Reserve Act, such as I have already referred to, aimed at restricting the use of credit for speculative purposes.

Pursuant to these provisions the Board has issued twin Regulations, T and U. Regulation T, following Sections 7 and 8(a) of the Securities Exchange Act of 1934, governs the extension and maintenance of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation U, following Section 7(d) of the Act, governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges. In general, these regulations fix the maximum loan value of securities subject to their provisions at 45 percent of their current market value. This means a margin requirement of 55 percent. This loan value applies equally to margin accounts with brokers and to similar loans made by banks.

In the case of brokers who are financing other brokers in order to enable them to carry accounts of their customers - as may happen, for example, when a large city broker is financing a correspondent broker in a small community - loan values of 60 percent are permitted. Special provision is also made to facilitate the financing of securities' distribution.

The Board has authority to change the loan value percentages as necessary in order to prevent, in the language of the Act, "the excessive use of credit for the purchase or carrying of securities".

The provisions of the law and of the regulations are too technical and too numerous for me to discuss in detail, but I shall mention a few distinctions and exceptions which are to be observed. To begin with, Regulation U does not prevent a bank from taking collateral in addition to that required by regulation; it does not require a bank to have any outstanding loan reduced or paid, nor additional collateral put up. Neither regulation applies to loans on government obligations, nor on a number of similar types of exempted securities. They do not apply to loans, however secured, which were not made for the purpose of purchasing or carrying registered securities. I wish to emphasize this last point. Regulation U does not restrict the right of a bank to extend credit, whether on securities or otherwise, for any commercial, agricultural or industrial purpose, or for any other purpose except the purchasing and carrying of stocks registered on a national securities exchange. In other words, it does not interfere with the available supply of credit in general. Instead, it achieves its purpose by imposing restrictions upon the demand for credit from the speculative quarter.

For example, under the regulation last issued, it is possible to borrow $45 on each $100 of stocks, valued at the market. That obviously means a very definite restriction upon the extent to which speculators can expand their holdings. If market prices nevertheless rise so that the $100 worth of securities becomes worth $125, $150, or $200, at the market, the amount that can be borrowed, namely 45 percent, becomes of course progressively greater, until such time as the Board finds it advisable to reduce the ratio of loan value. As the Board reduces the ratio, the effective demand is checked. In principle, therefore, the Board has the power to prevent the use of too much credit for speculation and to prevent an expansion dependent too largely upon the ease with which money can be borrowed. Moreover it is enabled to do this without making credit any the less available for commercial, agricultural or industrial purposes, and without raising its cost for such purposes. It is not the function of the Board to attempt control of security prices nor to do anything in conflict with the responsibilities of the Securities and Exchange Commission in its supervision of securities exchanges. The function of the Board is confined to control of credit.

As you will recall, one of the conditions at which the original provisions of the Federal Reserve Act were aimed was the use of bank funds to finance stock market speculation. It has always been clear that the Act sought to make credit ample for commercial, industrial, and agricultural purposes without encouraging its speculative use; but the difficulty has been to make measures of control work in one field without producing corresponding but undesired results in the other. A discount rate that was advantageous to agriculture was advantageous to speculation, and a rate that was disadvantageous to speculation was disadvantageous to agriculture. This difficulty in the way of discriminating between the possible uses to which credit might be put was characteristic of attempts to reach the objective by control from the angle of supply. It appears to be obviated in the new provisions, which, as I have said, attempt to reach the objective from the angle of demand.

This is because the power which has been given the Board to impose and relax restraints upon the demand for credit for speculative purposes is definitely selective. It is aimed at a particular use of credit and at the specific channels through which demand becomes effective. For this purpose, it extends the powers of the Board outside the Federal Reserve System to reach directly brokers and nonmember banks. It differs from powers of discount, because while these powers may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. Moreover, the discount power is not of effect until such time as individual banks make up their minds to dispose of some of their assets.

Open Market Operations are even more general in their effect. They influence the total amount of funds but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. Direct action can be used to discriminate against the speculative use of credit, but only in individual cases. It cannot be applied comprehensively, uniformly, and simultaneously in all relevant cases as can the power to fix the loan values of securities.

In the case of margin accounts, the regulation is directed at an unmistakable objective and cannot miss affecting the speculative use of credit. In the case of loans by banks for purposes of speculation it may be felt that the objective is less distinct, since the purpose of such loans may be disguised. This may appear especially possible since Regulation U permits a bank to rely upon a signed statement, accepted in good faith, as to the purpose of a given loan. Of course if means of evasion develop, they will have to be dealt with, but the Board has chosen to avoid imposing inquisitorial investigations in the absence of reason for believing that evasions will be deliberate or of serious consequence.

I have alluded to the exemptions from these new regulations; I imagine they are of special interest to you and should be mentioned in detail. The regulations covering brokers and dealers do not apply to United States Government obligations, State, county, and Municipal obligations, and such other securities as the Securities and Exchange Commission may exempt. These regulations also do not apply to credit extended by a broker for bona fide commercial or industrial purposes or extended for limited periods to finance bona fide cash transactions in securities.

In the case of the regulations covering bank loans made for the purpose of purchasing or carrying stocks, the following are some of the transactions to which the regulations are not applicable:

> Any loan made for any agricultural or industrial purpose, even though the loan be collateraled by stocks.
>
> Any loan for the purpose of purchasing or carrying securities not registered on a national securities exchange.
>
> Any temporary advance to finance the purchase or sale of securities for prompt delivery which is to be repaid in the ordinary course of business upon completion of the transaction.

Any loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange.

Any loan to a broker or dealer that is made in exceptional circumstances in good faith to meet his emergency needs.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discounts, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special. Let me mention a few things that complicate the task of credit control.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. It does not now. The majority of banks in the United States are outside the System. Although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible.

For another thing, there is always the important consideration that United States Treasury activities must be taken into account. These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks and created a quite unprecedented credit situation.

These factors, among others, necessarily limit and modify the exercise of credit control.

In concluding I want to assure you how much I appreciate the opportunity you have given me to discuss these matters with you. In the first place, it is particularly important to me because I am at home here. I feel as if I were coming back to report to friends who have more than a formal interest in what I have to say; certainly in addressing you I feel more than a formal interest in my subject matter.

In the second place, it is important to discuss matters with people such as yourselves who have understanding and who are able to enlighten others. I feel, as I have probably said before, that an administrative agency cannot function properly without having behind it a well informed and sympathetic public interest. Credit control unfortunately is a matter which bristles with technical difficulties and abstract ideas; but it is nevertheless essential, if the important objectives of credit control are to be achieved, that at least their general purpose and philosophy be understood.

Speech delivered before
Oregon Bankers Association Convention
Portland, Oregon
June 13, 1936

CREDIT CONTROL

Under various provisions of federal law there are five principal means of credit control which the Federal Reserve Banks or the Board of Governors may use. These are:

Discounts
Open Market Operations
Direct Action
Reserve Requirements
Margin Requirements

Discounts

The Federal Reserve Act provides that each Federal Reserve Bank establish from time to time rates of discount, subject to review and determination by the Board of Governors of the Federal Reserve System. To this the Banking Act of 1935 added the new requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board". This does not mean that the rates must be changed every time, but that they must be regularly and frequently reviewed.

When the Federal Reserve Act was adopted the prevailing idea seems to have been that discount rates were the most important means of credit control. This idea was apparently based upon a belief that member banks would borrow funds at a low rate of interest in order to relend at a higher rate. As a matter of fact, banks rarely borrow from the Reserve Banks for the purpose of relending. They do not like to borrow and as a general thing they will not borrow, no matter how low the rediscount rate is, except when they have to augment depleted reserves.

The Federal Reserve Act formerly limited the classes of paper which Federal Reserve Banks could discount for member banks, on the principle that a definite preference should be maintained for short-term credit based on self-liquidating commercial transactions. The Reserve Banks were, therefore, given the power to discount only paper arising out of commercial, industrial, and agricultural transactions, or paper backed by United States Government obligations.

As a result of various financial and economic developments, the classes of paper which could be used as a basis for borrowing from the Reserve Banks for many years constituted a decreasing proportion of the assets of member banks. In 1929 it was only about twelve percent of their total loans and investments, and in 1934 it was only eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks whose assets as a whole were good nevertheless had very little that was technically eligible. They therefore had to dump their assets on a falling market in order to raise the funds they needed.

The new banking act increases the powers of the Federal Reserve Banks so that advances may be made to member banks for periods not exceeding four months on any security satisfactory to the Reserve Bank. This amendment modifies and makes permanent the emergency legislation which was adopted in 1932.

Open Market Operations

If the Reserve Bank had no other means of credit control than the power to discount the paper of member banks at given rates, it might have to wait passively and idly until individual member banks decided that they would like to borrow. As a consequence of the need of meeting responsibilities more positively, other means of credit control have been developed.

Open market operations consist of the purchase and sale by the Reserve Banks of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available; because in the process of paying for the securities that are sold the reserves of member banks become diminished. And as a member bank's reserves decline toward the legal minimum it is less able to make extensions of credit.

On the other hand, by purchasing securities the Reserve Banks put funds into the market and more credit becomes available; because the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them. And as their reserves expand, they are in a position to extend more and more credit.

In principle, therefore, open market operations enable the Reserve banks to increase or decrease the funds available for lending, by buying or selling securities. They enable the Federal Reserve banks to take corrective action with respect to abnormal credit conditions on their own initiative.

The powers of the Reserve Banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act. The first operations were carried on by the Federal Reserve Banks independently of one another, but it was soon found that action would have to be coordinated; and a committee representing several banks was formed for the purpose of directing the operations. For some time purchases had been made with the idea of providing income to meet expenses, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned.

The Banking Act of 1933 gave specific recognition to open market operations and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve Bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. This was to the effect that they be conducted "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made a further change by providing that the

Federal Open Market Committee should consist of the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve Banks.

Direct Action

Direct action means efforts to discourage credit policies of given member banks in given circumstances. Opportunity for it occurs on various occasions, but particularly when a member bank is being examined, or when it is seeking to rediscount some of its paper. In this sense, direct action is aimed at the correction of specific conditions in particular banks. It may also be resorted to with reference to general conditions and for the purpose of enforcing general credit policy.

The effectiveness of direct action was increased by the Banking Act of 1933 in several particulars. If a member bank makes undue use of bank credit for any purposes inconsistent with sound credit conditions, it may be suspended from recourse to credit facilities of the Federal Reserve System. Furthermore, authority has been given to remove any officer or director of a member bank who continues to violate the law governing the bank's operation or who has persisted in unsafe and unsound practices in conducting the bank's business.

Power to Change Reserve Requirements

Recent legislation has also given the Board power to change reserve requirements. For most banks (chiefly those outside the larger cities) the requirement is and has been for years that they have reserves equal to at least 7 percent of their demand deposits, and 3 percent of their time deposits. The power to alter these requirements was first given the Board in 1933, but under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the present requirements nor increase them to more than twice the present requirements. The result of raising them would be to decrease the lending power of member banks and consequently the amount of available credit. The effect of lowering them later on would be, of course, to enlarge the lending power and the amount of available credit.

Margin Requirements

Another new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying registered securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934.

Pursuant to these provisions the Board has issued twin Regulations, T and U. Regulation T, following Sections 7 and 8(a) of the Securities Exchange Act of 1934, governs the extension and maintenance of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation U, following Section 7(d) of the Act, governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges. In general, these regulations fix the maximum loan value of securities subject to their provisions at 45 percent of their current market value. This means a margin requirement of 55 percent.

This loan value applies equally to margin accounts with brokers and to similar loans made by banks.

In the case of brokers who are financing other brokers in order to enable them to carry accounts of their customers - as may happen, for example, when a large city broker is financing a correspondent broker in a smaller community - loan values of 60 percent are permitted. Special provision is also made to facilitate the financing of securities' distribution.

The Board has authority to change the loan value percentages as necessary in order to prevent, in the language of the Act, "the excessive use of credit for the purchase or carrying of securities."

For example, under the regulation last issued, it is possible to borrow $45 on each $100 of stocks, valued at the market. If market prices nevertheless rise so that the $100 worth of securities becomes worth $125, $150, or $200, at the market, the amount that can be borrowed, namely 45 percent, becomes of course progressively greater, until such time as the Board finds it advisable to reduce the ratio of loan value. As the Board reduces the ratio, the effective demand is checked. In principle, therefore, the Board has the power to prevent the use of too much credit for speculation and to prevent an expansion dependent too largely upon the ease with which money can be borrowed. Moreover it is enabled to do this without making credit any the less available for commercial, agricultural or industrial purposes, and without raising its cost for such purposes.

The power which has been given the Board to impose and relax restraints upon the demand for credit for speculative purposes is definitely selective. It is aimed at a particular use of credit and at the specific channels through which demand becomes effective. For this purpose, it extends the powers of the Board outside the Federal Reserve System to reach directly brokers and nonmember banks. It differs from powers of discount, because while these powers may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. It also differs from the power to conduct open market operations which influence the total amount of funds but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. Direct action can be used to discriminate against the speculative use of credit, but only in individual cases.

In the case of margin accounts, however, the regulation is directed at an unmistakable objective and cannot miss affecting the speculative use of credit. In the case of loans by banks for purposes of speculation it may be felt that the objective is less distinct, since the purpose of such loans may be disguised. This may appear especially possible since Regulation U permits a bank to rely upon a signed statement, accepted in good faith, as to the purpose of a given loan. Of course if means of evasion develop, they will have to be dealt with, but the Board has chosen to avoid imposing inquisitorial investigations in the absence of reason for believing that evasions will be deliberate or of serious consequence.

It is not the function of the Board to attempt control of security prices nor to do anything in conflict with the responsibilities of the

Securities and Exchange Commission in its supervision of securities exchanges.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discounts, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. Although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible.

For another thing, United States Treasury activities must be taken into account. These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks and created a quite unprecedented credit situation.

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Speech delivered before
Eighth New England Bank Management Conference
Hotel Statler, Boston, Massachusetts
November 5, 1937

THE TECHNIQUE OF CREDIT REGULATION

During the past year, the Federal Reserve System has adopted measures of unusual significance and interest. Some were the familiar measures of credit regulation. Others were quite new, and involved the exercise of powers only recently granted by Congress to the Federal Reserve System and never before exercised.

These measures serve to illustrate the technique of credit regulation and I should like to review them with you as examples of technique rather than from the standpoint of policy. Let me first restate the purposes and scope of credit regulation and also the general long range policy that has been pursued by Federal Reserve authorities in the recent past.

The basic purpose of what may be described broadly as central banking powers, such as those vested in the Federal Reserve System, is aid in stabilizing and equalizing monetary conditions so that the supply of credit is neither inadequate for sound business activity nor so excessive in amount that it invites speculative abuse. For the achievement of this purpose, the Federal Reserve banks depend largely upon open market operations. That is, they may purchase investment securities in the open market at times when the supply of funds in the money market needs to be increased, or they may sell investment securities at times when an excess of funds overhangs the money market and needs to be absorbed lest it stimulate speculation.

In addition there are other means of influencing credit, particularly by raising or lowering the discount rate and by advancing funds to such individual member banks as apply for accommodation to replenish their reserves.

These means of credit technique are exercised by the banking authorities to implement policies which they believe the economic situation requires. At one time, they may feel that the situation requires a restraining policy, and to carry out that policy they may sell securities from their portfolio, or they may raise rediscount rates, or do both. At another time, they may believe that the situation requires a policy of ease, and to carry out that policy they may purchase securities in the open market - thereby supplying banks with additional reserves - and they may lower the rediscount rates. Open market operations and changes in the discount rate are the two principal means of credit technique. They are flexible instruments and they are general in their application. That is, they affect the credit picture as a whole, rather than individual banks.

As you know, the Federal Reserve authorities have felt and frequently stated that an easy money policy is essential to help promote economic recovery. Rather than speak of the considerations upon which this policy is based, I wish to invite your attention to the various technical steps whicl have been taken and the several means employed in carrying out this broad general policy during the past year or so. A knowledge of the technique employed to implement a particular policy seems to me of practical importance and of interest irrespective of what that policy may be. In other words, I wish to discuss how a given policy was effected rather than why.

The measures I wish to review began with the increase in reserve requirements a year ago last August. This was not what I call a measure of credit technique. It was instead intended as a basic readjustment which placed the System once again in a position to use its traditional and flexible credit instruments and to make them effective. It was adopted because a situation had developed in which the ordinary means of credit technique - namely, open market operations and rediscount rates - had lost their efficacy. This situation arose primarily, as you know, from the flow of gold into this country from abroad, as a result of which the excess reserves of domestic banks swelled to such an extraordinary degree that the customary instruments of credit policy were wholly ineffective. If the Federal Reserve System had desired to have easy money conditions regardless of the consequences that might ensue in case unsound and inflationary conditions developed, it could have adopted a policy of doing nothing at all. But it sought instead to reestablish the position it was intended by law to occupy - a position in which it could act promptly and effectively either in the direction of easing the credit situation further, or in the direction of restraint - whichever appeared to be in the public interest.

Theoretically and historically, the technique of credit regulation has been considered most efficient when member banks have had a minimum of excess reserves and could expand the amount of credit outstanding when and as steps are taken to increase their reserves. This can be most readily effected by open market purchases, which have the effect of making funds available to the money market and of making it unnecessary for most member banks to apply to the Federal Reserve banks for advances. However, should individual banks still require funds, they may borrow from the Federal Reserve bank and when they do so its discount rates can be reduced in conformity with a policy of ease, or conversely can be raised if an opposite policy is adopted. But, of course, when the banks are superabundantly supplied with reserve funds from an outside source and therefore have little, if any, occasion to seek additional funds from the Federal Reserve banks, the discount rate, like open market operations, ceases to be applicable. Under such circumstances, even if the Federal Reserve System were to sell off its entire portfolio of government securities, the action would fail to absorb the excess reserves. Moreover, by such action the System would be flinging away the possibility of conducting further open market operations to any purpose, because subsequent purchases of securities that it might make would merely increase the excess of reserves again. The System would be exhausting its principal means of influencing credit conditions. In other words, the situation would continue to be out of control.

The Board, in explaining its action at the time, said:

"For current adjustments of the reserve position of member banks to changes in the credit situation the Reserve System should continue to rely on the traditional methods of credit control through discount policy and particularly through open-market operations. By the present action excess reserves will be reduced to within the amount that could be absorbed through open-market operations, should such action become desirable. Conversely, should conditions develop requiring expansion of reserves, they could be increased through open-market operations."

Subsequently, the Secretary of the Treasury announced that the Treasury "proposes, whenever it is deemed advisable and in the public interest to do so, to take appropriate action with respect to net additional acquisitions or releases of gold by the Treasury Department. This will be accomplished by the sale of additional public-debt obligations, the proceeds of which will be used for the purchase of gold, and by the purchase or redemption of outstanding obligations in the case of movements in the reverse direction."

The Treasury's purchases of gold pursuant to this policy had the effect of keeping the gold from getting into bank reserves and swelling them to greater volume.

On January 30 the Board announced final increases in reserve requirements and pointed out in its statement made at the time that by this action the System would be restored to "a position where such reduction or expansion of member bank reserves as may be deemed in the public interest may be effected through open-market operations, a more flexible instrument, better adapted for keeping the reserve position of member banks currently in close adjustment to credit needs."

These measures - the increase in reserve requirements by the Federal Reserve System and the sterilization of gold by the Treasury - were unusual measures taken to offset an unusual condition, namely, the enormous inflow of capital and gold from abroad. They were outside the category of normal measures of credit regulation. They were related to normal measures of credit regulation in somewhat the same way that reballasting a ship is related to its regular operation. They were measures intended to neutralize the effect of major financial disturbances originating abroad, and to keep the domestic credit situation amenable to the established technique of regulation.

As the Board emphasized at the time, these measures involved no abandonment of the policy of monetary ease which the Board has consistently pursued, by using, as it announced that it would, the customary and flexible instruments of open market and rate policy.

At this point perhaps I should briefly restate the process by which open-market operations achieve their purpose. In the first place, as you know, when a bank enlarges the amount of credit it has outstanding, either by additional loans to its customers or by additional purchases of investment securities, its reserves tend to be reduced. Consequently it cannot enlarge the amount of credit it has outstanding unless it has reserves in excess of what it is required to have. On their own initiative banks may procure additional reserve funds either by borrowing or by selling securities. Or the Federal Reserve System on its initiative may supply banks in general with additional reserve funds by open-market purchases of investment securities; for as the Federal Reserve banks pay for the securities they buy, either by check or by credit, the reserves of member banks are increased. In April, the Federal Reserve banks purchased about $100,000,000 of securities and this amount immediately flowed into member bank reserve accounts. It eased their position so that they would have no lack of funds for continuing to extend credit, whether in the form of loans or in the form of investments. Contrariwise, if the Federal Reserve System had sold securities, the process of paying for them, whether purchased by member banks or by the customers of member banks, would have reduced the reserves of member banks. Purchases by the System tend to ease the money market, sales by the System tend to tighten it.

The ease produced by the System's purchases in April, therefore, was deliberately brought about. If need had arisen that condition of ease could have been as deliberately ended by a reversal of policy and the sale of investments. The situation, in other words, was one that had been made amenable to the normal measures for influencing credit.

In August and September a further step in pursuance of the System's established policy was taken when the Federal Reserve bank rediscount rates were lowered. In approving the first of these changes the Board stated that its "approval was based upon the view that the reduction of discount rates at this time would assist in carrying out the System's policy of monetary ease and make Federal Reserve bank credit readily available to member banks for the accommodation of commerce, business and agriculture, without encouraging member banks to borrow outside of their districts or to liquidate their portfolios in order to be in a position to meet the needs of present or prospective borrowers."

The Board went on to say "The reduction in discount rates, which have had little or no practical effect during the period when excess reserves were abnormally large and widely distributed throughout the System, brings the rates into closer relation with the interest rate structure generally prevailing, and affords to member banks the benefit of rates, on advances made by the Federal Reserve bank, which are in line with those available in the money market. During the extended period when excess reserves of the banking system were between two and three billions of dollars, the occasion did not arise except in rare instances for member banks to borrow from the Federal Reserve banks, and the discount rates were accordingly inoperative as a practical matter.

"As a result of the continued progress of the recovery movement, demands of agriculture, industry and commerce for bank accommodation have steadily increased and at the present time are augmented by seasonal requirements, particularly with relation to crop movements.

"It is the Board's view, therefore, that at this time the Federal Reserve System can best discharge its public responsibility and promote the continuance of recovery by making it possible for member banks to obtain accommodation from Federal Reserve banks at rates which will encourage them to employ their funds to meet the needs of agriculture, industry and commerce."

Later in September, the Federal Open Market Committee announced that it had authorized purchase in the open market from time to time of "sufficient amounts of short-term United States Government obligations to provide funds to meet seasonal withdrawals of currency from the banks and other seasonal requirements." It said further:

"Reduction of the additional holdings in the open market portfolio is contemplated when the seasonal influences are reversed or other circumstances make their retention unnecessary.

"The purpose of this action is to maintain at member banks an aggregate volume of excess reserves adequate for the continuation of the System's policy of monetary ease for the furtherance of economic recovery."

At the same time, the Committee announced that at the request of the Board of Governors the Secretary of the Treasury had agreed to release - that is, to desterilize - approximately $300,000,000 of gold from the Treasury's inactive account. Accordingly, the Treasury was credited with that amount on the books of the Federal Reserve banks which in the course of regular Treasury disbursements found its way into the reserve accounts of member banks and increased their available funds correspondingly. This was an effective means of utilizing our monetary measures to maintain the policy of ease. The Committee's statement made at the time pointed out that:

"This action is in conformity with the usual policy of the System to facilitate the financing of orderly marketing of crops and of autumn trade. Together with the recent reductions of discount rates at the several Federal Reserve banks, it will enable the banks to meet readily any increased seasonal demands for credit and currency and contribute to the continuation of easy credit conditions."

As stated in the October Federal Reserve Bulletin, this action toward augmentation of member bank reserves was taken to anticipate the usual seasonal needs of member banks for currency and credit. The action of the System in bringing about an increase of available funds put banks in a still easier position to meet seasonal needs as well as increasing demands for bank credit. It was an exercise of credit technique under normal and typical conditions.

Before passing on to the latest measure of credit technique taken by the System, I want to mention a recent change in the regulations governing discounts by the Federal Reserve banks. This change was effected by the issuance of Regulation A in revised form effective October 1. Its significance lies in the fact that in determining the eligibility of paper for discount, the form of the obligations to be discounted is considered of less importance than it used to be. Originally the privilege of rediscount at the Federal Reserve banks had been restricted to relatively short-term paper arising from certain commercial and agricultural activities. As you know, the amount of such paper has tended in recent years to constitute a smaller and smaller proportion of the total amount of paper available to banks. To the extent that banks were dependent on such paper for discounts, the decrease in its amount meant in effect a curtailment of the power of the Federal Reserve banks to extend credit. The Banking Act of 1933 and the Banking Act of 1935 both enlarged the classification of paper upon which individual member banks might procure funds from the Federal Reserve banks for the replenishment of their reserves, and Regulation A as recently issued by the Board carries out the purpose of these changes in the law.

The new Regulation had been in preparation for a long period and the time of its issuance had no special bearing with respect to the current situation. It was rather a longer range measure. Moreover, its issuance was not of course a measure of credit regulation, like open market operations or changes in the discount rate, but a liberalization of the conditions under which the regular means of credit regulation are exercised. Let me emphasize that the term "credit regulation" is not altogether satisfactory. I have taken care to avoid using the phrase "credit control", for that is far too strong. The technique which I have been describing "influences" rather than "controls".

The latest measure of credit regulation taken by the System was the change in margin requirements announced a little over a week ago and effective last Monday. The power to fix margin requirements is, as you know, a new and special responsibility imposed upon the Board by the Securities Exchange Act which Congress adopted in 1934. Its effect is not general upon the whole field of credit. In this respect, it differs from other means of credit regulation, namely, open market operations and changes in the discount rate. It is directed exclusively at the use of credit advanced by brokers, dealers and by banks for the purpose of carrying registered securities. Theoretically, margin requirements can be raised when it appears advisable to restrain speculative use of credit and they can be lowered when it appears advisable to relax the restraints.

Because of the special nature of this particular power of credit regulation, it can be exercised independently of other measures by which the credit situation is influenced. Thus it is possible to pursue a restraining policy with respect to the use of credit for securities' speculation at the same time that an easy money policy is being pursued with respect to the use of credit for commerce, industry and agriculture. By its most recent action the Board reduced margin requirements from 55 percent to 40 percent. This eased credit conditions so far as securities' trading is concerned. It happens that this policy of ease in the special field of stock market trading coincided with the policy of ease which the Board has all along pursued in the general field of credit, but since I am discussing the technique of credit regulation I wish to emphasize the fact that conditions do not always call for a parallel policy by any means. The peculiar character of the power to fix margin requirements is that it makes it possible to influence credit conditions in a particular field independently, if necessary, of what is done in other fields.

It is evident that the exercise of Federal Reserve functions, like those of any other organization, involves sometimes merely the use of certain tools according to accepted procedure, and sometimes a change in the tools themselves or in the conditions under which they are to be used. Open market operations and changes in discount rates are the customary tools regularly employed in performance of Federal Reserve System functions. They are practicable, flexible and tested tools, which can be used to ease money conditions at one time and to tighten them at another. They can be made to accomplish their purposes without shock - without violent and painful adjustments. They can be applied gradually so that their effect is barely perceptible. If necessary, they can be applied vigorously and sweepingly.

It is true of any technique that its effectiveness is dependent upon the conditions under which it is used. The inflow of gold into this country from abroad created a condition under which the normal, flexible credit tools had lost their effectiveness. Raising or lowering the discount rate would mean nothing when banks had such a super-abundance of funds that they had no occasion to look to Federal Reserve banks for accommodation. Selling government securities when the excess reserves to be absorbed were greater than the volume of securities available for sale, would amount to throwing away tools which are necessary if there is to be any effective supervision to influence general credit policies in the broad public interest.

There has been no change meanwhile in the basic policy of monetary ease. Open market purchases of securities and lowering of the rediscount rates have been undertaken in pursuance of this same fundamental policy. And it is important to note that a situation has been restored where the normal technique of credit regulation once more applies.

The functions and responsibilities I have been discussing are not peculiar to the Federal Reserve System, of cource. They are the functions and responsibilities of the central banking organization of virtually every country. And as such they differ essentially from the functions and responsibilities of privately managed banks operated for profit. A central banking organization makes loans and purchases securities not for the purpose of making a profit, but for the purpose of increasing the supply of credit available through privately managed banks. At the present time, for example, the twelve Federal Reserve banks have cash and reserves of nearly nine and a half billion and earning assets of only two and a half billion. Such a position, which is quite different from what an enterprise operated for profit would choose to maintain, is entirely normal for a central banking organization.

It appears, therefore, that during the period I have reviewed, the System has consistently pursued a policy of <u>monetary ease amenable to regulation</u>. The increase in reserve requirements and the sterilization of gold had <u>amenability to regulation</u> as their objectives. The open market purchases, the reduction of discount rates, and the desterilization of a small portion of the gold had further <u>ease</u> as their objectives. Each of these measures has been effective in its own way in helping to achieve the combined objective. This series of measures is informative and illuminating to those who are interested in the technique of central banking, and I appreciate your kindness in giving me this opportunity to review that technique with you.

Speech delivered before
Polish-American Luncheon Club of Metropolitan New York
George Washington Hotel, New York, N. Y.
December 28, 1938

CREDIT AND OUR ECONOMY

The Federal Reserve System has been in existence exactly twenty-five years and yet comparatively few people know what the Federal Reserve System really is, and still fewer know how it operates or the purpose for which it was created by Congress in 1913. May I, therefore, begin with a brief description of the general structure of the Federal Reserve System as the basis for my discussion on Credit and Our Economy.

In the first place, the Federal Reserve System differs from many of these other instrumentalities and agencies in that it is only in part a governmental institution. The member banks of the Federal Reserve System--about 6,300 in number--are privately owned and privately managed corporations in all parts of the United States. They are such banks as you keep your checking accounts with. Many of them were in operations long before the Federal Reserve System was organized. These banks that are members of the System are in competition not only with one another but with other banks that do not belong to the System. There are, in fact, more banks outside the Federal Reserve System than there are belonging to it, but the nonmembers, as we call them, though very numerous are relatively small. Around 80 or 85 percent of the banking business of the country is done within the Federal Reserve System.

The country is divided into Federal Reserve districts and each member bank deals with the Federal Reserve bank in its district. It owns stock in its Federal Reserve bank in proportion to its own capital and surplus and it maintains its required reserves with its Federal Reserve bank. The twelve Federal Reserve banks perform many services for their member banks and for the public, particularly in providing currency for circulation and in facilitating the clearance and collection of checks. The Federal Reserve banks also act as fiscal agents of the United States government. They carry the checking accounts of the United States government and do the servicing of the public debt. This means handling subscriptions for issues of government securities, paying interest, redeeming matured issues, making conversions and such things.

The twelve Federal Reserve banks are regional institutions. Each of them has a board of directors, representing not only the banking interests of the district but its agricultural, industrial and commercial interests as well.

Coordination of the activities of the twelve Federal Reserve banks is effected through the Board of Governors in Washington. The Board consists of seven members appointed by the President of the United States with the consent of the Senate. The Board, beside coordinating and supervising the operations of the Federal Reserve banks, has important regulatory powers as the administrative head of the whole System.

The members of the Board together with five representatives chosen by the twelve Federal Reserve banks constitute the Federal Open Market Committee. This committee directs the open market operations of the Federal Reserve banks, which I shall explain later.

Under the law, there are certain powers exercised directly by the Federal Reserve banks, there are certain ones exercised by the Board of Governors, and there are certain ones exercised by the Federal Open Market Committee. For the sake of simplicity, I shall simply use the term "Federal Reserve authorities" in speaking of the powers exercised under the Federal Reserve Act.

In order that they may perform their duties properly, the Federal Reserve authorities require all the accurate information they can procure as to the state of banking and business not only in the United States but in the world at large. Such information as relates to banking is secured from examination reports and from reports of condition which member banks themselves submit to the Reserve authorities. Much of the essential financial information required is reflected in the operations of the Federal Reserve banks, for no important monetary trend can fail to manifest itself in one or more of the general accounts on the books of the Federal Reserve banks. Certain financial movements will be reflected in increases and decreases in the volume of the bank reserves which constitute the deposits of the Federal Reserve banks. Certain financial movements will be reflected in increases and decreases in the amount of Federal Reserve notes in circulation. Certain movements will be reflected in increases and decreases in the volume of Federal Reserve bank loans and investments. Close observation and analysis of changes in Federal Reserve bank statements will consequently yield important information as to monetary conditions in general.

From sources outside the Federal Reserve System, the Federal Reserve authorities draw information as to industrial and economic production, prices, international trade and exchange, domestic trade, pay rolls, and employment. Most of this information is procured in cooperation with other agencies.

Although the Federal Reserve authorities make every reasonable effort to procure such information as will guide them in determining monetary policy, it goes without saying that there are many facts about economic life that are inaccessible. Nobody knows how much money is going to be spent by purchasers at next Christmas time; nobody knows what the prices of commodities are going to be six months from now; nobody knows exactly how many people are out of jobs at this moment. With respect to all such conditions, approximate and generalized information is the best that can be procured. Moreover, after the information is procured, it is not always possible to determine readily and exactly what course of action it calls for. The parts of our economic life are so closely interrelated and the factors determining it are so numerous that the unexpected is always happening. Employment influences production and production influences employment. Demand influences supply and supply influences demand. Political and international conditions affect business and business affects political and international conditions. Causes and effects are interwoven with one another so that the effect produced by one cause becomes itself the cause of other effects.

Bearing in mind these easily recognizable difficulties in the way of interpreting current information so as to determine the proper policy, you will be able to understand under what conditions the Federal Reserve authorities exercise the powers that I now wish briefly to describe.

The first of these is the power to conduct open market operations, which I have already referred to. Open market operations enable the Federal Reserve authorities by the purchase of securities in the open market to supply banks and the money market in general with additional reserve funds. Such purchases will be undertaken for the specific purpose of preventing tightness in the money market. At times such operations may be called for in order to increase the available supply of credit; at other times they may be called for merely to maintain a stable condition. In a broad sense, the mechanism of these actions is very simple. When investment securities are sold to the Federal Reserve banks, the money paid for them by the Federal Reserve banks naturally increase the funds available to the public.

On the other hand, when and if it appears that the volume of credit is excessive, the Reserve authorities may by the sale of securities withdraw from the market some at least of the excess. This results simply because the funds with which the securities are paid for when the Federal Reserve bank sells them disappear from the banks and the money market as they pass to the Federal Reserve banks.

In recent years the effectiveness of open market operations has been greatly circumscribed by the enormous accumulation of excess reserves of member banks. These excess reserves in turn have resulted from the movement of gold into the United States. Prior to the year 1934, the stock of monetary gold in the United States had never amounted to much more than four and one-half billion dollars. At the present time, it is more than 14 billion dollars. Over 3 billions of this increase is accounted for by revaluation, but a large part - perhaps the larger part - has come to the United States largely because of disturbed political and economic conditions elsewhere in the world. It has taken refuge here. It did not come because it was needed and it so far exceeds the requirements of the economic life of our people as to create a serious problem. More than one half of the monetary gold in the world is now in our possession. We have far more than we need and other countries have less than they need.

The effectiveness of any action that the Federal Reserve authorities may take is conditioned by the presence of these enormous reserves. Member banks now have reserve balances with the Federal Reserve banks of 9 billion dollars. Of this about 5 and one-half billions represent required reserves and 3 and one-half represent excess reserves. Purchases of securities by the Federal Reserve banks tend to maintain or increase this excess. On the other hand, since the Federal Reserve banks own only about 2 and one-half billion of securities, it is obvious that if they sold the whole amount it would no where near absorb the excess.

Another important power of the Reserve authorities is that of discount. When a member bank needs additional reserve funds it may borrow them from its Federal Reserve bank. There have been times in the past when member banks borrowed very heavily from the Federal Reserve banks, but under present conditions, as I have just described them, member banks in general have such a large volume of excess reserves that there is little occasion for them to borrow.

At times when there is an active demand for credit, the power of the Federal Reserve authorities to set the discount rate may be of considerable importance; a higher or lower rate will, of course, tend to influence the amount of borrowing. In recent years, the discount rates of the Federal Reserve banks have been extremely low. At present they range from 1 to 2 per cent. These are the rates at which member banks may borrow from the Federal Reserve banks; they are not, you understand, rates on borrowing in general.

The monetary policies of the Federal Reserve authorities are one of many important factors which help to make any given business situation what it is. Not one of these factors can be neglected; not one of them can be depended upon to accomplish all that is desired. In recent years, the Federal Reserve authorities have pursued what is called an easy money policy. They have endeavored to maintain such credit conditions as would be most favorable for active business and increased employment.

When one speaks of credit, one must speak of the Federal Reserve System and its relation to the credit of the country. This, no doubt, is evident at this point of my discussion.

The economic prospects, so far as we can see them, are reasonably encouraging at the present time. A year ago activity in prices had been declining for several months, but we had not reached the end of the decline. Quite naturally, therefore, many people were wondering whether the decline was to be another long depression like the one which began in 1929. Now, however, we have seen not only a slowing down in the decline during the first half of 1938, but a sharp advance in the business situation generally during the second half of this year.

The total income payments are about the same now as they were at the end of 1937. The decline in payrolls from a year ago is narrowing, but work relief is higher.

In industrial production, the November adjusted index shows 103 per cent of the 1923-25 average and December will very likely be higher. The same index a year ago for the month of December was 88. This, of course, is an encouraging sign. There was during 1938 less decline in nondurable manufactures such as textiles and shoes than in durable goods, and their output has been above 1937 in the past few months. Output of durable goods such as steel and automobiles has been lower for the year to date but has shown sharp recovery in recent months and is now currently in excess of the same time in 1937. Steel output for the current week is 52 per cent of capacity and the average so far in December is 57 per cent as compared with 27 in the corresponding period of last year. Automobile assemblies are now around 100,000 a week and they were about 85,000 during the first part of December of 1937. There is, of course, a smaller output of minerals which did not decline much until after the end of 1937.

In building construction there has been a sharp reversal in movements during the past year. Residential building was declining in the latter part of 1937 and with incomes being reduced, many thought there would be a further reduction in 1938, but instead with prices of materials reduced and down payments and current financing charges materially lowered early in 1938 by amendments to the Federal Housing Act, there was a more than seasonal increase in the Spring and currently contracts for private work of this type were double those of a year ago. Also, contracts on projects of the United States Housing authority are now being awarded in increasing volume.

Nonresidential construction shows a marked rise in public works contracts. By December 16th work was started on PWA projects to cost 1 billion 200 million dollars and to be substantially completed by July, 1940. A large part, but of course not all of this, represents an increase over a year ago when many of the projects started under earlier programs were being completed. There is, however, a continued low level of contracts for factories, commercial building, and other private nonresidential building.

In domestic retail trade, there was little decline until the end of 1937, except for automobiles and house furnishings and the current level in most lines is about the same as a year ago. There was considerable decline in the first half of 1938 which was followed by an advance. Department stores' sales by dollar volume have been slightly smaller than a year ago with prices somewhat lower, but indications are that the December figures will be close to, if not equal to, that of the 1937 month. Mail order sales and sales at Variety Stores are about the same as at the end of 1937, but retail automobile sales in the month of November of 1938 are above the sales of a year ago.

In foreign trade, during the month of October, the exports on a value basis were lower than a year ago by about one-sixth and imports were lower than a year ago by about a fifth. Export trade decline is less than anticipated in some quarters and import decline stopped soon after industrial recovery in this country began in 1938. Excess of exports is still unusually large and is around 100 million dollars per month.

Inventories of consumers' goods lowered considerably by the middle of 1938, after a long period with trade reduced only moderately, while production was sharply curtailed. Inventories in other lines are also reduced and improvement in the inventory position generally contributed much to the rise in orders and activity in the middle of 1938. Currently stocks are substantially lower than at the end of 1937, but information is not available to indicate just how much they are below the end of 1937. At department stores dollar volume of stocks is about 10 per cent smaller than a year ago.

Commodity prices in general are moderately lower than a year ago and the index is 77 per cent of the 1926 average as against 83 per cent in 1937. There was a decline in commdoity prices in the early part of 1938 and since May there has been little change in the general index. Some industrial materials currently are about the same as a year ago after a marked rise in the middle of this year. Agricultural products are lower than a year ago owing partly to increased carryovers, ample crops and also owing to increased supplies of live stock and dairy products.

Including Government payments, farm income is estimated at 7 billion, 625 million dollars for the calendar year 1938. This is down by one billion dollars from 1937, which was the highest since 1929.

On the whole, therefore, there are signs of improvement. Of course, I do not wish to darken the picture by going over the things which must prevent us from being too optimistic. You know well enough just what they are, but I should like to emphasize the fact that just as the Federal Reserve authorities cannot lay claim to having brought about the improvement mentioned through their sole effort, so also they can give no assurance that their policies only will make this improvement continue. Within the province of monetary matters, the Federal Reserve authorities have as their objective to maintain as favorable conditions as they can and business need feel no fear that sound and healthy activity will find any lack of the bank credit necessary to support it.

Speech delivered at
Dinner given by Federal Reserve Bank of Dallas
In honor of Board of Governors of the Federal Reserve System
Baker Hotel, Dallas, Texas
January 24, 1941

BRIEF REMARKS ON CERTAIN ASPECTS OF RESERVES

There has been a great deal of talk about excess reserves. Some of it has produced more heat than light. It seems important to me, therefore, to undertake to throw increased light on certain aspects of the subject which is so important to you, to the Federal Reserve System, and to the nation.

First: We have today the unprecedented amount of seven billion dollars in excess reserves. This excess can be used by the member banks of the System to extend credit by means of loans and investments.

Second: On the basis of this enormous volume of excess reserves the volume of deposits--now 60 billions--could be doubled. A volume of deposits twice as large could do twice as much work and if the amount of goods and services did not increase at the same rate, there would be the danger that prices would rise rapidly. This is not in the interest of a stable economy.

Third: It may also be pointed out that the same result could be achieved by doubling the use of existing deposits, namely, the sixty billions. In other words, at the present time the velocity of deposits--that is, the use or turnover of the present deposits--is about "thirteen". There have been times in the past when this velocity was "twenty-six". Therefore, if existing deposits should be used twice as actively as they are now used, that too would represent a dangerous situation. This is not in the interest of a stable economy.

Fourth: After deposits have once been created, there is little that the Federal Reserve System can do about them. That has to be dealt with by non-monetary means such as restricting of price advances, rationing, etc. The Federal Reserve authorities can, if given sufficient power, regulate the growth of deposits but they can not control the turnover of existing deposits.

Fifth: To control the growth of deposits, however, the Federal Reserve System needs sufficient powers in sufficient time to deal with the existing excess reserves should occasion arise for the System to act in the interest of a stable economy.

These facts are plain and simple. Let's now try to clarify the meaning of reserves.

I have found in talking about reserves that one often encounters misconceptions with regard to reserves and their functions. This is due principally to the fact that often the individual thinks of Federal Reserve Bank operations in terms of commercial bank operations.

An understanding of reserves requires more than that. It requires that the point of view of the banking system as a whole be taken; that the close inter-relation of bank with bank in an organic system be recognized as a fundamental condition and that the essential problems of central banking action be understood.

For example, there are those who sincerely believe that financing of Government deficits by banks increases excess reserves. This is not so, as I have attempted to show on previous occasions. When a bank buys a Government obligation and pays for it, the banker's reserves at the Federal Reserve Bank are thereby diminished and the Government's deposits at the Federal Reserve Banks are increased. On the other hand, when the Government later spends this money, the money goes into the hands of private persons in various sections of the country who pay their bills and the money finds its way into banks, or who themselves deposit the money in banks. The banks in turn re-deposit the money with the Federal Reserve Banks. The net result is that there has been no change in the total volume of member banks' reserves but there has actually been an increase in deposits. In other words purchasing Government securities by banks is lending to the Government by a bank and has the same effect on the volume of deposits as when a bank lends to anyone else. The extension of credit in either case increases deposits.

Incidentally, it may be mentioned again that Government deficit financing through the banks diminishes excess reserves. As deposits increase, required reserves, according to present percentages of reserve requirements, increase by roughly one seventh of the amount of the increase in deposits so that if the Government borrows a billion dollars from the banks, it will increase deposits by about one billion dollars and thus convert about one hundred and fifty million dollars of excess reserves into required reserves.

For the reasons outlined it has been suggested that a large part of future Government financing (though of course not all and certainly not at once) be accomplished, by drawing upon the existing large volume of deposits rather than by creating additional deposits through bank purchases of Government securities. This can be done by offering a security that will be desirable to and sought by the depositors, individuals, business corporations such as insurance companies and others. It has likewise been suggested that a means be provided for absorbing a large part of the existing excess reserves so as not to make possible a further large increase in deposits. The deposits are already large.

There is still another misconception. This misconception is even more widespread and has certain insidious implications.

Some think and say that when the Federal Reserve Banks engage in open market operations and are making discounts or advances to member banks the funds they use are the reserves of the member banks. What is worse, some even go so far as to say that the reason that the Federal Reserve System has raised or may in the future wish to raise reserve requirements is that it would have more funds to invest in Government securities. Of course this is not true.

It is perfectly apparent that an increase in reserve requirements does not necessarily result in an increase of reserve balances. The result is a change in amount of reserves from one to the other of the two labels--a larger amount on the books of the Federal Reserve Banks is labelled "required reserves" and a smaller amount on the books of the Federal Reserve Banks is labelled "excess reserves". The reserves, as such, at the Federal Reserve Banks may remain the same. The Federal Reserve System does not acquire any funds whatever by the process of increasing reserve requirements.

Furthermore the Federal Reserve Banks are not dependent on the member banks for their lending power. Let us look at our balance sheet. At the present time the Federal Reserve Banks have, on the resources side, twenty billion dollars of cash and two billion dollars of earning assets and on the liabilities side they have sixteen billion dollars of deposits and six billion dollars of Federal Reserve notes. If all the deposits of the Federal Reserve Banks were withdrawn by the member banks which, of course, could not happen, the result would be that the Federal Reserve Banks would have the same assets as before but instead of having sixteen billion dollars of deposits and six billion dollars of notes on the liability side of the statement, they would have no deposit liabilities but would have twenty-two billion dollars of note liability. There would be no change in the ratio of the Federal Reserve Banks' reserves to their liabilities which is about ninety per cent and there would be no substantial reduction in the Federal Reserve Banks' lending powers. I say substantial reduction--because as you know, the law requires the Federal Reserve Banks to hold a forty per cent reserve against notes--and only a thirty-five per cent reserve against deposits.

The lending power of the Federal Reserve Banks is based in the first instance on the power which Congress placed in the Federal Reserve Banks, when it established them, to issue Federal Reserve notes and to create deposits, holding forty per cent reserves against the notes and thirty-five per cent reserves against the deposits. Therefore, the lending power does not originate with the member banks; it originates from the Government granted power.

Since we have a practical situation in the Federal Reserve System and not a theoretical one, I shall not take your time now to discuss hypothetical and highly improbable situations, though I shall be pleased to have you send me questions or ask them tonight--after this dinner. Our actual situation is this:

> The liabilities of the Federal Reserve Banks--notes and deposits--are used by the banks or the public continuously because they need them in their business operations.
>
> Everyone needs a certain amount of pocket cash to meet certain kinds of expenditures. Therefore, Federal Reserve notes are issued. These notes stay out because they meet a public need and they stay out so long as this public need exists. When the public no longer needs them, they are returned to the banks and from the banks to the Federal Reserve Banks. If the need increases, the amount of notes increases and if the need decreases, the amount of notes decreases. This mechanism works well and we have no trouble with it.

As regards deposits, the member banks want their deposits to be in the Federal Reserve Banks and they want them there, not only because they are required by law to hold reserves in that form, but also because it is the most convenient way to clear with other banks and, finally, because the banks want to feel that a certain amount of their funds is absolutely intact and held in a public institution not operated for profit but devoted to the purpose of regulating the volume of bankccredit in the interest of economic stability.

This is the case even in foreign countries where there are no legal reserve requirements. In those foreign countries, commercial banks maintain reserves with their central bank even though they are not required to do so under law.

To point this up, let me state that the power of the Federal Reserve Banks to invest in Government securities or to discount for or make advances to the member banks is based on the fact that Congress has given the Federal Reserve System certain powers and back of these powers lies the fact that modern economies have found central banking mechanisms an essential part of modern life. The Federal Reserve Banks' lending power, therefore, rests in the final analysis on the fact that they perform necessary central banking functions.

The Federal Reserve authority can therefore make additional reserves available when needed, quickly and in ample volume to meet all the credit demands that go with economic activity. This authority is in the discount powers, the powers of open market operations and the power to lower reserve requirements. They have ample power to <u>increase excess reserves</u> should conditions require an increase.

Finally, let me point out that not only do the Federal Reserve Banks not depend on member bank deposits for their lending power, but, quite the contrary, the Federal Reserve Banks under normal circumstances have the authority to <u>regulate the lending power of member banks</u>. When the Federal Reserve Banks lend to the member banks or buy securities in the open market, they <u>create member bank reserves</u> and, therefore, <u>increase</u> the <u>member banks' lending powers</u>. When Federal Reserve Banks are re-paid or when the Federal Reserve Banks sell Government securities, they <u>diminish member banks' reserves</u> and <u>reduce the member banks' lending powers</u>. It is, in fact, in this power to influence member bank reserves and consequently to influence their lending power that lies the principal instrument of credit control possessed by the Federal Reserve System and, therefore, since a large part of member bank reserves is created through Federal Reserve purchases of Government securities, it is absurd (isn't it) to say that the Federal Reserve Banks use the member banks' reserves. How can the Federal Reserve Banks be <u>using</u> member banks' reserves when the operation itself <u>increases</u> member banks' reserves? It would be a case where the creature is supposed to be the creator of its creator.

I hope I have been helpful in throwing some light on the subject of reserves.

We are all concerned with our national success. Our part--yours and mine--in national success is in the responsibility we have in connection with influencing credit to the end of economic stability. It is plain common sense that to meet this responsibility, which is only one factor in the broad field of economic influences, the time to get ready to solve a national credit problem that may arise, is not when the problem is right on the doorstep of an individual bank--your bank for example--for then it may be too late.

Certainly too, everyone wishes to do his part in the program for national defense. That program has its effect on our national economy, now and later. You and I are in duty bound to be concerned with a strong national credit defense in the interest of economic stability in the United States. Economic stability makes for national success.

Speech delivered before
Alpha Chapter, Pi Gamma Mu
Catholic University, Washington, D. C.
May 18, 1941

ECONOMIC DEFENSE

A colored fellow walked into a drugstore and asked for a slug. He walked into the telephone booth - left the door open, deposited the slug, got his number. The clerk overheard the following conversation: "Does you all want a good man? A very good man who can keep your place very clean and work all hours of the day and night? What's that? You all have a man, and you're satisfied with him? You don't want another man? All right." He hung up, started to walk out of the drugstore. The clerk remarked, "I see you didn't get the job you called for." "Oh, boss - that's the job I got. I just wanted to know how I stand."

So true. We all want to know, and particularly do we want to know how we stand. More than that, we not only want to know, but we want to know why. Upon that principle is based all science.

We search for causes, reasons, principles.

In a world torn apart and depressed by the baser instincts of man, there is little light afforded to lead us in our search for causes, reasons, principles. We are almost lost. To say the least, we are bewildered. Even more bewildered than was Father Smith when, as he said himself tonight, he was asked to act as toastmaster.

And yet, it is during times such as these that greatness comes to the fore. Today's history will be written, and when it is, historians will show, or at least attempt to show, who is responsible, and why. Scientists will try to point to the causes, and politicians will make an attempt to remove them so that there will be no repetition of the present condition. And yet human nature tells us that men learn very little even from the most bitter of experiences. Therefore, is it all worth while? Shouldn't we just sit back and let events care for themselves? Should we? The answer is "Positively No!" For again human nature comes to the fore and produces leaders. Bad leadership led us into this condition, and again, good leadership will lead us out of it.

A gentleman with an excess of avoirdupois is riding horseback - he is perspiring, and the horse sweating, but on his chest are medals galore. He rides alone, stops, asks a passerby - "Did you see a parade go by here?" The passerby answers, "Oh, yes, it's gone by two hours ago." Response from the rider: "Oh, I must catch up. I just must catch up, for ... for ... I'm their leader." That is not the kind of leadership we speak of here. There must be order - logic in the thinking of our leadership, else we have chaos.

Therefore, upon you rests a great responsibility, not only because education enables you to think clearly, but also because you have the added advantage so essential - the advantage of religion. Once the world loses faith in God and in humanity, demagogs have easy prey. For the masses are crying for something - anything! - and the demagogs seem to provide that something or anything.

In a democracy - a form of government adopted by our United States - the citizenry must be especially informed in order to participate actively in its responsibilities to attain the end sought by the State - complete welfare.

Here, more than anywhere else in the world - because of our history, because of our social and economic and political nature, the individual must be constantly mentally alert to all of the processes of government. Otherwise, through blindness he is apt to be antagonistic at a time when he should be most cooperative. In other words, he may be helping to destroy the very thing that he cherishes and desires to preserve so much - liberty. Tonight at the dinner table Dr. Patterson asked me whether I knew the difference between the English expression "We muddle through" and the American expression, "We have the situation well in hand." I thought awhile and had to answer that I didn't. He looked at me and said he had given it a lot of thought, and had finally come to the conclusion that there was absolutely no difference - they both mean the same.

Our country is in the process of preparing its defenses. It is logical that we should in a day such as this be strong in order to retain the liberty that we enjoy. But while we speak of "defense" we shouldn't limit it to military and naval defense. That is a mistake often made. Social, political and economic defense are likewise processes with which we should be much concerned.

On the economic side we have two questions: (1) the effect of what is happening here and abroad on all of the factors that compose our economic structure - now; and (2) the effect of what is happening now, here and abroad, on our economic structure later, after the defense preparation period is over.

The Federal Reserve System has many responsibilities. Among them is the responsibility in connection with influencing credit to the end of economic stability. To meet this responsibility it must cooperate with and obtain the cooperation of other governmental agencies. Therefore, we are continuously advising and being advised by others in the government.

The uncertainties of the future are indeed tremendous. How long and how extensive will be the war? Will our participation be belligerent or nonbelligerent. Will the victory be partial or complete; will the peace be constructive or vengeful? However events may answer this question, we may be sure that the central banking functions of the Federal Reserve System will be more and more essential to our economy. We shall have more occasion than ever for a wise regulation of domestic credit, so that it may be readily available for proper use, wherever and whenever needed, and so that it may not be available for harmful, speculative use. This, therefore, requires that central banking responsibilities be implemented in due course of time with effective powers, and not left as at present with powers that the developments of recent years have rendered ineffective. We shall also have more occasion than ever for a strict husbanding of our credit resources against the time when they can be used for restoration of trade relations with other countries. It is in this process, both for our own good and for that of the world at large, that the proper use of our gold stock must be found, and as the gold now abnormally accumulated here is redistributed, the Federal Reserve bank credit may be counted on to take the place of the gold withdrawn, if necessary, to prevent distrubance of the economic supply of credit.

As you know, the member banks - that is, the commercial banks which are members of the Federal Reserve System - can borrow at the Federal Reserve Bank just as you borrow at your bank.

Today, of course, the member banks are not borrowing at the Federal Reserve Bank because they have a large excess reserve position. In other words, there are about six billion or more in excess reserves that the member banks can lend to their customers - to industry, commerce and agriculture.

At the present time, likewise, the volume of deposits at banks, now sixty billions, could be doubled. A volume of deposits twice as large could be capable of doing twice as much work, and if the amount of goods and services in the country did not increase at the same rate, there would be the danger that prices would rise rapidly. This, of course, is not in the interest of a stable economy. Finally, let me point out that the economy would become unstable if the use of existing deposits were doubled. In other words, at the present time the velocity of deposits - that is, the use or turnover of present deposits, is about 13. There have been times in the past when this velocity or turnover was 26. Therefore, if existing deposits should be used twice as actively as they are now used, that too would represent a dangerous situation. This, also, therefore, is not in the interest of a stable economy.

After deposits have once been created, there is little that the Federal Reserve System can do about them, as that has to be dealt with by non-monetary means, such as restricting of price advances, rationing, etc. The Federal Reserve authorities, however, if given sufficient power by Congress, can regulate the growth of deposits, but they cannot control the turnover or velocity of existing deposits.

Therefore, the Federal Reserve System has advised Congress of the fact that it needs sufficient powers in sufficient time to deal with the existing excess reserves of six billion, should ever the occasion arise for the System to act in the interest of a stable economy on the credit side of our economic picture.

Of course I must point out at this juncture that credit is not overextended just now. But the time may come when action may have to be taken because of the increased business activity in this country due principally to the defense program, and to take effective action, the Federal Reserve System must be in possession of powers to meet its responsibilities in this monetary field.

At the time that we issued our statement to Congress, which was on the first day of January, this year, there was much concern expressed by bankers and others about what was construed to be an unnecessary warning against inflation - that is, overextension of credit. But we did try to point out, perhaps ineffectively, that we weren't asking for the powers in order to use them at once, but rather we were asking for the powers to be in a position to use them should occasion arise for us to do so. For timing, as you know, is the essence of proper monetary action. To revert to the old saying - "You can't close the barn door after the horse has been stolen" - it just won't do any good.

That is the one side of our responsibility. The other side is the one that we are constantly concerning ourselves with. This requires long range studies. Every part of our economic structure must be geared up to an emergency tempo, and coordinated with one objective - our National success.

We envisage problems the solution of which is dependent upon the studies of various aspects of our past, current and future economy. Our central banking authorities - the Federal Reserve System - are studying and considering the following in order to be in a position to discharge their particular duties wisely.

1. The magnitude and timing of the Defense Program.

2. The probable effect of the Defense Program upon the national income, employment and output.

3. The probable magnitude of private investment in plant, equipment and housing, and the probable expenditures on automobiles and household equipment at various income levels. In this connection we are making special studies of instalment credit control.

4. The probable volume of business profits; of corporate, institutional and individual savings at various income levels.

5. The probable magnitude of tax receipts (assuming different tax structures) at various income levels.

6. The probable Federal expenditures and deficits under the Defense Program.

7. The probable Federal borrowing from commercial banks, savings institutions, corporations and individuals.

8. The prospect with respect to commodity price inflation (industrial, agricultural and food prices) under varying conditions.

9. The danger of bottlenecks with special reference to steel, railway equipment and skilled labor.

10. The prospect with respect to wage increases and labor unrest.

11. Control of inflation: rationing, priorities and other direct measures of control; consumption control; the so-called Keynes plan for compulsory saving and deferred payment; excess reserves and direct monetary controls.

12. The impact of the war on foreign trade and post-war trade policy.

13. Gold and exchange policy of the United States, especially in view of Germany's access to the gold and foreign balances of virtually the entire European continent.

14. Problems relating to the post-defense slump, particularly post-defense Federal budget, the fiscal capacity of the States, the Federal-State fiscal relations, variable grants-in-aid, social security programs (including old age, unemployment, food stamp plan, health, education), Federal Works programs, housing.

And, finally, 15. Long-range proposals with respect to expansion, full utilization of resources, anti-depression policy, flexible tax structure, flexible program of public works, a Fiscal Authority Planning Agency.

This is a formidable list, and it challenges our best efforts in study and research, and yet it is incomplete.

On the immediate side of our concern is the vast sum of money that must be raised by the government in financing our rearmament program. The question on that side is not put to us, directly, for the responsibility there is with Congress and the Treasury. But since fiscal operations have an effect on our economic structure, we naturally are concerned with a financing program. And we ask this question: What are the basic aims to be considered in formulating a program to obtain this huge sum for governmental expenditures?

Stated simply, the financing program must be or should be equitable and efficient. By equitable we mean that each of us shall bear his fair share of the burden, and by efficient we mean that the program should be one that can be carried out with rapidity and with the least possible disruption of our economic activity now and in the post-war period.

To spend this money the Government must first obtain it. It obtains it from two sources; first, by borrowing and second, by taxation. Both borrowing and taxation affect our economy.

If we borrow, we can borrow from the banks or from the public, by selling securities: bonds, notes and bills. Suppose we rely primarily on borrowing from the banks. What about the equity and efficiency of this method? Such a policy would have the effect of increasing the total supply of purchasing power, to which I referred a few minutes ago - namely, bank deposits would increase. For when the banks buy government securities they give the government credit on their books, which credit the government is then free to spend. Such an increase in the supply of bank money or deposits, especially now when we are all likely to spend our money more rapidly with better business conditions, is apt to lead to rising prices - to what is generally called inflation. Therefore, suppose we finance defense by borrowing from the public rather than the banks? What difference would this make? The answer is that while borrowing from the banks increases the total supply of purchasing power, borrowing from private savers only transfers purchasing power from them to the government. In other words, when securities are sold to the public, private savers give up so much purchasing power to the government, and therefore do not retain those funds to compete with the government in the market.

Thus the desire of the Treasury to sell as many of their securities as possible to private investors is most desirable. Such a program of course is by no means a guarantee against price rises for there are or may be many other causes of increased prices, but it does avoid increasing the supply of bank deposits, which might prove a basis for inflation.

Suppose we finance defense by taxation. Here the general effect is very very much like borrowing from the public so far as inflation is concerned. The effect is a transfer of purchasing power from private to governmental hands, and there is no increase in total purchasing power.

Taxes, however, must be equitable and efficient. And in the consideration of a tax program, we must give thought to the present tax burden. And from our observation and study, we find that there is no justification for substantially higher rates on the middle income group, and probably for a broadening of the income tax base below the $2,000 income for a family of two, assuming, of course, that new and different sales and excises falling heavily upon the lower income groups are to be avoided. Heavy excess profits taxes in business income surely have a proper place in an equitable defense taxation. Also on the efficiency side we must distinguish carefully between taxes as such and the effects of different, specific taxes, remembering all the while that from an economic stability point of view we must be in favor of taxation as the basic need to avoid serious price inflation in the future. For the present, therefore, there seems to be a strong case for the reliance on selected tax, and on borrowing from the public if we wish to finance our defense program equitably and efficiently.

In a period such as this, too much emphasis is apt to be placed on revenue alone, for revenue's sake, with little or no attention to the problems of equity in avoidance of post-war disruptions.

The Federal Reserve System, looking upon the economic picture as a whole and as one of the responsible public agencies cooperating with others, is giving its full energies to certain aspects of our economic problems. Alone, however, we can do very little. We can only be effective when the public is enlightened, when the public is cooperating.

Again I wish to repeat that democracy necessarily rests on an educated and cooperative populace. And to revert to my introductory remarks, responsibility rests upon the leadership of the country. Universities, therefore, play an important part in thos whole defense program, for education is an effective part of our National Defense.

This is our program, just as this is our country.

And it was written, as you know, that "it ain't the individual, nor the army as a whole, but the everlastin' teamwork of every bloomin' soul!"

Broadcast over
Radio Station K-M-T-R, Los Angeles, Calif.
October 5, 1941

TIGHTENING UP CREDIT

You doubtless know why the anti-inflation battle is on - you know that our country is spending enormous sums of money for defense - for ourselves and the Allies; you know that more and more people are finding jobs - that there are not only more people working, but more money in pay envelopes. A vast new stream of buying power is thus pouring over the nation, and at the same time supplies of many kinds of goods are running short. Defense requirements not only need the materials from which many of the goods that you and I are accustomed to buying are made, but also more and more our industrial plants and our workers are being turned from the production of civilian goods to the production of planes, guns, munitions, ships, etc.

To emphasize this even more plainly, there are more and more buyers in the market, and there are less and less goods to go around. Therefore, only one thing can happen - the prices of the goods available will be bid up to ever higher and higher levels, unless somebody does something about it, and does something about it in time. That "somebody" is the Government, for it represents us all, collectively. The Government can (and it is already in action) draw off some of this swollen stream of buying power by taxation - particularly by income and excess profits taxes, which are based on the equitable principle of the ability to pay. It can draw off more potential buying power by borrowing savings of all groups, big and little - hence, the Defense Savings Bonds, which enable us to help pay for defense and to store up buying power for the future, when our plants can again turn out goods for civilian use, and when we shall have need for some form of industrial activity to take the place of our present defense activity - when we shall need to keep our plants and our workers busy.

In other fields where there are acute shortages, the Government has had to act as speedily as possible to fix prices, to determine priorities - which means deciding how to distribute the limited supply of important but scarce metals and other materials according to the urgency of the need for it - defense coming first of all, of course.

But one of the greatest economic fields is that of credit - credit of all kinds - the kind you get or I get when we borrow at the bank or at the finance company, or when we buy goods on the instalment plan. And it is easy to see that it isn't sufficient to draw off buying power from the market place through Government taxes and through Government borrowing if amounts thus drawn off can be offset, or more than offset, by the creation of new buying power through credit.

In this connection, therefore, the Federal Reserve System has raised the reserve requirements of member banks. While this does not directly affect you, and while this of course is but a small step in itself, more important from a psychological than from an immediate practical standpoint, it does signify a trend toward dampening down excessive credit expansion by the banking system of the country. It means that the banks must keep more of their funds with the Federal Reserve Banks, and this in turn means that the banks will not have quite so much to lend, though of course they still have a great deal left for that purpose.

When this action was taken, the statement was made that -

> "The Treasury and the Board of Governors will continue to watch the economic situation and to cooperate with other agencies of the Government in their efforts, through priorities, allocations, price regulation, and otherwise, to fight inflation."

This includes recommendations of further action if necessary over bank reserves.

Not so long ago the Federal Reserve System was directed by Executive Order to put out (and it has put out) a Regulation to tighten instalment or consumer credit - to tighten up the terms on which you or I may buy automobiles, refrigerators, radios, vacuum cleaners, and a limited number of other articles - desirable articles that all of us like to have and do not like to go without - but nevertheless, articles that cannot be turned out and are not turned out during this emergency by plants and workers in sufficient quantities to go around while we are producing for defense.

It doesn't mean, however, that you can no longer buy on time. It simply means that on certain articles - articles primarily that use materials needed for defense - you and I will have to make specified down payments - a third in the case of an automobile - less in all other cases under the present terms of the Regulation. And you and I must pay the rest in 18 months on all articles listed, and besides that, on <u>all</u> cash instalment loans up to and including a thousand dollars, as well as loans above a thousand dollars made for the purpose of purchasing (and secured by) a listed article. Not very severe terms, to be sure, but it is only fair to warn you that the terms may have to be tightened and may have to cover more articles.

Naturally, there are some who will think it is rather hard not to be able to buy on very easy terms at a time when they have just found a job and are now in a position to buy what they have for some time needed or wanted. I know but one answer to that, and the answer is the same as you or I would make to any young man who complained that it was unfair to ask him to serve in our armed forces just as he was preparing for a bright future. Yes, it is a sacrifice, and sacrifices are not - cannot be equally borne. We can only try - try to see that the sacrifices are distributed as equally as is humanly possible. We are all on exactly the same footing when it comes to cooperating in combating inflation. For that, too, is a fight - a fight against a common enemy, the enemy that strikes hardest at those of small means - the factory workers, the farmer, the breadwinner, the housewife - the great masses of our population.

Let us consider for a moment what the alternative is, if there is no damper put on this very important type of credit - consumer credit - if it continues to grow rapidly, as it has been doing for many months.

Unless some check is put upon it, and other means of fighting inflation are also brought into action, there is no escape from soaring prices, and no thoughtful American wants to have that happen - wants to have the millions of Americans who now have steady jobs, perhaps for the first time in a long while - no one wants to see these workers exchange their hard-earned money for fewer and fewer things. It doesn't make sense - does it? - to earn good wages and have prices go up so high and so fast that the wages buy fewer and fewer goods, food, clothing, necessities of life - as well as the extras. Rather, if given the choice, every thoughtful citizen would prefer to save some of his income if in so doing - if in cooperation with his fellow citizens, subject to the same Regulations- he can help ward off price inflation, - and he will have laid by something for the future, for a time when he and everybody else can buy goods that can be produced in sufficient quantity to meet the demands. And that will be when peace comes, when our plants and workers can be turned back to normal activity producing things of peace instead of things of war.

We are happy to live in a democracy, but for a democracy to operate successfully, public understanding and cooperation are essential, and they are essential if the Government's fight on inflation is to succeed.

Those of us whose task it is to work directly on the program welcome the opportunity to report to you - to report on what we are doing. We welcome questions that lead the way to an understanding of credit regulation, taxation, the sale of Defense Bonds, price control, and other features of our effort. We are defending our democracy, and we wish to defend it by democratic means. The strength of our nation lies in our understanding and determination. Having these, we are invincible.

Speech delivered before
Illinois Association of Small Loan Companies
Edgewater Beach Hotel, Chicago, Illinois
October 25, 1945

POST WAR CREDIT

I was born and raised here. I worked here. From this very hotel I made weekly radio broadcasts on current topics. I like it here. It's always a pleasure to be back.

The war is over and here we are. Here we are--facing a new situation. We've faced so many situations together that this could easily be called just another situation; but this is more than that--at least that's the way it appears to me, at this point of transition from war to peace. It's worldwide, it's complicated, and we are in the forefront. The entire world looks to the United States for leadership. We're a creditor nation, greater than ever before.

And yet--our nation has emerged from the war in better shape than any major nation.

VE-Day and VJ-Day did not permit finance to demobilize. Rather, finance has moved up into the front line of the battle of peace. Our nation, which yesterday was the world's main source of war materials and armed men, is now looked upon as the world's pincipal source of peacetime goods and credit. The difficulties we have already overcome provide assurance that we can cope with those that lie ahead.

No one man saw the entire story of the credit problems of the war, but we in the Federal Reserve System did have close contact with its main theme. The System, as you know, is the central banking agency of the nation, and its broad function is that of contributing its share to the Government's purpose of maintaining economic stability. The Reserve System's part is played by influencing the supply, cost and uses of money and credit. Very early, with the approach of war, it became evident that the System's task, in the event of war, would center upon helping the Treasury to obtain all funds needed for the prosecution of the war and, equally upon stabilizing the market for Government obligations. That the nation was to absorb Government securities in excess of $220 billion on top of an existing national debt of $40 billion could not, of course, be accurately foreseen, but even so early it was evident that the demands upon investment would be vast and beyond all past experience. It was apparent that market fluctuations must not be permitted to interfere with Treasury offerings. But the necessity of supporting Treasury financing was parallel to another responsibility of the Federal Reserve System--that of fighting inflationary developments so far as possible by means at its disposal in the monetary and credit field. A serious inflation would have been vastly disruptive to our war effort. We couldn't afford to permit the value of money to depreciate and thus to weaken the will to save. While it was necessary to maintain credit ease for Treasury financing, it was a policy that could have been carried too far. That is why credit restraints in fields such as consumer credit and stock market credit were made operative.

Before the attack upon Pearl Harbor the Treasury and the System's Open Market Committee decided, in the event we were drawn into the war, to maintain a structure of yields on Government issues. The rates ranged from 3/8 of 1 per cent on 3-month bills to 2-1/2 per cent on long-term issues. Compared to those of the World War I, these rates were moderate indeed. Also, compared with the first world war, these rates did not increase as the war progressed. In fact, although the two terminal points of the structure of yields were maintained, the yields on medium-term securities are actually lower now than they were at the beginning of the war. The maintenance of such stability in rates may well be regarded as an unexampled feat in the annals of war financing. The principles that were applied were, fundamentally, as simple as they were successful.

First was the principle of buying and selling Treasury issues to steady the market. This was carried out through the open-market operations of the Federal Reserve System. There is no mystery about this: when offerings of Government securities were in excess of demand, so that the rate structure might be inclined to rise, the System bought those issues in the open market in amounts sufficient to balance supply with demand and to neutralize the upward pressure. Conversely, when the demand for individual issues was in excess of supply, so that the rate structure might fall, the System made sufficiently substantial sales of those issues to satisfy the market. I do not wish to give the impression that the application of this policy was as easy as falling off the proverbial log, for decisions have been difficult at times, but the record of results remains.

Second--in order to provide an adequate and continuous market for Treasury offerings, it was necessary that the resources of the commercial banks, which were fortunately at a high level, be released on a gradual basis, as the situation might require. On the day after the Pearl Harbor attack, the Board of Governors issued a statement to the banks calling attention to their plentitude of funds, assuring them that the Federal Reserve System would support them in full in their aid in financing of the war, so far as that aid was required, and specifically stating that the System stood ready to advance funds to banks on Government securities at par. This statement proved effectual. The System backed it up with action. In November 1942 the System, together with the Treasury, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the executive committee of the Association of State Bank Supervisors, issued a statement, assuring banks that the examination and supervisory policy would not deter bank investment in war securities with certain restrictions as to kinds of securities banks can buy; also that these supervisory authorities would not look with disfavor on loans up to 6 months made to the public for the purpose of public buying of Government securities.

However, the stabilization problem became not only one of sufficient credit ease but also one of excessive ease. So rapidly were funds supplied to the Treasury and so rapidly did these funds begin to pervade the productive economy, through increases in dollars in circulation and increases in bank deposits resulting from purchases of Treasury offerings by banks, that member banks began to feel the need of replenishment of their reserve position. The increasing demands for bank credit by enterprises producing for war further increased the banks' requirement of reserves. It was a demand which early in 1943 passed the $3 billion mark in loans outstanding, and rose to $3.5 billion by the end of the year.

It was, of course, encouraged by the guaranteeing of war production loans under the Board's Regulation V.

Therefore, this condition called for an approach along several lines. First, the Federal Reserve System so directed its open market operations as to relieve some of the pressure upon bank reserves; but, mind you, not to release large and unnecessary amounts of excess reserves, but small and necessary amounts as needed. Next, the reserve requirements for central reserve city banks (New York and Chicago) were reduced from 26 to 20 per cent. Borrowing by banks from Federal Reserve Banks, which had been largely a discontinued practice in the period when excess reserves were abundant, was encouraged through establishment by the System of low discount rates. Reserve Bank loans to member banks reached the highest levels in both number and amount for many years.

The System in addition established the policy of buying Treasury bills from banks, under an option by which banks could repurchase them, at 3/8 of 1 per cent. Also, Congress suspended reserve requirements against war loan deposits for the period of the war. However, the System's policy was influenced by the general objective of selling as large amounts of Government securities as possible to buyers other than banks; a policy that not only greatly helped to ease the pressure upon bank reserves but also absorbed idle funds that, otherwise, might have been used to bid up prices to create uncontrollable inflation. Not only did the Federal Reserve in its operations follow this guiding policy, but it gave counsel to the Treasury and to the banks on this vital matter, in pursuance of this policy.

By means of these various actions, and of others that were taken from time to time as the situation required, the largest scale financing in history was accomplished without swamping the investment market or undermining the dollar on which the entire operation was based. We inherit in this period of reconversion a credit responsibility carried over from the war, and this is it.

I need not tell you that, because of the success in marketing and maintaining the market for Government obligations, this type of investment is today of underlying importance in the financial structure of banks, insurance companies, savings banks, and institutional investors of every type; of business corporations large and small, of the very numerous unincorporated businesses, and of countless individual investors like ourselves. I need not point out that the value of this all-pervading investment would be affected by inflation.

Of all our responsibilities, it seems to me, perhaps the greatest continuing responsibility is that of protecting our common investment from a decline in its value; which is only another way of saying that we must do our utmost to prevent inflation. We must protect our investment in the victory that has been won.

Because I wanted its connection to this most fundamental of all problems to be clear, I have omitted until now my mention of one aspect of Federal Reserve policy that most nearly concerns you. I spoke of the abundance of purchasing power in consumer hands, and the capacity of that buying power, if not applied to aiding the war effort, to go in the other direction, to burst the price ceilings, and, by reducing the worth of the dollar, to operate to the detriment of the entire financing of the war. This danger was especially serious because liquid funds in the form of currency and bank deposits have been and are at an unprecedented high level. Dollar circulation increased to $27,804,000,000 on September 30, 1945, and demand deposits of individuals, partnerships, and corporations in insured banks rose from $36.5 billion at the end of 1941 to more than $64 billion at the end of 1944.

Many consumer goods have been and still are in short supply. Obviously the danger of inflation from this cause still exists.

The classic effect exerted by inflation through a high cash buying power against a short supply was subject to restraint by price ceilings, These were established, but the pressure against them was heavy, and it was clear that the additional buying power which consumer credit could supply could easily, added to the cash pressure, be the marginal factor, however small, that could burst the ceilings and with them the war investment market. In 1941 the President of the United States took cognizance of this possibility and by Executive Order No. 8843 enjoined the Federal Reserve System to take action to discourage consumer credit. The Board of Governors in response to that order issued Regulation W. You are familiar with the terms of that Regulation, and I need not recount them, except to call attention to the temperate language used by the President in his message to Congress bearing upon the order, an attitude that was reflected in the Regulation itself:

> "To keep the cost of living from spiralling upward, we must discourage credit and installment buying, and encourage the paying off of debts, mortgages and other obligations; for this promotes savings, retards excessive buying and adds to the amount available to the creditors for the purchase of War Bonds."

The order, unprecedented as it was in this country, met with immediate response. Financing institutions at the time, 1941, were at their all-time peak of consumer credit, especially installment financing. Those institutions that were directly engaged in financing of consumers might be conceived of as having two conflicting points of view, their immediate interests appearing to run counter to their long-time interest; their daily business to pull in one direction, their stake in the war effort in another. If such were the case, then the record shows that they chose the long-time point of view, for the extent to which Regulation W has been self-enforcing on a voluntary basis stands as clear evidence that those men most interested in the financing of buying power were willing to help fight inflation at the cost of reduced business to themselves.

Now, the record further shows, first, that the fight against inflation, while not completely won, has by no means been completely lost; and further, that the commercial banks felt the dislocating effects of Regulation W more than did the small loan companies. I understand that from about 1910, when States began to pass enabling laws, to about 1934, the licensed small-loan companies had this field fairly well to themselves except for some competition by credit unions, industrial banks and receivable financing companies. About 1934, the commercial banks became active in installment financing, and in the ensuing 7-year period, in which the total volume of installment financing rose from about a half-billion to about 2-1/2 billion outstanding, the small loan companies gained in volume by about 115 per cent, whereas the outstandings of commercial banks rose from less than $50 million to about $780 million, or by a much greater percentage. However, the total volume of outstandings declined by about 50 per cent from 1941 to the early part of 1944. This was due to various factors: The shortage of consumer durable goods resulted naturally in a limited volume of new business, and Regulation W tended to expedite the repayment of debts incurred. Naturally those parts of the consumer credit business that were the most intimately tied to the market for consumer durable goods suffered the greatest losses in volume. The discounting of sales contracts for automobiles and similar goods declined more than four-fifths and this effect was felt most keenly by sales finance companies and banks. Cash installment loans were somewhat less severely curtailed. Such loans at commercial banks declined by almost one-half from the peak of 1941, by about two-fifths at credit unions and industrial banks, and by about one-third at small loan companies. For more than a year now there has been relatively little change in consumer credit volumes; such change as has taken place has been mainly a slight increase.

I need not here discuss action taken by our Board to restrain uses of stock market credit. May it suffice to say that the present cash requirements are 75 per cent.

And so we come to the situation as it is today.

There is much complexity and there are many contradictions in our present situation; yet I feel sure there is a virtually universal recognition of the fact that increased production, the greatest abundance of production we can get and at the earliest date, is the primary key to those problems that present themselves as the most serious to finance.

On the one hand: The Office of War Mobilization and Reconversion, in its report to the President on October first of this year, states that

> "By next spring with demobilization running at better than a million a month, unemployment may rise to about 8 million. The total will depend on how fast reconversion and expansion can be accomplished."

And again, in that same report, Mr. Snyder, Director of Reconversion, speaking of our vast purchasing power and stifled war-time demands, says

> "Big as the backlog is, our economy cannot carry on out of accumulated savings alone. These savings are largely in the hands of middle and higher income groups. There are millions of families with little or no savings. The steady market that business and agriculture need, to reach full employment, must come chiefly from current wages and salaries."

Shrinkage of current income, of course, is a deflationary element in our economic picture. There are also other contributing deflationary features in the present situation which we need not detail now.

On the other hand: We do not need theory to recognize that, in maintaining the stability in a free economy, a normal balance between the supply of goods and the demand for goods is the main necessity. If the supply-demand equation is over-balanced on the supply side, prices drop; if the equation is over-balanced on the demand side, prices rise.

At the immediate moment, production is far in arrears; demand for goods is enormous and urgent. There is a psychology that tells us that the war is over, that we can put the rifle in the corner and go home, relax and enjoy life in its fullness. Yet we need hardly to be told that the poorest service we could render to our economy would be to let the forces of a pent-up domestic and world demand be unleashed upon that economy, without restraint and without safeguards to prevent these forces from having an inflationary instead of a constructive and stabilizing influence.

The present unbalanced situation, we know, is temporary. In some consumer lines, alleviation of shortages already appears. There is world shortage of supply in lumber, paper and pulp, rubber, cotton and woolen textiles, sugar, fats and oils, brick, lead, tin and other basic commodities. Some of these shortages will be overcome sooner than others; all will ultimately be overcome. There is a bright side of the picture, too, in the fact that, generally speaking, American productive enterprise is well equipped with funds for the internal financing of its reconversions, and in the fact that planning for individual reconversions is in many cases complete. But we also know that the manufacture of new machinery takes time, labor-management adjustments take time, proper tax adjustments take time, and until a consistent flow of needed raw materials and parts is assured, the mass-producing industries, especially, cannot start their assembly lines. Some industries are beginning to revive and replenish the inventory shelves already, others will do so with a considerable lag; it is a process of step-by-step reconversion, paralleling the uneven previous process of conversion to war.

Looking at the demand side again, which remains the dangerous side until shortages are removed, we see not only the deferred domestic demand, of which various high estimates have been made, but also the demand of the devastated and impoverished foreign countries, as to which no reliable estimate exists. Both demands will draw heavily upon the producing capacity of the United States; the domestic demand because it is here already, and the foreign demand because governments, relief agencies and individual businesses in foreign countries must have goods of every type, and we are the best potential source of what they need. We want to meet that foreign demand, not only for the sake of the trade and an expanded business activity at home or because of the friendly international relations and a sense of moral obligation to share with those who deserve our gratitude, but also because the prosperity of our international environment directly affects our own prosperity and our own economic stability at a high level. The new international structures, proper policies of our Export-Import Bank operations and other Government lending and sound judgment in private lending and business investment abroad can and doubtless will spread the impact of the foreign demand upon our markets; international loans made and under consideration will gradually revive foreign production and aid in establishing a balanced world economy essential to world stability; there is a good prospect that the international effort to stabilize foreign currencies in terms of our own will not be frustrated by the kind of price-bidding that causes inflation in the world as at home. But here again we seek balance--balance of international payments. International credits, unlike domestic credits, involve transfers from one currency to another, and these transfers can be made only if merchandise exports and imports, together with other international transactions, are all in balance. The difficulties of making international transfers--particularly if major trade barriers must be hurdled--have been much in our minds. It is a complex question of great concern to our economy. Much can and doubtless will be said about it, but this is not the time.

What we ourselves must concentrate upon in our domestic program is the maximum acceleration of production; and until inventories are also in balance, we must concentrate upon the maximum possible prevention of inflationary purchasing, here at home.

In the encouragement of industry to speed production, various actions have been taken by Government. The Board of Governors has taken two actions which reflect the policy of balancing the supply-demand equation as soon as possible by the use of credit. While, generally speaking, our productive enterprise is well equipped with funds, there are and will be many exceptions in the reconversion of small business, depending on kind and size of enterprise as well as type of reconversion. More than a year ago, therefore, in conformity with the forward-looking recommendations of the Baruch-Hancock Report, the Board asked Congress to amplify the powers of the Reserve Banks, under Section 13b of the Federal Reserve Act, to underwrite the loan risks of commercial banks and other private lending institutions in providing funds to business and industry for reconversion purposes. The form of underwriting that is proposed is the same that has been tested by experience during the war under Regulation V, in guaranteeing some $10.4 billion of credit authorizations for war production, and in fact was well tested prior to the war by Federal Reserve Banks in guaranteeing bank loans under the commitment provisions of the existing Section 13b. The guarantee is simply a "take-out agreement", by which a Federal Reserve Bank contracts with the lending institution, in advance of each loan, to buy a participation up to a stipulated percentage of the loan at any future time, on demand of the lending institution. For this assurance that it can in the future rid itself of part of a transaction, should loss be threatened or occur, the commercial lender pays a portion of its return on the transaction as a fee. The result is a net return, for the guaranteed loan generally represents new business--typically, a technically troublesome loan, or one in which the security is somewhat inadequate--which otherwise would have to be declined. The proposed guarantee plan may apply to any type, purpose or term of business loan, and any type of lending institution may use it. In practice, it appears that the plan will most greatly aid the smaller businesses, whose ability to supply loan collateral in proportion to their credit needs is often deficient. Congress to date has not adopted this measure, known as the Wagner-Spence bill (S. 511 and H.R. 591); the measure which by its terms is intended only for the transition period, is before the Banking and Currency Committees of the House and Senate, and

I commend it to your attention because it is a constructive measure that would strengthen the national economy and thereby be of indirect benefit to small loan companies. It is a well-known fact that your business expands as the national economy expands.

The second action taken by the Board of Governors is more familiar to you, and indeed I understand that there has been some disappointment in this connection. In its desire to release credit as soon as possible for purposes of production and employment, the Board on September 25, by an order effective October 15, adjusted Regulation W by exempting credits for home repairs and improvements (for which a great social need exists), and by lengthening from 12 to 18 months the maturity limit on loans which are not for the purpose of purchasing consumers' durable goods. Production thus gets the green light, whereas, for reasons that I have tried to explain, loans for financing the purchase of consumers' durable goods listed in Regulation W still remain under their former degree of partial restriction. To emphasize the temporary nature of the present situation, let me recall to you the language used by the Board in making this initial relaxation:

> "Until consumers goods come on the market in sufficient supply to meet demands, the Board believes that the use of consumer credit should be discouraged. Accordingly, the Board, after reviewing Regulation W now that the war has ended, has concluded that the Regulation should not be substantially amended at the present time except in the two particulars specified."

It is my understanding that you would like to have the latest amendment to Regulation W clarified in its application to outstanding nonpurpose loans made before October 15. It is also my understanding that you would like to have the regulation contain more explicit and more liberal provisions respecting consolidations, or what you call "new loans to present borrowers". Both of these matters are now being worked on by the Board and the Federal Reserve Banks and you may be sure that, among others, representatives of the small loan companies are being and will be consulted with respect to any amendment that may be proposed.

It is indeed a matter of timing, and timing is of the essence of the problems of credit that now exist. Timing of supply so that it increases with the utmost rapidity in each given line, timing of demand so that it does not prematurely swamp supply and postpone the day when the supply-demand equation is generally balanced. We know our amazing productive capacity, and we know that the demands of a devastated and goods-hundry world assure that capacity of abundant markets for a long time to come. What we cannot be so sure of is that mistakes in details may not be made; that the impatience that everyone feels to confide the credit task to the free forces of a free economy may not result in premature action at times. I am not a prophet but, for what my forecast is worth, it is that as the restoration of production goes forward and the national peacetime economy expands, the total volume of consumer credit will increase again and in a few years will be vast, to say the least, by anycomparison. We hope the expansion will be orderly, will not lead to excessive demands for goods, and will not be followed by severe liquidation. Having thus far held the line against inflation, not perfectly, but with a remarkable degree of success in view of the economic pressure thus far, we have no reasons for lack of confidence that, with a more widespread understanding of how fundamental the value of the dollar is to this nation and to the world, those who are on the firing-line of the credit problem will obtain the necessary cooperation.

To summarize: The war is over. We won. Free enterprise is once again on trial and credit is the blood and sinew of free enterprise.

Will private credit meet the test by adjusting operations in the transition period to the sound economic requirements of short and long-term reconversion of our country? In a world torn asunder by a total war that has not only wrought destruction to property and manpower but has changed the face of the earth economically as well as socially and politically, this will not be easy. It will really take more than understanding; it will take bulldog tenacity and infinite patience. As private lending meets the test, however, it will help not only to establish a sound peace but it will help assure the maintenance of our economic system.

The Federal Reserve is aware of its responsibilities in the monetary and credit field during the transition.

The situation is full of contradictions, but as these did not deter us from winning the war together so they will not deter us from winning the peace together and, God willing, we shall have peace!

Speech delivered before
Economic Club of New York
New York City
May 1, 1946

OUR MONETARY PROBLEMS

The monetary problems that we face today are largely a heritage of the most tremendous war financing in history. This financing was successful because we all worked together to win the war as quickly and as effectively as possible.

Now that the war is won, we need to work together again--this time, to win our fight against the immediate danger of inflation. Countless millions of Americans have loyally supported the home front battle against the inflationary forces generated by the war. It would be tragic to lose this battle at the eleventh hour by prematurely abolishing essential price controls and the other remaining protective measures, irksome though many of them may be and eager as we all are to be rid of such restraints as soon as we can safely do so. If we were to permit inflation to demoralize our economy now it would place in jeopardy our justifiably high hopes for establishing an enduring prosperity at home. And a prosperous America is essential to a lasting peace abroad.

A solution of our monetary problems is a part of winning that fight against inflation. I should like to touch on some of these monetary matters tonight.

At the outset we should admit that we can not solve our monetary problems with some simple single device, with some single action, or for all time. We must move cautiously, not abruptly, and we must take the problems as they come--as objectively as we can. That is the economic and politic thing to do. There can be no easy nor quick way.

We do not live and work in a vacuum. We live and work in an active day-to-day economy under a free enterprise system, which we propose to preserve under our form of Government. This Government, like our economy, has many parts, and these parts have many departments and divisions in which responsibilities are not always exact and precise. Solutions to national economic problems do not lie in any one single part, department, or division, nor in any one segment of our economy. The solutions should not result in favor of any single group or groups of our people. The solutions of our monetary problems must be considered with one fundamental aim--economic stability at a high level of production and employment. That goal can not be reached through monetary and credit measures alone, but it can not be achieved without appropriate monetary and credit measures.

In peace time, as has been said often before, the primary objective of Federal Reserve policy is to provide monetary and credit conditions favorable to sustained sound economic activity in commerce, industry, and agriculture. In war time this objective continued to be of great importance but it was influenced by the special requirements imposed by military necessity. In reconversion from war to peace, it is influenced by the special requirements imposed by the accumulated demands for goods here and abroad, the short supply of certain goods, the large purchasing power in the hands of the public, and the interest cost on the extraordinarily large public debt--all resulting from the war. The primary problem, therefore, is to meet the accumulated demands for goods, needed both at home and abroad, through an expansion of production that will achieve as rapidly as possible a better balance between supply and demand without, at the same time, causing a rapid inflationary rise in prices that would end in deflationary collapse.

It is important to note right here that inflation increases the cost of Government as prices rise sharply. The increased cost would likely continue during the subsequent collapse as the Government would need to make expenditures for recovery and relief.

To fight inflation we need to encourage continued savings by the public on a substantial scale. The savings bond program is, therefore, vitally important and deserving of support. We should exert every effort to insure the balancing of our budget. Hence we should not reduce taxes further in the coming year and should hold Government expenditures to the minimum.

On the monetary side, as you are aware, individuals and businesses have accumulated huge amounts of liquid assets which are held in the form of currency, bank deposits, and readily convertible Government securities. The public, even after paying greatly increased war-time taxes, had a large excess of income relative to the supply of goods and services available for purchase. If the public had spent a larger part of this excess income, the result would have been a ruinous inflation.

Notwithstanding the fact that taxes were increased heavily and that tax receipts of 153 billion dollars comprised about 40 per cent of all funds raised during the war period, the public debt rose from less than 50 billion dollars before the war to a peak of approximately 278 billion.

This increase in debt inevitably added tremendously to the liquid assets of the public. Liquid assets--that is, currency, bank deposits, and Government securities--held by individuals and businesses, exclusive of financial institutions, rose from about 80 billion dollars at the time we entered the war to approximately 225 billion at the end of 1945--an increase of some 145 billion dollars. This is an inflationary potential that dwarfs anything in our past.

As you know, it has been the policy of the Government to sell the largest practicable amount of its securities to investors other than commercial banks and to induce these nonbank investors to hold their securities. The purpose has been to channel as much as possible to the current income and idle funds of nonbank investors from the purchase of scarce goods and services to investment in Government securities. This, in turn, has 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. You are familiar with the devices used to implement this policy--war loan drives, payroll savings plans, and issues of Government securities whose ownership was general - restricted to nonbank investors.

In spite of this, a large part of the Government securities went to the banks.

It is often said that the basic cause of inflation is the Government deficit and the resulting borrowing from banks that creates new money. This is essentially true, but the results of that situation now exist and they can not be eliminated overnight. No country has ever been able to impose sufficient taxes to finance a war without borrowing or creating new money in the form of bank deposits. Now that the war is over, the deficit has practically disappeared; it is no longer necessary to create this new money by borrowing to finance the Government. Nevertheless, the money created during the war still exists and might be expanded through further transfers to the banks of Government securities already in the market. Until those funds are firmly invested or until our economy has grown up to them, they are potential inflationary tinder.

These funds, in addition to current incomes that result from current production of goods and services, are available for spending or investment in other assets. Thus the potential spending power can continue far in excess of the current flow of goods and services even though production should increase considerably. Expanding production would not prevent or check inflation, if the public should attempt to spend its accumulated savings as well as current income. Nor can these accumulated liquid assets be substantially reduced except by debt retirement--at best a slow process. We can hope that they will remain firmly held until they can be gradually invested in peace-time pursuits. In the meantime, controls of various sorts over goods in limited supply and over prices will continue to be necessary.

Although this background is familiar to you, it is so vital to any discussion of our monetary problems that it bears repeating.

In the monetary field the responsible authorities face a difficult though not impossible dilemma. Under the existing structure of interest rates, with its wide spread between short-term and long-term rates, there is an incentive for both commercial banks and nonbank investors to shift their holdings from short-term to longer-term securities. By this means they can obtain both the higher yield on the longer-term securities and the profit that accrues as each issue, with the passage of time, automatically becomes shorter and consequently declines in yield and increases in price. For this reason there generally has been a supply of short-term securities in the market and a demand for longer-term securities. The Federal Reserve is continuing, as it did during the war period, to support present short-term rates by purchasing all of the short-term securities that are offered in the market at those rates. On the other hand, the Federal Reserve can not supply the market demand for longer-term securities, because it has already virtually exhausted its portfolio of these issues.

The result is that, so long as holders of Government securities want to shift from short-term to longer-term securities, Federal Reserve holdings increase. This increases member bank reserve balances at the Federal Reserve Banks. On the basis of these increased reserve balances, commercial banks as a group can expand credit for whatever purpose they choose by six times the increase in reserve balances at the Federal

Reserve Banks. The expansion averages six times the increase in reserve balances because on the average a given amount of reserve balances will support six times that amount of deposits. Expressed the other way around, present reserve requirements for the various reserve classes of banks are at levels that equal, on the average for all member banks, one-sixth of net demand deposits. To summarize, so long as present short-term rates can be maintained only by Federal Reserve purchases, there is an inducement for bank credit to expand further. This increased bank credit is available to the public for spending in addition to their current income.

You may ask, quite properly, at this point: "Why not use the methods that the Federal Reserve has employed in the past? Why should not the Federal Reserve discontinue buying Government securities? Would not this top the further expansion of bank credit? If the Federal Reserve discontinued buying securities, would not this make it more difficult and more costly for nonbank investors to raise funds by selling Government securities, by borrowing from banks, or, as in the case of corporations, for example, by the issuance of their own new securities?"

I think the answer to these questions is that the present situation is entirely different from anything in the past. The difference lies in the large public debt, the large interest cost of that debt, the large profits that commercial banks as a whole receive from Government securities, and the large holdings of Government securities by nonbank investors.

If the Federal Reserve discontinued buying the securities, short-term interest rates would no doubt increase. This, in turn, would increase the interest cost of the debt to the Treasury as maturing short-term issues were refunded at higher short-term rates. The importance of this interest cost is shown by the fact that, as a result of the war-time expansion of the debt, it has increased fivefold from a billion dollars a year to about five billion a year. Who pays this interest cost? The taxpayer. As you know, the public and the Government are in no mood to increase the cost of servicing our tremendous public debt.

An increase in interest rates also would unnecessarily add to the profits of commerical banks. The importance of this consideration is shown by the fact that, as a result of war-time purchases of Government securities, commercial bank profits have more than doubled. You may say that, since an increase in bank profits was of no concern to the Government in the past, it should be of no concern now. I believe, however, that the difference lies in the fact that in the past bank profits came principally from the public in the form of business loans, corporate securities, and like assets. At present, however, a considerable part comes from the Government, which in the last analysis means you and me as taxpayers. More important still is the continuation of our free enterprise system, and increasing the profits of commercial banks at this time at the expense of the taxpayer is not a good way to preserve the system of free enterprise--or, to be more specific, to preserve our private banking system.

I do not want to seem in any way to disparage either the need for the existence of a healthy commercial banking system or the excellent job that commercial banks did for their country during the war. Commercial banks were an important factor in selling Government securities to nonbank investors. Also, they purchased the Government securities that the Treasury was unable to sell to nonbank investors. They performed many other valuable functions in the war effort. Always--in war or in peace--they are vital, useful institutions and as such they must earn sufficient profits to maintain their existence. Also, in exceptional circumstances, some individual banks or groups of banks have not participated in the general increase in profits but banks in general do not need to obtain higher rates of interest on Government securities to maintain their existence.

There is a third reason for avoiding a rise in short-term interest rates, in addition to the effect on the interest cost of the debt and on commercial bank profits. It is said that a rise in short-term rates might result in liquidation of present holdings of Government securities by nonbank investors. If this were to reach large proportions of a flight from Government securities, it would have inflationary consequences. After interest rates have been prevented from increasing for four years, the first break in the dike might possibly bring on a flood. For my part, I do not believe that this would be the result, but the possibility at least indicates that we should proceed with caution, and there are those who stress this point.

On the other hand, there is the long-run danger that lies in the fact, well known to you, that as commercial banks purchase medium-term bonds from nonbank investors and the nonbank investors in turn bid against each other for long-term bonds not available to commercial banks for purchase, yields on these bonds decrease. A decline in long-term yield tends to result in such attractive premiums that holders of long-term bonds other than institutional investors are tempted to sell them at those premiums, with profit, and to seek other employment for their funds. The result is that the funds tend to shift to other markets--first to high grade corporate bonds depressing their yields to the point where they become unattractive, then into lower-grade bonds, stocks, real estate, etc., bidding up their prices and tending to accentuate speculation in such investments. A decline in long-term yields tends to reduce the income of insurance companies, savings banks, and endowed institutions, which hold a large part of the savings of the public and perform essential public services. It seems to me, therefore, that lower interest rates, especially at this time, would not be desirable.

What I have been saying up to this point seems altogether negative. There is something, however, on the positive side. Most important is the state of the Federal budget. In the first quarter of this year, the Treasury had a small surplus of tax and other receipts over Government expenditures. Receipts were larger and expenditures had been reduced more rapidly than had been expected. The budget is close to a balance on an annual basis. As long as inflationary pressures continue, however, there is no justification for further tax reductions and Government expenditures should be held to the minimum of public needs. I believe that budgetary surpluses to retire public debt should be the order of the day.

The favorable trend in the budget means that the Government deficit is not nearly so large as it was and that there has been a reduction in the excess of the public's income over the available supply of goods and services. In addition, it means that the Government debt will not continue to increase.

In fact, the Government debt has already started to decrease because the Treasury very wisely has been retiring maturing and called securities by using part of the large cash balance not needed for current expenditures. Since the cash balance is still large, the Treasury is in a position to continue to retire debt. Since banks held a large proportion of the maturing and called issues, the result is a substantial reduction in bank credit. From March 1 through May 1, 1946, the Treasury retired a total of 6.4 billion dollars of certificates, notes, and bonds. Of this amount commercial banks held somewhat over 4 billion dollars and Federal Reserve banks 1.2 billion.

Another new factor that may retard the monetization of our public debt is that the yields on the medium-term bonds that commercial banks have been eager to purchase have declined to 1-3/8 per cent, compared with 2 per cent only a little over a year ago. The spread between these bonds and the 7/8 per cent certificates consequently has been reduced from 1-1/8 per cent to 1/2 per cent. The type of switching that leads to further expansion of bank credit is not nearly so profitable as it was formerly. Finally the debt retirement has reduced commercial bank holdings of the shortest-term securities and consequently has lengthened the average maturity of their portfolios. This also tends to make them a little hesitant to extend their maturities further by selling certificates and purchasing medium-term bonds. In fact, during recent weeks commercial banks seem to have been shortening rather than lengthening the maturities of their Government securities.

In any event, because of this combination of circumstances, the situation looks much more favorable than it did a few months ago or at the time you invited me to speak here. The demand deposits of individuals and businesses have stopped expanding, and the total of bank loans and investments has actually declined. Total loans and investments by weekly reporting member banks declined from 68 billion dollars in February to 65.5 billion dollars on April 17. Whether this is a temporary phenomenon or a major change, I would not undertake to say, but I hope it is a major change.

In addition, a return flow of currency and gold imports, which could have been a basis for further expansion of bank credit, has been offset by a decline in Government securities held by the Federal Reserve Banks. Currency in circulation has declined by about 700 million dollars from the war-time peak of nearly 29,000 million dollars reached last December. Gold imports in this period have amounted to about 200 million dollars. The effect of these movements, which is to increase bank reserves, has been more than offset by a decline in Government securities held by the Federal Reserve Banks. As a result of the Government's debt retirement program and sales of securities in the market the Federal Reserve System's portfolio has been reduced by 2 billion dollars since the first of the year. It is now 22 billion dollars.

As I have indicated, there are serious obstacles under present day circumstances to the use of the traditional monetary powers to implement anti-inflationary policies in a way that would increase interest rates. Our Board announced last week Thursday that it "does not favor a higher level of interest rates on United States securities than the Government is now paying." The problem of exerting further pressure to arrest unnecessary and undesirable monetization of the public debt through the commercial banking system may require Congressional study and legislation.

One perhaps relatively minor but certainly desirable step was the ending of the war-time preferential discount rate of 1/2 per cent on Government securities due or callable in a year or less. This special rate was established purely as an emergency war measure to help the Treasury in the successful sale of its securites to obtain funds required to win the war. It was designed to enable commercial banks to obtain more readily the excess reserves needed to purchase Government securities that could not be sold to the public. To facilitate them in adjusting their reserve positions, and finally to encourage them to buy short-term rather than long-term securities.

This rate not only had passed its period of usefulness but had made it possible for banks to borrow at 1/2 per cent in order to purchase higher yielding Government securities. The magnitude of the possible credit expansion is several times the amount borrowed from the Federal Reserve because, as I have already explained, the bank reserves created by the additional Reserve Bank credit provide the basis for a six-fold expansion of bank credit. The preferential rate also encouraged banks to lend on Government securities at low rates, thus giving substantial profits to borrowers and encouraging speculation. Although such loans have declined from the war-time peak, they still exceed 3 billion dollars. The preferential rate has not been an important instrument of monetary policy and its elimination is merely a post-war adjustment in conformity with the Government's stabilization program.

Various other proposals concerning our monetary problems have come to my attention. For example, to stop further expansion of bank credit and a further decline in the long-term yield and to do so without increasing the interest cost of the public debt and without increasing further the already large profits of commercial banks, several suggestions have been made to require commercial banks to hold a certain minimum amount of Treasury bills and certificates, or, following the example of the Canadians, to prohibit the commercial banks from holding more than a certain maximum amount of Treasury bonds.

It has likewise been proposed by some that the required reserves of central reserve city banks be increased to 26 per cent against net demand deposits. They are now 20 per cent, the same as at reserve city banks, while so-called country banks are required to hold reserves of 14 per cent against their net demand deposits. That is the limit of our authority. It has also been proposed, therefore, that the Federal Reserve ask the Congress for some additional power to raise reserve requirements above the present maximum for each of the three classifications of member banks. It seems to me that whatever merit there may be in the various proposals that have come to my attention, one thing is evident and that is that they deserve very careful study for, as you know, they have both advantages and disadvantages.

Sudden or drastic action with respect to our monetary situation is not advisable, economically or politically. We should move slowly, cautiously, moderately--step by step--in the monetary field, giving whatever help we can to increased production, giving whatever help we can to prevent inflation. What we do in the monetary field, while essential, is only supplemental to the larger economic influences inherent in the budget and in debt retirement, for example. Monetary and credit policies can help, but they can't do the whole economic job alone.

Forums such as this are important and necessary to widen our understanding of the economic problems of the times and to aid us in arriving at the most satisfactory solutions. Some of the problems are complex and not widely understood by the general public. I think we may justly classify the problems of debt management, of interest rates, and of monetary action through the commercial banking system as being among the most complex and least understood generally.

If you feel that I have dealt in too general terms in speaking about some of these monetary matters, I must confess that I have done so deliberately and, in part at least, in the hope of stimulating discussion rather than assuming to know the final and best answers to many of these complex problems today. We shall arrive at the right solutions by patient, open-minded study and discussion--not by dogmatism or any narrow consideration of our individual interests apart from the broader interests of the nation as a whole. By your program and your presence here, you signify your desire to hammer out the right answers on the anvil of full and free discussion. That, in essence, is democracy--and, by the same token, we shall preserve our democracy and our economic system only by such full, free, and fair discussion and debate.

Speech delivered before
Directors and Officers of
Savings Banks Trust Co. and Institutional Securities Corp.
New York, N.Y.
June 14, 1946

OUTLOOK FOR INTEREST RATES

Considering the size of the public debt and the great importance of the interest cost of servicing the debt, few, if any, would be so bold as to forecast sharp increases in interest rates over the next several years. I make no claim as a forecaster, and as a member of the Board of Governors should not place myself in that position. However, I can discuss with you some of the factors which will bear importantly upon the future cost of interest rates and some of the considerations which probably will influence public policy in this matter.

The War Situation

The demand for and the supply of loans and investments have always been the underlying factors determining the course of interest rates. During the war, the conditions of demand and supply in the security markets, as in any other sectors of the economy, were of an altogether unusual kind. From Pearl Harbor to early this year the public debt rose from 64 billion dollars to 280 billion. This enormous increase in the supply of securities was made necessary to pay for some 60 per cent of the war cost which was not covered by taxation.

At the same time, there was also a vast increase in funds available for investment in Government securities. Wages, salaries, farm incomes and profits, after allowing for deduction of income taxes rose from an annual rate of little over 90 billion dollars to a rate of well over 140 billion. As the supply of civilian goods did not increase during the war years and prices were held fairly stable, savings, and hence the demand for investments, rose sharply. As the economy moves along, these factors keep changing with it. Of the 216 billion dollar increase in the debt, over 50 per cent was absorbed by this investment demand outside the banks. The remainder was absorbed by the banking system. To adjust the combined demand for securities to the requirements of war financing, the commercial banking system, for this purpose, was supplied with the necessary reserve funds.

Thus we have for the war period a vast increase in the supply of securities, accompanied by an equally sharp rise in demand. On balance, the two factors tended to offset each other and it was possible to maintain interest rates at a fairly stable level. Rates on Government securities ranged from 3/8 per cent on 3-month Treasury bills to 2-1/2 per cent on long-term marketable bonds. In fact, during the latter part of the period there was strong market pressure for interest rates on medium-term and long-term Government securities to decline. The spread between corporate and other securities narrowed during this period as a result of the decline in yields on corporate securities; interest rates on loans also declined.

The Transition Period

With the end of the war, there was a rapid change in the financing picture. The Federal budget has tumbled from its wartime peak of annual expenditures of over 100 billion to less than 40 billion dollars. The deficit has well nigh disappeared, and by the end of the year we should begin to have a cash surplus. The increase in the debt has stopped, and due largely to the drawing down of Treasury balances it is being reduced at a considerable rate. On the supply side the situation has thus eased a great deal. The problem which was one of rapid debt expansion has become one of refunding and retirement.

On the demand side the change has been less drastic. The level of income has remained extraordinarily high. Notwithstanding strikes and other disruptions, our production record since V-E Day has belied the pessimists and surpassed most expectations. Production during the months before the coal strike was higher than ever before in times of peace. If we manage things at all well in the months ahead, finished products will be flowing to the market at an ever-increasing rate.

With incomes remaining high, the dollar volume of private savings will continue at a high level. Although it is only natural to expect that the rate of savings should decline from its wartime peak, a substantial amount of current savings will continue to be available for investment in Government securities. Individual savings are now at an annual rate of about 20 billion, as against 7 billion in 1940. The demand for Government securities, similarly, should be sustained by the existence of the huge volume of liquid funds which has been created in the course of wartime borrowing from the commercial banking system. The volume of demand deposits (adjusted) and currency alone increased from 39 billion in 1940 to 130 billion by the end of April.

But here is where the inflation problem enters the picture. Even under the most favorable prospects for full production, the supply of goods for some time is bound to remain scarce relative to demand. Inflation pressures are bound to remain strong. If we can hold them in rein, if we can avoid the vicious spiral of price and wage and price increases, there is every reason to hope that pressures will relax within a year or so. If, on the other hand, we fail to do so, if we give the investor any reason to fear that the purchasing value of his security holdings is threatened by upward spiralling prices, the entire demand side of the security market will be most seriously threatened. Already, there is an overflow of funds into speculative investments, and capital values in many lines have reached inflationary levels. This is true especially in the real estate market, both for urban and residential real estate. The prices of low-cost houses are generally 65 per cent, and in many cases 100 per cent, over their 1940 levels. Also, there has been a steady inflow of funds into the stock market and prices during the past 12 months have increased by 30 per cent. All signs show that strong inflationary pressures will continue.

Lest this situation should get out of hand, we must use all our powers to stem inflationary forces until production has time to bring about a reasonable balance between the factors of supply and demand. Monetary policy and Federal Reserve policy has an important though secondary role to play in preventing a further increase in, and if possible in reducing the money supply at this time. This means avoidance of further increases in bank credit and, if possible, a reduction. The Treasury in this connection has embarked upon a program of retiring debt out of the large cash balances that were built up during the Victory Loan. The cash balance remains sufficiently large to continue this debt retirement program over the next several months. The securities being retired are, of course, short-term maturing issues, which are largely held by commercial banks and the Federal Reserve Banks. This will have a tightening effect upon bank reserves.

The Federal Reserve System also has announced the discontinuance of the war-time preferential discount rate of 1/2 per cent on short-term Government securities. At the same time the Board stated that it does not favor a higher level of interest rates on U. S. Government securities than the Government is now paying. Assurances have been given that the rate of 7/8 per cent on one year certificates would be maintained. In practice that means that the Federal Reserve from time to time needs to purchase short-term securities in the market in order to prevent short-term interest rates from rising above the level that the Government is now paying. Medium-term and long-term rates are below the coupon levels that the Government is now paying and consequently do not need support. As the Federal Reserve purchases short-term securities in the market the reserve balances increase and commercial banks generally can expand credit by several times the amount of the increase in reserve balances. Since an expansion of bank credit is dangerous at this time of inflationary pressures, some method should be devised to stop this expansion. The orthodox methods of influencing the level of bank credit cannot be used, however, because they would no doubt result in a higher level of short-term interest rates. Some new instrument of credit policy, therefore, is needed.

Several methods have been proposed and are being carefully studied. Some would directly or indirectly increase commercial bank demand for short-term securities, either by requiring commercial banks to hold secondary reserves in the form of these securities or by limiting the amount of bonds that they may hold. Another would offset Federal Reserve purchases of short-term securities by increasing the reserve requirements of member banks. These plans have disadvantages as well as advantages. None of them should be put into effect until we are sure that the advantages clearly outweigh the disadvantages. Congressional study and action is a prerequisite.

In the meantime, retirement of Government debt is anti-expansionary. As long as this retirement continues, the problem of bank credit expansion becomes less urgent. This gives us a breathing spell in which to study the problem. The development of a substantial budget surplus would go a long way toward solving this problem, because it would permit the Treasury to continue to reduce the Government debt. While I hope that the inflationary problem on the monetary side can be solved without the need for employing any new method that would restrict the operations of commercial banks, I believe that the prudent course would be to develop a new method of influencing bank credit and have it ready for use if the need for it should arise. Prudence, caution, and proper timing are of the essence.

The Longer-Run Outlook

Over the longer run, developments defy prediction. Assuming a high level of business activity, which we are all striving for, savings banks, insurance companies and other savings institutions will have a substantial accumulation of funds to invest. Over the war period these funds have found outlet in Government securities, and since the Government is now embarking upon a debt retirement program, this source for investments will not be available. The funds of these institutions, therefore, will exert strong pressure on market yields of existing Government issues, and will force a lowering of the long-term rate unless the demand for long-term funds by corporations, the mortgage lending field, the World Bank, the Export-Import Bank and others offset those pressures. It may be desirable in this connection to devise special long-term nonnegotiable Government issues, somewhat similar to the F and G bonds which will attract these institutional funds. In view of the backlog of demand for goods both at home and abroad, and in view of the demand for housing, I would venture an opinion that while there may be periods of fluctuations, the demand and supply factors might be approximately in balance at the present level of interest rates.

Conclusions

So far, we have dealt with some of the conditions of demand and supply by which interest rates are determined. It remains to be emphasized that these conditions do not represent a set of natural forces which are beyond our reach or influence. On the contrary. Debt and credit policy have a very direct bearing on these conditions. The authorities in charge of debt and credit policy have a very direct responsibility for them. This was obvious during the war when the vastly increased supply of securities was balanced by a controlled increase of bank credit available for such investment. Because of this policy, which assured that securities not sold outside the banking system would be absorbed by bank purchases, it was possible to finance the war debt at a low interest rate. Now the problem is to prevent further additions to bank holdings of securities and hence to the country's money supply, and if possible to reduce them. We must do so without raising the taxpayer's interest bill. While the problems have changed, they have not become simpler. The importance of a wise credit and debt policy has been greatly increased by the wartime debt expansion.

An intelligent opinion concerning the outlook for interest rates, therefore, involves the use of judgment as to the net effect on interest rates of many policy problems that are confronting the Government's authorities at the present time and of many crosscurrents and unpredictable factors in the demand and supply aspect of the problem. The only conclusion of which we may be reasonably sure at this time is that rates on short-term Government securities are not likely to rise, and as long as short-term rates stay down, it is unlikely that long-term rates will increase to any significant degree. Some of the wartime factors bringing about declines in long-term rates no longer exist, but others remain. It may be necessary to adopt new measures to avoid a further decline in long-term rates. With this exception therefore, I think it hazardous to venture an opinion. I would be inclined to agree with the prevailing opinion that long-term interest rates over the next six months to a year would be less likely to increase than to remain stable.

Speech delivered before
District of Columbia Bankers Association
Mayflower Hotel, Washington, D. C.
October 20, 1947

OUR CURRENT INFLATION AND MONETARY PROBLEM

With little pause after fighting and winning the most costly war in history, we are now facing a crucial battle against inflation. This is not altogether surprising. It was necessary for us to create a huge amount of money in order to finance the war and at the same time to restrict the availability of goods and services for which the public would customarily use additional money. To complicate our domestic problem there is the necessity of helping to restore the productive capacity of countries whose populations and resources have been ravished by war.

My remarks to you this evening are addressed primarily to the domestic phases of our inflation problem. Some weeks ago, in a paper that I shall be glad to make available to you, I reviewed the international phases of this problem with particular reference to Germany, a defeated enemy country. Here it is sufficient to say that the present economic difficulties of European democracy are inextricably entangled with our own problem. It would be foolhardy to deny that aiding in their reconstruction will amplify our own inflationary curve, but it would be equally foolhardy to assume that we can put our own house in order while large areas of the world are in chaos.

Without our own volition, we have been catapulted into a position of world leadership, and in the interest of our own stability and welfare, we must assume the responsibilities of this leadership. The greatest single antidote for inflation is increased production. Our own productive capacity is already running at full speed and the largest immediate reservoir of unused productive resources is in Europe. The answer to this part of our problem is clearcut. I know you will concur in my belief that we are qualified to take the measure of this problem and, in cooperation with other nations, to find constructive ways of helping devastated European countries to help themselves.

This hydra-headed problem of inflation cannot be mastered for all time by any single device or any single approach. But with a proper combination of effective policies we have reason to hope that we still can establish a lasting prosperity at home and contribute to enduring peace in the world.

We have been a little tardy in lining up our forces against inflation. Weary of the disciplines of war, we have been prone to rest on our oars and drift with the current. Inequities have already been worked on the recipients of fixed incomes by the arbitrary transfer of part of their purchasing power to classes benefiting immediately from rising prices. This process must be stopped if we are to avoid the cataclysmic consequences of a run-a-way inflation.

Extent of price inflation

During wartime, price and other controls kept our own inflationary forces under check, if not under complete restraint. It was not until after the lapse of these controls in the early summer of 1946 that inflation carried many commodity prices to new high levels. Essentially temporary shortages in supply have contributed greatly to successive spurts in the prices of many goods. The rising cost of living has necessitated widespread wage and salary adjustments that have raised production costs and justified many price increases. In many instances, however, price advances have exceeded increased costs and have helped to generate record profits.* The combination of these factors has entangled the economy in what appears to be an irresistible upward spiral of wages, costs, and prices.

Let us compare some of our current prices with those prevailing before the war. Corn before the war was selling at 45 cents per bushel, now it is $2.45. Hog prices were $6.75 per hundredweight, now they are $29.50. Cotton was 9 cents a pound and is now 32 cents. Lead prices were 5 cents a pound and now they are 15 cents. Southern pine lumber prices were $22 per thousand and now they are $80.

These are only examples of important primary commodities that have risen from 200 to 400 per cent since prewar days. In general, advances in prices of primary commodities have been much greater since the outbreak of war in 1939 than they were between 1914 and the peak of the postwar inflationary period in 1920.

The average level of all wholesale prices, including primary commodities as well as manufactured goods, is now 110 per cent above the prewar level and the retail prices of many goods have risen by almost the same proportion. Retail food prices have advanced by more than 100 per cent and clothing and housefurnishings are up 85 to 100 per cent. With rents up only 10 per cent, the rise in cost of living shown by the consumers' price index is about 65 per cent.

Prices were already high during the war and the early postwar period. When price controls were dropped last year, prices rose considerably further. Since June 1946 the average level of wholesale prices has risen 40 per cent and the cost of living 22 per cent. This spring prices showed signs of downward readjustment, but domestic and foreign developments since that time have resulted in another sharp upswing.

Inflation problems

Our sharply inflated price levels are unstable elements in the nation's economic position and the higher prices rise, the more unstable they become. This is because disparities among prices develop with inflation and become greater and greater as inflation proceeds. Thus inflation begets inflation and in the process produces economic dislocations and distortions that bear the seed of ultimate collapse and widespread unemployment.

Let us consider some of the critical tensions that attend current inflationary developments.

Prices are becoming more and more dependent on buyer's demands, which

*Cotton textile manufacturers, paper mills, lumber producers, automobile dealers and wheat farmers, to cite a few examples, are making several times the profit returns of prewar years.

in turn are dependent on other inflated prices. Inequities and discontent are multiplying. Consumption in some directions is being curtailed because the rise in prices is greater than the expansion in incomes. Price increases are making the problem of financing foreign aid and recovery particularly difficult. Foreign countries with limited dollar resources are finding the loss of purchasing power of these dollars a serious handicap.

While organized labor has been able to obtain wage increases to cover a part of the increase in living costs, the majority of consumers have been in a less favorable position. Consumers with relatively fixed incomes, especially those in the low income groups, are being forced to curtail their purchases of goods, to reduce current saving, and to draw heavily on accumulated savings. In short, they are fighting a losing battle against the cost of living.

It is important to recognize that the present upward price spiral reflects in part essentially transitory developments. These include the persistence of wartime disruptions in production and trade, deferred private demands for investment and consumption, a rapid expansion in credit extended by private organizations to business and consumers, and unusually large Government expenditures for military purposes and foreign aid. Undoubtedly, too, the upward surge of prices is being pressed by speculative forces, but the extent of this speculation will only become evident after the cumulative force of these special transitory factors has been spent.

The higher prices rise in an inflation, the more widespread and severe the subsequent readjustments are likely to be. Inevitable readjustments will affect not only prices, but production, incomes, and employment as well. The uneven character of demand, together with the special and in part temporary character of supply, has already brought striking readjustments in price relationships.

The higher production costs generated by inflation are becoming imbedded in the price structure. This development foreshadows an eventual price level substantially higher than that prevailing before the war. Since inflations tend ultimately to end in collapse and deflation, it is probable that the price level established when the liquidation of inflation is complete will be sharply below peaks reached in the present upward spiral of prices.

Breaking the inflation circle

Clearly, a primary factor in the postwar price inflation is the increase of 160 billion dollars in money and other liquid assets which occurred during the period of the war. This huge accumulation of money and liquid assets was the direct result of Government borrowing to finance war. It was essential to winning the war.

At the war's end these monetary assets represented an enormous backlog of deferred demand for goods of all types, but particularly durable goods. As a consequence, demand at current prices was far in excess of any supplies of goods that were available or could be quickly made available. The result, when wartime controls were removed, was a sharp rise in prices and the spiral of inflation that is still going on. The sooner this spiral is broken, the better off our people and our economy will be. Also, the nearer at hand will be the goal of sustained high levels of production and employment.

Today, the country's aggregate stock of money and other liquid assets exceeds 225 billion dollars, an amount about equal to the total national product. Prior to the war, aggregate liquid assets approximated only 65 billion dollars, or nearly one-third less than total product. Since redundancy of money and liquid assets is a primary factor in the present inflationary spiral, attack on this strategic factor is an essential requirement for breaking the circle of rising prices. The difficulty confronting any such attack, however, is that the existing supply of money and liquid assets is based on public debt issued to finance war.

We can only reduce the volume of Federal debt by having a budget surplus. With a Government debt of 260 billion dollars, it is clear that a surplus in any one year will not greatly reduce the total. For the current fiscal year, the President has recently estimated that we may have a budget surplus of 5 billion dollars that will be available for debt retirement. With the further rise in national income that we have been experiencing, the available surplus may exceed the President's estimate. But the new budget assumed no reduction in taxes. It also assumed no increase in Government expenditures, such as may be necessary to fulfill the nation's international obligations under the proposed program for European relief and recovery. Thus, the amount available for debt retirement this fiscal year may actually be less than currently seems possible.

Reduction in public debt through retirement from budget surpluses will be a slow process at best. Not every year will budget conditions be so favorable as this year. But it is urgent that we use debt retirement whenever possible and that we continue to do so while we are confronted by acute inflationary dangers. In the present situation, this means, of course, that moderation should be the rule to govern any immediate adjustments in our tax structure.

The problem of restraining further bank credit expansion

Six months ago it appeared that postwar expansion in the money supply had been effectively brought under control and that our answer to the inflation problem was to increase production to a level consistent with the existing volume of money. Since business was already operating near full capacity, however, expansion of output appeared to be a time-consuming process. Some price rise, therefore, was a method of facilitating and shortening the adjustment period and could be viewed without alarm.

We attained this leveling off in monetary expansion by using large accumulated balances of the Treasury combined with some surplus from the Federal budget to retire Government securities. The retirement program, as you know, was directed particularly at Government obligations held by commercial banks and by the Federal Reserve Banks. Retirement of obligations held by commercial banks reduced deposits directly, because Treasury deposits were exchanged for maturing bank-held Government securities. Retirement of obligations held by Reserve Banks reduced the volume of both bank deposits and bank reserves. In this case, funds were shifted from commercial banks to Federal Reserve Banks and the retirement of Government securities held by Reserve Banks cancelled a corresponding volume of member bank reserve balances. It is true that commercial banks were still free to restore reserve positions by selling other Government securities in the open market at rates kept stable by Federal Reserve System policy, and this the banks did in limited degree. But in general the pressure exerted was enough to keep further bank credit and monetary expansion under restraint.

Unfortunately, the control of postwar monetary expansion can no longer be affirmed. The total money supply is currently increasing at approximately 9 billion dollars a year. This increase in the money supply is directly inflationary and is seriously accelerating the upward spiral in prices.

The renewed expansion in the money supply is based in part on increased holdings of gold, largely received by this country in payment for exports needed by other nations. So far this year, the country's gold stock has increased by 1.8 billion dollars and imports of gold are still adding to this stock. This new gold has provided the banks with the reserves necessary to support additional deposit expansion notwithstanding the fact that the Federal Reserve has brought some pressure on reserves by selling some of its holdings of Government securities. Deposit expansion has gone on because of heavy private demands for credit from business, property owners, consumers, and State and local governments. During the first nine months of the year, bank loans increased by almost 5 billion dollars, or by almost as much as they increased during the whole of last year. The increase is still going on and, with the momentun being gathered, credit expansion can continue without check for some little time.

Therefore, our inflationary spiral problem is now not only a matter of the wartime accumulation of money and other liquid assets, but also a problem of renewed monetary expansion. Since we cannot rapidly reduce the excessive money supply that is based so largely on public debt, the least we can do is to endeavor to restrain further monetary expansion based on private debt creation.

There is unfortunately a fundamental change in the financial situation which handicaps such restraint. This fundamental change is the ability of the banking system to contineu credit expansion that the Federal Reserve System is not in a position to offset because of its responsibility for maintaining orderly and stable prices of Government securities.

The Board of Governors has given considerable thought and study to the problem presented by this fundamental change in the banking picture and has suggested several methods by which the Government securities market might be protected and traditional credit controls reestablished. These methods, which are discussed in the Board's Annual Reports to Congress for 1945 and 1946, are to empower the Federal Reserve to increase member bank reserve requirements (with the exception of raising reserve requirements from 20 to 26 percent for banks in central reserve cities, the Board of Governors has already applied the present statutory maximum reserve requirements to member banks), to introduce by statute a secondary reserve requirement against demand deposits, or, lastly, to authorize the System to limit commercial bank holdings of long-term Government securities. Chairman Eccles, in a recent speech before the National Association of Supervisors of State Banks, has underscored the importance of our changed banking problem and the urgency of finding an effective way of meeting it.

In the absence of authority to deal with the changed banking situation through one or more of these methods, there has recently been some increase in short-term rates of Government securities. But the rise in bill and certificate rates has not as yet exerted an effective retarding influence on credit expansion. As you are aware, the sheer size of the 260 billion dollar public debt, the problems of refinancing large monthly maturities, and the role of interest cost in the Federal budget are among the main reasons why short-term interest rates have not been allowed to rise more sharply. Secretary of the Treasury Snyder will announce soon action on the November 1st refunding.

The responsibility falling on the banks

Although the Federal Reserve System is handicapped by its present responsibilities, on the one hand, and by the limited scope of its authority in dealing with the present type of inflationary banking situation, on the other hand, the System will do all it can, directly and indirectly, to restrain further credit expansion. Nevertheless, a heavy responsibility devolves upon individual banks to submit to self-restraint. Under present conditions, banks are incurring large risks in private credit expansion and they should be constantly aware of these risks. Banks that conserve their credit resources and stubbornly maintain a high degree of liquidity will have less to regret and fewer losses to write off than institutions that ride the crest of the inflationary tide. This is particularly true for banks specializing in real estate and consumer credit, but it is also true for banks engaging in extensive business and agricultural lending.

A greater alertness on the part of bankers regarding the composite inflationary effects of their individual credit advances can do much to restrain the rate of current bank credit and monetary expansion. It can also do much to reduce the undesirable effects upon banks when inflation comes to an end and is followed, as it inevitably will be, by deflation. To be sure, the business of banks is to make loans and investments which accommodate industry, commerce, and agriculture, and when they discontinue this activity they cease to be true banking institutions. I am not urging banks to deny themselves their proper sphere of activity. They can reasonably be asked, however, to recognize a common responsibility in times such as these and in their self-interest to take double precautions to make loans and investments that are in every respect sound—not only sound in individual cases, but sound as related to the present inflationary economic picture.

Debt management policy

If the present spiral of rising prices is to be broken before serious damage to the economy is done, every avenue of public financial policy must be examined for whatever contribution it can make to meeting this key problem. Debt management policy is one of these avenues. Debt retirement operations in the present situation should be as anti-inflationary as possible. This means, of course, that any retirement program made possible by the current budget surplus should focus on the retirement of Government securities held by the commercial banks and the Federal Reserve Banks.

As I have said before, retirement of issues held by the Reserve Banks is more restrictive and, therefore, more anti-inflationary that retirement of issues held by commercial banks. (The Federal Reserve now holds 22 billion dollars of Government securities.) This process necessitates the adjustment of reserve positions by many banks. However, any retirement of Government securities held by banks is helpful and in the direction of restraining further credit expansion.

Another important phase of debt management policy would be to increase the sale of long-term bonds to investors and to use the proceeds to retire part of the debt held by banks. Important banking and other groups have strongly urged such a program and recently the Treasury has taken an important step to implement the suggested policy. I refer, of course, to the new Series A nonmarketable investment bonds. Further experience along these lines is desirable.

Maintenance of as high a level of sales of savings bonds as possible will also need to be an essential aspect of an effective debt program designed to help check the inflationary spiral. The vast majority of American families strongly believe that regular saving is important, and more than half of all families think that saving is even more important now than it was during the war. This is one of the significant findings of the Board's recent surveys of consumer finances. It lends substance to the belief that a continuing flow of funds will be available to the Treasury from sales of savings bonds in excess of redemptions, even though personal savings are lower in volume than in war years. The amounts in any one year will probably not be large, but they will help to transfer securities from banks to nonbank investors in accordance with desirable debt management policy. Again, consideration must be given to the use of these funds to retire bank-held obligations in the way that will be most anti-inflationary.

It is clear that debt management policy can serve constructively to check the present price spiral by helping to restrict further monetary expansion. It is clear too that the inflationary situation is serious enough to warrant as much use of such policy as is feasible. The actual working out of policy appropriate to current conditions, is, of course, a highly technical matter. The subject is under continuing study by the Board, the System's Open Market Committee, and the Treasury, and the effective liaison that exists between the authorities assures that every suggestion or alternative will receive careful study and consideration.

Conclusions on domestic inflation and monetary policies

Economic stability at high levels of employment and output is seriously threatened by the current inflationary spiral. One of the main causes of this inflationary condition is the excessive money supply created by war finance. Expansion in the money supply under the pressure of forces that are largely domestic, but to some extent international, in origin is being resumed. Meanwhile, the demand for available supplies of goods and services is driving prices higher. If the inflationary spiral is to be broken, it is imperative that the world supply of goods and services be expanded as rapidly as possible. Today the greatest available supply of unused resouces is in Europe and it should be developed without delay.

Fiscal, debt management, and monetary policies must also be brought to bear on the inflationary spiral.

At least, it is urgent to restrain further expansion in the money supply. Maintenance of a large budgetary surplus is essential for this purpose. This can be accomplished, however, only by holding taxes up and governmental expenditures down so far as is possible under existing conditions.

Monetary policies should be directed to keeping in check further bank credit and deposit expansion. Not much can be done through Federal Reserve policies, however, in the existing situation. Therefore, individual banks have to assume a greater responsibility for credit expansion, to recognize more fully the composite effects of their actions, and to take account more directly of the abnormally high risks that are involved in current credit extensions.

Public debt management policy should be as anti-inflationary as circumstances permit. Emphasis on retirement of bank-held Government securities is essential and every feasible measure for transferring Government securities out of the banks into the hands of nonbank investors should be applied.

The task of breaking the present inflationary spiral through fiscal debt management, and monetary policies may not prove insuperable. If successful, however, the attack will require the full cooperation with Government of all banks, financial institutions, and businesses. And if it is not successful, our private banking system may once more be the scapegoat in the eyes of the public. First, it may be held responsible for having caused inflation. And second, it may be accused of having caused the collapse and deflation which, if history is any guide to future events, will at some stage inevitably come unless prudent realistic measures are applied in all quarters without delay.

Speech delivered before
Annual Stockholders' Meeting, Federal Home Loan Bank of New York
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January 22, 1948

THE CHANGED SITUATION
IN
OUR MONETARY AND CREDIT PROBLEMS TODAY

Since the days when I was active in the operations of building and loan associations, many changes have taken place--changes in the number and size and activities of building and loan associations, and changes in the operation of our economy and the organization of our society. The problems which confront the central banking authorities with which I have been associated are also reflected in the problems with which you have to cope.

In 1914 the United States was a debtor nation; a substantial part of national development had been and was being financed abroad. We were in the process of shifting from a predominantly agricultural nation to a predominantly industrial and urban nation. Our conventional patterns of finance drew no distinction between the fiscal position of Government and that of individuals and businesses.

There were about 6,600 organizations of the type we think of as building and loan or savings and loan associations, as compared with about 6,000 today. These associations, through the thrift and saving of their members, had accumulated total assets of 1,360 million dollars, as compared with about 11 billion dollars today. At the same time, there were about 26,000 commercial banks with total deposits of about 17 billion dollars, compared with about 14,000 banks today with deposits of 140 billion dollars. The Federal debt was only 1 billion dollars. Today it is 254 billion.

Our pre-World War I economy was a composite of regional economies. Perhaps the heart of our central banking problem at that stage of the country's development was to reconcile the monetary and credit needs of major regions and to maintain a balance between these needs. It was largely with this end in view that the Federal Reserve System was established. At that time there did not seem to be any necessity for separate provision to balance special needs of the various regions for mortgage credit.

When the Federal Reserve Act was revised substantially two decades later, between 1933 and 1935, the nation had become a great creditor country internationally and a great industrial economy domestically. Our monetary and credit problem had changed from the problem of distributing funds among regions--which had been solved fairly well--to the problem of controlling the total supply of money and equating this supply to various national uses. In addition, the economy had gone through a great war, two great "booms", and two great "busts". The war, the "booms", and the "busts" were national in ramification. While regional differences in economic organization still existed, the reality of regional interdependence was a more fully demonstrated fact than every before in our history. During these two decades there were indications that traditional methods of mortgage financing were not completely adequate. We had the notable experiment with various kinds of mortgage bonds, mortgage participations, and "guaranteed" mortgages, and we had the notable failure of traditional mortgage financing methods in the Florida "boom" and crash.

Our great "bust" of 1929 had been particularly severe and its aftermath was widespread bankruptcy, unemployment, and poverty. The economy's critical problem of that period was "idle men, idle machines, idle money". It was determined to solve the problem on a national basis. Fiscal policy and central banking policy became, more directly than formerly, the instruments of national economic policy. Many new agencies were created to complement these two major instruments of national policy. In mortgage credit, the Federal Home Loan Bank System was given the form we know today, and provision was made for chartering Federal savings and loan associations. The Home Owners' Loan Corporation was formed to take over "slow" mortgages and strengthen lending institutions, and the Federal Savings and Loan Insurance Corporation was established to insure share accounts in building and loan and savings and loan associations. At the same time, under the Federal Housing Administration, the program of mortgage insurance was inaugurated, and this program made use of much of the experience with mortgage credit which had been acquired by building and loan associations in their many decades of operation.

Once more we find ourselves in a new period. We have again gone through a great and devastating war. The war has changed our position in international affairs, and we find ourselves overwhelmingly a creditor.

The balance of power between capital and labor is different from what it was in 1914 or 1935, and is still changing. The relationship between creditor and debtor has also changed, in important part because better financial arrangements and techniques have been worked out. Banks make one kind of arrangement with farmers for the repayment of loans and a different kind of arrangement with manufacturing concerns, each arrangement calculated to fit the operations of the borrowers. Relatively little mortgage credit is extended today for the short periods of one, three, or five years which used to be "conventional". Most mortgage lenders have adopted the practice of writing long-term amortized loans which building and loan associations were pioneering in 1914.

The Government is no longer merely another borrower in the market. It is by far the largest borrower. The Federal debt accounts for nearly three-fifths of the entire indebtedness of the country, and interest on the debt is a major item in the Federal budget, amounting to more than 5 billion dollars a year. In this situation, special arrangements have had to be made for selling and managing the public debt. The Treasury and the Federal Reserve work closely together in issuing, retiring, and refunding the debt. This greatly increased importance of the public debt is one of the major factors in the present inflation.

Why has this increase in the public debt contributed so strongly to inflation? If we understand this point, we shall understand why some of the problems of the Federal Reserve System are so difficult to handle.

During the war, the Government spent more than twice as much as it collected in taxes, making up the difference by borrowing. Producers--workers, farmers, and business organizations--were paid for all the production of the economy, but the taxes they paid were less than half the money spent by the Government for the goods and services needed to win the war. Producers, as consumers, therefore, were left with more money to spend or save than the value of the goods and services they could buy. To some extent, they used these excess funds to bid up prices, but because we were at war, and because some goods, such as automobiles, were not available, controls were effective in spreading the supply of goods and services and restraining price increases. People, therefore, saved. Some of the savings were in currency, some in bank deposits, and some in other liquid assets, particularly Government securities.

The country's aggregate money supply, as measured by currency in circulation and privately-held demand, time, and savings deposits, is two and a half times as large as at the beginning of the defense program, about 170 billion dollars, compared with 66 billion in June 1940. In addition, the general public, outside of banks, insurance companies, and Government agencies, increased its holdings of Government securities to 105 billion dollars, or nearly seven times as much as in June of 1940. These Government securities in the hands of the public are practically the equivalent of money because they are readily convertible into cash. In sum total, this stock of purchasing power available to buy the current output of goods and services amounts to almost 275 billion dollars, compared with a stock of about 80 billion in 1940.

Most of this expansion in the money supply and liquid assets in the hands of the public occurred during the World War II period. However, further expansion has taken place over the postwar period, and in recent months the expansion has shown marked signs of acceleration. This recent acceleration of expansion largely resulted from very active bank lending to businesses and individuals.

Since the war, the economy has been operating very close to capacity and the general public has shown a pronounced disposition to enjoy all the things that were in short supply during the war, from shirts and socks to automobiles and houses. People have been willing to spend their current incomes and dip into some of their accumulated savings. They have also supplemented these funds by borrowing from banks and other lenders, and by buying on installment credit. As a result of these strong demands for goods and services--demands in excess of supplies--prices have risen, and we have had inflation. As long as the volume of goods and services available, valued at current prices, remains less than the amount of money being spent, inflation will persist. This condition, in fact, is the essence of inflation.

Two other factors are adding to inflationary forces. First, the addition of productive facilities to the economy is going on at a rapid pace. Second, we have a large export surplus. On the first, producers are paid now for turning out machinery and building warehouses, factories, and houses, and, on the second, producers are paid for making the goods which are being shipped abroad. But goods and services to match these incomes will be turned out by the machinery and buildings only over a period of years, and it will also take some years for us to receive goods and services from abroad in payment for our exports financed through loans.

Both expansion of productive capacity and the export surplus have resulted in additions to the money supply through the creation of credit, and by the use of funds previously held idle. An additional source of increased money supply has been payment in gold for some of our exports of goods.

This brings me to the problem which confronts the banking authorities and about which the Federal Reserve Board is deeply concerned, for it shows clearly the changes which have taken place in the tasks of the Federal Reserve System.

Taken as a whole, the commercial banking system is fundamentally a mechanism for creating money--for allowing borrowers to spend money which no one has saved. This is in contrast to other types of lending--lending such as your institutions, or savings banks, or insurance companies, or individuals do--which is a matter of transferring savings from those who have them but do not wish to spend them to those who do wish to spend them.

Limits are set to the amount of credit banks can create by the legal requirements that they must hold cash reserves to the extent of some proportion of their deposits--which are themselves largely the result of loans and investments. Banks which are members of the Federal Reserve System, which hold 85 per cent of all commercial bank deposits in this country, must hold their reserves as deposits with the Federal Reserve Banks, and no income is derived from these reserves. On the average, required reserves amount to about one-sixth of commercial bank deposits. For every dollar of reserves, credit can expand sixfold.

Reserves are the heart of commercial banking, and control over commercial bank credit has traditionally been exercised by control of these reserves. Three techniques have been used to exercise this control: (1) varying the rediscount rate, or the rate of interest at which member commercial banks may borrow from the Reserve Banks; (2) open market operations; or the buying and selling of Government securities by the Reserve System; and (3) varying the level of reserve requirements, that is, the amountswhich member banks deposit with Federal Reserve Banks as legally required reserves.

Two of these techniques for controlling bank reserves--discount rates and open market operations--are not so effective as they once were, while the third--varying the level of reserve requirements--was exhausted under present law as a restraining weapon early in the recent war, except for a relatively small percentage in central reserve cities--New York and Chicago. The present limited effectiveness of available credit control technique is due almost entirely to the size and wide distribution of the public debt largely inherited from the war. Commercial banks now hold 70 billion dollars of Government securities, an amount equal to about 50 per cent of their total demand and time deposits, which they can sell in order to obtain additional reserves without borrowing from the Reserve Banks.

The traditional open market operation to reduce excess bank reserves is for the Federal Reserve System to sell Government securities, thus drawing down private deposits at commercial banks. In turn, this draws down the reserves of commercial banks by reducing their deposits with the Federal Reserve Banks.

Here, however, we come up against the problem of management of our huge public debt of 254 billion dollars. If the Reserve System were to sell enough Government securities to reduce bank reserves and curb credit expansion, it would involve great dangers for the entire economy. To make possible this volume of sales, the prices of Government securities would have to be permitted to decline. With a marketable public debt held by investors other than the Federal Reserve Banks amounting to 143 billion dollars, no one can say how great this decline in prices would have to be. As prices declined because of Federal Reserve sales, investors would suffer capital losses and in turn would be encouraged to sell their holdings while their losses were still small, and these sales would further drive prices downward. In brief, Federal Reserve open market operation to reduce bank reserves might lead to a disruptive decline in Government security prices, which might spread to the prices of other securities. This is a risk too serious to contemplate.

Traditional open market policy would also have serious consequences for the Treasury. As prices of bonds decline, their yield, or effective interest rate, rises, and, if Government securities were to fall seriously, all future Treasury financing would have to be done at higher interest rates, thus raising the cost of servicing the Government debt. Also, in such a market, the price at which the Treasury and other borrowers could sell securities would be altogether uncertain, and this uncertainty would interfere with the orderly management of the public debt as well as the orderly financing of private corporate investment programs.

The Federal Reserve System through its open market and discount policy in close cooperation with the Treasury, has already recognized that interest rates have undergone an upward readjustment, probably in response to temporary forces. It has recognized this, first, by lowering the support price (increasing the yield) on short-term Government securities, and second, by lowering the support price on long-term obligations (with assurance, however, that support of the lowered levels would be aggressive and continued for the foreseeable future), and third, by the increase in discount rates from 1 to 1-1/4 per cent. It seems much better to us to permit interest rate changes in this manner than to leave the economy's marketable debt to find its own interest level in a free market, dominated by Government securities.

It should be apparent from what I have said that the most important change in the problem facing the central banking authorities is the greatly increased influence of the public debt in our monetary and fiscal affairs. After the First World War the public debt (26 billion dollars) could be looked on as merely another set of obligations—to be allowed to find their own price level in a completely free market. This policy, which was in line with traditional attitudes, resulted in large losses to many individuals and businesses, but these consequences were not nearly as serious as those which would result from a similar policy now. The public debt today is a factor to be reckoned with in all public and private decisions. Both its size and its wide distribution have given it great leverage in monetary policy and economic conditions. Moreover, the fact that the Treasury, unlike other borrowers, must constantly refinance its debt makes stability of the market for the public debt particularly crucial.

The increased importance of the public debt is also a factor in another situation which has received relatively less attention in public discussion. This is the shift which has taken place from the hands of the banking and fiscal authorities of a significant part of the control over the supply of money. I have already mentioned the primary difference between bank credit and credit extended by other lenders--namely, that nonbank lenders lend only savings which have been accumulated by savers, while banks also make available to borrowers funds created by the 6 to 1 expansion of deposits to which I have referred above.

It has been customary and, in the main, correct, to say that loans made by nonbank lenders add nothing to the money supply. Today this is no longer true. Before we can say whether a loan by, for example, an insurance company or a savings bank or a savings and loan association adds to the money supply or not we must know where these funds were obtained.

Take an insurance company for example. In the first place, of course, the insurance company obtained the funds from its policyholders in the form of insurance reserves on policies--that is, policyholders' savings. In this sense the funds were saved by the policyolders. But this is not the full answer. If the insurance company had these funds invested in Government securities, and, in order to make a loan, it sold these securities indirectly to the Federal Reserve Banks, it added to the money supply, or at least to the potential money supply. Such an addition to the money supply results because when a nonbank investor sells Government securities, their prices tend to fall, and if prices threaten to fall too far, the Reserve System buys in order to preserve a relatively stable and orderly market for these issues. This increases private deposits at commercial banks, and the deposits of commercial banks at the Federal Reserve Banks, thus increasing bank reserves, and the capacity of the banks to lend. The effect, in other words, may be just as inflationary as if commercial banks had sold the securities. The insurance companies, the savings banks, and the savings and loan associations are apostles of thrift and foes of inflation and yet by selling Government securities to add to their currently available funds for investment they are contributing to inflationary pressures.

In the light of all these considerations, the Federal Reserve Board has recommended to Congress the adoption of a plan which we feel would restore some of the powers over the money supply which have been lost because of the great increase in the public debt. Very simply, this plan involves a temporary increase in reserves which all banks would be required to hold, except that instead of being legally required to add to their cash reserves, banks would be permitted to hold certain income-producing assets, namely short-term Government obligations.

We could, of course, ask Congress to raise the limits to which required cash reserves may be increased, but it now appears to the Board that to increase required cash reserves by this means far enough to be relatively certain of bank credit restriction, that will be required, would mean reducing the earnings of banks below expenses and a reasonable return on capital. This, however, in my opinion, may become an alternative to the special reserve plan proposed by the Board.

We recognize that the Board's proposal is no cure-all and that it would only deal with a part of the inflationary problem. But the proposed measure would constitute an important, available restraint, which is now lacking, on bank credit expansion in the present inflationary situation.

There is likely to be little need for the suggested special reserve during the next three months because of the large amount of Treasury surplus funds, taken from the market through taxes, which will be available to retire bank-held public debt. This will temporarily exert pressure against bank credit expansion. If inflationary bank credit expansion continues after this period, however, and if further Treasury surpluses are foregone in favor of tax reduction, the need for restraining pressure will be urgent. It is better to have power to deal with the situation when it develops rather than to have it provided, if at all, too late to be used.

The urgency for the Federal Reserve Board's proposal, or some other proposal to curb credit expansion, will be especially great if we relax our current fiscal policy while inflationary dangers exist. Fiscal policy is by far the most effective way to deal with the demand side of inflation just as production and particularly more production per man hour is the most effective way to deal with it on the supply side. This means rigid Government economy and deferment of all deferable expenditures. It also means as large a surplus of tax receipts as possible so that dollars are removed from the spending stream and used to retire public debt held by the Federal Reserve System. This takes dollars out of the money supply by an equivalent amount and is a reversal of the wartime process by which the money supply was expanded. The classical precept of sound finance that debt should be paid off in boom times has peculiar virtue in the case of a public debt the size of ours, so much of which is held by the banking system.

There is still another side to the credit picture.

As you know, curbing of inflationary pressures cannot be accomplished by monetary and fiscal policy alone. Among other necessary measures are appropriate private decisions. You, for example, must ask yourselves whether, as a group, you are extending mortgage credit on a sound basis--credit which will stand up in whatever storms are ahead of us. In this connection, I commend to your attention, as well as to the attention of all bankers, the program formulated several weeks ago by the American Bankers Association, and the joint statement on "Bank Credit Policy During the Inflation", issued November 24, 1947, by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Executive Committee of the National Association of Supervisors of State Banks.

As you can see, I have so far spoken almost entirely about a fairly technical side of the inflation problem which confronts the monetary and fiscal authorities, that is, about how the supply of money is being increased. Another, and just as important, problem is how this large and increasing supply of money is being used. Here, again, developments have removed a substantial measure of control over bank lending from the hands of the banking authorities.

Banking authorities have always exercised some measure of influence over the kind of loans and investments made by banks as well as over the total volume of their credit. Such influence has been exercised by way of statutory prohibitions or limitations, by way of varied privileges of access to Federal Reserve credit, and by way of bank supervision. Statutory prohibitions and limitations have generally been quite inflexible. Federal Reserve influence on the kind of lending done by member banks has usually been accomplished, therefore, by keeping informed as to the credit policies followed by member banks and limiting the access to Reserve Bank credit of those member banks found to be following unsound policies. Bank examination policy is also adapted, in cooperation with other supervisory authorities, to changing conditions.

Developments over the past fifteen years, particularly in Government programs, have modified the effectiveness of the powers of the central banking authorities. This modification is particularly marked in the case of real estate loans. It would be rather difficult, for example, for the Federal Reserve Board to say that banks with large mortgage loan portfolios shall be denied the right to borrow at the Reserve Banks--even if rediscounting had any significance today--when a large part of bank real estate loans are guaranteed by the Federal Government, either in whole or in part. Similarly, in these conditions, a bank examiner might have some difficulty in convincing bankers to reduce the volume of their guaranteed real estate loans or to establish additional reserves against them.

It is probably not correct to say that restraint or encouragement of credit expansion through central bank credit and supervisory policies ever exercised a decisive influence on the lending activities of <u>nonbank</u> lenders. It would be equally incorrect, however, to say that such policies in the past exercised no influence. Central banking policy gradually came to exert a broad influence over national credit conditions and the prudent nonbank lender took these conditions carefully into account in shaping his own lending program. But since the middle thirties, financial developments, particularly those of wartime, have tended to reduce the influence of central banking policy. In addition, the link between important sectors of the credit market has been weakened at several points.

In the case of mortgage credit, for example, where this change is most pronounced, programs and practices instituted since 1932 have resulted in almost complete separation of this field of lending from general credit policy. Even mortgage lending by commercial banks has been largely sheltered from the influence of general credit conditions. Loans underwritten by the Federal Housing Administration and the Veterans Administration are obviously difficult to discourage by ordinary techniques of bank credit control when they are being encouraged on social grounds by other agencies.

Your own organizations, the savings and loan associations, are adding to the problems of restraining inflationary credit developments, again largely because of Federal programs developed since the passage of the original Federal Home Loan Bank Act in 1932. Let me say here that I would not argue for one moment in favor of returning the savings and loan business to the conditions that existed before that date. Then, there were no effective restraints on savings and loan lending except the volume of capital available to associations, and you suffered severely as a consequence. There was no effective means for transferring funds from areas of oversupply to areas of scarcity, and developments in real estate were uneven as a result. There was not sufficient protection for shareholders against either mismanagement or unfavorable economic conditions--and many investors lost heavily through no fault of their own.

The savings and loan system has been strengthened to perform its functions, and that is a good thing. We must face the fact, however, that this very strengthening of the system has made it independent of national credit policy, in a way it never was before. Funds are attracted to a savings and loan association as much by the insurance of share accounts as by an association's reputation for being a sound, well-managed institution. The right of borrowing from the Home Loan Banks makes it possible for associations to make more real estate loans in a community than there are savings in the community available for real estate lending. The capacity of the Home Loan Bank System to borrow in the general money market makes it possible to channel the funds available for investment in institutions sponsored by the Federal Government into the particular field of real estate. All of these conditions, among others, have given savings and loan lending a degree of independence it never had in the days when the only resources of an association were the investments of its shareholders and depositors and loans from commercial banks.

Let me emphasize that the present condition is much sounder than the earlier condition. Home-mortgage credit, accounting as it does for almost a fifth of all private debt, is important enough in the economy to warrant special facilities operating under special legislation. Just because it is so important, however, its general policies need to be related to and integrated with broad national policy in the credit and fiscal areas. Mortgage credit can, and does, add to inflationary pressures at a time like the present. I know you realize that credit is needed to finance the construction of houses, and you are making more and more of your loans for this purpose. You are also aware that credit extended for the construction of more houses than can be built with the materials and labor available drives prices upward and I am sure you are limiting your lending in such a way as to minimize these price pressures. As experienced business men, you know not to lend money to Tom Jones just so that he can pay more for a house than Harry Smith can afford, because that is the way bad loans are made, and bad loans seem to have a way of staying on the books longer than good loans.

And now let me summarize and conclude my remarks on this occasion.

Important changes have taken place in the structure of our economy and in the organization of our society. As a result, central banking and fiscal policies have lost a large part of the influence they once exerted over the supply of money. The credit and monetary control thus lost has not been placed in other hands, but has been diffused throughout all financial sectors. At the same time, national influence over the use to which the money supply is put--never as strong as control of the supply itself--has been weakened, partly by these same forces, partly also by the independence which particular credit programs have had because they are specially sanctioned and encouraged by the Government for social reasons.

The Reserve Board has recommended adoption of a special reserve plan which it believes would restore a desirable degree of control over the money supply. I suggest that the reconstruction and strengthening of policy controls over the use to which the credit supply is put also requires careful and conscientious study. I do not suggest that we keep reaching out for more power and more controls, but I am aware of the fact that in honestly and sincerely seeking to promote economic stability at a high level, new effective techniques may perhaps be devised to meet the changing situation. For many years the Board has been able to control the flow of bank credit into the securities market, and during the war it was given the task of regulating consumer credit. The Board has recently asked Congress to renew this power, at least so far as installment credit is concerned.

It is possible that central banking policy will find the instruments necessary to perform its tasks under the new conditions which we face in a combination of traditional controls over the supply of money and selective controls over the use to which credit is put. If this be so, cooperation will be necessary between the central banking authorities and other agencies. For example, the mortgage credit field may be one in which such cooperation will be fruitful. At any rate, this is a question that you and we should be studying at this time, both separately and jointly.

The problems which monetary and credit policy must face today are different from those of a few years ago. On our success in finding ways to deal with these problems will depend in no small measure our success in reaching the goal of sustained prosperity.

Speech delivered before
Sociology Club, University of Maryland
College Park, Maryland
March 23, 1948.

OUR PRESENT FINANCIAL SITUATION.

Before going into the discussion proper, I should like to spend a few moments in making a brief sketch of certain background information which will be helpful in our discussion.

In 1914 the United States was a debtor nation; a substantial part of national development had been and was being financed abroad. We were in the process of shifting from a predominantly industrial and urban nation. Our conventional patterns of finance drew no distinction between the fiscal position of Government and that of individuals and businesses.

At that time, there were about 26,000 commercial banks with total deposits of about 17 billion dollars, compared with about 14,000 banks today with deposits of 140 billion dollars. The Federal debt was only 1 billion dollars. Today it is 257 billion.

Our pre-World War I economy was a composite of regional economies. Perhaps the heart of our central banking problem at that stage of the country's development was to reconcile the monetary and credit needs of major regions and to maintain a balance between these needs. It was largely with this end in view that the Federal Reserve System was established.

When the Federal Reserve Act was revised substantially two decades later, between 1933 and 1935, the nation had become a great creditor country internationally and a great industrial economy domestically. Our monetary and credit problem had changed from the problem of distributing funds among regions--which had been solved fairly well--to the problem of controlling the total supply of money and equating this supply to various national uses. In addition, the economy had gone through a great war, two great "booms," and two great "busts." The war, the "booms," and the "busts" were national in ramification. While regional differences in economic organization still existed, the reality of regional interdependence was a more fully demonstrated fact than ever before in our history.

Our great "bust" of 1929 had been particularly severe and its aftermath was widespread bankruptcy, unemployment, and poverty. The economy's critical problem of that period was "idle men, idle machines, idle money." It was determined to solve the problem on a national basis. Fiscal policy and central banking policy became, more directly than formerly, the instruments of national economic policy.

Once more we find ourselves in a new period. We have again gone through a great and devastating war. The war has changed our position in international affairs, and we find ourselves overwhelmingly a creditor.

The balance of power between capital and labor is different from what it was in 1914 or 1935, and is still changing. The relationship between creditor and debtor has also changed, in important part because better financial arrangements and techniques have been worked out. Banks make one kind of arrangement with farmers for the repayment of loans and a different kind of arrangement with manufacturing concerns, each arrangement calculated to fit the operations of the borrowers.

The Government is no longer merely another borrower in the market. It is by far the largest borrower. The Federal debt accounts for nearly three-fifths of the entire indebtedness of the country, and interest on the debt is a major item in the Federal budget, amounting to more than 5 billion dollars a year. In this situation, special arrangements have had to be made for selling and managing the public debt. The Treasury and the Federal Reserve work closely together in issuing, retiring, and refunding the debt. This greatly increased importance of the public debt is one of the major factors in the present inflation.

Why has this increase in the public debt contributed so strongly to inflation? If we understand this point, we shall understand why some of the problems of the Federal Reserve System are so difficult to handle.

During the war, the Government spent more than twice as much as it collected in taxes, making up the difference by borrowing. Producers--workers, farmers, and business organizations--were paid for all the production of the economy, but the taxes they paid were less than half the money spent by the Government for the goods and services needed to win the war. Producers, as consumers, therefore, were left with more money to spend or save than the value of the goods and services they could buy. To some extent, they used these excess funds to bid up prices, but because we were at war, and because some goods, such as automobiles, were not available, controls were effective in spreading the supply of goods and services and restraining price increases. People, therefore, saved. Some of the savings were in currency, some in bank deposits, and some in other liquid assets, particularly Government securities.

The country's aggregate money supply, as measured by currency in circulation and privately-held demand, time, and savings deposits, is two and a half times as large as at the beginning of the defense program, about 170 billion dollars, compared with 66 billion in June 1940. In addition, the general public, outside of commercial banks, mutual savings banks, insurance companies, and Government agencies, increased its holdings of Government securities to about 90 billion dollars, or nearly six times as much as in June of 1940. These Government securities in the hands of the public are practically the equivalent of money because they are readily convertible into cash. In sum total, this stock of purchasing power available to buy the current output of goods and services amounts to almost 260 billion dollars, compared with a stock of about 80 billion in 1940. It is now more than three times what it was in 1940.

Most of this expansion in the money supply and liquid assets in the hands of the public occurred during the World War II period. However, further expansion has taken place over the postwar period, and in recent months the expansion has shown marked signs of acceleration. This recent acceleration of expansion largely resulted from very active bank lending to businesses and individuals.

Since the war, the economy has been operating very close to capacity and the general public has shown a pronounced disposition to enjoy all the things that were in short supply during the war, from shirts and socks to automobiles and houses. The inflation is continuing for one major reason--people have been willing to spend their current incomes and dip into some of their accumulated savings. They have also supplemented these funds by borrowing from banks and other lenders, and by buying on installment credit. As a result of these strong demands for goods and services--demands in excess of supplies--prices have risen, and we have had inflation. As long as the volume of goods and services available, valued at current prices, remains less than the amount of money being spent, inflation will persist. This condition, in fact, is the essence of inflation.

Two other factors are adding to inflationary forces. First, the addition of productive facilities is going on at a rapid pace. This has the effect of diverting scarce materials and labor from the production of consumer goods to the production of machines to make machines to make consumer goods. This latter process is all to the good in the long run for it is primarily in this way that we increase the productivity of the nation and obtain the increasing standard of living that is both an American tradition and a goal. In the short run, however, it adds to the bidding up of prices on scarce materials and manpower and because producers are paid now for turning out machinery, buildings, warehouses, factories and inventory which will not add to the immediate flow of consumer goods. Therefore, not only are the prices of scarce materials and manpower bid up by such a process but producers' income generated in the process is added to the total demand for the existing stock of consumer goods, already deficient. In addition, the supply of money is expanded because to finance this expansion in facilities, businesses are borrowing from many sources, and particularly from commercial banks.

Secondly, we have had a large commodity export surplus in our international trade for several years. International trade which results in a commodity balance is inherently anti-inflationary since it means that emphasis is being placed on the production of those goods which can be produced the most efficiently and trading these for others which are not so efficiently produced. A commodity export surplus, on the other hand, is essentially inflationary, for producers are paid for the production of goods sent elsewhere in greater volume than other goods are received. Production of this excess of exports, moreover, may have been financed by inflationary bank credit expansion. If the surpluses are balanced by Government loans financed out of taxes which would otherwise be used by the fiscal and monetary authorities to reduce the excessive money supply, or by private lending to foreigners, the net result is likewise inflationary. To the extent that export commodity surpluses are paid for by imports of gold an added inflationary element is created in the form of increased deposits and reserves in the commercial banking structure.

Both of these factors, then, expansion of productive capital and the export surpluses, have resulted in additions to the money supply through the expansion of credit, in the use of funds previously held idle, and in additions to bank reserves growing out of the payment in gold for some of our export surpluses.

This brings me to the problem which confronts the banking authorities and about which the Federal Reserve Board is deeply concerned, for it shows clearly the changes which have taken place in the tasks of the Federal Reserve System.

Taken as a whole, the commercial banking system is fundamentally a mechanism for creating money--for allowing borrowers to spend money which no one has saved. This is in contrast to other types of lending--such as lending by building and loan associations, or savings banks, or insurance companies, or individuals. These institutions transfer savings from those who have them but do not wish to spend them to those who do wish to spend them.

Limits are set to the amount of credit banks can create by the legal requirement that they must hold cash reserves to the extent of some proportion of their deposits--which are themselves largely the result of loans and investments. Banks which are members of the Federal Reserve System, which hold 85 per cent of all commercial bank deposits in this country, must hold their reserves as deposits with the Federal Reserve Banks, and no income is derived from these reserves. On the average, required reserves amount to about one-sixth of commercial bank deposits. For every dollar of reserves, credit can expand sixfold.

Reserves are the heart of commercial banking, and control over commercial bank credit has traditionally been exercised by control of these reserves. Three techniques have been used to exercise this control: (1) varying the rediscount rate, or the rate of interest at which member commercial banks may borrow from the Reserve Banks; (2) open market operations; or the buying and selling of Government securities by the Reserve System; and (3) varying the level of reserve requirements, that is, the amounts which member banks deposit with Federal Reserve Banks as legally required reserves.

Two of these techniques for controlling bank reserves--discount rates and open market operations--are not so effective as they once were, while the third--varying the level of reserve requirements--was exhausted under present law as a restraining weapon early in the recent war, except for a relatively small percentage in central reserve cities--New York and Chicago. The present limited effectiveness of available credit control technique is due almost entirely to the size and wide distribution of the public debt largely inherited from the war. Commercial banks now hold about 70 billion dollars of Government securities, an amount equal to about 50 per cent of their total demand and time deposits, which they can sell in order to obtain additional reserves without borrowing from the Reserve Banks.

The traditional open market operation to reduce excess bank reserves is for the Federal Reserve System to sell Government securities, thus drawing down private deposits at commercial banks. In turn, this draws down the reserves of commercial banks by reducing their deposits with the Federal Reserve Banks.

Here, however, we come up against the problem of management of our huge public debt of 257 billion dollars. If the Reserve System were to sell enough Government securities to reduce bank reserves and curb credit expansion, it would involve great dangers for the entire economy. To make possible this volume of sales, the prices of Government securities would have to be permitted to decline. With a marketable public debt held by investors other than the Federal Reserve Banks amounting to 140 billion dollars, no one can say how great this decline in prices would have to be. As prices declined because of Federal Reserve sales, investors would suffer capital losses and in turn would be encouraged to sell their holdings while their losses were still small, and these sales would further drive prices downward. In brief, Federal Reserve open market operations to reduce bank reserves might lead to a disruptive decline in Government security prices, which might spread to the prices of other securities. This is a risk too serious to contemplate.

Traditional open market policy would also have serious consequences for the Treasury. As prices of bonds decline, their yield, or effective interest rate, rises, and, if Government securities were to fall seriously, all future Treasury financing would have to be done at higher interest rates, thus raising the cost of servicing the Government debt. Also, in such a market, the price at which the Treasury and other borrowers could sell securities would be altogether uncertain, and this uncertainty would interfere with the orderly management of the public debt as well as the orderly financing of private corporate investment programs.

The Federal Reserve System, in close cooperation with the Treasury, has already recognized that interest rates required an upward readjustment. It has recognized this through its open market and discount policy: first, by lowering the support price (increasing the yield) on short-term Government securities, and second, by lowering the support price on long-term obligations (with assurance, however, that support of the lowered levels would be aggressive and continued for the foreseeable future), and third, by the increase in discount rates from 1 to 1-1/4 per cent. It seems much better to us to permit interest rate changes in this manner than to leave the economy's marketable debt to find its own interest level in a free--"bottomless"--market, dominated by Government securities.

It should be apparent from what I have said that the most important change in the problem facing the central banking authorities is the greatly increased influence of the public debt in our monetary and fiscal affairs. After the First World War the public debt (26 billion dollars) could be looked on as merely another set of obligations--to be allowed to find their own price level in a completely free market. This policy, which was in line with traditional attitudes, resulted in large losses to many individuals and businesses, but these consequences were not nearly as serious as those which would result from a similar policy now. The public debt today is a factor to be reckoned with in all public and private decisions. Both its size and its wide distribution have given it great leverage in monetary policy and economic conditions. Moreover, the fact that the Treasury, unlike other borrowers, must constantly refinance its debt makes stability of the market for the public debt particularly crucial.

The increased importance of the public debt is also a factor in another situation which has received relatively less attention in public discussion. This is the shift which has taken place from the hands of the banking and fiscal authorities of a significant part of the control over the supply of money. I have already mentioned the primary difference between bank credit and credit extended by other lenders--namely, that nonbank lenders lend only savings which have been accumulated by savers, while banks also make available to borrowers funds created by the 6 to 1 expansion of deposits to which I have referred above.

It has been customary and, in the main, correct, to say that loans made by nonbank lenders add nothing to the money supply. Today this is no longer true. Before we can say whether a loan by, for example, an insurance company or a savings bank or a savings and loan association adds to the money supply or not we must know where these funds were obtained.

Take an insurance company for example. In the first place, of course, the insurance company obtained the funds from its policyholders in the form of insurance reserves on policies--that is, policyholders' savings. In this sense the funds were saved by the policyholders. But this is not the full answer. If the insurance company had these funds invested in Government securities, and, in order to make a loan, it sold these securities indirectly to the Federal Reserve Banks, it added to the money supply, or at least to the potential money supply. Such an addition to the money supply results because when a nonbank investor sells Government securities, their prices tend to fall, and if prices threaten to fall too far the Reserve System buys in order to preserve a relatively stable and orderly market for these issues. This increases private deposits at commercial banks, and the deposits of commercial banks at the Federal Reserve Banks, thus increasing bank reserves, and the capacity of the banks to lend. The effect, in other words, may be just as inflationary as if commercial banks had sold the securities. The insurance companies, the savings banks, and the savings and loan associations are apostles of thrift and foes of inflation and yet by selling Government securities to add to their currently available funds for investment they are contributing to inflationary pressures.

In the light of all these considerations, the Federal Reserve Board has recommended to Congress the adoption of a plan which we feel would restore some of the powers over the money supply which have been lost because of the great increase in the public debt. Very simply, this plan involves a temporary increase in reserves which all banks would be required to hold, except that instead of being legally required to add to their cash reserves, banks would be permitted to hold certain income-producing assets, namely short-term Government obligations. The proposal has come to be called the Board's special reserve plan.

The Board has also asked Congress, as an alternative, to raise the limits to which required cash or primary reserves may be increased. To increase required cash reserves far enough to be relatively certain of effective bank credit restriction, however, would mean reducing the earnings of banks below expenses and a reasonable return on capital. Notwithstanding this certain effect, many bankers favor this method over the Board's special reserve plan as a means of dealing with the present problem of too easy bank credit.

The need for bringing the money supply more definitely under control by providing additional authority for regulating the level of bank reserves has also raised the problem of appropriateness of our existing system of reserve requirements. This scheme has long been recognized as inequitable in certain respects; indeed the System has engaged in many studies of methods to improve it. Ultimately, it will be desirable to have our reserve requirements based on the type of banking business conducted by a bank rather than on the basis of location, as is now the case. But this is a complicated matter, as matters of equity invariably are, and will take time to remedy.

Meanwhile, we confront a situation of an excessive and highly expansionary money supply, and the problem is to find some way of regulating growth of bank credit in the public interest with the object of preventing recurrent outbreaks of inflation. Either the Board's special reserve plan or authority to raise further existing reserve requirements seems to be the most feasible, available restraint for this purpose, taking into account the over-shadowing size of our public debt.

There has been little need for increased reserve requirements during the past three months because of the Treasury's favorable fiscal developments, which have made possible a substantial retirement of bank-held public debt. Such retirement has temporarily exerted pressure against bank credit expansion. But in the future this type of pressure will not be available in the same degree, and bank credit conditions may become unduly easy. If this should happen, the need for some special, additional restraint will be urgent. It is better to have authority to deal with a situation as it develops than to have authority provided, if at all, too late to be used.

The urgency for the Federal Reserve Board's proposal, or some other proposal to curb credit expansion, will be especially great if we relax our current fiscal policy while inflationary dangers exist. Fiscal policy is by far the most effective way to deal with the demand side of inflation just as production and particularly more production per man-hour is the most effective way to deal with it on the supply side. This means rigid Government economy and deferment of all deferable expenditures. It also means as large a surplus of tax receipts as possible so that dollars are removed from the spending stream and used to retire public debt held by the Federal Reserve System. This takes dollars out of the money supply by an equivalent amount and is a reversal of the war-time process by which the money supply was expanded. The classical precept of sound finance that debt should be paid off in boom times has peculiar virtue in the case of a public debt the size of ours, so much of which is held by the banking system.

There is still another side to the credit picture.

As you know, curbing of inflationary pressures cannot be accomplished by monetary and fiscal policy alone. Among other necessary measures are appropriate private decisions. Bankers, for example, must ask themselves whether, as a group, they are extending credit on a sound basis--credit which will stand up in whatever storms are ahead of us. In this connection, I commend to your attention, as well as to the attention of bankers, the program formulated some time ago by the American Bankers Association, and the joint statement on "Bank Credit Policy During the Inflation," issued November 24, 1947, by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Executive Committee of the National Association of Supervisors of State Banks.

As you can see, I have so far spoken almost entirely about a fairly technical side of the inflation problem which confronts the monetary and fiscal authorities, that is, about how the supply of money is being increased. Another, and just as important, problem is how this large and increasing supply of money is being used. Here, again, developments have removed a substantial measure of control over bank lending from the hands of the banking authorities.

Banking authorities have always exercised some measure of influence over the kind of loans and investments made by banks as well as over the total volume of their credit. Such influence has been exercised by way of statutory prohibitions or limitations, by way of varied privileges of access to Federal Reserve credit, and by way of bank supervision. Statutory prohibitions and limitations have generally been quite inflexible. Federal Reserve influence on the kind of lending done by member banks has usually been accomplished, therefore, by keeping informed as to the credit policies followed by member banks and limiting the access to Reserve Bank credit of those member banks found to be following unsound policies. Bank examination policy is also adapted, in cooperation with other supervisory authorities, to changing conditions.

Developments over the past fifteen years, particularly in Government programs, have modified the effectivness of the powers of the central banking authorities. This modification is particularly marked, for example, in the case of real estate loans. It would be rather difficult for the Federal Reserve Board to say that banks with large mortgage loan portfolios shall be denied the right to borrow at the Reserve Banks--even if rediscounting had any significance today--when a large part of bank real estate loans are guaranteed by the Federal Government, either in whole or in part. Similarly, in these conditions, a bank examiner might have some difficulty in convincing bankers to reduce the volume of their guaranteed real estate loans or to establish additional reserves against them.

It is probably not correct to say that restraint or encouragement of credit expansion through central bank credit and supervisory policies ever exercised a decisive influence on the lending activities of <u>nonbank</u> lenders. It would be equally incorrect, however, to say that such policies in the past exercised no influence. Central banking policy gradually came to exert a broad influence over national credit conditions and the prudent nonbank lender took these conditions carefully into account in shaping his own lending program. But since the middle thirties, financial developments, particularly those of wartime, have tended to reduce the influence of central banking policy. In addition, the link between important sectors of the credit market has been weakened at several points.

In the case of mortgage credit, for example, where this change is most pronounced, programs and practices instituted since 1932 have resulted in almost complete separation of this field of lending from general credit policy. Even mortgage lending by commercial banks has been largely sheltered from the influence of general credit conditions. Loans underwritten by the Federal Housing Administration and the Veterans Administration are obviously difficult to discourage by ordinary techniques of bank credit control when they are being encouraged on social grounds by other agencies.

And now let me summarize and conclude my remarks on this occasion.

Important changes have taken place in the structure of our economy and in the financial organization of our society. As a result, central banking and fiscal policies have lost a large part of the influence they once exerted over the supply of money. The credit and monetary control thus lost has not been placed in other hands, but has been diffused throughout all financial sectors. At the same time, national influence over the use to which the money supply is put--never as strong as control of the supply itself--has been weakened, partly by these same forces, partly also by the independence which particular credit programs have had because they are specially sanctioned and encouraged by the Government for social reasons.

The Reserve Board has recommended an increase in reserve requirements which it believes would restore a desirable degree of control over the money supply. I suggest that the reconstruction and strengthening of policy controls over the use to which the credit supply is put also requires careful and conscientious study. I do not suggest that we keep reaching out for more power and more controls, but I am aware of the fact that in honestly and sincerely seeking to promote economic stability at a high level, new effective techniques may perhaps be devised to meet the changing situation. For many years the Board has been able to control the folow of bank credit into the securities market, and during the war it was given the task of regulating consumer credit. The Board has recently asked Congress to renew this power, at least so far as installment credit is concerned.

It is possible that central banking policy will find the instruments necessary to perform its tasks under the new conditions which we face in a combination of traditional controls over the supply of money and selective controls over the use to which credit it put. If this be so, cooperation will be necessary between the central banking authorities and other agencies.

The problems which monetary and credit policy must face today are different from those of a few years ago. On our success in finding ways to deal with these problems will depend in no small measure our success in reaching the goal of sustained prosperity.

Speech delivered before
Northwest Town Kiwanis Club
Chicago, Illinois
April 6, 1948

CURRENT CREDIT PROBLEMS

Three years ago at this time we were all looking forward eagerly to the end of the war, which in the European theater was only a month away. It then seemed that if only the fighting would come to a stop, our troubles would be over. But three years have passed and difficulties, economic and political, are thick all around us. No matter what the field of interest, uncertainties as to the future are weighing down heavily and problems face us demanding solution and at the same time defying it. These problems are both domestic and international.

The Board of Governors of the Federal Reserve System, of which I am a member, is no better off in this respect than anybody else. Difficulties are normal, of course; we always have them, and if it isn't one thing it's another. But just now, both in the field of bank supervision and in the field of central banking, varied problems seem to be pressing on each other and crowding for attention to a degree I have seldom if ever observed before. I should like to take this occasion to review some of the things that are of immediate interest to the Board--not merely because they are of personal interest to me but because they are of interest to you. They concern banking and banking in turn concerns all of us. These matters all involve legislation, either pending or prospective, and relate either to the supervisory or central banking responsibilities of the Board.

The first of these is a measure proposed by the Board, and now pending in Congress, to provide more effective supervision and control of bank holding companies. Bank holding companies, as you know, are organizations engaged in owning or controlling banks. There are a number of such companies in various parts of the country which control substantial groups of banks and, in some instances, have major nonbanking interests. In the Banking Act of 1933, Congress attempted to deal with the problems presented by this development but experience has demonstrated that the existing law is inadequate. In substance, it merely forbids a holding company to vote any stock it owns in a member bank unless it first obtains a voting permit. As a practical matter, submission to regulation is to a large degree voluntary and the regulatory powers which can be exercised by the Board are very limited.

It is inherently dangerous to permit companies which are not subject to regulation to dominate major portions of the banking facilities in particular sections of the country and, particularly, to combine with that activity the control or operation of businesses unrelated to banking. To deal with this situation, the Board has recommended legislation which would regulate <u>all</u> bank holding companies, treating them in much the same manner as banks themselves and including provisions controlling their expansion and requiring them to divorce nonbanking activities. The proposed bill provides that bank holding companies meeting the prescribed definition shall register with the Board and, having registered, shall be automatically subject to all of the regulatory provisions of the statute.

In controlling expansion and requiring the separation of banking and nonbanking activities, the proposed legislation would be applying to bank holding companies accepted principles of bank regulation. Existing law does not permit banks to establish additional offices without the approval of supervisory authorities or permit them to engage in any business other than banking; and there is no justification for permitting bank holding companies to do so. The abuses resulting from unregulated group banking and the potential dangers thereof continue and the need for legislation is urgent.

In the field of central banking the Board has several proposals. One of these is a recommendation to Congress that the Federal Reserve Banks be authorized to grant partial guarantees of loans made by chartered banks to business. The purpose of the guarantees would be to insure that financial assistance is made promptly available to small business firms that might find financing otherwise difficult. The small individually-owned business has a basic need for long-term funds, but it has not recourse to the machinery for raising such funds through the flotation of securities in the money markets that large scale business has. Federal Reserve Bank guarantees would be subject to a charge proportionate to the percentage of the loan guaranteed. A part of this proposal is that the existing provisions of law authorizing direct loans by the Federal Reserve Banks under terms of Section 13b of the Federal Reserve Act be repealed.

These proposals of the Board are aimed at making existing provisions of the law simpler and more effective by providing that the Federal Reserve Banks should not make direct loans to business but should guarantee loans made by private banks to business. The changes proposed would remove the Federal Reserve Banks from any appearance of competition with the private banking system. They would tend rather to enlarge the scope of the private bank's operations. They would provide a stand-by arrangement to fall back on when the need for such credit arises at times in the future. At the moment the provisions for guaranteed loans would not have much if any occasion to be utilized, for our present problem is not at all one of inadequate credit. When present conditions have passed, however, means should be ready to check recession by a ready extension of bank credit to qualified borrowers.

Another measure in the central banking field is the regulation of consumer credit, which was established as a war measure by executive order and should have been continued, in the Board's opinion, as a means of restraining postwar inflation. Actually, Congress did not approve the Board's recommendation but instead terminated the regulation last fall. Inflation, however, was not terminated. The prices of goods are still high, and the purchasing power of the dollar continues to shrink. In the judgment of the Board, it is to the interest of consumers to be discouraged from borrowing in order to pay high prices. In order to avoid alternating booms and busts, it is also in the general interest that the consuming capacity or buying power of the public be maintained as evenly as possible. Otherwise it tends to exhaust itself in competitive buying as prices rise and to be suffocated beneath a mass of debt and unemployment when they fall.

Since the end of the war three years ago, the Board has been preoccupied with the dangerous surplus of money that the war left on our hands in the form of greatly expanded bank deposits. This is an inevitable result of war because in wartime resources are diverted from supplying consumers' and producers' goods to supplying military materials, and people are paid large amounts for producing goods and providing services which they can not purchase with their incomes. In consequence, the supply of money is everywhere excessive in comparison with the supply of things to buy with it. This condition might be corrected from either side or, better still, from both. On the one hand, we need to produce more goods but on the other we also need to restrain further expansion of the money supply.

On the side of production, however, there is little prospect of immediate relief. We are producing at close to maximum volume. Industrial production and employment remain far above all prior peacetime levels, and employment is currently above the wartime peaks. But offsetting this is a level of demand greatly in excess of prewar years. Our people need new cars, new houses, new equipment. And on top of that there is the need of Europe for the materials to restore her economic life. This is not Europe's need alone. It is to our own direct self-interest that the economies of Europe be restored to the point where they can be useful and self-dependent members of the world community, buying our products and contributing their share to world production. Her disorganization and lack of productive power, which we are endeavoring to help her correct, is a prime cause of the pressure we are under. But help to that end can not be given without sacrifice for the time being on our part; if we furnish Europe the things she can not yet supply herself, we must to that extent forego having them ourselves.

Moreover, it is now apparent that we must also renew and expand our military strength. This too will divert money, manpower, materials, and equipment which might have been used for the production of consumer and producer goods. If we turned our backs on the international situation and produced exclusively for our domestic requirements, we should for a short time lighten the pressure of inflation and enjoy the comforts of increased consumption. But our interval of ease would be short and the termination of it painful. No such course can be considered, and we have already turned definitely from it.

In the face of these needs--economic and military--there is little prospect, as I have just said, that production can expand enough to meet the demands for domestic consumption and for export. The problem is largely a physical one--a problem of enough machines, enough material, enough men to produce what the world now needs.

Aggravating this deficiency on the side of production, we have an inflationary excess on the side of purchasing power. Unless this excess is reduced or at least not permitted to increase, it will result in higher prices and increased living costs. The one most effective way to reduce this excess purchasing power is by reducing the Federal Reserve Banks' holdings of Government debt.

Liquidation of the public debt held by the Federal Reserve Banks is an effective curb on inflation because it involves not only a reduction of bank deposits but also of bank reserves. For when the taxpayers' money is used to pay a Government obligation held by a Federal Reserve

Bank, the payment reduces commercial bank deposits and also bank reserves. Thus it extinguishes existing purchasing power in the form of bank deposits and at the same time reduces the possibilities of renewed expansion of those deposits. But though it is important accordingly that Federal Reserve Bank holdings of Government debt be reduced, the difficulty is that so long as the Reserve Banks stand by to purchase Government obligations in support of their market value, it is hard if not impossible for reduction of their holdings to be accomplished.

But as taxes are reduced instead of public debt the problem is made more difficult. For in the first place, to stop retiring the public debt means abandoning the most effective means we have today of restraining inflation. Reduction of taxes means still more: it means that we stimulate inflation, because if the Government takes less money in taxes, then we all have so much more money to spend, and the volume of purchasing power forcing prices upward will be so much the greater. Every dollar not paid to the Government will be available to bid for scarce goods. To each of us individually the reduction of taxes is welcome, of course; but when we think of the response of prices to the increased demand, it is evident that we stand too good a chance of being worse off with the money than without it. For a dollar with prices at present levels may well be worth more than a larger sum with prices at still higher levels.

The tax reduction passed by Congress is $5 billions. In addition to that we are now facing enlarged expenditures not only for European recovery but for military purposes. It is said that approximately $4 billion will be needed for such items as universal military training, a greater air force, and an increase in the authorized strength of the standing army. So if we reduce taxes by $5 billion and increase expenditures by $4 billion, we shall have about $9 billion less with which to reduce the public debt or combat inflation through fiscal policy. The chances are rather that the $9 billion will feed inflation still further.

If fiscal policy can not be relied on, the need of credit controls seems to me all the greater. And if inflated purchasing power can not otherwise be reduced to a reasonable par with the supply of goods, it may at least be pinned down temporarily by a measure which the Board has already recommended to Congress. This is that banks be allowed to count Treasury short-term obligations (bills, certificates, and notes), and cash, cash items, inter-bank balances, and excess reserve balances with the Federal Reserve Banks as special reserves required to be held in addition to legal reserves. This is in substance an increased requirement, the additional reserves to be held at the bank's option, however, either in the form of balances with the Reserve Bank or in Treasury obligations, cash, etc.. Its effect would be to reduce the basis of credit expansion.

These special reserves might reach a maximum of 25 per cent of demand deposits and 10 per cent of time deposits; the requirements would be imposed gradually at the discretion of the Board; and they would apply to all commercial banks, whether members of the Federal Reserve System or not. The arrangement would not oblige banks to reduce the volume of their earnings assets, but it would restrain the further expansion of bank credit. It would also give a fresh effectiveness to the traditional instruments of credit control, namely, discount rates and open market operations. The banks would still be able to meet the credit needs of borrowers, and yet the responsible authorities would be in a position to act for protection of the economy from the inflationary evils of further credit expansion.

This is viewed as a temporary measure limited to a period of three years. It would be helpful in stemming the tide and giving us time to study the new conditions that have sprung up around us. Our present difficulties are not only real but essentially unfamiliar. I think we can not assume that they will quiet down of their own accord. Indeed, wherever one looks conditions that tend to continue to intensify inflationary threats are evident, nowhere can one see any automatic tendency to mitigation or any material forces operating to bring it about. Nor can we assume that the instruments and procedures we have been accustomed to in the past will meet the needs of the future. But neither can we postpone action till we have everything figured out. Something needs to be done now. We have a basic problem which at best must be the subject of long range planning; and we have in addition a mounting emergency. Present proposals may not be perfect but they do go far to meet the immediate need.

Our present reserve requirements have come to be what they are by a process of legislative changes that have never caught up with the facts. For a long time this condition made little difference, but we are now getting to the point where an arrangement originating in Civil War times is altogether too far out of line for present day needs. The arrangement I mean is that which determines the required reserves of banks on the basis of their location. As a matter of fact a bank's location is under modern conditions a pretty poor criterion for determining the reserves it should maintain. The important thing is the kind of deposits, no matter where the bank is, and I think that exploration for a more sensible basis for reserve requirements should be in that direction without regard to location. The further objective should be a requirement administratively feasible, equitable, and adapted to the American system of banking.

So far in considering this problem it has been argued, at one extreme, that deposits should not be classified at all or that requirements should be uniform against all classes of deposits. This was the situation under the National Bank Act and is still the situation under the banking laws of half of the States. At the other extreme, it has been argued that a detailed classification should be made based on such characteristics as turnover, volatility, size, and economic activity of depositor--whether an individual or a business, whether local or national. Some classification is necessary, I believe, but it should not be too elaborate. Furthermore, the requirements should be subject to administrative change, as at present, and they should take account of vault cash and inter-bank balances.

But this search for a new basic system of requirements is a long range affair which the immediate emergency can not wait for; and I think it would be wrong for me to leave you with the thought that we are concentrating on the future and comfortably leaving the present to take care of itself. On the contrary, we feel the need of covering both fronts at once. We feel the need of giving greater effectiveness to the permanent instruments of credit control, but we also feel the need of powers to correct the maladjustments that the war we thought we had won is still vexing us with and that the cold war we now have on our hands is aggravating.

I am glad to have had this opportunity to discuss with you these measures which the Board believes its responsibilities call upon it to recommend. The public has a right to hear from the Board on the problems that engage its attention and the Board feels very keenly the responsibility resting upon it to keep the public informed, not only in the annual reports which it submits to Congress but in special reports from time to time. The measures I have been describing need to be weighed in the light of present difficulties, economic and political, domestic and international. Though they involve technicalities and factors that seem remote from the day-to-day problems of business, they have in reality a close bearing on the future demand for your goods and services as business and professional men, on the supply of goods and services you require, and on the future value of your dollar. I hope that my account of them has been helpful in clarifying their relationship to your individual interests.

This much we all know, we are living in most unusual and uncertain times. We therefore must be informed and prepared to meet any eventuality.

Speech delivered before
55th Annual Convention of the
Alabama Bankers Association
Birmingham, Alabama
May 7, 1948

WHAT ABOUT MONEY AND CREDIT?

The economic situation in which we find ourselves today is indeed difficult. Instead of the happy security we hoped to enjoy after the war we are beset with fears, confusions, and discouragement. We are dangerously close to a process of turning around and heading back in the direction from which we just came.

During the past winter we were making noticeable headway in the fight against inflation. Although the underlying economic situation continued to be basically inflationary, there were signs that the pressures of an undersupply of goods and an oversupply of money were undergoing gradual, cumulative abatement.

On the side of production, the output of goods was not only holding up at maximum levels, but in some areas was catching up with demand. Crop prospects in the world at large were encouraging, and the fall in the prices of foods and other agricultural products was a desirable, corrective readjustment. The program of world aid recovery, then under consideration, seemed to hold promise of providing an effective basis on which to reestablish lasting peace.

Recent Monetary Developments

On the monetary side, fiscal and monetary policies were having significant restrictive effects. The money supply, though still excessive, was being sharply reduced by the Treasury's seasonal surplus of tax receipts over expenditures and by accelerated retirement of public debt held by the Federal Reserve Banks and commercial banks. There had been some rise in interest rates during the fall and early winter in response to tightening credit conditions. At that juncture, the Government bank supervisory authorities launched efforts to discourage further expansion of bank credit, and these efforts were strongly reinforced by a nationwide program of voluntary restraint by the banking fraternity. Finally, the credit situation was affected restrictively by successive Federal Reserve actions: first, the lowering of support levels for Government security prices at the end of December; second, the rise in discount rates early in January; and third, the moderate increase in reserve requirement for banks in New York and Chicago in February.

Despite a large inflow of gold, a heavy seasonal return of currency from circulation, and large sales of Government securities by nonbank investors to the Federal Reserve during winter months, fiscal and monetary operations kept bank reserves under unslackened restraint. Federal Reserve holdings of Government securities fell by about one and a half billion dollars. The combined effect of fiscal and monetary operations, too was to reduce the total money supply by nearly 4 billions. Considering all of the circumstances, this was a notable anti-inflationary accomplishment.

Government Budget Outlook

In view of these salutary developments, it came to be widely hoped that inflationary pressures were finally under control and that taxes could be safely reduced. The response of Congress to this belief was a general reduction, taking away about 5 billion dollars per annum from the revenue of the Government and adding this sum to the annual purchasing power of the public. The effect of this action was to eliminate any further budgetary surplus and any anti-inflationary restraint the surplus might have had on bank credit expansion, while at the same time unleashing new inflationary pressures through larger purchasing power.

While Congress was acting upon a tax program and a program of world aid, the international situation commenced to display alarming portents--especially in Czechoslovakia and in Berlin. These portents put an entirely new face on our international position. They produced a program of renewed military preparation that promises before it is completed to add billions to the Federal budget. In undertaking such a preparedness program, we must remember that our recently enacted program of world aid for the coming year is only a part of a larger program covering several years. It is, so to speak, a first instalment. I wish to underscore this fact. It means that we are adding expanded military preparedness on top of an already heavy budgetary load. We may shortly be confronted by budgetary deficits; in fact, we may have some budget deficit as early as this coming fiscal year. And this is only the beginning of developments for which no terminal point, as a matter of stark realism, can now be set.

The elimination of the Government's budgetary surplus and the prospect of imminent budgetary deficits strike the economy before the fight against postwar inflation has been decisively won. Prices of many products are still very high in comparison with prewar and wartime levels, and many commodity and service prices, including wages, are still advancing. The total money supply, while reduced from last fall, continues redundant in relation to the output of goods, and the public's 250 billion dollar stock of available purchasing power--currency, bank deposits, and Government securities--remains excessively large. Sustained high levels of production and employment, which are likely, will generate high levels of consumer income, but supplies of goods for final consumption must be diminished by amounts required for foreign aid, for military preparedness, and for domestic capital maintenance and expansion.

Prospective Bank Credit Expansion

These conditions present a picture of continuing inflationary pressures. They also add up to a strong possibility that the financing needs of the Federal Government, together with those of business, State and local governments, home owners, and consumers, will exceed the supply of available savings. This possibility implies a large demand for financing through the banks, repeating the type of bank credit development which occurred last year. Renewed expansion of bank credit and money could only result in accentuating our inflationary pressures.

The commercial banks could readily accommodate any amount of demand for further bank credit expansion. In all likelihood, bank reserves will be increased somewhat by an inflow of gold from foreign sources, and also by such purchases of Government securities from nonbank investors as the Federal Reserve may make for the purpose of maintaining an orderly market. Finally, commercial banks, though obliged to sell some Government securities in recent months, still hold about 66 billions of such investments, which are readily convertible at the discretion of banks into reserves. And as reserves from these various sources expand, they make possible, for the banking system as a whole, a six-to-one inflationary expansion of bank credit and deposits.

Faced with these prospects, further bank credit expansion, which will add to our existing superfluity of money and liquid assets, will be very difficult to keep in check. We must probably resign ourselves to some credit expansion; we should certainly take every precaution, however, to keep it within the bounds of the essential. I suggest as a criterion of what is essential the expansion of bank credit required by our current program of national preparedness and world aid. This means, of course, priority for the bank financing of production related to these programs and also for the financing of any Government deficits that may result. It means, too, a rigorous avoidance of bank credit expansion for nonessential production, for speculation, and for consumption purposes.

Measures for Monetary Restraint

There is no simple or single way of accomplishing this task. It will have to be accomplished in a combination of ways--by general credit controls and in particular areas by selective controls. Moreover, credit controls alone cannot do the entire job. Banking and monetary policies will need to supplement fiscal and other national policies--including, if necessary, direct economic controls. I speak, however, only of the factors lying in the field of money and credit; they are not the most potent but they are essential.

The responsibility of the Federal Reserve System in this situation is to conserve the nation's credit resources in the interest of the longer-run stability of our democratic capitalism. In view of this responsibility, the System will be obliged to use its influence to restrain unnecessary credit expansion. Its capacity to fulfill this responsibility is necessarily circumscribed, in part as a result of statutory authority, and in part as a result of the nature of our banking system.

Applicability of Interest Rate Policy

Taking these limitations into account, there are two lines of general credit policy open to the System. The first of these alternatives, which is entirely within the System's existing statutory authority, is to permit a general rise in the level of interest rates. Such a program would have a three-fold purpose: first, to strengthen the incentive for savings; second, to meet increased financing needs; and, third, to discourage nonessential borrowing. It is a program that would conform in major respects to the traditional precepts of "orthodox" finance.

Yet it is a program that should not be accepted without careful consideration; for the effect of rising interest rates varies and may be the opposite at one time of what it is at another. Thus the initial effect of rising rates may be to encourage economic activity and they may not become restrictive till an alarmingly high level has been reached. They are first taken as harbingers of rising prices and active business. Under inflationary conditions, especially, rising rates would put businesses under a strong inducement to undertake expansion programs before rates and costs went still higher; and they would hardly become deterrent until they had become extremely high. They would impel consumers to avoid higher prices in the future by making credit purchases in the present. They would draw out savings now held in bank deposits or in savings bonds and add them to the volume of credit. But they would not discourage Government borrowing, for the Government borrows not because rates are low but because appropriations and tax legislation make borrowing necessary.

Still further aspects of a policy of higher interest rate levels are the primary effects of such a policy upon the market prices of Government bonds and the secondary effects of lowered price levels for Government bonds upon the soundness and the functioning of financial institutions. It is one thing to contemplate higher interest rates on a public debt of 25 billion dollars, such as we had at the end of World War I; it is another thing to contemplate higher interest rates when public debt amounts to 253 billion and exceeds the total of all private and other debt by nearly 50 per cent. We have also to keep in mind that marketable public debt alone amounts to 162 billion, or approximately 75 per cent more than the value of all listed stocks and non-Government bonds.

The additional cost to the Government of a higher interest rate program is another matter requiring thoughtful consideration, since a maturing debt of 50 billion dollars this year and 100 billion in five years would have to be refunded at higher rates. This aspect of the interest rate problem has a further implication. The Treasury might become a borrower at the higher interest levels. This would raise the knotty question of equity with regard to present holders of Government securities. The program of financing participation in World War II, in contrast to that of World War I, was geared to avoidance of this problem by adherence to a stable pattern and level of interest rates.

These considerations with respect to the general level of interest rates do not mean that the existing structure of interest rates should remain rigid. Long-term interest rates reflect conditions in the capital market--the supply of savings relative to the demand for investment. Short-term interest rates are more largely determined by liquidity preferences and other more transient money market factors. To the extent possible without raising long-term rates, short-term rates may be permitted more flexibility than they have had in recent years. In particular, short-term and discount rates somewhat higher than those now prevailing may help to encourage investment in short-term Government securities by banks and other holders of liquid funds and reduce the amounts that need to be bought by the Federal Reserve. Such a policy may be helpful in avoiding creation of additional bank reserves.

Proposals for Higher Required Reserves

In the light of these considerations, I think you will agree that there are fairly clear practical limitations on the use of interest rate policy to restrain further growth in bank reserves and accompanying bank credit expansion. This leads me to the second alternative, namely, an increase in the reserve requirements of all commercial banks. This alternative would require legislation granting additional authority to the Reserve System. The System still has unused power to increase the reserve requirements of member banks in New York and Chicago, but the leverage to be exerted through this authority would be relatively minor in relation to the problem that the banking system confronts. What is needed is a more general authority which would apply, as a matter of equity as well as economics, to all commercial banks. To this end, the Federal Reserve Board has recently recommended to the Congress that authority of a two-fold character be provided.

In the first place, the authority should make it possible for the System to impose on all commercial banks a primary reserve requirement up to 10 per cent of aggregate demand deposits and 4 per cent of aggregate time deposits, in addition to present requirements. If desired, the authority could be graduated by class of bank. This measure would give the Reserve System authority to increase total reserve requirements by a maximum of about 12 billion dollars. It would enable the System, over the next few years, to absorb and sterilize the credit expansion potential occasioned by gold inflows and by Federal Reserve purchases of Government securities from nonbank investors.

In the second place, the recommended legislation would enable the System to impose on all commercial banks, under proper safeguards, a special reserve requirement up to 25 per cent of aggregate demand deposits and 10 per cent of time deposits. This may be preferably described as an optional reserve requirement, because the special reserve could be held, at the option of the individual banks, in specified cash assets or in certain marketable short-term Government securities.

It seems to me at this time that perhaps the most desirable arrangement would be to package together the optional reserve plan and the proposal for authority to increase primary reserves made by the Board to Congress in April. Provision might be made both for the optional reserve and for an increase in primary reserves as proposed, with the general limitation that the total increase in required reserves that might be applied by the two types of authority taken together could not exceed 25 per cent of aggregate demand deposits and 10 per cent of aggregate time deposits.

At the special session of Congress last fall when the Board was asked to say what might be done in the monetary and credit field to deal with inflationary forces, its response was to recommend consideration of the special reserve plan. The proposal attracted considerable attention, much of which was adverse. It was objected that the situation was not yet serious enough to warrant such a measure, and that the Board already had enough power anyway. As to the timing, the Board proposal was not that the power be granted for instant application but that its use be authorized when necessary. The mere existence of such an authority would have some effect, of course, for most bankers had rather act on their own initiative than wait for a regulation to tell them what to do. Moreover to wait till a situation is desperate before recommending appropriate legislation is scarcely what one would call statesmanship. As for the adequacy of Board powers, I think the point is whether the present powers are applicable. The power to raise reserve requirements in New York and Chicago, for example--which the Board could do--is not very helpful when the problem largely lies elsewhere. Moreover, it is impracticable to exhaust powers before the moment of their greatest effectiveness and unfortunate to have to exhaust them without some power in reserve. Finally, the Board was not seeking power but was responding to a request for suggestions at a time which was not of its own making or choice.

Some bankers have liked the special reserve plan and some have not. I have had doubts about it myself, and can sympathize with the doubts of others. Yet I know of nothing better, and the plan has advantages, I think, which have not been understood or appreciated.

Generally speaking, the optional or special reserve requirements would be capable of accomplishing the same restraints on bank credit expansion as a straight increase in primary reserve requirements, but it would be considerably less onerous to the banks. As I have just said, I sympathize with bankers who have questioned the desirability of the special reserve plan and I think I understand their misgivings. Bankers naturally resent being blamed for everything. They did not bring on the inflation and they do not like to feel that all the pressure to stop it is being put on them. In reality, of course, restraint on the extension of credit happens to be one of the effective ways of resisting inflation, and we must not forget that we are speaking about it because banking is the field of our responsibility and not because we expect everything that is done to be done in that field and nowhere else. I certainly do not wish to give the impression that I have any patience with the tendency to take everything out on the bankers. I have a public duty to perform, but that duty is certainly not against the long-run interests of bankers. One of its aims is the protection of banking through banking itself. It is in this spirit that I should like to clarify the optional reserve plan, for perhaps our explanations have not sufficiently described the relative merits of the proposed measures.

Optional Reserve Plan

By way of preface it should be emphasized, as I noted earlier, that banks now hold 66 billion dollars of Government securities. From the standpoint of an individual bank and from the standpoint of the banking system as a whole, these securities are virtually excess reserves. That is, banks may sell Government securities in the market to obtain reserves and unless other buyers appear, the Federal Reserve System must buy them in support of orderly and stable market conditions. In the process new bank reserves are created. As a matter of fact, nearly all large banks and many medium-sized and small banks recognize this characteristic of Government securities by adjusting their reserve positions continually through purchases and sales.

Any plan to place restraint on the total volume of bank credit and the money supply must recognize the potential reserve feature of the

Government securities held by banks, or for that matter, of those held by other investors. As a measure to reduce the volume of potential reserves, it is as effective to immobilize a part of these securities in the portfolios of banks as it is to require banks to sell them to the Reserve Banks in order to meet an increase in primary reserves. In fact, as a device for meeting the very special kind of situation that now confronts us, the special or optional reserve plan has certain important advantages both to banks and to the public generally.

In the first place the optional or special reserve requirement, if imposed, would leave the banks with their holdings of Government securities intact. It would make possible an increase in bank required reserves and at the same time avoid a considerable amount of banking readjustment, as well as any serious adverse effect upon bank earnings. It would simply immobilize a portion of commercial bank portfolios of Government securities and discontinue the treatment of these holdings as excess reserves, i.e., as assets equivalent to cash and available for conversion into actual reserves at the bank's discretion through sale to the Federal Reserve.

The optional or special reserve, which would strengthen the demand by banks for short-term Government securities and thus aid in the maintenance of relatively stable interest rates on Government securities, would, on the other hand, make possible some increase in interest rates on private borrowing, particularly on short-term and medium-term borrowing. Any such rise would have the same restraining effects on inflationary borrowing as higher interest rates in general might have. More importantly, the plan would put pressure on the lender to ration scarce bank credit among customers and to reduce voluntarily the bank credit available for business expansion and consumer financing.

Furthermore, if Government deficit financing again becomes necessary at some not too distant stage, the optional requirement would make it possible to tie the deposits created in deficit financing to the securities sold to the commercial banks and held as assets against the deposits. Consequently, it would be much more adaptable in coping with the problems of credit control incident to Government deficit financing than an increase in primary reserve requirements would be.

Lastly, the optional or special reserve authority would restore flexibility and effectiveness to the customary instruments of Federal Reserve policy, i.e., open market operations and discount rates. In the traditional sense of their use for credit control purposes, these instruments have become largely unusable because of the dominance of public debt in the credit situation.

Criticism has been made of the special reserve plan that it would be too restrictive and again that it would not be restrictive enough. Yet as a device for meeting the serious problems of excessive credit expansion the special reserve could be used with greater precision and with less danger of adverse reaction than could an increase in primary requirements, since the special reserve, as I said before, would involve fewer banking adjustments. Moreover, safeguards against too rapid application of the requirements are an integral part of the plan.

It has been said that the special reserve would not be restrictive enough because immobilization of short-term Government securities would still permit banks to sell longer-term securities to obtain reserves. It is of course true that the plan would leave banks largely free to do this. Banks would be deterred from doing this, however, because they would be sacrificing a higher-yielding security, possibly at a book loss. Further, since their short-term securities would be immobilized as special reserves, banks in practice would need to hold at least a portion of their long-term Government securities as secondary operating reserves. Should banks sell long-term securities, moreover, buyers other than the Reserve Banks might be attracted by these higher-yielding issues, thus avoiding the creation of new bank reserves through Reserve Bank purchases.

Some have criticized the special reserve plan because banks might need to sell higher-yielding bonds to obtain sufficient short-term securities to meet requirements. The resulting loss in earnings, it has been said, might cause banks to reach out for more risky, high-interest loans and investments, with consequent expansion in private bank credit and impairment of the condition of our banks. I believe this criticism does less than justice to the good common sense of the average banker as well as to the effectiveness of our bank supervisory agencies. It also does not take into account possible higher interest rates on sound private credit, and the increase in bank earnings from this source.

It is worth mention that a special reserve requirement, like an increase in primary requirements, would reduce the ratio of multiple deposit expansion that could be built on new reserves that banks might acquire from whatever source.

Supplementary Measures of Credit Restraint

My remarks thus far have been concerned with the major means of restraining redundant credit expansion. But there are also other measures supplementary to general credit policy which should be restrictive in particular credit areas and therefore helpful in controlling the aggregate volume of bank credit. I refer to the areas of stock market credit, consumer credit, and housing mortgage credit.

Credit to finance the purchase or carrying of listed stocks has been restrained up to the present by the Federal Reserve Board's regulation of margin requirements; and in view of the dangerous inflationary possibilities of the immediate future, it would be a grave mistake, in my judgment, to ease those requirements at this time.

Regulation of down payments and maturities in the field of consumer instalment credit is also needed, in my opinion. Re-establishment of this control would help to dampen consumer demand, especially for durable goods, financed on time-payment plans. This would help to curb further inflationary growth in consumer expenditures and to reduce the competition for available supplies of basic materials and manpower, on which the national defense and world aid programs must draw heavily. An auxiliary effect of this restraint would be some increase of savings, encouragement of which may be put down as an essential element of any program to fight inflation in the period ahead.

The third area that I mentioned where selective credit control might be used to advantage is mortgage credit for housing, which for some time now has been one of the most inflationary factors in the current situation. Since early last winter, there have been mounting complaints--mainly from the building industry and veterans organizations--that residential mortgage credit is becoming tighter. Partly in response to these complaints, consideration is being given by Congress to legislation designed to reverse this situation. You are perhaps familiar with the proposals under consideration. They are, first, to continue on an unsound basis the mortgage insurance program under Title VI of the National Housing Act; second, to create a Government financed secondary market for mortgages already underwritten by the Government; and third, to relax lending conditions under Titles I and II of the National Housing Act. However, I am glad to say that, in this proposed legislation some relevant economic facts have been faced; permissive interest rates on guaranteed and insured mortgages have been placed one-half per cent higher, and the pernicious "necessary current cost" cost formula for appraisal has been replaced by a "value" formula.

We are not at all sure that mortgage credit is getting tighter in any real sense. Financial institutions, including commercial banks, are still making mortgage loans at a substantial rate. Mortgage premiums, bonuses, and fees offered by lenders are lower or have disappeared, but loans are being placed. Borrowers are having a harder time getting 100 per cent or 90 per cent loans, but there is no sound economic reason why they should ever have had such loans. If recent anti-inflationary monetary and fiscal policies have been tightening residential mortgage credit somewhat, that seems to me all to the good, and, considering the inflationary conditions that prevail in the housing market, entirely consistent with the objectives of those policies. There is no such thing as an effective program of over-all credit restraint that avoids restrictive effects in particular areas which have large financial importance, such as residential mortgage credit.

Even without a strongly inflationary outlook for domestic economic developments, there would be very good reason for reconsidering and moderating any new program for the encouragement of mortgage lending. With such an outlook, the need for reconsideration is urgent. It would be better if we abandoned the program altogether, but at the least any further special encouragement of mortgage credit should be limited to rental housing. We shall not succeed in overcoming the housing shortage by increasing the competitive pressures on scarce supplies of materials and construction labor. What is needed is a continuing effort to keep the volume of mortgage credit from pressing too powerfully against these important supplies.

The sale of savings bonds offers a positive check on inflation that approaches the problem from a different angle. It withdraws money from the spending stream, thus reducing the pressure of buyers on a scanty supply of goods, and it substitutes private investment in Government securities for bank investment, thus reducing the volume of bank credit and of bank deposits.

Lastly, an over-all restrictive credit policy will need to be supplemented by vigilant watchfulness on the part of the supervisory authorities and by voluntary self-restraint on the part of individual bankers. We believe that supervisory policy should vigorously maintain the soundness of credit extension by individual banks, and we have actively cooperated with the American Bankers Association in its nationwide program of fostering banker-self-restraint. But the banks may expect continuing strong credit demands from businesses and individuals, and they are not in a position to refuse the sound credit demands of individual customers in good credit standing. I think that banks can fairly be asked to adhere strictly to conservative lending standards, and I believe that banks universally will respond to such requests. But I do not believe that they can extend credit competitively, as they must, in the interests of their local communities, and at the same time refrain from redundant credit expansion on a national basis--especially with the basic factors present that are now stimulating credit expansion.

Financial Strength Essential

Before closing, I should like to stress the fact that there is such a thing as a prudent, sound financial course for an entire economy. We are compelled by circumstances beyond our control to undertake commitments for world recovery and peace that no one till very recently would have anticipated. These commitments come at a time of full utilization of our manpower and resources, of heavy current and deferred peacetime demand by our own people, and of recent action to reduce our heavy burden of Federal taxes. There is no financial sleight-of-hand by which we can carry the unavoidable burden of our national program and still avoid further serious inflation. We must raise from the public the money that has to be spent and there must be some restriction on domestic demand for goods financed through bank credit.

These matters I have put before you are matters that it is the duty of the Board to bring not only to the attention of Congress but also to the attention of bankers and the public at large. Furthermore, it is our duty to do so in sufficient time to allow Congressional and public discussion and debate. And furthermore the powers the Board requires in the discharge of its responsibilities must first be granted by Congress in sufficient time for their exercise to be effective. Powers granted too late serve no particular good.

I hope the suggestions we are offering will not be greeted with the hackneyed comment that the Federal Reserve merely wants more power. To make that comment is to beg the question. The Federal Reserve System was set up nearly thirty-five years ago to exercise certain authorized functions in the public good. The world has not stood still since then, and presumably it will not stand still in the near future. We have had two great wars in that time, the magnitude of business operations has grown, and new forces have arisen. These developments make it necessary to adapt and enlarge the powers that changed conditions have rendered inadequate. I leave to your consideration the question what should be done about it.

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OUR PRESENT ECONOMIC SITUATION

Introduction: Governor Szymczak, as a member of the Board of Governors of the Federal Reserve System over the past 15 years and with experience abroad in 1944 for the Foreign Economic Administration and again in 1946 and 1947 with the American Military Government for Germany, has been in an unusually good position to watch economic developments, both in this country and abroad. We are delighted to have him discuss "Our Present Economic Situation".

Question: Governor, I think the economic problem uppermost in the minds of many of us is the high cost of living. Can you tell us what prices are so high? And why the chances are that they might come down after a while?

Answer: That is a long story. Even so, I think we might first take a look at how high the cost of living is now. According to the Bureau of Labor Statistics index (which is to be used to adjust wage rates under the new General Motors-United Automobile Workers contract), consumer prices in May were 70 per cent higher than in 1939 and 9 per cent higher than a year ago.

Question: Wasn't there a sharp drop in grain prices early this year?

Answer: Yes, but it did not help the cost of living much. Food prices dipped temporarily, but they are now somewhat above their January peak and clothing prices have risen further. So have rents, but in comparison with 1939 levels rents are up less than 20 per cent while food and clothing are double what they were before the war.

Question: Governor Szymczak, what about meat prices?

Answer: They have risen considerably in the past few months and are now about 20 per cent higher than a year ago and more than two and a half times the pre-war level.

Question: You said that since a year ago the total cost of living has risen 9 per cent. Have any items come down?

Answer: Reductions in retail prices have been few and far between. Radios and vacuum cleaners are cheaper than they were a year ago. Some textiles and miscellaneous products have also been reduced.

Question: That covers the main facts on the present cost of living; plenty of housewives can supply the details from their own experience. Now, can you tell us what caused these high prices?

Answer: Chiefly the war. During that period a great deal of the world's productive resources was diverted to war purposes. In this country, at the peak of the war over two-fifths of all production was for war uses. Abroad, factories were destroyed and trade was disrupted to an extent not readily appreciated by those of us living at a distance from the scenes of actual warfare.

Question: So that for a period of five or six years production for civilians was low and supplies of consumer goods were reduced?

Answer: Yes, and at the same time incomes the world over were expanded tremendously because people were being paid for producing munitions and waging war. The increased incomes were partly taken away by Government taxes but people still had much more money to buy goods than there were goods to be bought. Price rises were limited by controls. In this country the amount that people saved out of their incomes increased very greatly during the war period.

Question: And as a result of this people had more money in the bank after the war?

Answer: More money in the bank, more cash in their pockets, and more Government bonds. The total amount of these so-called "liquid assets" held by individuals and corporations at the end of the war was more than three times as great as before the war.

Question: And where did all these liquid assets come from?

Answer: Less than half of the Government's expenditures during the war was financed by taxes and the remaining amount was borrowed. Some of this amount was borrowed from savings and the rest was borrowed from the banks. The Government paid the money out for war equipment, and the money was deposited in banks or held as currency. The expansion in these funds and increased holdings of redeemable Government bonds resulted in a record supply of purchasing power.

Question: The main point, as I get it, is that people accumulated money during the war, when many goods were not on the market. Then after the war they were able to pay high prices if necessary for what they wanted urgently in the way of food, automobiles, and houses. Is that right?

Answer: Yes, people could back up their wishes with more dollars than ever before--dollars accumulated during the war and also dollars received out of current incomes which generally continued high after the war in spite of the curtailment of the war program. There were plenty of jobs immediately after the war and even more now. In June employment reached a new record and wage rates have advanced further.

Question: How much have wages risen?

Answer: At manufacturing plants average hourly earnings are more than double prewar levels. This spring wage rates have risen less than before as marked resistance developed in leading industries. Recent increases in automobile and electrical equipment industries have been within the general range of 5 to 15 cents an hour, which has been characteristic this year where any increases at all have been negotiated.

Question: Now that you are discussing wages, Governor, I want to ask you whether they are high because prices are high or are prices high because wages are high?

Answer: I am glad you asked that because there seems to be so much misunderstanding about it. Basically prices, wages, and profits are all high because of heavy demands for goods. It needs to be remembered that wages are not the only business cost; that, particularly in times like these, many prices are not very closely related to costs; and that consequently care should be taken in attributing price increases to wage increases.

Question: But wage increases add to costs and they add to incomes so they must have some influence on price increases.

Answer: They most certainly do. Actually these things are all interrelated, which is one reason why we talk about the "inflationary spiral". Such a spiral once under way is difficult to stop. In a period of heavy demand and rising prices, increases in prices and wages reinforce each other. Only those who receive fixed incomes can claim that they do not contribute to the spiral.

Question: Governor, there is another question I would like to ask you in this connection--has the banking system contributed to the rise in prices by expanding loans?

Answer: Earlier I mentioned that during the war the banks loaned a great deal of money to the Government, which the Government spent for war purposes, and this resulted in an increase in the purchasing power people held. In the last two years the Government has raised more in taxes than it has spent and with the surplus has paid back some of these loans, which has tended to reduce the supply of money. But bank loans to private business and to consumers have expanded sharply since the war, tending to increase spending.

Question: Have bank loans continued to rise this year?

Answer: Loans for commercial and industrial purposes have not risen since the beginning of the year, partly because of seasonal influences and partly because of substitution of other means of financing. Also, banks have shown some restraint in making loans. Loans on real estate have continued to rise rapidly, despite some restrictive policies; and so also have consumer loans.

Question: Do you regard increases in loans as a cause or a result of rising prices?

Answer: Extension of credit since the war has in some degree made possible more production, but borrowed funds have also been used to compete for a limited supply of goods, thereby adding to the pressure on prices. Higher prices in turn have required larger loans to finance a given physical volume of business.

Question: How about loans to foreign countries? Haven't they been sizeable and helped push up prices?

Answer: Yes, Federal loans and grants to foreign countries have been large and they have contributed to increases in prices of domestic commodities, but it is a cost that we have willingly assumed in order to assist in relief and recovery abroad. Even without United States assistance, however, foreign demands would have been very large relative to prewar because of wartime shortages of goods and accumulations of gold and dollar balances.

Question: You have been discussing so far the influence on prices of various demands for goods. Now, would you tell us something about supplies? How large has production been?

Answer: Total physical production of goods and services has been about two-thirds higher this year than in the 1935-39 period; output of manufactured goods has been double the prewar average. Of course, that period was quite a while ago and since then the population has increased by 11 per cent. Also, there were many unemployed in the 1935-39 period. Even so, the present production level is very high--practically at peacetime capacity with present equipment.

Question: You are emphasizing then that in spite of a very large volume of output since the end of the war the pressure for price increases has been very great.

Answer: Yes, and this pressure was particularly evident in the latter part of 1946 when practically all price controls except those over rents were removed. This action was taken partly with the hope that production could thereby be increased. Since then, in the past year and a half, production has increased, but by only a moderate amount because of capacity limitations, and prices have advanced further.

Question: Has the high level of production since the war eased the shortages of goods prevailing then?

Answer: Yes, quite a little. Merchants and manufacturers have been able to substantially increase their stocks of goods. More--though not enough--housing accommodations have become available. Consumers have satisfied some of their more urgent deferred demands for goods not available in wartime. In some lines, as in the shoe industry, supplies have exceeded demand and output has been curtailed.

Question: Have there been any periods when supplies of goods generally seemed to be catching up with or exceeding demand?

Answer: Such appeared to be the case for a time in the second quarter of 1947 when hesitation was noticeable in a number of markets, even reducing production in a number of lines for a short time; but a new wave of buying and price rises occurred in the summer and autumn, stimulated partly by short feed grain crops and new plans for aid to Europe, and production later reached new peak levels.

Question: How about the situation since then?

Answer: Early this year there again was some hesitation in buying, as grain prices declined sharply on prospects of excellent crops in this country and abroad, but demand has since increased again owing in part to the actual and anticipated effects of a reduction in taxes, increased foreign aid, and the expanded armament program. Generally, production has been close to capacity levels and supplies of some important products, such as steel, have continued to fall short of demands. Upward pressures on prices and wages have been strong.

Question: Can it be expected that prices, wages and profits, and the volume of bank credit will go on expanding indefinitely?

Answer: That is a very basic question. The answer which economists read from the pages of history is that booms come to an end, with serious consequences for production, employment, financial assets, and economic well being generally. The bigger the boom the more likely it is that the bust will be disastrous. That is why efforts should be made to check a boom and prevent the distortions in prices, production, profits, and the like which lead to severe reaction.

Speech delivered before
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BANK RESERVES AND MONETARY RESTRAINT

The present inflationary situation is so patent that no analysis or description of it is necessary; certainly not here. Consumer prices are up 70 per cent over what they were in 1935 to 1939, and they have gone up 10 per cent within the past year. On some items, of course, the increase is much larger, for the figures I have mentioned are averages.

We are taught to think of an inflationary situation as one in which there is a wide disparity between the available purchasing power of the public and the available supply of goods and services. At the present time there is little, if any, productive capacity that is not at work, and we can not expect any great increase in production. There are, to be sure, some points at which inflationary pressures are less strong than they have been, but it is too early to say whether production is catching up with demand. We can only note the fact that crop prospects are extremely good and that a shortage in farm production should therefore not be a factor. The supply of certain nondurable goods, such as shoes, appears to be catching up with demand. The same is true of certain durable goods, such as radios. Despite these few signs, however, the present outlook on the production side is still inflationary.

Turning to the other side of the picture we find that total commercial bank credit, other than credit extended to the United States Government through purchases of its securities, has increased nearly $20 billion since the middle of 1945. In this same three-year period privately owned deposits have increased about $27 billion. In the first half of the present year bank loans have expanded $1.7 billion. This recent growth is the net result of several different trends. The first of these is that real estate loans and consumer loans have continued a substantial growth, whereas business loans have declined slightly, loan demand being seasonally slack during the first half of the year. Most of the mortgage loan expansion has occurred at country banks, where all types of loans have shown an increase. City banks have increased their real estate and consumer loans substantially, but this increase has been partly offset by the decline in business loans. Total loans at city banks, however, increased nearly a half billion dollars. Since the end of June the current loan expansion has been accelerated, and at weekly reporting banks, loans to businesses, and to real estate buyers have been increasing at the rate of about $100 million a week. This postwar credit and deposit expansion is in addition to the large expansion of purchasing power during the war. It has raised the volume of deposits and currency in the hands of the public to over $165 billion, more than 2-1/2 times as great as at the end of 1939.

Any attempt through the central banking mechanism to curb the expansion of bank credit than I have been describing brings up the question of bank reserves immediately. Originally, as you know, bank reserves were thought to be of importance because they were supposed to insure the ability of banks to redeem their circulating notes. When deposit liabilities came to take the place of note liabilities, bank reserves were conceived of as a means of assuring the ability of banks to pay their depositors. Now, however, our concept of the role of bank reserves has developed into a very different one. They no longer are thought of merely as assets which banks maintain in readiness for instant use. Being the assets upon which a bank's freedom of action depends, they have come to be the direct object of regulatory effort. The Federal Reserve System can, under proper conditions, increase or decrease the volume of bank reserves. Hence, reserves now have their principal significance as an instrument for influencing the supply of money.

At the present time a given addition to reserves makes possible about a six-fold increase in bank deposits. A contraction in reserves of a given amount tends to produce a six-fold contraction of deposits.

The basic principle underlying this possible expansion and contraction is that bank deposits have their principal source in bank credit. If a bank were without any competitors to which it might lose deposits, it could expand its deposits indefinitely by making loans to its customers and placing the proceeds of the loans to their credit in their checking account. The only limitation would be the amount of reserves it had to maintain in proportion to its deposits as a result either of its own rules or of legal reserve requirements. At the present time member bank reserve requirements are on demand deposits 24 per cent at central reserve city banks, 20 per cent at reserve city banks, and 14 per cent at country banks and on time deposits 6 per cent at all classes of banks. These requirements average about 15 per cent of deposits. Fifteen per cent reserves permit deposits to expand about six and two-third times. Thus, if there were but one large commercial bank serving the entire country and holding all the deposits of the people, its deposits could expand to $666 for each additional $100 of reserves. This expansion could be effected by lending and investing, deposits being set up on the bank's books in payment for the loan and investment paper acquired. Being the only bank it would not need to fear loss of deposits and inability to honor the checks of its depositors. It would, therefore, not be subject to the inhibition that banks are under in actual competitive situations. Persons who receive checks on the bank would deposit them in the bank and the effect would be a transfer of deposit ownership on the bank's books without any actual transfer of deposits from the bank.

But we have approximately 14,000 commercial banks. Therefore, in the actual competitive situation that exists where there are many banks in existence, as in the United States, no bank dares to lend six and a fraction times the amount of newly acquired reserves. It dare not do so because bank customers do not borrow with the expectation of leaving the borrowed funds on deposit; they borrow in order to expend, and the funds they borrow are more apt to be checked out to another bank than to remain with the bank which lent them. Actually, when a bank receives a deposit of $100, it must put aside $15 as a reserve against the deposit and it can lend $85. This $85 will probably be transferred in a monetary payment to a depositor of a second bank. The second bank receiving the $85 deposit must increase its reserves by 15 per cent of the deposit; that is $12.75. It then has $72.25 left which it can lend and which will probably find its way through a monetary payment to a third bank.

This process continues through a succession of banks, assuming there is an aggressive demand for bank credit, until taking all the banks together a result is reached which is the same as would be reached if there were only one bank. That is, all banks taken together constitute a system analogous to a single bank performing all the banking business. Deposits may shift from bank to bank but, as a general thing, they do not leave the banking system. So, the process of lending and moving funds from bank to bank with resulting increases in deposits and in required reserves can continue through a succession of banks until the total of the new deposits, counting the original deposit of $100 at the first bank and the successive deposits created through the successive loans, will amount to $666. The reserves set aside by the banks involved will amount to $100, which is the 15 per cent required against the aggregate deposit of $666.

Since the amount of deposits is keyed to the amount of bank reserves, control of the volume of bank reserves and of the percentages of reserves that must be held against deposits gives the Federal Reserve System power to restrain or encourage the expansion of bank deposits and their adjustment to the needs of the economy. These controls over bank reserves have been exercised traditionally in three different ways:

The first and basic means of control has been through changes in the rediscount rate, for these rates by being raised or lowered, respectively, discourage or encourage banks to borrow from the Reserve System in order to obtain additional reserves.

The second means of control has been through open market operations, the effects of which are to decrease or increase bank reserves. This instrument was partly used for making discount rate policy effective.

The third device is that of varying reserve requirements. The generally accepted thought has been that this was a device to be used only occasionally to effect broad general changes in the credit situation and to make the other instruments of control more effective.

The power to change reserve requirements was first granted to the Federal Reserve Board in 1933. Through a series of changes maximum requirements gradually came into effect in 1937 and in 1938 they were slightly reduced. Subsequently they have been raised. Before the enactment of recent legislation allowing higher requirements to be imposed, requirements under the earlier authorization were at a maximum except for central reserve city banks, where requirements were 24 per cent against net demand deposits as compared with the possible maximum of 26 per cent.

In what I have just said the traditional instruments of credit control have been described as they might operate under ideal conditions. As you know, ideal conditions never exist. Actually, the Board's freedom of action is constantly subject to conditions and limitations over which it has no control. Thus at the present time the Federal Reserve

System has the responsibility for maintaining orderly and stable conditions in the Government security market. With this responsibility it is not possible to use aggressively the open market and rediscount power the Federal Reserve System possesses to contract the volume of bank reserves.

If, for example, the Federal Reserve withdrew support from the Government securities market and undertook to sell Government securities in the market to absorb bank reserves, long-term yields on Government securities would rise until investors would find Treasury securities attractive as compared with competing demands for their funds. This balance would be reached at some yield level as the larger return on Government securities attracted funds out of hoards or from spending and as rates to private borrowers rose to levels which would cause some of them to abandon their less urgent expenditures. If (as pointed out recently by Mr. Allan Sproul, President of the New York Federal Reserve Bank and Vice Chairman of the Open Market Committee, in a letter to a President of an insurance company) the level of long-term rates at which this would occur should be 4 per cent, then the Treasury 2-1/2 per cent bonds of 1967-72 would need to decline to about 77. The shock of such a move on business and markets would probably be severe. We would get results, but in the way of bringing about a decline in production, a decline in employment, and a reduction in the income of a large segment of the consuming public. As it is, therefore, open market operations under the support program must operate within the framework of the support structure. The central bank authorities have, in fact, little initiative; control of the situation being largely in the hands of bank and nonbank investors.

The rediscount rate is also of very limited importance at the present, because banks generally adjust their reserve positions by sales in the security market and not by borrowing from the Reserve Banks. An increase in the rediscount rate may effectively accompany a rise in short-term rates but an increase in the rate by itself would be only psychological in its effect.

This leaves only the third device still available for use, especially since Congress has recently given the Board limited additional authority over reserve requirements. However, if banks are required to hold reserves in excess of what they now are required to hold they might meet the situation by the sale of Government securities. If the Federal Reserve Banks purchase these securities it would simply be providing the additional reserves that it had just required; and thereby it might undo with one hand what it did with the other.

These recent additions to the Board's authority over reserve requirements do not by any means settle this country's central banking problem. In its immediate aspects, this problem is one of helping control the current inflation. In its larger aspects it is the very old one of finding more efficient means of credit control than have yet been devised. The instruments we possess result from a long and rather haphazard history, and the Board has for many years been seeking to develop ways of improving and strengthening them particularly with respect to reserve requirements. I wish now to describe to you some of the proposals that have been given consideration in recent years.

Before going into these proposals, however, let me remind you that we have followed since the war a program of action which has generated a moderate amount of credit restraint. The rate on short-term Government securities has been permitted to rise from the wartime levels of 3/8 per cent on 91 day bills and 7/8 per cent for one year certificates to about 1.1 per cent and 1-1/4 per cent, respectively. The rediscount rate has been raised from 1/2 per cent to 1-1/2 per cent. Surplus Treasury funds, particularly over the past year, have been used to retire securities held by the Federal Reserve Banks, a process that drains away bank reserves.

I wish first to refer to the reserves to which the Reserve Banks themselves are subject, for the matter has been brought up frequently of late.

As you know, the Reserve Banks are required by law to hold reserves of gold certificates equal to 25 per cent of their note and deposit liabilities. The proposal has recently been made by the House Banking and Currency Committee to increase this requirement to 35 per cent against the deposit liabilities of the Federal Reserve Banks (that is, the reserve balances due their member banks) and 40 per cent against their note liabilities. The proposal, in other words, would restore the requirements that were in effect before the middle of 1945 when the present requirements were adopted.

Restoration of the previous ratio of required gold certificate reserves held by Federal Reserve Banks of 40 per cent against Federal Reserve notes and 35 per cent against Federal Reserve bank deposits would make no contribution whatever to the fight against inflation. It would not sterilize new acquisitions of gold nor would it give the Federal Reserve System any additional powers to curb inflationary expansion of bank credit.

The present reserve requirements of the Federal Reserve banks stand at a uniform level of 25 per cent. Congress established them at this level in consequence of the wartime expansion of currency and Reserve bank credit. The previous requirements of 40 per cent against notes and 35 per cent against deposits, incorporated in the Federal Reserve Act of 1913, were largely arbitrary.

To restore the prewar levels now would only entail needless operating difficulties for some of the Federal Reserve banks. The combined banks at present hold gold certificates amounting to 50.6 per cent of their total note and deposit liabilities, or approximately $6,000,000,000 in excess of the proposed higher requirements. Thus, they would not prohibit Reserve banks from providing member banks with additional funds on which to base a considerable further expansion of bank credit.

Although the Reserve System as a whole has gold certificate reserves in excess of the proposed higher requirement, there is considerable variation among individual Federal Reserve banks. As a practical operating matter, these banks cannot permit the ratios to go down to the vanishing point and hence require a working margin of at least three percentage points.

If the higher requirement were restored, some Federal Reserve banks would have a substantial deficiency, others would be below or close to the necessary operating margin, while still others would have a large excess.

Reserve banks with a deficiency would be obliged to sell some of their Government securities to or to borrow from Reserve banks which had an excess. The reserve position of the individual Federal Reserve banks is constantly changing with seasonal and other movements of funds in the economy. Therefore, the proposal would entail operating difficulties and constant inconvenience without accomplishing any useful purpose.

Expansion or contraction of Reserve Bank credit should be determined by the needs of the economy and not by the amount of gold certificates which Reserve banks happen to have, which in turn is contingent upon international movements of gold.

The Reserve banks do not control the amount of currency which the public wishes to hold. It is the depositors of the banks and the recipients of checks who determine the volume of outstanding currency. They create the demand and member banks come to their respective Federal Reserve banks to obtain such amounts of currency as their depositors or others presenting checks may desire to have.

Next let me discuss with you reserves as they relate to member banks. First among these plans is the optional or special reserve proposal, which was recommended to Congress in the Board's Annual Report for 1945 and again was recommended to Congress in November 1947. This proposal is that for the period of this inflation emergency the Federal Reserve Board be authorized to impose on all commercial banks, member and nonmember, a special reserve requirement up to 25 per cent of aggregate demand deposits and 10 per cent of time deposits.

This is called an optional requirement because the reserves required could be held at the option of the individual bank either in specified cash assets, that is vault cash or interbank deposits, or in certain marketable short-term Government securities.

There are several important advantages in the plan. First, it would immobilize a portion of each bank's holdings of short-term Government securities. Instead of selling them, banks would have to sell their higher yielding long-term issues if they wished to increase their reserves. Second, the plan would bring about a decrease in the ratio of multiple credit expansion; for the higher the requirement the less the ratio of expansion can be. Third, the plan would not reduce the amount of earning assets from longs to shorts held by banks. Fourth, the rise in interest rates consequent upon recourse to the plan would be limited largely to the field of private credit. The effect would not be to increase the cost of carrying the public debt.

The plan to increase primary reserve requirements also was proposed in the Board's Annual Report for 1945 and again in April 1948, the recommendation being that the maximum requirements authorized by law be increased by 10 percentage points for demand deposits and 4 percentage points for time deposits. The recent increase in authority granted by Congress in August was in terms of this plan but the amount of authority given was smaller and its application was limited, as you know, to member banks and does not include nonmembers.

The advantage of increased primary reserve requirements is that it is in line with traditional practice. Furthermore, the increases can be imposed as a means of mopping up additional reserves resulting from the flow of gold into the country, which has amounted to about three billion dollars last year and one billion thus far this year, from the return of currency from circulation which over the last twelve months has amounted to about $300 million, or from the purchase of Government securities by the Federal Reserve System in supporting the Government securities market. The power can also be used to force banks to sell Government securities to the System and thereby reduce a source of secondary reserves potentially convertible into primary reserves.

A disadvantage of this plan is that increased primary reserve requirements tend to diminish the earning assets of banks.

Next is the Uniform Reserve Plan, which is still in the study stage and is subject to change, and which is based on the consideration that changes in reserve requirements may become our major instrument of credit control, especially in view of the limitations imposed upon open market operations and discount policy by the need of supporting the Government security market. If this is so, changes should be made in the present system of reserve requirements so as to make the instrument of changing reserve requirements more flexible and to eliminate inequities that would become burdensome as the requirements were increased.

There are six features of the Uniform Reserve Plan considered from this point of view. First, central reserve city and reserve city designations would be abandoned. Second, the following initial reserve requirements would be prescribed against classes of deposits:

a. 30 per cent against interbank deposits less cash items in process of collection.

b. 20 per cent against other demand deposits, less cash items in process of collection.

c. 6 per cent against time deposits.

Third, banks would be permitted to deduct from their required reserves a percentage of balances due from other banks equal to the percentage of reserves required to be held by them against interbank deposits. Fourth, banks would be permitted to count vault cash as a part of required reserves. Fifth, during a transition period the Federal Reserve Board would be empowered to waive, by regulation, penalties for deficiencies in reserves resulting from increased requirements on the new basis. Sixth, the Federal Reserve System would be empowered to increase or decrease basic reserve requirements by some suitable percentage (say a maximum of 50) in either direction as to any or all classes of deposits.

The Uniform Reserve Plan has several advantages. To begin with, it would eliminate fundamental inequities in the present system which involve higher reserves for some banks than for others similarly situated simply because of the arbitrary classification of the communities in which the respective banks are located. Another advantage is that long standing problems incident to reserve city designations would be ended. Banks whose business requires them to hold large amounts of vault cash would no longer be under the disadvantage of having to maintain the same required reserves at the Reserve Banks as other banks which have to carry little vault cash. Furthermore, under the Uniform Reserve Plan, changes in the volume of interbank deposits would no longer affect the volume of other deposits that could be supported by a given aggregate volume of reserves. Finally, increases could be made in reserve requirements, with the same advantages and disadvantages as attend a straight increase in reserve requirements. The Uniform Plan is now getting further serious study from the System.

There is another plan for reserve control which I should like to present to you for your study at this time. I am not recommending it but am only submitting it. It has been named the Optional Ceiling Reserve plan. The effect of this plan would be to restore monetary control to the monetary authorities and at the same time permit continued stabilization of the Government security market. The plan would make this possible, moreover, without causing a single bank to undergo any transition adjustments. The plan would not reduce bank earnings and it would not prevent an individual bank from making as many loans as its resources might permit.

The features of the Optional Ceiling Reserve would be as follows:

1. At the Federal Reserve Bank two deposit accounts would be set up for each member bank. One of these would be the member bank's Reserve Account and the other its Clearing Account.

2. Each member bank would start with an amount in a Reserve Account equal to its reserve requirements at the time. Any excess reserve (or deficiency) that it might have at the time would be posted to its Clearing Account.

3. Only those funds in a bank's Reserve Account could be used to satisfy basic reserve requirements.

4. All ordinary transfers of funds, including the clearing of checks by the banks, would be effected with the funds in Clearing Accounts. Thus, when a bank received from one of its customers a check drawn on another bank, it might send the check to its Reserve Bank for deposit to its Clearing Account. The paying bank would in turn have its Clearing Account reduced by the amount of the check. When a member bank found itself in possession of more currency than it needed and sent it for deposit to its Federal Reserve Bank, credit would be given in its Clearing Account.

5. A bank might buy or sell Reserve Account deposits in the market just as Federal funds are now traded, and such funds would be transferred from the Reserve Account of the selling bank to that of the buying bank. As at present a bank might also borrow Reserve Account deposits from its Reserve Bank at the discount rate set by the Reserve Bank. The Reserve System might also buy or sell Reserve Account funds in the market.

6. Government securities bought in the market by the System and securities sold by the System would be paid for with funds drawn from the Clearing Account deposit.

7. The computation of reserve positions under this plan would be simple. For reserve city banks, for example, Reserve Account requirements would equal 20 per cent of net demand deposits less Clearing Account balances, and plus 6 per cent of time deposits. Some of these Clearing Account balances might be invested at the option of a bank in a security issued by the Reserve System or perhaps by the Treasury.

The Optional Ceiling Reserve plan that I have just described would seem to make bank reserves independent of the influence of the erratic haphazard factors that now tend to increase or decrease them. These are principally the flow of gold into and out of the country, the movement of currency in and out of circulation, fluctuations in Treasury working balances, and fluctuations in foreign deposits at the Reserve Banks. The volume of existing bank Reserve Account balances would be subject to increase or decrease by action of the Federal Reserve System in buying or selling Reserve Account balances in the open market. These transactions would be carried out in accordance with the needs of the economy.

It would be neither necessary nor desirable for the Reserve System to have authority to vary reserve requirements under this plan. Individual member banks would adjust their reserve position as they gain deposits either by buying Reserve Account balances in the market or by exercising the option of holding larger Clearing Account balances or of investing in Reserve Securities. When a bank lost deposits, its Clearing Account balances would be reduced and if it wished to replenish them, it could do so by cashing Reserve Securities. It would also have some excess Reserve Account balances to sell if it chose to do so.

Let me give you an example of how this plan would work. Suppose the X Bank of Chicago has an increase in its demand deposits of $100,000 as a result of a favorable balance in its check clearings with other banks. How would the bank adjust its reserve position? Under the Optional Ceiling Reserve Plan the X Bank could send the balance to its Reserve Bank for credit to its Clearing Account. The X Bank's Clearing Account would be increased by $100,000 which would match the increase in its deposits, and its reserve needs would be fully met. Or, if it chose, the X Bank could invest the $100,000 in interest bearing Reserve Bonds. Again its reserve needs would be fully met. Or, third, the X Bank might purchase, or borrow from another bank or from the Reserve Bank, a Reserve Account deposit sufficient to meet the rise in its Reserve Account requirements implied by a $100,000 increase in its demand deposits. With a 20 per cent reserve requirement, this would mean that the X Bank would have to acquire $20,000 of Reserve Account deposits. Having done this, the X Bank would then have the remainder of the newly acquired funds available for lending or investment.

In adjusting to a $100,000 demand deposit loss--a result of an unfavorable clearing balance, or a withdrawal of currency by depositors say for Christmas or Easter shopping--the X Bank could again follow alternative procedures. It could permit its Clearing Account balance or its holdings of Reserve Bonds to decline by $100,000. Since the decline in these items would match the decline in deposits, the reserve position of the X Bank would be unchanged and all reserve needs would be satisfied. Alternatively, the X Bank might decide to keep the total of its Clearing Account balances and holdings of Reserve Bonds intact, and provide funds to meet the deposit loss by liquidating other assets, such as selling Government securities to the Reserve Banks. In this case, the volume of Reserve Account deposits that the bank would need to hold would automatically decline. With the 20 per cent requirement, a $100,000 deposit loss would release $20,000 of Reserve Account deposits which could be sold in the open market established for Reserve Account funds. The remainder could be raised through liquidation of other assets.

What about a bank's lending operations under the Plan? When a customer wishes to borrow money the X Bank might be able to accommodate him out of funds received from repayment of other loans. If not, the bank might need to liquidate other assets to make the loan, say short-term Government securities. Under the plan the sale of securities, which would increase the bank's Clearing Account balances, would provide the reserve offset needed to set up a deposit to the borrower in making the loan. These clearing balances would be drawn upon as the loan deposit was checked on by the borrower. Except for a difference in timing, the net result corresponds closely to the way that an individual bank meets its loan demand now--that is, by selling Government securities to meet deposit losses that may result from lending.

The crux of the Optional Ceiling Reserve Plan is that, from the standpoint of an individual bank, lending activities and operations might go on in about the same way as now. But taken as a whole, the banking system would not have the multiple monetary expansion it has today. I discussed this multiple expansion early in my talk. As a system, banks could not base a multiple deposit and credit expansion on a given volume of new funds.

As I said before, I am not proposing the Optional Ceiling Reserve Plan as my solution to the problem of monetary stability. I have told you about the plan so as to set you thinking about it and more generally to thinking about the broad problem of what we can do to establish our money and banking systems on a sounder basis following the most costly war in history.

Speech delivered before
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OUR FEDERAL RESERVE POLICY TODAY

Introduction

Our inflation is an offspring of the war. During the war, resources had to be diverted from the production of goods and services for civilians and turned to the production of military necessities. But the fact that goods were not available did not mean that the demand for them automatically dissolved. Unsatisfied wants accumulated, awaiting the return of peace and prosperity. Today the impact of those accumulated wants is still being felt in almost every sector of our economy.

But the most important aspect of the war from the point of view of explaining the present inflation is the way in which it was financed. Fundamentally the Government had two sources upon which to draw for its funds: (1) the pocketbooks of individuals and business firms which it could reach through taxation or borrowing; (2) the resources of the banking system.

Taxation is, of course, a noninflationary form of finance. When taxes are imposed, the spending power of the public is reduced by the amount that the Government's is increased. No expansion in the total spending power of the community takes place. The taxpayer receives in exchange only a tax receipt, which he cannot use to make purchases in the market, either in the present or in the future.

No government has ever succeeded in financing the total cost of war through taxation, and ours was no exception. It is estimated that less than half of the total funds raised by the Treasury from the middle of 1940 to the end of 1945 came from taxes. Now, there are serious practical obstacles that place a definite upper limit to the tax burden that can be imposed in wartime without hampering the war effort itself. Just where that limit is cannot be determined exactly. But it is certain that we didn't reach it. We should have done better, and had we used taxation more during the war, inflation would not be the problem that it is today.

Another noninflationary type of finance, at least while war is going on, consists in borrowing from the nonbank public. Since in purchasing a Government security the individual gives over a portion of his current spending power to the Government, borrowing from the nonbank public is in one aspect similar to taxation. It has a basic difference from taxation, however, which is all important for the postwar period. Holding a Government security is the next best thing to holding money, so far as a resevoir of purchasing power is concerned. This means that the loss of spending power involved in lending to the Government was not permanent, as with taxation, and that the power could be reclaimed in the future pretty much at the lender's demand. We have been seeing the effects of this potentiality since the war's end. Thus, while borrowing instead of taxing helped to relieve current pressures during the war, it was storing up pressure trouble for the postwar era.

An outright inflationary way to finance a war is through borrowing from the commercial banking system. When commercial banks lend to the Government, which they do by means of security purchases, bank deposits are created and placed at the disposal of the Treasury. During the war this deposit creation typically took the form of additions to the Treasury. During the war this deposit creation typically took the form of additions to the Treasury's war loan accounts. Thus, by borrowing from the banks, the Government increased its spending power through an expansion of credit and the money supply. There was not, as was the case for taxation and borrowing from the nonbank public, an offsetting reduction in the spending power of the rest of the community. And when the Government spent the funds it acquired from the banks, a general rise of money incomes took place. With no commensurate increase in the supply of goods and services upon which the community could spend the higher incomes, the result was an intensification of the upward pressure on prices.

In this process of wartime borrowing from the banks, trouble was also being stored up for the postwar era.

Support of Government Securities

As you know, the pivotal wartime policy of the Federal Reserve was the maintenance of the longer-term interest rate structure at approximately the level existing at the beginning of the war. As was generally known at that time, this policy was intended to serve several purposes: to forestall delay by investors in purchasing securities, who might otherwise have awaited higher interest rates as during World War I; to keep down interest cost on the Government's war debt; and to prevent an undue growth in bank and other investors' earnings from their holdings of public debt, issued to fight a victorious war.

Another important purpose of the policy was to facilitate necessary bank purchases of Government securities. For though it was generally recognized as desirable that the balance of expenditures not covered by taxes should be borrowed out of the people's savings, it was also recognized that as a practical fact the Treasury would rely on the commercial banking system for a fairly substantial portion of its funds. The Federal Reserve accepted as an over-riding obligation the necessity of assuring the availability of whatever funds the Government needed for the prosecution of war, even though it was constantly stressing the importance of sales of securities to the public rather than the banks. About one-fourth of the total funds raised by the Treasury during the war came from the banking system. This was clearly excessive, even in view of any practical difficulties of wartime finance. As the Board of Governors pointed out in its 32nd Annual Report to Congress, in the interest of a successful financing of a victorious war we committed the double error in our wartime finance of taxing too little and expanding bank credit too much.

From the point of view of the problem of postwar inflation control, the chief consequence of the policy of maintaining the interest structure on the Government debt is that it has seriously impaired the capacity of the Federal Reserve to perform at this time its chief central banking function: namely, the control of expansion of bank credit and the money supply.

Expansion of bank credit requires, of course, that banks have access to an expanding volume of reserves. Consequently, in exercising control over the total volume of money and credit, traditional Federal Reserve policies have had as their focal point the reserve position of member banks. Through changes in the rediscount rate banks were to be encouraged in, or discouraged from, borrowing, from the Reserve System to obtain additional reserves. Through changes in reserve requirements the Reserve System was to influence the volume of credit that member banks were able to extend on the basis of any given amount of reserves. Through its open market operations the System was to be able to bring about expansion or contraction in the volume of reserves itself -- though always of course within amounts set by the criterion of orderly security market conditions.

Now, with the Federal Reserve committed to supporting the market, Government securities in commercial banks are essentially potential legal reserves. Banks can always count on liquidating their holdings of Government securities, in order to obtain reserves for credit expansion.

Furthermore -- and this is a point that I think has been frequently overlooked in discussing the problem of credit control in the current situation -- so long as a support policy is in force, the Government security holdings of financial institutions other than banks must also be classified as part of the potential reserve base for credit expansion. When these institutions sell Government securities to obtain funds for loans to private borrowers, the effects may be exactly the same as when commercial banks sell securities to make private loans. In the absence of other buyers the securities must be absorbed by the Federal Reserve under the support program. When the proceeds of the sale are then added to the institution's bank account the legal reserves of the bank receiving the deposit as well as its deposits are increased. In other words the behavior of nonbank lending institutions can be a factor that seriously aggravates the problem of credit control.

As the portfolios of Government securities of member banks themselves continued to swell throughout the war, so, in a sense, their reserve position became stronger and stronger, and they became more and more insulated from any restraining influence by the System. Except for its psychological impact, the rediscount rate lost much of its effectiveness as an instrument of control, since banks could generally adjust their reserve position by sales of securities and not by borrowing from the Reserve Banks. From 1941 forward, reserve requirements had been raised to the prevailing legal maximum for country and reserve city banks, and the increases still remaining for central reserve cities were not large. In any event, moderate increases in reserve requirements were not likely to be very effective, since banks on the whole could meet the higher requirements fairly readily by selling Government securities. Finally, the policy of support precluded the possibility of refusal by the System to supply banks with reserves at their volition when they offered Government securities for sale. Open market policy as an instrument of restraint was rendered essentially inoperative.

Money and Credit Supply

As a result, then, of our methods of wartime finance, the nation's money supply and the national debt experienced a tremendous growth. Between December 1939 and December 1945, currency and bank deposits in the hands of the public increased from 63 billion to 151 billion. The increase in the gross national debt, other than that held by agencies and trust funds of the Federal Government itself, amounted to 210 billion. Of this increase nearly 115 billion, or 55 per cent, was held by nonbank investors; approximately 75 billion, or 35 per cent, went into the portfolios of commercial banks; and the remainder into the holdings of the Federal Reserve Banks.

Thus the stage was set for postwar inflation. First, there was a generally pent-up demand that would take several years to satisfy, even with the economy operating at full capacity. Second, there was a huge volume of liquid assets held by individuals and business firms which could be drawn on to make demands effective in the market place.

And third, though by no means third in importance, there was the banking system, and other financial institutions as well, capable of providing a huge supplementary flow of spending power through credit expansion, and well insulated under existing powers from any restraining influence by the Federal Reserve. For it was clear that the policy of System support of the Government securities market, inhibiting though it was, could not be abandoned or suspended at the termination of hostilities. The public debt had grown to tremendous proportions during the war -- five times its prewar peak. Its interest level had become integrated into our whole asset and liability structure. Aside from any considerations as to increased interest cost on the public debt, withdrawal of support might well have a disastrous impact on our whole financial system. Perhaps never again, or at least not for a long time could public debt management be permitted to recede from its position as a prime preoccupation of Federal Reserve policy.

Well, I do not need to remind any of you here tonight that on that well-set stage a very vigorously acted-out play took place and is still taking place. The plot has been simple: an upward spiral of wages, profits and prices. The only element of suspense has been, where will they stop? And the great concern of us all has been, what is to be the sequel? A leveling off into enduring prosperity is the great hope; deflation and unemployment the great fear.

Restraints

Nevertheless, there have been a number of restraining elements in the postwar situation to date, without which matters might have been much worse. Particularly since mid-1947, Treasury fiscal and debt management policies, as well as Federal Reserve credit policies, have had as a major objective generation of restraint on monetary and credit expansion.

Perhaps most significant has been the restraining influence produced by the Treasury cash surplus. During the period between July 1947 and September 1948, receipts by the Treasury from taxes and other sources exceeded expenditures by about 10 billion dollars. This excess of receipts over expenditures has had the effect of directly reducing the spending power of the community. Further, by using the surplus substantially to retire debt held by the Reserve Banks, funds have been permanently withdrawn from the commercial banking system as well as from the public. Thus pressure has been brought to bear on the reserve position of commercial banks.

To raise the cost of reserve funds to the banks, and also to encourage the willingness of banks and nonbank investors to hold on to the securities they own rather than unload them onto the System, short-term market rates and Federal Reserve discount rates have been permitted to rise. Rates on Treasury bills have risen from 3/8 of 1 per cent in mid-1947 to more than 1 per cent today. Yields on one-year certificates have increased from 7/8 to 1-1/4 per cent, while the Federal Reserve Banks have raised their discount rates from 1 to 1-1/2 per cent.

Moderate pressure has also been brought to bear on the reserve position of member banks by increases in reserve requirements. Prior to the legislation enacted in August, this was a possible course of action only for the New York and Chicago banks, since for all other classes of banks requirements were at their legal limit. In January, and again in June of this year, the Federal Reserve Board raised by 2 percentage points the reserve requirements on net demand deposits at New York and Chicago banks. On the basis of the temporary authority granted by the Congress in August, the Board raised reserve requirements by 2 percentage points on demand deposits and 1-1/2 percentage points for time deposits. These new requirements became effective September 16 for country banks, and September 24 for central reserve and reserve city banks.

As a measure of direct restraint in an area in which credit expansion has been very rapid, the Board has reinstituted controls on down payment and maturity terms of consumer installment credit. First imposed in 1941, these controls expired in November of 1947. They have been revived under the temporary authority granted the Board in the August legislation.

Today's Situation

Today the Board's responsibility for restraining the forces of inflation is perhaps greater than ever. Certainly the general situation is as volatile as it has ever been. Yet the 1948 tax reduction act, calling for an estimated reduction in revenue of around 5 billion dollars, and expanded defense and foreign aid expenditures have cut deeply into the Treasury surplus. Thereby one of the most important elements of inflation restraint in the postwar period has been removed — though I should perhaps point out that I do not mean by this to suggest that the defense and foreign aid expenditures are the cause of the present inflation. Rather, they are today a contributing factor, no different in this respect from certain other forms of government expenditures, or from the expenditures of consumers and business firms, especially capital expenditures. No one of these expenditure components is, alone, responsible for the present inflation. But all of them together are responsible in the sense that they add to a total of spending that is excessive in relation to the total volume of goods and services that can be made available. The even greater responsibility then that today's situation imposes may confront the central banking authorities of the United States with a very real dilemma: to seriously modify the policy of supporting the Government securities market in the interest of credit control, and thereby risk demoralization of our capital markets; or to adhere to the support policy and risk the possibility of a further serious inflation resulting from excessive expansion of bank credit.

Either horn of our dilemma would obviously be intolerable. Would escape between them be possible?

To put the matter in another way, it may be necessary to seek more efficient means of credit control than the Board now possesses -- instruments that take into account the changed environment in which central banking policy must operate today. What would be the nature of such instruments? Many proposals have been made, and I would like at this juncture to mention briefly to you some that have been given consideration.

Optional Plan

The first of these is the optional or special reserve proposal which was recommended to Congress in the Board's Annual Report for 1945 and again recommended in November of 1947 and in April 1948. Under this proposal the Board would be authorized to impose on all commercial banks, member and nonmember, a special temporary requirement that could be met, at the option of the individual bank, either in specified cash assets or certain marketable short-term Government securities. Nonmember banks were included in the proposal since it was recognized that the responsibility for curbing inflationary credit expansion should be shared by the whole banking community, and not only by members of the Federal Reserve System. It would be unfair and inequitable to do otherwise.

An important advantage of the plan is that it would immobilize a portion of each bank's holdings of short-term Government securities, and thereby cut down the reserve potential of the banking system. At the same time, however, the earning assets of the banks would not be reduced, and any consequent rise in interest rates would be limited largely to the field of private credit and would not be reflected in an increase in the cost of carrying the public debt.

Further, the special requirement would automatically reduce the increase in total deposits that could be supported by any new reserves the banking system might acquire. At the present time, member bank reserve requirements on the average work out to be about 17 per cent, or 1/6, of total deposits. Thus $100 of new reserves can support an expansion in deposits of $600 of new reserves can support an expansion in deposits of $600. If the special requirement were to raise total required reserves to, say, 25 per cent of total deposits, then $100 of new reserves would permit an expansion of only $400 in deposits. For the individual bank, the imposition of the special reserve requirement would mean that when it received a new deposit it would have to put aside an amount to meet primary reserve requirements as it does now, and then an additional amount in the form of assets eligible to meet the special requirement. As a result, less would remain for new loans and investments.

Uniform Reserve Plan

It has also been proposed that if changes in reserve requirements should become a major instrument of credit control modifications should be made in the present system to eliminate inequities that would become more burdensome as requirements were increased. Essentially what the proposal -- termed the Uniform Reserve Plan -- calls for is the abandonment of distinctions based upon central reserve and reserve city designations, so that reserve requirements would be based solely upon classes of deposits as such, regardless of the bank's physical location. Under this plan, vault cash and interbank balances would be eligible for meeting reserve requirements.

Thus, under the Uniform Reserve Plan individual banks would no longer be placed at a disadvantage because of the arbitrary classification of the communities in which they are located, or because their business requires that they hold a larger volume of vault cash. Power to increase or decrease reserve requirements is part of this Uniform Reserve Plan which is in process of a Federal Reserve System study.

Dual Reserve Account Plan

Another plan involving a somewhat different approach to credit control policy has been named the Optional Ceiling Reserve Plan, or, alternatively and perhaps more accurately, the Dual Reserve Account Plan.

The plan calls for establishing two deposit accounts at the Federal Reserve Banks: a Reserve Account and a Clearing Account.

Each member bank would start under the plan with an amount in its Reserve Account equal to its existing reserve requirement at the time. Any excess or deficiency of reserves would be posted to the Clearing Account.

Reserve Account balances could be bought or sold among banks in the market just as Federal Reserve funds are traded now. But only the Open Market Committee, through deliberate purchase or sale of Reserve Account Deposits, would be able to affect the total of Reserve Account balances available to the banking system as a whole.

After the plan had been put into operation, the computation of Reserve Account requirements would be simple: For reserve city banks, for example, Reserve Account requirements would equal 22 per cent of net demand deposits less Clearing Account balances, plus 7-1/2 per cent of time deposits. No changes in the Reserve Account requirements would be necessary under the plan as a method of controlling credit expansion and the money supply. For this purpose, any desirable change in the Reserve Account position of the banks could be better achieved by use of the more refined method of Open Market Committee purchase or sale of Reserve Account deposits. However, the changes in requirements that would be necessary to incorporate the advantages of the Uniform Reserve Plan could, of course, be readily adopted at any time.

All new funds received by a bank from ordinary transfers or from such sources as a return flow of currency or gold inflow from abroad, would expand only the bank's Clearing Account balance and by just the amount needed to cover the rise in deposits. Or, as a possible alternative that would protect bank earnings, new funds could be invested in a special, interest-bearing Reserve Bond. In either case there would be no excess to be used for loan expansion and further increases in deposits.

But more important, funds received as a result of System purchases of Government securities would also affect only the Clearing Account and not Reserve Account balances. Thus after the plan is installed a $100 purchase made by the System in supporting the Government securities market would provide the basis for no more than a $100 expansion in total deposits, and not a $600 deposit expansion, as is the case today. The conflict between the policy of market support and the need for restraining the growth in the money supply would clearly be considerably mitigated.

Finally, the plan could be introduced without causing a single bank to undergo any transition adjustments. It would not reduce bank earnings, and while it would severely limit the amount of credit expansion that could be produced by the banking system as a whole, it would still leave individual banks free to make loans on a basis essentially similar to that which prevails today. This plan has no status in the Federal Reserve System and is being submitted here only for your study.

Conclusion

To repeat, in view of current and foreseeable conditions, it may be necessary to devise additional instruments of credit control of the kind suggested by these and other proposals. Not to do so may mean that the central banking authorities will have to default on one or the other of their major responsibilities. And, as a cost of that default, there may come new techniques of control much less compatible with the framework of our free enterprise economy.

Speech delivered before
The Buffalo Chamber of Commerce
Hotel Statler, Buffalo, New York
October 27, 1948

THE CURRENT ECONOMIC SITUATION

The years since the end of the war have been uneasy ones, economically as well as politically. While we have attained the objective of high levels of employment, there has nevertheless persisted widespread uncertainty as to our ability to sustain these levels. In part, our fears stem from our experience in the dismal thirties; in part, from the knowledge that recurrent boom and recession have always been characteristic of our economy; but especially are we afraid that the inflation of the past few years has set in motion forces that will eventually make a downturn both inevitable and severe.

In this general anxiety, we are beset by conflicting interpretations of the present and expectations of the future. On the one hand, every dip in price and every slackening in sales--whatever the commodity may be--is taken as proof that a general downturn is upon us. On the other hand, we have the thesis that despite the distortions which have developed in recent years the economy is fundamentally so strong that full employment, production, and income will go on more or less indefinitely, rolling over one difficulty today and another tomorrow--all the time approaching closer and closer to an equilibrium which is not defined. It is clear that the current economic situation--whenever "current" may be--is not a figure or a combination of figures, but an interpretation which looks both forwards and backwards.

Postwar Inflation in Retrospect

Looking backwards, we see that the war is largely responsible both for the high levels of employment and for the inflation that characterized the postwar years. During the war, about two-fifths of our gross national product was devoted to prosecution of the war. The expenditures for war goods created consumer and business incomes for which there was no matching supply of available goods.

A policy which financed all war expenditures through taxation would have soaked up this excess of purchasing power and would have prevented the large-scale increase in liquid assets. For a variety of reasons, such a rigorous policy was not feasible, and the war was financed through a combination of borrowing and increased taxes, with taxes accounting for less than half the total amount raised. From December 1939 to December 1945 the national debt, other than that held by Federal agencies and trust funds, increased by 210 billion dollars. Of this increase, nearly 115 billion was accounted for by nonbank investors; about 75 billion was held by commercial banks, and about 20 billion by the Federal Reserve Banks.

During the war, price and wage controls and rationing kept prices remarkably stable, even if allowance is made for activity in black markets. But this stability was possible only because consumers and industry in general exercised remarkable restraint in the use of their income by saving voluntarily, rather than attempting to secure larger individual portions of the limited civilian output. Thus, about one-fourth of personal income after payment of taxes was saved in 1944 as compared to less than 5 per cent in 1929 and to about 7 per cent today. A very large share of these wartime savings took the form of liquid assets, i.e. currency, bank deposits, and government bonds. From the end of 1939 to the end of 1945, personal holdings of liquid assets more than tripled, increasing from about 50 to over 150 billion dollars.

When the war ended, the economy had available for spending not only high current incomes but the large accumulation of war savings as well as exceptional access to credit. The incentives to spend were strong in view of the great backlogs of demand for both consumer and producer goods. At the same time, we had heavy responsibilities abroad both for relief and reconstruction. It simply was not possible to increase production fast enough to meet demand. Moreover, increasing production itself increases current income correspondingly.

It was in such a war and postwar situation that inflation was bred. Inflation means that effective demand—i.e. demand backed by purchasing power—exceeds the current supply of goods and services at prevailing prices. Unless controlled, prices advance in such a situation and each advance breeds further advances without necessarily bringing supply and demand into balance at a reasonable price level. Rising prices have resulted in rising incomes and expanding credit which have maintained a gap between effective demand and supply. This now familiar spiral of increased prices followed by increased income has been repeated again and again since the end of the war. For example, since 1939 wholesale prices have increased about 120 per cent, consumer prices 75 per cent, and personal income 190 per cent. A very large proportion of each of these increases has come after 1945.

Notwithstanding all the inflationary forces at the end of the war, we removed prematurely such wartime controls as might have been used as transition safeguards. These included controls over prices and wages, consumer credit, material allocations, and the excess profits tax. Furthermore, for one reason or another we adopted policies which from a strictly economic point of view were more suitable for inducing recovery from low levels of activity than for curbing inflation. The extreme gravity of the housing shortage led to easy mortgage financing. Generous provision was made for veterans. The agricultural program resulted in price support for farm products at levels which prevented large crops from having as deflationary an effect as they might otherwise have had. Desires to grant taxpayers some relief after the long years of high taxation brought tax reduction at a time when incomes were already excessively high in relation to the available supply of goods. In short, when a policy desirable for other reasons came in conflict with price stability, stability frequently was sacrificed. It should not be surprising, therefore, that prices are very high.

Significance of Postwar International Situation

The problem of maintaining price stability would have been difficult in any event in the face of an unprecedently strong restocking and investment boom for new plant and equipment, inventories, construction, and consumers' durables and semi-durables with demand supported by large and widely held liquid assets and high and rising incomes. In addition, however, a disturbed postwar international situation has been superimposed on an already inflationary domestic one. Postwar has unfortunately not meant peace. Defense expenditures were cut drastically after the termination of hostilities, but they nevertheless remained far above prewar levels. More recently, the intensification of international tension has resulted in a substantially enlarged defense program, with adoption of both a Selective Service program and plans for a 70 Group Air Force. For fiscal 1949, the expenditures for defense may run more than 1-1/2 billion dollars above those for the preceding year. The present program, if fully carried out, will mean a further substantial increase in fiscal 1950. The President was recently quoted to the effect that he was recommending a budget of about 14-1/2 billion dollars for defense in fiscal 1950. At the same time, the President indicated that military leaders had requested a budget of 23 billion dollars.

Furthermore, the war left a large part of the world desperately in need of outside aid. This was true both of our allies and of our former enemies. Our vast foreign aid programs for relief and reconstruction reflect not only humanitarian motives but also a desire for enhanced security. By the spring of 1947, our exports of merchandise had risen to a level close to that in wartime, which included lend-lease. Since then, exports have declined more or less steadily, but are still at very high levels. Meanwhile, imports have continued to increase. As a result of these divergent movements, the excess of exports of goods and services has declined from its peak in the first half of 1947, but is still very great, amounting to an annual rate of over 7 billion dollars in the second quarter of 1948.

The continued excess of exports of goods and services has been financed in a variety of ways, but the most important has been aid furnished by the United States Government. This aid has taken the form of both gifts and loans. It has included credits on sales of surplus property and ships, loans made by the Export-Import Bank, the British loan, contributions to UNRRA and post UNRRA, civilian supplies for occupied countries, interim aid to France, Italy and Austria, the Greek-Turkish aid program, and most recently the European Recovery Program. Loans have become relatively less important while gifts have become increasingly important. It is estimated that this country will spend or lend more that 6 billion dollars on such aid in the current fiscal year, which is close to the very high rate of the first half of 1947. A large proportion of this year's aid represents expenditures under the European Recovery Program.

Other major means of financing the export surplus have been liquidation of foreign holdings of gold and dollar assets (which were run down by 4-1/2 billion dollars in 1947 and by about 1 billion dollars in the first half of 1948), operations of the International Bank and the Monetary Fund, and gifts and loans from private sources in the United States.

Developments in 1948

The year 1948 has in general witnessed a continued development of postwar expansive forces. The first quarter was one of some business hesitation, with gross national product showing no change over the fourth quarter of 1947, and with prices of many farm products breaking sharply in February. In the second quarter, however, adoption of the enlarged defense program, the European Recovery Program, and tax reduction furnished a strong upward push to the economy, and especially so since these actions were taken in a situation still characterized by excessive over-all demand. Expansive tendencies were further reinforced late in the second quarter by the responsiveness of large mass-production companies to wage demands after an earlier show of strong resistance to a third-round wage increase. After the signing of a two-year agreement between General Motors and the United Auto Workers on May 29, new wage contracts were soon negotiated elsewhere in the automobile industry and in such other key industries as electrical machinery, rubber, farm equipment, bituminous and anthracite coal, and steel. Wage increases have since spread, and are still spreading, throughout the economy generally. Although the increases this year have been more selective and diverse than in preceding years, the average increase approximates the rise in consumer prices during the last year.

After the first quarter, further increases occurred in retail sales and consumer and wholesale prices. Gross national product and disposable income (i.e., income of individuals after payment of personal taxes) reached new peaks in the second and third quarters as business, government, and individuals all enlarged their expenditures. Unemployment has continued at a low level, below 2 million persons. The index of industrial production which had declined in July, recovered in August, and by September was back to its June level.

Meanwhile, expansion in bank loans has continued to make a substantial contribution to total spending power, though not on quite as large a scale as last year. Loans of all banks are estimated to have increased 1.8 billion dollars between the second and third quarters, as compared to the 2 billion dollar expansion in the corresponding period last year. Though somewhat smaller in total, the second-to-third quarter growth of loans this year has followed a pattern not much different from that of last year. Increases have taken place in all three of the main loan categories—business, real estate, and consumer loans. Present estimates do indicate, however, that the somewhat smaller increase this year is chiefly to be accounted for by a decline in the rate of growth in the business loan category.

Data from the latest survey of planned expenditures for new plant and equipment indicate some increase in outlays by manufacturers for the second half of 1948 in comparison with planned expenditures reported in surveys taken earlier this year. Moderate gains over the first half of 1948 are also forecast by electric and gas utilities. All in all, on the basis of reported intentions, total plant and equipment expenditures should amount to about 18-1/2 billion dollars for all of 1948, as compared to about 16 billion in 1947.

Meanwhile, personal income continues to increase, both as a result of increasing employment and of the spreading of third-round wage increases throughout industry. Despite the sharp drop in prices of many crops, net income of farm proprietors has been maintained at a level above the already high level of last year. The price-support program combined with the large volume of marketings prevents substantial declines in farm incomes. Personal holdings of liquid assets are still very large and are widely distributed, despite some tendency to concentration in the hands of upper income groups. Re-establishment of Regulation W has not precluded the further expansion of consumer credit.

These factors--high current income, large past savings, and ready access to credit--reinforced by the continued backlog of demand for some durables (e.g., automobiles) furnish a strong basis for continued high levels of personal consumption.

Taken together, all these indicate a considerable degree of current strength. Nevertheless, there are also evidences that in some important areas supply is equalling or exceeding demand at current prices. These products include not only some finished consumer goods but some raw materials as well. As these products tend to stabilize or fall in price, they serve to relax somewhat other upward pressures on costs and prices elsewhere in the economy. Probably the most important development of this sort has been the record breaking crops of this year, which have resulted in reduction of prices of wheat, corn, and cotton to support levels. The effects of these large crops have not yet been materially reflected in over-all retail food prices, however. Furthermore, meat prices have continued to rise until very recently, when they started to come down even more sharply than in broad conformity with their usual seasonal pattern.

Reports of possible balance or even excess of supply at current prices are also heard in connection with such products as cotton textiles, shoes, men's clothing, liquor, housefurnishings, coal, paper and radios. There have even been reports of more than seasonal weakness in prices of new-used cars.

It may also be noted that wholesale prices in general have shown smaller increases so far this year than in 1947. Furthermore, considerable divergence has developed in price movements of various commodities. Great strength has been shown by metals and moderate strength in such industries as building materials and fuels. On the other hand, prices of some foods, hides and leather, textiles, paper and pulp, and chemicals are close to or below their January levels.

Another possible symptom of general weakness may be read into the fact that new housing starts declined in August to 83,000 units, a level 11,000 below July and 3,300 below August last year. A further decline occurred in September. This behavior contrasts with that of 1947 when new starts increased steadily to a yearly high of 94,000 units in October. The declines this year at this time may be interpreted as an indication of some softening in the market, reflecting the facts that the most urgent demands for housing have been met, and that consumer resistance to the extremely high prices charged for houses is becoming effective. Nevertheless, construction costs have continued to advance steadily and the index of wholesale prices of building materials in early October was at its peak.

Any signs of general weakness must be watched closely, because after the great price increases of recent years, the economy is becoming increasingly vulnerable both to sharp price declines in particular areas and to the effects of such declines on credit and on business and consumer expectations generally.

On the other hand, it is well to remember that the postwar boom has already over-ridden many deflationary forces and periods and that greater strength in some lines may well continue to offset weakness in specific lines. In the past two years, we have overcome the sharp break of stock prices in the fall of 1946, the weakness in nondurable goods and trade in the first half of 1947; some reduction in new private construction in the second quarter of 1947, the sharp break in prices of many farm products in February of this year, and the large Federal cash surplus in the first quarter of this year and the use of much of this surplus to retire bank held debt.

More important than all of these things in conditioning my thinking about current economic trends is the continued state of tension in international affairs. Our defense requirements have precluded any reduction in Federal expenditures. On the contrary, they are most likely to result in further sharp increases in Federal expenditures during the remainder of the fiscal year and well beyond that. The enlarged defense and foreign aid programs adopted this spring are being carried out at an accelerating rate. Their full economic effects will not be felt until next year. But who can say that the present programs will represent the peak of defense and foreign assistance efforts? In recent weeks, there have been more and more rumors in the press about the adoption of military lend-lease. Under the circumstances and with the continued threat of further deterioration in the international situation, it would be dangerous to assume that inflationary forces have run their course. While the recent indications of moderation of some inflationary pressures are hopeful signs, the direction of most broad measures of economic activity is still upward. It is still too early to be confident that our hopes for stability will not again be disappointed.

Monetary Measures to Curb Inflationary Tendencies

Under these circumstances, what can the Federal Reserve System do to curb inflationary tendencies? Traditional instruments of monetary control in a boom--increases in reserve requirements within existing laws and in rediscount rates and sales of securities in the open market--have only limited effectiveness because the banking system can obtain all the reserves it needs by selling Government bonds to the Federal Reserve. This situation is a result of our war-created debt. Holders of these various debt obligations--including commercial banks, insurance companies, other investment institutions, and individuals--feel free to sell their securities to obtain funds for other purposes. Thus, the total volume of current expenditures can be expanded. The Federal Reserve System has to serve as the residual buyer in the market for Government bonds in order to preserve confidence in Government credit and to provide an orderly market for the enormous refunding operations of the Treasury. Confidence in the stability of Government security prices is essential to prevent a possible large volume of selling of such securities. Aside from any considerations as to increased interest cost on the public debt, withdrawal of support might well have a disastrous impact on our whole financial system.

The Federal Reserve's support program keeps interest rates stable and at the same time gives the banking system access to all the reserves it needs with practically no deterrent. The banking system even obtains reserves which it does not itself seek when the Federal Reserve purchases bonds sold by nonbank investors. In recent months, unfortunately, nonbank investors--notably insurance companies--have sold a substantial amount of restricted bonds to the Federal Reserve System.

It is true that the Federal Reserve System would presumably be able to curb credit and monetary inflation by withdrawing its support of the Government bond market. But, as I have already indicated, this would be drastic action indeed, all the major consequences of which cannot be foreseen. It therefore seems more desirable to make full use of less drastic measures and to explore new legislative methods of credit control. Some additional powers have recently been made available to the System through the restoration of consumer credit controls and the authority to increase reserve requirements. Use of these powers is possibly exerting some moderating influence. In addition, there have recently been further increases in short-term interest rates and perhaps further increases will be needed. The rediscount rate has been increased and in due course will, if necessary, be increased again.

Another remedy which can be tried is enactment of legislation which would prevent the ready conversion of Government securities into banking reserves. One such proposal which would restrain such conversion by commercial banks has been sponsored by the Federal Reserve Board. This would give the commercial banks an option to hold special reserves in cash or in the form of short-term Government securities. Since short-term Government securities afford reasonable earnings--especially as short-term rates increase--the likelihood is that a large part of bank holdings of Government securities would be immobilized. Means to prevent the creation of reserves through the sale of bonds by institutions and other holders outside the banking system should also be explored and adopted. Also, some pressure would be placed on the reserve position of commercial banks if the Treasury were to draw further on its War Loan Accounts at such banks and use the proceeds to retire debt held by the Federal Reserve.

There are further important measures which lie beyond the control of the commercial banks or of the Federal Reserve System. Most important of these is the maintenance of the Federal budgetary surplus. But here we run into the great conflict of this period between the need for economic stability and the demands of national security. Government expenditures cannot be reduced so long as the state of international relations is such as to require a large and increasing defense effort and large commitments for aid and reconstruction to foreign countries.

Our continuing inflationary pressures stem largely from our defense requirements. It is clear then that confidence in the existence of an enduring peace is the desperate need of our times from every point of view.

Remarks before
Advertising Council of America
The White House, Washington, D. C.
February 9, 1949

THE CREDIT SITUATION

On behalf of the Board of Governors let me express my appreciation of this opportunity to give you a resume of what the Federal Reserve System has sought to do and will try to do in performing its function of influencing the volume of bank reserves and the supply of money. That is the fundamental responsibility of a central bank--and the Reserve System is a central banking organization. If it were done away with some other mechanism of regulating the country's supply of money would have to be set up in its place. A modern nation has to have some such machinery, most of all a nation that occupies a dominant role in the world today. It follows that this mechanism should be equipped and adapted to perform its primary function under changing economic conditions.

Our System has not been and is not now adequately equipped. True it has very great power. It could force a contraction of credit and bring about a severe, indeed a catastrophic, deflation. It could do that by using its open market powers, that is, by withdrawing from the Government bond market, selling off System holdings of Government securities and contracting the credit base and raising the discount rate, thus forcing interest rates to rise. That would be the meat axe way of dealing with an inflation. The Board and the Open Market Committee is of one mind in rejecting such a course. It has been argued by some that small doses of this strong medicine might have effected a cure for inflation. I shall not burden you with the pros and cons of the argument which has been widely aired until recently. The Board has strongly believed that some other means--other than a credit contraction forced through a breaking of the Government securities market--should be found to influence the money supply. If no other devices were available, it might be argued that this deterrent should be used as a last resort. But whether in small doses or not, the forced credit contraction and high interest rate remedy, if it is to be effective, almost inevitably precipitates deflation. The first objective of Government policy, as declared in the Employment Act of 1946, is to steer a middle course between inflation and deflation. We are not prepared to admit that we must founder on one or the other rock.

That is why, in search of alternative means of checking continued growth of the money supply, the Board, in its annual reports to Congress from 1945 on, has suggested various other ways of meeting the situation. That is why the Board is united in support of the recommendations on the credit front which are contained in the President's economic report to this Congress.

There are two proposals on this front: First, that Congress give the Reserve System continuing authority to require all insured banks--not just members of the System--to hold a supplemental reserve requirement in addition to whatever other reserves they may be obliged to hold under State or Federal laws. Second, that Congress give the Board continuing authority to regulate credit terms in the consumer instalment credit field.

Concerning the first proposal, it may be recalled that the late Senator Glass, an author and unfailing defender of the Reserve Act, insisted in the Banking Act of 1935 that all insured banks, having deposits of a million dollars or more, should qualify for membership in the Reserve System. The 1935 Act so provided. Had the date for entry into the System not been first postponed, then dropped, insured banks would have been subjected to the cash reserve requirements which all member banks are now required to have on deposit with their respective Federal Reserve Banks. That would have been a much more drastic step than is proposed in the President's economic report. This proposal does not require membership in the System and does not subject insured banks to the cash reserve requirements required of member banks. It simply proposes that if further--or supplementary--requirements are imposed, the burden shall be borne by all insured banks, not merely by member banks. Member banks are today put at a very serious disadvantage as compared with nonmembers because of the relatively large percentage of their deposits which they are obliged to keep on deposit with Reserve Banks. It is an unfair and inequitable state of affairs.

It is unfortunate, I think, that some other word than "reserves" was not invented to describe these cash requirements. They are not reserves in the sense in which a banker or businessman thinks of reserves. They are, rather, a required fund immobilized so far as feeding further monetary expansion is concerned. They are, in effect, a protective fund for the purpose of preventing continuing monetary inflation. Since preventing inflation protects the whole community, it is wholly inequitable to put the community load on some banks and to exempt others. That is why it is proposed that all insured banks, sharing as they do this governmental advantage, should share some of the burden of having their funds immobilized against over-expansion of the money supply.

Authority to change member bank reserve requirements was first made an instrument of credit control in 1933. The Board was authorized, under the so-called Thomas Amendment, to raise reserve requirements in order to prevent an injurious expansion of credit provided the President declared the existence of an emergency and with approval of the Secretary of the Treasury. Under the Banking Act of 1935, the emergency provision was removed, but the authority was limited in that the reserve requirements could not be more than double the ratios stated in the law.

Excess reserves of member banks rose considerably in 1934 and 1935 as a result of a substantial gold inflow. The Board decided in the summer of 1936 that it would be in accordance with the spirit of the law to raise reserve requirements, which could be done without putting banks in debt, and thus prevent the large volume of excess reserves from becoming the basis for a possible injurious credit expansion. Requirements were raised 50 per cent effective in August 1936.

In early 1937 economic activity was increasing rapidly. Inventories were accumulating, a wave of buying was in progress and prices of certain raw materials were rising sharply. Capital expenditures of manufacturers were growing rapidly and prices of securities were at the highest levels since the early part of the depression. In the light of these developments, and in view of the large volume of excess reserves held by banks, the Board decided to raise reserve requirements in two steps to the limit permitted by law, that is, to double the basic amount stated in the law.

This action was not a reversal of the policy of monetary ease pursued since the beginning of the depression. After meeting the requirements, banks still held large amounts of excess reserves. Interest rates remained very low. The Board's action was precautionary in character and placed the System in a position to control an injurious credit expansion by open market operations and discount policy, should such an expansion occur.

In the spring of 1938, as a part of a general move by the Government to combat a rapid decline in business activity, the Board reduced somewhat the reserve requirements for member banks. Gold inflow in the late 'thirties was very large, however, and excess reserves increased rapidly. In the fall of 1941 reserve requirements were raised again to the legal limits, a step which still left excess reserves at about 3.5 billion dollars.

In order to facilitate financing of the war, reserve requirements at banks in central reserve cities (New York City and Chicago) were lowered in three steps over the late summer and early fall of 1942 to the same levels prevailing for banks in reserve cities.

As a part of the System's general program to place under restraint the inflationary credit expansion of the postwar period, the Board in February 1948 and again in June 1948 increased by 2 percentage points the reserve requirements of member banks in New York City and Chicago. Reserve requirements of other member banks could not be increased since these were already at the highest levels permitted by law. In August 1948 Congress granted the Reserve Board temporary authority to increase reserve requirements of member banks only and the authority was limited to 4 per cent on demand deposits and 1 1/2 per cent on time deposits. So far, the Board has not used 2 per cent of this authority affecting demand deposits. Presumably the Board would have no occasion for applying the additional reserve requirement authority when bank credit is not expanding, as has been the case in the past two months.

Increases in reserve requirements in 1948 absorbed about 3 billion dollars into required reserves of member banks. This was somewhat more than the total amount of new reserve funds banks obtained from gold inflow and return flow of currency from circulation during the year.

It is not suggested that the supplemental reserve now proposed--which would amount, if fully used, to ten per cent of demand deposits and four per cent of time deposits--is the last word, and the perfect solution for the problem of arming the monetary authorities with adequate means of performing their primary function. It is to be hoped that possibly through another monetary study Congress will arrive at a still better long-range means of dealing with the question of bank reserves. The pending proposal, however, is a necessary step in the right direction. Together with other powers now available, it would equip the central banking mechanism with authority to cope with overexpansion of the money supply in case that danger again threatens us. It is a workable substitute for the now unusable discount rate and open-market operation weapons.

Perhaps I should digress here long enough to point out that in speaking of open-market operations I am referring to their effects in increasing long-term interest rates. As you are aware, it has been possible to have some dampening effect on the creation of bank reserves by permitting discount rates and short-term Government interest rates to rise somewhat and thereby encourage the banks and other investors to hold short-term Governments and to increase their holdings. Purchases of additional holdings in this way can help to offset the credit expansion effects of additional reserves supplied by Federal Reserve purchases of Government bonds, by gold imports, or by inflows of currency from circulation.

I should like to quote the President's words, in this connection, because they state, briefly, the fundamental principle that the country's monetary authorities should be equipped at all times to deal with inflationary pressures on the one hand or deflationary forces on the other. Monetary policy is not a one-way street. It must be flexible, and suited to the changing economic situation.

> "On previous occasions", -- the President said, "I have recommended that adequate means be provided in order that monetary authorities may at all times be in a position to carry out their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures."

So far as the recommendation relating to consumer instalment credit regulation is concerned, this type of selective credit control, like the statutory margin requirements on listed stocks, is always a fruitful source of debate. It can be said fairly, I think, that the Regulation is exerting some effective pressure on instalment credit expansion. With more than 8 billion dollars in instalment credit outstanding, it seems to us desirable to have some concern over the soundness of this credit and over any further excessive growth of it. It is in the public interest, too, to have competition in consumer markets take place in prices and in quality of product rather than in credit terms. Recently, with the reimposition of consumer instalment credit regulation under authority granted last summer, the inflationary credit and monetary expansion based on such loans has slackened considerably. The volume of consumer instalment credit, which had been increasing at the rate of from 180 to 200 million dollars a month through September 1948, showed a much more moderate growth (150 millions a month) over the last three months of the year.

Available evidence suggests that in the major sector of instalment credit--new passenger car financing, Regulation W has had the direct effect of increasing average downpayments from 47 to 49 per cent and decreasing average maturities from 20 to 16 months. Average monthly payments have apparently increased from 73 to 89 dollars. Differences in these effects appear, of course, among the various car-price classes.

Another impact in the automobile field, attributable in some part to Regulation W, has been a sharp decline in the prices of used cars, particularly prices of recent models. Premium prices are still obtainable on many "used" new cars, especially in lower price brackets.

Retail sales of consumer durables, particularly of household appliances and used cars, exhibited a marked weakening in the fourth quarter of 1948, and total retail sales showed distinct signs of leveling off. Levels of dollar sales, however, are substantially above prewar years. With respect to all categories of durable goods, dealers appear to face a problem of maintaining sales volume at prevailing prices for the first time since the war.

Factory production of most consumer durable goods has continued at high levels, but with recent flagging sales, there has probably been some inventory accumulation at wholesale and retail levels. In 1948 output of a few household lines was moderately below 1947.

Employment in consumer durable goods industries has also continued at high levels, but there are currently more frequent reports of temporary lay-offs, actual or prospective. Generalization of recent tendencies is difficult because of varying seasonal and other production conditions in the several industries.

Equity positions in the sales finance business were under strain prior to Regulation W and subsequent developments have brought only slight, if any, improvement in financial positions. Partly under pressure of limited funds, some sales finance companies have apparently been placing greater emphasis on automobile financing, causing dealers in appliance lines to rely more heavily upon their own resources and on bank financing. Furniture dealers continue to rely on their resources supplemented by bank financing. Reports indicate that sales finance companies are especially concerned about the volume of funds they have tied up in dealer stocks, and are tending to limit the volume of "wholesale" paper they are willing to handle for individual dealers. Such policy "rationing" of dealer financing has an immediate impact on factory sales, output, and employment.

The Board's use of its authorities over listed stock margins has also been a helpful means for checking inflationary credit and monetary expansion. Loans for purchasing and carrying stock have not risen during the postwar period. We have not, as in some past boom periods, weakened our economic position by allowing a speculative boom to develop in the stock market on the basis of an expansion of security loans.

In the Securities Exchange Act of 1934 the Congress directed the Board to issue margin-requirement regulations "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities." The Act does not define what use of this credit shall be deemed "excessive," but leaves this to be determined by the Board. The context and legislative background indicate, however, that decisions to change margin requirements should give consideration to the general economic and credit situation, as well as to the extent of speculative activity and credit inflation in the securities markets themselves.

In general, it may be said that the purpose of security margin requirements is to help prevent economic instability. The Securities Exchange Act of 1934 was a result of the general public recognition that stock speculation had been a very important factor in the serious instability of the economy in the late twenties and early thirties.

According to the broad principles which ordinarily underlie the Board's credit policy, margin requirements would presumably be raised or lowered only when such action appears to be called for both by developments in the general business situation, actual or impending, and by developments in the stock market itself. The pertinent criteria which indicate developments in the stock market itself relate primarily to the degree of speculative activity in the markets. For this reason, the level of the various market indices usually is given less consideration in decisions to change margin requirements than is the rate of change of these indices. Rapid changes, particularly in stock prices, may provide a basis for a change in margin requirements that would not be justified if the same amount of change were spread over a longer period.

Specific stock market criteria usually considered in connection with a change in margin requirements include the following: (1) The level and rate of change of common stock prices; (2) The amount of credit borrowed by customers from brokers in margin accounts; (3) The number of shares traded, and the extent of public or professional participation in the market; (4) The volume and ease of flotation of new security issues.

Two points should be mentioned in connection with the term "excessive use of credit" in the statutory mandate. This has been generally interpretated in the past by the Board as applying not only to the amount of credit in use but also to its turnover, that is, the extent to which a given amount is being used. For instance, an active and sharply rising market may in itself indicate an excessive use of credit even though customers' debit balances remain relatively stable. Furthermore, studies by the Board's staff and others have indicated that most of the credit used in the stock market is not absorbed by the market but flows into the general stream of spending for capital goods and consumer goods throughout the economy. Consequently, the major question in determining whether or not a particular amount of stock market credit is excessive is whether economic stability would be promoted by an increase or by a decrease in the quantity of credit money being spent generally in the markets for goods and services.

Stock prices have been comparatively stable since 1946. For conditions of inflationary prosperity, however, they have maintained stability at severely deflated levels in terms of current earnings and dividends and in relation to prices of fixed income securities and of real estate. While the common stock price factor in itself does not suggest an urgent need for a change in margin requirements at this time, the current high ratios of earnings and dividends to prices expose the requirements to continuing criticism as "unduly strict." However, a lowering of margin requirements could not be expected in itself to change public appraisal of stock price earnings or dividend relationship.

There have been a few short periods in the past year when considerable public participation in the market was evident. In May 1948, there was heavy activity when volume averaged nearly 2-1/2 million shares in a week of sharply rising prices. Again in November 1948, activity in the market suggested considerable public liquidation as stock prices fell 10 per cent in a week after the election. On the whole, however, the market has been relatively inactive in the past two years, with little indication of any sustained bullish or bearish speculative participation at any stage.

There has been a relatively small volume of new stock issues in the past year in relation to the general business level and corporate financing in general but the present 75 per cent margin requirement has been only one factor in this situation. In 1946, when margin requirements were 100 per cent, there was a relatively large volume of new stock issues, compared with past years. The large supply of equity money obtained through undistributed profits, and the sharply lower cost of debt as compared with equity funds, were probably more important factors than the level of margin requirements in influencing the low volume of new stock issues in 1948.

In view of the present huge supply of money and other liquid assets, rising Government expenditures, and the threat of resumed inflationary tendencies, the desirability of substantial lowering of margin requirements at this time, in order to expand the amount of stock market credit and credit money generally flowing into commerce and industry, may be questioned. Inflationary tendencies have shown recent signs of abatement. Should further slackening of inflationary pressures materialize, an economic case for a relaxing of margin requirements would develop.

These two credit regulations that I have just discussed--instalment credit and margin requirements--are flexible. Terms that are appropriate for a time of inflation, scarce goods, and an over-supply of money are not appropriate for a time of deflation, when goods are in abundance and effective purchasing power is not adequate.

I want to stress the point again that monetary measures must be adapted to the times. Credit restraints must be eased in slack times, just as they should be tightened in boom times. The President's economic message broadly states the basic principle which should guide monetary and credit policy. It does not operate in a vacuum. It needs to be closely coordinated with other major economic policy, including notably fiscal measures.

This point is especially important with respect to housing. As to the need of housing and the importance of a housing program, it seems to me there can be no difference of opinion. Yet it is obvious that we have to deal with two things here that are in direct conflict. We can not, that is, expand credit for a housing program with one hand and restrict credit to combat inflation with the other. The time to stimulate economic activity is not when it is over-stimulated already. Housing, unless it is carefully timed, entails a demand for materials that will drive prices up and intensify the inflationary condition that we are trying to cure. It is necessary, therefore, that Federal programs for encouraging housing construction and re-development be so conducted as to minimize inflationary pressures during periods of substantially full employment and production. We must not frustrate policy by attempting to do things simultaneously that are bound to interfere with each other. Whatever we do must be timed not only to be effective itself but to avoid rendering other measures ineffective.

What the present situation still calls for, in my opinion, is the sort of corrective the President emphasized in his Economic Report. He said:

"It is essential to sound fiscal policy to have a budget surplus now. This is our most effective weapon against inflation. It will enable us to reduce our debt now; it would be much more difficult to do so in less prosperous times......

"Increased taxation is only one of the means by which we can accumulate a budget surplus. The other is a careful limitation of Federal expenditures. It is essential that our fiscal policy under present circumstances contemplate not only a surplus of revenues over expenditures, but also a surplus achieved at the lowest level of expenditures which is consistent with our needs."

Finally, let me say a word about the downside of the cycle. The Reserve System today is far better equipped than ever before to help offset deflationary dangers. Apart from relaxing instalment credit and margin requirement regulations, it has virtually unlimited means of supplying the market with additional reserves through purchases of Government securities. Under existing legislation with respect to gold reserve requirements--25 per cent of note and deposit liabilities--the System is not now hampered by any crippling limitations on its ability to supply funds to the market, should the need arise. The Federal Reserve Banks have $23 billions of gold certificate reserves, only half of which is required by the law. Accordingly, their note and deposit liabilities could be more than double what they now are. The System is also in a position to make advances freely--that is, to lend on any assets of member banks acceptable to the Reserve Banks as security. This greatly liberalized lending authority was provided by the Banking Act of 1935. In addition the Reserve Banks are empowered to make direct loans for working capital purposes to business and industry, in case other lenders are not available.

If the System is now armed by the new Congress with sufficient means to deal with over-expansion of credit--just as it has been armed since the mid-thirties with important powers to offset deflationary credit forces--it will be equipped once more to play the role that central banking has to play in a modern economy. The adequate equipping of this mechanism should not be left for another emergency. The time to prepare for stormy economic weather is before the storm breaks. The President's recommendations are adequate for the period ahead, and they are moderate.

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CONTEMPORARY MONETARY POLICY AND ECONOMIC STABILITY

Those who have the task of making policy decisions sometimes admonish the academic economist to avoid theorizing in a vacuum. However that may be, the policy maker himself must beware of making decisions in a theoretical vacuum. Absorbed as he must be in day-to-day operations, the policy maker can easily lose perspective. If he fails to relate each new problem to what has gone before and to what may come after, the result will be inferior policy.

Let me take this opportunity to heed my own warning and review contemporary monetary policy broadly in the light of experience in this country with both theory and practice. In so doing, I realize that I may not say anything new. But my purpose is to provide perspective for consideration of more immediate monetary issues, which I shall come to in my second lecture and in the seminar between the two lectures.

Gold Standard Background of Modern Monetary Policy

Our conception of the responsibilities of monetary policy has been continuously evolving and broadening for the last half centruy or so. During the nineteenth century and the early years of the twentieth century, the theory of the gold standard dominated most thinking about monetary affairs. This theory was preoccupied with the rigid stabilization of the international exchanges, rather than with the internal stability of the nations adhering to the gold standard. The domestic money supply of individual nations was thus assumed to be determined automatically by international market forces and the responsibilities of monetary policy were relatively meager.

Under established gold standard rules, monetary or central banking policy was regarded as largely passive. The primary function accorded the monetary authorities was to facilitate the smooth operation of the gold standard mechanism and the rules for action were simple and unambiguous. A net inflow of gold was a signal to ease monetary and credit controls, a net outflow was a signal to tighten controls. Response to both of these signals involved immediate use of the discount rate, the chief instrument of monetary policy. It is a fair generalization that monetary policy under the gold standard was primarily expressed through the discount activities of central banks.

Popular Basis of the Gold Standard System

The popularity of the gold standard system, in theory and in practice, was due to several factors. The impersonal and automatic fashion in which the gold standard mechanism was supposed to operate had an appealing elegance to the nineteenth century mind. It seemed to place the mysteries of money matters in Olympian hands and to protect them from erring mortals. Also, it fitted well into the mechanistic view of organized society which dominated scientific thought in the nineteenth century.

The emphasis placed on the stability of international exchanges attracted support from all those who were especially impressed with the advantages of an expanding volume of international trade. Economists in particular supported the gold standard because they saw in the development of world markets the possibility of greater specialization in the use of resources than would be possible within the limits of a national economy. Active support also came from the commercially minded enterprisers who were so influential in the nineteenth century, particularly in England. This group clearly saw the connection between national and individual prosperity and the unhampered flow of international trade at stable exchange values.

Still another reason for the popularity of the gold standard was a widespread fear of inflation. By the nineteenth century, as you know, the civilized world had had many, many sad experiences with inflation. There was comfort in the idea that fiat money could be avoided by maintaining a constant relationship between the currency unit and a fixed quantity of the scarce metal.

Finally, the wide acceptance of the gold standard theory reflected the assumption of a high degree of flexibility in domestic prices and wages. Whether such flexibility obtained in practice was little questioned. The real fact was that people quite generally thought that prices and wages were flexible and they regarded price and wage flexibility as a good thing.

Changing Role of Monetary Policy

The operation of the gold standard mechanism was not without its hardships. Gold standard countries experiencing a contraction in gold stocks found themselves confronted with deflationary pressures. These harsh effects necessarily put the rules of the game to severe test. After a succession of such tests, it was inevitable that a more flexible concept of monetary policy would emerge. It eventually became the practice of the monetary authorities--that is, the central bankers, who after all had to come into direct contact with the human problems of adjustment--to act in a way that would mitigate some of the harsher effects of the gold flow mechanism.

Little by little, such practices became the rationale of modern central banking. By 1914 when the Federal Reserve System was established, the special contribution of central banking was conceived to be that of preventing undesirable monetary and credit stringency during periods of transient emergency, such as might arise from a temporary drain of gold or from seasonal swings in commerce, industry, and agriculture. As a result, the originally narrow concept of monetary or central banking policy under the gold standard theory had to be broadened to take more account of internal consequences.

After the disruptive effects of World War I, the gold standard never regained the form it had had in the prewar era. In those countries where its suspension had been considered only a wartime measure, its reestablishment was on substantially modified lines. In the new environment, monetary authorities were acknowledged to have even more extensive and flexible responsibilities. As a matter of fact, they were assigned the double role of functioning as an overt buffer against the upsetting consequences of gold flows and as the means of continuously adjusting monetary and credit conditions to the needs of domestic trade and industry. The Federal Reserve Board's Annual Report for 1923 is a classic example of the newer thinking with regard to monetary or central banking policy. At that time, when gold was flowing to the United States, the Board indicated that the increasing gold ratio of the System was not a signal for an automatic easing of Reserve Bank credit. The report stated: "It is its (i.e., the Federal Reserve's) responsibility to regulate the flows of new and additional credit from its reservoirs in accordance with solid indications of the economic needs of trade and industry."

In this climate of thought, stability of the international exchanges as a primary preoccupation of monetary policy became definitely subordinate to domestic economic stability. Accordingly, during the Twenties, major gold movements were interpreted as calling for deliberate measures to counteract rather than to reinforce their effects. And to fulfill the broader responsibilities of monetary policy more effectively, new policy techniques were developed--including, in our country, open-market operations, a more systematic bank supervisory policy, formally issued policy statements for public information, and the publicizing of relevant statistical facts.

With this background of developing ideas about monetary management, it was only to be expected that the great financial collapse of the late Twenties and early Thirties would further change the character of monetar policy. The breakdown of the gold standard internationally, involving widespread depreciation and devaluation of currencies in relation to gold put monetary policy in many countries into direct control over foreign exchange transactions, particularly over capital movements. Subsequent monetary reorganization brought about a position of more positive influence over the activities of banks and other financial institutions.

You are acquainted with developments during this period in our own country. We devalued the dollar and undertook a comprehensive overhaulin of our monetary machinery. Time does not permit a review of these fundamental reorganization measures. I want only to remind you that two new techniques of continuing monetary policy were introduced at that time--authority to vary the level of reserve requirements of member banks and control over the margins required on stock market loans. The reserve requirement authority provided a powerful new method of general monetary policy, while the regulation of margins afforded a selective instrument to influence credit conditions in a particular but important area. The importance of these innovations, as well as of the inclusive reform of ou monetary structure with which they were associated, is that they meant a still more explicit commitment to active monetary policy focused on national economic stability.

During the Thirties, sheer necessity of depressed economic condition and widespread unemployment made reattainment of a satisfactorily high level of business and consumption activity the principal preoccupation of monetary and other public policy. You will recall the upsetting, though not altogether novel, experience we had of reaching a cyclical peak in business activity without approaching full levels of output and employmen You will also recall that previously accepted notions as to the potency o monetary policy, fostered particularly in the Twenties, were seen to be grossly exaggerated. To combat the powerful forces of maladjustment during this period, reliance had to be placed on other measures--notably fiscal policy. Even with the extensive use of other policy measures, large-scale unemployment persisted until the outbreak of World War II.

Postwar Conception of Monetary Policy

The huge demands generated by war soon eliminated unemployment. But the experience of the depressed Thirties had a lasting impact. How to prevent the recurrence of large-scale unemployment was a dominant question in all discussions of postwar policies. From these discussions it became clear that public economic policy would have to assume a great postwar responsibility for the maintenance of continuously high levels of employment. There is no better testimony as to how intense was the concern over this issue than the Employment Act of 1946, which was passed, incidentally, by a conservative Congress.

But the goal of high level employment was not to be pursued at all costs. For example, "full employment" through inflation, was recognized as an undesirable long-run solution. Resort to wasteful, "make-work" projects was considered unacceptable. And, of course, all policy measures were expected to meet the general requirement of consistency with a "free private enterprise" system.

Not high employment alone, but stability at high levels of employment and output, achieved within the framework of a free private enterprise economy, became the emerging conception of the primary purpose of all public economic policy, including monetary or central banking policy. The part which monetary policy was to play in realizing this conception was not entirely clear. But that its responsibility was to be a large one, there can be no doubt.

I want to state at this point that wartime and early postwar thought regarding the future role of monetary policy was not neglectful of the international aspects of the money problem. It was recognized that some mechanism had to be devised as a substitute, internationally, for the former gold standard mechanism. The fruit of this thinking, as you are aware, was the international agreement reached at Bretton Woods providing for the establishment of an International Monetary Fund and an International Bank. It was felt that the first of these co-operative institutions--the Monetary Fund--could adequately assure relative stability of international exchange values, and that the second agency--the Bank--could contribute to the progressive expansion and balanced growth of world trade.

Both of these institutions were projected to function in a peaceful world in which member countries pursued national economic and monetary policies designed to promote high levels of employment and real income and to develop as fully as possible the productivity of their resources. The new agencies were not expected to be final answers to the international monetary problem. On the other hand, there was a conviction that success in the experiment of continuous international consultation and cooperation through these organized channels would give the world a better monetary mechanism internationally than had been provided by any former gold standard system. A stable expansion of international trade, if a favorable environment for such expansion could be established, would progressively strengthen the new international financial institutions and permit them to perform their respective functions with increasing effectiveness.

Such then is the postwar conception of the objectives of policy in the management of money, and, as I have said, the goal of a stable but progressive private enterprise economy puts a very heavy responsibility on monetary management.

Complex Structure of the Money Supply

For monetary policy to do its part, it must provide the economy at all times with a supply of money consistent with the needs of a stable and expanding economy. This is easier said than done, for the term "money supply", at least in our own country, is a highly complex concept. Our particular money supply is not a quantity of readily identifiable and additive items. Rather, it is an amorphous mass.

We have currency money issued by the Treasury and the Federal Reserve Banks. We have the demand deposit money created by the commercial banks. We have a large amount of other liquid assets in the form of time deposits and savings accounts, building and loan shares, and the cash value of readily convertible insurance policies. We have an even larger volume of other liquid assets in the form of Government securities, exchangeable into money at par, by redemption or sale. We have still other assets--e.g., corporate bonds and obligations of State and local governments--that are very high in liquidity, and therefore by nature close to money. Some of our money, moreover, when lodged in the reserves of Federal Reserve Banks and commercial banks, possesses the property of multiplying through loans and investments into still more money. These bank reserves have correctly been called high-pressure dollars.

The significance, from the standpoint of monetary policy, of this complex money structure becomes even greater when we realize that the ultimate concern of monetary policy is not with the money supply itself, but with the flow of money through the economy. The active money flow in the economy bears the impact of changes in the money supply and of the activation or deactivation of existing money stocks. In our complex money system, both of these types of monetary change reflect the independent decisions of many individuals and institutions, as well as the decisions of the monetary authorities.

In vew of this complexity of monetary problems it is not surprising that the total monetary flow will at times reveal a tendency to become excessive, producing the symptoms of a general price rise, or that at other times it will show an opposite tendency, producing price declines and unemployment.

Ideally, monetary policy should completely forestall either tendency and maintain a total monetary flow that is at all times perfectly adjusted to the stability needs of the community. But the limitations on our ability to forecast economic behavior is itself sufficient reason to suppose that such an ideal is impossible of attainment in the near future. At present the most that we can feasibly aim for is to achieve and approximation to this ideal.

Need for Flexibility in Formulating Policies

Such an approximation is by no means an unambitious goal. It inevitably requires all the foresight, knowledge, and judgment that we can muster. One cardinal virtue to be cultivated is flexibility both in thought and in action. No rigid policy, no matter how well thought out in advance, will enable us to cope adequately with the problems of an uncertain future. Nor can monetary authorities expect to avoid mistakes that will require remedial action. Improvisation and reversibility should be inclued in a proper concept of flexibility.

We must not overlook the risks of flexibility in the making of public policy, not the least of which is that flexibility can itself become a source of economic instability. A well functioning private economy requires stability in certain areas of public policy as much as it requires flexibility in others. An important part of wise policy making, as I see it, is to recognize and adhere to the boundaries of each of these areas. The importance of this aspect of policy making is reflected, I think, in the considerable recent popularity of what has been termed built-in, or automatic, flexibility--a concept to which I shall refer again in a few minutes. Essentially, this concept undertakes to compromise the advantages of flexibility and stability in economic policy.

Strategic Factors in the Money Flow

The major changes that do occur in the economy's money flow are heavily dependent on certain strategic forces such as capital formation by private business, consumer expenditures for durable goods and housing, and international trade. To a greater or less degree each of these forces is subject to influence by the monetary authorities through the terms and conditions on which new money is available to borrowers. However, their susceptibility to such influence is qualified by the fact that these forces are in turn heavily dependent on non-monetary factors.

The volume of business capital formation, for instance, is affected by current expectations of future business activity, and investment plans are subject to expansion, modification, postponement, or withdrawal as the economic outlook changes. Demands for consumer durable goods stem from wants that are now deeply imbedded in the American standard of life. The state of international trade is a reflection of world political tensions as well as the product of reciprocal needs among nations for goods and services. In general, policies operating through the cost and availability of money--the major ways in which the monetary authorities can influence developments--are apt to meet with greater success when it is a matter of restraining rather than stimulating monetary expansion.

I might add at this juncture that the complexity of the money flow process is the basic justification for such instruments of monetary policy as margin requirements and consumer instalment credit regulation. By influencing credit conditions in selected areas, these instruments help to keep the use of credit in balance as well as to maintain sound credit conditions in the sectors affected. They thus afford a means of keeping certain strategic non-monetary forces from having an undue influence on the money supply and on the monetary flow through the economy. While they are relatively new techniques of monetary policy, in the brief period they have been available they have had a helpful supplementary effect. The extent to which they may be forerunners of a broader development of selective credit technique cannot be judged at this stage of monetary development. Much more experience than we have had to date will be necessary before the desirability of such a development can be judged.

Timing of Treasury Surpluses and Deficits

The monetary flow through the economy is also affected strategically by Treasury surpluses and deficits. Whether considered within the scope of monetary policy proper or viewed as a separate area of public policy, the fiscal operations of Government play a significant role in monetary affairs. They cannot be ignored in any consideration of contemporary problems.

A current surplus on a cash basis means that the Government's outlays are running less than its income, and it is therefore having a contractive effect on the total money flow in the economy. A current cash deficit means that outlays are running in excess of income, and that the net effect of the Government's fiscal operations is to have an expansive effect on the current monetary flow. Consequently, under a stabilizing economic policy, surpluses should be accumulated whenever there is a tendency for the monetary flow to become excessive, and deficits ought never to arise except when it is desirable to expand the monetary flow.

This principle of fiscal policy is, or ought to be by now, a thoroughly elementary notion. Though I cannot speak with the authority of one who is directly concerned with making fiscal policy, it seems to me that a much more relevant and difficult problem is how to provide for Government surpluses and deficits of the right amount at the right time. In other words, to me, the really crucial problem in developing an adequately stabilizing economic policy is that of providing proper flexibility in Government finance.

Flexible Fiscal Policy

A certain amount of flexibility in Government fiscal policy can be provided on an automatic basis, that is, without requiring deliberate and specific action by either the Congress or the Executive. If the structure of tax rates remains unchanged, revenues will rise as the monetary flow expands, tending to reduce a deficit or increase a surplus. As the monetary flow contracts, revenues will fall, tending to reduce the surplus or create a deficit. With no opposing changes in expenditures, this automatic ebb and flow of revenues will itself exercise a stabilizing influence on the monetary flow. Such stabilizing influence may be supplemented, of course, by equally automatic fluctuation in the volume of outlays made on behalf of such items as unemployment compensation.

A stabilizing fiscal policy achieved through automatic devices is an undeniably appealing approach to the problem, and its potentialities are well worth stressing. But I suspect that its potentialities can never be great enough to preclude entirely the need for specific tax or expenditure adjustments as well. Just what tax or expenditure adjustments ought to be a part of a program of fiscal stability, I am not prepared to discuss in detail. In general, my preference is for relying on the tax rather than the expenditure side of the budget. It is my impression that most expenditure items do not lend themselves readily to rapid expansion or contraction; but such rapid changes would be necessary if expenditure adjustments are to be heavily relied on to promote economic stability. Aside from the problem of workability, I am not sure that we ought to rely on changes in the volume of Government expenditures as a major means for ironing out fluctuations in the economy. For the scope of the Government's direct role in the market place is related primarily to the size and nature of its expenditures on goods and services. I think the scope of this role is one of the elements that, in a free private enterprise economy, ought itself to be kept as stable as possible.

Long-Run "Neutrality" of Fiscal Policy

The problem of stability at high levels of employment, insofar as it depends on fiscal policy, may involve resort to deficit financing, but only on a temporary and not on a permanent basis. A belief in the need for a chronic Government deficit to attain stability reflects, it seems to me, a lack of confidence in the viability of our economy. The long-run fiscal objective of budget neutrality--i.e., of a balanced budget--is, in my outlook, entirely consistent with the achievement of stable and high levels of employment and output.

From the point of view of stabilization needs, our real danger may be that we will lapse into an excessive use of deficit finance. If tension in the international situation persists, no retrenchment from a huge military budget will be possible. At the same time a considerable expansion in the welfare activities of the Government is probable. This combination of a welfare and garrison state means a large and growing volume of Government expenditures, implying in turn an average volume of Government revenues equally large if in the long run we are to maintain a balanced budget. In this situation, the temptation--and the danger--is to slip into a policy of chronic deficit financing. Should we default on our fiscal-monetary obligations in this way, the result may be to create a demand for comprehensive direct controls in order to combat a chronic condition of inflationary pressures.

Management of Surpluses and Deficits

The implications for monetary policy of a stabilizing program of Government finance are not confined alone to the timing of surpluses and deficits. They extend also to the way in which a surplus is disposed of or a deficit is financed. Differences in disposing of a surplus and in financing a deficit will be reflected in different effects on the money supply. Broadly speaking, their significance will depend on such factors as the nature and strength of the demand for investable funds and the reserve position of commercial banks.

To illustrate my point, a surplus might be used to retire debt held by the nonbank public. In this case, the process of accumulating and disposing of a surplus would not in itself result in any reduction in the money supply; it would only shift the ownership of money from taxpayer to security owner. On the other hand, if a surplus is used to reduce debt held by the commercial banks, a portion of the money supply will be extinguished, while the immediately available supply of bank reserves for new money creation will be increased. If a surplus is used to retire Federal Reserve held debt, bank reserves as well as the money supply will thereby be reduced. Clearly, this last disposition of a budget surplus is the one that will make a maximum contribution to a policy of monetary restraint.

A similar type of analysis applies to the financing of a deficit—leading to a similar conclusion, namely, that if the deficit is to make a maximum contribution to monetary expansion it should be financed to the extent that it is feasible to do so through borrownig from the central banks—in our own country the Federal Reserve Banks.

Other Aspects of Government Finance

In addition to the management of budget surpluses and deficits, Government finance affects monetary policy through its management of outstanding public debt. Aspects of debt management, such as methods of refinancing, maturity, distribution, and of course the pattern and level of rates, must all be comprehended in, or related to, modern monetary policy. The principal objective of debt management from the point of view of monetary stability is easy enough to state: during inflationary periods when the monetary flow is excessive, it is desirable to attract investors' funds into public debt holdings and away from private investment expenditures, thereby reducing the active money supply. During deflationary periods, it is desirable to induce an exchange of public debt holdings for cash, thereby increasing the active money supply.

In this area of debt management more than anywhere else in the monetary and fiscal field, it seems to me, we are limited in the development of stabilizing policies by the incompleteness of our knowledge. With a debt of the magnitude of 250 billion dollars, with a stable level of long-term interest rates held long enough to permeate the entire asset and liability structure, and with a tense international situation, we do know that monetary policy must maintain orderly conditions at all times in the Government securities market.

But within this limitation, how much can be done? Are there changes to be made, through refinancing operations, in the maturity and ownership distribution of the debt that would improve it from the point of view of monetary stabilization? During inflationary periods, is some flexibility in the prices of Government securities compatible with maintenance of orderly market conditions? What would be the sure effects of such flexibility? Would these effects compensate for the known advantages of certain confidence in the orderliness and stability of the Government securities market?

Firm answers to questions such as these are prerequisite to development of debt management policies. Yet, even with much more intensive thought than this matter has thus far been given, the answer will be slow in coming. We have, after all, only acquired our present huge public debt within the past decade. We will need to proceed cautiously in building up our experience in improving methods for its management.

Concluding Comment

In the present lecture, I have endeavored to sketch the evolving role of monetary or central banking policy in relation to economic stability. You will see that over the years it has undergone a profound change. If I have read the trend of history correctly, the change has been consistently in the direction of a broader and more flexible role, but with more definite responsibilities toward facilitating the maintenance of high levels of employment, stable values, and a rising standard of living—in short, towards facilitating greater over-all economic stability.

If we agree that this reading of history is a proper one, then we must conclude, I think, that the contemporary role of monetary policy is indeed a matter of crucial importance to all of us. We must also ask ourselves a very basic question: do we know enough about economic behavior and organization to stabilize a progressive private enterprise economy by the application of monetary and other public economic policies?

You are all familiar with the wide range of answers given to this basic question. They extend from a doctrinaire affirmative to an agnostic negative. My own position, as you might deduce, is towards the middle of these extremes. I do not believe that any one possesses the ultimate truth on the question. Nor do I think that we know too little and can never know enough to have a rational basis for action that will advance us along the road of stability. I do believe our knowledge and understanding is great enough so that we can proceed with some confidence of ultimate success. In going forward, we must recognize that monetary policy can carry only its share of the responsibility, that many other public policies—particularly fiscal policy—will have to do their part. We must recognize, too, that if the responsibilities are to be carried effectively, the public agencies charged with carrying them out will need to be adequately equipped with appropriate authority to perform their proper functions.

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THE PROBLEM OF POST-WAR MONETARY POLICY

In my previous lecture I dealt in very broad terms with the subject of contemporary monetary policy in relation to economic stability. Today, I have planned a more specific approach. I propose to discuss the problems of monetary policy as they have developed in the context of our post-war experience to date.

Since the end of the war, monetary policy has had to cope with more or less continuous inflation. Effective demand, until recently, has consistently exceeded the available supply of goods largely because spending from current income has been substantially supplemented by drafts on accumulated liquid savings and by rapid expansion of private credit. This condition of excessive demand has inevitably placed an upward pressure on prices. Advancing prices accompanied by expanding money income, leading to further price increases, is the spiraling process of inflation with which we are now all too familiar. As a result, between mid-1946 when price controls were initially terminated, and August 1948, wholesale prices rose 50 per cent, consumer prices 31 per cent and total personal incomes expanded by 24 per cent.

Basically, our post-war inflation is the product of our wartime financial policies. The war cost around 320 billion dollars. This huge volume of expenditures was financed in part out of our current income, tapped through taxation and sales of securities to the public; and in part through expansion of the money supply brought about by borrowing from the banking system.

Purely from the point of view of monetary stabilization, taxation is, of course, the ideal method by which to finance a war. When taxes are imposed, the spending power of the public is reduced by the amount the Government's is increased, and current expansionary pressures are thereby held to a minimum. Also, and perhaps more significantly for our problems, taxation does not add to the "liquidity" of the economy, since the taxpayer receives in exchange only a tax receipt which he cannot convert into spending power either in the present or the futrre.

Borrowing from the nonbank public shares with taxation the advantage of absorbing current spending power, but has quite opposite liquidity implications. The loss of spending power involved in lending to the Government is not permanent as with taxation, but may be reclaimed by the lenders at a future date. In other words, unlike taxation, issuance of Government securities to the public results in an expansion of the economy's stock of liquid assets.

Borrowing from the banking system is an outright inflationary method of financing war expenditures. It absorbs no current income, but instead produces an immediate expansion of the money supply. Furthermore, as matters have turned out, it leaves the banking system in possession of assets that can, when the opportunity arises, be readily converted into reserve funds to back a multiple expansion of private credit.

It was not reasonable to expect our expenditures for war to be financed entirely through taxation. There are serious obstacles, essentially non-monetary in nature, that place a definite upper limit to the tax burden that can be imposed even in wartime. As the tax burden grows, particularly when it grows rapidly, the interrelated problems of administrative feasibility, equity, and incentives become increasingly difficult to handle. More safeguards against widespread evasion and its generally demoralizing effects have to be devised. Numerous special adjustments are required to maintain a general consistency with the community's standards of fairness, without which no tax system can long survive as an effective instrument of policy. And, finally, a rapid stepping up of the tax bill may, at least in the short run, have adverse effects on effort incentives and thereby interfere with achieving a maximum wartime output.

Just where that upper limit of taxation is, cannot be determined exactly, but it is safe to say that we fell short of it by much too wide a margin. Less than one-half of the funds raised by the Treasury between the middle of 1940 and the end of 1945 came from tax sources.

Further, not only did we rely much too heavily on borrowing, but on borrowing of the most inflationary kind. Of the total amount borrowed by the Treasury from mid-1940 to the end of 1945 more than two-fifths came from the banking system including commercial banks, Federal Reserve Banks and mutual savings banks. Thus, in our war finance we made the twofold mistake of taxing too little and borrowing from the banking system too much.

As a consequence, then, of our wartime financial policies we entered the postwar period with an economy characterized by an excessive degree of liquidity. Government securities held by commercial banks--their highly liquid secondary reserves--grew from 17 billion in June 1940 to 91 billion by December 1945. They constituted the bulk of total bank loans and investments. It is estimated that over the war period the stock of liquid assets--currency, bank deposits, and Government securities--held by individuals and businesses including insurance companies, increased approximately threefold while over the same period the gross national product only about doubled.

This greatly increased ratio of liquid assets to the value of the national product reflected in part a considerable restraint on the part of consumers and business concerns who, for economic as well as patriotic reasons, were willing to accumulate liquid reserves rather than bid for the scarce supply of goods that were available during the war. And, of course, the high "liquidity ratio" that developed over the war reflected the fact that we had gnerally effective direct controls on prices and materials.

Combined with a heavy backlog of unsatisfied real demands, this high degree of liquidity meant that strong inflationary pressures would inevitably develop, particularly if the wartime controls were prematurely removed.

But our wartime policy of heavy reliance on borrowing held yet another implication for the problem of stabilization in the post-war world. Our national debt grew during the war to a peak of 275 billion dollars, a figure of astronomical proportions by prewar standards. Its ownership was widely distributed and its interest pattern had become integrated into the whole asset and liability structure of our economy. Confidence in the market value of the public debt was almost synonymous with a stable financial organization.

Clearly, no realistic conception of the problem of postwar stabilization could afford to ignore these facts about the public debt. Yet to take them into account, enormously complicated the role that monetary policy was called upon to play in our postwar economy. For it meant that no measures could be undertaken to control an expansion of credit and the money supply that were inconsistent with the objective of maintaining an orderly and stable market for government securities at all times.

Now, I do not want at this time to cover again the pros and cons of the support policy that the System has followed since the end of the war. Suffice it to say that as I have understood the arguments set forth by serious critics, they have always seemed to be very uncertain as to just what the consequences of suspending supports would be. And in view of the uncertain effects of such an action and the compensating advangages which confidence in the stability of Government security prices has had, it seems to me that the decision to adhere to the support program has been necessary and wise.

Nevertheless, it is true that for the Reserve System to fulfill the role of residual buyer in the Government securities market placed severe limitations on the usefulness of traditionally powerful techniques for controlling the volume of credit and deposit expansion. As a residual buyer the Federal Reserve System became a source of reserve funds which commercial banks could tap at their own volition by offering Government securities for sale. Banks also received additional reserve funds involuntarily whenever nonbank investors sold securities to the Reserve Banks. And with a fractional reserve banking system, each dollar of reserve funds provides the basis for a manifold expansion of private credit and the money supply.

Moreover, because of the abundant security holdings that the banking system acquired through the processes of war finance, commercial banks no longer had extensive need for borrowing funds from the Federal Reserve Banks. Adjustments of reserve positions could be achieved instead through security sales in the supported market. As a result, except for whatever psychological impact it might have, the rediscount rate lost its effectiveness as an instrument of credit control.

Finally, sales from their holdings of Government securities offered an easy means by which banks could offset in some measure pressure that might be brought to bear on their reserve position through a rise in reserve requirements. In consequence, relatively small changes in reserve requirements could not be relied on to have severely restrictive effect. And while larger variations in requirements could be an effective weapon, they have not been available to the Federal Reserve during most of the post-war period because of practical exhaustion of statutory discretion on the upward side.

Thus, under the circumstances that have existed during most of the period since the close of the war, the traditional instruments available to the Federal Reserve for influencing money and credit developments in this country were either ineffective, inoperative, or near exhaustion. Meanwhile, the volume of credit extended to private borrowers during this period underwent a considerable expansion. From the end of 1945 to the end of 1948, commercial and industrial loans of all insured commercial banks almost doubled, which represented an absolute increase of approximately 9 billion dollars. Agricultrual loans of these banks rose by 1-1/2 billion over the same period, while real estate loans increased by approximately 6 billion. Finally, the increase for the period in the consumer loan category of insured banks amounted to almost 4-1/2 billion dollars.

I do not mean to suggest that our post-war monetary policy has been a failure. There have been significant elements of restraint, without which the situation would have been decidely worse.

The most important factor of restraint in the post-war period has been the Treasury cash surplus. For the calendar years 1946, 1947, and 1948, Treasury receipts from taxes and other sources exceeded cash outlays by a total of about 14 billion dollars. This surplus has exerted a powerfully contractive effect directly on the expenditure-income stream and on the supply of credit and money. Without it the upward pressure on prices would unquestionably have been more severe.

Further, a substantial portion of the surplus has been used to retire debt held by the Reserve Banks. As I pointed out in my first lecture, this disposition of the surplus is the one most consistent with a policy of monetary restraint; for it results in a withdrawal of funds not only from the general income stream, but from the commercial banking system as well, thereby bringing pressure to bear on the reserve position of commercial banks. The Treasury also exerted a similar pressure on bank reserves by drawing down the deposits that had been permitted to accumulate previously in the war loan accounts of commercial banks.

Moreover, the System has vigorously used its relatively modern accessories—control over stock market credit and control over consumer instalment credit. Since the end of hostilities in mid-1945, margin requirements for extensions of credit on listed securities by banks and by brokers and dealers have not been below 75 per cent, and for the year ending January 1947 were at the level of 100 per cent. Bank loans for purchasing and carrying securities other than U. S. Government securities amount to only about a billion dollars today. These loans have not increased since the war--in fact, they have declined slightly while debit balances of customers at their brokers and dealers have also decreased since the end of the war and are today actually less than their credit balances. Credit and monetary expansion in the post-war period has not been due to speculative credit in the stock market.

Regulation of consumer instalment credit, in the periods it has been in force since the war, has also been an influence in restraining the increase in this type of credit. As you know, Congress, in mid-1947, terminated this authority effective November 1, 1947. Subsequently expansion in this credit went forward at a sharply increasing rate. Since September of 1948, when the regulation was reinstated on the basis of authority granted in the special session of Congress, consumer instalment credit has increased only moderately, although prior to that action it had been expanding at a rate of nearly 200 million dollars a month. Only a few days ago, as you know, the Board modified somewhat the September terms of consumer instalment credit.

The System has also used carefully its influence over interest rates. To raise the cost of reserve funds to the banks, and also to encourage banks and non-bank investors to hold on to the short-term Government securities they own and to buy more rather than to unload them on the System, short-term market rates and Federal Reserve discount rates have been permitted to rise. Rates on Treasury bills have risen from 3/8 of 1 per cent in mid-1947 to more than 1 per cent today. Yields on one-year certificates have increased from 7/8 to 1-1/4 per cent, while the Federal Reserve Banks have raised their discount rates from 1 to 1-1/2 per cent.

The System has applied more vigorously than the banking community has desired available statutory authority to regulate member bank reserve requirements. Prior to the legislation enacted in August, increasing member bank reserves was a possible course of action only for the New York and Chicago banks, since for all other classes of banks requirements were at their legal limit. In January, and again in June of last year, the Federal Reserve Board raised by 2 percentage points the reserve requirements on net demand deposits at New York and Chicago banks. On the basis of the temporary authority granted by the Congress in August, the Reserve Board raised reserve requirements by 2 percentage points on demand deposits and 1-1/2 percentage points for time deposits early last fall.

Finally, the System has used its informational resources to urge upon Congress and the public the importance of restraint in credit expansion and of the need for a strong fiscal policy.

The American Bankers Association has cooperated in this program by urging bankers to practice self-restraint in their own as well as in the national interest, and some other lenders have taken a similarly enlightened view of the need for self restraint in lending.

The fact that despite a vigorous application of those powers which could be used under existing circumstances, we nevertheless experienced, considerable post-war inflation has, it seems to me, one very clear implication. There is a basic need for strengthening our monetary powers.

Monetary authorities should have at their disposal at all times adequate means for checking growth of the money supply without endangering the Government's credit. To this purpose the System needs to be given authority to prevent or restrain credit expansion by an increase in reserve requirements of banks. By this authority the System could absorb or immobilize additional reserves acquired from a return flow of currency, from gold inflow, or from sales to the Reserve Banks of Government securities, either by banks or by their depositors. Furthermore, on grounds of fairness as well as on grounds of making the requirements more effective, the authority ought to be extended to all insured banks.

As a supplement to quantitative controls over bank reserve positions, selective-type controls need to be developed further to strengthen the System's influence over monetary and credit developments. Experience with controls over stock market and consumer instalment loans has demonstrated the helpfulness of operating directly on the demand side of the credit market. The Board strongly believes in the continued usefulness of both of these controls for achieving greater economic stability, and has recommended to the Congress enactment of legislation which would replace the present temporary authority to regulate consumer instalment credit with a permanent authority.

The case for continuing regulation of consumer instalment credit merits special comment. Consumer instalment credit is directly associated with the distribution and financing of durable goods. In an advanced and rich economy such as ours, increases in our standard of living come about more and more in terms of ownership and enjoyment of a greater volume of durable goods. These goods, however, usually have a long and variable life of service. They are generally items of high unit value and not many of each are purchased in the average consumer's lifetime. Original purchases and replacements can be postponed for indefinite periods. Even if their purchase were on a strictly cash basis, demand would be unstable with changing conditions of unemployment, income and buying psychology. With unrestrained use of instalment credit financing, instability in the demand for durable goods tends to be accentuated. In periods of business expansion consumers draw heavily on their future income to swell their purchases of these goods. When a downturn sets in, instalment loans are being paid off and the payments reduce further an already inadequate volume of consumer purchasing power. By limiting or relaxing the terms of instalment credit, not to stifle its growth but to spread its growth, much can be done to space our purchases of durable goods more evenly over time. This will add to the stability of the entire economy.

Recently we have had an interruption of the inflationary course. In an increasing number of areas supplies have caught up with, and in numerous lines, exceeded demand at current prices. Indicative of the changed situation are the recent declining prices, the moderate slackening of investment in producers' goods and business inventories, and the increased supplies of goods, many of which were in tight supply a year ago. Average wholesale and consumer prices have been declining from their August peaks. In fact, by mid-February average wholesale prices were slightly lower than a year ago, while consumer prices were probably very close to their levels of February 1948. Prices of farm products in mid-February were 8 per cent and foods 6 per cent below a year ago. Average prices of commodities other than farm products and foods were only 3 per cent above a year ago, and have been virtually unchanged on the average since August, with prices of most commodities in their group other than metals generally either remaining stable or drifting down. Retail sales have recently shown substantial evidence of increasing consumer resistance. When figures become finally available on department store sales for February they will probably show a decline from a year ago despite intensified merchandising efforts.

Though employment has continued at generally very high levels there have been recent declines. Claims for unemployment compensation increased more than seasonally and by mid-February they totaled about 750,000 or 45 per cent higher than a year ago.

Notwithstanding these developments I strongly emphasize the need for making the System's authority adequate to cope with inflation. I certainly hope that there will not be further inflation. My emphasis rather reflects my concern that our System at all times be equipped to cope with whatever monetary problems we may be facing.

The Reserve System today is far better equipped than ever before to help offset deflationary forces should they actually develop. A major deficiency of the banking system that has aggravated business contractions in the past--the inability of the central bank to provide adequate funds when needed by the market--no longer exists. The System has virtually unlimited means of supplying the market with additional reserves through purchase of Government securities. The Reserve Banks at present hold 23 billion dollars of gold certificate reserves, and, on the basis of existing legal gold reserve requirements, the System could more than double its outstanding note and deposit liabilities. Moreover, as a result of the liberalized lending authority provided by the Banking Act of 1935 advances can now be made on any assets of member banks that are acceptable to the Reserve Banks as security. Thus the supply of funds will not be undesirably restricted by the need to adhere to "eligibility" rules. Further, when other lenders are not available, the System empowered to make direct loans to business firms for working capital purposes. Finally, the System can always contribute to monetary ease generally by a reduction in reserve requirements and in special areas through relaxing instalment credit and margin requirements.

My point, then, is that monetary policy must be as adequately forearmed to cope with expansive forces in the economy whenever they occur as it now is to counteract the forces of contraction (always bearing in mind that on the downside our major contribution is to create a monetary climate favorable to business expansion; the forces that generate expansion lie outside the realm of monetary policy alone). Only if the System is forearmed can we have the full advantage of the stabilizing potentialities of action in the monetary sphere--about which I have already indicated my optimism. It is my conviction that monetary policy, along with coordinative action in the fiscal area, can contribute a great deal to curbing the effects of unstabilizing elements in our economic life. However, I want to emphasize again the essential role that timing will always play in determining the success or failure of even the best of available weapons. Not only must we have the power to act, but it is essential that our action be undertaken in the right amount at the right time.

In conclusion, I would like to say that my interest in this general monetary approach to economic stabilization is based not only on my optimism with regard to its results. My interest is also based on the conviction that this is a good approach for a free competitive economy. It calls for no great expansion of the allocative powers of Government over the nations's resources. It calls for no proliferation of Government directives--the mechanism of a regimented economy. Rather, it promises both economic stability--which we somehow have to achieve--and economic freedom--which we dare not give up.

Outline of Remarks before
Convention of Wisconsin Bankers Association
Milwaukee, Wisconsin
June 21, 1949

THE CURRENT ECONOMIC SITUATION

I. Introduction:

A. For over seven years, we have been in a war and postwar boom. Thus, in the fourth quarter of 1948 when the boom was close to its peak

1. Gross national product (reflecting changes in both production and prices) was at an annual rate of 265 billion dollars as compared with 90 billions in the year 1939, an increase of almost 200 per cent.

2. Industrial production (1935-39 = 100) averaged 194, as compared with 109 in 1939.

3. Employment in nonagricultural establishments (seasonally adjusted) averaged 45.5 million persons, as compared with 30.3 million in 1939.

4. Unemployment averaged 1.8 million persons compared with 9.5 million in 1939.

5. Wholesale prices had increased by 112 per cent and consumer prices by 73 per cent from 1939.

B. This boom appears to have come to an end late last year. This evaluation is made on the basis of both -

1. Analysis of the basic factors which caused the boom and which have now largely run their course.

2. The fact that most measures of economic activity and prices have been generally downward since last fall or winter.

a. Thus, gross national product declined to an annual rate of 256 billion dollars in the first quarter of 1949, a decline of 9 billion dollars, or 3 per cent from the record rate of the preceding quarter. This was the first significant decline since the end of the early reconversion period. A further decline of 2 or 3 per cent is estimated for the current quarter.

b. In May industrial production was 12 per cent below its postwar peak of last November.

c. Wholesale prices have declined 8 per cent (in the first week of June) and consumer prices 3 per cent (estimated May) from their peaks of late August.

d. While employment is still at a relatively high level, unemployment has increased substantially, amounting to 3.3 million persons in May.

C. Corporate profits before tax for the first quarter of 1949 are estimated to be at an annual rate more than one-seventh below the postwar record level of the 4th quarter.

D. In the first five months of 1949, bank loans are estimated to have declined about 1.5 billion dollars in contrast to an increase of 1.5 in the same period last year.

E. The basic questions that now confront us are -

1. How severe will the adjustment or recession be?
2. How long will it last?
3. What actions should be taken by (a) private business and (b) Government to improve the situation?

F. We must not overlook the fact, however, that despite recent declines employment, production, prices, and profits are still all high in relation to 1939.

II. The postwar boom was largely the outgrowth of wartime developments and policies.

A. The length of the war and the intensity of our effort created vast postwar demands-

1. For replenishment of inventories.
2. For plant and equipment by industry and farms.
3. For consumer durables and housing.
4. For schools, roads, and other state and local improvements.
5. High incomes contributed to demand for all sorts of commodities and services.

B. The war and postwar developments also provided the financial resources to make these demands effective.

1. Holdings of liquid assets were at record levels and fairly widely distributed--largely as a result of our heavy reliance on borrowing to finance war expenditures.

a. More than half of our wartime expenditures were financed through borrowing. From December 1939 to December 1945 the national debt, other than that held by Federal agencies and trust funds, increased by over 200 billion dollars.

b. From the end of 1939 to the end of 1945, personal holdings of liquid assets (i.e. currency, bank deposits, and Government bonds) more than tripled, increasing from about 50 to over 150 billion dollars.

2. Incomes were high and rising.

3. Profits were high and profit prospects good.

4. Credit was easily available and cheap.

C. At the same time, the highly unsettled international situation, resulted in heavy Federal expenditures both for foreign aid, relief and reconstruction, and defense.

D. Demand generally was in excess of supply currently available.

E. As a result of all of these factors prices rose rapidly.

III. Since late last year, most indicators point to a marked change in the nature of postwar economic activity and prices.

A. Reflecting the changed situation is the fact that a year ago our major immediate concern was with rising prices and measures designed to curb inflation; while currently our major concern is with declines in employment and industrial output.

B. The magnitude of the declines which have already occurred should not be overstated, although many measures of activity and prices--particularly the more sensitive ones--have shown large declines.

C. As pointed out earlier, gross national product declined by 3 per cent in the first quarter of this year and has probably declined further since then. The decline in the first quarter was largely accounted for by a considerable drop in expenditures for personal consumption, a sharp reduction in the rate of inventory accumulation, and declines in expenditures for new private construction and producers' durable equipment.

1. Following a small increase in the fourth quarter of 1948, expenditures for personal consumption declined by almost 4.5 billion dollars (seasonally adjusted annual rate) or 2-1/2 per cent, the first reduction in the postwar period. Expenditures for both durable and nondurable goods declined substantially with expenditures for services showing a small increase. Such expenditures appear to have levelled off since the first quarter.

a. While total retail sales increased about 1 per cent from March to April, they were 2 per cent below a year ago. Sales of automotive stores were 18-1/2 per cent above a year ago, but sales of all other store types (except drug stores) were lower.

b. Department store sales in May were about 5 per cent below a year ago.

2. Nonfarm inventories were accumulated at an annual rate of over 4 billion dollars in the fourth quarter of 1948. In the first quarter of 1949 this rate dropped to about 1.5 billion dollars. On the basis of data through April, it appears that inventories are being liquidated in the current quarter.

3. Expenditures for new private construction showed a decline (at an annual rate) of more than 1 billion dollars or 8 per cent in the first quarter. In April and May, however, such expenditures leveled off, and in terms of contracts awarded which would become expenditures later, increased somewhat.

   a. In the first four months of 1949, the number of new residential units started was almost 13 per cent fewer than a year ago. However, the increase from March to May was greater than a year ago, and the number of new starts in May this year was only 5 per cent below the very high number of a year ago when they amounted to 100,000 units.

   b. Public construction has continued to increase strongly and has maintained the total volume of construction activity above the comparable periods of last year.

   c. Costs of construction and prices of building materials have declined somewhat from their peaks of last year.

D. Noteworthy has been the steady decline in industrial production for the past 7 months. The Board's seasonally adjusted index is estimated at 172 in May, (1935-39 = 100) a decline of 12 per cent from the postwar peak of 195 of last November. A further substantial decline now appears highly probable for June.

1. The declines have been general throughout manufacturing and mining, with output declining in nearly all major industry groups and with output of durables and nondurables each declining 13 and 11 per cent respectively.

   a. Especially large reductions have taken place in textiles, machinery, chemicals, and fuels.

2. Steel production has declined steadily. For the week beginning the 13th of June the scheduled rate was 86.7 per cent of capacity compared with the actual March rate of almost 103 per cent.

3. Output of passenger automobiles, however, has been maintained at very high levels, except for the Ford strike.

E. The postwar expansion of employment came to a halt in the fall of 1948. Since then, the demand for labor has declined while unemployment and part-time employment have increased.

1. Unemployment was 3.3 million in May compared to 1.6 million in October and 1.8 million a year ago. A further increase is expected in June as new workers enter the labor force from schools and as industrial employment declines further.

2. Seasonally adjusted employment in nonagricultural establishments in May 1949 was 1.9 million less than in October and about 1 million less than a year ago.

a. Although declines in employment since last October have been general, the largest relative reductions have been concentrated in manufacturing, transportation, and communication. Average hours of work have also declined sharply in manufacturing from 40.0 in October to 38.3 in April.

b. Total seasonally adjusted man-hours worked in manufacturing in April 1949 were 11 per cent fewer than in October 1948 and declined further in May.

3. Weakening in the labor market has been reflected in wages.

a. Average hourly earnings in manufacturing have declined slightly below the December peak.

b. Weekly wages in manufacturing have been reduced owing to the reduction in average hours of work and in April were $52.62 or $2.39 below the end of 1948.

c. Total wage and salary receipts declined 5 billion dollars from their peak in November 1948 to April 1949, when they were at an annual rate of 133 billion dollars, and were reduced further in May, probably by an additional 1 or 1-1/2 billion.

F. Personal income had declined by 7 billion dollars, or over 3 per cent, from its peak in December 1948 to April this year when it reached 214 billion dollars. It is estimated to decline further in May, probably by about 2 billion dollars.

G. After reaching their postwar peaks in August of last year prices of all commodities at wholesale have declined 8 per cent, and consumers' prices 3 per cent.

1. Significantly, prices of all commodities other than farm products and foods have been declining steadily in recent months and for the week of June 7 were 5.5 per cent below their highs of mid-November last year and almost 3 per cent below a year ago. These price declines have been widespread.

2. Prices have weakened in the metals markets this year. Since December metal scrap prices have dropped about 50 per cent. Prices for copper, lead, and zinc have fallen sharply, and some reductions have been made in prices of some iron and steel products.

3. Prices of basic commodities have declined more than 27 per cent from August to the middle of June.

IV. The economic developments described above seem to indicate that the postwar expansive forces have finally lost much of their vigor. Three years of high-level industrial production and more than ample harvests have converted shortages to surpluses at prevailing prices.

A. Inventories have been adequately built up at all stages of production and distribution for practically all commodities. In fact, inventories are currently being reduced as pointed out above.

B. Backlog consumer demands for durables have been satisfied, except possibly for autos.

C. The expansion program of industry for plant and equipment are nearing completion in many cases. Thus, the Commerce-SEC Survey estimates that planned expenditures on new plant and equipment this year will be about 5 per cent below those of 1948. More serious in its implications than this rather moderate reduction in the total for the year is the expectation that expenditures in the second half of this year will be 14 per cent below the second half of 1948. For manufacturing industries the decline in the second half of 1949 is estimated at 22 per cent. On the other hand planned expenditures for electric and gas utilities show increases over a year ago.

D. Demands from abroad are also less urgent than earlier, as the process of reconstruction makes headway.

E. Government--Federal and state and local--is likely to increase its expenditures on goods and services for the remainder of this year but such increase will be less than last year when private demand was more urgent than currently. Furthermore, the personal income tax reduction of last year resulted in a sharp increase in consumer income available for personal spending. This will presumably not be repeated this year.

V. While it is clear from the recent record of major business indicators that we are in a period of downward readjustment of employment, activity, and prices, it should be stressed that the deflationary process has thus far been an orderly one.

A. I shall not attempt to predict the detailed course of activity for the period ahead. We must remember, however, that ours is a cyclical economy and that there has been much variation in the intensity and duration of the downswings. In 1924 the downward adjustment was moderate and short. In 1920-21 and 1937-38 industrial production declined by one-third in a short period. From 1929 to 1932, liquidation was prolonged and drastic.

B. In appraising the prospects, however, we must take into account the many supporting factors which are present and which should moderate the speed and limit the depth of any cumulative adjustment. Among these are the following:

1. Unemployment compensation benefits which partially maintain the income and expenditures of the unemployed. On the average, those covered by such benefits receive about $20 a week for a maximum of about 6 months.

2. Payments under the farm support programs are maintaining incomes and reducing the dangers of unlimited price declines.

3. Continued large and widely-distributed holdings of liquid assets--Government bonds, savings and checking accounts. It should be pointed out, however, that the Board's recently computed Survey of Consumer Finances indicates that the proportion of units with no liquid assets has risen from 24 per cent in 1946 to 29 per cent this year.

4. While a reduction in personal incomes and housing prices may make a part of our large mortgage debt vulnerable from the standpoint of the borrower, widespread use of mortgage amortization and of Government guarantees provides the lender with important protections.

5. The fact that the postwar period has generally been free of speculative excesses in the securities markets, the strong financial status of industry, and the great strength of the banking system are factors that make a prolonged and drastic liquidation less likely than in other periods of decline.

6. The current reduction of inventories has resulted in production lower than consumption in some lines and the basis is being laid for renewed buying and increased production. In this connection, the Board's annual Survey of Consumer Finances shows that demand for automobiles, appliances, furniture and houses continues to be large.

7. Government expenditures are high and likely to increase further. It is likely that budget expenditures in fiscal 1950 will amount to about 44 billion dollars.

8. The expected payment of over 2 billion dollars of dividends on National Service Life Insurance in the first half of next year may prove an important expansive factor.

VI. While the cushions mentioned before will be of great help in limiting declines in activity, they do not assure high levels of output and unemployment. Both the private sector of the economy and government must adopt appropriate policies to attain this.

A. An excessive concern with security and liquidity may well prove self-defeating. We must not forget that a major factor in the adequate working of the free enterprise system is the willingness--even the eagerness--of businessmen to assume risks.

B. A bold approach should be taken towards reducing costs and prices. Prompt and realistic price reductions--even if they require reduced profit margins--would help maintain sales and thereby both incomes and employment.

C. Banks and other financial institutions should continue to make available an ample supply of credit at relatively low cost and without strong pressure on borrowers for repayment.

D. Government policy should be directed towards encouraging business and consumer spending. In part, this may be accomplished by expanding Government expenditures and by appropriate tax policies, such as reductions in excise taxes. Declines in economic activity are likely to result in a Federal cash deficit for fiscal 1950. We must be realistic enough about such a prospect to realize that drastically cutting expenditures or raising taxes in an effort to prevent a deficit would be partly self defeating since they would probably result in still lower levels of activity, employment, and income, further increases in unemployment compensation and relief payments, and further reductions in tax receipts.

Lecture at
School of Banking, University of Wisconsin
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THE FUNCTION OF BANK RESERVES

The term "bank reserves" is one that may have several meanings. It may be used to refer to the total amount of reserves which qualify for meeting legal requirements of commercial banks or it may be used to include quick assets that banks hold as secondary reserves. Both commercial banks and the Federal Reserve Banks hold reserves but these are quite different in form. In our discussion today, when I refer to bank reserves I shall in general be referring to the reserves that member banks hold on deposit with the Federal Reserve Banks, of which a part are legally required reserves and a part may be excess reserves. Nonmember bank reserves take several forms in accordance with various state laws, but the bulk of them are held in vault cash and on deposit with correspondent banks. Reserves of the Federal Reserve Banks consist of gold certificates held in their vaults.

For more than a century, it has been an accepted feature of the nation's banking system that commercial banks should be required to hold a certain fraction of their deposit or note liabilities in reserves. As our monetary and banking institutions have developed, however, our conception of the primary function of legal reserves of banks has undergone significant change. Originally the principal purpose of legally required reserves was to assure the ability of individual banks to meet liabilities on demand during a period of strain. That is to say, it was to provide for the convertibility of bank notes and bank deposits into cash. With the establishment of the Federal Reserve System, the role of bank required reserves was greatly modified, and today they serve mainly to set a limit on the total volume of bank credit and the money supply.

Reserve requirements against circulating bank notes became a part of American banking law a century ago, and requirements against bank deposits were introduced by the National Bank Act in 1863 and by two States even earlier. At first each bank's reserves comprised the specie in its own vaults. Later these reserves came to include funds which a bank might have on deposit with another bank in a financial center.

In the course of time it became evident that reserves alone were not an adequate protection to banks and their depositors. The reserves which a bank was legally required to maintain were not reserves which the bank could pay out. In other words, required reserves did not assure the ability of a bank to honor its obligations on demand. Moreover, since part of these reserves was held on deposit with correspondent banks, their recall for meeting the demands of local depositors only transferred to the correspondent banks the problem of raising cash to liquidate banking system liabilities. In fact, in deposit withdrawal emergencies, outlying banks tended to rely on borrowing from their correspondent banks with whom they maintained deposits. But these banks could use only their excess reserves for such lending, and the scattered excess reserves of the entire banking system were inadequate when a large number of banks were facing unusually heavy depositor withdrawals.

Gradually it became more clearly understood that the ultimate safety of bank deposits depended much more upon the availability of a reservoir of reserve funds, to be drawn upon in case of need, than upon legal reserves. That is, what was needed was an institution to provide additional money and reserves in emergencies; and, more important, to provide additional means of payment, under appropriate regulatory safeguards in accordance with the growth of agriculture, industry and commerce.

The Federal Reserve System was established primarily to meet these needs. The Reserve authorities were empowered to issue money. They were also empowered to lend to member banks or to buy United States Government securities or certain kinds of commercial paper in the open market, a process that creates member bank reserves in the form of member bank deposits at the Reserve Banks. It was provided that member banks could not legally reduce their reserves below the statutory minimum and since excess reserves do not produce income, it was expected that member banks would not ordinarily keep excess reserves. The Federal Reserve System, through its discount and open market instruments, was given authority to exercise a regulatory influence over the volume of deposits which member bank lending and investing activities could create.

These facts gave bank reserves and reserve requirements a new significance. Instead of serving largely as an individual bank's main guaranty of readiness to honor its obligations, they became the means by which the central banking authorities exert a restrictive or expansionary influence, as public economic interest directs, on the ability of banks to extend credit and expand deposits.

Relationship of reserve requirements to the volume of deposits:

The two factors I have just mentioned--the volume of bank reserves and legal reserve requirements--serve as a team to set a limit to the total volume of deposits at any time. I shall have more to say later about the volume of bank reserves. First, I should like to examine with you, as I have before, the present-day role and significance of bank reserve requirements--that is, the percentages of demand and time deposits that banks are required to hold as reserves.

At existing levels of reserve requirements, one dollar of reserves will support over 6 dollars of bank deposits. Stated in another way, a given addition to bank reserves makes possible about a six-fold increase in bank deposits. A contraction in reserves of a given amount tends to produce a six-fold contraction of deposits.

The basic principle underlying this possible expansion and contraction is that bank deposits have their principal source in bank lending and investing. If there were only one bank in the country and if we can assume that people hold their money in the form of bank deposits, the bank could expand its deposits indefinitely by making loans to its customers and crediting the proceeds of the loans to its customer checking accounts. Being the only bank, it would not need to fear loss of deposits to other banks. Those who receive checks drawn on the bank would deposit them at the bank, the effect would be merely a transfer of deposit ownership on the books. The only limitation on the expansion in deposits would arise out of the amount of reserves in proportion to its deposits which the bank maintained, either because of its own rules or because of legal reserve requirements. At the present time member bank reserve requirements average about 15 per cent of total deposits. Fifteen per cent reserves permit deposits to expand about six and two-third times. Thus, if there were but one large commercial bank serving the entire country and holding all the deposits of the people, its deposits could expand to $666 for each additional $100 of reserves.

But we have not one bank but approximately 14,000 commercial banks. Therefore, in the actual competitive situation that exists no bank can expand its deposits by making by itself new loans and investments of six times the amount of any newly acquired reserves. It can not do so because bank customers do not borrow with the expectation of leaving the borrowed funds on deposit; they borrow in order to spend, and the funds they borrow are more apt to be checked out to another bank than to remain with the bank which lent them. Consider an illustration of how credit and deposit expansion tends to occur, using an average reserve requirement for all banks of 15 per cent. When a bank receives a deposit of $100, it must put aside $15 as a reserve against the deposit and it can lend $85. When it has done this it has both the $100 deposit and the $85 deposit put to the account of the borrower. But this $85 will probably be transferred by a payment to a depositor of a second bank. The second bank receiving the $85 deposit must increase its reserves by 15 per cent of the deposit; that is $12.75. It then has $72.25 left which it can lend and which will probably find its way through a payment to a third bank.

This process may continue through a succession of banks, assuming a demand for bank credit, until taking all the banks together a result is reached which is the same as would be reached if there were only one bank. That is, all banks taken together constitute a system comparable to a single bank performing all the banking business. Deposits may shift from bank to bank but, as a general thing, they do not leave the banking system. So, the process of lending and moving funds from bank to bank with resulting increases in deposits and in required reserves can continue through a succession of banks until the total of the new deposits, counting the original deposit of $100 at the first bank and the deposits created through the successive loans and investments, will amount to $666. The reserves set aside by the banks involved will total $100, which is the 15 per cent required against the aggregate deposit of $666.

From this illustration we may draw two important generalizations. First, the lower the percentage reserve requirements of banks are, the greater the volume of credit and deposit expansion a given volume of additional reserves will support and the greater the volume of credit and deposit contraction a given loss of reserves will tend to require. Second, with our system of 14,000 independent banks, legal reserve requirements at some level are an essential element in the mechanism through which the total volume of bank credit and deposits may be brought under some over-all control.

Reserve requirements of the Federal Reserve Banks:

I believe it is helpful for a fuller understanding of the modern role of commercial bank reserves to contrast the significance of commercial bank reserve requirements and the requirements in gold certificate reserves applicable to the Federal Reserve Banks. It needs to be recognized that as far as reserve requirements are concerned, as in other respects, there are important differences between commercial banks and Federal Reserve Banks. As we have seen, the principal present-day function of commercial bank reserves is as a mechanism through which the total amount of money in the country may be influenced. What is the purpose or role of the reserve requirements imposed by law on the Federal Reserve Banks?

The reserve of 25 per cent against deposit and note liabilities that the Federal Reserve Banks are required to hold in gold certificates has importance in connection with two major kinds of functions performed by the Federal Reserve System. Such reserve requirements could, in a period of vast credit expansion, restrain the System from expanding Reserve Bank credit beyond a certain point. This would then tend to put an automatic limit, although sometimes a high one, on the total monetary and credit expansion that could take place. The System, however, does not expand its credit irresponsibly; substantial increases in Reserve Bank credit have been made only to meet national emergencies of depression and war. Moreover, if the System were disposed to act in an irresponsible way to expand credit in a period of inflation, it has now more than enough leeway of excess reserves to cause very serious damage before its reserve limits would even begin to be effective.

While the limit on the expansion of Federal Reserve credit which is set by the gold reserve requirement is not an effective or necessary device for curbing monetary expansion, it may at some stage hinder the Federal Reserve in meeting a financial emergency. The System is the agency responsible for assuring the convertibility of bank deposits (and today perhaps I should also add Savings Bonds) into currency, should anything cause the people to want to hold currency rather than bank deposits or these other liquid assets. The System also is responsible for providing needed elasticity in the supply of available bank reserves. The reserve requirements on the Reserve Banks serve to limit their capacity to perform these functions. It seems to me that under the kind of a monetary and banking system we now have, there is no reason for any mechanical limitation on the capacity of the Federal Reserve to insure the convertibility of bank deposits into currency or to extend needed credit to member banks.

Federal Reserve influence over the volume of bank reserves:

As I pointed out earlier, two factors limit the volume of deposits that banks may create and hold: the volume of bank reserves, and the reserve requirements of banks. When the volume of bank reserves increases, banks as a group may expand their deposits by a multiple amount; conversely, a loss of reserves tends to induce a multiple contraction of deposits. Thus if the Federal Reserve can influence the volume of bank reserves it can restrain or promote the expansion of bank deposits and help to bring about their proper adjustment to the needs of the economy.

There are three principal instruments which the Federal Reserve System may employ to alter the volume of bank reserves. One means of control has been through changes in Reserve Bank rediscount rates. When a member bank has lent or invested all of its available funds, it may obtain additional reserves by rediscounting or borrowing at its Federal Reserve Bank. Although when a member bank applies for such accommodation the Reserve Bank is under no obligation to grant credit, a member bank with satisfactory collateral can usually obtain it. Federal Reserve policy of encouraging or discouraging borrowing by member banks is expressed principally not in the granting or refusing of loans but in the rate charged for rediscounts and advances. When the Federal Reserve believes that it is in the public interest to encourage credit expansion, it traditionally sets its rediscount rate low in relation to prevailing market rates. When it wishes to discourage credit expansion, it raises the rediscount rate.

Banks, and the entire money market as well, also have access to Reserve Bank credit through Federal Reserve buying of bills. These may be either Treasury bills or bankers' acceptances, but the latter while of great importance in the 'twenties are not widely used today. The influence of the System over the extent of such access to Reserve Bank credit is traditionally made effective by raising or lowering interest yields or rates at which the Federal Reserve will purchase these market instruments. Relatively low Federal Reserve buying rates encourage the money market to sell these to the System; high rates discourage such sales. The bill avenue has been traditionally the cheapest way to Federal Reserve credit, and today the Treasury bill is playing an important role in the adjustments in reserve positions made by banks, particularly the money market banks. Recent actions taken by the System to increase the flexibility of market interest rates to adjust to changing credit situations may tend to give the bill instrument an even more pivotal role in the credit mechanism.

With both the rediscount instrument and the bill buying mechanism the Federal Reserve operates essentially passively to influence the volume of bank reserves. That is, having set for the time its rediscount and bill buying rates, the System traditionally awaits the action of banks and the money market in general to seek out Federal Reserve credit. The Federal Reserve has an active instrument of control over the volume of bank reserves in its open market policy. That is, it can enter the market at its own initiative to sell Government securities to contract Reserve Bank credit and to buy Government securities to expand that credit. Bank reserves may thus be contracted or expanded by the System as it seems in the public interest to do so.

<u>Federal Reserve authority to change member bank reserve requirements</u>:

As you know, the Board of Governors has the power to vary the reserve requirements of member banks. The basic requirements established by law against demand deposits are 13, 10, and 7 per cent for central reserve city, reserve city, and country banks, respectively. These may be raised by the Board to a maximum of 26, 20, and 14 per cent, respectively. Reserve requirements on time deposits at all member banks may range from 3 per cent to 6 per cent. In August, last year, Congress, as an anti-inflation measure, gave the Board temporary authority to impose additional reserve requirements on member banks up to 4 per cent on demand deposits and 1-1/2 per cent on time deposits. Under this authority, which expired at the end of June, the Board raised reserve requirements last September, and lowered them in May and June.

The instrument of changes in reserve requirements is not one that is well adapted to frequent use for influencing the total volume of bank credit and bank deposits. It is instead a measure to be used from time to time as needed for contracting or expanding the liquidity position of the banking system and for bringing the other credit control instruments of the Federal Reserve into broad contact with the credit situation. In the period of financial reconversion from war through which we have now largely passed, however, changes in bank reserve requirements assumed exceptional importance as an instrument for credit and inflation control. This was the case because the System's other instruments for influencing the total volume of money and credit were severely limited in use by special circumstances arising out of the financing of the war and the absence of real peace after the war. Recent developments, which I shall discuss shortly, indicate that perhaps greater emphasis may now safely be placed on other monetary instruments and that the instrument of changes in reserve requirements may play a more balanced role in the future.

Recent Federal Reserve Credit Action:

A year ago, when I discussed the subject of bank reserves at a seminar session of this School of Banking, circumstances were such that these Federal Reserve instruments for affecting the volume of bank reserves were very severely limited in their usefulness. At that time, with financial transition to peace-time conditions only partially accomplished and with the international situation as it was, stability in the Government securities market was an overriding consideration. Open market operations, therefore, were not then usable for the purpose of affecting aggressively the volume of bank reserves. For exercising some measure of restraint on monetary expansion over the period of postwar inflation, monetary authorities were obliged to rely on use of the then substantial Treasury cash surplus, on a modest rise in short-term rates, and on increases in reserve requirements.

By the end of last June circumstances were such that the Federal Open Market Committee was able to announce a change in policy which should help to restore the effectiveness of certain traditional instruments for influencing the volume of bank reserves. Purchases, sales, and exchanges of Government securities are now made with primary regard to the general business and credit situation. The policy of maintenance of a relatively fixed pattern of rates has been discontinued, although it will continue to be the System's policy to maintain orderly conditions in the Government security market, and the confidence of investors in Government bonds.

About the time the change in open market policy was announced, excess reserves of member banks were expanded approximately 800 million dollars by the expiration of the special reserve requirement authority that Congress granted to the Board a year ago. These free funds, seeking investment, pressed down the market yields on all Government securities, but particularly short-term interest rates. After the short-term yields had declined about 1/4 of 1 per cent it became clear that these rates were under such pressure that further precipitous declines were likely, and the System made short-term Government securities, largely bills, available from its portfolio in order to avoid a disorderly market situation.

In early August the Board announced further reductions in reserve requirements, and over August and early September these reductions are making available to member banks an additional 1,800 million dollars of excess reserves. Short-term Government securities, again primarily bills, are being supplied in the market from the System portfolio so that banks may find at least temporary investment for these funds without pressing down short-term yields to an undue extent.

Generally speaking, the Board's reserve requirement actions coupled with the change in open market policy of the System have had two major effects that should help to promote the availability of bank credit at this time. Member bank liquidity positions--that is, their holdings of cash, excess reserves, and short-term Government securities--have been expanded by about 2,600 million dollars. At the same time the yields on short-term Government securities are down considerably from what they were in the early summer, and accordingly the attractiveness of these investments is much reduced as compared with say a loan to a business concern or to a farmer. I should also mention the fact that the Reserve System is no longer freely selling Government bonds to keep their yields from declining. With the adoption of this policy by the System, pressure of market forces brought about a decline in yields on medium, and long-term Government securities, with an accompanying tendency for investors to seek corporate and municipal securities as outlets for the funds they have available for investment. I believe that these credit actions by the Federal Reserve have had some influence in making the current economic situation somewhat more favorable than in general it promised to be a few months ago.

<u>How should the burden of holding reserves be distributed among banks?</u>

In order to keep the volume of money in the country at a level which is appropriate to economic conditions, we have seen that under our banking system it is essential that banks be required to hold reserves, and that the Federal Reserve be able to influence the volume of reserves available to banks. At any given time, there is an appropriate volume of total reserves that banks as a group need to hold to promote monetary stability. But bank reserves are immobilized assets that cannot be loaned or invested to earn an income. The required reserves which an individual bank holds represent, therefore, a contribution which the bank makes to effective national monetary policy. The basis or principle for allocating the total burden of holding required reserves as among different banks thus becomes extremely important.

The Federal Reserve System has studied the problem of allocating the reserve burden among banks for a long time. As you all doubtless know, the existing statutory basis for member bank reserve requirements dates back to the establishment of the National Banking System over 85 years ago. The requirements are related to the geographic location of the bank. That is, a bank's classification for reserve requirement purposes depends on whether it is located in a central reserve city or in a reserve city, or whether it is outside of these cities--a so-called country bank. A member bank located for example in a reserve city must under this scheme hold reserves at the higher percentages designated for such a center whether or not it is doing a reserve banking type of business. Another member bank doing a reserve banking business but located outside the reserve city areas need hold only country bank reserve requirements. From time to time the Federal Reserve has been able to relieve some banks in reserve cities of a discriminatory reserve burden through its limited discretionary authority relating to outlying areas of reserve cities. But many cases of inequity cannot be solved in this way and a basic problem of equity of reserve requirement treatment as among member banks still remains.

There is also a fundamental problem of equity as between member and nonmember banks, where the differences in treatment are frequently very, very wide. Certainly from the standpoint of the reserves it must hold, the average nonmember bank is now making a disproportionately small contribution to monetary stability. The nonmember bank not only is subject generally to much lower reserve requirements, but it is also permitted to hold its reserves at correspondent city banks where they serve a double purpose--both as legal reserves and as a needed correspondent balance. A member bank holds both a reserve balance in its Reserve Bank and balances with its correspondents. Further, the actual contribution to monetary control of a reserve balance held with a correspondent bank is only equal to that fraction of the balance which the correspondent bank is in turn obliged to hold with its Reserve Bank, since the correspondent bank is free to, and usually does, invest or lend the remainder. In some states, moreover, nonmember banks are permitted to invest a portion of their reserves in interest bearing public securities. Discriminatory treatment in favor of nonmember banks as far as reserve requirements are concerned tends to weaken the ability of the Federal Reserve to promote proper adjustment of the volume of money to the needs of the economy. The large difference in the requirements tends to discourage banks from joining the System, and could result in weakening the System by encouraging banks to withdraw from membership. It is difficult to see the justification for discrimination of this kind.

Uniform Reserve Plan:

As I said a year ago at this School of Banking, a staff committee of the Federal Reserve System has developed a plan for rationalizing existing practices for distributing the reserve requirement burden among banks. They have called the plan the Uniform Reserve Requirement plan, and at the request of the Joint Committee on Economic Report of Congress they presented to that Committee the results of their study. The suggestions of the Federal Reserve staff group are in the discussion stage and have no official status in the System. I find the ideas in the plan very interesting, however, and I should like to tell you something about them. The plan deals only with member bank reserve requirements, but if it is adopted it could be, and I believe certainly should be, extended with appropriate modifications to cover all commercial banks.

The Uniform Reserve Requirement plan consists of five basic points. These have been described by the chairman of the staff committee that developed the plan as follows:

First, the plan would abolish central reserve city and reserve city designations of banks. In other words, the geographical basis for the assessment of reserve requirements would be dropped as too inequitable as among banks which are doing various kinds of commercial banking business.

The second point of the plan is that, for purposes of reserve requirements, deposits would be classified into interbank deposits, other demand deposits, and time deposits. Many a theoretical hair has been split in disputes over the classification of deposits. The compelling practical objection to treating all deposits alike is that, depending on the level set, starting such a system would create enormous excess reserves in central reserve city banks, enormous deficiencies in non-reserve city banks, or both. The compelling practical objection to a full system of deposit classification is that it would be impossible to administer, since any classification of deposits is somewhat arbitrary. Advantages given for the proposed classification are that, by and large, the three classes of deposits are used for different purposes, are readily identifiable, have traditionally been treated differently, and differential treatment would minimize initial disturbances while yet retaining effective over-all control. The staff committee recommended that initial requirements be established at 30 per cent against all interbank deposits, 20 per cent against other demand deposits, and 6 per cent against time deposits, which would have left the total volume of required reserves at about the level existing at the time. (Slightly lower requirements would be appropriate of course should the plan be adopted now.)

The third point of the plan is that the Federal Reserve should be given authority to change the requirements within limits established in the law. We have already discussed the use of changes in reserve requirements from time to time in order to help prevent injurious credit expansion or contraction. This is a modern instrument of central banking policy which is discussed with approval in virtually every textbook on money and banking.

As a fourth point, banks would be allowed to count vault cash as part of their legal reserve. The role of vault cash in the banking system has changed fundamentally in the past half century. Before the Federal Reserve System was established, vault cash was the ultimate reserve of the banking system, since it alone was available to meet cash withdrawals. The Federal Reserve Banks, however, are authorized to create additional reserves or cash when needed. The use of vault cash as reserves would not impair the System's influence over the volume of bank credit, provided initial requirements are established at appropriate levels to offset the change. From the point of view of credit control, there need be no concern as to the form of Federal Reserve Bank liability--whether it be Federal Reserve notes or reserve deposits--that a member bank prefers to hold as reserves. The transition to the new system of reserve requirements would be facilitated by permitting banks to count vault cash as legal reserves. Establishment of the suggested uniform requirement against other demand deposits would increase required reserves of country banks. Since, however, such banks hold relatively larger amounts of vault cash the increase in their total requirements would be offset in part by permitting them to count vault cash as legal reserves.

The fifth and last point is to permit a bank to count as reserves that portion of its balances held at other banks which those banks, in turn, are required to hold as reserves against such balances. The relationship between correspondent balances and reserves is a problem with a long history. After many discussions the staff concluded that correspondent balances ought to be related to reserves in such a way that (a) a shift of funds by member banks into or out of "due from banks" would not affect the total volume of excess reserves in the system as a whole; (b) "reserve credit" would be allowed for precisely the portion of "due from banks" that is on deposit with Federal Reserve Banks (by way of the reserve requirement imposed on deposits due to banks); and (c) correspondent bank relationships and interbank balances would be recognized as an established part of our banking system. The fifth point is designed to accomplish this result. So long as the rate at which the "country" bank or the reserve city bank is allowed reserve credit for its "due from" balances is equal to the rate at which depositary banks are required to maintain reserves on interbank deposits, a given reserve will support the same volume of nonbank deposits irrespective of whether the owner-bank keeps all of its reserve with its Federal Reserve Bank, or keeps a portion of it on deposit with a correspondent and therefore indirectly with a Federal Reserve Bank. In either case, only vault cash and balances which are directly or indirectly on deposit with Federal Reserve Banks would constitute legal reserves.

The analysis of the Uniform Reserve Plan may be summarized as follows:

Reserve requirements are an essential feature of the mechanism by which the volume of money and credit is adjusted to the needs of the economy but the present system of reserve requirements is frequently inequitable; required reserves of many banks are higher or lower than those of other banks doing a similar business simply because of the classification of the communities in which they are located. The uniform system of reserve requirements would require all member banks, or preferably all commercial banks, regardless of location, to maintain the same percentages of reserves against each of the three major classes of deposits--interbank deposits, other demand deposits, and time deposits. Banks whose business requires the holding of disproportionately large amounts of vault cash would no longer be penalized by being required to maintain the same reserves in Federal Reserve Banks as other banks doing a similar type and volume of business but whose cash requirements were less. Changes in the total volume of interbank deposits would no longer affect the volume of other deposits of member banks that could be supported by a given volume of reserves. City banks would have to maintain larger reserves than now against balances due to country correspondents, but the latter would be given corresponding credits for such balances against their required reserves. The uniform system would increase the required reserves for some banks and lower them for others, but the changes would be reasonable and in the direction of greater equity.

Speech delivered before
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MONETARY MANAGEMENT ABROAD AND AT HOME

There are many different attitudes toward the role and importance of what is called monetary management. If we assume that money leads the way in economic development, then the administration of money is about the most important task of government. On the other hand, if we assume that money follows rather than leads in economic change, then the function of monetary management is to keep money in its proper and subordinate place. If we assume that the function of money in the economy lies somewhere between these two extremes--probably the more correct view to take--then the monetary policy is one of several important factors that influence the course of economic development and the degree of stability which characterizes such development.

Monetary Postwar Problems

There is general agreement today, I believe, that monetary management is essential to economic stability. And for good reason. We have recently passed through an extended and disruptive period of world-wide war. Like all major wars in history, the second world war was partly financed by the creation of money--in short by inflation. Since the war, all the major participants have been seeking to adjust their economies to swollen money supplies. They know from hard experience that stable progress is impossible when economic activity is driven and distorted by inflationary pressures.

Attainment of postwar financial stability has been difficult enough in the United States. But our wartime monetary expansion, although dramatic, was moderate in comparison with that of the war ravaged countries of Europe. Also, our productive capacity was not subject to wartime destruction and our output is now greater than it was before the war. Consequently, we in the United States were subjected to neither unduly repressive postwar measures, like price controls or rationing, nor excessive open price and wage inflation. The problem of dealing with monetary expansion becomes extremely difficult only when accompanied by a sharp drop in the available supply of commodities, such as occurred in most countries of Europe and the Far East.

After the first world war, in most countries of Europe, monetary management had been confronted with a similar situation. It took more than half a decade to restore some kind of monetary stability in the most important countries of Continental Europe. That stability was reached only after a number of nations, and especially Germany, had experienced uncontrolled hyper-inflation that reduced the value of money almost to zero. By comparison with the events following the first world war, the results of monetary management following the second world war have been very good indeed. This time, inflation was curbed in most countries within three years after the end of hostilities, and there are reasons for believing that postwar inflation has been curbed for good.

Monetary Stabilization in Western Germany

The most noteworthy example of success in monetary stabilization is that afforded by Western Germany. In that country wartime government expenditure had expanded the supply of money to about ten times the amount that would have been needed under normal economic conditions, and perhaps twenty times the amount consistent with the level of economic activity actually existing immediately after the war. Western Germany's currency reform of June 1948 reduced the existing supply of money by more than 90 per cent; most holders of currency and bank deposits received only one new mark for 16 old ones. Economic activity picked up immediately. Previously, with money virtually worthless, incentives for harder work and better management were almost entirely lacking. Restoration of a sound monetary system provided fresh incentives for both, raising the level of production by two-thirds within less than a year.

While Western Germany still has a long way to go to complete economic recovery, the standard of living of its population at present is probably not appreciably lower than that of other Western European countries. Furthermore, the country is well on its way to becoming again a leading industrial nation, and should be able to contribute to the general rehabilitation of Continental Europe. Monetary stabilization, of course, was not the only reason for that sudden change. Stabilization was accompanied by a radical reduction of government restrictions of economic activity and by substantial grants under the European Recovery Program. Without financial stabilization, however, action to decontrol would have been impossible and our economic aid would have been largely squandered.

Monetary Stabilization in France and Italy

In a less spectacular way, similar developments have taken place in France and Italy. In both countries, monetary over-expansion had been about as bad as in Germany, but the economic consequences were less disastrous, mainly because controls hampered economic activity less seriously. In Germany, inflation was "repressed"; that is to say, effective controls prevented prices and wages from rising. In France and Italy, inflation came more into the open; the authorities were unable to keep prices stable. The continuous rise in prices hampered the revival of production less than the "repressed" inflation of the kind that prevailed in Germany. However, the rise in prices impaired the competitive position of French and Italian export industries in world trade and thereby intensified balance-of-payments difficulties. These difficulties, arising from having to pay more foreign exchange to other countries than was received from them, have plagued all European countries since the war.

In France, postwar inflation was stopped after the middle of 1948. This was accomplished in part by restrictive credit policies and by fiscal measures; in part it reflected the effects of a good harvest. Between that period and the middle of 1949 industrial production rose by about 25 per cent. In an even more decisive movement, the volume of exports rose by 40 per cent while imports remained approximately constant. As a result, the deficit in the balance of trade was cut to one-fourth, from a monthly average of $110 million in 1948 to $28 million in the summer of 1949.

In Italy, financial stabilization was virtually achieved in 1947, as the result of the strict monetary policies of the government. Between 1947 and 1948 the volume of exports increased by 40 per cent, with imports remaining constant. Thus the excess of imports over exports was cut in half, from $800 million to $400 million per year. In both countries ERP assistance was essential to bridge the remaining gap and was helpful in blocking further inflation; but that aid would have been largely dissipated if it had not been accompanied by financial stabilization.

Monetary Difficulties in the United Kingdom

An example of a different kind is provided by the United Kingdom. The economic situation in that country, which is more dependent than any other upon foreign trade and international finance, is too complicated to permit easy generalization. Few observers doubt, however, that the repressed inflation from which the country has been suffering since the end of the war has played an important role in its economic difficulties. Between 1938 and 1946, the supply of money in the United Kingdom rose about three times as much as prices and wages, while production remained virtually unchanged. A large inflationary potential thus remained unabsorbed and made necessary the continuation of stringent wartime controls. Between 1946 and the present, production increased by one-third. Even so, upward pressures on prices and wages remained a factor disturbing not only the possibilities of domestic progress but especially the prospects of attaining a balance in Britain's international trade.

The inflationary situation in Britain, as usual, reflected an excess of consumer capacity to buy over the available supply of commodities and services at prevailing levels of prices. As a result, there was a particularly strong demand for imports and for the domestic use of exportable goods. Since a hard core of imports is essential for the very existence of the British people, Britain has experienced great difficulties, despite stringent controls, in keeping imports from rising. At the same time, the country has been confronted by a growing inability to meet the competition of other exporting nations on foreign markets. As long as the world-wide scarcity of goods was so pressing as to permit the sale of virtually any exportable surplus, there was no serious problem of finding markets for exports. When the world export boom began to slacken, however, the rise in exports which had been the just pride of Britain's economic management slowed down and exports to the dollar area fell substantially. Unfortunately, it was impossible to bring about a drop in imports. The balance-of-trade difficulties and the so-called dollar shortage in the countries that use sterling currency (the sterling area) thus can be at least partly explained by the difficulties which the United Kingdom encountered in its effort to stabilize its domestic monetary system.

Change in Dollar-Sterling Rate

Repressed inflation in the United Kingdom was a very important element in precipitating the recent wave of currency devaluation. What happened may be explained this way. It was impossible, as a matter of practical politics, to adjust the swollen domestic money incomes plus the accumulated buying power in the form of liquid asset holdings to the available supply of real goods and services--either by cutting down the volume of money through a currency reform of the German type, or by permitting the price level, but not the wage level, to rise as in France and Italy. Therefore, the only alternative for Britain was to reduce the entire monetary level of the domestic economy in relation to world market prices by curtailing the value of the domestic currency in terms of the world's most stable currency, the U. S. dollar.

Re-establishment of Britain's international balance may be achieved through the effects of this action on imports and exports. On the import side, the rise in the domestic price of dollar imports may keep dollar imports down by increased reliance upon the market mechanism rather than by arbitrary and disturbing rationing. In other words, people will buy fewer imported goods because imports have become too expensive, not because of Government controls. On the export side, the main result is an inducement to producers in Britain and throughout the sterling area to divert a larger part of their total production to the export market at existing dollar prices. In other words, since the equivalent of say 100 dollars now yields about 36 pounds to the British producer, instead of 25 pounds, exports to the dollar area have become more profitable. Moreover, by increasing the margin between costs and prices, devaluation makes possible more aggressive competitive efforts, including price competition. British domestic costs have been cut, if not in comparison to British prices, at least in relation to international dollar prices. It is true that these results might be endangered if British labor were to insist on increasing wage rates in proportion to the devaluation, or if increased taxation counteracted the incentives for management to raise exports. But if a substantial rise in British domestic costs is avoided, there is indeed hope that devaluation may contribute towards the realization of British financial stability.

It is pertinent to observe that many other countries decided to join the British in devaluation, including such countries as France and Italy which had already curbed the danger of inflation. If they had not so joined, the improved competitive position of the British exporters would have threatened the success which French and Italian anti-inflationary policies have had to date. In both countries, monetary stabilization has been too recent and is still too precarious to withstand great shocks. This development indicates plainly how problems of financial stability in one country affect not only that nation itself but the entire world economy.

Problems of Excessive Monetary Stability; Supply and Composition of Credit

Recent European monetary experience gives ample proof, I think, of the crucial role that attainment of financial stability must play in economic rehabilitation. It further shows, in my opinion, that curbing of expansion in the money supply does not complete the task of monetary management. Two additional problems are particularly important.

The first problem grows out of the danger that too great a stability in the supply of money and credit may lead to recession, or at least to an unwarranted slowing down of economic progress. An expanding economy needs an expanding supply of money and credit, and the lack of necessary expansion may bring about a deflationary situation.

The second problem relates to the fact that not only the quantity but also the composition of credits affects an economy's progress. It often happens that short-term credit is ample but long-term credit insufficient. In that case, the oversupply of short-term credit may lead to inflationary symptoms in some parts of the economy while the scarcity of long-term credit may lead to recession in other parts.

Deflationary Tendencies in Western Germany and Italy

Some observers believe that in Western Germany and in Italy monetary management has recently over-emphasized the objective of stability of the money supply, and that the gains of stabilization may thus have been jeopardized to some extent. These two countries have received high praise because of their management of money and credit. Both nations have been able to end a period of inflation without catastrophic disorganization of their economic structures. In both countries, however, some recent tendency toward a slowing down of recovery and a reemergence of unemployment has appeared.

In neither of these countries could this tendency be explained mainly by ultra-prudence in monetary management. Italy has suffered from overpopulation for many years, and unless it finds new ways of utilizing its excess manpower, the problem probably will not be solved except by large-scale emigration. Just for that reason a rapid rate of industrialization is extremely important to Italy's further recovery. Weather conditions, affecting the supply of hydro-electric power, may also to some extent be responsible for temporary stagnation. Some critics contend, however, that the disinclination of the central banking authorities to refinance sufficient credits bears a share in the responsibility, and that as a result of this policy, Italy has not been able to utilize all the possibilities opened by the aid granted under ERP.

The situation is similar in Germany. After the astonishing success of the currency reform of June 1948, production moved at a breath-taking pace until March 1949, when it reached 90 per cent of 1936. By that time the fear of renewed inflationary developments had induced the central banking authorities to concentrate upon the struggle against overexpansion of money. Monetary management, aided by other contributing influences, indeed succeeded in preventing inflationary tendencies during the fall of last year from developing further. But industrial production soon stopped its rise and did not reach the March level again until August 1949. Unemployment increased to more than 1.2 million, or 9 per cent of the employed labor force.

As in Italy, the rise in unemployment in Western Germany is attributable in large part to causes which could not be remedied by monetary management. The inflow of 3 million refugees from Eastern Germany has disturbed the balance of the population, and unemployment is particularly strong in those areas in which the refugees have settled. Some analysts believe, however, that not more than one-third of the total unemployment could be explained in this way and that it would help to eliminate at least part of the remaining two-thirds if appropriate credits were being made available to German industries.

The management of the German banking system has good reasons to beware of credit policies that might again bring about the slightest trace of new inflation. In view of the extremely unstable domestic and international political situation in Germany, however, the recent rise in unemployment, with its accompanying social tensions, is particularly dangerous. Re-emergence of the specter of unemployment that haunted Germany in the thirties might sooner or later lead to an overthrow of the present administration and to dangerous monetary experiments. On the other hand, the recent development may be nothing more serious than the inevitable consequence of the transition from an inflationary to a reasonably balanced situation.

Long-term Credit Problems in Western Germany

The example of Western Germany also shows the importance of the composition of the supply of new credit. Most economists agree that lack of sufficient investment is frequently the cause of unemployment. Often the insufficiency of investment is due to lack of opportunities for profitable expansion, or to a scarcity of manpower and natural resources; but under present conditions it is often ascribable to the lack of long-term credit. In countries which suffered from wartime destruction and from inflationary developments in the postwar period, private savings--which normally form the basis of long-term credit funds--are generally at a low level. The gap therefore has to be closed either by the banks with the help of the central banking system, or by public authorities. Large-scale creation of long-term credit by the banking system is generally considered to be unsound and unsafe banking practice. It has inherent dangers of inflationary over-expansion and is likely to be followed by a period of contraction, made more difficult by frozen bank assets. Large-scale credit creation by public authorities usually either has inflationary implications (if based on deficit finance) or requires that taxes be maintained at, or increased to, very high levels. But high taxation tends further to reduce private savings and investment. Both methods have to be used with the greatest caution, and are at best poor substitutes for the formation of capital out of private savings.

In Western Germany the central banking authorities have been extremely reluctant to extend rediscount and similar facilities to long-term credit institutions. Very recently, the central banking system, after long deliberation, has been permitted to refinance 300 million marks, or about $72 million, of medium and long-term credits, but this sum is very small in relation to needs. The Reconstruction Loan Corporation, which has the function of financing investments, has so far received loan applications for 7.4 billion marks, but has been able to grant loans of only 0.4 billion. This situation has led to an increasingly large role by public authorities in financing new investment, largely out of current tax revenues. The prominence of government financing contrasts heavily with the intention of the German government to return as fully as possible to a free economy based upon private initiative. Moreover, the government itself has recognized that the existing level of taxation is a serious obstacle to further economic progress, sapping incentives for both labor and investment. The only part of public investment that is not based on taxation utilizes the so-called counterpart payments, namely the payments received by the local government from purchasers of goods imported by means of U. S. aid. These funds, however, can be invested only according to a program which has to be approved by our Economic Cooperation Administration.

Accordingly, the release of these funds is a complicated process. Counterpart funds, moreover, will not be available after the end of the European Recovery Program. Reestablishment of a well-functioning domestic capital market is thus one of the most important goals of fiscal and credit policy in Germany, as it must also be in many other European countries which seek to recover from the distortions caused by the recent war.

Long-term Credit Problems in Low Countries

Another example may help us to understand the importance of the problem of long-term credit utilization. Belgium and the Netherlands are two neighboring European countries very similar in size, population, and economic, social, and political conditions. Not long after the war, they reached an agreement to form an economic union. Since then, their economic fates have taken very different turns. It is true that a large part of these differences may be explained by events beyond their control. Belgium was liberated in 1944 and suffered very little war damage while the Netherlands was liberated many months later and only after heavy destruction. Belgium's colonial possession, the Congo, remained under Allied administration throughout the war and in postwar years has become extremely prosperous. Indonesia, the main overseas territory of the Netherlands, was for many years under Japanese domination and has been ravaged by civil war ever since the end of the Japanese rule so that it has become a burden rather than an economic advantage to the mother country. Moreover, the Netherlands has been hit far more severely than Belgium by the impoverishment of Germany, with which it had very close economic ties.

It is therefore not surprising that Belgium has recovered more fully and more rapidly than the Netherlands. To some extent, however, the difference in development also may be due to a different course of economic and financial management. The Belgian authorities promptly adopted a successful currency reform in 1944, which set the pace for all other Western European attempts of that kind and also permitted Belgian industry to become geared to the satisfaction of consumer demands rather than to a high degree of investment. The Netherlands' authorities, on the other hand, embarked on one of the most ambitious investment programs of Continental Europe, destined to overcome as rapidly as possible the destruction caused by the war and also to provide for a rapidly increasing population.

As a result of all of these factors, Belgium soon was able to regain a higher degree of financial stability than most of its neighbors and to dispense with virtually all wartime controls of private economic activity. As in so many other countries under conservative financial management, however, there have been some recent signs of slackening progress and rising unemployment. These developments may be interpreted either as reflecting deflationary troubles or as indicating a transition to a normally balanced economy. In any case, the Belgian currency is today, next to the Swiss franc, the most coveted European currency.

The Netherlands, on the other hand, has been confronted with great difficulties in meeting the capital requirements of its investment program and has felt compelled to retain a system of strict government controls over most phases of its economic life. Furthermore, it has been allocated a very large amount of aid under the European Recovery Program while Belgium not only has not received any net assistance but has undertaken to provide credits for less fortunate European nations. Despite that aid the Netherlands must still follow a policy of strict austerity and has shown until recently familiar symptoms of repressed inflation. Advantageous as its large investment program may prove to be in the long run, it certainly has outrun the country's capital resources. Only as a result of truly heroic efforts have the Netherlands people in recent months come somewhat nearer to internal and external financial stability.

Conclusions: Monetary Problems of the United States

Let us now recapitulate the results of our hurried review of monetary management in Europe. The example of Western Germany, France, Italy, and Belgium has demonstrated the overwhelming importance of financial stability for achieving and maintaining prosperity. The case of the United Kingdom has shown us how fundamentally a financial disequilibrium in a major country affects the international financial relations of the entire world. However, the examples of Western Germany, Italy, and Belgium have indicated the necessity for supplementing stability by the guaranteeing of a steady flow of credit so as to avoid the danger of interrupting economic growth. Finally, the development of Western Germany and the Netherlands has shown the special importance of a sufficient supply of long-term credit as a source of expansion and progress.

Each one of these countries has tried to solve its problems in a different fashion. I am anxious to emphasize that my discussion of these differences should not be interpreted as criticism. Every government must deal with a complex social and political situation, and a policy that seems best to the outsider may be impossible to pursue. The danger of inflation, for instance, appears in a very different light in Germany after two hyper-inflations in one generation, and in Britain, where the currency has never become worthless. France, which has also suffered from inflation in the past, nevertheless seems to prefer inflation to government controls, in contrast to the Netherlands, which has not had a serious inflation. While the problems themselves are the same the world over, the solution that would be right for one country might be wrong for another.

It remains only to consider very briefly the application of these results in our own country. The United States, like all other countries involved in the second world war, had to finance the war to a large extent by inflationary methods. Postwar readjustment of our economic system, despite the vast monetary expansion during the war, has been greatly facilitated not alone by our tremendous productive capacity but also by the high degree of public confidence in money and Government bonds and the willingness of the public to hold large amounts of these assets as liquid reserves. This willingness to hold liquid reserves permitted a rapid reconversion and a tremendous increase in civilian output during the years following without completely upsetting our price system. We are all aware that we did have a substantial rise in prices and wages, but it might have been much greater if monetary management had not taken measures to keep the inflationary tendencies under control.

International Aspects of U. S. Monetary Management

Domestic monetary management in this period could not concentrate exclusively upon our domestic problems. The United States could re-establish a lasting prosperity only in a world which in turn enjoys a reasonable degree of stability and prosperity. It was therefore vital for the success of our own financial reconversion from war that we aid in the rehabilitation of the chief trading countries of the world. To this end, we made very substantial loans and grants to European and Far Eastern countries. Moreover, in order to ensure the adequate utilization of these loans and grants, we had to interest ourselves in the problems of domestic financial stability of the countries to which we extended our aid.

Our influence upon financial developments in foreign countries rests in considerable part upon our voice in the use of the counterpart funds. These funds represent the payments in local currency made by the purchasers of the goods imported under our relief programs and especially under the grants of the European Recovery Program. The counterpart funds are legally the property of the local governments. But the governments are pledged to dispose of them only with our expressed approval. In many countries these funds are large enough so that decisions as to their use or non-use have fundamental effects upon financial stability, expansion, or stagnation.

In these decisions we are confronted with the very problem which was the main subject of our discussion, namely the choice between insisting upon strict stability in the supply of money or permitting a moderate expansion. In the first case, we may invite stagnation. In the second, expansion may go too far and end in an inflationary spiral. Wise decisions involving the use of counterpart funds can claim some credit for stopping inflation in Europe, but difficult questions remain to be solved in countries now threatened by a stoppage in progress and by rising unemployment.

Domestic Aspects of U. S. Monetary Management

To a lesser degree, these same problems confront monetary management at home. The threat of inflation, which darkened our economic prospects in the prosperous years from 1946 through 1948, was followed by a slight downtrend in our economic activities, which began in the winter of 1948-49. This downtrend, however, may be hailed as a necessary and inevitable readjustment. The pent-up demand for goods and services that had not been available for many years was bound to disappear. Labor and management have been making adjustment to a more normal level of demand, entailing a reduction in output and prices that had risen out of proportion to the development of the economy as a whole. The supply of money has been more stable between the middle of 1948 and the middle of 1949 than at any other time since the beginning of the second world war.

It is true that during the past twelve months our industrial production declined by 12 per cent and the number of our unemployed, although still at a low level, was almost doubled. In recent months, however, an upturn in sales and in production has been evident, although output is now being curtailed by strikes. The devaluation of many foreign currencies may pose some short-run problems in our international trade before its long-run benefits become apparent. These facts indicate the difficulties of the task with which we are confronted.

From our domestic as well as our foreign experience it has long been recognized that the objective of monetary management must be to regulate the supply, availability, and cost of money with a view to contributing to the maintenance of a high level of employment, stable values, and a rising standard of living. Economic progress involves the absorption of an ever-increasing number of workers together with an ever-increasing productivity per worker in a way that will not lead to unsustainable expansion. Monetary management alone cannot achieve these results, but without monetary management they are not likely to be reached at all.

The United States is at present the leading country of the free world, both because of its material resources and because of dogged adherence to the principles and practices of free enterprise. Our economic fate will determine the economic and political future of many other nations. We must achieve steady economic progress, without inflation or serious depressions, not only for our own sake but also to reinforce the faith of the rest of the world in the economic and social principles for which we stand.

Speech delivered before
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WHAT DOES A CREDIT MAN THINK ABOUT TODAY?

One thing I'm not going to do is try to tell you how to run your business. Capable credit men need no such advice--and the others wouldn't take it anyway. A good credit man knows the many elements to be considered in granting a loan and he knows that he cannot afford to overlook any one of them in reaching his decision. Something of little importance today may, because of rapid economic and other changes, be of first importance tomorrow.

You members of the Robert Morris Associates are well aware of the need for evidence of the borrower's integrity, for assurance that the money he borrows will be employed for provident and productive purposes, and for reasonable certainty that the loan can and will be repaid upon the terms and conditions granted. You know that your advice and counsel must accompany many loans if the credit is to be used to best advantage. You are aware of the dangers of relying too heavily on the continued success of any one industry or enterprise, and of the need for diversification in your lending activities. In short, you know the many angles to this business of lending other peoples' money to other people, and you are endeavoring to consider all of them in an effort to protect your depositors, to provide a fair return on the investment of your stockholders, and to assure the maximum sound productive use of credit in your community.

It is not my purpose this evening to review the many detailed considerations that enter into the granting of a loan. Rather, as a native of this city and former associate of yours, I should like to discuss some of the broader problems of national and international credit policy with which I have been conversant for the past 16 years. In today's world, the conduct of economic affairs at home and abroad is greatly influenced by considerations of social responsibility. In the interest of the greatest good for the greatest number we as a nation have set ourselves the task of maintaining high employment, stable values, and a rising standard of living.

The attainment of these national economic objectives, in view of the growing complexity of our economy, gives rise to many perplexing problems. Considering the essential role of credit in our highly specialized system of producing and distributing goods and services, it is not surprising that these problems are a matter of concern to each and every credit man in our country.

The Robert Morris Associates deserve high praise for publicizing the essentials of constructive credit policies and for encouraging and facilitating the exchange of information and ideas among credit men. The Associates' financial statement studies, which are continually being enlarged and refined, have provided members with standards of comparison that are extremely useful in analyzing and evaluating particular loan applications, and in detecting changes in business financial structure.

Through its Monthly Bulletin and meetings such as this, the Robert Morris Associates are encouraging that sort of thoughtful analysis essential to a sound solution of our many problems and to the realization of our economic goals.

The Role of Credit and Credit Institutions

We all know that an adequate supply of credit at the right place, the right time, the right cost, and the right repayment terms is essential to the smooth functioning of our economy. There is hardly an individual, a business man, a municipal or state government, or a national government that doesn't need credit from time to time. In order to meet these varied needs for credit, different types of lending and investment institutions have been developed. Some, like the commercial bank, evolved in response to a need for short-term business credit; others, such as the savings and loan association, were created for the purpose of supplying special types of longer term credit. Still others, such as mutual savings banks and insurance companies, have, in recent years, turned to lending and investing funds normally supplied by commercial banks. The commercial bank, however, is still pre-eminent in the field of shorter-term credit. It must, because of the high proportion of its demand to its total liabilities, concentrate on shorter-term credit. In contrast, life insurance companies, the majority of whose obligations represent lifetime contracts with policyholders, and mutual savings banks, which hold peoples' savings, are able to extend credit for longer periods through the purchase of long-term bonds, obligations secured by real estate, and other investments of a long-term nature.

While the demand character of much of their deposit liability largely restricts commercial banks to short-term lending, member banks can, if confronted with unforeseen deposit withdrawals, obtain funds from their Reserve Banks. In its capacity of lender of last resort, the Federal Reserve System has introduced a much greater degree of flexibility into commercial bank lending than previously existed. In this respect, the powers of the System were broadly expanded in 1935. Banks can now grant loans without fear that tomorrow or the day after they may be forced to liquidate them on short notice in order to meet depositors' demands. On the other hand, we recognize that certain types of credit extension are not for commercial banks--among them, purchase and lease of business properties and investment in equity shares. In other words, the role of the commercial bank should continue to be largely that of provider of short- and medium-term credit to business corporations, unincorporated enterprises, farmers, consumers, home owners, and all levels of government.

In this connection, I should like to say a word about public lending institutions that provide emergency financial assistance to banks and business. I think most credit men would agree that Government competition in the field of direct lending is undesirable if private lending institutions can provide the amounts and types of credit needed. On the other hand, I think we should have some public credit agency or agencies available on a standby basis to render assistance in periods of financial stress--at least until such time as the commercial lending institutions are able to cope with any conceivable situation. In addition, there may be some remaining gaps in our present structure of financing agencies--for example, agencies that would provide long-term debt capital to small enterprises. Such gaps may have to be filled by new types of private or public financial institutions.

Whether the potential expansion of Government lending agencies poses any serious competitive threat for private credit institutions will depend, in my opinion, on our success in minimizing or eliminating cyclical expansion and contraction of business activity and credit and in filling any gaps with appropriate private lending institutions wherever possible.

The dual responsibility of the commercial banker on the one hand to protect the interests of his depositors and stockholders, and on the other hand to expedite the production of essential goods and services by granting credit, is a difficult one. The desire to protect depositors may cause individual bankers to change their credit policies at the first signs of financial stress. The over-all effect of such action, by sharply curtailing or even liquidating credit lines, might seriously impede economic activity and hurt all bank depositors. Individual bankers might find it difficult to continue granting credit freely when competitors are calling in their weaker loans and tightening up their credit terms.

The only real solution to this problem lies in the prevention, by means of over-all credit and monetary action, and other public and private means too numerous to mention on this occasion, of any economic development that might lead to sharp retrenchment and liquidation of credit.

Role of the Federal Reserve System

The Federal Reserve System, as the central monetary and credit authority, is charged with responsibility for regulating the over-all supply, availability, and cost of money with a view to contributing to the maintenance of high levels of employment, stable values, and a rising standard of living.

In an effort to meet its responsibilities, the System takes positive action to curb or to encourage credit expansion, as circumstances require. It operates by using either quantitative or selective instruments, or both. Quantitative instruments, such as changing the required reserves of member banks or open market purchases or sales of Government securities, increase or decrease the reserve base for credit extension but leave to the individual bank the decision as to the type or types of credit that should be expanded or contracted. Selective credit instruments, such as margin requirements for the purchase or carrying of listed stocks or emergency regulation of consumer instalment credit, apply to a particular type of credit, but impose no direct limit on the total amount of credit outstanding.

Generally speaking, action taken by the Federal Reserve System to influence the expansion or contraction of credit has the primary effect of suggesting, rather than requiring, certain responses on the part of individual lenders. This is particularly true in time of economic recession when the Federal Reserve can enlarge the basis for credit expansion but is powerless to force additional credit into business and trade channels. The latter can be done only by aggressive response on the part of individual banks in extending credit and by willingness on the part of business men and others to utilize credit in expanding their operations. To make this possible, both public and private policies should inspire confidence on the part of business men, bankers, and the general public.

In influencing credit policies in an effort to contribute to monetary and economic stability, the Federal Reserve System must act in the public interest. Oftentimes such actions are unpopular, especially among the banking fraternity. Sometimes central banking officials resign, voluntarily or otherwise, because of the unpopularity of their actions. This is particularly true in periods of inflation, when most people do not want to see business activity curtailed. However, as recently demonstrated in a number of Western European countries, the need for drastic action to ensure monetary stability does arise and the results of such action are beneficial. In the end, most groups recognize the wisdom of action which they at first opposed.

In the final analysis, the major contribution of the System to the smooth functioning of our economy lies in its early detection of undesirable economic trends and prompt action to guide commercial credit policy away from paths that may lead to serious inflation or deflation. Without the understanding and cooperation of the entire banking system and the public much of the effectiveness of Federal Reserve action is lost.

The organization of the Federal Reserve System, with its 12 regional banks and their 24 branches, provides grass-roots information on what our leaders in the fields of agriculture, industry, commerce, and banking are doing and planning. In similar manner, the System obtains first-hand information about economic developments in foreign countries and in the field of international trade and finance through its membership in the National Advisory Council and from various Federal Reserve and other Government missions and representatives abroad. Much of this information is relayed to credit men through the publications of the System so that individual lending policies may be reviewed in relation to national and world-wide economic developments.

<u>The Current Business Situation and Outlook</u>

In the first place, as you know, determination of appropriate credit policies depends in part on our longer-range economic objectives. But it depends also on the present and probable future course of business activity. Between November 1948 and July 1949 industrial production, as measured by the Federal Reserve index, declined roughly 17 per cent; during the same period, wholesale prices, as measured by the all-commodity index, dropped 6 per cent and business inventory holdings declined 5 per cent. These declines in industrial activity and prices, together with smaller business credit demands on banks and other lending institutions, prompted several monetary and credit actions by the Federal Reserve System during the spring and summer of 1949. Down-payment and repayment requirements on consumer instalment loans were gradually moderated prior to the termination of Regulation W. Margin requirements on stock exchange loans were decreased substantially, successive reductions in reserve requirements of member banks were instituted, and a policy of flexibility in open market operations to permit freer play of general credit forces in the determination of market rates and yields was adopted.

The moderate recession in business activity that we experienced during the first half of this year probably reflected inventory and price readjustments, rather than any basic difficulties. Whether the recovery that began this summer may lead to further inflationary pressure or will be replaced by a resumption of the earlier downward readjustment is now a subject of considerable discussion.

Among the various aspects of the present situation that suggest continued high levels of business activity, one of the most significant is the record level of construction activity. In a recent joint report, the Department of Commerce and Department of Labor estimated that the total value of new construction put in place during 1949 would exceed 19 billion dollars, or slightly more than the 1948 total of 18.8 billion. Moreover, these same sources predicted that the total of new construction expenditures in 1950 will equal that of 1949.

Consumer expenditures on goods and services of all types were still running at an annual rate of 179 billion dollars a year in the third quarter of 1949--less than 2 per cent under the peak annual rate reached in the fourth quarter of 1948. Moreover, recent Federal Reserve Board surveys have revealed the existence of continued large-scale demands on the part of individuals for automobiles, houses, and other durable goods. Not only is the demand great, but individuals have cash or other liquid assets, or are able to borrow, to finance purchases of these goods. National service life insurance premium refunds during the winter and spring of 1950 are counted upon to bolster consumer demand, while continued large-scale Government expenditures will sustain a demand for many types of goods and services. The over-all financial position of business is sound, despite a substantial increase in business indebtedness during the past few years. In general, the supply of credit is large and elastic and the cost, both of short- and long-term credit, relatively low. Furthermore there is a marked absence of speculative excess, such as we had in the late twenties, while the great strength of the banking system enables it to deal effectively with any sort of economic development one might reasonably expect at this time.

At the same time, we should not overlook the fact that we have gone a long way toward satisfying the immediate postwar demands for industrial plant and equipment, business inventories, and consumers' goods. Business expenditures on new plant and equipment, which reached a peak of 5.4 billion dollars in the fourth quarter of 1948, are estimated at 4.3 billion dollars for the fourth quarter of 1949--a decline of about 20 per cent. Business inventories, which expanded by 28 billion dollars between December 1945 and December 1948, have since declined by roughly 4 billion dollars. Wholesale prices have continued to fall and at the end of October were about 8 per cent below their level of a year ago. While industrial production has picked up since July, and is admittedly being held back by recent work stoppages in the coal and steel industries, the current level is still some 12 per cent below the level reached in the same month last year.

Moreover, there is some possibility that business expenditures on new plant and equipment will continue to decline, and that further increases in business inventory holdings will be relatively small. Bumper crops in many lines of agricultural production foreshadow continued downward pressure on farm prices and incomes. It is evident to you, I am sure, that we are still confronted with marked price disparities, such as aluminum versus copper, synthetic fabric versus cotton and wool cloth, and lumber versus other building materials. For example, the price of lumber is still over 3 times its 1939 average, as compared with a current average price of building materials (excluding lumber) that is somewhat less than twice the 1939 level. More liberal pension fund provisions, of the type recently negotiated in the steel industry, together with postwar wage increases in most lines of industry and trade, and the high cost of postwar additions to plant and equipment, have saddled many business concerns with relatively large and inflexible cost structures which may seriously impede price reductions that might be needed if demand should start to fall off.

All things considered, the credit man is faced with the rather formidable fact that the present balance between further inflation and deflation is a delicate one, which could easily be upset by expansion in Government expenditures and deficit financing on the one hand, or by any pronounced curtailment of consumer or business demand on the other. Such a situation calls for lending policies that will permit utilization of credit for continued production of goods and services, and at the same time will not encourage premature exhaustion of consumer demand. Later in my talk I shall mention several types of lending activity which credit men are watching closely in view of recent economic developments.

<u>Recent Economic Developments Abroad</u>

If I learned anything in my several assignments abroad, it is the fact that the time has long since passed when we could isolate our domestic economy from that of the rest of the world, particularly from the effects of economic developments in the western European countries. Immediate postwar European demand for food and manufactured products of various types provided a large export market for whatever could be spared in meeting our domestic requirements. At the same time, and especially as ECA aid became available, European countries began to rebuild their factories, re-establish their raw material supply lines, and resume production of manufactured goods. In order to attract private capital to their industries and place their own economies on a sound footing, most of the western European countries introduced drastic currency reforms for the purpose of stabilizing prices and money values.

Once the European countries succeeded in establishing some measure of internal stability, their next step on the road to economic recovery was to rebuild their export trade, particularly to this hemisphere. Devaluation of their currencies in relation to the dollar has had the effect of lowering the price of European goods in the

American market and enabling European countries to sell more in this country. At the same time, it has raised the prices of our goods in foreign markets and curtailed their consumption to some extent. All these changes are no doubt reflected in your thinking and planning.

It is most important to us that the progress toward general economic stability, in which most countries of the world have participated, should continue. While United States aid has been essential to the progress that many foreign countries have made since the end of the war, I am confident that the contemplated gradual reduction in the amount of such aid will not interrupt nor delay such progress. However, this does mean that if foreign countries are to continue buying goods which they need from the United States, they must be able to expand sales of such of their goods as have a market in this country. To spend dollars here they must first earn dollars, directly or indirectly, and with much of their international transport, financial, and other dollar producing services destroyed or disrupted by the war, more emphasis must be placed on the sale of goods in the world market.

In this connection, the credit man today asks questions about the value of the dollar, not only from our own domestic viewpoint, but in relation to the currencies of other countries. Recently you have been hearing many rumors about devaluing the dollar in terms of the price of gold. Devaluation of foreign currencies was a necessary step toward trade expansion and recovery; undoing its effects by devaluing the dollar would have just the opposite consequences. Nor would dollar devaluation aid our domestic situation one iota. On the contrary, it would add to any inflationary tendencies that exist. There is no shortage of credit or gold reserves in this country, and an increase in the dollar price of gold, even if the legal obstacles to such action could be overcome, would merely mean an indiscriminate subsidy to domestic and foreign gold producers.

Financial Developments of Current Significance

Thus far, we have been talking about some of the broader aspects of the domestic and international economic scene that have a bearing on credit policies. Now let's take a look at a few of the more specific problems in the field of credit and commercial banking that are of interest to the credit man today.

Instalment credit. Since June of this year, the amount of consumer instalment credit outstanding has increased by nearly one billion dollars. Some thought is being given by the lending officer to the implication of too rapid an expansion of such credit at this time. Many people buy certain large items of furniture and major household appliances only once in their lifetime. To a certain extent, the same is true in the case of automobiles. Once immediate demands are fulfilled, they may recur only after the lapse of considerable time. Moreover, the use of instalment credit enables people to buy now and pay for purchases out of future income. If we encourage too widespread a use of instalment credit at a time when cash demands of consumers are high, we may exhaust not only the present market but a good part of the potential market of the future. The results of doing so should be perfectly obvious--sales of automobiles and other consumer goods may suddenly fall off and unemployment may ensue, while a larger proportion of the reduced income available would go to pay for goods purchased last year or the year before.

No credit man is in a position to say who shall or shall not buy with instalment credit, provided the borrower can establish his credit-worthiness. On the other hand, he can influence the use of instalment credit by maintaining prudent downpayment and amortization requirements.

Real estate credit. My comments with respect to instalment credit are equally true of real estate credit. During the four years 1946-49 home mortgage debt alone has increased by an estimated net amount of some 17 billion dollars. In part, your concern is that the volume of debt incurred may be so large as to threaten a serious credit liquidation. In part, it is that the ability of individuals to purchase housing with the aid of mortgage credit is being exhausted so rapidly that the remaining demand will not be adequate to ensure continued high levels of employment in the building and building materials industries. Again, the banker cannot deny credit to credit-worthy borrowers. He can, however, require conservative owner equities and repayment provisions in times of abnormally high demand, and relax his requirements somewhat when the demand begins to slacken. These are powerful measures of influence, and I am certain that bankers want, in their own as well as in the general interest, to make them as effective as possible.

Term loans. Term loans are often employed by the borrower in the purchase of machinery, equipment, and other more or less fixed capital items, and are repaid out of future earnings. In recent years the well-informed credit man is making term loans with caution, for three reasons. First, construction and machinery and equipment costs are well above prewar levels, and there is a good chance that such fixed assets may prove to be overvalued in the long run. Second, there is always some uncertainty about the profitability of future business operations. Third, the situation with respect to business expenditures on machinery and equipment is somewhat analogous to purchasing of automobiles and housing by individuals--some restraint in the use of credit during boom times should be encouraged.

From time to time questions arise as to the feasibility of developing a formula, or of devising definitions and limits for the guidance of banks in determining what proportion of their assets may properly be invested in term loans. Such an undertaking would have little chance of success. In the first place, the diversity of type, purpose and conditions of such loans makes satisfactory definition practically impossible. In the second place, the appropriate position for an individual lending institution can only be determined after careful analysis and consideration of the character and volatility of its liabilities, its relative capital position, and the probable credit demands to which it may be subject. The determination of an optimum amount of term loans involves problems similar to those in selecting an investment portfolio, and no rule of thumb applicable to all banks would appear to be practicable.

Conclusion

It is evident, therefore, that the time-honored distinction between the trees and the forest is equally true of credit. The individual credit man is primarily and rightfully concerned with the welfare of the individual trees; the central credit authority is charged with responsibility for promoting the welfare of the forest. While the interests of the two may appear to conflict in specific situations, the thoughtful credit man realizes that there are no fundamental differences in their ultimate objectives.

It is further evident that certain types of credit, notably consumer instalment and home mortgage, have increased substantially in recent years. In the interest of minimizing their inflationary pressure, spreading demand for automobiles, housing and other consumer goods over a longer period of time and protecting loan portfolios against subsequent deterioration in value, credit men are examining downpayment and repayment provisions with particular care.

As we know, change has always been characteristic of human behavior, whether it be social, political, or economic. The principal difference in the economic changes that occur now and those of a hundred years ago is that present changes occur more rapidly, and affect a much greater number of economic activities. No able credit man can isolate himself from change, nor prevent it by ignoring it. On the contrary, he deems it his responsibility to maintain that prudent flexibility of thought and action that welcomes the opportunities for constructive service afforded by change. His is not a dull and routine duty. It is full of constant interest--not only in loans and lending policies, but also in broader economic developments.

Speech delivered over
Radio Station W-I-N-D, Chicago, Illinois
December 9, 1949

WHERE NOW?

Before facing up to that question, let me mention some of the important things that have to be taken into account in trying to answer it.

To begin with, let me speak about what has happened recently and what is going on now. Back in November 1946 there were 57,000,000 people employed in our factories, in our stores and offices, and on our farms. Approximately two years later--October 1948--the number so employed reached a postwar peak of over 60,000,000 while the number looking for work, the unemployed, had dropped to a little over 1,500,000. Between the end of last year and the middle of this year the number of unemployed increased rather sharply to a little over 4,000,000. Since then, business has recovered somewhat from its midyear lull and today 59,500,000 people are working while almost 3,500,000 are looking for work. While total employment is now only 600,000 below last year's peak, the extent of the revival in business activity isn't quite so great as these figures might suggest. Every year we find more young men and women joining the labor force than we do older people leaving it--at the present time the net addition is about 600,000 people a year. If all the people who want to work are going to have jobs next year and the year after, the total number employed will have to be larger than it is now and larger than it was last year. That's a pretty big order, finding jobs to keep more than 60,000,000 people employed. It's going to require a great deal of effort on the part of everyone to keep our economic machine running smoothly and efficiently enough to provide all these jobs.

During the first part of last year--1948--everyone was aware of rising prices and expanding business. In some ways it looked good, but I think most people were uneasy about it. They felt that high prices meant that it would be harder and harder for them to make both ends meet. Then after the middle of 1948 the picture changed. Between November 1948 and July 1949, production in American factories declined about 17 per cent. In the same period, wholesale prices fell about 6 per cent; and inventories of goods on hand fell 5 per cent. At the same time a large part of bank loans to business was paid off, with the result that total borrowings from banks by businessmen declined.

This general downward movement of prices, production, and business in general gave everybody something new to worry about. We had been afraid that prices would go too high; now we began to fear they would drop too low. Before, we had been afraid of a boom; now we began to be afraid of a bust.

The decline which set in about the middle of 1948 has proved to be very moderate. This past summer there was marked recovery. The question now is whether that recovery will continue. In other words, granted we are where we are, what is going to happen next? The signs are mixed.

On the other hand, it seems clear that the country has gone a long way toward satisfying the immediate postwar needs for plant and equipment, which is our production machinery, and this means less demand than there has been for new factories, heavy machinery, and such things. On the farms bumper crops have been harvested and their effect will be to depress the prices of farm products. This is in accord with the principle of supply and demand. While prices on the average are down about 8 per cent from last year, there are still disparities, such as the price of aluminum versus copper, cotton and wool cloth versus synthetic fabrics, and lumber versus other building materials. The price of lumber, for example, is three times what it was ten years ago, while the average price of other building materials is somewhat less than twice what it was just before the war. These disparities necessitate adjustments to establish a sound balance which gives us stability. It takes time to work out these adjustments and meanwhile business is slowed down by the process.

Against these conditions, which at least for the time being tend to restrain business expansion, there are other conditions which point to sustained activity. The general public's purchases of goods and services remain steady and strong, and there is evidence of a great backlog of demand for automobiles, houses, and other durable goods. During the winter and spring of 1950, veterans will be receiving millions of dollars in refunds on their life insurance premiums, and most of this money will be spent for cars, homes, merchandise, and services. All of which means that business ought to be brisk. At the same time, the credit situation seems sound; individuals here and there may be heavily in debt, but taking the country as a whole, private indebtedness is not excessive, and there is no speculative mania such as we had in the late twenties.

The Federal Reserve System, as the central monetary and credit authority, is charged with responsibility for regulating the over-all supply, availability, and cost of money with a view to contributing to the maintenance of high levels of employment, stable values, and a rising standard of living.

From the standpoint of money and credit, which is the purchasing power in our economy, there are two factors that I think need to be watched in particular. The first is instalment credit. Since June of this year, the amount of instalment credit for the purchase of automobiles, home appliances, and so forth has increased by nearly one billion dollars. These are not things that people buy and consume as they do food and fuel and then come back for more. The purchaser of an automobile or of a washing machine is apt not to be buying again for a long time, once a purchase is made. Obviously, if everybody bought cars and appliances at the same time, there would be a long period in which nothing more could be sold. Exactly that situation will probably never occur, but it is clear that when buying has been excessively heavy it tends afterwards to grow slack. Now, instalment credit in the right amount helps to make buying steady and consequently helps to make production and employment steady. But too much instalment credit is as bad as not enough--or worse, because it concentrates buying in boom periods instead of spreading it out evenly.

The other factor is real estate credit. Here the same thing is true. The total of home mortgages outstanding increased by 17 billion dollars during the four year period of 1946, 1947, 1948, and 1949. How long can such a rate of increase continue? Is the ability to buy being used up so fast that the construction business will soon have nothing left to live on? I don't know, but neither can I see how home buying can go on indefinitely at the present rate.

So far, I have spoken only of conditions within the United States, but it is obvious that conditions outside the United States must also be considered. We have been exporting large quantities of goods abroad ever since the war, and those exports have been an important element in American production. If, in the near future, any great change occurs in the amount of exports we send abroad or in the amount of imports we purchase, it is inevitable, of course, that American business will be affected by the change. But the change, in the long run, should be to the good. It provides a proper balance in international payments and eliminates need for our government gifts and loans.

Up to now, the aim of European countries has been to rebuild their factories and regain their markets. Our aim has been to help them, so that they can again stand on their own feet. But an essential feature of the program of European recovery is that the United States buy a larger amount of foreign products than it has in the past. This is simply another of the possible changes to which American business may have to become adjusted. Like most adjustments, it will involve practical difficulties, particularly with respect to those American products with which imports from abroad will directly compete; but actually the needed increase in imports is only a very small fraction of our total trade.

According to a statement recently made by Mr. Hoffman, Economic Cooperation Administrator, Europe needs to sell us an additional $2-1/2 billion worth of goods to balance her payments--and this $2-1/2 billion, he points out, amounts to only one per cent of the total value of goods and services produced (the gross national product) in this country during 1948. The adjustment needed for us to absorb these additional imports may not be painless, but it is essential. Foreign countries can not spend dollars unless they can earn dollars. If we wish to have them spend dollars by buying <u>our</u> products, we must be prepared to help them earn dollars by buying <u>their</u> products.

This need for selling goods in our markets was the reason for the recent devaluation of currencies by Great Britain and other countries. Devaluation is another name for reduced prices, for devaluation of a country's currency reduces the prices of its goods in foreign markets. The purpose of the recent devaluation, therefore, was to make foreign goods more attractive to Americans by reducing their price. The United States welcomed this reduction. Yet I should say in passing that, notwithstanding this fact, rumors have persisted that the United States was going to devalue American currency too. There are not the slightest grounds for this notion. It would be directly contrary to American policy to devalue our currency, and it would directly spoil the efforts we have been making to help other countries get on their feet and do without the costly assistance we are now giving them.

To conclude--our economy, generally speaking, appears to be in pretty good shape. However, it will bear careful watching. We face the important fact that the present balance between further inflation and deflation is a delicate one which could easily be upset. On the one hand, we may have expansion in Government expenditures and borrowing of money by the Government above taxes to meet these expenditures. On the other hand, there is always the possibility of a sizeable reduction of purchases of goods and services by businessmen and by the public at large. To steer a safe course between these two extremes will require constant vigilance, sound judgment, steady nerves, and confidence in the future.

SPEECHES OF

M. S. SZYMCZAK

MEMBER
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C.

RELATING TO

INDUSTRIAL LOANS

1935 - 1936

-1950-
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Speech delivered before
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RECENT RELATIONS OF THE FEDERAL RESERVE SYSTEM
WITH BUSINESS AND INDUSTRY

The name is difficult. Once I almost lost a place on a college football team because the coach thought that I was playing a practical joke on him when I handed in my name with others who were applicants for places on the team. He called me later and said "You are through." I asked him why. He said "Because you can't play jokes on me. What was it you handed in when I asked for names? It looked like the alphabet thrown together without any vowels." I had to explain to him very seriously that that was really my name. He finally believed me and I stayed on the team.

Illinois is the State of my birth, in which I lived and worked for many years. So you can understand that I was more than pleased to accept the invitation of Mr. H. A. Brinkman, your President, to appear on this program. I was especially glad to have the opportunity to meet you and listen to what you have to say, so that I might return to my office in Washington better informed and better able to aid, even if in a small way, in the solution of the problems presented daily to the Federal Reserve Board.

Let me begin by discussing something known to all of us - and lead slowly to something that may be news to some of us.

As you know, the Federal Reserve Act emphasizes the principle that the System shall be administered for "The accomodation of commerce, industry and agriculture." This is the basic thought of the Act.

The Federal Reserve banks - bankers' banks - are public institutions serving the entire country. In addition to the banks which are members of the System and stockholders of the Federal Reserve Banks, the System consists, first, of 12 Federal Reserve banks, 25 Branches, and two Agencies. There are 9 Directors of each Federal Reserve bank; 6 are elected by the member banks and 3 are appointed by the Federal Reserve Board. Each Branch has 5 or 7 Directors, the majority of whom are appointed by the Directors of the Federal Reserve bank of the district in which the Branch is located.

Second, the System includes the Federal Advisory Council of 12 active bankers - one from each of the 12 districts - elected by the Directors of the respective Federal Reserve banks.

Third, the System includes the Federal Reserve Board. Many powers are vested in the Board, among them being the duty to exercise general supervision over the Federal Reserve Banks.

At the present time the Federal Reserve banks hold larger member bank reserve deposits than at any other time in the history of the System, and the member banks are less indebted to them than at any other time in this history of the System. In 1920, fifteen years ago, the Federal

Reserve banks held the discounted paper of member banks in the amount of nearly three billion dollars; in contrast to this, on February 20th of this year the amount of discounted paper was less than six million dollars. Fifteen years ago, in April 1920, member bank reserve deposits were less than two billion dollars; in April of this year they amounted to nearly five billion dollars. At the present time the excess reserves of member banks amount to more than two billion dollars.

This means that the banks of the country have an enormous amount of funds which are not in use. At the same time in the country as a whole there is an enormous number of men unemployed. We have, therefore, this situation: on the one hand men are out of work, and on the other hand money is out of work. To the average layman, this is difficult to understand.

The Government is finding work for these idle men by embarking on various public activities and projects. A large part of the money required for these work-relief projects is and will be provided by the local banks' purchases of Government obligations. In other words, the Government is using its credit to bridge the gap. Would you prefer to have the Government continue doing this, or would you prefer to lend money directly to local enterprises yourself? I think I know your answer, and that brings me to the one thing I want to emphasize here this afternoon.

The Federal Reserve System has been authorized, and stands ready, to assist you in making loans to local enterprises under Section 13b of the Federal Reserve Act for the purpose of furnishing working capital to established industrial and commercial businesses. When lending activities are resumed through the usual and accepted channels, the Government will, as I understand it, withdraw gradually from its Public Works Program and from the use of its credit for such purposes. Sincerely, therefore, I should like very much to know just what is the attitude of the individual banker toward the loans to industry and business authorized by Section 13b of the Federal Reserve Act. I should like to know any and all reasons why these loans can or can not be made. This information will be helpful, not only to me and to the Board, but to the executive and legislative departments of your Government in Washington. It will also be helpful to you.

Accordingly, I wish to sketch briefly the background of the industrial loans program of the Federal Reserve System, and place before you as clearly as I can the advantages to you and to your communities of loans made under the provisions of Section 13b. These provisions had their origin in the feeling that as a result of long continued adverse economic conditions a large number of small business and industrial enterprises were suffering from depleted working capital.

On March 19, 1934, the President of the United States, the Honorable Franklin D. Roosevelt, sent a letter to Senator Fletcher, Chairman of the Senate Banking and Currency Committee, and to Representative Steagall, Chairman of the House Committee on Banking and Currency. In this letter he suggested the creation of twelve Credit Banks for Industry, to help provide working capital for small industries, and to follow up the aid given to agriculture, the banks and large business corporations, by doing something for the medium size man in industry and commerce.

On the same day the President wrote the letter, Senator Fletcher introduced in the Senate, and Congressman Steagall introduced in the House a bill "to provide for the creation of credit banks for industry". But Congress decided, instead of creating a new agency, to give the Federal Reserve Banks and the Reconstruction Finance Corporation authority to extend the credit which was required. That is the way the law now stands and the Federal Reserve System is firmly committed to carrying out the added responsibilities which Congress has given it.

The new legislation was adopted June 19, 1934. It amends the Federal Reserve Act by the addition of Section 13b, which provides that the Federal Reserve Banks may cooperate with member banks, nonmember banks, and other financing institutions in making loans to furnish working capital to established industrial and commercial businesses, and in exceptional circumstances, may make such loans direct when credit is not available on a reasonable basis from the usual sources.

An Industrial Advisory Committee composed of active business men in the district is created under the law. The law limits funds available for advances and commitments by the Federal Reserve Banks to the total surplus of the banks as of July 1, 1934, or about $140,000,000, plus certain payments to be made by the United States Treasury, which would bring the total available up to about $280,000,000.

The Federal Reserve System went to work promptly. A conference of Chairmen and Governors of the Federal Reserve Banks was held in Washington, June 25 and 26, at which the new industrial loans provisions of the Federal Reserve Act were the principal subject of discussion. Regulations had been drafted for the administration of Section 13b, and after they had been considered by the Conference and approved by the Federal Reserve Board, they were issued on June 26. In order to make as easy as possible the performance of the new functions granted to the Federal Reserve Banks, these simple regulations left the broad powers granted by Congress to the Federal Reserve banks wholly unimpaired and prescribed no restrictions beyond those prescribed in the law itself. Any attempt to supply technical definitions was avoided, lest it have the effect of restricting and hampering the operations of the Federal Reserve Banks. The late Governor E. R. Black, who was very much interested in this amendment to the Federal Reserve Act, wrote a letter on June 30 to the Federal Reserve banks, in which he said in part:

> "I am certain that you have carried home to your directors our earnest feeling, first, that these new loans will materially aid the Recovery Program, second, that it gives your bank an opportunity to render a real service in your district, and third, that this opportunity entails a responsibility that for the good of the Federal Reserve System must be fully met."

Since then several conferences of Governors have been held in Washington, at which the administration of Section 13b was discussed in detail.

I have visited every Federal Reserve bank, and about 90 per cent of the Branches since July 1, 1934. In fact, I visited some of the districts several times during the course of the last year for the purpose of discussing this subject with all concerned.

On September 27 a conference of the Chairmen of the Industrial Advisory Committees was held in Washington for consideration of the provisions of Section 13b. By this time the administration of Section 13b had been under way for some weeks and it was possible to consider the program in the light of actual experience. Among other things consideration was given at this conference to the report that many member and non-member banks were reluctant to make industrial loans because they were uncertain of the attitude that might be taken by bank examiners toward such loans when found in the bank portfolios. It was recommended that a definite announcement be made as to the policy to be followed by examiners.

In compliance with this suggestion the Federal Reserve Board on October 6 issued instructions as to the manner in which industrial loans should be included in condition reports and examination reports. About the same time the Comptroller of the Currency issued corresponding instructions. The purpose of these statements by the Board and by the Comptroller was to clear up such doubt as might exist as to the classification of such loans and the net effect was to assure member banks that industrial loans with long maturities which were covered by commitments from the Federal Reserve Banks or the Reconstruction Finance Corporation would not be classified as "slow".

Pursuing the administration of Section 13b, Mr. Albert M. Creighton, who is Chairman of the Industrial Advisory Committee of the Boston Federal Reserve District, and who is likewise Chairman of the Committee consisting of the Chairmen of the 12 Industrial Advisory Committees of the System, is now in Europe studying industrial loans in the various countries, at his own expense. He is expected back some time in June with a report of what is being done in this respect by other Banks of Issue by other Governments, and by other banks and financing institutions.

On December 11 and 12 a Conference of representatives of the Federal Reserve banks, the Industrial Advisory Committees and the Federal Reserve Board was held at Cleveland to consider the procedure being followed by the banks and the committees in passing on applications. It was realized that much of the success of the program depended upon a smooth and expeditious handling of applications.

The fact was emphasized that both the Industrial Advisory Committees and the Federal Reserve Banks have given and will continue to give careful and sympathetic consideration to each application, regardless of the amount of money being applied for.

On December 19 another Conference of the Chairmen of the Industrial Advisory Committees was held in Washington to review the work done by the Committees and to consider means of furthering the program.

Also the Federal Advisory Council, which was created in 1913, as you know, met in Washington on September 17-18, 1934 and discussed the subject of industrial loans under Section 13b in detail. At several of the meetings since that date the Advisory Council has, upon the request of the

Board, discussed the cooperation in this matter of member banks with the Federal Reserve Banks.

In addition to all these conferences and to continuous study of the situation the Federal Reserve banks have actively convassed their districts in order to inform financing institutions and prospective borrowers of the new provisions of the law. Every effort has been made through pamphlets, letters, addresses, personal calls and even by radio to make the new functions of the Federal Reserve Banks widely known.

I have gone into all this rather minute detail, even at the risk of boring you, to give you some idea of the earnestness with which the Federal Reserve System has prosecuted the industrial loans program.

The question naturally arises, what are the results? As of May 8, 1935, the Industrial Advisory Committees had approved 1,676 applications, amounting to $88,066,000 and the Federal Reserve banks had approved 1,509 applications, amounting to $84,008,000. Adding the advances actually made ($29,626,000) and the commitments outstanding ($18,040,000) for a commitment is equal to an advance, since the money must be kept available for the purpose of taking up the paper - we have a total of $47,666,000 of credit actually in use. There have also been some repayments, some applications have been withdrawn, and some are awaiting completion by the applicant before disbursement of funds can be made.

The fact that the Federal Reserve banks have about $280,000,000 available for industrial loans, under the provisions of the Act, and after nearly a year have a little more than $88,000,000 of advances approved by the committees might suggest either indifference on the part of the System to the program or that there was little demand for the kind of credit made available by the Act. I believe that neither of these conclusions is warranted by the facts. The Board and the Federal Reserve Banks have stressed the program repeatedly and at the same time evidence still exists of a need for such credit for small industry and business.

As you know, there has been a certain amount of skepticism as to the existence of this demand for credit. The skeptics may possibly be right. But I do not know how we can prove what the need is, except by earnestly pursuing the possibilities of extending credit to small industry under Section 13b with all frankness and sincerity. We must at least exhaust every means of informing bankers and borrowers what the opportunities are.

Banks were very sick. They called the doctor. They recuperated. Now they are, as it were, learning to walk again, but they are very cautious. That is human.

Laws, too, are human. They are made by man in accordance with what is considered the need of man. We know of man's needs by the law of averages.

Let me tell you of a human incident by which a clerk in a haberdashery tried to apply the law of averages:

A wife called at the haberdashery and said - "I wish a collar for my husband." The clerk asked her for the size collar desired. She said - "I don't know, I will go back and ask my husband. The clerk, who thought he knew something of human nature, said, "I think I know the size of the collar your husband wears." She said "Really". The clerk said "Yes I think he wears a size 11 1/2 collar." She said "That is right - I remember now - but how did you know?" The clerk said - "A man who sends his wife out for a collar wears about that size."

I repeat that it is perfectly natural that after their experiences of recent years bankers should feel extremely conservative. It is perfectly natural that applicants should have difficulty in proving their present prospects are good. And it is to be expected that a new provision of law bringing the Federal Reserve System into the field of long term loans should be hard to make generally known and understood. We are working as effectively as we can to overcome these obstacles.

Now, after thus explaining the plans and intentions of the Reserve System, I wish to point out how this law directly concerns you as bankers.

Although it is provided in the law that credit for industry may be furnished to the borrower either by the Federal Reserve bank directly or by the commercial banks with the cooperation of the Federal Reserve banks, the law itself favors the latter procedure. To make this point clear, let me read the first two paragraphs of Section 13b:

The provision of the law authorizing the Federal Reserve Banks to discount or purchase loans made by member banks and other financing institutions is as follows:

> "(b) Each Federal Reserve bank shall also have powers to discount for, or purchase from, any bank, trust company, mortgage company, credit corporation for industry, or other financing institution operating in its district, obligations having maturities not exceeding five years, entered into for the purpose of obtaining working capital for any such established industrial or commercial business; to make loans or advances direct to any such financing institution on the security of such obligations; and to make commitments with regard to such discount or purchase of obligations or with respect to such loans or advances on the security thereof, including commitments made in advance of the actual undertaking of such obligations. Each such financing institution shall obligate itself to the satisfaction of the Federal Reserve bank for at least 20 per centum of any loss which may be sustained by such bank upon any of the obligations acquired from such financing institution, the existence and amount of any such loss to be determined in accordance with regulations of the Federal Reserve Board."

In non-technical language, that provision enables the bankers to make loans to furnish working capital to industrial and commercial borrowers on long maturities and at the same time get the promise of the Federal Reserve bank to take over the loan at any time without recourse for 80 per cent of the loan.

In order that the credit may be made available even though the bankers fail to take advantage of this opportunity to put their funds to work with a minimum of risk, the law also authorizes direct loans by the Federal Reserve banks to industry by the following language:

> "(a) In exceptional circumstances, when it appears to the satisfaction of a Federal Reserve bank that an established industrial or commercial business located in its district is unable to obtain requisite financial assistance on a reasonable basis from the usual sources, the Federal Reserve bank, pursuant to authority granted by the Federal Reserve Board, may make loans to, or purchase obligations of, such business, or may make commitments with respect thereto, on a reasonable and sound basis, for the purpose of providing it with working capital, but no obligation shall be acquired or commitment made hereunder with a maturity exceeding five years."

As the law was originally drafted these two paragraphs appeared in the order in which I have read them, but for some reason that order was reversed in the legislative mill and to a casual reader of the law it might appear that the emphasis was on direct loans by the Federal Reserve banks rather than on advances or commitments to banks. This is not the fact. On the contrary, the law says definitely that direct loans are to be made only in exceptional circumstances and when credit is not available from the usual sources; there is no such limitation on rediscounts or on commitments covering loans made in the first instance by local banks or other financing institutions.

As a matter of fact, strange as it may seem, up to the present most of the money has had to be placed on direct loans by the Federal Reserve banks. And that needs to be explained. The Federal Reserve banks are not organized to take business away from the local bankers, and they most certainly do not wish to do so.

It is stipulated in the law that direct loans shall be made by the Federal Reserve banks only in exceptional cases and when the required credit is not available from the usual sources. The Federal Reserve Board and the Federal Reserve banks have felt that this stipulation was extremely wise. The objection that the banker makes to these loans is, of course, that they have too long maturities and sometimes may be considered poor risks; but these objections were largely removed so far as local banks are concerned by the commitment which the Federal Reserve Bank will make to take over the loan from the lending bank without recourse except that the lending bank must obligate itself for at least 20 per cent of any loss. This means, of course, that the member bank or other financing institution which makes a loan is able to insure liquidity for the loan, and also to have as much as 80 per cent of it underwritten by the Federal Reserve bank. A long term loan that may be discounted at the Federal Reserve bank at any time without recourse as to 80 per cent of any loss, is, from the point of view of the commerical bank, as liquid as any earning asset it may hold.

You, of course, are trustees of your depositors funds, and it certainly is not, and cannot be our aim to urge you to risk those funds by loaning on a basis that is not reasonable and not sound. That is plain.

But in times like these when the banks have more funds than they can put to profitable use, and on that account have difficulty in making adequate earnings, it seems to me important that you should understand the possibilities open to you under Section 13b and should make the most of them.

In concrete terms, what the provisions of the law mean to you bankers may be stated as follows:

First: You may make a loan on a reasonable and sound basis with a maturity not exceeding five years to an established industrial or commercial business in your community for the purpose of supplying it with working capital.

Second: If the loan is acceptable to the Federal Reserve bank (which may be determined before the loan is made) you may obtain from the Federal Reserve Bank a commitment to take over the loan on stated terms at any time within the period of the commitment.

Third: You pay the Federal Reserve Bank a small charge for this commitment, the amount paid depending principally upon the length of time covered by the commitment. For the Federal Reserve Districts in which this State is located, the Federal Reserve Bank rates on commitments are from 1 to 2 per cent per annum, which may be called either an insurance charge or a charge for standing by. Having paid it and received its commitment, the bank is assured that the loan which the commitment covers is perfectly liquid.

Fourth: If you subsequently need to dispose of the loan on which you hold the commitment, you inform the Federal Reserve Bank of your desire, and the loan is taken off your hands. The Federal Reserve Bank discount rates on industrial loans in the Districts in which this State is located are from 4-1/2 to 6 per cent.

Fifth: Under the terms of the commitment, the Federal Reserve Bank will relieve you of obligation for as much as 80 per cent of any loss sustained on the loan. In other words, you can sell or rediscount the loan without recourse up to 80 per cent of its amount, but you continue under obligation for the remainder, which may be only 20 per cent.

One banker who has been very active in making industrial loans described in the following words his plan for setting up a special reserve to cover possible losses in such loans.

"The usual participation is, of course, on an 80-20 basis. Generally the entire loan bears the maximum rate of 6 per cent. We look upon the 80 per cent guaranteed part of the loan as a prime investment - to the point that if such an investment were available in the open market we would be willing to buy same on a 1 per cent per annum income basis. We take all the income above 1 per cent obtainable from that part of the loan guaranteed by the Federal Reserve bank and set it up in a special reserve account to provide against any loss sustained in our participations."

I have been talking so far, necessarily, in general terms. Now let me describe a typical actual loan under Section 13b.

A varnish manufacturer with a plant in a medium-sized industrial city needed $25,000 working capital. He needed it for a longer time than his local bank cared to lend without provision for liquidity. Accordingly, an application was made by the local bank, which was a non-member, to the Federal Reserve bank for a commitment. After investigation of the business and the security offered the application for the commitment was approved. A loan of $25,000 was made by the local bank repayable in equal semi-annual instalments, the last instalment becoming due in four years. The security comprised a lien on plant and equipment, assignment of stock in another corporation and assignment of two life insurance policies. The loan bears interest at 6 per cent. Covering this loan the Federal Reserve bank gave the local bank a commitment to take over the loan at the local bank's request any time within twelve months. The local bank pays 1 per cent per annum for this commitment. Before the end of the twelve months, it can either procure a commitment for a further period, or ask the Federal Reserve Bank to take the loan off its hands. The local bank is thus enabled to hold a loan of which the liquidity is assured, on which its part of any loss may not exceed 20 per cent, and on which it receives 5 per cent net.

You will also be interested in types of loans which have been rejected. We have had relatively few complaints from disappointed applicants. Those who have complained, however, have had their applications reviewed by the Federal Reserve Banks and every effort has been made to render assistance in accordance with the intent and purpose of the law. There was recently received by one of the Federal Reserve Banks an application from a manufacturing company which had been organized in the last year or so to reopen a plant that had been closed for some time. The plant at one time had apparently been successful, but its former owners had subsequently become bankrupt. The new company was organized by people who had no previous experience in the business and who had insufficient funds. Their business records gave no assurance of ability to succeed and their bankers were unwilling to make the loan nor participate in it. The Federal Reserve Bank was asked to lend them practically all of their capital. There was doubt whether the applicant was eligible as an established business, but even leaving that question aside, the application had to be rejected because there was little prospect that the loan could be repaid from the profits of the business, and the underlying security was inadequate. I notice that in the case of the Chicago and St. Louis banks, the chief reasons for rejections have been insufficient security, unsatisfactory financial condition, for the law requires the loan to be made on a "reasonable and sound" basis, and ineligibility, in that funds were not really required for working capital.

Question has arisen as to whether the law permits loans to be made in cases where the proceeds are to be used for the refunding of existing indebtedness held by member, non-member banks or other financing institutions. The purpose of the loans, in the language of the Act, is to furnish working capital to industrial or commercial business; that is one of the few specific conditions which the law imposes. Obviously, a loan transferred from one creditor to another does not provide the industrial or commercial borrower with additional working capital; nor, considering the fact that the banks are already supplied with more funds than they are finding use for, can it be said that the transfer of such indebtedness from local banks to Federal Reserve banks gives the local banks funds required by other borrowers. Consequently, applications have had to be rejected where it appeared that the principal effect of the loan would be to transfer certain slow assets from the portfolio of a member bank to the portfolio of a Federal Reserve bank. When, however, the transfer of existing indebtedness is clearly an essential part of a plan of rehabilitation involving new working capital, it seems in accord with the spirit of the law to allow a portion of the proceeds of a given loan to be used for refunding.

Question has also arisen as to the meaning of the term "established", in view of the fact that the law authorizes loans to be made to established industrial and commercial businesses. A new corporation may perhaps be organized to take over an old business, and while the question whether in any particular case the applicant can be regarded as an established business may have to be determined by counsel, it is felt that in general the term should be interpreted as liberally as possible.

I wish to remind you that the Federal Reserve banks are not required to submit each application to Washington for the approval or disapproval of the Federal Reserve Board. The action taken by the Federal Reserve bank in each case is final, although the Board does keep constantly in touch with the Federal Reserve banks on the administration of Section 13b.

In this connection, if I had time, I should like to read you recent letters which the Board has sent to the Reserve banks. They have suggested the expediting of work on applications so as to get funds actually into use more quickly. They have emphasized the need of calling the attention of all banks to the advantages of Section 13b. They have stated the Board's judgment that loans should be made by local banks under commitment from the Federal Reserve banks rather than by the Federal Reserve banks directly.

In fixing their rates on industrial loans direct to the borrower, the Federal Reserve banks have tried to avoid making rates so low as to attract this business away from member and non-member banks and other financing institutions. In general, here in the middle west, commercial banks and other financing institutions appear to be getting from 5 to 6 per cent on such loans. The rates charged by Federal Reserve banks on commitments vary with different conditions, but in general run from 1 to 2 per cent per annum. So, for example, as in the case already described, on a loan which bears 6 per cent interest, a member or non-member bank may pay 1 per cent to the Federal Reserve bank for a commitment, which will leave 5 per cent net to the member or non-member bank.

The loans made either by the Federal Reserve Banks direct or by financing institutions under commitments from the Federal Reserve Banks vary in size from $250 up to amounts of several million dollars. The maturities range from a few weeks to five years. A wide variety of enterprises is covered.

I might add that the automobile industry is at the head of the list in total amount advanced under Section 13b - nearly $12,000,000. It may also be worth noticing in the copy of my speech which will be, or has been, handed you, how many of these concerns which have been borrowing under Section 13b are directly or indirectly connected with the building industry. Most of them are makers of or dealers in essential products and necessities of life - 175 loans were made to manufacturers of and dealers in food products, and 162 to dealers in and manufacturers of lumber and builders' supplies.

I trust I have given you a definite idea of what industrial loans should mean to you. I hope that if you find enterprises in your communities which could use additional working capital to an advantage, you will not hesitate to communicate with the Federal Reserve Bank about such prospects.

In this connection, I should like to read you at least one letter, copy of which was received by a Federal Reserve Bank, which shows that real assistance has been rendered under Section 13b:

> "We wish to thank you for having permitted the Federal Reserve Bank to make loans to individuals, as the banks that we do business with have refused to help us; had it not been for the Federal Reserve we probably would have been at a great handicap, that is, our farmers would have had to go on the relief. The folks here in the Reserve Bank are the way real bankers should be: prompt, courteous, business all the way through, and very competent.
>
> "Thanking you and trusting that you will leave this avenue of finance open to us, I am
>
> Faithfully yours......"

This loan has already been paid back in full.

I could illustrate cases one after another, but even these would not show all the assistance that has been rendered, for in many cases the Federal Reserve banks and member and nonmember banks have helped the small industry and business without even the necessity of granting a loan, by giving advice - business and financial, by assisting in reorganizations, and in innumerable other ways that cannot be, and are not, recorded in a statement of figures. Through Section 13b the Federal Reserve System has come closer to the public in a tangible and concrete way, though the figures, at first glance, might make the service actually rendered appear rather small.

If certain banks lending under Section 13b find that some of these loans are better risks than they had supposed, and thus decide to lend a little more freely to comparable enterprises, it will be a distinct advance toward putting bank funds profitably to work.

While, of course, there is much more to say about industrial loans, I realize that the occasion does not permit an exhaustive discussion.

I am afraid I have already taken too much of your time, and I don't wish to have you tell me so. You have been kind and courteous - quite unlike the fellow who was listening to a long speech by a professor on the origin of man. Let me say to the press that this is off the record. The professor, after three hours of continuous speaking, asked - "If man originates from the monkey, where is our tail?" Someone in the audience replied quickly - "We have worn it off by this time sitting here listening to you."

I hope, however, that I have stated enough to arouse your interest in the amendment, at least to the extent of reading Section 13b, which is very short, and the regulations of the Federal Reserve Board and the Federal Reserve Banks of Chicago or St. Louis, in whose districts the State of Illinois lies. These have been supplied to the Secretary of the Association, and he promised to distribute them among the delegates to this Convention.

Senior officers of the Chicago and the St. Louis Federal Reserve Banks are present. They will be glad to meet you to discuss any matters respecting the Federal Reserve System, and particularly participations or commitments under Section 13b of the Federal Reserve Act. The Chairman or Secretary of the Convention can direct you.

Let me conclude by saying that of course we learn by experience. As the years roll by, we look back and find that the big things that we have done - the really big things, in the final account - which helped our communities and our country most - were things that appeared very small at the moment.

Human beings are apt to spend their efforts pushing large boulders when the removal of several small pebbles from under the large boulders would enable the boulders to move of themselves - so with our economic problems.

Of course, we all look for a day when the sun will shine once again on our highway. But the dawn doesn't usually come up like thunder. It often steals upon us almost unawares.

Just when our most strenuous endeavors seem to be ending in flat failure, and our most elaborate and best laid plans seem to be going wrong, we are in no mood to notice the more certain, if less conspicuous results of all our efforts. But why search for words of my own? There's a brief poem that says it all so much better, and it comes irresistibly to my mind these days - perhaps it is familiar to you:

"Say not, the struggle nought availeth,
The labor and the wounds are vain,
The enemy faints not, nor faileth,
And as things have been, things remain.

If hopes were dupes, fears may be liars;
It may be, in yon smoke concealed
Your comrades chase e'en now the flyers,
And, but for you, possess the field.

"For while the tired waves, vainly breaking,
    Seem here no painful inch to gain,
Far back, through creeks and inlets making,
    Comes, silent, flooding in, the main.

And not by Eastern windows only
    When daylight comes, comes in the light,
In front, the sun climbs slow, how slowly,
    But Westward, look, the land is bright!"

Speech delivered over
National Broadcasting Company System
September 5, 1935

LOANS TO INDUSTRY AND BUSINESS BY THE FEDERAL RESERVE BANKS

Let me thank the National Broadcasting Company and officiated stations for extending me the privilege of addressing the country upon the subject of "Loans to Industry and Business by the Federal Reserve Banks".

The occasion reminds me of a time more than twelve years ago when radio speeches were in their infancy, and when regularly each week I traveled to a North Side radio station in Chicago to deliver talks on educational topics. This evening the topic I shall speak on over this national hookup is a quite different one, and yet in a sense what I said then on economic-philosophic subjects involves the same fundamentals as what I have to say tonight on the subject of credit.

By way of preamble, let me say that it is difficult, to say the least, for anyone to state the principles upon which solution of our economic problems is possible. No economist and no expert has been able to state the remedy clearly and persuasively. That is because each economist and expert sees the situation from his own point of view, and his point of view is frequently based on opinions he has already expressed, especially if he has written a book or two. I am not speaking disparagingly of economists and experts. I have two daughters who, I hope will soon major in economics. I think very highly of economists and experts and know they have contributed much. But I too have studied and taught economics, and therefore know its limitations as well as its possibilities

Personally, however, I believe that the beginning of a solution of our problems lies in a full realization that selfishness is at their bottom. If we could, without appearing to preach, or lecture, speak so as to move the heart as well as the mind of man for and in behalf of his fellow man, we would be making a real step in the direction of a permanent solution of our economic perplexities.

It is humanly so difficult, however, for us to see anybody else's needs and sufferings but our own. What is worse, perhaps, it is hard for us to realize that our own welfare rests on what we are willing to do for others. In human relations, repayment in kind is inevitable. We get back eventually with interest, exactly what we give out to others - good or bad. No matter how long it might appear to take - Human accounts are settled one day.

You have heard this often and much more ably said than I can say it. You have seen actual cases - by the House and Senate - yet you may be inclined to feel that it is too easy and can not be true. You may feel that problems so intricate as ours can not be solved by so simple a method - that there must be some formula much more complex than just this simple formula of charity - real charity of the heart.

We are inclined in our own human way to be much impressed by things we do not understand - like the boy who came home from school one afternoon, and all out of breath said to his mother: "We had a very brilliant professor teaching us physics this afternoon. He took the place of the regular professor who is sick, and he talked to us all afternoon and nobody in class could understand a thing he said. It was just wonderful Mother." How many of us are just like that boy. We look for complex and mysterious remedies for our ills, and we place on a pedestal the individual whose words are big and whose theories are beyond our mental grasp.

Yet in fact truth is very simple. It is here - there - everywhere. We could see it if it were not for the fog of prejudice and ignorance in which we live. Occasionally the fog lifts and then we see the truth that was there all the time. It may be astounding, - it may even be shocking, but seeing it we accept it, for the light of truth is its own evidence, and the mind can not resist it, nor remain dark when penetrated by its beams. So it is with our economic difficulties. The solution of these problems rests in simple truths that are all around us - truths in whose midst we have our dwelling - truths which are near at hand and everlasting - truths which distinguish right from wrong in the relation of man to man.

These are the principles upon which to base the solution of our economic problems; and yet, because the statement of them is so simple, I dare say you are smiling at this very moment and saying, "Doctor - heal yourself". But no one can do it alone. The problem is collective as well as individual, and the solution therefore must be collective as well as individual.

The correction of evils, economic or social, must begin with a sincere and frank admission of our own limitations - our failures to see the truth - our mistakes. From that point on we can begin to live a new life for the good of society. Once we have begun our new economic and social life based upon these fundamental principles, we can proceed <u>courageously</u> without even the smallest fraction of a fraction of fear, and going forward we become leaders - others follow. The world however never follows <u>one</u> who is afraid or uncertain.

I have mentioned these general and fundamental considerations because they are the essential background to my subject. What I am to speak of is only one of the simple measures that we have adopted in order to meet the economic difficulties that we are endeavoring to solve. It is a measure for the lending of money to established industrial and commercial enterprises whose working capital has become depleted. It is not a measure intended to dispel all our economic difficulties. But it is helpful, and for that reason I want to explain it so that every business man to whom it may be of benefit may know of its provisions and how he may avail himself of them.

An outstanding fact about the present business situation is that the banks of the country have an abundance of money to lend. There are two main reasons why this money is not being used by borrowers. The first and most important probably is that responsible business men do not wish to borrow unless they are confident that they can make a profitable use of the funds. The second is that bankers do not wish to lend unless they too are confident that the borrowers can make a profitable use of the funds. But credit is necessary for business, and no effort is to be spared in removing obstacles to the availability of credit whenever and wherever credit can profitably be used. Accordingly, the Federal reserve banks have been authorized to make a distinct departure from their established practice. They have been authorized under certain circumstances to guarantee loans which local banks may not be willing otherwise to make, and in exceptional circumstances, to make such loans themselves.

Briefly, the conditions are as follows: A Federal reserve bank will either cooperate with a local bank in making a loan to a commercial or industrial borrower, or it will make the loan direct. This provision applies, however, first, only to loans to established industrial and commerical businesses; second, only to loans which are for working capital purposes; third, only to loans which have maturities of not more than five years; fourth, only to loans which can be made on a reasonable and sound basis.

In administering the law the effort has been to avoid narrow interpretations. The question whether or not a business is an established one is interpreted as liberally as possible, though the law can not by any stretch of interpretation be held to authorize the making of loans to people who wish to start a new business. Similarly, the term "working capital" can not be stretched to cover loans made for the purpose of the erection of buildings, the purchase and installation of permanent equipment, or the refinancing of existing indebtedness. Such uses of credit are desirable and may be taken into consideration incidentally in passing upon applications for loans to provide working capital, but they do not come within the primary purpose of this law, which applies instead to funds required for current operations.

The requirement that loans have maturities of not to exceed five years is a very generous one. It gives the ordinary business man ample time in which to restore his working capital. He can meet his successive payrolls, purchase his materials, renew his inventories, and turn over his stock again and again before his loan has finally to be paid back. Generally the loan is made payable in easy installments.

In imposing the requirement that the loans be made on a reasonable and sound basis, Congress has left it to the judgment of the Federal reserve banks as to what security should be required in individual cases. The types of business covered by these loans are of the utmost variety, and for that reason standard requirements as to security can not be made in detail. It can only be required that the security offered, whatever its nature, be adequate. The Federal reserve banks have on occasion accepted real estate mortgages, chattel mortgages, stock and bond collateral, pledge of accounts receivable, endorsement, assignment of life insurance policies, etc. No business man who has assets of value to offer as security need hesitate merely because they do not conform to the types of collateral which banks usually require.

The Federal reserve banks are not in competition with local banks in making loans. On the contrary, the idea is that the Reserve banks should cooperate with local banks, which are the proper agencies to supply credit to their communities. Accordingly, the first step for any prospective borrower is to go to his local bank and state his needs. He should say to his banker that he is not seeking an ordinary short-term extension of credit, but a loan under the terms of Section 13b of the of the Federal Reserve Act. His banker should know at once what he is talking about. If he does not, the borrower should tell him what he has heard me say; he should tell the banker that under the provisions of Section 13b of the Federal Reserve Act the Federal reserve banks are authorized to cooperate with local banks in making loans for working capital purposes. In case the banker is not familiar with this fact he should ask him to communicate with the Federal reserve bank of his district and find out the particulars. And the local banker should be glad to do it. Ordinarily, of course, he does not wish to make long-term loans; he thinks of the depositors who may at any time demand their money, and he wants his funds where he can call them in quickly if he is subjected to such a demand. But the banker need not worry about the long maturity, for under Section 13b the Federal reserve bank will grant him a commitment to take the loan off his hands during the period of the commitment. That commitment makes the loan as liquid as anything the banker can have in his bank. Furthermore, in taking over the loan, the Reserve bank will assume as much as four-fifths of any loss. It makes no difference whether the local bank is a member of the Federal Reserve System or not.

The borrower will probably find, however, that his banker already knows all this; and if the applicant's credit is good and the loan is one that the banker is justified in making he will be very glad to place his funds in use under an arrangement which assures him perfect liquidity and guarantees him that his loss will not exceed 20 percent of the loan.

If, however, the banker does not respond, the borrower should communicate directly with the Federal reserve bank of his district. The Federal reserve banks are authorized to make the loans direct only in exceptional circumstances and when credit is not available from the usual sources. The loan should be adequately secured and there should be a reasonable prospect that it can be repaid from the operations of the business. The loan is not a gift. Applications are acted on as promptly as possible. They are not referred to Washington. They are passed on in the distrcits where they originate, and each Federal reserve bank has final authority to reject or approve the loans for which it receives applications.

The provisions of Section 13b of the Federal Reserve Act have been in actual operation for more than a year. In that time the Federal Reserve banks have approved nearly 1800 applications, aggregating about $107,000,000.

As of June 30, the automobile industry was using over $7,000,000 of this credit. Manufacturers of metals were using over $5,000,000. The machinery and machine tool industry was using over $3,000,000. Textiles were using $2,500,000.

Loans have been made in all amounts. The smallest so far is a loan of $250.00, the largest a loan of $6,000,000. It should be clear, therefore, that the program is one which is open to all business men, large or small, whose businesses are established and whose prospects are such that loans can be justified.

There now, that is simple, isn't it? - like those truths I mentioned in the beginning. Its purpose is to aid business and industry and to maintain and increase employment.

For further information and for application forms, ask your banker, or write to the Federal reserve bank of your district.

Thank you, and good night.

Speech delivered before
Cosmos Club
Washington, D. C.
February 27, 1936

FEDERAL RESERVE SYSTEM LOANS TO INDUSTRY

WHAT IS FEDERAL RESERVE SYSTEM

The Federal Reserve System was established in 1913 by the Federal Reserve Act, one of the most important pieces of financial legislation ever passed in this country. The System was created after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907, and after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908. Since 1913, on the basis of actual experience and in response to new developments, numerous amendments have been made to the original Federal Reserve Act. During the depression changes were made by the Glass-Steagall Act of 1932, the Emergency Banking Act, the Banking Act of 1933, the Gold Reserve Act of 1934 and other acts. The recent legislation, approved August 23, 1935, makes important permanent changes so that the System can be more effective in the future in meeting the credit needs of the country.

FUNCTIONS OF FEDERAL RESERVE BANKS

There are twelve Federal Reserve banks, one in each of the twelve Federal Reserve districts into which the whole country is divided. Several of the Federal Reserve banks have branches which operate in different parts of their district. There are now in all twenty-five branches and two agencies.

Banks of the country become eligible to use the facilities offered by the Reserve banks by becoming members of the Federal Reserve System. All national banks were required by law to join and State banks are permitted to become members if they fulfill certain requirements as to capital structure and as to the general nature of their business.

Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Generally speaking, they do not deal directly with the public. Their customers are the member banks who come to secure credit or currency just as the public goes to the local banks. The capital stock of the Federal Reserve banks is owned by the member banks, which are required by law to subscribe to capital stock equal to six per cent of their capital and surplus. One half of such subscription is paid in cash and the other half is subject to call. The management of the bank is in the hands of a board of directors which represents not only the member banks but other business interests of the community.

One of the purposes of the Federal Reserve Act was to provide institutions which would hold reserves of the nation's banking system.

All member banks are required by law to keep their reserves on deposit in the Federal Reserve bank of their district and it is the business of the Reserve banks to supply member banks with credit or cash in such emergencies.

Reserve banks are sometimes known as the central reservoirs of credit of our banking system because of this function of holding in trust the reserves of the member banks. Under the Federal Reserve System our banks no longer have any fear that they will be unable to get their reserves when needed. One important risk has been eliminated from commercial banking.

Loans to Member banks: Equally important with their function of holding member bank reserves is the power of the Reserve banks to make loans to member banks. Through these loans the member banks are able to increase their deposit balances and thus provide the reserves necessary for the expansion of credit. Reserve banks may supply funds to member banks by rediscounting paper or by making advances to member banks, as provided by law and Board regulations, or by purchasing bills and securities, and entering corresponding credits to the account of the member banks, thus increasing their reserve balances. Member banks in turn can increase their loans to the public in the aggregate by an amount several times the amount of the additional reserves.

Currency issued by Reserve Banks: Another phase of the activity of the Reserve banks is the issuance of Federal Reserve notes, which are the paper money put out by the Reserve banks under the provisions of the act for supplying the country an elastic currency; that is, currency whose volume can be readily increased or decreased according to the public demand for it. Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the issuing bank. The bank is required to keep reserves in gold certificates at least equal to forty per cent of the notes in actual circulation.

Other functions: Reserve banks have greatly simplified the procedure whereby banks collect checks they receive which are drawn against other banks. This has been very useful to business men because it has permitted more prompt and cheaper settlement of many business transactions. The Reserve banks in effect act as a nation-wide clearing house. Banks merely send the checks against other banks to the Reserve bank of their district. Checks on banks in the district are cleared on the books of the Reserve bank and those on banks in other districts are cleared through the other Reserve banks. The Reserve banks perform similar services in connection with other credit items such as collection of notes, drafts, bonds and coupons, and the acceptance of exchange drafts. Machinery has also been set up for prompt payment of funds from one part of the country to another without actual movement of currency. The System maintains a fund in Washington called the Gold Settlement Fund established by deposits of the twelve Federal Reserve banks. Transfers from one district to another are made daily by adjusting the accounts of the various Reserve banks.

Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and in administering deposit accounts of the Government in the Reserve banks.

FUNCTIONS OF BOARD OF GOVERNORS

The most important duties of the Board of Governors in Washington relate to the broad credit policy for the country as a whole and are sometimes spoken of as its power to influence the volume and cost of credit. Experience has indicated that powers of the Board which affect the expansion and contraction of the general supply of credit are of vital importance to the country, since the volume of credit is a factor in determining the course of business, and proper changes in the cost and volume of credit may exert an influence toward moderating excessive expansion or contraction of business, or in other words, may reduce the danger of inflation and deflation.

The Board's instruments for influencing the volume of credit are its power to change discount rates and reserve requirements, and through its majority members on the Federal Open Market Committee, to determine open-market policies.

Discount rates are the rates charged by the Federal Reserve banks on loans to member banks. These rates determine the cost of borrowing by member banks and consequently affect the cost at which the public can borrow from these banks. Under the Federal Reserve Act changes in discount rates made by the various Federal Reserve banks are subject to review and determination by the Board of Governors. This gives the Board final responsibility on the discount rates so that the most of the borrowing in the different sections of the country may be kept consistent with general credit conditions for the country as a whole.

The new banking act strengthens the Board's power to control these rates by making the further provision that discount rates must be submitted to the Board of Governors every fourteen days. This establishes as a matter of law the requirement that the discount rate policy shall be reviewed at least every two weeks.

The Board of Governors also has the power to change the reserve requirements of member banks. The volume of credit which any member bank may extend is limited by the amount of reserves which are required by law to be maintained against its deposit liabilities. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit.

Another important means of control over the supply of credit are the so-called open-market operations, responsibility for which under the new banking act will be vested in a new Federal Open Market Committee. This committee will consist of the seven members of the Board of Governors and five representatives of the Reserve banks selected by the Reserve banks in different regions.

Open-market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. These operations have the effect of increasing or decreasing the supply of credit available in the market. By selling securities the Reserve banks withdraw funds from the market and there is a decrease in the supply of credit. Through a purchase of securities a Reserve bank puts funds into the market, thus tending to ease credit conditions.

The Board of Governors has a variety of other duties which tie in with its general responsibility for supervision of the System. These include the examination of Reserve banks, passing on applications of State banks and trust companies for membership in the System, obtaining condition reports from State member banks, administration of those provisions of the Clayton Anti-trust Act which relate to inter-locking directorates, regulation of the maximum rate of interest to be paid by member banks on time and savings deposits, regulations under the Security and Exchange Act governing the margin requirements for loans on securities listed on the stock exchanges, and maintenance and operation of the Gold Settlement Fund.

It is also a part of the System's problem to watch indicators of credit trends and to develop a better general understanding of the facts bearing upon credit policy. The System has pursued a policy of collecting information bearing on banking conditions throughout the country and on production, employment, trade and prices. In a monthly publication, the Federal Reserve Bulletin, and in its Annual Report, the Board has undertaken to give to the public a comprehensive view of current banking and financial developments at home and abroad and also to furnish detailed information on conditions of banks throughout the country and on the business situation.

LOANS TO INDUSTRY - SECTION 13-B

I want to take a few minutes now to tell you about recent special work of the Federal Reserve banks. I refer to operations under an amendment to the Federal Reserve Act approved June 19, 1934, which authorizes the Federal Reserve banks to make direct loans to industry and to guarantee for banks certain types of loans to business men which the banks might not otherwise be willing to make. The purpose of these provisions is to give both bankers and business men some added assurance in making commitments during a difficult period when they tend to feel unduly conservative.

Anyone in an established industrial or commercial business who wants a loan for working capital purposes which is reasonable and sound and has a maturity of not more than five years should now be able to get such a loan from his local bank. This applies to both member and nonmember banks. Furthermore, if the local bank cannot accommodate the borrower, he may be able to borrow from the Reserve bank itself. No business man who has assets of value to offer as security need hesitate because they do not conform to the types of collateral usually required by banks.

The local banks are given special assurance in making these loans through the privileged status which they enjoy at the Reserve banks. The loans are eligible as a basis for borrowing at the Reserve banks. More than that, if the bank wants to dispose of a loan it can procure a commitment from the Reserve bank to take it off its hands and the bank is guaranteed against loss up to 80 per cent of the loan.

The Federal Reserve banks do not seek, however, to supersede the local banks. They do not make an advance if there is a local bank willing to make it. They seek to have the local bank at least participate in the loan, and the law goes so far as to permit the Reserve bank to relieve the local bank of all but 20 per cent of any loss on the loan. Since the middle of 1934 when this program began the Federal Reserve banks have approved applications for about $126,000,000 of such credit.

The credit has been used by a wide variety of businesses. Only established commercial and industrial enterprises are eligible, the loan must be on a reasonable and sound basis, and the maturity must not exceed five years.

Speech delivered before
Real Estate Board of Kansas City
Kansas City, Missouri
May 8, 1936

BUSINESS RECOVERY AND INDUSTRIAL LOANS

There are three principal aspects to be noted in the credit situation during the last three years. These are:

1. The growth of bank reserves.
2. The increase in the volume of bank deposits.
3. The limited use by business and by individuals of the funds which banks have available.

Growth of bank reserves

Since June 1933 the reserves of member banks have shown exceptional growth. They now stand at the highest levels on record, $5,800,000,000. Between June 1933 and March of this year total member bank reserve balances had increased $3,500,000,000. Required reserves increased in that period by about $1,000,000,000, which left an increase, therefore, of about $2,500,000,000 in excess reserves. Excess reserves are now about $3,000,000,000.

The growth of reserves has resulted principally from the movement of about $3,300,000,000 of gold to this country from abroad.

Since June 1933 the public debt has increased about $9,000,000,000. Banks (including Federal Reserve banks, member banks, mutual savings banks, and other non-member banks) increased their holdings of Government obligations by nearly $6,000,000,000, or 2/3 of the total increase of the public debt. These funds borrowed by the Government from the banks have been expended to provide relief and employment. They increased bank deposits.

The increase in the volume of bank deposits

The deposits of the general public, excluding inter-bank and United States Government deposits, but including deposits at non-member as well as at member banks, now total about $45,000,000,000. There has been an increase of about $11,000,000,000 since June, 1933. Deposits at present are still below the 1929 peak by about $5,000,000,000. However, since that time Postal Savings deposits not redeposited in banks have increased by nearly $900,000,000, and money in circulation outside of banks has increased by $1,500,000,000. Accordingly, the available cash resources of the public are altogether only about $3,000,000,000 - or 5 percent - less than they were in 1929.

The increase of $11,000,000,000 in deposits since June 1933 is due largely to an increase of about $4,000,000,000 in monetary gold and silver stock and of about $5,500,000,000 of Government expenditures from the proceeds of direct obligations purchased by banks, including the Federal Reserve banks, and by the Postal Savings System.

The limited use by business of the funds which banks have available

Although the volume of bank deposits is now almost as large as at the peak in 1929, the rate of turn-over is still relatively small; deposits turned over about fifteen times per annum in 1935 as compared with twenty-seven times in 1929, and as compared with twenty times in other years more normal than 1929. Accordingly, although it is to be expected that deposits will increase still further this year, as the result of government borrowing and expenditure, it does not necessarily follow that the rate of turnover will increase.

It is unusual for banks to have any large amount of excess reserves such as they now have. Prior to 1931 they never had excess reserves of more than $75,000,000 or $100,000,000 altogether for any great length of time. With excess reserves in such an amount as $3,000,000,000 it is natural that the banks should be seeking ways of putting these funds to use.

It is obvious that the possible expansion that may take place on the basis of present reserves is far greater than may be needed for sound business conditions. On the present basis, credit could be extended and bank deposits thereby increased to $90,000,000,000 or $100,000,000,000. This would be about twice what deposits are now, and about twice the amount that they were in 1929 at the peak. These deposits would represent funds immediately available for use.

The possibility of increasing the use of funds and also the amount of funds to be used depends upon two things: First, it depends upon the desire of owners of existing deposits to use what they have either for spending on a freer scale or for permanent investment. In the second place, it depends upon the desire of business to use the funds already available and to borrow still more for the purpose of expanding operations.

In the past year developments in capital markets were marked by a sharp increase of activity. Stock market trading increased and securities prices rose by over 50 percent. New security issues in 1935 were the largest since 1930. The principal issues however were for refunding; these totaled $3,300,000,000. Issues to raise new capital totaled only $1,400,000,000, of which $1,000,000,000 represented issues of States, municipalities, and Federal land banks. Corporate issues for new capital totaled only $400,000,000. This compares strikingly with the figures in the late twenties when corporate issues for new capital amounted to $4,000,000,000 or more a year.

Although the greater portion of the financing indicated has been for refunding of existing indebtedness, this refunding has been at lower interest rates and consequently has tended to decrease costs and to increase the profitableness of enterprise. The small volume of issues for new capital is not in any event an accurate measure of business expenditures for plant and equipment, since not all the proceeds of such issues are used for this purpose, and since, on the other hand, corporations have a large volume of idle funds available. Moreover, developments in the business situation indicate that these funds are being more freely used.

Industrial loans

In this connection I think it will be interesting to mention the experience of the Federal Reserve banks in making idustrial loans. In June 1934 the Federal Reserve Act was amended by the addition of a new section, namely 13b, authorizing the Federal Reserve banks to make credi available for working capital purposes to established industrial and commercial enterprises on maturities not exceeding five years. This authorization was made because it was felt that as a result of the depression a good many business enterprises had suffered such depletion of working capital that they were unable to take advantage of new business opportunities. It was also felt that the local banks in many instances were still reluctant to make credit advances. Under these circumstances the Reserve banks were authorized to discount such paper for local banks, and also to grant commitments to local banks insuring such paper up to as much as 80 percent of its face value. The Reserve banks were also authorized, in exceptional cases where credit was notavailable from the usual sources, to make loans for working capital purposes direct to the borrower. This was a marked departure for the Federal Reserve banks, which hitherto had held only short term obligations or marketable securities, and had not made loans direct to the borrowing public. The new functions seemed required by the emergency however, and the Reserve banks set out energetically to make the fact known to the business public that credit for working capital purposes was amply available. Local banks were also informed of the exceptionally favorable conditions upon which they could make loans for such purposes. At the time banks were especially anxious to maintain a highly liquid condition, and would not have been interested in long term loans unless there were provision for their liquidity. This was provided however by the commitments granted by the Reserve banks. Under their terms, the Reserve banks would agree to purchase such loans from local banks practically on demand, provided of course the loan had been approved in advance by the Reserve bank. When it is considered that beside this provision for liquidity, there was also a provision that the local bank might be relieved of 80 percent of the risk, it is apparent that the terms were calculated to give substantial encouragement to the local banks to make the loans which the depleted condition of many businesses made necessary. By the same token it is clear that the Reserve banks were in no sense entering into competition with local banks.

As of April 29 the Federal Reserve banks had approved 2,139 applications for working capital credit in the amount of $131,000,000. In recent months there has been very little increase in the amount of such applications approved. At the same time, however, there has been a distinct falling off in the number and the amount of applications received. In the first three months of last year 841 applications were received and the total amount was $29,000,000. In the first three months of this year the number of applications received was only 347 and the amount was only $13,000,000. Both in number and amount, applications were less than half what they were in the corresponding period last year. Moreover, there has been an almost uninterrupted decline every quarter since the beginning of last year.

Repayments, on the other hand, show marked increases. In the first quarter of last year they amounted to about $1,700,000; in the second quarter, \$2,100,000; in the third quarter, \$1,600,000; in the fourth quarter, \$3,600,000; and in the first quarter of this year, \$3,500,000.

The Federal Reserve banks still stand ready to make this credit available wherever it can be done on a reasonable and sound basis and local institutions are unwilling to advance it. In this connection, however, it is important to emphasize that the law permits the Reserve banks to make this credit available only for working capital purposes and only to established industrial and commercial businesses. The credit is not available for permanent capital, nor to refund existing indebtedness (except in minor amounts incidental to provision of working capital), nor to new enterprises.

Increased production and trade

In 1935 there was a large increase in production and trade following an irregular upward movement since 1932. The index of industrial production for 1935 as a whole averaged 90 percent of the 1923-1925 average and rose to 104 in December, partly because of an unusually large output in the automobile and related industries. There has since been some decline, February and March showing an index of 94. There appears to have been an advance in the index since that time. It appears, therefore, that the recovery in industry reached in 1935 is being maintained in 1936.

This recovery appears in many lines of industry. It is apparent to some extent in non-durable goods, comprising mostly articles of everyday consumption, which declined but moderately in the depression. It is apparent principally in durable goods, comprising building material, industrial equipment, automobiles, and more lasting household equipment.

The greatest decline in the depression occurred in the field of construction. Residential building, which in 1933 declined to 11 percent of the 1923-1925 average, did not increase until 1935. Then, however, contracts almost doubled those of the previous year. In the first quarter of 1936 there was an important increase in private construction other than residential. The greatest hope for expansion lies in the field of private construction. Shortages of residences have developed; new and improved types of housing are available; financing costs are lower; the burden of financing as a whole has been lightened; and the facilities for financing have improved. Construction costs are also somewhat lower.

In the field of trade, consumer purchasing has increased. Department store sales in 1935 were at 79 percent of the 1923-1925 average, compared with 67 percent in 1933. Sales in March of this year were up to 88 percent. In rural areas sales have shown a marked increase in recent years, which indicates that the status of farmers has improved. In recent weeks automobile sales have been at high levels, and gasoline consumption has been the largest on record. Wholesale sales have increased considerably, particularly in the durable goods lines - agricultural implements, hardware, and household equipment.

These, then are the facts and figures on business recovery as of today.

Let me suggest in connection with industrial loans under section 13b that you avail yourself of the willingness of the Kansas City Federal Reserve Bank to give you further and more detailed information on the subject for the general good of your community.

Speech delivered before
Washington Bankers Association Convention
Spokane, Washington
June 18, 1936

INDUSTRIAL LOANS

When the Federal Reserve Banks were established they were authorized to discount for member banks only certain eligible types of paper. These represented advances of credit for short terms only on the basis of commercial and agricultural activities. The idea in limiting the discount powers of the Federal Reserve Banks to these classes of paper was to facilitate the use of bank credit for legitimate commercial and productive purposes, and to discourage its use for speculative and nonproductive purposes.

Without departing from this objective, it has been found necessary from time to time in recent years to modify the limitations in the original Act. Most of these departures were made as the result of emergency needs arising during the depression. It was for this reason that in 1932 the Federal Reserve Banks were authorized under certain conditions to make advances to member banks on the basis of any collateral satisfactory to the Reserve Banks. In the Banking Act of 1935 this provision, which had previously lapsed, was restored to the Federal Reserve Act in Section 10b and made more general in its application. The result is that at the present time, as you know, Reserve Banks may make advances to member banks on any type of collateral satisfactory to them, provided the paper has not more than four months to run. This power is no longer restricted, as it formerly was, to periods of emergency. Advances of Federal Reserve Bank credit on such bases as well as on the basis of the class of paper originally defined as eligible are now within the scope of the regular powers of the Federal Reserve Banks. At the present time, of course, when banks in general have an abundance of funds, the authorization for the Federal Reserve Banks to make such advances has little occasion to be exercised. If the banks have occasion to borrow in the future as they have in the past, however, these powers may come to be of great importance.

There is one special type of loan which the ordinary bank would probably hesitate to make if the law did not permit the loans to be discounted at the Reserve Bank on especially favorable terms. These are working capital loans with five year maturities, authorized by Section 13b of the Federal Reserve Act.

The difference between Section 10b and 13b is mainly that 10b authorizes advances on any satisfactory collateral for not more than four months; whereas 13b authorizes advances and discounts for working capital purposes for not more than five years.

The powers to discount industrial loans were given to the Federal Reserve Banks under the terms of an Act of June 19, 1934, which added Section 13b to the Federal Reserve Act. The adoption of this measure was preceded by considerable discussion as to the proper means of making credit available to business enterprises whose working capital had been depleted. One suggestion that has often been made is that there should be intermediate credit banks established for the purpose. The basis for the suggestion usually is that small business enterprise has great difficulty in procuring capital. Whatever the merits of this question, Congress decided to use an existing agency rather than establish new ones, and to provide the facilities aimed at through extension of the powers of the Federal Reserve Banks.

The amendment which was adopted authorized the Federal Reserve Banks to discount loans made by member banks and others for working capital purposes, or in cases where credit was not procurable from the usual sources to make such loans direct. The law stipulated that the loans were to be made to established industrial or commercial enterprises; they were to be for the purpose of furnishing working capital; and they were to have maturities not exceeding five years. With respect to such loans to be discounted by the Federal Reserve Banks, the law reads as follows:

> "Each Federal Reserve Bank shall also have power to discount for, or purchase from, any bank, trust company, mortgage company, credit corporation for industry, or other financing institution operating in its district, obligations having maturities not exceeding five years, entered into for the purpose of obtaining working capital for any such established industrial or commercial business; to make loans or advances direct to any such financing institution on the security of such obligations; and to make commitments with regard to such discount or purchase of obligations or with respect to such loans or advances on the security thereof, including commitments made in advance of the actual undertaking of such obligations. Each such financing institution shall obligate itself to the satisfaction of the Federal Reserve bank for at least 20 per centum of any loss which may be sustained by such bank upon any of the obligations acquired from such financing institution, the existence and amount of any such loss to be determined in accordance with regulations of the Board of Governors of the Federal Reserve System."

You will notice that the Federal Reserve Banks may make these discounts not only for member banks, but for non-member banks or any other type of financing institution.

The arrangements that may be made under this authorization are extremely favorable to the bank which desires to make the loans in cooperation with the Federal Reserve Bank; for the commitment which the Federal Reserve Bank is authorized to grant is an agreement under which a local bank may carry such a loan in its own portfolio at a good rate of interest and with the privilege of disposing of it at any time at the Federal Reserve Bank. Moreover, when it is sold or transferred to the Federal Reserve Bank, the latter will assume without recourse as much as 80 percent of any eventual loss on the loan. The commitment, therefore, gives the local bank assurance that the loan is perfectly liquid even though it may run for a period of five years, and also that its own loss on the loan may be limited to 20 percent.

The Federal Reserve Bank of San Francisco makes a charge of from 1/2 to 2 percent per annum on the commitments it grants. The exact rate depends upon various factors of credit risk, maturity, etc. It charges a discount rate of from 3 to 4 percent on that portion of any loan for which the bank which made the loan retains obligation, and from 4 to 5 percent on that portion from which the bank which made the loan is released from obligation.

In granting a commitment, of course, the Federal Reserve Bank has to consider the credit risk exactly as if it were making the loan itself. It may be said indeed that the Federal Reserve Bank assumes somewhat more risk in granting a commitment than in making a direct loan, since a loan which it makes itself is under its own immediate care, whereas a loan held by another institution is not. Obviously the circumstances are such that the Federal Reserve Bank must be assured that the loan is a good one and that it will be properly serviced. In practice, therefore, applications for such loans are usually considered simultaneously by the Federal Reserve Bank and by the bank which contemplates making the loan.

In cases where a loan is refused by the local banker but is considered by the Federal Reserve Bank a good loan, the Reserve Bank may make it direct. Under such circumstances it cannot be said that the Reserve Bank is competing with member banks. The Reserve Banks in general prefer that local business be handled by local banking agencies. They do not desire to develop direct banking relations with the public as a matter of policy in any cases where local banking facilities are adequate.

As you know, the central banks of some other countries, for example, the Bank of England and the Bank of France, have a certain amount of private business which they conduct in competition with other banking institutions. Before their central banking functions developed, these institutions had much more of such business. The private business which they still have, however, is not essential to their functioning as central banking organizations. The same thing is true in the United States. The basic functions of the Federal Reserve Banks are central bank functions. The Reserve Banks are in the main intended to supplement regular banking facilities and to stand in reserve behind the local banks. They are not competitors of their members.

It is now nearly two years since the Federal Reserve Banks were given the authority I have been discussing. In that period they have received, as of June 3, 8,127 applications of which 2,165 have been approved. The total amount that has been applied for is $330,026,000. The amount approved is $132,626,000. Of this amount, $27,144,000 has been conditionally approved, and $105,482,000 finally approved. These final approvals include direct advances outstanding of $30,701,000 and commitments outstanding of $24,878,000. Repayments have amounted to $14,988,000. Withdrawals of approved applications, etc. have amounted to $21,676,000. Financing institutions participations with the Federal Reserve Banks have amounted to $11,970,000, and there is in process of completion advances and commitments of about one and one-quarter million.

During the same period, that is since June, 1934, the Federal Reserve Bank of San Francisco has received 1,065 applications, of which 254 have been approved. The total amount applied for was $31,324,000, and the amount approved was $11,942,000. Outstanding advances now amount to $1,668,000, and commitments outstanding amount to $4,363,000.

Repayments have amounted to $150,000. The Bank now has in process of completion approved advances and commitments of about $463,000.

The statute limits the amount available for these loans and commitments to $280,000,000 for all the Federal Reserve Banks, of which the Federal Reserve Bank of San Francisco has $19,500,000. This constitutes a revolving fund, so that as payments are received and new loans made, the total credit that may be extended far exceeds the amount mentioned.

In order to assist the Federal Reserve Banks in dealing in a field of credit which Congress felt might be new to them, it provided that each Reserve Bank should have an Industrial Advisory Committee. The members of the Industrial Advisory Committee of the Federal Reserve Bank of San Francisco are as follows:

Stuart L. Rawlings	V.P., Calaveras Cement Co.	San Francisco, Calif.
Ralph Burnside	V.P., Eatonville Lumber Co.	Eatonville, Wash.
Shannon Crandall	Pres., Calif. Hardware Co.	Los Angeles, Calif.
Henry D. Nichols	V.P., Tubbs Cordage Co.	San Francisco, Calif.
William G. Volkmann	Sec., A. Schilling & Co.	San Francisco, Calif.

All applications received by the Reserve Bank are considered by the Industrial Advisory Committee and recommended for approval or disapproval. The Bank's action, however, is final. It is lending its own funds and it has the say as to whether or not a loan should be made. Consequently it may reject a loan recommended by the Industrial Advisory Committee or it may decide to make one even though the Industrial Advisory Committee's recommendation is adverse.

Furthermore, applications are not referred to Washington. They are considered and passed upon finally by the Reserve Bank of the district in which they originate. The Board in Washington, D. C. merely issues general regulations for the administration of Section 13b and supervises the activity for the entire system.

While you may have full knowledge of this section and while you may have already availed yourself of its provisions, it seems entirely proper that we should remind business men from time to time of the service that is being rendered by an institution that was originally intended to be only a banker's bank. It is with this purpose in mind that I speak to you on this subject today.

There has been a falling off during recent months in the number of applications submitted for industrial loans, as the following figures for all districts show.

Period since enactment of Section 13b June, 1934	Applications Received Number	Amount	Applications Approved Number	Amount
1st 6 months	5053	$188,000,000	984	$50,000,000
2nd 6 months	1565	75,000,000	662	39,000,000
3rd 6 months	997	44,000,000	347	35,000,000
4th 5 months	512	23,000,000	172	9,000,000

While the above figures show a marked falling off in the number and amount of applications received and approved, it is important to observe that the proportion of approvals has greatly increased. In the first six months, that is, from June to December 1934, only 19% of applications were approved and only 27% of the amount represented was approved. In the first five months of this year, 33% of applications were approved and 37% of the amount involved was approved. These figures indicate that the average quality of the applications is now much better than it was in 1934.

The smallest amount of any loan made to date in the 12th district is $500, and several loans of this amount have been granted. The largest single loan approved in this district was for $1,000,000.

Many banks have found it desirable to make these industrial loans even without Federal Reserve Bank participation. Not all such cases are reported, but the Federal Reserve Bank of San Francisco has been informed that 72 applicants, applying altogether for $1,715,000, have received loans without participation by the Reserve Bank. Some borrowers who originally obtained credit from the Federal Reserve Bank have subsequently borrowed from local banks and paid off the obligation to the Federal Reserve Bank before maturity.

The principal lines of business which have received 13b credit in this Federal Reserve district are the following:

Kind of Business	Number of Applications Approved	Amount Approved
Manufacturing	91	$ 3,912,000
Lumber	36	3,784,000
Wholesale and Retail	90	1,954,000
Packing	21	865,000

In addition to the Federal Reserve Banks, the Reconstruction Finance Corporation has also authority to make loans of similar nature and for similar purposes.

It has been my opinion that the more often we discuss the Federal Reserve System, the more firmly will its functions become directed toward the accommodation of commerce, industry, and agriculture, as was intended in the original Act. That is why I appreciate the opportunity you have given me to say these words about this particular, new function of the Federal Reserve Banks in the field of working capital loans.

SPEECHES OF

M. S. SZYMCZAK

MEMBER
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C.

RELATING TO

POSTWAR RECONSTRUCTION

1945 - 1948

-1950-
WASHINGTON, D. C.

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ECONOMIC PROBLEMS OF LIBERATED BELGIUM

One glance at the map of western Europe will impress one with Belgium's importance to postwar Europe.

The present German counterattack emphasizes the strategic role of Belgium as the hub of international communication lines between central and western Europe and the Channel ports. Fortunately, the fighting has not reached any important industrial or agricultural area. But it may have completed the destruction of the Ardennes forest, and certainly has retarded the rehabilitation of the country by forcing the Allies to devote more supplies and transportation facilities to purely military purposes. In view of the additional losses and sacrifices, the task of reconstructing the Belgian economy now becomes even more urgent.

In spite of its small size, Belgium is one of the most important industrial nations of the world and before the war its steel productionn was surpassed only by that of the United States, Germany, the Soviet Union, the United Kingdom, France, and Japan. Belgium has suffered from German aggression longer than any other western country, and its difficulties under German rule were symbolic of the fate of all the small nations of Europe. Belgian developments will now be watched for any clues as to the future of these small nations after liberation.

It may be expected that Belgium will play an important role in the reconstruction of other European countries. Its industries will no doubt be operating long before those of central and eastern Europe, and part of this output will be available for export. The use of these facilities by the Allies during the years of reconversion and rehabilitation, will save valuable shipping space and lessen the burden upon the resources of the other United Nations.

With an appreciation of Belgium's economic role in postwar Europe, the Belgian Delegation took an active part in and made a substantial contribution to the International Financial and Monetary Conference at Bretton Woods last July.

Belgium is a very densely populated country; in 1937 it had a population of 8.4 million, living in an area of 11,800 square miles. Sixty-nine per cent of the working population in 1930 was engaged in industry and commerce, as compared to 51 per cent in the United States. It depends heavily upon foreign trade; in 1937 it had imports of 27.9 billion francs,[1] exports of 25.5 billion, and a transit trade of 31.5 billion. Imports and exports together were equal to about 70 per cent of its national income, as compared to less than 10 per cent in the United States.

The country's national wealth, estimated at 443 billion francs for 1939, has been reduced severely by the German occupation. The Germans not only conscripted workers for labor in Germany and confiscated or

1/ The Belgian franc was quoted at 3.37 U. S. cents before the present war, and has been equal to 2.28 cents since liberation. Foreign trade figures are for the area of the Belgian-Luxembourg customs union.

looted the property of anti-Nazis and Jews, but they also imposed tribute payments upon the country in the form of occupation costs and so-called advances. In 1943 and 1944, these levies constituted about 45 per cent of the total national output; for the entire period of occupation, they amounted to about 143 billion francs. These payments, financed partly by the administration and partly by the central bank, increased the public debt from 66 billion to 156 billion francs, and the note circulation from 31.5 billion to 99.5 billion francs during the period of occupation. Thus Belgium was at the same time swamped with paper money and denuded of goods. The scarcity of necessary commodities, caused by the German efforts to gear the economy to the German demands for armaments rather than to the needs of the Belgian population, was aggravated by the stoppage of imports. As a result, Belgian national income, as measured in terms of actual purchasing power, declined from 64 billion to 27.5 billion prewar francs between 1939 and 1943.

In spite of these losses, the situation of Belgium is in some respects better than that of, say, the United Kingdom or the Netherlands. The country has retained most of its foreign assets (estimated at 50 billion francs as of 1939) and has not accumulated any foreign debts. Before the war, its exports were sufficient to pay for more than 90 per cent of its imports. Its extensive colonial empire has remained free from Axis occupation. Most important of all, it suffered little destruction during the campaign, its vital coal mines and the harbor of Antwerp remaining almost intact.

Immediate Tasks

The most urgent problems confronting the Government after liberation were the country's needs for foodstuffs and coal. Its unsettled financial condition also needed immediate attention. In order to combat inflation, the Government blocked a very large part of all cash holdings and bank deposits and decreed an exchange of most of the old currency for new notes. It is still too early to judge the effect of these measures, but according to preliminary reports the Government has succeeded at least in stopping the increase in the cost of living and curbing black market activities. The official price index stands at about 200 per cent of the 1939 average. Since the franc has been devalued by about 32 per cent, the price level is now equal to only 135 per cent of the 1939 figure in terms of gold or dollars. If the index could be stabilized, and actual prices made to conform to the official ones, this rise would be about the same as that of the wholesale commodity prices in the United States.

The Government has supplemented its program of domestic financial stabilization by a series of treaties with neighboring countries. It has negotiated a monetary and customs union with the Netherlands, and concluded an agreement with the United Kingdom, providing for mutual credits up to the equivalent of 5 million pounds for the purpose of ensuring the stability of the exchange rate of pound sterling and franc. The full effect of these agreements, however, will not be felt until greater freedom of trade has been restored.

Less progress has been made in solving the problems of food and fuel supply. Belgium's coal production (30 million metric tons in 1937) normally is ample for all its needs. Under German occupation, however, production fell to a fraction of normal, partly because of the lack of new machinery, but mainly because of the lower efficiency of the miners, due to underfeeding and even more to their unwillingness to work for the Germans. In order to restore the productivity of the mines, the Government must make available more food, and also convince the miners that sabotage, strikes, and slow-downs are no longer patriotic duties.

The food situation is particularly serious because in peacetime Belgium imported almost two-thirds of its foodstuffs requirements (4 million metric tons, valued at 5.4 billion francs, in 1937). The country is practically self-sufficient in vegetables and potatoes, and produces the larger part of its requirements of milk, beet sugar, and fruit. This was formerly true also of meat and animal fats. But livestock production was based on imported fodder and concentrated feeds, and under the German occupation the number of cattle was reduced by about one-sixth in order to reach a level more nearly corresponding to the domestic fodder supplies. The Belgian Congo used to supply quantities of vegetable fats (palm oil), cane sugar, and coffee. Grains (wheat, barley, and corn), which represent by far the most important single item, both as to bulk and value, will have to be shipped from non-Belgian overseas sources.

Ability to bring in required imports is limited by the scarcity of shipping and the necessity for using the harbor of Antwerp to supply Allied troops on the western front. The even flow of domestic supplies is hampered by the psychology of many farmers. For 4½ years it was considered patriotic as well as profitable to hide farm products from the administration (which acted as collecting agent for the Germans) and then channel them into the black markets where Belgians could secure them. Now the Government's problem is to convince the farmer that such activities are not only unpatriotic but also unprofitable. The deflationary measures of the Government were intended in part to make it clear that producers could not expect any further rise in prices. The farm situation is somewhat complicated by the linguistic problem; the majority of the farmers are Flemish while the majority of miners and workers in the heavy industries are Walloons. The Germans tried to exploit any differences between the two groups both in the First and the Second World Wars. The farmers fared better than most other groups under the German occupation, feeling less political oppression and making profits by black market operations. On the other hand, because of their wartime profits they were hard hit after liberation by the monetary program of the Government.

Rehabilitation of Communication and Industry

Once the people's minimum requirements of food and fuel are satisfied, the rehabilitation of industry and commerce will command chief attention. Paradoxically, resumption of trade will have to precede the increase in domestic output to some extent, since Belgian industry is based mainly upon imported materials. However, Belgium has large resources of gold and foreign exchange as well as an excellent credit rating, and imports therefore can be financed before Belgian goods become available for export. Difficulties in the supply of materials during the period of transition will arise from the lack of shipping and other reasons of military strategy rather than from financial factors.

The Belgian coal mine installations are greatly in need of renovation. The equipment has not been renewed since 1939, and is largely worn out or obsolete. A new source of supply for pit props must be found because some of the former sources can no longer be drawn on. The Germans have devastated a large part of the forests of Belgium and adjoining territories, which provided significant quantities of these crops before the war. Baltic timber may be needed by the states of the Soviet Union for the rehabilitation of their own mines, and Baltic exports therefore may be diverted from the Belgian market even after complete defeat of Germany reopens trade routes to the Baltic Sea.

The needs of the Belgian inland transportation system are even greater than those of the coal mines. Belgium has had for years a very dense railroad network (3,215 miles with 3,358 locomotives and 117,000 freight cars in 1937). German requisition of rolling stock, the absence of replacement, and inadequate upkeep have left the system with a depleted and dilapidated stock of equipment. Highway traffic has suffered just as severely. Belgium also has excellent roads (5,625 miles of national highways and 23,125 miles of provincial and municipal roads in 1938) and the number of motor cars was large by European standards (154,000 passenger cars, 76,600 busses and trucks, and 67,000 motorcycles in 1938). Looting, requisitions, and lack of replacements, however, have reduced these figures to a small fraction of their former size. The important system of inland waterways (1,080 miles with 9,000 barges and tugboats in 1937) needs new locks and new vessels.

Manufacturing industries will be compelled to import the machinery and tools necessary to get their own production under way until the domestic machinery industry is rehabilitated. Even in normal times, however, most raw materials processed by Belgian manufacturers must be imported. The speed with which particular branches of the industry will be able to reestablish their plants and secure materials will not be uniform. In the field of metallurgy, the steel industry will be easiest to satisfy because about one-third of the iron ore comes from Luxembourg and most of the balance from Lorraine. Moreover, the steel mills were kept in good condition by the Germans in order to produce armaments. The copper industry depends largely upon imports from the Belgian Congo. The zinc industry, next to that of the United States the largest in the world (representing 13.5 per cent of world production in 1937) may have to overcome greater difficulties because the raw materials have to be imported mainly from non-Belgian overseas sources.

In the field of textiles and clothing, the wool and cotton industries are the most important. Flemish woolen goods have been famous ever since the middle of the tenth century, and before the war imported raw wool was the most valuable single import (2 billion francs in 1937). From the point of quantity, wool and cotton imports were almost exactly equal; wool imports were mainly of Australian origin while one-third of the cotton came from the Congo and a large part of the rest from the United States. Linen production, the third largest branch of the Belgian textile industry, is based mainly upon domestic raw materials. The rayon industry was one of the oldest in Europe, but its importance relative to other countries had decreased in the interwar period. Under the German occupation, however, it expanded at the expense of the wool and cotton mills since raw materials for these industries were no longer available.

Mining, transportation, metallurgy, and the textile industries together employ about 60 per cent of all industrial workers in the country. Among the smaller fields of enterprise, the Belgian chemical industry in the past has acquired world fame. The country was one of the leading producers of industrial chemicals, artificial fertilizers, and photographic chemicals. If the Allies strip the German dye trust of its monopolistic power, the Belgian dyestuff industry probably will forge to the front in Continental Europe. Most of the industry's raw materials, with the exception of coal tar, must be imported, largely from other Continental European countries. Precious stones, many of them obtained from the Congo, form the basis of the Antwerp stone cutting and trading industry, the most important center of that kind in the world.

Prospects of Foreign Trade and Shipping

Belgian foreign trade may be expected to increase sharply as soon as the wartime difficulties of transportation are overcome. Imports must rise if Belgian industry is to receive not only its usual raw materials but also the machinery needed for its reconstruction. Exports must rise if the pent-up demand of other European nations for industrial products is to be satisfied.

Belgium always has been a protagonist of free trade, and before the First World War tariffs were for revenue only. In the interwar period a more protectionist attitude was adopted, but its free-trade area was enlarged by a customs union with Luxembourg in 1922, and trade agreements with the Scandinavian countries and the Netherlands (Oslo, 1930, and Ouchy, 1932). Treaties concluded immediately after liberation with the Netherlands and the United Kingdom, indicate that the country intends to continue on this course. A credit agreement has been concluded with France. These measures are the more important since the three countries just mentioned accounted for 45 per cent of Belgium's total foreign trade in 1937.

Closer economic relations with these areas are expected to compensate for the loss of part of the German trade, which accounted for 11.6 per cent of total Belgian commerce in 1937. During the war, the Belgian economy has been geared completely to meet German needs, and Germany became the country's best "customer." Therefore the consequences of a disruption of this trade will not be negligible. The prospects for Belgian trade with the rest of Europe are more promising, however. European countries other than those mentioned above accounted in 1937 for 14.5 per cent of total Belgian commerce. Belgium had an excess of imports in relation to all central and eastern European countries (with the exception of the Baltic states). Therefore Belgian commercial relations with these countries may profitably be resumed even before their currency conditions return to normal. Moreover, Belgian industry is able to replace Germany as a source of supply for central Europe, especially in the fields of metallurgy, textiles, and chemicals.

Belgian shipping also may be expected to profit from the German defeat. The harbor of Antwerp handled in 1937 about 13,500 ships with 25.5 million net register tons. This tonnage is bound to increase since Antwerp's main competitors, the ports of the Netherlands and Germany, will probably be out of commission for some time to come. In spite of the importance of the Belgian harbors, the Belgian merchant marine before the war was negligible, consisting of only 96 vessels of 252,000 tons in 1939. Belgian ships handled only 9 per cent of the traffic in Belgian ports while German ships handled 22 per cent -- twice as much as the trade with Germany itself. If Belgian vessels replace the German, at least as far as commerce in Belgian waters is concerned, the tonnage of the Belgian merchant marine might well expand to many times its prewar size.

Belgian -- United States Trade Relations

American investments in Belgium and Belgian investments in the United States were small before the war; only Belgian balances with American banks were significant (182 million dollars at the time of the German invasion, May 1940). Mutual trade relations, however, were very close. In 1937, the last year of normal international relations in Continental Europe, the United States took fifth place in Belgium's foreign trade, with exports to Belgium of 95 million dollars, and imports from Belgium of 75 million. This volume does not, however, indicate the limits of trade possibilities between the two countries. After the First World War, the United States exported goods valued at 378 million dollars in 1919 alone, and the annual average for 1920-1929 was 128 million. Total trade figures as well as the value of important exports and imports for characteristic years between 1919 and 1937 are shown in the accompanying table.

In addition to the commodities shown in the table, U. S. exports to Belgium included feeds, fruits, tobacco, chemicals, semimanufactured steel products, and industrial machinery while imports included other precious stones, wool manufactures, nonferrous metals, glassware, fertilizers, and wood products. In the period of rehabilitation immediately following the First World War, the United States exported large quantities of breadstuffs, meat products, cotton cloth, cattle, and wood products. The sharp drop in U. S. exports to Belgium in the thirties was due in part to the fall of the price level, but mainly to the shrinkage in the Belgian national income. In 1939, the income per head was equal to about 257 dollars, only about four-fifths that of the Netherlands, and one half that of the United States. Under conditions of international peace and economic cooperation -- such as did not exist in the 'thirties -- economic conditions in Belgium should improve rapidly and bring about a proportionate rise in imports, especially of consumers' goods. Some of the goods that are very sensitive to variations in the degree of prosperity form a large part of American exports to Belgium, such as automobiles, gasoline, canned fruit, and tobacco.

The amount of U. S. imports from Belgium apparently is less elastic; the 1937 figure was not surpassed materially in the interwar period. But Belgium will be able to pay for its imports not only with the proceeds of its own imports and with other revenues (foreign investments, tourist traffic), but also by utilizing the exports of the Belgian Congo. The United States imported goods from the Congo valued at only 2.6 million dollars in 1937, but since the outbreak of the Second World War imports have sharply risen. They reached 25 million dollars in 1940 and 34 million in 1941, and economic relations with the Congo have become even closer since the entry of the United States into the War. Part of these imports has been used for war purposes, another portion represents substitutes for materials temporarily unavailable elsewhere, and some went to the United States only as long as the Belgian market was closed to them. But at least part of the increase may well prove permanent, and together with Belgian gold and dollar balances already accumulated, help to prevent a "dollar scarcity" in Belgium.

Belgian-United States Trade, 1919-1937
(Millions of dollars)

Commodity	1919	1929	1932	1937
U. S. imports:				
Diamonds (cut, not set).........	1.8	17.2	5.8	21.8
Flax and flax manufactures......	(1)	6.5	2.5	9.1
Cotton manufactures.............	0.2	1.4	1.0	5.8
Iron and steel products.........	0.2	4.4	1.7	4.9
Furs (undressed)................	0.2	6.8	0.3	2.9
All others......................	5.3	37.7	10.1	30.6
Total........................	7.7	74.0	21.4	75.1
U. S. exports:				
Automobiles and accessories.....	2.2	26.5	7.2	21.5
Petroleum and products..........	8.6	12.7	6.3	13.3
Cotton (raw)....................	25.4	20.3	6.0	11.6
Wheat...........................	69.3	6.6	3.0	10.6
Chemicals.......................	1.0	0.7	0.2	4.7
Linseed cake....................	2.8	4.5	1.2	4.2
Copper..........................	1.6	8.8	1.1	4.0
All others......................	267.0	34.8	15.3	25.4
Total........................	377.9	114.9	40.3	95.3

1. Less than $50,000.
Based on data compiled from FOREIGN COMMERCE AND NAVIGATION OF THE UNITED STATES.

In this way, the reconstruction of the Belgian economy may be expected directly to contribute to the economy of the United States, and to strengthen the ties of international economic relations as envisaged at Bretton Woods.

Belgium's economic stability is essential to winning the peace.

Speech delivered before
Belgian Chamber of Commerce
St. Regis Hotel, New York, N. Y.
November 2, 1945

BELGIAN POST-WAR RECONSTRUCTION

Belgium was the first of the liberated countries to tackle with courage and decision the monetary and financial chaos bequeathed it by the war. In October 1944, immediately after liberation, the Government eliminated excess purchasing power through a drastic reduction of the amount of currency in circulation. This was accomplished by exchanging pre-liberation money for new bank notes and blocking all cash holdings and bank deposits of more than approximately 114 dollars. In October 1945, the legislature supplemented this action by imposing a confiscatory tax upon war profits and a 5 per cent capital levy, and by converting into a long-term Government loan that portion of the blocked accounts that was not absorbed by these taxes. These measures though thought drastic by some, nevertheless, set an example for all other liberated nations, and they have been imitated in large degree all over Europe and the Far East. Although the legislation brought temporary hardship to a large part of the population, particularly businessmen, it was supported by all political parties, conservative and socialist alike.

As a result of these measures, Belgium's struggle against an over-expansion of the currency has been all but won. At the end of September 1945, bank note circulation amounted to 64 billion francs, as against 100 billion in September 1944, and 30 billion at the time of the German invasion in May 1940. In comparing the figures of 1945 and 1940, it mus be remembered that the Belgian franc was devalued by about one-third to 2.28 cents in terms of dollars in the fall of 1944. It should also be remembered that world market prices in terms of dollars have risen by at least one-third since 1940. Therefore, 64 billion francs in September 1945 would be equivalent to about 32 billion in May 1940. Currency in circulation at the present time would not appear excessive if the production of commodities could be increased to the pre-war level.

Although suffering from the consequences of war and invasion, the country's fiscal situation also appears to be well in hand. Government expenditures for 1945 have been budgeted at 46 billion francs or almost four times as much as before the war. The increase is due to the rise i prices and wages and also to the special needs of the post-war period, such as the expense of distributing foodstuffs, the reconstruction of transportation facilities and public buildings, and the provisions made for war victims. During the first six months of 1945 tax collections have amounted to only 9 billion, but the enactment of the Government's new tax program will undoubtedly increase revenues. The deficit, though large, has been met by borrowing from the public. Only expenditures for advances and "mutual aid" to the Allies were covered by central bank credits, presumably because the Government expects eventually to be reimbursed for these amounts in foreign exchange. The public debt has been estimated officially at 204 billion francs, as against 62 billion in April 1940. The interest-bearing part of the debt however, is expected to be reduced as the result of the Government's fiscal program. If the country's national income again reaches the pre-war level, or about 130 billion francs at the current purchasing power, the service of the debt may be expected to require less than 5 per cent of the national income.

The most unsatisfactory part of the financial situation is the level of prices and wages. Official prices have been maintained at about twice the pre-war level, thus corresponding to the new dollar value of the franc and the general increase in world market prices. The black market, however, has not been eliminated, and the actual cost of living therefore is still about four times the pre-war amount. On the other hand, wage rates have increased only about as much as the official prices, and the actual purchasing power of wages therefore has been virtually cut in half. This situation is unsound, not only because of its effect upon labor but also because of the resulting disparity between the domestic and the international price levels. Pessimistic observers have suggested that the Government will be unable to prevent a further rise in official prices and wages, and may be compelled again to devalue the currency. The Government, however, is convinced that as the rehabilitation of the economy progresses, the actual price level will eventually be brought down to the official figure and thus permit the maintenance of the present wage scale and exchange rate.

It is not surprising that the financial situation of the country has not fully returned to normal notwithstanding the success of the Government's currency program. During the war, the country suffered losses, including about 140 billion francs in payments to Germany, and a very large amount of physical destruction and looting. Moreover, a large part of the country's investments in Central and Eastern Europe is now practically worthless. These losses represent a very substantial portion of the country's estimated pre-war wealth. Even after liberation, the destruction of the country continued because of the unexpectedly long period of border fighting and the reinvasion which took place during the Ardennes offensive. For many months, the Belgian transportation system had to be used predominantly for the military requirements of the Allies and could be of little assistance in the rehabilitation of the country's economic system. The Port of Antwerp, Belgium's main harbor, and the industrial center of Liege were subject to V-1 and V-2 bomb attacks which caused even more actual damage than the fighting. These events delayed the repatriation of deported Belgian workers and retarded the reconversion of manpower and equipment to civilian uses. Consequently the supply of consumer goods remained at the low level which prevailed during the German occupation. This more than any other fact hampered the Government's effort to raise the efficiency of labor to the pre-war level.

Considering these difficulties, the progress made in the restoration of the country's industries is indeed astonishing. As late as February 1945, the country had more than 300,000 unemployed. In spite of the repatriation since that date of an equal number of workers deported during the occupation, the number of unemployed had dropped by September to 100,000. Power plants are working at 80 per cent of normal. The output of the coal mines, the backbone of the country's economic system, is approaching 60 per cent per normal and would be considerably higher if a great number of the foreign workers who formed the bulk of the mining personnel before the war had not left the country during the German occupation.

Inland waterways and textile mills are also operating at almost 60 per cent. Railroads and heavy industries are working at only 30 to 40 per cent of normal but even these low figures are six to eight times as high as those reached at the beginning of this year. These results have been achieved without aid from UNRRA, and it appears certain that the country will not need relief in the future.

The most important obstacle to a more rapid pace of industrial recovery is the lack of imports. Railroads and coal mines, the two worst domestic bottlenecks, require imports of new equipment for more efficient operation. The manufacturing industries all need basic raw materials from abroad. Since the country is one of the most densely populated and most highly industrialized nations of the world and is utterly dependent upon foreign sources of grain and meat, the population needs large quantities of imported foodstuffs. In 1937, Belgium imported 39 million tons of merchandise, valued at 27.5 billion francs. During the first six months of 1945, total imports were less than 1 million tons, valued at about 2.7 billion francs. This drop was caused mainly by the scarcity of shipping facilities. In recent months, more ship space has been made available for civilian goods, and the monthly figures are now approaching an average of 1 million tons, or about one-third of the pre-war figure. During the next few years, however, Belgium will need even larger imports than before the war. Inventories, completely exhausted by the Germans, must be replenished, machinery and materials are needed to repair the war damage, and consumer goods and other finished products, usually supplied by domestic sources, must be imported since domestic industries are not yet operating at pre-war levels. It may be expected, therefore, that in 1946 imports will reach a record total.

Until recently, the technical obstacles to increasing imports have been so great that the financial problems of international trade were of minor importance. In the future, however, the question of financing imports will become much more important. During the war, the Government made plans for a complete customs union with the Netherlands and close economic collaboration with France. As yet these proposals have not been put into effect, but the Government has concluded important trade and credit agreements with the United Kingdom, France, the Netherlands, Switzerland, and the Scandinavian countries, and is now negotiating others. While these agreements retain distinct traces of bilateralism and thus do not measure up to the standard of free trade, they assure a regular flow of merchandise within specified limits at stable rates of exchange and permit the country to resume gradually its position as one of the centers for international commerce.

It is to be expected that Belgium and the United States will soon reach an understanding with respect to commercial policy. For some time to come this country may have to be the main source of supply for most liberated countries, especially for reconstruction machinery and materials. It may be expected that during the next year a much greater part of Belgian imports will come from the United States than in pre-war times, and that its deficit in respect to the United States alone may reach a very substantial sum. Under normal conditions, this would require no special attention since the Belgian balance of current international payments as a whole was generally in equilibrium. In the past, the country was able to finance imports from the United States out of the proceeds from its exports to other countries and out of its foreign investment revenues. In the more distant future, the Bretton Woods organizations are expected to reestablish the smooth working of the international transfer of payments. At present, however, exports to most countries will not provide the Belgian economy with dollars because of exchange restrictions. The country, however, can face the problem of its dollar deficit with more confidence than most other European nations. Its gold and dollar assets are very considerable. Moreover, Belgium is the only Allied country that has granted more lend-lease aid to the United States than it has received. By the end of September 1945, total lend-lease aid and advances to the Allies by Belgium totalled 24 billion francs, or more than half the country's annual budget. In October 1945, the United States and Belgium concluded an interim agreement settling the mutual obligations. The United States paid a sum of 61 million dollars for troop pay advances made in francs by the Belgian Government prior to VJ-Day. The United States also acknowledged that the goods and services furnished to the American armed forces as "reciprocal aid" prior to VJ-Day exceeded by at least 90 million dollars the lend-lease aid given to Belgium. In view of that excess, the United States permitted the Belgian Government to select up to 45 million dollars of army surplus material stored in Belgium and having civilian utility, and cancelled a Belgian debt of about 42 million dollars for lend-lease goods that had remained undelivered by VJ-Day. Finally, the United States agreed to pay in cash for all goods and services furnished to the American armed forces after that date.

The Export-Import Bank of Washington has announced that it is about to grant to Belgium a loan of $100 million, $45 million of which would be for the purchase of lend-lease goods not delivered before the end of lend-lease on VJ-Day. It has also announced that Belgium would be eligible to benefit from a credit line of $100 million to be opened to exporters of American cotton. These credits and the settlement of Belgium's troop pay advances and reverse lend-lease claims will probably cover the greater part of the expected dollar deficit for 1946. The remainder of the deficit could be taken out of the country's reserves. In 1947, the deficit probably will have shrunk to manageable proportions, and in later years the country's reconstruction may have advanced sufficiently to permit its balance of international payments to reach the pre-war equilibrium.

A solution of these financial problems will go far to enable Belgium to readjust its foreign trade to the changes caused by the war. Belgium has always been more dependent upon foreign commerce than most other countries; its total foreign trade in 1937 including imports, exports, and transits, was larger than the total national income. The country is therefore greatly influenced by--and in turn exercises a great influence upon--other parts of the world, especially Western and Central Europe. In 1937, Germany was Belgium's second most important source of supply and its third most important customer. The loss of much of the trade with Germany and other Central European countries will be felt very deeply, and must be counterbalanced by strong efforts to secure new markets for Belgian products, especially in fields formerly dominated by certain types of German goods. Fortunately, the demands for most Belgian goods will be pressing for many years to come. In 1937, about two-thirds of all Belgian exports consisted of iron and steel, non-ferrous metals, textiles, coal, machinery, chemicals, and precious stones. Iron, steel, and machinery will be needed urgently for the reconstruction of the devastated areas. Belgium has a dominant position among Continental European countries for the refining of copper and zinc, and to a lesser extent of tin and lead. Having been cut off for six years from its main sources of supply of these metals, Europe will be ready to accept almost any quantity of them in the immediate future. Textiles and coal at present are probably the scarcest commodities in all Europe. Chemicals, and especially the famous Belgian fertilizers, will be vitally needed for the rehabilitation of European agriculture. In this field, Belgium will profit from the proposed dissolution of the German chemical trusts, which hitherto virtually monopolized the world market. Precious stones will not be needed in impoverished Europe but the United States will probably provide a remunerative market for them. During the years of general reconstruction, the export of all these items, and many less important ones, may well be limited by the country's productive capacity rather than by the demands of its customers.

For the United States, the revival of the Belgian export trade will mean relieving the strain upon our own industries. During the immediate future, our foreign trade policy may have to be directed toward preventing foreign demand from depriving domestic consumers of scarce commodities rather than toward a further expansion of exports, which will probably reach record dimensions in any case. Belgium will be able to produce such goods as machinery, textiles, and chemicals, and provide such raw materials as steel and non-ferrous metals, which the United States will not be able to export in unlimited quantities because of urgent needs for domestic use. Moreover, Belgium will be able to obtain from its customers many goods for which there would not be a market in the United States, such as grains, dairy products, ores, hard coal, hides, and fibres. Belgian foreign trade will therefore supplement, rather than compete with, our own. A typical example of this relation is indicated in the recent trade agreement between Belgium and Denmark, under which Denmark promises to supply Belgium with butter, cattle, potatoes, fish, and seeds, while Belgium undertakes to furnish Denmark iron and steel, chemical products, zinc plates, glass, and machinery. The exportation of Belgian fertilizers to Continental European countries will be of particular importance. The rehabilitation of European agriculture is necessary to end the semi-starvation of most European nations, and incidentally to limit the shipment of UNRRA supplies from the United States.

In recognizing the importance of free international trade, the Belgian Government has shown great interest in the Bretton Woods agreements and the proposed international trade conference. The whole structure of the Belgian economy is based upon multilateral trade since a large part of its exports goes to countries other than those from which it derives its imports. In 1937, the country had a sizable excess of imports from the United States, Canada, and Argentina, and this excess will probably be even larger in the post-war period. On the other hand, it had a substantial surplus of exports to the United Kingdom, France, and the Netherlands. Belgium therefore is vitally interested in having the currencies of its customers freely convertible into dollars. Its interest in this respect is identical with that of the United States.

Belgium will probably oppose any attempt to divide the world into currency blocs. We may expect this similarity of economic goals to contribute toward making the traditionally friendly economic and financial relations between the two countries even closer in the post-war period.

Speech delivered before
Annual Convention of Ohio Bankers Association
Columbus, Ohio
May 16, 1946

OUR FOREIGN LENDING PROGRAM

Most of Europe and important sections of Asia find themselves entering the period of peace with only a fraction of their normal export trade. They have not adequate means of their own to pay for the great volume of imports that they must have if their populations are to be kept alive, the damage of the war repaired, and their industries restocked with raw materials and set functioning again. Once this job is done, the warstricken countries will be able to look after themselves. They will once again have the exports necessary to pay for the goods they need and to service the debts they have incurred in process of rebuilding. Until this has been achieved, however, the United States, which has built up its productive power during the war, must be prepared to supply the goods and the needed financing on a great scale. Since this is a constructive job -- one that strengthens the economies of the countries and expands their output -- it is entirely appropriate that most of it should be done through loans rather than by a mechanism such as Lend-Lease. The countries that receive our aid will by reason of that very fact be placed in position to repay us in the years ahead. We are already engaged upon this lending program and I hope to give you a brief picture of it and the philosophy behind it in my talk today.

First, let me say, however, that we are going into it with our eyes open. We have not forgotten what happened to the investments that we had abroad in the 1920's. Our experience then was bad in many respects though not as bad as is commonly supposed. As a matter of fact on our total foreign investment in the 1920's we have received an aggregate service in dollars, which together with the undefaulted loans and equity holdings, is well in excess of the money we invested. Speaking very broadly, we have received something like the equivalent of 3 or 4 per cent return on the whole investment. This is primarily due to our good experience on direct business investments abroad and, in any case, it is far short of the 8 or 9 per cent which was charged on many individual loans in the 1920's; but rates of that magnitude give fair warning that the loan that is being made is a pretty poor risk. And such rates constitute a burden on the balance of payments of the debtor country that is almost impossible to carry when a major world depression strikes.

This time the rate of interest we are charging on reconstruction loans is in the neighborhood of 3 per cent -- a rate which, as I have just remarked, appears to have been actually realized on the investments of the 1920's as a whole. Also, this time foreign loans are being carefully screened to meet only the most urgent and productive needs. They are not being blindly pressed upon countries to finance undertakings that are beyond their means. They are being judged in terms of the effects they will have upon the whole economy of a country and its international position. And notwithstanding the enormous uncertainties of the years ahead, there are new factors in the situation that afford some hope that the problem of transferring service on these loans across the international balance of payments will not prove to be the stumbling block it was in the 1930's.

The chief ground for this hope is that we have probably learned enough in the last ten or fifteen years to prevent the full recurrence of such a depression as then occurred. While we are far from having mastered the problem of how to keep a free economy running smoothly at maximum production -- while there are many years of trial and error ahead -- we have, I believe, learned enough to prevent the most extreme fluctuations. Steadier economies in the major countries will lessen the disturbances to international trade. In addition, the most upsetting element in the international situation in the 1930's -- great capital flights -- will be severely under control in most countries in the years ahead. All this will tend to limit the size of the international deficits we must face. And as these deficits occur the International Monetary Fund, an institution which was not available in the 1930's, will swing into action. It will use its position to help assure that adequate corrective measures are taken and taken in time. While they are being taken and until they can bear fruit, the Fund will be prepared to assist a country financially by making foreign exchange resources temporarily available to it. Not only will countries have access to the billions of dollars available in the International Monetary Fund, but they already have gold and dollar reserves of their own, which are more than double the reserves that were available to them to meet the crisis of the 1930's. These reserves are not, of course, evenly distributed according to need, and in any case they must largely be used for currency stabilization purposes rather than for the reconstruction job. That job is too big for them. But the loans made for reconstruction will be safer if a larger measure of currency stability and freedom of exchange markets is achieved.

Here then are four major reasons -- diminished business fluctuations, control of capital flights, action of the International Monetary Fund, and larger basic reserves abroad of gold and dollar exchange -- four major reasons why the international financial breakdown of the 1930's is not likely to be repeated on the same scale again. I might add to this list of economic factors the progress that we hope to make in the forthcoming conferences on commercial policy. If these conferences achieve substantial reductions in the barriers to international trade and open the field more widely to private enterprise and competition, the effectiveness of measures designed to correct balance of payments deficits will be correspondingly enhanced. Even on the political front, although the immediate problems are great, we are better organized than in the anarchic period of the 1930's; for now we have the United Nations embracing all the great powers and with the United States playing a full and purposeful role. The possibility that war will cut across the whole pattern of international investment is materially lessened though, of course, far from eliminated by the United Nations Organization.

All of this may sound a bit optimistic to you bankers. I can sympathize with that feeling. If one looks only at the problems that face us today in the international sphere, there can be few grounds for optimism. The problems themselves are unprecedented, and it would be a bold man who would predict in just what way this war-stricken world will finally settle down. What I have been trying to emphasize, however, is that we are far better organized, and equipped to deal with these problems than we were with those which were left behind by the first World War. We should not just sit back and assume that history will repeat itself. The basis of international investment has been strengthened in many important respects and we are taking what the generals would call "calculated risks" when we come to the assistance of the war-damaged countries of Europe and Asia. If we can aid these countries to get back on their feet; if we can tide them over these first years when their shortages are temporarily acute and their means of paying for them through exports are not yet restored; if we can help them to obtain the means to help themselves; then we may find not only that they can repay us what we have lent, but that they are strong enough to participate with us in building a world of free enterprise and expanding employment and production. It is in that sort of world that democracy can best thrive.

We have kept these purposes clearly before us in the lending program we have undertaken. The key loan is, of course, that to the British. The United Kingdom is the greatest trading nation in the world and the pound sterling is the currency in which much of the world's business is carried on. The many countries that export to England more than they buy from her were at one time able to employ the sterling proceeds of their sales to buy outside the sterling area -- particularly in the United States. Under war conditions this freedom was lost. England could not possible restore it again in the difficult transition years without the aid of the American loan. She doesn't have the dollars. Without the loan she would be driven to desperate measures -- to a whole series of bilateral deals, every one of which would discriminate against the United States and would draw world trade away from its most productive channels. Although in the end this system would seriously shrink world trade as a whole and work against Britain's own interests, the United Kingdom would be forced to get what she could out of it in the critical transition years. Anything gained in that period when exports were still insufficient to pay for the most urgent import needs would be worth considerable sacrifice of future potentialities. Once set on this path it would be hard for her ever to disentangle herself. So many vested interests would grow up around the discriminatory bilateral arrangements that even the Bretton Woods Fund could hardly blast them loose. And with England playing this sort of economic game the chances for cooperation in the political field would be jeopardized.

The loan agreement with the British, therefore provides specifically that, within one year from the date when the agreement becomes effective, sterling due on current transactions with any part of the world shall be made convertible unless the United States consents to an extension of time. This is written into an agreement in which $3,750,000,000 is provided to help England purchase the supplies she will urgently need before her exports and other sources of international income build up sufficiently to enable her to pay her own way. Because the loan deals with a key situation and has larger objectives than a mere financial transaction, it is on a larger scale and on more liberal terms than any other contemplated by the United States. It has been laid before Congress for approval; and the funds, if supplied, will be voted by Congress for this specific purpose.

The remainder of the United States lending program is largely being carried out by the Export-Import Bank. Substantial credits, to be sure, are being extended by other agencies in connection with the sale of Lend-Lease inventories and surplus property abroad, and the Maritime Commission has been authorized to sell ships on credit. All this is helping to meet the needs of Europe and Asia on the basis of deferred payments. But the loans of actual money are being made almost entirely by the Export-Import Bank.

Our policy on Export-Import Bank loans has been to meet only the most pressing needs that must be financed before the International Bank for Reconstruction and Development is ready for business. The resources of the Export-Import Bank were increased last summer from $700 million to $3,500 million and the President has stated that he will ask Congress for another $1,250 million to enable the Bank to complete its part of the reconstruction job. Substantial loans have already been authorized to France, Belgium, Netherlands, Denmark, Norway, Finland, Poland, and Greece and still larger loans to these and other countries are now under discussion. The programs have been pared down repeatedly; but the rock-bottom needs that must be met before the International Bank is ready to take over remain on a vast scale.

Reconstruction loans by the Export-Import Bank have been made on a 3 per cent 20-year basis except for a few special loans for 30 years at 2-3/8 per cent. These special loans have been made only to France, Belgium and the Netherlands and have been for the purpose of financing goods authorized under the Lend-Lease program but ordered after the end of the war. They amount to about $650 million. The remainder of the great Export-Import Bank reconstruction loans, which are on a 3 per cent basis with serial maturities, may in the course of time prove salable in some measure to the private market. This is particularly likely in the case of the shorter maturities.

The Bank is anxious to sell as much as it can to the market because it is under a legal directive to supplement private investment rather than compete with it and because the more it can sell, the more resources it will have to do those parts of the job which private investors are not yet ready to do. As you know, the $200 million loan recently made to the Netherlands Government was opened to the banks of the country on a participation basis. Since it was an extremely short maturity of from 1 to 2 years and bore an interest rate of 2-1/4 per cent it is not surprising that $100 million of it was in fact taken by the banks. It is not, to be sure, the usual type of loan provided for reconstruction purposes. That would require a much longer term. The $200 million credit is merely in anticipation of other measures that the Dutch will take to borrow here or liquidate their assets. Nevertheless it is cause for considerable satisfaction that a market which is extremely cautious about resuming international lending after the experiences of the 1930's has made on this occasion so substantial an investment.

The chief channel through which private funds will flow abroad in the immediate future, however, is likely to be obligations of the International Bank. The major part of the Bank's lending will be financed with funds raised in the market, since the Bank can use only 20 per cent of its own capital for making loans. The remaining 80 per cent can be called up only to the extent it may be needed to meet the obligations of the bank. The Bank may raise funds either by issuing its own securities or by guaranteeing the issues of foreign borrowers. In either case private investors will be supplying funds to foreigners while the Bank assumes the credit risk.

I should be interested to have your comments on the market prospects for bonds of the International Bank. It is possible that there will be an offering of such bonds before the year is out. As you know, the International Bank came into existence last December, and in March the first meeting of its Board of Governors was held in Savannah. The smaller working group of Executive Directors to whom the Board has delegated most of its powers is even now in session in Washington. The President of the Bank will have to build up a staff, and this may take some months. Gradually the Bank will acquire working funds through calling up a portion of its capital. Under its statutes, however, it can hardly call up much more than $400 millions of dollar subscriptions before the fall; and if, as seems likely, the demand of foreign countries is predominantly for dollar resources, it may be necessary for the Bank at an early date to offer its bonds for sale in this country.

At the outset insurance companies and savings banks in many States may find that the existing legislation does not provide for purchase of this new type of bond. Until a few months ago this was the case in New York; but through prompt action a law was passed permitting the savings banks of that State to invest in the obligations of the new International Bank when they become available. Commercial banks in general will be free to invest up to 10 per cent of their capital and surplus. It will be for them to determine to what extent they wish to purchase securities of the International Bank, taking into account maturity, risk, marketability, etc. The Bank will undoubtedly exercise great care to adapt the form of its securities to the potential market which it finds available.

As regards the basic risk involved I might make one comment. The Bank cannot lend more than its unimpaired subscribed capital, surplus, and reserves, which today amount to about $7,600 million. Hence if it borrows and lends to the maximum possible, both its loans and its obligations will amount to about $7,600 million. The obligations will be covered to the extent of about $3,200 million by the United States subscription. The remaining $4,400 million will be covered by claims against foreign governments and central banks amounting to about $12 billion -- i.e., $4,400 million of foreign government subscriptions to the capital of the Bank plus the $7,600 million of loans, all of which must have behind them the credit of a government, central bank, or similar institution acceptable to the International Bank. This $12 billion of claims against foreign governments or central banks would have to shrink through defaults to $4,400 million before the bonds of the International Bank would cease to be covered in full. No such shrinkage as this occurred in the servicing of our foreign investment during the ill-fated 1930's and there is little reason to believe that it will occur in the decades ahead -- particularly in view of the factors to which I have called your attention earlier in this talk.

If the securities of the International Bank find a ready market in the United States it should be able in 1947 to relieve the Export-Import Bank of most of the burden of making reconstruction or development loans While the shift from the Export-Import Bank to the International Bank wi be from an agency of the United States to an institution representing some 40 nations, the predominant role of the United States in international lending will not be greatly altered by the change. As I have already remarked, the United States investment market will be expected to supply most of the International Bank's funds. Furthermore the American director of the bank wields about 37 per cent of the total voting power. Even more important than this, however, are the provisions under which the consent of the United States is required before the Bank can lend the dollars subscribed by the United States or can float or guarantee an issue in the American market.

The power to give or withhold consent in these cases has been assigned by Congress to a new body which already has assumed primary importance in our international lending picture. I refer to the National Advisory Council on International Monetary and Financial Problems, commonly known as the N.A.C. This Council is composed of three Cabinet members -- the Secretaries of State, Treasury, and Commerce -- and the Chairmen of the Federal Reserve Board and the Export-Import Bank. These five men have been given the task of coordinating the foreign lending policies and financial operations of this Government and of the United States representatives on the International Bank and the International Monetary Fund. It is for them to keep the whole program that I have been discussing in this talk in proper proportion and order. Not only must it be adapted to the needs and capacities of one foreign country as against another, but it must be fitted into the position of our domestic economy in such a way as to help preserve its stability. The N.A.C. is taking its task with the utmost seriousness. The Secretary of the Treasury is chairman and there are regular meetings in his office. The group is constantly shaping and reviewing the lending program of this country, both in detail and as a whole. As the International Fund and Bank come into full operation the task of the N.A.C. will be increased. But it is already clear that an adequate system has now been devised for bringing together the Government agencies primarily concerned with our foreign financial policy. I believe that you have in this Council the best assurance you could ask that the lending program of the United States will continue to be broadly conceived and well-integrated, and that it will make the most effective use of our admittedly limited resources. It will be powerfully directed toward rebuilding the kind of international world in which American free enterprise can thrive side by side with foreign enterprise, and the foundations of the peace can be made secure.

Speech delivered before
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OUR STAKE IN GERMAN ECONOMIC RECOVERY

Two world wars and their aftermath have made it clear that the problem of Germany is one of the keys to world peace and prosperity. For two years, your representatives in military government have sought a basis for the solution of this problem. They can only succeed if the American people are aware of both their achievements and their difficulties, and if in turn the military government officials in Germany understand the attitude of the public at home. To contribute to a mutual exchange of such information is the main purpose of this paper.

Principles of American Economic Policy in Germany

We all know that the German economy operated in the past as one integrated unit. Each part made its contribution to, and received its support from, the rest of the country. This integration alone made possible the industrial development of Germany. None of the areas that constitute the nation was ever self-sufficient in the past or can be made self-sufficient in the future. None of the German industries draws its tools and raw materials from one single area or one single zone of occupation. Steel and coal of the British zone are vital to the metal-working industries of the American zone, but the coal mines in the British zone cannot operate without pit props from the American and Russian zones. The light industries of the American zone need optical glass from the Russian, and glue from the French zone. On the other hand, they supply the French and Russian zones with electrical equipment, anti-friction bearings, and dyestuffs.

For purposes of occupation Germany west of the Oder-Neisse line has been divided into four zones: American, British, French, and Russian. Moreover, the area of prewar Germany lying east of that line has been put under Polish (or Russian) administration. The Potsdam Agreement provided that the four zones should be treated as one economic unit. It has not worked out that way, however. Therefore, I shall not speak so much of global German problems such as economic unification, the levels to be established for German industry, and the reparations program. Instead I shall concentrate on discussing the economic problems of the American zone and as far as necessary of the combined American and British zones.

All of us are aware of the importance of early high-level decisions on the basic economic questions which were recently discussed at Moscow. The issues were pointed out some time ago by Secretary Marshall and we all know their substance and the urgent need for their solution.

In view of the history of German aggression and the part played therein by German industry, it may be difficult to understand that one of the major tasks of military government is the provision of assistance in rebuilding at least part of the German industrial system. Such a reconstruction, however, is necessary for two reasons: to prevent Germany from remaining a source of perpetual unrest in Europe, and to aid in the recovery of our allies.

In the crop year 1946-47, German farmers in the combined American and British zones of occupation are producing foodstuffs sufficient to provide an average diet of only about 1,000 calories daily for that part of the population that does not live on self-sufficient farms. Such a diet is less than half of the minimum standard endorsed by the United Nations Food and Agricultural Organization. Unless we are prepared to forego payment for the large supplies of food that must be sent to Germany for an indefinite period just to prevent wholesale starvation, we must permit Germany to redevelop its manufacturing industries which alone can produce the exports necessary to pay for food imports.

Moreover, the products of German industry are indispensable for the reconstruction of continental Europe. In 1936—the last year in which the bulk of the German economy was operated on a peacetime level—Germany was the largest exporter to, and the largest importer from, Austria, Bulgaria, Czechoslovakia, Greece, Hungary, Italy, Rumania, Switzerland, Turkey, and Yugoslavia. It was first as a supplier and second as a market for the Netherlands, Poland, and Sweden. 1/ Almost the entire manufacturing industry of continental Europe was dependent upon German machinery, precision instruments, electrical appliances, optical goods, transportation equipment, and chemicals.

1/ The importance of Germany for continental Europe is indicated by the following table, showing Germany's trade with some of the leading European countries.

Country	Imports from Germany	Per cent of total imports	Exports to Germany	Per cent of total exports
	(Millions of dollars)		(Millions of dollars)	
Netherlands	151	23.3	74	15.7
Italy	116	26.4	77	19.5
France	106	7.0	40	4.3
Sweden	99	23.9	61	15.8
Switzerland	92	24.8	51	19.4
Denmark	83	25.3	62	20.3
Belgium	82	11.5	69	10.4
Soviet Union	62	22.8	23	8.5
Czechoslovakia	55	17.5	45	14.3
Norway	41	17.6	23	13.2
Austria	40	16.9	29	16.1
Turkey	34	45.1	48	51.0
Rumania	33	39.0	30	21.1
Hungary	33	25.8	35	23.1

The fact that Germany today cannot even supply spare parts is hampering economic reconstruction in such different countries as Austria, the Netherlands, and Poland. The general shortage of coal, which is the greatest single factor in retarding European recovery, is due largely to low production in the Ruhr mines. Lack of German potash is delaying the rehabilitation of agriculture all over Europe. An increase in the output of coal and potash mines, however, depends upon the availability of mining equipment and upon larger supplies of consumer goods for miners. A German miner can earn in two days all he needs to buy his meager weekly rations and thereafter has little incentive to work. A relatively small increase in consumer goods offered to miners was an important element in raising production in the Ruhr mines by about one-fifth between the fall of 1946 and the spring of 1947. A large-scale revival of German consumer goods industries would have proportionately greater results.

Our own economy would benefit from the resumption of German industrial exports because the availability of German goods would help meet the foreign demand for many American goods which are still in scarce supply relative to our own domestic demand. Furthermore, some European countries can pay for imports from the United States only with the aid of dollar credits because they lack dollar resources and lack exportable commodities adapted to the American market. If they could import goods from Germany, however, they could pay for them by exporting products urgently needed in that country. In that way, they would lighten the burden which the American economy has had to bear both in respect to the reconstruction of their own economy and to the rehabilitation of Germany. For instance, before the war the Netherlands exported substantial quantities of vegetables to Germany while Germany paid for these imports in steel and machinery. If that commerce could be restored today, it would make it unnecessary for the American economy to extend credits to the Netherlands in order to enable that country to buy American machinery an it would make it also unnecessary to divert scarce American foodstuffs tc Germany.

Obstacles

While the principle of assistance to German recovery has been generally accepted in this country, it has been very difficult to carry out the program on an adequate scale. For obvious reasons of justice and policy, the countries invaded by Germany have been given a prior claim to our aid. Our financial and material resources are limited and foodstuffs and raw materials continue to fall short of total demand. The allocation of wheat and non-ferrous metals, for instance, is a task that simply cannot be fulfilled to the satisfaction of all. Similarly, coal, of which Germany is a major producer, is in generally short supply. In order to promote reconstruction in the rest of Europe, we have had to undertake substantial exports of German coal even though the revival of German manufacturing industry would have been considerably accelerated if it had been possible to retain German production for German domestic use.

It may be hoped that these scarcities will disappear within a few years, but other obstacles may take their place. Concern has frequently been expressed that the reconstruction of German industry may go too far and restore Germany's war potential. The occupying powers have tried to differentiate between industries that could be used for aggressive purposes and therefore should be restricted, and others that might be considered peaceful and therefore should be encouraged. The most innocuous industries, however, could conceivably be used for war purposes, and dangerous ones frequently are indispensable for peacetime uses. For this reason, some of the United Nations are critical of any move to improve the level of German industry even though they concede that such an improvement would benefit them from the economic point of view.

Finally some countries see in Germany less a source of supplies or a market for exports than a dreaded competitor. At present, such fears seem premature since production the world over has not caught up with demand, and German production remains a neglibible part of the total. As soon, however, as world market conditions become less favorable to the sellers, any increase in German industrial production and especially in German industrial exports, may injure the interest of some industrial group in other countries. Although such exports will in turn make possible imports into Germany and thus benefit the economies of Germany's trade partners as well as its own, the groups benefiting from access to the German market frequently will be different from those affected by German competition.

Achievements of Military Government

Despite the conflict of objectives and the limited financial and material means at the disposal of the occupation authorities, there has been a degree of rehabilitation in Germany.

a) Food and Agriculture

The food situation continues to be the central German problem. It is far from satisfactory, but we have been able to avoid not only outright starvation but also any serious deterioration of public health. Since last fall the official ration has been maintained in the American and British zones until recently at 1,550 calories daily for the so-called normal consumer. This ration still is more than one-fourth below the minimum necessary to insure health in the long run and more than two-fifths below the German prewar standard of nutrition. Moreover, the diet is far poorer in quality than would be advisable from the point of view of nutrition, a larger proportion consisting of grain products and a smaller proportion of so-called protective foodstuffs. Even so, the ration has been maintained only by importing into the combined American and British zones foodstuffs equal to about 60 per cent of their domestic production. These imports, including monthly shipments of 200,000 tons of bread grains and flour, and substantial quantities of potatoes, sugar, fish, and milk, require an expenditure of $360 million in the current crop year.

The food situation is constantly being threatened by the fact that stocks of supplies are dangerously low. Food is needed in many parts of the world. For the sake of food importing countries a further rise in world market prices must be avoided as far as possible and priorities must be established by the exporting nations. Every ton of food allotted to Germany causes hardship in other parts of the world. Difficulties in ocean transportation frequently delay shipments urgently needed for maintaining stocks in Germany at the minimum level needed for the planning of equitable distribution. German farmers frequently fail to deliver their quotas. Trains must be rerouted to alleviate a crisis in some part of Germany, thus creating a shortage in another part. Losses from pilferage increase in proportion to the deterioration of food conditions An unfortunate accumulation of such factors was the cause of the difficulties currently experienced in the Ruhr district. Delays in deliverin the full rations invariably lead to unrest, diminish the efficiency of labor and the output of industrial goods, and thus add to the difficulties of rehabilitation.

In future, we expect domestic production, collection, and distribution to yield substantially larger quantities than this year. Such an improvement will depend upon the availability of fertilizer and upon a supply of industrial consumer goods which will induce farmers to raise more crops for sale. It also will depend upon the enforcement of a strict program of collection and distribution which must be efficiently performed by German officials. We can have the utmost confidence in the ability of military government under General Clay to meet this situation if they are given fair means to carry out their program.

In the long run, however, the efficiency of industrial labor can not be maintained on a diet representing less than 2,600 calories daily for the so-called normal consumer. The American and British zones cannot expect to produce more food than sufficient for an average of 1,600 calories daily. Import requirements in the long run therefore will be the equivalent of at least 1,000 calories daily, or about two-thirds mor than actual imports in the current year.

b) Industrial Production

In 1945, most manufacturing industries in the Western zones of Germany were at a standstill. By November 1946, industrial production in the American zone had reached 44 per cent of 1936--a year of virtually full employment in Germany. 1/ With the exception of lumber, the production of all commodities is below the 1936 figure, but by 1948 prewar output is expected to be reached in a number of important industries. I the British zone, industrial production had recovered last fall to only 38 per cent of 1936. The British zone includes mainly heavy industries, most of which are under severe restrictions as possible war industries, while the American zone contains mainly light industries, manufacturing consumer goods.

1/ The rise in industrial production in the American zone is indicated by the following table, comparing production of some important commodities in the first and the last quarter of 1946.

Commodity	First quarter 1946	Last quarte 1946
Trucks (units)	400	1,434
Electric motors (thousands of horsepower)	28	131
Lumber (thousands of cubic meters)	549	1,015
Potash (metric tons)	36,849	311,098
Textile yarns, including rayon (metric tons)	5,737	10,200

Unfortunately, the exceptional severity of the last winter has undone some of the progress experienced during the preceding year. Industrial production in the American zone fell in December to 39 per cent, in January to 31 per cent, and in February to 29 per cent of 1936. In March it recovered to 35 per cent, but this level still is about one-fifth below the peak of November 1946.

In spite of the low level of production there is little unemployment. Even in February 1947, unemployment in the American zone was less than 450,000 out of a labor force of more than 7 million. Only in the white-collar classes is the number of job openings constantly smaller than that of job seekers. This is the result of three facts. The labor force has been greatly reduced by war losses and by the Allied retention of a large number of prisioners of war in some countries. Secondly, much labor is needed for work, such as removal of rubble and plant repair, which does not show in production statistics but nevertheless is vital for resumption of economic activity. Thirdly, for physical and psychological reasons, the productivity of labor has fallen considerably, in some cases by as much as two-thirds. The gradual revival of economic activity, more food, housing facilities, and improved availability of industrial consumer goods will do much to remove the causes of low efficiency.

c) Housing

Next to food, housing accommodations are the most pressing requirements of the German people. Despite all war losses, the population of the American and British zones has risen by around 20 per cent in comparison to prewar, mainly because of the inflow of Germans expelled from the area under Polish administration and from Czechoslovakia and other Eastern European countries. At the same time, urban housing suffered from terrific bomb damage during the war, especially in the industrial and commercial centers. In Bremen, for instance, 55 per cent of all homes were unusable in the summer of 1945. Reconstruction has been hampered by the scarcity of building materials, which in turn is due largely to the lack of coal: approximately 12.5 tons of coal are needed for producing the material necessary to build a small apartment. Allied legislation provides for the equitable distribution of available housing among the population, but this measure can bring only small relief since the complete equalization of all housing would only provide around 80 square feet per person in the American, and less than 70 square feet per person in the British zone.

Improvement in housing conditions is particularly needed in the Ruhr district since the inflow of additional miners from the Southern area of our combined zones, required to fulfill the program of output expansion, depends upon the availability of homes. A short range program has been and a long range is being prepared to provide additional housing, including temporary camps and billets and permanent reconstruction. In addition to building material, beds, bedding, and furniture must be produced. While military government plays an important role in drafting the program, its execution is entrusted to the German authorities. Military government has helped in that task by reducing to a minimum the requirements for military installations.

d) Domestic Trade and Transportation

Despite the interdependence of the four zones of occupation, interzonal trade has been slow to develop largely because of the lack of economic unification.1/ Since January of this year, trade between the American and British zones has been free, as the result of the economic merger of these zones, and trade between the merged zones and the rest of Germany will be increased under agreements concluded among the zonal authorities. Until and unless the over-all economic unity of Germany is achieved, however, German recovery will be hampered by obstacles to the free flow of goods within the country. Transportation has suffered particularly badly from war damage. Military government can be proud, however, of its record in repairing railroads, inland waterways, port facilities, and highways. Railroad tracks in operation represent 97 per cent of the prewar total. Almost as many sunken vessels have been raise in the American zone as in all other zones together and the proportion of port channels cleared is higher than in any other zone. The American zone also has a larger proportion of operating motor vehicles than any other zone.2/ Despite this progress, transportation is even now in need of repair and maintenance is a constant problem. Allocations of materials are being made for this purpose but must be revised as required to meet new priority demands from other sides of the battered economic structure.

e) International Trade

In 1946, the foreign trade of the American zone was almost entirely confined to the importation of foodstuffs and other essential goods by the occupation forces in order to prevent disease and unrest among the population. Such imports are financed by War Department appropriations. The only other substantial import transaction was the shipment of some surplus American cotton held by the Commodity Credit Corporation. This cotton was delivered to German processors; the finished goods are being exported in an amount sufficient to pay for the cost of the imports, and the rest is available for German consumption. In the fall of 1946, simi lar arrangements were made by American Military Government for the impor tation of raw materials required for the manufacture of ceramics, optica instruments, building materials, chemicals, and toys. The interim financing for these imports is handled by the U. S. Commercial Corporatior

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1/ In the nine-month period April through December 1946, the American zone shipped goods valued at 475 million marks (around $190 million at the prewar exchange rate) into, and received goods valued at 471 million reichsmarks from, the other zones. Trade with the British zone accounted for 63 per cent, with the French zone for 28 percent, and with the Russian zone for only 9 per cent of the total.

2/ The work done in this respect may be illustrated by some figures: More than 200 miles of railroad tracks, 78 bridges, and 18,000 miles of railroad telephone lines have been rebuilt; about 1,600 locomotives, 109,000 freight cars, and 8,600 passenger railroad cars have been repaired; about 800 miles of inland waterways have been cleared and 3,000 miles dredged; 978 river barges have been raised, and abo 1,350 repaired; more than 900 miles of highways and 261 highway bridges have been rebuilt.

a subsidiary of the R.F.C. Exports from the American zone in 1946 were confined mainly to lumber and hops and a few industrial goods, taken from existing inventories or produced from raw material stocks. The amounts shipped were very small, in the neighborhood of 3 per cent of the estimated prewar exports of the zone's area.

Imports into the British zone were similar to those of the American zone, but exports from the British zone were considerably larger, due almost entirely to Ruhr coal. Coal exports reached a weekly volume of 260,000 tons in the summer of 1946, or about 40 per cent of prewar, but this involved heavy drafts on existing stocks and inadequate allocations to the needs of the German economy. As a result, exports of coal had to be reduced by about 30 per cent in the fall of 1946. Even the peak figure in the summer of 1946 was far from sufficient to meet demand in the rest of Europe, and the reduction of coal exports was a heavy blow to the importing countries.

In the first months of 1947, exports had to be curtailed still further reaching a low of 103,000 tons per week in February. Meanwhile, however, the output of the Ruhr mines had risen and coal exports could be increased again. In April and May, the unsatisfactory food situation brought about some labor disturbances which kept coal output somewhat below the March peak.

As soon as these difficulties are overcome, a further rise in output is expected, and in that case exports will reach in summer a minimum of 265,000 tons per week, while at the same time allotments for the needs of the merged zones will be a minimum of 860,000 tons per week, or about 30 per cent above the peak allotment in 1946. The increase in domestic allotment will mainly benefit industrial enterprises, which in this way will be enabled to raise their output and thus to contribute more efficiently to the projected expansion of foreign trade.

Apart from coal exports, foreign trade of the merged zones in 1947 will be determined by the working of the bizonal merger agreement. This agreement provides for the cooperation of the American and British occupation authorities, and of the representatives of the German states, in formulating an import-export program for the rehabilitation of the German economy. A major objective of this rehabilitation program is to put the merged zones of Germany back on a self-supporting basis, i.e., to develop exports to a point where they cover imports. Meanwhile, however, the occupying powers must bear the cost not only of the basic program for the prevention of "disease and unrest", but also of the raw material and equipment imports required to "prime the pump" of German export industries. Certain funds are already in hand for this second part of the program, including the receipts from exports of 1945-46, some former German external assets transferred to the occupying powers under agreements with neutral countries, and the credits negotiated with the U. S. Commercial Corporation. The United Kingdom is participating in the program in two ways. It bears half of the costs of sending basic necessities to the merged American and British zones, and it finances half of the funds needed for "priming the pump" of the area's industry. Whenever, in the future, additional advances should be required, the United Kingdom also will bear an equal share with the United States.

The expected increase in imports will necessitate, but also make possible, larger German exports. In order to facilitate exports, the occupation authorities have authorized foreign businessmen to correspond with prospective German trading partners. Only so-called non-transactional mail, i.e., correspondence preparing rather than concluding actual contracts, has been allowed so far, but transactional mail may be admitted in the near future. Military government also provides facilities for foreign businessmen to travel in Germany and renew trade contacts. Contracts have to be submitted for approval to the Joint Export-Import Agency of the U.S.-U.K. occupying powers, and all payments have to be made to the account of the Agency rather than individually to German exporters. The Agency has issued rules of procedure, stating the principles which will determine the approval or rejection of contracts, and has established branch offices in the most important trading centers of the merged zones, mainly the state capitals. Finally, the Agency is prepared to act as seller of goods if a foreign buyer is prevented by government restrictions from entering into legal contracts with German nationals.

The necessity of setting up the bizonal export-import organization and the hardships of the winter months have delayed the beginning of the new program. Despite these handicaps, foreign trade has started to rise In the first quarter of 1947, contracts for exports were negotiated to the amount of $22 million. Export deliveries, which, however, include coal, reached $34 million. Imports, excluding basic necessities importe by the occupation authorities, were approved to the sum of $10 million. These amounts still are far below the levels that must be reached in order to fulfill the bizonal program, but they represent a material improvement in comparison with preceding periods.

f) Money and Exchange

When the occupying powers entered Germany, the collapse of the currency appeared imminent. Money in circulation had increased to approximately six times the prewar level. The German people's recollection of the hyper-inflation that followed the first World War added to the dangers of the situation.

Despite the oversupply of money and the scarcity of goods, the occupying powers took over the existing German system of price and wage controls and have been able to prevent any serious rise in legal prices and wages. The official cost-of-living index stood in December 1946 at approximately 120 per cent of 1938. It is true that only the meager official rations can be purchased at these prices. The supply of black market goods, however, is probably smaller than the amount of goods distributed through legal channels. Furthermore, many black market transactions take the form of barter, especially for cigarettes, rather than the form of sales at high money prices.

The maintenance of the official price and wage level at virtually prewar figures has had some unforeseen consequences. At the beginning c the occupation, a military exchange rate of 10 marks per dollar was established, as compared to a prewar exchange rate of 2-1/2 marks per dollar. This rate was introduced merely for the administrative use of the occupying authorities, especially in calculating payments in marks to the troops. Its application for general purposes, however, would have tended to upset the entire price and wage system. German domestic prices even before the war were managed in such a manner that they had lost all relation to world market prices. No uniform exchange rate, and least of all the military rate, would represent a generally applicable ratio between domestic prices as expressed in marks, and world market prices in dollars.

Thus a difficult problem has arisen in connection with the pricing of export and import goods. The German exporter receives for his sales the legal domestic price in marks. Similarly, the German importer has to pay for his purchases the legal domestic price in marks. On the other hand, the foreign importer of German goods pays, and the foreign exporter of goods receives, the world market price in dollars.

Therefore, the occupation authorities have decided for the time being to refrain from fixing a uniform conversion factor for the translation of mark into dollar prices, and vice versa. Instead we have issued a long list of various conversion factors, reflecting for all major commodities the actual relation between legal domestic prices in marks and world market prices in dollars. For instance, the conversion factor for carbon brushes is 30 cents, and for pharmaceuticals 80 cents per mark. This means that a certain quantity of carbon brushes that sells domestically for 100 marks has to be priced for exports at $30, but pharmaceuticals that sell domestically for 100 marks have to be priced for exports at $80. As a practical matter, this is the best that can be done until major monetary reforms are undertaken in Germany and a more normal price system is developed there. These problems have been under quadripartite (four zones) discussion for some time and it is to be hoped that an early agreement will be reached.

g) Banking

In December 1946, military government established a new central banking organization in the American zone. Following the principle of decentralization, each German state received its own central bank, which took over the assets of the former Reichsbank as far as they were located in its area. The organization of the central banks was largely influenced by the model of the Federal Reserve System. As soon as the economic unification of Germany is implemented, the state central banks will be coordinated by a central board, which will issue currency through the medium of the state central banks. Until such time, however, the central banks have no power to issue bank notes or any other currency.

In consequence of our principle of decentralization, commercial banks in the American zone have been ordered to sever their connection with central offices in Berlin. Depositors are free, however, to dispose of their accounts both within the American and in transactions with the British and French zones, except for blocking measures applied in the process of denazification. From the beginning of occupation to the end of 1946, deposits in the American zone increased by 75 per cent. Most of the rise in deposits had to be kept by the banks in cash or with other credit institutions since no other investment opportunities are available. Total assets of the banks in the American zone were 75 billion marks on June 30, 1946, of which one-third was kept in cash or bank balances, and two-fifths in Treasury bills and other government securities, the service of which has been suspended since the end of the war.

Problems and Prospects

All these achievements are merely the first step on the road to rehabilitation. The obstacles that still have to be overcome are no doubt as great as any which we have encountered so far.

First of all, the provision of the Potsdam declaration which calls for the economic unification of Germany must be carried out. Unification in itself will not solve the economic problems of Germany, but it will ensure the development of the whole German economy on a more rational basis. Uncertainty as to economic unification is a handicap in many fields, notably in adjusting the so-called Level-of-Industry Plan to changed conditions. Under that plan, which was approved by all four occupying powers one year ago, maximum levels were established for most German industries with a view particularly to preventing the resurgence of German war potential. Most experts agree that this plan needs substantial corrections, but the necessary amendments in each zone will largely depend upon developments in other zones and upon the question of whether the German economy is to be redeveloped as a unit or in separate self-sufficient parts.

Another problem that urgently needs attention is currency reform. The disproportion between the supply of money and of goods at prevailing prices cannot be maintained indefinitely. All experts agree that a reduction in the volume of currency will be necessary. Obviously, the execution of such a reform also depends upon the fate of unification. If common action of all four occupying powers is not forthcoming, the advantages and disadvantages of separate action in the merged American and British zones must be weighed.

Other problems arise in connection with the political aims of occupation. The decentralization of the German economy must be achieved in order to make it impossible for the country to reorganize for aggressive purposes. In this connection, military government in the American zone has enacted a drastic decartelization statute, which is aimed at destroying the concentration of economic power in Germany industry. Property of allied nations looted during the war has been and is being restituted. War plants have been and are being destroyed, and other plants have been and are being removed for reparations. The overall problem of reparations, however, still remains to be solved.

The lack of unified action of the four occupying powers, moreover, creates uncertainties that are detrimental to economic progress. As long as the management of an enterprise does not know whether or not a plant will be subject to restitution, or to destruction, or to removal under the reparations program, it cannot make definite plans for reconstruction or start an investment program which might be interrupted at any moment.

Finally, military government has to deal with the problem of reaching equilibrium in the balance of international payments of the merged

American and British zones. In this connection, the question of economic unification again becomes decisive. As long as unification is not achieved, interzonal trade must be treated as international rather than domestic commerce, with the resulting need for controlling interzonal payments.

The problem of equilibrium is particularly interesting to the American public. As long as the proceeds from exports do not exceed import requirements, they must be devoted entirely to paying for current imports. Only when an export surplus is reached, will it be possible for our merged zones to start repaying the advances made by the occupying powers for the importation of basic necessities.

Our stake in the economic problems of Germany, however, is greater than our interest in receiving repayment of our advances. We want peace, and we know that in order to have peace, we must have economic stability in Germany and in the rest of Europe.

Broadcast over
Station W-I-N-X
May 23, 1947

OUR JOB IN GERMANY TODAY

Mr. Szymczak gave a talk over the Washington radio station WINX on May 23, 1947, 8:30 p.m., on the subject "Our Job in Germany". The summary of the highlights of his radio address follows.

American policy in Germany aims at economic unification, according to the provisions of the Potsdam Agreement. In the short run, food continues to be the central question. The occupation authorities have been able to avoid in the American zone not only starvation but also serious deterioration in public health. The present official ration of 1,550 calories daily for the average consumer, however, is more than one-fourth below the minimum necessary to ensure the maintenance of public health in the long run. Even so, the ration has been furnished only by importing into the zone from abroad foodstuffs equal to 60 per cent of domestic production.

Military government is also facilitating German efforts to rebuild at least part of their industrial system. This may be difficult to understand in view of the part played by German industry in the history of German aggression. The reconstruction of German peaceful industries is necessary, however, to prevent Germany from remaining a source of perpetual unrest in Europe, to aid in the recovery of our allies, and to enable Germany to become self-supporting in international trade. At present, production is somewhat smaller than in the fall of 1946 because of the exceptional severity of the last winter which disrupted transportation and production all over Europe. It is much larger, however, than a year ago, and the output of several important consumer foods industries is expected to reach prewar levels by 1948.

Economic rehabilitation is hampered by the difficult currency situation. Money in circulation increased during the war to six times the prewar level, and the extreme scarcity of goods adds to the danger of inflation. The occupying powers have been able to prevent official prices and wages from rising seriously, but only the meager rations are available at legal prices. In the long run, the disparity between the supply of money and goods cannot be maintained. Currency reform is under consideration by the four occupying powers, but if uniform action is not forthcoming, the advantages and disadvantages of separate action by the government of the combined American and British zones must be weighed.

Peaceful reconstruction of Germany also depends upon the integration of the German economy in the network of international trade. Imports into the American zone have consisted mainly of foodstuffs and other essential goods necessary to avoid disease and unrest among the population. Military government also arranged for the importation of cotton and other raw materials to be processed in Germany. A new cotton program is now being discussed in Germany by American cotton shippers and Export-Import Bank representatives with Military Government officials. Part of the finished goods are being exported to pay for imports, and the rest becomes available to the domestic economy. Other raw materials imported are used for production for export only. The economic merger of the American and British zones will make possible a more ambitious program, and present plans call for putting ther merged zones on a self-sustaining basis by the end of 1949. The American taxpayer is particularly interested in having the merged zones evolve an export-import balance because only thus can the merged zones pay for the importation of the foodstuffs required to avoid starvation.

Our stake in the economic recovery of Germany, however, is greater than our interest in receiving payment for our supplies to Germany. We want peace. In order to have peace we must have economic stability in Europe. This means economic stability in Germany. At the same time we are striking at the seeds of aggression in Germany by decentralization of the country not only politically but also economically. Measures to that end are now in effect. That is our long range objective.

Speech delivered before
New York Board of Trade
New York, N. Y.
June 12, 1947

OUR INTEREST IN GERMAN FOREIGN TRADE

Recovery in Europe is lagging. Since V-E Day, this country has provided billions of dollars of assistance to Europe. Still we find the continent struggling with shortages of food, of fuel, of raw materials, of most of the essential ingredients for economic recovery and stability. Until Europe can export enough to pay its own way in the world, we shall find ourselves continually confronted with a hard choice: We must either provide further billions of assistance or see economic, social, and political disintegration in that vital area. We face exactly this problem in Germany; but, more importantly, our failure to handle it there on an adequate scale will seriously reduce the chances of our success in the rest of Europe. Other European countries are vitally dependent upon the renewed flow of supplies from Germany, first and foremost of coal. The reconstruction of the European economy is inseparable from the rehabilitation of Germany.

Before the war Germany, next to the United States and the United Kingdom, was the most important trading nation in the world. As late as 1937, despite efforts of the Nazi regime to make Germany independent of foreign supplies and markets, the country's foreign trade represented about 9 per cent of the world's entire international commerce. Its exports reached $2.4 billion and its imports $2.2 billion, equivalent at present prices to $4 billion in each direction. More than half of these exports and imports came from or went into those areas of prewar Germany that today constitute the American and British zones of occupation. About two-thirds of the imports were raw materials and semi-finished goods needed for the operation of the German industrial system. Almost nine-tenths of the exports were finished industrial products. Germany provided a highly important market for many foreign countries, and its exports met essential needs in wide areas, especially in the rest of Continental Europe.

In 1946, imports from other countries into the American and British zones of Germany totaled about $650 million. More than four-fifths of that amount represented foodstuffs needed to avert outright starvation among the German population. Only about one-tenth of the total consisted of raw materials for German industry, mainly American cotton and British wool. The importation of industrial materials thus was only a very small fraction of the quantity which the zones used to import before the war. Exports were equally small. They amounted to only some $150 million and three-fourths of that sum was provided by coal exports from the Ruhr mines in the British zone. Most of the remainder was raw materials like lumber and hops. Exports of industrial goods were negligible.

As a result of this situation, the American and British occupation authorities had to finance an import surplus into their zones of occupation amounting to about $500 million in 1946. Despite such a large outlay of money, the economic situation of the zones remained critical. Food imports were just sufficient to keep the ration of the average consumer around 1,550 calories per day, an amount one-fourth below the minimum standard set up by the United Nations Food and Agricultural Organization, and two-fifths below the quantity needed for the maintenance of an efficient labor force. The scarcity of imported raw materials was an important factor restricting the revival of industrial activity. Stagnation in German industry has prevented an adequate flow of German exports to pay for imports and to contribute to the recovery of other European countries.

In December 1946, the United States and the United Kingdom agreed upon a new German foreign trade program based upon an economic merger of the American and British zones of occupation. The two occupying powers set the goal of making the combined zones self-supporting within a period of three years by stimulating both imports and exports, and in the meantime agreed to share equally in financing the necessary import surplus. They set up a Joint Export-Import Agency and implemented their agreement a few days ago by establishing a German Economic Council. This Council will be composed of representatives of the legislatures of the German states located in the combined zones. It will be assisted by an Executive Committee representing the governments of the German states, and by a number of executive directors, heading bizonal administrative departments. Through these organizations the population of the occupied zones will be mobilized for attaining the goals set by the Agency. It was hoped that France and the Soviet Union would join in the agreement and thus reestablish the economic unity of Germany, which is indispensable for the eventual rehabilitation of the German economy and to which all four powers had agreed at the Potsdam Conference of 1945. Unfortunately, the other occupying powers refused to join in the merger, and the American and British authorities had to proceed on their own, leaving the door open, however, for future adherence by the other two powers.

In meeting our share of the cost of supporting Germany during this interim period, we rely upon appropriations by the Congress to cover food requirements. Raw materials and equipment for industrial rehabilitation, on the other hand, are financed through credits from U. S. Government agencies. The Commodity Credit Corporation shipped $30 million worth of surplus cotton into the American zone to be processed by German firms. The finished materials are exported to an extent sufficient to pay for the imported cotton and the remainder is either exported in order to pay for the importation of additional raw materials or is made available to the domestic German economy. The U. S. Commercial Company agreed to finance similar shipments of raw materials for the ceramics, glass, chemical, toy and other industries. At present, a second cotton credit of $20 million is being negotiated with the Export-Import Bank of Washington and American cotton exporters.

The two occupying powers also have established a joint revolving fund of foreign exchange that can be used for importing other goods needed by German industries. The fund consists of the proceeds of exports from the combined zones in 1945 and 1946, insofar as they have not been used already for import payments, and of German external assets transferred to the two occupying powers by neutral countries. This provides the Joint Export-Import Agency with a necessary working balance for priming the pump of German export industries.

The actual start of the foreign trade drive has been somewhat delayed. For many months the unprecedented hardships of last winter disrupted transportation and production in Europe. The new export-import organizations had to be set up and proper rules of procedure established. The exact specifications for the export-import programs, which had to be submitted to the Agency by the German authorities, often were found unworkable. Already, however, the Agency is approving export and import contracts at an accelerating rate. Moreover, the Agency has issued regulations facilitating the renewal of contacts between German and foreign businessmen. American and other businessmen now may visit Germany in substantial numbers, and after June 15 German exporters and foreign importers will be permitted to conclude contract negotiations by mail. The Agency, however, has to approve all import and export contracts, either at its headquarters or through one of its branches, and it is designated to receive all foreign exchange proceeds from export shipments. These precautions are necessary in order to make sure that all export proceeds are mobilized for the payment of essential imports.

Imports in 1947 will have to include at least as much food as those of 1946. The deficiency of fertilizer and agricultural machinery, and the scarcity of able workers in Germany makes it unlikely that this year's crop will be much in excess of last year's. Even if some progress in German production is made, however, it could not be sufficient to bridge the gap between present supplies and the minimum needed for the preservation of public health in the long run. In addition to food imports, the combined zones will need imports of raw materials in substantially larger volume than now contracted for. While for some time to come it will not be feasible to restore the proportion between imports of foodstuffs and of industrial materials to the prewar ratio of one to two, the value of material imports will have to approximate that of foodstuffs to enable German industry to reach a satisfactory level of operations.

Exports in 1947 are expected to consist of coal, textiles, and other raw materials and industrial products, each of these three main categories to be of about equal value. In each case, however, reaching the goal will mean a hard struggle. The authorities will have to decide whether the overall European economy is better served by exporting Ruhr coal or by letting German industries use that coal for the production of exportable finished goods. If coal is to be used domestically, a given quantity could yield far higher export proceeds than if it were exported as a raw material. On the other hand, such a solution would be opposed bitterly by the industrial groups in those countries that depend upon German coal exports. This dependence is far greater than before the war: Only limited quantities of British and Sileasian coal are available for export to Western and Central Europe, and the shipment of American coal to Europe is very expensive because of transport costs and cannot be easily expanded because of transportation difficulties. The present allotment of Ruhr coal, agreed upon between the bizonal authorities and the French Government, attempts to satisfy both domestic and foreign demand at least to a somewhat higher extent than in 1946, but the fulfillment of the program depends upon a substantial improvement in coal output. Coal production increased materially during the first three months of this year. The advance, however, stopped in April and May, mainly because of labor unrest caused by the tightening of the food situation. Satisfactory coal exports from Germany thus will be possible only if increased domestic production aided by increased imports makes available more food and other consumer goods to the Ruhr miners.

Increased exportation of textiles will depend upon additional imports of cotton and wool. Here again improvement of labor efficiency through greater availability of food and other consumer goods is an important factor. Exports of lumber and potash encounter difficulties similar to those faced by coal exports. Both these materials are needed urgently in the German economy. Lumber is vitally important for pit props in the mines and for housing--next to food, the most severe shortage hindering improvement in labor productivity. Potash for fertilizers is indispensable for raising the output of German agriculture. On the other hand, Germany's neighbors need those materials for exactly the same reasons.

Similar difficulties arise in the importation of industrial materials. Since German exports have to pay for necessary food imports, imported materials should be primarily such as to make possible the production of exports. On the other hand, the considerations of labor policy which I indicated earlier make it necessary also to import materials needed for the production of goods for German consumption. We continually encounter this problem of how much work individuals can and will do. As long as the wage of a German worker can be used virtually only for buying the meager official food rations and similar goods, the German worker has no inducement to increase his efforts in order to secure a higher income. Labor productivity cannot be restored unless higher earnings are accompanied by a greater supply of consumer goods. To achieve this end would require a sharp increase in the production of goods for domestic consumption. The occupation authorities must approve a program dividing available means between the importation of materials for export and for the domestic market. If a liberal allotment is made for consumer goods, however, the decision will be severely criticized by the uninformed public in the occupying countries, which have to advance the funds for imports into the merged zones not directly covered by German exports. If the allotment is not liberal, the Germans will be inclined to feel that they are working for the occupying powers rather then for themselves. Charges of exploitation of the combined zones by American and British capital sound incredible to those who know the burden that the American and British taxpayers have to bear in order to keep the zones alive. Such accusations are often made, however, in Soviet newspapers and propaganda broadcasts to Germany, and it would not be surprising if some German workers were led to believe them. This would impair the beneficial effects of our import policy upon the efficiency of German labor.

Another difficulty is presented by the state of the German currency. The occupation authorities have been able to maintain official prices and wages at only 20 to 25 per cent above the prewar level. Black market prices, however, are either a multiple of the official quotations, or are expressed in terms of cigarettes or foreign currency. Thus, the German currency does not fulfill its function as a generally accepted means of payment. The German price system was isolated from world market developments by the Nazi regime even before the war. This circumstance, aggravated by the disparity between legal and black market price levels makes it impossible to fix any given exchange rate as representing a reasonable relation between the German and the world market price systems. Official German prices would be completely out of line with world market prices if they were converted into dollars at the exchange rate of 10 marks equal to 1 dollar, which was established at the time of occupation for purposes of military accounting. For this reason, the Joint Export-Import Agency has issued a list of so-called conversion factors, giving for each major type of commodities a specific relation between official German prices in reichsmarks and world prices in dollars. For instance, carbon brushes, which in Germany are selling for 100 marks, have a conversion factor of 30 cents per mark. This means that they are to be offered in the world market for $30. On the other hand, certain pharmaceutical products have a conversion factor of 80 cents per mark, which means that such goods selling in Germany for 100 marks are to be offered in the world market for $80. While this solution is not ideal, it is the best that could be found at present.

In the long run, however, currency reform will be indispensable for the rehabilitation of foreign trade with Germany. Such a reform should be carried out by all four occupying powers in order not to create further barriers among the four zones of occupation. An American project dealing with all aspects of the reform has for some time been under discussion among the occupying powers, and it is to be hoped that the relatively few unsolved problems can be settled in the near future.

Our efforts to reconstruct German foreign trade would be greatly facilitated if Germany's economic unity were restored in accordance with the Potsdam Agreement. Since the four zones are interdependent to a very high degree, full merger would make possible a much more efficient economic operation. If, however, the four powers cannot agree on the terms of unification, the American and British authorities will have to press forward in their efforts to put at least their area of occupation back on its own feet. This will require a reorientation of industrial production in the two zones, and an increase in industrial activity above the level set by the four occupying powers about a year ago. Within this framework the foreign trade program will make a decisive contribution to the restoration of economic stability in Germany and thus in all of Europe.

Broadcast over
N.B.C. Network
June 13, 1947

OUR INTEREST IN GERMAN FOREIGN TRADE

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The two occupying powers also have established a joint revolving fund of foreign exchange that can be used for importing other goods needed by German industries. The fund consists of the proceeds of exports from the combined zones in 1945 and 1946, insofar as they have not been used already for import payments, and of German external assets transferred to the two occupying powers by neutral countries. This provides the Joint Export-Import Agency with a necessary working balance for priming the pump of German export industries.

The actual start of the foreign trade drive has been somewhat delayed. For many months the unprecedented hardships of last winter disrupted transportation and production in Europe. The new export-import organizations had to be set up and proper rules of procedure established. The exact specifications for the export-import program, which had to be submitted to the Agency by the German authorities, often were found unworkable. Already, however, the Agency is approving export and import contracts at an accelerating rate. Moreover, the Agency has issued regulations facilitating the renewal of contacts between German and foreign businessmen. American and other businessmen now may visit Germany in substantial numbers, and after June 15 German exporters and foreign importers will be permitted to conclude contract negotiations by mail. The Agency, however, has to approve all import and export contracts, either at its headquarters or through one of its branches, and it is designated to receive all foreign exchange proceeds from export shipments. These precautions are necessary in order to make sure that all export proceeds are mobilized for the payment of essential imports.

Our efforts to reconstruct German foreign trade would be greatly facilitated if Germany's economic unity were restored in accordance with the Potsdam Agreement. Since the four zones are interdependent to a very high degree, full merger would make possible a much more efficient economic operation. If, however, the four powers cannot agree on the terms of unification, the American and British authorities will have to press forward in their efforts to put at least their area of occupation back on its own feet. This will require a reorientation of industrial production in the two zones, and an increase in industrial activity above the level set by the four occupying powers about a year ago. In this framework the foreign trade program will make a decisive contribution to the restoration of economic stability in Germany and thus in all of Europe.

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THE IMPORTANCE OF GERMANY FOR THE ECONOMIC RECONSTRUCTION OF EUROPE

The American public is well aware of the general importance of reconstructing the German economy. Few people, however, understand how much German rehabilitation means for those areas that form the core of democratic capitalism in Europe.

For political reasons, the Nazi regime tried long before the war to loosen the ties between the economies of Germany and the western democracies. Germany became the most important trading partner of the other Central and Eastern European countries, but this development did not appreciably diminish the overwhelming role that Western Europe and non-European countries always have played in German foreign trade. In 1937--the last year in which the German economy was run on a peacetime basis--Germany had imports of $2.2 billion and exports of $2.4 billion. Of its imports, 35 per cent came from Western Europe, 23 per cent from the Americas, 21 per cent from Asia, Africa, and Oceania, and 21 per cent from Central and Eastern Europe. Of its exports, 47 per cent went to Western Europe, 15 per cent to the Americas, 16 per cent to Asia, Africa, and Oceania, and 22 per cent to Central and Eastern Europe. Germany's importance for the western nations becomes even more apparent if countries that supplied more than half of German imports and took more than half of its exports, are listed in the order of their contribution to German foreign trade. The nations from which Germany had the largest imports were the United Kingdom, Argentina, the United States, Sweden, Italy, the Netherlands, Belgium-Luxembourg, Brazil, Rumania, British India, China, and Denmark. The countries that took the largest quantities of German exports were the Netherlands, the United Kingdom, France, Italy, Belgium-Luxembourg, Sweden, Switzerland, Denmark, the United States, Brazil, China and Czechoslovakia. Of these fifteen countries only Czechoslovakia is located in Central Europe, and only Rumania in Eastern Europe.

In the long run, those countries will have to reestablish the German market as an outlet for their products. At present, however, Germany is more important to them as a source of supply than as a customer. Many of the goods that Germany supplied before the war, are indispensable today for the economic reconstruction of its former customers.

Among the raw materials exported by Germany, coal always has played the most important role. In 1937, Germany exported 40 million tons, the value of which was then $180 million and would be today $400 million. Most of it came from the mines of the western zones, especially the Ruhr and Saar districts, and went to Italy, France, Belgium-Luxembourg, the Netherlands, and Switzerland. In 1946, exports from the western zones totalled 13.4 million tons, and these exports had to be divided among many more claimants than the threefold amount in 1937. The decline in the output of the British mines, which made necessary a reduction in British coal and coke exports (including bunker coal) from 52 million tons in 1937 to 9 million in 1946, has deprived the Scandinavian countries of their customary source of coal. The agreements concluded by Poland with the Soviet Union have diverted to that country a large portion of the Sileasian coal output from its usual Central European markets. Domestic coal production almost everywhere in Europe was below prewar, on account of war damage and disorganization. The only other source of coal open to European countries was the United States, but the rise in coal exports from the United States between 1937 and 1946 was only 29 million tons, or only two-fifths of the decline in exports from Germany, Great Britain, and Poland. Moreover, American coal is too expensive because of transportation costs for rational use in Europe. Thus coal has remained the most severe single factor retarding the recovery of the industrial countries of Europe, and especially of France, the Low Countries, Italy, and Austria.

The situation is the more serious since even the small German exports of 1946 were made possible only by drawing on existing stocks and by reducing at the same time allocations of coal to German industry to a level which made the rehabilitation of the German economy impossible. The collapse of the allied efforts to reconstruct the German economy on a peaceful basis could be averted only by sharply curtailing export allocations in the fall of 1946. Under the system of allocations recently established by the western occupying powers, the 1946 export volume will be reached in 1947 only if present coal output is increased by about 10 per cent. A more nearly satisfactory export volume equal to about half of the 1937 level will depend upon an increase in output by at least 40 per cent.

Similar problems arise in connection with the exportation of German potash, which in 1937 went mainly to the Netherlands, the United States, Belgium-Luxembourg, and Denmark. Production of potash in the western zones reached 75 per cent of prewar, but domestic demand was larger than before the war because of the unavailability of potash from the eastern zone of Germany. In order to satisfy the foreign needs and thus assist in the rehabilitation of agriculture in western Europe, production in the western zones of Germany would have to surpass the prewar level.

In the exportation of textiles, Germany played a relatively minor role before the war, but at present the demand for such goods is so great that the absence of German supply is seriously felt in Europe. In the fields of chemicals, however, the lack of German exports is far more important. The industries of Sweden and the Netherlands as well as plants in the United Kingdom and the United States, were heavily dependent upon semi-finished products of the German chemical industry. German pharmaceutical products could be used to greatest advantage in the public health programs forming part of the rehabilitation projects for Greece, Italy, Austria, and even for the countries of the Middle and Far East. While most of these products today can be made available from American sources, many countries in need of them cannot afford them since they cannot export to the United States but could export to Germany to pay for German products.

Next to coal, the greatest need of European industry today is for steel and steel products. In 1937, Germany exported semi-finished iron and steel goods to the extent of 2.6 million metric tons, including ingots, tubes, plates, wires, and the like. The Netherlands alone imported from Germany 450,000 tons of such products, Denmark more than 250,000 tons, Greece almost 100,000 tons, and China about 150,000 tons. German exports of finished iron and steel products, other than machinery, amounted to almost 700,000 tons in 1937, of which almost one-tenth went to the Netherlands. Exports of these two categories were larger than the entire iron and steel production in the western zones of Germany in 1946, and almost half of the total permitted to all of Germany under the so-called level-of-industry plan. Unless that plan is revised and actual steel production increased up to the permitted limit, the exportation of these materials badly needed for reconstruction will be impossible.

Exports of machinery and vehicles, although smaller in tonnage than those of other iron and steel products, were even greater in value and importance. In 1937, they reached about 1 million tons, valued at around $600 million, and included among others $80 million of machine tools, $125 million of electrical appliances, $80 million of motor vehicles, $55 million of textile machinery, and $45 million of precision instruments and optical goods. Virtually all countries of the world were large customers, with the Low Countries, the Scandinavian nations, Italy, France, and China among the most prominent. These countries today are in particular need of such machines for reconstructing their industrial system. Nevertheless, there were no German exports of such commodities in 1946, and under the level-of-industry plan it is questionable whether some important categories could ever again be exported.

The lack of these exports endangers daily the work of the industrial enterprises of Europe. It means that these industries, with their extensive use of German machinery, are unable to receive replacements or even spare parts for the growing number of machines that become unfit for operations after the neglect of the war years and the strain of the post-war period. Recent setbacks in Netherlands manufacturing industries, in Polish coal mines, and in the Austrian transportation system were due to the impossibility of making repairs without German spare parts. The needed expansion of industry, and even the development of new plants to replace those destroyed during the war, are hampered even more seriously than mere repair work. The machinery industries of the few countries that did not suffer from the war, and especially those of the United States, cannot make up for the deficit since they are fully occupied with domestic orders and exports to their regular markets, and since in many cases they do not specialize in the types of machinery needed by European enterprises and traditionally produced in Germany. Since it is to be expected that in the long run these countries will revert to their normal German sources of supply, it would not be economical for the American machinery industry to attempt to convert their manufacturing processes so as to cater to what may prove to be a mere temporary demand.

Given the need for stimulating German exports in order to help in the recovery in the rest of Europe, the following steps are necessary. First of all, the efficiency of German labor must be restored. This in turn implies an early currency reform so as to give the German worker wages expressed in a currency with real purchasing power. As long as the German mark cannot be used for anything but the purchase of the meager official rations, the German worker has no incentive for earning higher wages than the modest amount that he can spend on his rations. This means that he has no incentive to work efficiently. This tendency is reinforced by the fact that as the result of the currency situation black market operations are far more remunerative than honest work. Plans for currency reform have been formulated long ago, and only relatively minor points are in dispute among the occupying powers. If it proves impossible to reach an early agreement on these points among all four occupying powers, the American and British authorities must weigh the advantages and disadvantages of unilateral action in the combined American and British zones.

Currency reform, however, can cure only the monetary causes of the low level of German productivity. It is even more important to bolster the purchasing power of the currency by an increase in the supply of consumer goods. The most needed of these goods are foodstuffs. At the present rate of 1,550 calories per day for the so-called normal consumer, labor efficiency cannot be maintained in the long run. The occupation authorities hope to raise the ration in the not too distant future to 1,800 calories per day, but even that would be far from sufficient. We must plan to reach about 2,600 calories per day; this would still be less than the prewar level, and especially it would not mean a return to prewar standards of quality, but it would guarantee adequate nutrition. In the long run, it can be hoped that the combined American and British zones may produce domestic foodstuffs up to the equivalent of 1,600 calories daily per normal consumer, as compared to the present level of about 1,000 calories. In the next few years, however, no more than a production of 1,300 calories can be expected. This means that we must import at least 1,000 calories per day and person, and possibly as much as 1,300 calories, or in other words, at least 60 per cent and perhaps as much as 100 per cent more than during the current crop year. Importation of foodstuffs during the first six months of 1947 into the combined American and British zones requires the expenditure of $270 million. On the basis of 2,600 calories, foodstuff imports would cost at least $850 million per year at present prices.

Food alone, however, would not satisfy the needs of the German worker. Next in importance is housing, much of which can be furnished by the aid of domestic labor and materials, but for which some materials, like non-ferrous metals, have to be imported. Third in line is clothing which in normal times can be supplied by German industry, but only with the aid of imported raw materials like cotton and wool. At present, German firms receive American cotton for processing purposes with the provision that part of the finished products is exported in order to pay for the imported material; the remainder is either also exported in order to pay for additional imports, or put at the disposition of the German consumer. An extension of these arrangements is under negotiation with the Export-Import Bank and private cotton exporters. The quantities in question, however, are far from sufficient. The population of the combined American and British zones need for their own consumption about 400,000 tons of textiles per year, of which about 200,000 tons of cotton and 100,000 tons of wool have to be imported. Another 100,000 tons of textiles have to be imported for processing and reexport. The total of 400,000 tons of imports which would still be less than the prewar imports of raw and semi-finished textiles into the area of the combined zones would cost around $300 million per year at present prices.

Other raw materials for consumer goods industries, both for domestic production and reexports, include hides, lumber, gasoline, lubricants, and rubber. More important than any of these goods, however, will be the importation of iron ore and non-ferrous metals needed to enable the Germans to resume exports of steel and machinery. In 1937, such imports required $340 million. In the postwar period the sum will be somewhat smaller since the rise in prices will be overbalanced by the reduction in German productive capacity, needed for reasons of international security. Altogether, the rehabilitation of the German capacity to export will require the importation of industrial raw materials about equal to the value of imported foodstuffs.

The American and British occupation authorities have given their attention to this problem for many months. They have accumulated funds to pay for some imports needed to prime the pump of the German industry, and they have negotiated credits with public agencies to provide for additional raw materials. Again, however, the present program must be expanded if its purpose is to be fulfilled. New credits will not only have every chance of being repaid out of the increased German exports, but they will also enable the combined American and British zones to start paying for the food imports which at present are financed by the occupying powers out of appropriated funds. It is to be expected that within a few years the exports from the combined zones will be large enough to make unnecessary the further use of appropriated funds of the occupying powers, and perhaps even to begin the repayment of the funds advanced in the interim period.

In addition to currency reform and increased imports of foodstuffs and raw materials, the German export program needs the revision of the level-of-industry plan adopted by the occupying powers in the spring of 1946. There can be no question of abandoning the main idea of that plan; namely, the prevention of a revival of German war potential. The occupation authorities will continue to enforce the provisions of the plan in regard to war industries. It will be necessary, however, to revise periodically the list of industries classified as dangerous, and the quotas of production established for restricted enterprises, which include most of the heavy industries. In each case the possibility of an abuse of increased capacity will have to be weighed against the advantages of using that capacity for the benefit of the rest of Europe. It appears clear, for instance, that the permitted steel production of 5.8 million tons for the current year is utterly inadequate for the peacetime needs of Europe, and the majority of the occupying powers seem to feel that about double that amount would be more reasonable. Whenever possible, such revisions should be undertaken by agreement of all four occupying powers. If, however, no such agreement can be reached, the American and British authorities again will have to weigh the arguments for and against unilateral action in their zones of occupation.

Unilateral action, however, can provide only for a partial solution of the German economic problem. Rehabilitation of the German economy would be greatly facilitated if the occupying powers could reach an agreement on the implementation of the Potsdam Agreement which provided for treating Germany as an economic unit. The division of Germany into zones of occupation separated from each other by excessive trade barriers and other methods, already has hampered the reconstruction of Germany as much as any other single cause. The nearer the German economy comes to reaching again a more normal level of production, the more disastrous will be the separation. Every zone is dependent upon raw materials from other zones, and can work rationally only if assured of markets for its products in the other zones. Moreover, only early economic unification can prevent industries from being developed in one zone that will be forced to close down once more efficient plants in other zones will again be able to compete with them.

The contribution that Germany can make to the rehabilitation of the rest of Europe thus will be the greater, the closer the relations among the occupying powers. Restoration of harmony among the Allies will make possible agreements in the matters of currency reform, level-of-industry plan, and economic unification. In this as in so many other respects, the economic interests of Europe and the political interests of the United States are in complete harmony.

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AMERICAN ECONOMIC POLICY IN GERMANY

American economic policy in Germany has two main purposes: to contribute to the political security and to the economic rehabilitation of Europe.

These two purposes are not mutually contradictory. In general, people are the more inclined to be peaceful the better their economic situation. The Germans are no exception to this rule. During the prosperous years of the late 20's, German foreign policy was led by Minister Streseman who made important contributions to the restoration of friendly relations among the European powers. The Nazi regime came into power only when the depression of the early 30's had reduced the standard of living of the German people far below the level reached before the first world war. It is true, however, that economic rehabilitation alone might not be sufficient to prevent aggressive tendencies from again influencing German policy. Just before the outbreak of the second world war, Germany was reasonably prosperous, but the improvement of its economic situation did not lessen the aggressive tendencies of its government and of the major part of the population. It would be a mistake, therefore, to concentrate all American efforts upon improving economic conditions in Germany. On the contrary, it might become necessary in some instances to adopt measures contrary to the economic interests of Germany in order to make impossible the revival of German war potential. The fundamental problem confronting long-run American economic policy in Germany is to find the correct proportion in which stimulation and limitation of reconstruction in Germany must be blended.

In recent weeks there has been much talk about the need for coordinating American assistance to Europe. While this need is extremely urgent, it would be a great mistake to assume that the American authorities so far have been ignorant of that problem. Under the Bretton Woods Agreements Act the National Advisory Council was established to coordinate all international financial transactions of U. S. government agencies. The National Advisory Council not only instructs the American representatives in the International Monetary Fund and International Bank for Reconstruction and Development, but also advises the management of the Export-Import Bank of Washington and all other similar agencies. The program for Germany is a part of the plans considered by the National Advisory Council and its member agencies. What has been lacking so far has been less coordination of policies among the American government agencies than full cooperation among the European countries. A basis for cooperation was laid some time ago when the Economic and Social Council of the United Nations established the Economic Commission for Europe. It remained for the historic Harvard speech of Secretary Marshall, however, to stimulate concrete action to that end.

It is exactly the influence of the German economy upon the development of other European countries that makes the rehabilitation of Germany necessary from the point of view of the economic stability of the world.

Germany's neighbors, today more than ever before, are dependent upon commodities produced by Germany. Before the war, all European industries used large quantities of German machinery. Today such machinery is needed not only for repairing the damage done to the industries of Germany's neighbors during the war but also for developing those European countries that need further industrialization. Cutting off the supply of German machines has considerably delayed the rehabilitation of the victims of German aggression and thus the restoration of economic stability in all of Europe. Equally important for the other European nations are German chemicals and textiles and especially German coal. On the other hand, Germany's neighbors wish to export to Germany certain commodities which are abundant in other parts of Europe and for which there is great need in Germany. They cannot afford to let Germany have their products, however, without receiving German goods in return. If the Netherlands, for instance, could export to Germany its vegetable surplus in return for industrial imports from Germany, both the Netherlands' and the German economies would profit. In addition, the American economy would be freed from the obligation of advancing to the Netherlands the funds for importing American rather than German machinery and advancing to Germany the funds necessary for importing American rather than Netherlands foodstuffs. The Low Countries always have benefited by a large volume of transit traffic with the industrial districts of western Germany. The resumption of German industrial production will contribute substantially to the revival of the Netherlands' and Belgian ports and thus to the economic rehabilitation of those countries that form the core of democratic capitalism in continental Europe.

In the short run, the main purpose of American economic policy is to prevent the German economy from suffering a complete breakdown. We must admit that after two years of occupation the danger of such a breakdown is not appreciably smaller than immediately after the end of the war. Three reasons contribute to the unsatisfactory progress of German rehabilitation. First, twelve years of Nazi rule, six years of war, and the repercussions of defeat and occupation have had a great psychological impact upon the German nation. The sense of responsibility and the desire for initiative have almost completely disappeared. The Germans work as well as ever if they are told exactly what to do. But whenever they are asked to make decisions of their own, delays and uncertainties arise. The American occupation authorities are neither able nor willing to direct the German economy in every detail. They are not able to do so because of the severe limitations in personnel and means imposed upon the military administration in Germany, and they are not willing to do so because this would run counter to the political principle of re-education for democratic self-administration. The clumsiness of the German administrative machinery in evolving a system of economic policy is part of the price which must be paid if the occupation is to achieve political as well as economic purposes.

The second reason for the present state of the German economy is the physical exhaustion of the population. For two years the average German has had to live upon a ration which at best reached 1,550 calories per day or about 3/4 of the minimum acceptable to the United Nations Food and Agriculture Organization. Furthermore, the Germans lack housing as much as food. Floor space for the average German in the British zone of occupation, which includes the industrial heart of

Germany, is about 70 square feet. Other consumer goods are almost as scarce as food and housing and especially clothing and footwear present very difficult problems. A person who is gravely undernourished as well as ill-housed and ill-dressed, cannot possibly perform the heavy work needed for the reconstruction of the German economy.

A third reason for the slowness of economic progress is the scarcity of capital available for repairing the extensive war damage and for restocking inventories. The war has destroyed a large portion of Germany's fixed capital and exhausted the supply of most raw materials needed by German industry. Until Germany is able to accumulate new capital either by foreign credits or out of domestic savings, the German economy cannot hope to reach the level of its prewar output.

The remedies for these ills are simple in principle but extremely complicated in their practical application. The German psychology can be changed only by a patient attempt at re-education which certainly cannot be completed within a few months or even a few years. The best we can hope for is to convince the Germans that cooperation with us is in their own interest. This objective is not easy to reach since the Germans have learned under the Nazi rule to distrust deeply all official declarations of benevolent sentiments.

The lack of food and housing can be overcome only by an increase in imports, accompanied by an increase in domestic production. This apparently simple measure is rendered difficult, however, by the general scarcity of supplies all over the world, and by the obligation imposed upon the American authorities to contribute to the recovery not only of Germany but at least as much to that of the other European nations. Whatever supplies we send to Germany cannot be sent to one of our Allies. Before allocating a shipload of food we have to decide where the shipment would be best utilized and what nation should be deprived of some assistance in order to make possible help to another.

The same dilemma confronts us in the case of capital assistance. The industrial system not only of Germany but also of most other European nations has been destroyed by the war, and the nations that have suffered from German invasion expect us to help reconstruct their economies before we help reconstruct German enterprises. Machinery and raw materials are extremely scarce and we are unable to satisfy all foreign demands in addition to the needs of our domestic economy. We have to weigh our own needs as well as the needs and the moral claims of many other nations before we can decide to give help to Germany.

The remedies for the ills of the German economy which we have discussed so far are not only clearly recognized by the American authorities, but are also constantly applied in practice. Our program of re-education is being implemented by a steadily increasing extent of self-administration granted to the German population in the American and British zones of occupation. At the local and state level there is almost complete autonomy subject only to the veto power of military government. At the zone level we have established a state council (Landerrat) through which the various state governments coordinate their policies. At the level of the combined American and British zones we have established quite recently a German Economic Council assisted by an executive committee and by a staff under a number of executive directors. This council will act as the supreme agency in economic affairs and will have power to give binding directives to the state governments. It will consist of representatives of the German population and will be entrusted not only with executing the economic policy of the occupation authorities but also with assisting in the formulation of the policies themselves. The occupation authorities will confine themselves largely to supervision and control. This program will remain far from perfect as long as similar German institutions are not established for all four zones of occupation so as to implement the Potsdam Agreement which provides for treating Germany as an economic unit. The American and British authorities have urged the other occupying powers to abide by the Potsdam Agreement and quite recently again expressed their hope that the other occupying powers would join in the bi-zonal arrangements. So far, this has not been done and therefore the American and British authorities have had no choice but to go ahead with establishing German self-administration at least in their zones of occupation.

The problem of increasing the German supplies of basic necessities has been pursued ever since the beginning of the occupation. In 1945 and 1946, the American and British armies spent huge sums for importing into their zones of occupation commodities needed for the prevention of disease and unrest among the population. In addition, they turned over large supplies of army surplus for the use of the German economy. In the calendar year of 1946 alone the total amounts made available to the Germans were 360 million dollars in the American and 350 million dollars in the British zone. The British zone has a larger population than the American. In view of the grave economic difficulties from which the British people themselves have been suffering for the past several years, it would have been impossible for them to spend as much per capita as the Americans. In fact, the British, whose economic plight is due to German aggression, have again proved their sense of statesmanship as well as their economic foresight by diverting such a large amount of funds from their own use to that of their former enemies.

Since January 1, 1947, the importation of basic necessities into the combined American and British zones--so-called Category A goods--has been financed equally by the United States and the United Kingdom. Under the bi-zonal agreement of December 2, 1946, the two zones are treated as an economic unit, and it is to be expected that the standard of living in the British zone will be raised to that of the American zone. In the short run this means that the United States will spend somewhat larger funds than would be necessary in order to supply only the American zone with basic necessities. In the long run, however, the arrangement will be to the benefit of the American public since the British zone not only has larger needs at present, but also a larger potential for future industrial production. In a few years the British zone, therefore, may be able to help to pay for the deficit of the American zone.

The basic necessities to be imported under the bi-zonal agreement are not gifts presented to the German people. Germany will have to repay the sums advanced for such imports but only after it has reached a level of production sufficient to pay for current imports. That is to say, that the advances made by the American and British public for the importation of basic necessities will be re-paid after the balance of payments of the American and British zones of occupation has reached equilibrium on current account, but before any other payments to other powers are made out of current production.

In the first six months of 1947 the imports into the combined zones of the so-called Category A goods, including 2.3 million tons of foodstuffs, will require 270 million dollars. This seems to be a very large sum but it is far from sufficient. If we want to enable Germany to reach its prewar level of production we must increase German food consumption from the present average of 1,550 calories daily to about 2,600 calories. Domestic food production in the American and British zones of occupation last year averaged about 1,000 calories per day for the non-farm population. We can hope to increase this production in due time to the prewar level of 1,300 calories and perhaps to a maximum of 1,600 calories. Even under the best conditions, however, production in the American and British zones would leave a food deficit of 1,000 calories daily per head of the non-farm population. Present imports provide for only about 600 calories daily per person. In the long run, therefore, food imports far from being reduced will have to be increased substantially if our economic goals are to be reached.

The need for continued food imports is another reason for reviving German industry. Industrial goods must be produced in order to make possible exports that can be used for the payment of food imports and the production of industrial goods, in turn, is tied to the raising of the consumption levels of the German worker.

In comparison with the importation of Category A commodities, imports of materials needed by German industry -- the so-called Category B goods -- have remained almost insignificant. Most of these imports are made under credit arrangements whereby German manufacturers receive raw materials for processing, and then export a quantity of finished goods sufficient to pay for the cost of the imported raw materials. The most important transaction of that kind in the American zone was undertaken by Military Government with the Commodity Credit Corporation and concerned 30 million dollars worth of American cotton. A second arrangement involving 20 million dollars worth of cotton at present is being negotiated with the Export-Import Bank of Washington and American cotton exporters. Smaller credits of a similar nature have been arranged with the U. S. Commercial Company, a subsidiary of the Reconstruction Finance Corporation; they concern raw materials for ceramics, glass, chemicals, toys, and construction materials industries.

These arrangements are supplemented by the use of a fund accumulated by the joint Export-Import Agency of the American and British Military Government. This fund includes the proceeds of exports from the American and British zones of occupation in 1945-46, plus a sum made available to the United States and the United Kingdom by the Swedish Government out of German external assets in Sweden, surrendered to the United Nations under an agreement of July 1946. The total fund is equal to around 100 million dollars and will provide means for importing such materials as are required for priming the pump of German industry. It is to be hoped that before this fund is used up, current exports will provide the amounts necessary to pay at least for the current imports of Category B goods. For 1947, total imports of these goods may reach about $300 million. This would be less than half of the amount needed for insuring a normal level of economic activity in Germany, but it would be about three times the 1946 volume of such imports.

These Category B imports must include both materials for the export industries and for domestic German consumption. An increase in German production depends heavily upon the improvement in the supply of food, housing accommodations, and other consumer goods. Increased availability of such goods made available to the Ruhr miners was instrumental in bringing about a rise in coal production by 20 per cent between the fall of 1946 and the spring of 1947. The recent food shortages which were experienced in the Ruhr as a result of lags in transportation of imported supplies, immediately resulted in a drop of coal output by almost 10 per cent. Imports of consumer goods actually may result in a larger production of exportable goods than the importation of the same amount of industrial raw materials.

German exports so far have lagged even behind the small volume of Category B imports. In 1946, coal from the Ruhr mines in the British zone was the only commodity that was exported in substantial quantities from either the American or British zones of Germany. These exports reached 13 million tons, valued at $117 million, but they were not sufficient to satisfy even the most urgent needs of other European nations. Between 1937 and 1946, British coal exports dropped from 52 million tons to 9 million tons and German coal exports from 40 million tons to 13 million. The increase in American coal exports made up for less than half of the deficit, and moreover, American coal, because of huge transportation costs, cannot be used economically in continental Europe. The coal famine was made worse by the decline in domestic coal production in most other European countries and by the fact that as a result of Polish-Russian agreements large parts of the Silesian coal production was deflected from Central Europe to the Soviet Union.

German coal exports were kept even at their modest level only by drawing upon existing stocks and by curtailing allocations for German consumption. The German industrial system thus was prevented from utilizing even that part of its capacity that otherwise would have been available. This system led to such difficulties in the German industrial districts that by the end of 1946 coal exports had to be drastically reduced. This reduction was in the interest of the economies of the rest of Europe as well as of Germany. Coal allocated to German industry can be used for producing exportable goods which have greater value and thus fetch higher prices than the coal itself. In Moscow, the American and British authorities concluded an agreement with France providing for a flexible ratio of coal exports to coal production. This agreement is based upon the assumption that daily output in Ruhr mines will reach about 250,000 tons daily by the beginning of July or 10 per cent more than the May average. On this basis, the combined American and British zones would receive a weekly coal allocation of 860,000 tons (including a small amount contributed by the Saar mines in the French zone) as compared to an average of 710,000 tons in 1946. Deducting the quantities set aside for shipments to the Russian zone and Berlin, this would leave an exportable quantity of around 250,000 tons weekly as compared to an average of 230,000 in 1946. Any increase in output of the coal mines will be divided in such a way that the German economy receives 80 per cent and foreign countries 20 per cent of the additional tonnage. If, however, output increases above 290,000 tons daily the allocation for exports will rise gradually until any excess above 330,000 tons daily will be divided equally between domestic consumption and exports. The allocation of coal exports among the various European nations in turn is determined by the European Coal Organization which is to be integrated with the Economic Commission for Europe.

An increase in output to the point where exports would take more than 20 per cent of total production does not seem likely this year. Even if only the expected minimum of 250,000 tons daily is reached, Germany as well as the other coal consuming countries will be far better off than they were in 1946. Unless this minimum can be achieved, however, the coming year will witness a repetition of the disasters of the last winter when the lack of coal disrupted production and transportation in most European countries.

Exports of commodities other than coal amounted to about $37 million in 1946. This compares with exports other than coal out of the area of the present American and British zones of occupation totaling more than $1.2 billion in 1937. Thus the exportation of goods other than coal was about 3 per cent of prewar despite increases in the prices of most export commodities. Moreover, in 1937 those exports included mainly finished products while in 1946 they consisted chiefly of lumber, hops, and other raw materials while the volume of industrial exports was negligible. In the first four months of 1947, exports other than coal were larger than in the corresponding period of 1946 but were still below expectations. For the whole of 1947 it was planned to increase the exportation of commodities other than coal from the American and British zones to about $250 million. The unprecedented hardships of the last winter combined with the difficulties in setting up an entirely new export organization, however, have delayed the start of the foreign trade program by several months.

German industrial production is somewhat higher than foreign trade figures seem to suggest. In November 1946 the production index in the American zone of occupation stood at 44 per cent of 1936, a year in which the German economy had about reached full employment on a peacetime basis. In the following months, production lagged on account of the coal crisis but in May this year the index had recovered to 45 per cent and it is expected that this figure will be substantially exceeded by the fall of 1947. We may expect to reach in 1948 the prewar level in some important industries, provided that our import and export program progresses according to the present plans. In the British zone of occupation industrial production is somewhat lower since the British zone includes mainly heavy industries which are severely restricted for reasons of military security.

A large rise in production in heavy industries will imply changes in the so-called level-of-industry plan, which was adopted by the four occupying powers in the spring of 1946 and which sets specific limits to the production of all industries that might be considered part of the German war potential. Under this plan Germany is forbidden to maintain certain industries, especially in the field of synthetic oil, synthetic rubber, synthetic ammonia, heavy machine tools, heavy textiles, radioactive materials, war chemicals, radio transmitters, and a number of non-ferrous metals. Steel production for the current year is limited to 5.8 million tons, subject to review by the Allied Control Authority, and the consumption of non-ferrous materials is limited to fixed quantities. The capacity of the chemical industry and of the engineering industries are to be substantially reduced; that of the machine tool industry, for instance, to 11.4 per cent of the 1938 capacity. Production limits in actual figures are set for automobiles, railroad cars, agriculture machinery and precision instruments. Only mining and light industries are to remain completely free from restrictions.

Because of the low level of economic activity in Germany not even the limits set by the level-of-industry plan were reached in 1946 or in the first half of 1947. If the coal situation improves, however, the expected increase in industrial production will render acute the problem of raising the limit, especially in the field of steel production. In 1937 Germany exported iron and steel products equal to 70 per cent of the tonnage that it is permitted to produce in the current year. Exports approaching the prewar level obviously would be possible only if that limit is substantially raised. Most occupying powers appear to feel that a level about twice as high as that set for the current year would be reasonable. It is to be hoped that this problem can be solved by agreement among the occupying powers, but if this proves impossible, the American and British authorities will have to decide whether or not to permit a unilateral increase in the level of industry in their zones of occupation.

The problem of reparations also affects the German recovery. Under the Potsdam Agreement, Germany is supposed to pay reparations mainly by transferring existing capital goods. In practice this method has not been too successful. The removal of plants other than those that can be used only for war purposes is likely to damage the German economy more than it benefits the receiving countries. Moreover, the destruction of productive facilities encounters the passive resistance of German labor and has a detrimental effect upon German industrial efficiency. The managers of German industries cannot make decisions about re-starting or developing their enterprises unless they are satisfied that their plants will not be dismantled and shipped abroad.

On the other hand, the payment of reparations out of current production would be economically feasible only if we could expect Germany to produce exportable goods in excess of those needed for the payment for essential imports. As long as such a surplus does not develop the American and British treasuries have to finance the import surplus into their zones of occupation. If this import surplus were to be increased by using the proceeds of German exports for reparation payments rather than for the payment of imports, this would mean that the United States and the United Kingdom would in fact bear the burden of the reparations. From the point of view of American economic policy, the plan of paying reparations out of current production therefore has even more considerable drawbacks than the plan devised at Potsdam. In any case, a speedy agreement among the four occupying powers will be necessary in order to put an end to the present uncertainty which is an important factor in throttling the initiative of German entrepreneurs.

Another step needed for reviving the German economy is the solution of the currency problem. At present the German currency can be used virtually only for buying the official rations of food and consumers' goods. The German worker, therefore, is not induced to earn more money than he needs for that purpose. This means that he has no incentive for working harder and better. Currency reform, by making the German currency again a generally accepted means of payment, would be a valuable stimulus for increased labor efficiency. At the same time, it would contribute to eliminating black market transactions which today absorb a large part of the activities of the average German. Black market transactions are not only more profitable than honest work but also almost indispensable for supplementing the meager rations. An elimination of the black market, therefore, would also help to improve the labor situation.

Furthermore, the present currency situation makes the pricing of imports and exports extremely difficult. German domestic prices have lost all contacts with world market prices since the Nazi regime deliberately attempted to isolate the German economy from the world market and imposed a rigid system of price control. Today this isolation is enhanced by the differences between German legal and black market prices, the legal prices being far below and the black market prices far above the world market level at the present military exchange rate. As long as currency reform has not taken place it is necessary to equate German and world market prices by means of conversion factors which are set at different levels for different commodities. For instance, the conversion factor is 30 cents per mark for carbon brushes and 80 cents per mark for pharmaceuticals. This means that carbon brushes which are valued in Germany at 100 marks on the basis of legal prices are quoted for export at $30, while 100 marks worth of pharmaceuticals are quoted for export at $80. Such conversion factors can be set with relative ease for standard commodities, but it is very difficult to establish them for special goods in which German exports constitute a large part of the world market, for instance, optical goods and precision instruments. Currency reform followed by an adequate readjustment of domestic German prices would eliminate the need for such measures and make possible the restoration of foreign trade on the basis of uniform prices and exchange rates.

Finally, the success of our economic policy in Germany would be facilitated by the economic unification of Germany, as contemplated by the Potsdam Agreement. The four zones of occupation are highly interdependent. The American and British zones, for instance, need foodstuffs, potash, and brown coal from the Russian zone and chemical raw materials from the French zone while much of their hard coal, steel products, and industrial consumers' goods have their markets in the areas of the other zones. As long as the fate of unification is undecided, all efforts toward economic reconstruction of the American and British zones will be hampered by uncertainties as to the developments in other zones. There will always be the risk of developing industries which later will be unable to compete with enterprises in other zones, and of neglecting the expansion of other industries that would find profitable markets in other zones.

Unfortunately, the other occupying powers so far have not responded to the repeated American and British appeals toward a restoration of German economic unity. It is our sincere hope, however, that we shall find a way to an agreement with the other occupying powers, which will result in a policy as beneficial for Germany as for the rest of the world.

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RUHR COAL, GERMANY, AND EUROPE

When I came back from Germany, about 3-1/2 months ago, I felt that the American public needed to be more fully informed of the crucial role to be played by the German economy in the reconstruction of Europe. In the meantime, the German question has become the center of attention. At present, Anglo-American discussions are taking place on the subject of German coal mining, and another conference, with the participation of French delegates, is going to tackle the over-all problem of the level of German industry. Thus the need for emphasizing the urgency of these subjects has lessened, but it still may be helpful to point out the essential questions involved in those discussions.

The main bottleneck of European rehabilitation is the scarcity of coal, caused mainly by the decline in British and in German coal production. In the Ruhr, where the most important German coal mines are located, daily output averaged some 430,000 metric tons before the war. In 1946, it stayed at less than 200,000 tons until late in the fall when an increase in food rations for miners raised it gradually to 238,000 tons in March 1947. Unfortunately, at that time growing unrest appeared in the Ruhr. The food situation deteriorated because of the unprecedented severity of the winter of 1946-47 that hampered transportation and production in all of Europe, and the uncertainties of international political developments made the outlook even more gloomy. Output dropped to an average of 212,000 tons. Only in recent weeks did production again approach the March figures, after the food situation had improved because of increased imports from the U. S. and after added incentives in the form of other consumer goods had been promised to the miners.

What did the drop in coal output mean to Germany? The four occupying powers, in the level-of-industry plan adopted in the spring of 1946, agreed that German steel production, which is the basis of Germany's heavy industry, was to be limited to 5.8 million metric tons annually, a figure corresponding to the depression level of 1932. Actually because of the lack of coal the Ruhr district, to which the great bulk of total German steel production was allocated, did not even produce half of the permitted amount. As the result of the lack of steel, heavy industrial production in the combined US-UK zones of Germany also has remained well below the limits of the level-of-industry plan. Moreover, the production of building materials (cement), urgently needed for rebuilding the shattered German cities, and of textiles (artificial fibers) also was decisively affected by the lack of coal. Total industrial production in the combined US-UK zones stood at 39 per cent of 1936 in May and June 1947, the best months of the period of occupation, as against a planned level of 55-60 per cent. In the field of agriculture, domestic production has declined to about 60 per cent of prewar. This decline is due largely to the lack of artificial fertilizer, and this in turn, to the lack of coal.

The scarcity of consumer goods leads to a vicious circle; the miners won't produce more coal if they don't receive more food, better housing facilities, more clothing, and other consumer goods. In order to improve food production, housing conditions and the supply of other consumer goods, however, more coal must be mined.

We might say that this dilemma is the consequence of German aggression, and that it is historic justice that the German people suffer. But what are the consequences for the victims of German aggression? German coal always has been essential for the industries of most Central and Western European nations. The Ruhr alone used to export more than 30 million tons of coal per year. In 1946, for reasons of justice and diplomacy we forced the export of coal at the expense of German consumption. Even so, we were unable to export more than 11 million tons--less than one-third of prewar. And this smaller quantity had to be sufficient for countries which suffered from a decline in their own coal production and in British coal exports. Thus the lack of coal also prevented the French, Belgian, Netherlands, Italian, and Austrian industries from utilizing their full productive capacities. In the winter of 1946-47, the catastrophic situation of the German economy compelled us to curtail coal exports far below the level reached in previous months so that in February 1947, exports dropped below half of the 1946 average, and in the first five months of 1947 had reached an annual rate of only 8 million tons, less than one-fourth of the prewar level. This decline in Ruhr coal exports was one of the most important reasons for the deterioration in the European economic situation in the spring of 1947.

The drop in coal exports is not the only adverse effect of the lag in German coal production. Equally disastrous for Europe is the lack of exports of German industrial products. Before the war, the German industry was the source of supply for the great bulk of European machinery and precision instruments. For instance, half of the Netherlands industry is equipped with German machine tools. Some European countries had hoped that the limitations imposed upon German industry would enable them to capture German markets. But in many of these countries, the domestic industry cannot make use of that opportunity because it cannot work efficiently without German equipment and especially without German spare parts. Thus some countries, like the Low Countries, the Scandinavian countries, and Austria that would have most reason to see German heavy industry condemned to perpetual stagnation, today are among those that ask most loudly for the revival of German heavy industry which has to furnish them with urgently needed parts.

Finally, the lack of German coal production has made it necessary for the US and UK governments to come to the help of the German people in order to avoid wholesale starvation, disease, and unrest. Since Germany, largely because of the lack of coal, cannot produce the food and other subsistence goods which the German people need for survival, these commodities must be imported from the UK although other European countries, many of them our allies during the last war, also are in great need of these goods, and although such exports are a tremendous burden upon the UK and in a lesser degree a burden upon our own economy. To a certain extent, the present exchange difficulties of the British people are due to the exports to Germany. Moreover, these exports must be financed temporarily at least out of budgetary receipts, which means out of the taxes paid by the British and American public. We don't consider them to be gifts to the German people, and we hope to be repaid in future years. For the time being, however, the economic effect of these expenditures is not much different from that of unilateral contributions.

Thus the problem of increasing the coal production of the Ruhr is of the greatest interest not only to the Germans, but also to all European countries and to the British and American taxpayer. In fact, it is one of the few points on which all nations of the world are in complete agreement. The question is only, how increased production should be attained. The experiences in the fall of 1946 and the summer of 1947 have shown that an increase in goods made available to the miners, especially food, housing and other consumer goods, will bring about an increase in output. But such supplies have either to be taken away from the rest of the German people, whose meager rations do not leave room for such measures, or again, have to be financed by the occupation powers. The British obviously are unable to take over additional burdens, and so the expense of such an incentive program would have to be borne by the U. S. The cost certainly would be worthwhile, even in terms of dollars, since every increase in coal production lessens the strain on our own economy by the demands of other European nations for relief grants or credits with which to purchase our own scarce coal. However, it is hardly possible for us to pay for such a program without having a controlling influence upon its execution. The Ruhr is in the British zone, and British ideas of management and ownership are sometimes somewhat different from our own. It is incorrect to say that the British are bent on socializing the Ruhr mines, or to say that we are absolutely opposed to socialization, but it is true that there are some differences of opinion. The first question is whether or not we can expect the mines to be better managed by the occupation authorities or by the Germans themselves. Everybody acquainted with military government procedures will agree that German management would be more efficient. Then the question arises, who should do the managing. The old masters of the Ruhr coal cartel were among the major German war criminals, and we cannot think of restoring the crucial European industry to their control. Such a step would not only produce the danger of outright sabotage of our efforts toward European cooperation, but also arouse our most faithful friends in Western Europe against us. But where to find German managers not tainted by too close collaboration with the old Nazi gang? The British argue that only socialization can solve that dilemma, while we point out, first, that the Germans themselves are not too happy about that idea--the German bizonal economic council, elected by the legislatures of the German states, just has appointed a strictly anti-socialist directorate--and, secondly, that the inexperienced German democratic burocracy would be even less efficient than the experienced British administration. The present discussions certainly will lead to some compromise, but only the future can tell whether it will be practicable.

Another problem is, what to do with the increased coal output once it is mined. We cannot expect production to increase so much that the domestic as well as the export demand will be fully satisfied. A few days ago, the German bizonal economic council submitted an economic plan for 1947-48, based upon the production of 70 million tons of hard coal as against 54 million in 1946-47. At the present rate of output, this figure appears reasonable. The council, however, wishes to cut exports substantially below the 1946 level, and to devote not only a larger part of the present output but also the entire increase to German consumption. This is understandable because the needs of the German economy are closer to the heart of the German people and its representatives than the need of the rest of Europe; moreover, it can be argued that German miners will be spurred by the knowledge that all increases will accrue to the German economy. But such a solution obviously would not be acceptable to Germany's neighbors that need German coal as urgently as Germany itself. In contrast, the coal distribution plan agreed between the US-UK zonal authorities and the French in the spring of 1947 would allocate to exports the present quota plus about one-fifth of the increase in output. Obviously, the French will not agree to the execution of the coal program to be turned over to German authorities, unless they are satisfied that their import requirements will receive due consideration.

Once the question of allocating coal is solved, the problem remains what to do with the coal reserved to the German economy. The German council proposes to allocate only 10 per cent of the German quota to household consumption despite the hardship which such a small allocation is bound to cause. The resumption of German industrial production is indeed more important than the comfort of the German population--although too much discomfort may force the population to spend a disproportionate amount of time on the search for other fuel (woodcutting) and induce pilferage and black market operations. Still, the problem remains whether to use the remaining 90 per cent of the German quota mainly for the production of export goods, or for the production of goods destined to German consumption. The diversion of too much coal to production for the German market will leave the needs of the victims of Germany unsatisfied--and indirectly force us to grant further aid to those victims--while a diversion of too much coal to the production of export goods will hurt German labor morale and efficiency, and in addition make necessary further relief imports into Germany, thus again in the last resort burdening the U. S. economy.

So you see how closely related the coal problem is with that of the level of the German industry, and with our own contributions to the recovery of Europe. We can only hope that the participants in the conferences will contribute to the solution of the over-all European problem by keeping in mind the broad implications of their decisions. Their main goal should be not just an increase of so much per cent in the production index of such or such country, but the reintegration of the entire European economy. That alone will bring about not only economic progress but also, more importantly, the prospects of permanent peace.

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GERMANY'S ROLE IN EUROPEAN RECONSTRUCTION

Economic recovery of Europe is a prerequisite of economic stability of the world. Economic stability is a prerequisite of peace. Economic chaos leads to war.

All short-range measures in the field of international economics, sometimes apparently contradicting each other, must be related to our long-range policy: the maintenance of economic stability in this country and abroad, with one single aim--peace in the world.

Our own economy is directly related to what happens in Europe. We must enable Europe to produce and exchange goods. We must help rebuild a sound system of foreign trade, in the interest of both the United States and the rest of the world, based upon the mutual exchange of goods and services and the unrestricted flow of means of payments.

Meanwhile, however, we must weather a transition period. At present, our export surplus is abnormally large: it will have to be curtailed--some day. In the future, increased imports of goods and services will supply other countries with dollars. Until then, foreign purchases of certain scarce goods affect our price structure. The world is in short supply of our goods, and of the means of payments for our goods. In this period of transition we must be concerned primarily with forestalling starvation and unrest in the world, in order to make possible in the long run normal economic conditions and stable economic relations between nations.

This general aim has been the reason for a second stage in our policy in occupied Germany. During the war, we could not relax our efforts. We had to win the war--regardless of the economic consequences of the destruction of Germany. The first directive sent to General Eisenhower immediately before the end of hostilities in Germany expressly forbade the occupation authorities to be guided by the interests of German rehabilitation. By its own terms, however, that directive--commonly known as JCS-1067--was only for "the initial post-defeat period" and never was intended to be a long range policy. The Potsdam Agreement, concluded three months later, softened that injunction. A more penetrating study of the complex relations of European political and economic problems has convinced most American experts and observers of the necessity of reintegrating the German economy into the European framework. Former Secretary Byrnes at Stuttgart, Germany, in September 1946 gave a clear public expression to this conviction. He concluded his historic speech with this statement: "The American people want to help the German people to win their way back to an honorable place among the free and peace-loving nations of the world." This conviction resulted in the directive issued to the Military Governor of the U. S. zone of occupation in July 1947. From that time on, American policy has placed increasing emphasis on Germany's importance for the rehabilitation of the rest of Europe.

This shift in emphasis is not without some danger. Many European nations are apprehensive lest we go too far in aiding Germany. Such a fear is perfectly understandable in view of Germany's aggressive war record. It is exploited, however, by anti-American propaganda, which proclaims daily that the American interest in Germany is a serious threat to the safety of the rest of Europe. People are told that American imperialists and capitalists want to rebuild Germany in order to use a reconditioned German war machine for dreams of world domination similar to those of Nazism. We can dismiss these charges as senseless but we cannot dismiss the genuine anxiety of many Frenchmen, Belgians, and Central Europeans that we may further German rehabilitation at the expense of the recovery of the rest of Europe and that unwittingly we may help to rebuild a dangerous German war potential. In recent weeks such concern has been expressed not only by responsible European statesmen but also by serious American observers like former Under Secretary of State Sumner Welles. A continuous discussion of the German problem therefore is necessary in order to refute the arguments against our participation in German rehabilitation, and, on the other hand, to define the limits which this participation should not exceed.

First of all we may concede that several reasons which sometimes are advanced in support of this second stage in our policy cannot stand up to serious examination. It has been said that a harsh policy toward Germany would be inconsistent with our ideas of international justice. This argument overlooks the fact that whatever the Germans have suffered for the last two and one-half years is nothing as compared to the suffering they brought to the rest of Europe, and that morally the victims of German aggression certainly have a better right to our assistance than the Germans. Secondly, some people hope that the policy will lead immediately to a lowering of the cost of occupation. We shall see presently that this will not be the case.

Thirdly, some business interests--in the words of Mr. Welles--expect fat profits from a highly industrialized Germany. These expectations certainly will not be realized: even with all possible assistance, for many years to come Germany will remain too poor to afford the importation of American semi-luxuries. Moreover, the German economy is largely competitive with the American, and the reconstruction of the German industry is just as likely to diminish as to increase the profits of American industrialists. Apart from these considerations, the expenditure of huge amounts of public funds in order to increase the chances for profits of a few exporters or investors certainly would not be justified.

Finally, some people cherish the hope that a rehabilitated Germany could be used as a buffer state against the Soviet Union. These people may well be mistaken. It is true that today most Germans are emphatically anti-Russian, but this attitude need not endure. If the Soviet Government wants to gain the good will of Germany, it need only offer to the Germans sufficient political and economic concessions. For instance, as Walter Lippman recently pointed out, we could never match the territorial and other advantages that Russia, as the supreme power in Eastern Europe, could effectively promise to the Germans at the expense of its Eastern European satellites. In such a case, any reliance upon Germany as an ally against Russia would be ill-founded to say the least.

Thus we are willing to agree with many of the arguments that have been brought forth against our occupation policy. These arguments, however, are not decisive because they overlook the essential point: unless Germany is economically rehabilitated, Western Europe cannot attain economic stability. In order to refute the arguments against our efforts toward the rehabilitation of Germany, we have to show that this rehabilitation is necessary for the recovery of Western Europe.

Let me emphasize the fact that I speak to German economic recovery only as it plays an essential part in the recovery of the economy of Europe.

The economic interrelation of Germany and Western Europe is based upon Germany as a source of supply and Germany as a market. Under the present conditions of scarcity, the first point is far more important than the second. To a large extent Germany has to supply the rest of Europe with two commodities of primary importance: coal and steel products. Most of the exportable coal comes from the Ruhr district, which forms part of the British zone of occupation. In peacetime this district exported as much as three million tons per month, mainly to Western Europe. Ruhr coal was essential for the heavy industries in France, Belgium, Luxembourg, the Netherlands, and Sweden.

Hard coal production in the areas that today form the British zone of occupation dropped from 117 million tons in 1936 to 54 million tons in 1946. After establishing a system of substantial incentives, including a daily food ration to the Ruhr miners of 4,000 calories as compared with a normal consumer's ration of 1,550 calories, which made them by far the best supplied part of the German population, production increased in July 1947 to an annual rate of 72 million tons. The deficit as compared to 1936 still amounts to about 45 million tons annually. These 45 million tons are a principal reason for the present plight not only of Germany but also of the industrial countries of Western Europe. They are the bottleneck for the rehabilitation of transportation and for the production of steel and machinery. The lack of transportation facilities and machinery retards the reconstruction of all other industrial enterprises in Europe. It may even be said that these 45 million tons are also one of the main reasons for the present world-wide scarcity of foodstuffs. The European food deficit is largely due to the lack of fertilizer, and the lack of artificial fertilizer in turn is due to the scarcity of coal. Similarly, the lack of coal hampers the production of textiles and other scarce consumer goods.

A less direct effect of the lack of Ruhr coal is the deterioration in the international financial position of the United Kingdom. If industrial production in continental Europe had reached a higher level, the United Kingdom would have been able to purchase more of its necessary imports in continental Europe. In that case, it would have experienced less of a drain upon its dollar resources and perhaps would have been in a better position to maintain the convertibility of sterling.

German steel and steel products are equally indispensable to the rest of Europe. German machinery always has been extensively used in most industries of Western and Central Europe. Half of all industrial enterprises in the Netherlands, for instance, are equipped with German machine tools. During the war and postwar years, many machines were destroyed, and the rest has deteriorated. Their owners urgently need spare parts for repairs and new units for reconstruction and expansion. It is not surprising, therefore, that a recent statement by the Netherlands Government asserted that "the security and welfare of the Kingdom are in a high degree dependent on the prosperity of Germany . . . and the Netherlands is vitally concerned in the decisions which are ultimately to be made by the Allies with regard to the future of the German economy." The shutdown of the German machine industry has prevented the mines in Polish Silesia from working at capacity, hampered transportation in countries as far apart as Austria and the Low Countries, and made it impossible for many other industrial nations to reach their prewar level of production. It has thus delayed the recovery of all of Europe.

The Committee of European Economic Reconstruction, which was appointed by the Western European nations in response to the historic appeal by Secretary Marshall, clearly has recognized these facts. Although many of the nations represented on the Committee had every reason to feel extremely hostile toward Germany, the Committee report emphasizes again and again the need for an increase in the production of German coal and steel. It bemoans the "continued inability of the German economy to supply the coal and other products upon which so much of Europe's economic life depends." It proposes an increase in the coal production of the combined U.S.-U.K. zones of Germany by 60 million tons and an increase in the steel production of these zones by 7.2 million tons annually over and above the present level. Finally, it states expressly that a large part of Western Europe's import requirements for steel products should be met from these zones. The proposal for the huge increase in steel output is particularly remarkable in view of the fact that hitherto the French Government, whose delegates played a leading role in drafting the report of the Committee, had sharply objected to American and British proposals for large-scale expansion of German steel production. This change in attitude shows the interdependence of economic and political considerations in all European problems. Deep-seated political animosities can be overcome once it is understood how one country benefits from the improvement in the economic status of another country.

The increase in German coal and steel production, however, cannot be accomplished without an increase in total production. Ruhr coal output is so much lower than before the war mainly for two reasons, namely the lowered productivity of labor caused primarily by lack of sufficient food and the deterioration in mine equipment. The miners, despite the recent improvement of the economic situation, still cannot hope to receive for their increased wages a substantially increased volume of food, other consumer goods, and housing accommodations; they have little personal incentive, therefore, to do their utmost in the mines. Moreover, after many years of insufficient nutrition, defective housing, and lack of most amenities of life, they are neither physically nor psychologically able to work as hard as before the war. Thus any large-scale rise in Ruhr production will be possible only if sufficient food is supplied and if the amount of consumer goods available to the miners is substantially increased. Such an increase in turn depends upon a rise in the German production of food and consumer goods since continued importation of the bulk of such goods would place an unbearable stress on the German foreign exchange position. Farmers and industrial workers who must produce the food and consumer goods needed by the miners, also require more goods for themselves as an incentive for harder work. It would be impossible, therefore, to attempt the regeneration of one particular branch of the German economy, such as coal mining, without being prepared to help all other industries that participate in the production of consumer goods.

The second reason for the low output of the Ruhr mines is the obsolescence of the technical equipment. Since the beginning of the war and especially since the end of hostilities, mine machinery has not been adequately renewed. More important still, transportation equipment has been permitted to deteriorate so that the transportation of coal has become almost as much of a problem as its production in the mines. These difficulties can be remedied only by making available large quantities of steel and steel products to those industries that produce the necessary equipment. For this reason an increase in the output of coal requires not only the revival of the German consumer goods industries but also the reconstruction of the German heavy industries.

Steel production hitherto has been hampered by difficulties with labor, equipment, and transportation similar to those encountered in coal mining, and especially by the lack of coal. Moreover, the so-called level-of-industry plan, adopted in the spring of 1946 by the four occupying powers, limited steel production in all of Germany to 5.8 million tons, or about half the amount that today is being contemplated for the combined U.S.-U.K. zones alone. Although this limitation did not have any direct effect since actual production remained far below the permitted level, it probably had an indirect influence by making managers and workers despair of the future of the steel industry. An attitude of "what's the use", fostered by the strict limitations of the level-of-industry plan, certainly contributed to the reduction in the efficiency of German labor.

The recovery of the German industrial system also is necessary for the solution of the second problem, namely, the restoration of Germany as a market for the products of other nations. Germany needs large quantities of foodstuffs, raw materials, and other producers' goods. At present, it is unable to pay for any substantial amount of imports. Shipments that the occupation authorities in the combined U.S.-U.K. zones consider absolutely necessary for the prevention of disease and unrest have to be financed by advances from the occupying powers. In the first six months of 1946, such shipments into the combined zone were valued at $299 million, including $274 million of foodstuffs, $19 million of fertilizer, and $6 million of oil products. In contrast, commercial imports totaled only $17 million. The value of food imports, most of which came from the United States, certainly looks very large, but it was just sufficient to keep the German people on a semi-starvation diet of about 1,500 calories a day for the normal urban consumer--one-third less than the amount considered a minimum subsistence level by the United Nations Food and Agricultural Organization. If we want to restore a level of nutrition that enables the German worker to reach his prewar efficiency, food imports will have to be increased rather than reduced even if the productivity of German agriculture can be raised to its prewar level. Obviously, these imports cannot be financed forever by the occupying powers. Moreover, Germany needs raw materials and other producers' goods in such quantities that their value should at least equal that of food imports. Exports of coal and crude steel, significant as they will be, can cover only a fraction of that value. Germany must be able to pay for its imports by exporting finished industrial products, just as it did before the war.

The future need to export will be even greater than before the war, because of the necessity for imports of foodstuffs and raw materials previously obtained from those parts of the Reich which now are under Polish administration. Moreover, a larger proportion of imports will have to come from the sterling and dollar areas, at least as long as the grain and timber surpluses of Eastern Europe are withheld from western markets. Fortunately, the highest valued types of exports from Western Germany, like special machinery, precision instruments, and chemicals traditionally went to the West. It is true that as long as the general scarcity of dollars continues Germany too will be affected. The dollar scarcity in Europe, however, will be much smaller if Germany is reconstructed because Western Europe will obtain goods from Germany which otherwise would have to be purchased from the United States for dollars.

At present, imports of raw materials and other producers' goods are negligible because they are not financed by the governments of the occupying powers, but handled on a commercial basis. They cannot, therefore, exceed the sum of exports and commercial credits. During the first six months of 1947, exports from the combined zones totaled only $66 million; they consisted mostly of coal and some other raw materials like timber and potash, rather than of industrial products which before the war formed the bulk of German exports. So far, it has been possible to negotiate credits only with the help of government institutions, such as the Export-Import Bank, the U. S. Commercial Company, and the Commodity Credit Corporation, and their sum has not exceeded $60 million. Moreover, most of the credits have taken the form of processing arrangements, German manufacturers receiving raw materials such as cotton, and paying for them out of the proceeds of the exportation of the finished products. Such arrangements are feasible mainly in some consumer goods industries, especially textiles, and not readily applicable to the heavy industries which form the basis of the German economy. Neither exports nor commercial credits, however, can be expanded substantially as long as domestic industrial production is hampered by the lack of imported raw materials and producer goods. Obviously, this vicious circle must be broken. At present, the bizonal Joint Export-Import Agency has at its disposal a fund equal to more than $100 million, accumulated out of the proceeds of past exports and of certain former German assets made available to the Allies by the Swedish Government on the basis of an agreement concluded in 1946. This relatively small fund is to be used for initial imports that will stimulate the production of export goods, but two-thirds of it consists of sterling and therefore is available for international payments only within the sterling area, which at present can supply only limited quantities of necessary commodities. Accordingly, the economy of the combined zones is confronted with the problem of finding additional sums in dollars in order to finance adequate imports of goods other than minimum food requirements.

The extent of our contribution needed for the recovery of Germany thus becomes painfully clear: we must not only continue and if possible, in the light of world conditions and the needs of liberated countries, increase our exports of foodstuffs, but we must also make advances of one kind or another for the importation of raw materials and equipment. Moreover, as far as the materials have to be purchased in the dollar area, we are confronted with the fact that the United Kingdom has made it known that it wishes to be relieved from the burden of having to use its scarce dollar resources for German rehabilitation. The cost of the German occupation to be borne by the United States during the next few years certainly will be higher rather than lower in comparison with 1946-47.

The report of the Paris Conference estimates the foreign trade deficit of the combined U.S.-U.K. zones in relation to the dollar area alone at $1.15 billion for 1948. This would be almost twice the total deficit of the zones, as estimated for the year 1947 at the time of the bizonal agreement in December 1946. Only part of that increase, however, would be caused by the proposed extension of the reconstruction program: a large part will be due to the rise in American prices, especially for foodstuffs, and another part to the lag in the production of export goods caused by the catastrophic weather of the last winter. The sum is very large, but it is only one-seventh of the estimated total deficit of Western Europe, exactly corresponding to the proportion of the population of the zones to the total population of Western Europe. Since Germany's reconstruction is far less advanced than that of any other Western European nation, the estimate of German needs does not appear excessive.

The way for the implementation of our policy has been paved by the joint U.S.-U.K. decisions that were taken in the past weeks. We have raised the permissible level of industry for the combined zones approximately to the 1936 figures so that there will be no artificial limitation on the capacity of the German industries the rehabilitation of which we shall deem essential. We also have secured an equal voice in the management of the Ruhr mines. In addition, discussions are about to commence on the problem of sharing the occupation costs for the coming year between the United States and the United Kingdom. They will determine how far the present agreement, under which each power defrays half of the total, should be amended, at least as far as dollar payments are concerned.

All our efforts toward a solution of the German economic problem will be in vain, however, if we do not allay the fears of our Allies that we are putting the interests of Germany ahead of those of our friends. Otherwise, we might lose, as a result of growing anxiety and animosity in the rest of Europe, whatever we might gain from German rehabilitation. Fortunately, the program adopted in Paris in response to the appeal of Secretary Marshall promises the reconciliation of viewpoints. The plans adopted in Paris show what commodities Western Europe needs. We also know what commodities the German economy can produce if we are willing to render initial assistance. For the reasons which we discussed previously, it would not do to concentrate <u>exclusively</u> upon the reconstruction of German export industries since all branches of the German economy are needed for the efficient operation of the export industries. Within these limitations, however, we certainly shall put emphasis upon the development of those German industries that produce the goods needed in Western Europe. Obviously, it is easier to propose these principles than to execute them. It will be necessary to reconcile the need for coal, steel, and other goods for German domestic consumption with the equally pressing needs for these commodities on the part of other nations. Last Spring, a compromise was reached with the French, promising them an increased percentage of Ruhr coal in case of an increase in output. The report of the Paris Conference shows that a similar solution is acceptable to the Western European nations in the matter of Ruhr steel production. This indicates that working compromises also can be reached for other heavy industries.

In this connection, I am fully aware of the fact that our allies are interested not only in present allocations of increased German production but likewise interested in future long-term allocations which relate to their long-range planning for the reconstruction of their economies and the maintenance of economic stability at a high level. This is a proper concern of our allies and should not be overlooked. I feel certain it will not be overlooked.

The reintegration of the German economy into the European framework will pay, in the long run, for the financial burdens in the form of food and other supplies which we have to assume during these coming years. In this respect, the fact that the German economy is competitive with the American paradoxically will prove to be an advantage rather than a shortcoming. Whatever Germany can furnish to Western Europe need not be furnished by the United States. Since Western Europe suffers from a scarcity of dollars, additional exports to Western Europe would have to be made largely on the basis of advances, the repayment of which would pose difficult questions. It will be cheaper for us to furnish foodstuffs and raw materials to Germany rather than more expensive finished goods to Western Europe. In this respect, the reconstruction of Germany will directly benefit the financial position of the United States.

German economic recovery and therefore European recovery, however, can not be attained by one step or gesture. It requires, first, an attitude. That attitude is that European economic recovery is necessary--to Europe and to us. Second, it requires a realization that the alternative is chaos. Third, it is evident to me that recovery in Europe is a gradual process in which we play an important part.

If we succeed in our rehabilitation program with proper safeguards against German rearmament, Germany will plan again the economic role to which it is predestined by its natural resources and the skill of its workers, and the cause of intra-European economic cooperation will be materially advanced. Thus we are led back to our first premise. Our present stage of economic policy in Germany is not dictated by soft hearts or short memories, and it is not destined to give German recovery any priority over and above the rehabilitation of the rest of Europe. On the contrary, it is meant to make possible economic stability in all of Europe, and thus to further the maintenance of our own economic stability at a high level, and--most important of all--it is meant to promote world peace!

Speech delivered before
Polish Falcons of America
William Penn Hotel, Pittsburgh, Pennsylvania,
April 11, 1948

U. S. FINANCIAL ASSISTANCE TO FOREIGN COUNTRIES

I wish to speak to you briefly this evening on the subject of the international financial situation, and the financial assistance that the United States has been giving and will be giving to other countries.

At the present time, the so-called ERP--European Recovery Program--occupies a central position in this country's foreign financial and economic program. However, the main problem that has to be met in Europe, if that continent is to be self-supporting again, is not financial but is rather the problem of insufficient production.

To maintain the economic life of any modern country requires goods and services of many different kinds, some of which can be produced in the country's own farms and mines and factories, and some of which must be imported from outside. No country in Europe, or anywhere else in the world, can be entirely self-sufficient. In order to pay for the kinds of goods that have to be imported, the country must be able to produce other kinds of goods in excess of its own needs, and must be able to export and sell these goods abroad. Some countries have also helped out by selling services, such as shipping services, to other countries - a sort of "invisible export" - which serves the same purpose as exporting goods.

If a country does not have enough exports to pay for the imports that it needs, its first remedy is to increase its domestic production. This, as I have said, is Europe's present problem. Another alternative is for a country to reduce its domestic consumption. For Europe, however, this would be in general a most undesirable solution, since any further reduction from present levels of consumption would reduce both the willingness and the ability of their working populations to work, and thus lead to a vicious circle of increasing inefficiency in production, and ultimately to social unrest or economic breakdown or both. One might say that a main objective of American aid under the European Recovery Program is to <u>relieve</u> European countries from the necessity of making further reductions in their domestic consumption in order to achieve a balanced trade position.

Countries can also pay for foreign goods that they need by selling gold or other assets that they have accumulated during past periods of prosperity, but it must be obvious that countries, like individuals, can only do this for limited periods. Many of the European countries have been doing this during the last two years, and their holdings of such resources are being rapidly depleted. Finally, countries can obtain imported goods that they need by obtaining either loans or gifts from the governments of other countries or from private investors or contributors in other countries. It is the purpose of the ERP to provide such loans or gifts during a temporary period while European countries are increasing their own production and developing self-supporting economies.

The postwar difficulties of European countries have arisen from a combination of different causes. At the end of the war, many countries had widespread physical damage to be repaired. By now a large part of the direct damage to factories, railways, and the like has been repaired, but to some extent the effects of this damage still continue. There was also widespread deterioration of equipment due to wartime wear and inability to make replacements. This will take years to make up in full, and meanwhile, it is an important factor in preventing maximum efficiency in production.

Another quite different factor in the present difficulties of some European countries is the fact that they have lost or have had to liquidate large amounts of foreign investments, or they have lost large parts of their merchant shipping fleets, which before the war had provided income that these countries needed to help pay for imports of foreign goods. In addition most of the countries have faced the necessity of re-orienting their foreign trade because of changes in sources of supply and in markets for their products.

Finally, almost all European countries have been faced with monetary and fiscal problems which have caused serious dislocations throughout their economic and social structures. It has been clear that European countries would not be able to get their production going again at maximum levels until they could restore adequate incentives to working men to give their best efforts, incentives to business men to produce efficiently, and a regular flow of supplies for industry and agriculture. This has involved political and social as well as economic problems. Where adequate currency reforms and other anti-inflationary measures have been taken, they have been very helpful, but in some cases, the underlying political and social difficulties have proved to be more deep-seated than was at first apparent, and the full solution of these problems is taking longer than might have been hoped.

In addition to the dislocations within individual countries, all of Europe has suffered from insufficient coordination between countries. It is clear that greater efficiency can be obtained if each country arranges its production programs and the development of its resources in cooperation with neighboring countries. However, international cooperation of this kind is more difficult to achieve than appears on the surface, especially when the countries concerned are only in the first precarious stages of recovery and are anxious to avoid disturbing their reviving domestic industries. When production of any sort is urgently needed, it may be too early to start scrapping inefficient plant in some countries in the hope that efficient plant can be developed elsewhere. Furthermore such schemes may require a degree of government planning and intervention which we would be reluctant to see.

The production problem in Europe affects not only the European countries themselves but also the countries of Latin America and other parts of the world. For example, the economic development programs of Latin American countries were interrupted during the war because both the United States and the principal equipment-producing countries of Europe had converted their industries to the production of war materials. For the same reason, Latin American countries fell behind in the maintenance of their existing industrial plants, railways, etc. The equipment needs of these countries cannot be fully met except as production becomes available from

European as well as U. S. sources. At the same time, the countries of Europe constitute very important markets for Latin American agricultural and mineral products. For all these reasons, it is impossible to achieve any real basic stability in other parts of the world as long as Europe is in its present state of uncertainty.

Because of these considerations, the United States Government laid plans even before the end of the war, for the giving of necessary assistance to countries in Europe and other parts of the world. One step in these plans included cooperation in organizing the United Nations Relief and Rehabilitation Administration - UNRRA - for taking care of the most urgent needs of the populations in war-devastated countries. Congress also increased the lending power of the Export-Import Bank by almost 3 billion dollars, and the Bank has now used most of this increase to extend rehabilitation loans to European countries. In addition, large amounts of credit were extended to European and other countries in connection with our disposal of United States war surplus materials that could be of use in their civilian economies. Finally, to meet the special problems of the United Kingdom in the period of transition after the war, Congress approved a special loan of $3,750,000,000 to that country.

As a result of these contributions by the U. S. Government, combined with very real efforts brought to bear by the European countries themselves, almost every country in Europe has made substantial economic progress since the end of the war. The United Kingdom has succeeded in bringing its industrial output to levels above those of the prewar period, and has achieved considerable progress in readjusting its industrial structure to meet longer-range postwar conditions. In France, industrial production has reached the 1938 level, and a bold policy of supplementing foreign assistance by large-scale liquidation of gold and foreign exchange holdings made it possible to give a start to the Monnet Plan of Reconstruction and Modernization. Italy has achieved considerable progress in rebuilding its war-torn transportation system, in reviving industrial output, and in reestablishing its position in export markets. The Netherlands has rebuilt its heavily damaged transportation system and drained and put back into production practically all of the lands flooded during the war, while Belgium has been able not only to place her economy on a self-supporting basis, but also to extend assistance to neighbor countries. Norway has succeeded in replenishing its merchant fleet to about 85 per cent of the prewar tonnage. Only Germany has shown very little evidence of recovery, largely as the result of the shattering effects of the war upon its physical plant and the morale of its people.

At the same time, eastern European countries, notably Poland and Czechoslovakia, have made great progress in restoring the productivity of their industries. In particular, the large increases in coal production in Poland put that country in a position where it could make important contributions to industrial recovery in other countries. On the other hand, because of political developments which interfered with coordination between eastern and western Europe, both groups of countries have failed to achieve the full degree of progress that might have been expected.

It became apparent, however, during 1947, that further economic assistance on a large scale by the United States to European countries would be necessary. Notwithstanding the substantial strides that had been made, with American help, toward general economic recovery, it became clear that the disruptions of the European economy were so widespread that substantial further strengthening would be needed. It was necessary to provide further financial aid if these countries were to continue to obtain needed goods from the U. S. and other foreign sources. At the same time, if dollar aid were given to European countries for this purpose, it would help Latin American and other countries which try to earn dollars through sales to Europe in order to meet their own dollar needs.

In June, therefore, the Secretary of State announced publicly the concern of the United States regarding the European economic problem. He explained also that he had in mind the entire continent, including the Soviet Union. The British and French foreign ministers then proposed a general European conference to take up the subject, and proposed that the Soviet Government join in this project. When it appeared that agreement could not be reached, the British and French foreign ministers nevertheless issued invitations to all other European countries (except Spain) to send representatives to a meeting in Paris. In the end, however, not only Russia but also the other countries which have fallen under its domination refrained from sending representatives. The Committee of European Economic Cooperation was then formed by the 16 remaining European nations, consisting mainly of the countries of western Europe.

This Committee drew up and presented in September, a four-year program designed to restore Western Europe to a self-supporting basis. The Committee's report called for closer cooperation among European countries and it also gave estimates of the external assistance that would be required in order to carry out such a program.

The proposals made by this Committee were given the most thorough study in the United States Government. After critical review, they were accepted as a reasonable starting point in formulating proposals for United States aid. However, the Committee's estimates were scaled downward where they appeared to be higher than necessary. They were also scaled downward where it appeared that the amounts of goods that were called for would not actually be available in the world markets, or where it appeared that the provision of these amounts would involve undue demands upon goods that are in short supply in the United States.

The estimates finally reached in the United States Government involve U. S. assistance to Europe in the amount of $5.3 billion during the first year of the program. There have been tentative estimates that the total amount of aid needed to restore the European economy might be $17 billion over a period of 4-1/4 years. It is clear, however, that estimates of European requirements more than a year or so in advance must be of a rather uncertain nature.

This financial assistance from the United States is directed toward genuine economic recovery in the participating countries of Europe (including western Germany). It is not in any sense intended to be merely relief. The program provides for food requirements and for supplies of fuel and raw materials. But also, and more importantly, it provides for capital equipment to assist Europe in the task of building up its own productive capacity. The program contemplates that the European countries will take vigorous steps to assure that all the assistance they receive from the U. S. will be used efficiently to further the objective of full recovery. This includes the taking of financial and other measures to stablize their currencies and generally to restore confidence in their monetary systems, to stabilize their price systems, and to cooperate with each other in increasing the exchange of goods and services among European countries, all with the objective of achieving the greatest possible efficiency in the use of their own resources to increase their production.

To the extent that European countries appear able to repay this country for the assistance that they receive, it is contemplated that the assistance will be extended in the form of a loan calling for repayment. Where it does not appear that repayment will be possible without jeopardizing the long-run objectives of the program, assistance will be given on a grant basis instead.

While attention has been concentrated on Europe in recent months, the needs of other areas of the world have not been ignored. Part of th dollars supplied to European countries under the ERP will be spent by them in Canada or Latin America. In this way, our aid to Europe will also serve to provide Canada and Latin America with large amounts of dollars that they in turn can use to pay for the goods that they need from the United States. In addition the Export-Import Bank and the International Bank for Reconstruction and Development, in Washington, are prepared to make loans to finance sound development projects in Latin America as well as in other parts of the world. As for China, while present political conditions make it impossible to plan any real economi recovery in that country, it is contemplated that China will receive relief assistance that should enable it to hold its own in an economic sense until its political difficulties are settled. In Japan the relief assistance which has been supplied since the end of the war may soon be supplemented by more far-reaching aid designed to put that country back on its feet within a measurable period of time. Thus, the European Recovery Program is only one element, even though the largest, in this country's plans for foreign economic cooperation.

It must be recognized that all of these programs impose a very real burden upon the United States--a financial burden upon our Federal budget and an economic burden upon our people who are called upon to export to foreign countries far more goods and services than are received in ex change. These programs have been decided upon, however, in the light of very careful studies of our capacity to bear this burden. The conclusio to be drawn from these studies are that the foreign aid programs contemplated for the coming year will not impose any greater drain upon United States resources than has occurred during the past year; that this drain will not significantly affect the standard of living of the American people; and that its initial inflationary impact can be held in check by appropriate domestic measures. The most important of these domestic measures is fiscal policy; it is supremely important that Government expenditures on foreign aid be covered to the maximum extent possible with a balanced budget. If this practice is followed, the purchasing power created by foreign expenditures in this market will be withdrawn from the market through taxation. At the same time, in view of the inflationary pressures arising from domestic as well as foreign sources, it is important to carry out a monetary policy designed to restrain undue expansion of bank credit. If we pursue vigorous anti-inflationary policies in the fiscal and monetary fields, we may be able to avoid reimposing direct controls upon the allocation and movement of goods in the domestic economy.

There can not be any assurance in advance that the European Recovery Program will be a success. The European countries will have real problems to surmount in order to be fully self-supporting at the end of the four-year period. The increasing political tension between eastern and western Europe tends to worsen the economic prospects of both groups of countries. Nevertheless, I feel most strongly that the ERP represents a wise policy on the part of the United States. The cost in money is large, but is well within the capacity of this country. And by such a bold and ambitious program, directed toward the economic health of key countries of Europe, we can exert a powerful influence toward the maintenance of peaceful conditions in the world. When and as the countries of western Europe achieve the economic health that this program envisages, we can confidently expect one result to be improvement in the economic condition of other countries and progress toward the ultimate goal of a peaceful and prosperous world.

Speech delivered on
Occasion of the Commemoration of
the 3rd of May Polish Constitution
Patterson Park, Baltimore, Maryland
May 2, 1948

THE EUROPEAN RECOVERY PROGRAM

One of the most important actions that Congress has taken in recent years is the passage of the Foreign Assistance Act of 1948, which became law on April 3. The central feature of this Act is the authorizing of an amount of $5,300,000,000 to be used in a program of helping European countries along the road to full economic recovery. More importantly, as a matter of principle, Congress by this Act recognized the importance of our taking bold economic and financial measures in order to maintain conditions abroad in which free institutions can survive.

An understanding of the background of this program is essential to every American. Because the airplane and radio and other recent scientific developments have made the world so much smaller than it used to be, the situation in foreign countries is becoming more and more important in our daily lives. Furthermore, the expenditure of large sums for foreign assistance is bound to have effects on our domestic financial situation, and these two have to be taken into account.

The Need for Production

The main problem that has to be met in Europe, if that continent is to be self-supporting again, is the problem of reviving and increasing the production of goods. While the European Recovery Program, as authorized by Congress, is expressed primarily in terms of giving financial and material assistance to European countries, the great problem in the administration of this program will be to see that the assistance is successfully used by the European countries in order to rebuild the productivity and efficiency of their own industries.

The production problem in Europe assumes a very special importance to all of us because it affects not only the European countries themselves but also the countries of Latin America and other parts of the world. For example, the economic development programs of Latin American countries were interrupted during the war because both the United States and the equipment-producing countries of Europe had converted their industries to the production of war materials. For the same reason, Latin American countries fell behind in the maintenance of their existing industrial plants, railways, etc. The equipment needs of these countries cannot be fully met except as production becomes available from European as well as U. S. sources. At the same time, the countries of Europe are normally very important markets for Latin American agricultural and mineral products. For all these reasons, it is impossible to achieve any real basic stability in other parts of the world as long as Europe is in its present state of uncertainty.

The Problem of Paying for Imports

To maintain the economic life of any country, in Europe or elsewhere in the world, requires goods and services of many different kinds, some of which can be produced in the country's own farms and mines and factories, and some of which must be imported from outside. No country in the present-day world can be entirely self-sufficient. In order to pay for the kinds of goods that have to be imported, the country must be able to produce other kinds of goods in excess of its own needs, and must be able to export and sell these goods abroad. Some countries have also helped out by selling services, such as shipping services, to other countries - a sort of "invisible export" - which serves the same purpose as exporting goods.

If a country does not have enough exports to pay for the imports that it needs, its first remedy is to increase its domestic production. This, as I have said, is Europe's present problem. Another alternative is for a country to reduce its domestic consumption. For Europe, however, this would be in general a most undesirable solution, since any further reduction from present levels of consumption would reduce both the willingness and the ability of their working populations to work, and thus lead to a vicious circle of increasing inefficiency in production, and ultimately to social unrest or economic breakdown or both. One might say that a main objective of American aid under the European Recovery Program is to relieve European countries from the necessity of making further reductions in their domestic consumption in order to achieve a balanced trade position.

Countries can also pay for foreign goods that they need by selling gold or other assets that they have accumulated during past periods of prosperity, but it must be obvious that countries, like individuals, can only do this for limited periods. Many of the European countries have been doing this during the last two years, and their holdings of such resources are being rapidly depleted. Finally, countries can obtain imported goods that they need by obtaining either loans or gifts from the governments of other countries or from private investors or contributors in other countries. It is the purpose of the ERP to provide such loans or gifts during a temporary period while European countries are increasing their own production and developing self-supporting economies.

European Postwar Difficulties

The postwar difficulties of European countries have arisen from a combination of different causes. At the end of the war, many countries had widespread physical damage to be repaired. By now a large part of the direct damage to factories, railways, and the like has been repaired, but to some extent the effects of this damage still continue. There was also widespread deterioration of equipment due to wartime wear and inability to make replacements. This will take years to make up in full, and meanwhile, it is an important factor in preventing maximum efficiency in production.

Another quite different factor in the present difficulties of some European countries is the fact that they have lost or have had to liquidate large amounts of foreign investments, or have lost large parts of their merchant shipping fleets. They have thus lost sources of income that had formerly helped to pay for imports of foreign goods. In addition most European countries have faced a great problem of re-orienting their foreign trade. This has arisen because some of the areas that had previously supplied goods to them have also suffered war dislocations. As a result European countries must rely on Western Hemisphere suppliers to a greater extent than before the war, and, in order to pay for larger imports from this hemisphere, they must endeavor to direct more of their exports here.

Finally, almost all European countries have been faced with monetary and fiscal problems which have caused serious dislocations throughout their economic and social structures. It has been clear that European countries would not be able to get their production going again at maximum levels until they could restore adequate incentives to working men to give their best efforts, incentives to business men to produce efficiently, and a regular flow of supplies for industry and agriculture. This has involved political and social as well as economic problems. Where adequate currency reforms and other anti-inflationary measures have been taken, they have been very helpful, but in some cases, the underlying political and social difficulties have proved to be more deep-seated than was at first apparent, and the full solution of these problems is taking longer than might have been hoped.

In addition to the dislocations within individual countries, all of Europe has suffered from insufficient coordination between countries. It is clear that greater efficiency can be obtained if each country arranges its production programs and the development of its resources in cooperation with neighboring countries. However, international cooperation of this kind is more difficult to achieve than appears on the surface, especially when the countries concerned are only in the first precarious stages of recovery and are anxious to avoid disturbing their reviving domestic industries.

Postwar Progress

Even before the end of the war, the United States Government had begun to lay plans for the giving of necessary postwar assistance to countries in Europe and other parts of the world. One step in these plans was cooperation in organizing the United Nations Relief and Rehabilitation Administration - UNRRA - for taking care of the most urgent needs of the populations in war-devastated countries. Congress also increased the lending power of the Export-Import Bank by almost 3 billion dollars, and the Bank has now used most of this increase to extend rehabilitation loans to European countries. In addition large amounts of credit were extended to European and other countries to buy United States war surplus materials that could be of use in their civilian economies. Finally, to meet the special problems of the United Kingdom in the period of transition after the war, Congress approved a special loan of $3,750,000,000 to that country.

As a result of these contributions by the U. S. Government, combined with very real efforts brought to bear by the European countries themselves, almost every country in Europe has made substantial economic progress since the end of the war. The United Kingdom has succeeded in bringing its industrial output to levels above those of the prewar period. France and Italy and the Netherlands have all restored their heavily-damaged transportation systems to a fair degree of efficiency and have made important progress in industrial recovery. Belgium has been able not only to place her economy on a self-supporting basis, but also to extend assistance to neighbor countries. Norway has succeeded in replenishing its merchant fleet to almost its prewar tonnage. Only Germany has shown very little evidence of recovery, largely as the result of the shattering effects of the war upon its physical plant and the morale of its people.

At the same time, eastern European countries, notably Poland and Czechoslovakia, have made great progress in restoring the productivity of their industries. In particular, the large increases in coal production in Poland put that country in a position where it could make important contributions to industrial recovery in other countries. On the other hand, because of political developments which interfered with coordination between eastern and western Europe, both groups of countries have failed to achieve the full degree of progress that might have been expected.

It became apparent, however, during 1947, that further economic assistance on a large scale by the United States to European countries would be necessary. Notwithstanding the substantial strides that had been made, with American help, toward general economic recovery, it became clear that the disruptions of the European economy were so widespread that substantial further strengthening would be needed. Further financial aid had to be provided if these countries were to keep on obtaining needed goods from the U. S. and other foreign sources. At the same time, if dollar aid were given to European countries for this purpose, it would help Latin American and other countries which try to earn dollars through sales to Europe in order to meet their own dollar needs.

Development of the ERP

In June, therefore, the Secretary of State announced the concern of the United States regarding the economic problem of Europe -- of the entire continent, including the Soviet Union. The British and French foreign ministers then proposed a general European conference to take up the subject, and proposed that the Soviet Government join in this project. When it appeared that agreement could not be reached, the British and French foreign ministers nevertheless issued invitations to all other European countries (except Spain) to send representatives to a meeting in Paris. In the end, however, not only Russia but also the other countries which have fallen under its domination refrained from sending representatives. The Committee of European Economic Cooperation was then formed by the 16 remaining European nations, consisting mainly of the countries of western Europe.

This Committee drew up and presented in September, a four-year program designed to restore Western Europe to a self-supporting basis. The Committee's report called for closer cooperation among European countries and it also gave estimates of the external assistance that would be required in order to carry out such a program.

The proposals made by this Committee were given the most thorough study in the United States Government. After critical review, they were accepted as a reasonable starting point in formulating our government's estimates of the amount of United States aid that is needed. However, the Committee's estimates were scaled downward where they appeared to be higher than necessary. They were also scaled downward where it appeared that the amounts of goods that were called for would not actually be available in the world markets, or where it appeared that the provision of these amounts would involve undue demands upon goods that are in short supply in the United States.

It was after careful consideration of all these factors that Congress determined to authorize $5.3 billion of aid to Europe for the first year of the recovery program. A program of four and a quarter years is contemplated, although this is subject to annual review by Congress. There have been tentative estimates that the total amount of aid needed over this period might be $17 billion, but it is clear that estimates of European requirements more than a year or so in advance must be of a rather uncertain nature.

In approving the Program, Congress authorized the creation of the ECA -- Economic Cooperation Administration -- as the agency to carry out the responsibilities of the United States under the program. As Administrator of the program, the President immediately appointed Mr. Paul Hoffman, one of the country's outstanding business executives, who has been president of the Studebaker Corporation. Mr. Hoffman is recruiting a staff of experts to assist him in Washington, and he is also a member of the National Advisory Council on International Monetary and Financial Problems, which coordinates the policies of all government agencies engaged in foreign financial transactions. The Act also provides for a roving ambassador to represent the Administrator in Europe and this post is to be filled by Averell Harriman, who has been Secretary of Commerce and who had previously served in important government posts abroad. There will be a special mission in each of the participating countries to supervise the operation of the program. Although the ECA is still in the process of being organized, an allocation of $21 million for the five most needy countries was made within one week after the passage of the Act. Further supply programs for all the participating countries are being established, and shipments of goods under the program have commenced.

Objectives of the Program

The program of assistance from the United States is directed toward genuine economic recovery in the participating countries of Europe (including western Germany). It is not in any sense intended to be merely relief. The program provides for food requirements and for supplies of fuel and raw materials. But also, and more importantly, it provides for capital equipment to assist Europe in the task of building up its own productive capacity. The program contemplates that the European countries will take vigorous steps to assure that all the assistance they receive from the U. S. will be used efficiently to further the objective of full recovery. This includes the taking of financial and other measures to stabilize their currencies and prices and generally to restore confidence in their monetary systems, and to cooperate with each other in increasing the exchange of goods and services among European countries, all with the objective of achieving the greatest possible efficiency in the use of their own resources to increase their production.

To the extent that European countries appear able to repay this country for the help that they receive, the assistance will be extended in the form of a loan calling for repayment. Where it does not appear that repayment will be possible without jeopardizing the long-run objectives of the program, assistance will be given on a grant basis instead.

While attention has been concentrated on Europe in recent months, the needs of other areas of the world have not been ignored. Part of the dollars supplied to European countries under the ERP will be spent by them in Canada or Latin America. In this way, our aid to Europe will also serve to provide Canada and Latin America with large amounts of dollars that they in turn can use to pay for the goods that they need from the United States. In addition the Export-Import Bank and the International Bank for Reconstruction and Development, in Washington, are prepared to make loans to finance sound development projects in Latin America as well as in other parts of the world.

As for China, while present political conditions make it impossible to plan any real economic recovery in that country, the Foreign Assistance Act of 1948 includes $338 million for economic assistance to China, in addition to $125 million that can be used for military aid. It is contemplated that this relief assistance should enable China to hold its own in an economic sense until its political difficulties are settled. In Japan the relief assistance which has been supplied since the end of the war may soon be supplemented by more far-reaching aid designed to put that country back on its feet within a measurable period of time. Thus, the European Recovery Program is only one element, even though the largest, in this country's plans for foreign economic cooperation.

Meeting the Cost of ERP

It must be recognized that all of these programs impose a very real burden upon the United States -- a financial burden upon our Federal budget and an economic burden upon our people who are called upon to export to foreign countries far more goods and services than are received in exchange. These programs have been decided upon, however, in the light of very careful studies of our capacity to bear this burden. The conclusions to be drawn from these studies are that the foreign aid programs contemplated for the coming year will not impose any greater drain upon United States resources than has occurred during the past year; that this drain will not significantly affect the standard of living of the American people; and that its initial inflationary impact can be held in check by appropriate domestic measures. The most important of these domestic measures is fiscal policy; it is supremely important that Government expenditures including those on foreign aid be covered to the maximum extent possible within a balanced budget. If this practice is followed, the purchasing power created by these expenditures will be withdrawn from the market through taxation. At the same time, in view of the inflationary pressures arising from domestic as well as foreign sources, it is important to carry out a monetary policy designed to restrain undue expansion of bank credit.

An expanded defense program is now being considered in Congress, and this program, if adopted, could add around $4 billion to Government expenditures during the next fiscal year and perhaps greater amounts in the future. This will cause additional upward pressure on prices. This development makes it even more imperative that anti-inflationary measures be applied in a strong and thorough manner. If we pursue vigorous anti-inflationary policies in the fiscal and monetary fields, we may be able to avoid reimposing direct controls upon the allocation and movement of goods in the domestic economy.

There can not be any assurance in advance that the European Recovery Program will be a success. The European countries will have real problems to surmount in order to be fully self-supporting at the end of the four-year period. The increasing political tension between eastern and western Europe tends to worsen the economic prospects of both groups of countries. Nevertheless, I feel most strongly that the ERP represents a wise policy on the part of the United States. The cost in money is large, but is well within the capacity of this country. And by such a bold and ambitious program, directed toward the economic health of key countries of Europe, we can exert a powerful influence toward the maintenance of peaceful conditions in the world. When and as the countries of western Europe achieve the economic health that this program envisages, we can confidently expect one result to be improvement in the economic condition of other countries and progress toward the ultimate goal of a peaceful and prosperous world.

Speech delivered before
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and the Friends of Polish Art
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AMERICA'S ROLE IN THE INTERNATIONAL ECONOMIC SITUATION

I shall speak on the problem of European recovery and on the role of the United States in assisting Europe to return to a self-supporting basis. As you all know, this country is now engaged in a great European Recovery Program, involving the expenditure of billions of dollars. This program, which forms such an important part of our present foreign policy is based not only on humanitarian considerations but on the conviction, which I heartily share, that European recovery is essential to world stability and to the attainment of an enduring peace.

In speaking to you about European economic problems, I may refer to my personal experience in Europe, both during the war and in 1946-47. When I was sent to western Europe in 1944, it was clear that the recovery of the war-ravaged countries would be a long and painful process; but, flushed with the recent Allied victories, most leaders were more optimistic than the economic conditions warranted. Two years later, this optimism in many places had given way to despair. It was realized that even the progress already made could not be maintained without continued large-scale assistance from the United States. Out of this despair was born the conviction of the inter-dependence of the economic interests of Europe and the United States, and thus the path was cleared for the European Recovery Program.

The nature of Europe's present economic crisis is not difficult to understand, but it requires a review of a few facts concerning the prewar situation. Before the war, the prosperity of European countries, like that of most other advanced nations, was highly dependent upon foreign trade. By specializing on the kinds of production that each country could perform efficiently, and obtaining other goods through the channels of international trade, European countries were able to achieve much higher standards of living than would have been possible had each country attempted to be self-sufficient. It should be emphasized, however, that while the European countries were not self-sufficient, they were self-supporting. They paid for their purchases of goods and services from abroad mainly in two ways: first, with the earnings from their exports of goods and services, and, second, with the income from investments which they had made overseas. Thus their purchases from abroad were covered by their earnings from abroad.

The effect of the war was to alter this situation profoundly. In the first place, the war brought about appalling destruction of factory buildings and equipment and of transportation facilities, including merchant fleets. The effect of this was greatly to reduce the capacity to export goods and services. In the second place, a large part of the foreign investments of European countries was destroyed by enemy action or had to be sold to meet the cost of the war. Thus these countries lost an important source of earnings that had gradually been built up during the course of centuries.

Deprived of a large proportion of their normal external earning power, European countries at the end of the war were confronted with a desperate situation. In the absence of generous and prompt assistance from abroad, widespread starvation would have been inevitable and on a scale which would have quickly led to revolutionary political changes. Fortunately, emergency relief assistance was immediately forthcoming on an extensive scale. Through UNRRA (the United Nations Relief and Rehabilitation Administration) and other agencies, the United States Government poured billions of dollars of relief expenditures into Europe in order to alleviate the acute distress occasioned by the war.

It was clear from the outset, however, that Europe's problems could not be solved by mere relief measures. The sharp disparity between import requirements and earning capacity could be narrowed only by measures designed to increase the ability of European countries to produce and to export. With foreign investments largely dissipated as a result of the war, it was clear that the volume of European exports would have to be raised to a level much above that prevailing before the war if pre-war living standards were to be restored on a self-sustaining basis. The necessary increase in production and exports could be attained only by measures of a recovery rather than a relief nature -- that is to say, by measures intended not only to restore but to improve the European productive machine. To accomplish this, however, required outside help. Without outside assistance, European labor and resources would have been required almost entirely for meeting the immediate urgent needs of consumption, and could hardly have been used for investment purposes, no matter how productive, which would not yield an immediate return.

At the end of the war, production in Europe was far below the pre-war level. For Europe as a whole (excluding the U.S.S.R.), industrial production in the first quarter of 1946 was at only 68 per cent of the 1938 level, and in the case of certain countries production was much lower than this average. In Italy, for example, industrial production was at not much more than a third of the 1938 level, while in Germany industrial production was running at only about a fifth of the pre-war rate.

In the three-year period since the end of the war, Europe has made a dramatic recovery in production. In the first quarter of 1948, European industrial production had almost recovered to the level of 1938, and if we exclude Germany, where recovery has been conspicuously slow, European production was actually above the pre-war level.

This does not mean that European consumption has returned to pre-war standards. In the case of food consumption, for example, the average person in western Europe at the present time is eating 25 per cent less sugar, 30 per cent less meat, and 30 per cent less fats than before the war. The reason that overall consumption has not kept pace with overall production is that a large fraction of current production is being devoted, as it should be, to restoring and improving the productive capacity of Europe. Moreover, for reasons which I have already pointed out, production will have to rise to a level much above pre-war if Europe is again to become self-supporting.

A problem very important in connection with European recovery has been the notably slow recovery of Germany. At the present time, industrial production in western Germany is at less than half the pre-war level. The drag on the rest of Europe resulting from this state of affairs is so important that I must give this matter special attention.

There may be some among you who deplore any help given to Germany at a time when the victims of German aggression still need all the assistance we can afford to grant. You have probably heard the propaganda that charges the United States with deliberately favoring the recovery of Germany, rather than the rehabilitation of the victims of German aggression, in order to prepare for a future alliance between the United States and a revitalized German Empire.

I need hardly say that no responsible person in the United States has ever had such intention--least of all the men who have initiated and now administer the European Recovery Program. The main reason why the European Recovery Program also embraces western Germany is the undeniable fact that rehabilitation of the other European nations would be impossible without the recovery of production in Germany. Western Europe must exchange large quantities of exportable surpluses for German coal, steel, machinery, and chemicals which cannot be purchased from any other source. This exchange, which before the war was one of the strongest pillars of European foreign trade, must be resumed now and not in the distant future. Western Europe needs these German products for the reconstruction of its own system of production, and it cannot wait for its own heavy industries to expand to such an extent as to make imports from Germany unnecessary. The United States simply cannot spare the additional quantities that western Europe would require if it were deprived of imports from Germany. Moreover, the United States cannot increase its grants to western Europe by the amount that would be required if Germany did not again become a market for western Europe's exportable surplus.

In 1947, trade between Europe and overseas countries was approximately back to normal. Intra-European trade, excluding Germany, had also made appreciable progress. The stagnation in the trade between western Europe and Germany, however, was a major cause of the unsatisfactory state of overall recovery in western Europe. The redevelopment of that trade is one of the most important contributions that can be made to the rehabilitation of the victims of German agression. In this connection, we have implemented our assistance to Germany by the recent currency reform which will greatly assist in directing German manpower and natural resources into useful production. Moreover, we insist upon developing German production in such manner that Germany's contribution to European recovery is maximized, while at the same time making sure that no future German government can use its reconstructed economy for purposes of aggression. We insist, therefore, upon continued German exports of coal and timber to western Europe, despite German domestic need of these vital raw materials; and we insist upon the removal of the remainder of the German war industries and the limitation of German heavy industrial capacity. With these safeguards, the amount spent for German recovery will be more useful to the rest of Europe than would a much larger amount devoted to additional direct assistance to the victims of German aggression

Another factor retarding European recovery has been the marked decline in trade between western and eastern Europe. Normally, eastern

Europe produces a surplus of foodstuffs and certain raw materials, such as timber, which it exchanges for the industrial products of the west. The importance of reviving this trade, which was highly beneficial to both regions, was recognized from the outset by the framers of the European Recovery Program, and from the very beginning eastern Europe has been invited to participate in the program. The Soviet Union not only declined that offer, but also forced the other eastern European nations - some of which were eager to participate - to remain outside. This failure to cooperate harms the eastern European countries more than the west. Nevertheless, the western nations do not intend to follow the Soviet Union in its attempt to foreswear economic rationality for reasons of ideology. We have continued our endeavor to expand trade with the east, and the Administrator of the recovery program has made available funds for the purchase of scarce commodities in eastern Europe - such as Polish coal for Austria. In this way, the eastern European nations derive some benefits from the European Recovery Program, and there is reason to believe that they are beginning to realize the loss they were made to suffer when they were prevented from becoming full-fledged partners in this great enterprise.

The present European Recovery Program represents a unified approach to the overall problems of Europe rather than the vastly more expensive and wasteful method of attempting to deal with the problems of individual countries on a piecemeal basis. After careful and exhaustive study by the technical staffs of the United States Government, Congress has authorized approximately $5 billion of aid to Europe for the first year of the recovery program. A program of four and a quarter years is contemplated, although this is subject to annual review by Congress. There have been tentative estimates that the total amount of aid needed over this period might amount to $17 billion, but it is clear that estimates of European requirements more than a year or so in advance must be of an uncertain nature.

These are very large sums of money, and we have a right to expect that they will be used in the most effective possible manner. The United States simply cannot afford to extend assistance to Europe without receiving assurances that its contribution will be efficiently used for the purpose of European reconstruction and that the recipient nations will cooperate to the full extent of their capacity in achieving the purposes of the program.

In this connection, the Administrator of the program has concluded agreements under which all recipient nations will undertake very substantial obligations. These obligations include the stabilizing of their national budgets, their currencies, and their exchange rates. The European nations agree to reverse the pre-war trend toward economic isolation, to reduce trade barriers, and to cooperate in making efficient use of their combined resources so as to minimize their dependence on the United States. They agree to put at the disposal of the United States scarce strategic materials in reasonable quantities and at reasonable terms, and to permit access to their natural resources by American investors.

Finally, whenever the United States Government furnishes commodities or services on a grant basis, the participating countries agree to pay the value of these goods and services in local currency into special accounts. These sums will then be used for constructive purposes on the basis of agreements between the country involved and the Administrator of the program. Such purposes include expenditures for the development of new resources, as well as retirement of currency or of government debt in order to put an end to inflation. In a number of cases, the amount in question will be a very substantial fraction of the country's total money supply. Thus, in these European countries, the Administrator will have the power to exercise a great constructive influence upon their financial situations.

While attention has been concentrated on Europe in recent months, the needs of other areas in the world have not been ignored. It has been intended that a substantial part of the dollars supplied to European countries under the European Recovery Program will be spent in Canada, Latin America, and other areas outside the United States. In this way, our aid to Europe will also serve to provide Canada and Latin America with dollars which they in turn can use to pay for goods they need from this country. In addition, the Export-Import Bank and the International Bank for Reconstruction and Development are prepared to make loans to finance sound development projects in Latin America and other parts of the world.

It must be recognized that our foreign economic program in the aggregate imposes a very real burden upon the United States - a financial burden upon our Federal budget and an economic burden upon our people who are called upon to export to foreign countries far more goods and services than they receive in exchange. The Administration's recommendations on foreign aid, however, were decided upon in the light of careful and comprehensive studies of our capacity to bear this burden. The conclusions to be drawn from these studies are that the amount of foreign aid contemplated for the coming year will not impose any greater drain upon United States resources than has occurred during the past year; that this drain will not unduly affect the standard of living of the American people; and that the inflationary impact can be held in check by appropriate domestic measures. The most important of these domestic measures is in the realm of budgetary policy; it is supremely important that Government expenditures, including those on foreign aid, be covered within a balanced budget. If this practice is followed, the purchasing power created by these expenditures will be withdrawn from the market through taxation. At the same time, in view of the inflationary pressures arising from domestic as well as foreign sources, it is important to carry out a monetary policy designed to restrain the expansion of bank credit. To achieve the proper combination of budgetary and monetary policies requires the close cooperation of the United States Treasury and the Federal Reserve System.

Cooperation is also required among all United States Government departments and agencies concerned with foreign economic policy. In order to coordinate the domestic and international financial policies of the United States, Congress in 1945 created the National Advisory Council on International Monetary and Financial Problems. This Council consists of the Secretary of State, the Secretary of the Treasury, the Secretary of Commerce, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Trustees of the Export-Import Bank, and now, also, the Administrator of the European Recovery Program. Since its creation, the Council has played an active part in the determination of international economic policy, and insures consistency of action on the part of all government agencies dealing with foreign financial matters. It also directs the votes of our representatives in the International Monetary Fund, which is concerned with international exchange-rate policies, and in the International Bank for Reconstruction and Development. Finally since the inauguration of the European Recovery Program, the Council has given advice to the Administrator of the Program. In all these ways, the Council attempts to make certain that our domestic and international policies are effectively geared together in a manner designed not only to insure the execution of our international obligations but to insure that our international actions do not threaten the stability of our own economic system.

While the cost of our foreign economic program is not to be lightly dismissed and represents a substantial measure of genuine sacrifice, it is small indeed compared to the cost of the alternative. If we should refuse to extend assistance to foreign countries in critical need, we would have to count on the likelihood of future developments of the most sinister character. We would have to expect revolutionary economic and political changes throughout the world. All hope of a democratic international order would be gone. War-wracked countries in Europe, deprived of the hope of a return to tolerable living standards, would become the easy prey of regimes which promise economic security in exchange for the surrender of political freedom. Confronted with a world largely made up of dictatorships of the Left or Right, the United States would find itself isolated in a cold and hostile world. To maintain even a pretense of security under these conditions would require a level of expenditure for defense vastly greater than any now contemplated. Against such expenditure, the present sums spent for foreign recovery pale into virtual insignificance.

There are those who are aware that foreign aid is in the national interest but who nevertheless maintain that all that is needed is an emergency relief program entailing only a fraction of the cost of a genuine recovery program. But the only basis on which a relief program is less expensive than a recovery program is if we confine our attention to the immediate future. In the long run, a relief program is wasteful in the extreme, since it deals with symptoms rather than causes and does not contribute to the economic stability and eventual self-support of foreign countries.

Of course there is no certainty that our foreign recovery program will achieve all that we hope for it. Difficulties at present unforeseen may arise to disappoint and thwart us, but such possibilities should not blind us to the certainty of disaster if we fail to carry out the attempt. In this connection, there is grave danger that we shall set too much store on the results achieved in the first year and, if these results are disappointing, take the short-sighted step of discontinuing or curtailing the program. In fact, the objectives sought by the program cannot possibly be achieved in one year, and to expect more than a sound beginning of the desired recovery would be to misunderstand the nature both of the problem and of the remedy. It should be remembered that after the first World War, which was vastly less destructive and disruptive than the recent conflict, it was not until 1925, or seven years after the defeat of Germany, that European economic activity was back to the pre-war level.

To a very large degree, the success of our foreign economic program will depend upon our own future actions. This applies not only to our actions directly relating to the program itself but to our decisions in the broader field of economic policy as a whole. For example, we cannot expect either the recovery of world trade or the recovery of Europe if, after a short breathing spell, we attempt to re-instate high tariffs and thereby prevent Europe from selling the exports it must sell if it is to pay for the imports it needs and thus become self-supporting again. For Europe to pay its way, it is not enough that European countries are able to produce the necessary volume of exports; they must also be able to sell them. This means that other countries, including our own country, must be prepared to increase imports.

In the second place, we cannot expect Europe to achieve economic and political stability if our own economy, which is such an important segment of the world economy, is characterized by severe booms and depressions accompanied by equally drastic fluctuations in our purchases from abroad. Much depends on our ability to keep our own house in order - particularly on our ability to avoid the evils of Inflation and Depression. Inflation is the immediate problem, and this we must fight at the source, which means increased production of goods in short supply and reduction of excess purchasing power. There must be control over further expansion of credit, and certain direct controls may also be required to minimize the painful effects of inflation while we are attempting, by more fundamental measures, to deal with the causes of the problem.

To a degree which is almost impossible to exaggerate, the future depends on the type of leadership shown by this country. Of the major countries which were engaged in the recent conflict, our country was almost alone in being able to keep its productive capacity intact, and it has been estimated that the United States at present accounts for roughly half the world's industrial production. Thus, without asking for the role, we find ourselves catapulted into a position of great power and influence which carries with it a great responsibility both abroad and at home. In the sea of problems which now beset us and which lie ahead of us, it will be very difficult to steer a straight course, but we must remember that the stakes of our action are very great. Civilization itself may be in the balance. We must not fail.

Speech delivered before
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FINANCIAL PROBLEMS OF THE EUROPEAN RECOVERY PROGRAM

Introductory Remarks

The European Recovery Program can be distinguished from other types of postwar assistance because of its main purpose - to bring about a balanced economy in Europe and throughout the world. It represents a unified approach to the over-all economic problems of Western Europe. American assistance under the program is intended to meet the costs of imports of goods and services essential to maximize production within the participating countries and to expand their trade among themselves and with the rest of the world. These long-range aims represent a great progress over relief measures and wasteful methods of attempting to deal with short-term problems of individual countries on a piecemeal basis. To these ends, self-help and mutual cooperation on the part of the European countries are the necessary counterparts to American assistance, and the United States has a right to expect that the very large sums of money made available by Congress will be used in the most effective possible manner.

The basic economic problem in Europe today is without doubt the problem of producing more goods. The physical damage and disorganization caused by the war, as well as the deterioration of equipment caused by wartime wear and neglect have not yet been entirely overcome. Furthermore, monetary and price dislocations arising out of the war have proved to be serious obstacles to recovery. Production cannot be restored to maximum levels unless adequate incentives exist both for business and labor, so as to ensure a regular flow of goods through the economy. Finally, wartime destruction in areas which previously had been important sources of supply for Europe have further hampered full production, and have made it necessary for European countries to rely more heavily than before on the Western Hemisphere for needed supplies.

This brings us to the problem of the balance of payments. Since few countries can produce for themselves all the kinds of goods they need, it is necessary for them to import certain things from outside, which they pay for, in effect, with surplus supplies of their own which are exported. If a country is not producing enough or cannot sell enough to pay for what it buys from outside, its balance of payments gets out of equilibrium. If a country cannot increase its production, it may have to reduce its consumption or its investment, to bring its balance of payments back to normal. Both of these alternatives, however, would be undesirable in most European countries today; any cuts from present consumption levels would reduce the productivity of the working population, while reducing the rate of investment would defeat the main object which is to restore and increase the country's productive capacity.

There are, of course, other reasons for the balance of payments problems of Europe today. One is the fact already mentioned that, due to the war, greater reliance has had to be placed on the United States and other Western Hemisphere countries for supplies. Thus, European countries have to redirect their trade so as to sell more to the Western Hemisphere, in order to be able to buy more. Another factor is the wartime loss or liquidation of large amounts of foreign investments, and the loss of a large part of European merchant shipping fleets, both of which facts have meant the loss of important sources of income which formerly helped pay for imports. Failing other means, countries might pay for their imports by using gold or foreign exchange resources accumulated in the past. Obviously, however, this can only be done for a limited time, and many European countries have been doing so for so long that their holdings are now reduced to extremely low levels.

Under these circumstances, the best solution appears to be assistance to Europe in the shape of loans or gifts over a temporary period, during which European countries could take the necessary steps to revive their own production and place their economies on a self-supporting basis. A program of four and a quarter years is contemplated for the purpose, and Congress has authorized approximately $5 billion of aid to Western Europe for the first year of the recovery program. This authorization was based upon careful and exhaustive studies by the technical staffs of the United States Government of essential European requirements and availabilities in the Western Hemisphere and elsewhere. It has been tentatively estimated that the total amount of aid needed over the entire period of the program might amount to $17 billion, but it is clear that estimates of requirements more than a year in advance must be very uncertain.

American assistance is not intended to enable European governments to continue practices of deficit spending and trade restrictions. The avoidance of inflationary practices in government budgets and the self-financing of internal costs of production and investments are regarded as prerequisite to the stabilization of currencies and the adoption of multilateralism in foreign trade. In this connection, the Administrator of the program has concluded agreements under which all recipient countries have undertaken very substantial obligations. These agreements embody the basic principles of the Charter of the International Trade Organization, which was adopted at Havana last March by 53 nations. Recipient countries agree to reduce trade barriers, to eliminate restrictive business practices, and to avoid arrangements restraining competition in international trade, limiting access to markets or fostering monopolistic control of natural resources. In particular, recipient countries agree to permit access to their natural resources by American investors and to put at the disposal of the United States scarce strategic materials in reasonable quantities and on reasonable terms. The financial problems involved in the European Recovery Program are examined in greater details in the following parts of the paper.

Local Currency Funds

Of special significance is the provision requiring recipient countries to set aside in a special account local currency in amount equivalent to the dollar value of goods and services received from the United States in the form of grants. These local currency funds are to be raised as part of the general government revenue and their uses are subject to approval by the Administrator of the program. In a number of cases the amount in question will be a very considerable portion of the country's total money supply. Thus, in these European countries the Administrator will be in a position to exercise a great constructive influence upon their financial situations. The use of these local currency funds is to be determined in accordance with the principles and aims of the European Recovery Program; namely, for retirement of currency or public debt as an anti-inflationary measure; for supplementing existing savings in new investments of productive character; for meeting certain government expenditures which would otherwise be financed in an inflationary way, and perhaps for financing net exports to other participating countries.

It must be noted that while the use of these local currency funds for debt retirement would usually have an automatic deflationary effect, this may be offset by contrary inflationary forces if expansionary measures (through private credit or budgetary deficits) were being taken at the same time. On the other hand, while expenditure of these funds on investment programs might ordinarily be expected to have an inflationary effect, yet conditions may arise under which the release of these funds for new investments would put to work available resources and manpower. In such cases the use of these funds would have no inflationary effect in the short run and would contribute to raise production and stabilize the economy in the long run. In other words it is the over-all financial and economic position of the country concerned that must be considered. If a country proposes to use its local currency funds for debt retirement, the U. S. Government would be concerned to ensure that the debt retirement is <u>effective</u> debt retirement.

In Italy, for example, lire deposits in the local currency account may amount this year to as much as one-third of the Italian Government's budget. The Italian Government might propose to use these funds for debt retirement. But when a country, as in Italy's case, is operating under a heavy budget deficit, it is not easy to see how any debt retirement carried out with the use of the local currency counterpart would be effective or "real". It is likely, therefore, that in most of the countries, an exception being the United Kingdom where there is a budget surplus, the local currency counterpart will be used to meet one or another sort of government expenditure. A country might ask permission, for example, to spend some of the local currency to subsidize milk production, or to subsidize flour millers so that bread might be maintained at an artificially low price as an anti-inflationary device. I do not wish to venture an opinion as to whether these would be appropriate uses to which to put the local currency counterpart, but I am sure you can see that some difficult policy decisions might be involved. Or, to take another example, a country such as France or Italy may wish to use considerable parts of the local currency counterpart for a general investment program—railways, port works, irrigation or reclamation, etc. Here the most important aspect of the decision may be to reach a judgment as to the general inflationary or deflationary situation in the spending country. We might feel that the country simply should not spend the additional amounts in view of already strong inflationary pressures; but the government of the country, for either political or economic reasons, might be very desirous of carrying out its program of investment.

It may also be added that not all countries are subject to the same degree of control through the deposit of local currency counterpart, as such deposits are required against grant assistance, but not against loan assistance. Probably if the economists could have been left free to draft exactly the kind of European Recovery Program which they wanted, they would have wished to provide the entire amount of aid on a grant basis, so as to avoid adding to the dollar debt of Europe during this difficult period of recovery. This would have preserved the dollar borrowing capacity of Western Europe to meet possible needs at the end of the European Recovery Program. Congress did not feel that it could go quite this far. But the Congressional Committee did ask the Government's witnesses whether they thought any part of the program could be arranged on a loan basis. The answer was that the amount which might be loaned would depend on the terms of the loans--that is, the rate of interest, the maturity, and the extent to which flexibility could be introduced to take account of fluctuations in the economic situation of the debtor countries in future years. The Congress finally provided that one billion dollars of the total amount of aid should be handled on a debt basis by the Administrator, i.e., he would borrow that amount from the Treasury and hence would loan that amount to ERP participants. This is about 20 per cent of the total. Moreover, as much as $300 million of this billion may be used to guarantee new investments of American enterprises in Western Europe, provided they are accepted by the Administrator and the recipient countries as part of the recovery program.

The Government experts have endeavored to work out loan-grant ratios country by country, which relate as accurately as can be determined to varying capacities of the ERP countries to incur additional dollar debt. As you may imagine, these ratios give rise to some touchy situations, since they result in some countries receiving all or nearly all of the aid in the form of grants while other countries receive all or nearly all of the aid in the form of loans. It has not been easy, moreover, to work out a sensible procedure for the handling of the loans. At first, it was tempting to explore the possibility of making a series of individual loans to each country for individual capital projects, such as power plants or refineries, with maturities and rates of interest possibly varying from project to project and country to country.

It has now become clear, however, that at least in the first year of the program it would be better to keep the terms of the loans substantially uniform as between foreign countries and, in effect, to set up general lines of credit. This having been done, it will be possible for the Export-Import Bank, as manager of the loan side of the Program, to work out arrangements so that these funds are used primarily for capital goods' projects. The ECA is at present negotiating with the ERP countries as to the terms of the loans and it is not possible to indicate how these negotiations are getting along. It is most important for the lending part of the Program to move along in pace with the grant portion of the Program. It is doubtful if Congress would be very happy to learn at the end of the first year that the Administrator had been quite successful in giving away $4 billion but had not been very successful in lending $1 billion. The European countries, it is believed, have come to appreciate this problem, although some of them did not seem to do so in the early months of the Program.

Financing Intra-European Trade

In a practical application of the principle of mutual cooperation among Western European countries, a possible use of the local currency funds might be for the purpose of financing intra-European trade. Since the end of the war the financing of such trade has been carried out largely through bilateral agreements, stipulating the kinds and amounts of goods to be traded and providing for the extension of reciprocal lines of credit. The restrictive nature of these agreements is obvious, as they tend to limit the volume of trade to the level of those countries which are least in a position to export. Moreover, the gradual exhaustion of the lines of credit has led creditor countries (such as Belgium) to insist on payments in gold or dollars for their surpluses or to balance trade on bilateral bases. Toward the latter part of 1947, this factor was apparently threatening a complete breakdown of intra-European trade. An attempt to solve this problem was made at that time, when a group of Western European countries agreed to set up a multilateral clearing system operated by the Bank for International Settlements. This mechanism proved to be workable, but its results were limited by the fact that settlement of intra-European balances could not be made automatic and universal. In fact, with few exceptions, most countries reserved the right to accept or reject propositions for compensations made by the Bank for International Settlements according to whether or not they considered such compensations desirable.

The European Recovery Program was designed primarily to meet the extraordinarily large deficit of Western Europe and the United Kingdom in its trade with the Western Hemisphere. At the same time, it was recognized that there are two other external deficits faced by the ERP countries: one with respect to other parts of the world outside of Western Europe, such as the Far East and Africa; the other arising within the ERP area, where a few countries (notably Belgium) are in a persistent creditor position with respect to the other participating countries. 1/ To a limited extent, both of these deficits might be eased were the ECA to carry on some "off-shore" procurement outside of the Western Hemisphere. For example, Pakistan jute or Belgian steel might be bought with dollars for delivery to France. In both cases, however, it would be reasonable to ask why Pakistan and Belgium could not themselves provide rupee or Belgian franc credits to France. The reply is that both of these creditor countries have their own dollar deficit problem with respect primarily to the Western Hemisphere. That is, both Belgium and Pakistan (illustrative of countries standing in a creditor position with other ERP countries) need dollars and, accordingly, tend to restrict credit to debtor ERP countries and even to divert their exports to countries willing and able to pay dollars. The result within the ERP area is an intensification of efforts at bilateral balancing which leads to forcing trade down to limits set by the current export capacity of the debtor.

The ERP countries have been struggling with this problem for almost a year and the plan which they have now put forward for consideration of the European and the United States Governments has the following main features: First: the ERP countries will work out some funding or "Standstill" arrangements for the debtor balances accumulated in the present Western European payments agreements. The creditor countries such as Belgium and the United Kingdom agree to set up adequate lines of credit in their own currencies with respect to their debtors in the ERP group.

1/ See Appendix

They also agree to work out as rapidly as possible some system of multilateral offset or clearing. Second: the ECA would agree that allocations of aid to the creditor countries in the ERP group would consist of two parts. One would be unconditional and the other, which would equal the estimated credit balance with ERP debtor countries in the subsequent period of time, would be conditional on the creditor country giving equivalent aid to its various debtors. The local currency counterpart could be used for this purpose. To illustrate, let us assume that the Paris Organization for European Economic Cooperation (OEEC) and the ECA have arrived at an estimate of $80 million as Belgium's need for dollars for a given quarter. Assume, also, that Belgium's debtors in the ERP area for the same quarter are going to need $40 million worth of Belgian franc credits or grants. The ECA would then make an unconditional allocation of $40 million and a conditional allocation of $40 million, the latter in consideration of equivalent aid to be given by Belgium to her debtors within the ERP area.

It is almost needless to remind you that these payments arrangements for Western Europe cannot lead to a permanent solution of the basic problem except insofar as the ERP area in the aggregate makes satisfactory progress toward genuine international equilibrium.

Exchange Rates and the International Monetary Fund

The ERP agreements contain clauses obligating the recipient countries to pursue orderly domestic economic and financial policies, by balancing the government budget, creating or maintaining internal financial stability, restoring confidence in the monetary system, stabilizing the currency and establishing or maintaining a valid rate of exchange. These agreements provide also for consultation with the United States on all matters, including, of course, exchange rates. Of course, it is not the desire of this Government to impose policies on other countries. Moreover, the Government has expressed its intention to make full use of the International Monetary Fund in dealing with exchange rate problems in connection with the European Recovery Program. At the same time, the United States reserves the right to initiate discussions respecting exchange rates.

The Articles of Agreement of the Fund require each member country to agree on a par value for its currency before it can obtain assistance from the Fund; they recognize, however, that such par values need not be permanent and provide a procedure for orderly changes through consultation with the Fund. Before beginning exchange transactions on March 1, 1947, the Fund approved the par values of thirty-two members 2/ and deferred determination in the case of nine members; subsequently it agreed on par values of seven other members 3/ (including five new members). At the time when these initial par values were established, both the Fund and the member countries recognized that the acceptance of such par values was tentative and that some of the rates would need modification from time to time.

The United States Government, through its interested agencies, gave careful consideration to the problem of initial parities and agreed with the Fund's view that par values established immediately after the end of the war could only be tentative. It recognized also that prevailing rates of exchange may in some instances be out of line with relative wage and price

2/ 3/ See Appendix

levels, and that some adjustments in exchange rates may prove necessary. There is general agreement that any action in Europe on exchange rates must be related to the steps taken toward internal stabilization of the economic and financial situations of the member countries. It is also clear that the United States has a direct interest in the maintenance of proper exchange rates in Europe as long as large scale dollar aid is being provided. Obviously, however, the adjustment of exchange rates cannot be made simultaneously for all countries, since the requisite degree of internal stability is attained at different periods.

Furthermore, the determination of what is a proper rate is by no means as simple as is often imagined.* Normally, a low exchange rate means more exports and less imports; a high rate means just the opposite. Even when this is true, of course, the inflationary effect of a devaluation may be worse than any temporary improvement which may have occurred in the balance of payments. But in some cases, a devaluation may not even have an appreciable effect on the balance of payments. If exports cannot be increased much due to production difficulties, and if imports were cut to the essential minimum anyway, the manipulation of exchange rates may not be beneficial. Moreover, even if it is believed that devaluation would be of advantage, the appropriate rate cannot be determined by simple price or purchasing power parity comparisons. This would be possible only if some base year could be selected in which a condition of perfect equilibrium had existed, and if in the interval since that year nothing had changed in the countries concerned except prices. There would remain difficulties of calculation even then, but it can be seen that the basic requirements are far from realistic.

Problems have already arisen in connection with the exchange rates of two important European countries, namely, Italy and France. At the time Italy was admitted to the Fund (March 1947) she had an exchange system based on multiple fluctuating rates and the Fund agreed to defer determination of the par value of the lira. Her exchange rate system had developed in this way: At the time of the Allied landing in Sicily in 1943 an exchange rate of 100 lire per U.S. dollar was established. In January 1946 this rate was de facto discontinued and a system of premiums and surcharges was introduced to make the effective rate for all transactions 225 lire per U.S. dollar. Beginning in March 1946 exporters were required to surrender to the Italian Foreign Exchange Office at this rate only fifty percent of their proceeds and were permitted to use the remaining fifty percent for their own authorized import needs or to dispose of it in a "free market" to importers of authorized commodities from free currency areas. It was this system which was in effect when Italy became a member of the Fund. On August 1, 1947, the premium of 125 percent was abolished and the official rate was changed from 100 to 350 per U.S. dollar; the average rate for exchange transactions continued to be determined on the basis of fifty percent at the official rate and fifty percent at the free market rate. In November 1947 Italy proposed to the Fund modifications in her exchange system, limiting spreads and fluctuations of rates. 4/ The Fund regarded this proposal as a step in the right direction, but could not give its approval because the new system was not made in accordance with the long-range objective of the

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* See International Monetary Fund "Third Annual Report" to be available 9/28/48

4/ See Appendix

Fund, the establishment of a single and stable exchange rate. Therefore, Italy is not entitled to draw on the Fund's resources.

In January 1948, the French Government proposed to change the par value of the franc, which had been agreed upon with the Fund at approximately 119 per dollar, and to modify the exchange system to include multiple and fluctuating rates. A new official rate of 214 francs per dollar (or the equivalent) was proposed for all currencies; but for the dollar (and the Portugese escudo, which is also a freely convertible currency) a "free market was established which actually was soon pegged at about 305 francs per dollar. Exporters to the dollar area could sell half their exchange at the free rate, which gave an effective export rate of 260 francs. The most essential imports from the dollar area were to enter at the 214 rate, but other imports would enter at the free rate. There was no intention to maintain cross rates in line with the new dollar rate. While the Fund recognized the special difficulties of France, it was unable to agree to a system which seemed unlikely to avoid uncertainty and instability in exchanges. Despite the Fund's objection, France put the system into effect. This action disqualified France from using the Fund's resources but did not require France to withdraw from membership.*

The United States Government has kept the Italian and French exchange system, as well as the exchange systems of other countries, under close and continual study. It believes that the pattern of exchange rates -- in Europe and elsewhere -- is by no means satisfactory for all countries, but is fully aware of the difficulties in establishing exchange rates which can be maintained by the member countries without undue recourse to the Fund under the circumstances prevailing in the world today.

The dollar resources of the International Monetary Fund as the result of a policy decision taken by the Fund last April are not available to countries participating in the European Recovery Program for the present, unless in exceptional and unforeseen cases. However, participating countries are free to draw one another's currency from the Fund. This decision is in line with the Fund's objective of maintaining its resources at a safe and reasonable level, and at the same time provides a means whereby European countries may help one another by lending through the Fund. Since April 20, 1948, the date of the Fund's policy decision above referred to, there have been no dollar drawings on the Fund by ERP countries. However, in this time, the Netherlands and Norway drew the equivalent of $6.8 million and $9.56 million, respectively, in Belgian francs. Total drawings on the Fund from the beginning of its operations to August 31 have amounted to the equivalent of $633.9 millions, of which $616.5 million was drawn in dollars. Of the $633.9 million - $558.1 million was drawn by present ERP countries, and of this $540.7 million was in dollars.5/

The Problem of Western Germany--Special

Before the war Germany played a vital role in the economy of Europe, both as a supplier and as a market for other European countries; hence the importance of Germany's reconstruction for the recovery of Europe as a whole.

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* See Fund's Third Annual Report to be released September 28, 1948

5/ See Appendix

In July 1948 industrial production in the US-UK zones reached 60 per cent of 1936, as compared to 42 per cent of 1936 in July 1947. As a result of the internal currency reform in the U.S.-U.K-French zones 6/ and the European Recovery Program, it is expected that a level of 70 per cent of 1936 probably will be reached in the near future. Even this ratio will be substantially lower than that attained by most other Western European countries. This lag justifies the expenditure of substantial ECA funds in addition to the large US-UK appropriations for the rehabilitation of the Western German economy.

The OEEC (Organization for European Economic Cooperation) which has been given the task of dividing ECA funds between the participating countries over the first year of ERP, has announced an allocation of $414 million for Bizonal Germany and $100 million for the French zone. The inflow of goods procured on the basis of these allocations is expected to raise the level of total imports in the second half of 1948 to almost $1 billion for the US-UK zones alone, or almost three times the figure of the second half of 1947. The sum corresponds in terms of real purchasing power approximately to the prewar level of imports. Exports of the US-UK zones, although also three times as large as in 1947, are expected to reach only about 40 per cent of imports and thus to remain still very much below the prewar level.

The currency reform was carried through in the US-UK-French zones of Germany in the period between June 18 and June 26. The reform ended the stage of "repressed inflation" which had hampered the Western German economy especially by diverting labor and capital to the black market and causing the hoarding of raw materials and finished products. In consequence of the restoration of the value of money, price control and rationing could be lifted for all but the most important commodities.

It is proposed to alleviate the scarcity of credit due to the currency reform by use of the local currency receipts for the sale of goods imported under ECA and US-UK appropriations. As indicated, these receipts are to be deposited in special accounts and it is proposed that these sums be used for establishing a reconstruction bank that will grant productive credits to the Western German economy.

Originally, the currency reform did not extend to Berlin, but the attempt of the Soviet authorities to force the currency circulating in the Soviet zone of Germany upon the Western sectors of Berlin without quadripartite action, forced the Western powers to introduce the currency of the Western zones in their sectors. The problem of unifying the Berlin currency system is still under quadripartite consideration.

The Role of the National Advisory Council

Cooperation on financial matters pertaining to the European Recovery Program is required among the various departments and agencies of the United States Government concerned with foreign financial activities. The medium for such coordination is the National Advisory Council on International Monetary and Financial Problems, which was created by Congress in 1945 under Section 4 of the Bretton Woods Agreement Act. The Council consists of the Secretary of the Treasury, the Secretary of State, the Secretary of Commerce, the Chairman of the Board of Governors

6/ See Appendix

of the Federal Reserve System, the Chairman of the Board of Trustees of the Export-Import Bank, and, now, also the Administrator of the European Recovery Program.*

Since its creation, the Council has played an active part in the determination of the foreign financial policy of the United States and in insuring consistency of action on the part of all Government agencies dealing with foreign financial matters. In particular, the Council has maintained constant consultations with the United States Directors of the International Monetary Fund and the International Bank, and has given advice to the Administrator of the European Recovery Program on matters of local currency funds, loan-grant ratios, and all other financial aspects of the program. It has been a primary concern of the Council to make certain that the domestic and international policies of the United States are effectively coordinated in a manner designed not only to insure the attainment of our foreign objectives, but to insure also that our actions in this field do not threaten the stability of our economic system.

<u>The American Economy and Foreign Aid</u>

It must be recognized that our foreign economic program in the aggregate imposes a very real burden upon the United States---a financial burden upon our Federal budget and an economic burden upon our people who are called upon to export to foreign countries far more goods and services than they receive in exchange. The European Recovery Program is the most important, though not the sole item of our foreign aid. Other Congressional appropriations have provided assistance to areas occupied by United States forces, such as Germany and Japan, and to other countries such as China, Greece, and the Philippines, while the Export-Import Bank 7/ and the International Bank for Reconstruction and Development 8/ (the latter thus far making little except dollar loans) continue to finance sound economic projects in Europe, Latin America, and other parts of the world. The predominant character of the European Recovery Program may be gauged by the fact that the amount authorized and appropriated on its account--$5 billion--represents about four-fifths of the total appropriations by Congress for foreign aid for the current fiscal year. 9/ Because of the large dependence of Europe on world trade, the role of the European Recovery Program goes far beyond any geographical limitations--in fact, it is intended that a substantial part of the dollars made available to European countries will be spent in Canada, Latin America, and countries outside the Western Hemisphere. In this way our aid to Europe will also serve to provide Canada and Latin America with dollars, which they in turn can use to pay for goods they need from this country, and will help to alleviate balance of payments problems in a wide area.

The Administration's recommendations on foreign aid were decided upon in the light of careful and comprehensive studies of our capacity to bear this burden. These studies were undertaken in the second half of 1947, at a time when taxation remained at wartime levels and defense expenditures were declining. The general conclusions were that the amount of foreign aid contemplated for the current year would not impose any greater drain upon

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* and/or their alternates.
7/, 8/, 9/ See <u>Appendix</u>

American resources than occurred during past years, and that this drain would not unduly affect the standard of living of the American people and the stability of the American economy. These conclusions were based on certain assumptions, mainly that there would be no overall increase in Government expenditures or decrease in taxation, and that the inflationary impact would be held in check by appropriate domestic measures. The most important of these domestic measures is in the realm of budgetary policies; it is supremely important that Government expenditures, including those on foreign aid and national defense, be covered within a balanced budget. If this practice is followed, the purchasing power created by these expenditures will be withdrawn from the market through taxation. At the same time, in view of the inflationary pressure arising from domestic as well as foreign sources it is important to carry out a monetary policy designed to restrain the expansion of bank credit. To achieve the proper combination of budgetary and monetary policies requires the close cooperation of the United States Treasury and the Federal Reserve System. This I shall develop further this evening--in the Seminar discussion.

The cost of the foreign economic program as a whole represents a substantial measure of genuine sacrifice and subjects the American people to further inflationary pressures on the domestic economy in the short run in order to contribute to international security and economic stabilization in the long run. The cost of foreign aid seems to be small indeed compared to the cost of the alternative. If we should refuse to extend assistance to foreign countries in critical need, we would run the risk of precipitating foreign developments of the most sinister character. We would be confronted with revolutionary economic and political changes throughout the world. All hope of a democratic international order would be gone. War-wrecked countries in Europe and the Far East, deprived of the hope of a return to tolerable living standards, would become the easy prey of regimes which promise economic security in exchange for the surrender of political freedom. Confronted with the world largely made up of dictatorships of the left or right, the United States would find itself isolated in a cold and hostile world. To maintain even a pretense of security under these conditions would require a level of expenditures for defense vastly greater than any now contemplated. The present and prospective sums spent for foreign aid should be measured against these alternatives.

Conclusion

It is premature to attempt any quantitative estimate of the progress toward domestic recovery and international equilibrium which is being made by the European Recovery Program countries. The Administrator and other Government officials are very keenly aware that the Congress will expect a full statement at the time a request is made for an appropriation to cover the second year. But the ECA did not come into existence until the first part of April and in the five intervening months a certain amount of time inevitably has had to be spent on getting started. According to the latest available figures, as of September 3, 1948, ECA procurement authorizations 10/ for Europe have reached a total of $1,369 million but, of course, by no means all of this amount of aid has

10/ See Appendix

yet actually reached Europe in the form of food, materials, and equipment.

There is, of course, no certainty that our foreign recovery program will achieve all that we hope for it. Difficulties at present unforeseen may arise to disappoint and thwart us, but such possibilities should not blind us to the certainty of disaster if we shrink from the task. In this connection, there is grave danger that we shall set too much store by the results achieved in the first year and, if these results are disappointing, take the short-sighted step of discontinuing or greatly curtailing the program. In fact, the objectives sought by the program cannot possibly be achieved in one year. To expect more than a sound beginning of the desired recovery would be to misunderstand the nature of the problem and of the remedy. It should be remembered that after the first World War, which was vastly less destructive and disruptive than the recent conflict, it was not until 1925, or seven years after the defeat of Germany, that European economic activity was restored to the pre-war level.

To a very large degree, the success of our foreign economic program will depend upon our own future actions. This applies not only to our actions directly relating to the program itself but to our decisions in the broader field of economic policy as a whole. For example, we cannot expect either the recovery of world trade or the recovery of Europe if, after a short breathing spell, we attempt to re-instate prohibitive tariffs and thereby prevent Europe from selling the exports it must sell if it is to pay for the imports it needs and thus become self-supporting again. For Europe to pay its way, it is not enough that European countries are able to produce the necessary volume of exports; they must also be able to sell them. This means that other countries, including our own country, must be prepared to increase imports.

In the second place, we cannot expect Europe to achieve economic and political stability if our own economy, which is such an important segment of the world economy, is characterized by severe booms and depressions accompanied by equally drastic fluctuations in our purchases from abroad. Much depends on our ability to keep our own house in order - particularly on our ability to avoid the evils of inflation and deflation. Inflation is the immediate problem, and this we must fight at the source, which means maintaining maximum production and restraining as well as reducing excess purchasing power.

To a degree which is almost impossible to exaggerate, the future depends on the type of leadership shown by this country. Of the major countries which were engaged in the recent conflict, our country was almost alone in being able to keep its productive capacity intact. It has been estimated that the United States at present accounts for roughly half of the world's industrial production. Thus, without asking for the role, we find ourselves catapulted into a position of great power and influence which carries with it a great responsibility, both abroad and at home.

Appendix - Footnotes

1. In 1947, Belgium had a favorable trade balance with respect to the other participating countries of $99 million. However, including invisible items (shipping, tourism, interest and dividends, etc.) as well as trade, Belgium's favorable balance with participating countries on current account amounted to only $81 million. Net credits for the third quarter of 1948 are estimated at $28 million. Belgium's over-all trade deficit with the world as a whole, however, has been estimated at $441 million and her deficit with the United States at $476 million.

2. Par values announced by International Monetary Fund, December 18, 1946:

Country	Par Value (¢ per unit of foreign currency)	Par Value (local currency units per dollar)	Comments
Belgium	2.28	43.83	
Bolivia	2.38	42.00	
Canada	100.00	1.00	
Chile	3.23	31.00	
Colombia	57.14	1.75	
Costa Rica	17.81	5.62	
Cuba	100.00	1.00	
Czechoslovakia	2.00	50.00	
Denmark	20.84	4.80	
Ecuador	7.41	13.50	
Egypt	413.30	.24	
El Salvador	40.00	2.50	
Ethiopia	40.25	2.48	
France	.84	119.11	[There has been no agreed par value for the Franc since France instituted its new exchange system on January 26, 1948]
Guatamala	100.00	1.00	
Honduras	50.00	2.00	
Iceland	15.41	6.49	
India	30.23	3.31	
Iran	3.10	32.25	
Iraq	403.00	.25	
Luxembourg	2.28	43.83	
Mexico	20.60	4.86	
Netherlands	37.70	2.65	
Nicaragua	20.00	5.00	
Norway	20.15	4.96	
Panama	100.00	1.00	
Paraguay	32.36	3.09	
Peru	15.38	6.50	
Philippines	50.00	2.00	

Country	Par Value		Comments
South Africa	403.00	.25	
United Kingdom	403.00	.25	
United States	100.00	1.00	

3. Par Values announced by International Monetary Fund subsequently:

Country	Par Value ($ per unit of foreign currency)	(local currency units per dollar)	Comments
Australia	322.40	.31	New member; par announced 11-17-47
Brazil	5.41	18.50	Par announced 7-14-48
Dominican Republic	100.00	1.00	Par announced 4-23-48
Lebanon	45.63	2.19	New member; par announced 7-29-47
Syria	45.63	2.19	New member; par announced 7-29-47
Turkey	35.71	2.80	New member; par announced 6-19-47
Venezuela	29.85	3.35	Par announced 4-18-47

4. The Italian system of exchange rates which was established then, and which is presently applied, is as follows:

The official "fixed" rate of 350 lire per U. S. dollar was replaced by a fluctuating rate determined monthly on the basis of the free market quotations of the previous month. The old rate of 350 lire per dollar was discontinued for current exchange transactions, although it has been retained for certain internal valuations and for determining rates applicable to certain payment agreements. Current transactions are conducted at the following rates of exchange: (1) An official rate determined each month by the average of the rates prevailing in the free market during the preceding month; this average is limited to quotations within a range of 350 lire to 650 lire per U. S. dollar. Fifty per cent of exchange proceeds from free currency areas are sold at this rate to the Italian Foreign Exchange Office, while on the selling side exchange is supplied at this rate for certain governmental imports and for imports under all payment agreements; (2) A free market rate at which the remaining fifty per cent of exchange proceeds from free currency areas is sold. All non-governmental imports from free currency areas are made at this rate; (3) The average of the above two rates, which is the effective rate for all exchange proceeds from free currency areas.

The exchange rates of the lira per U. S. dollar have remained very stable throughout the first part of the year, as indicated by the following quotations reported by the International Monetary Fund:

Exchange Rates (lire per U.S. dollar)	Jan.	Feb.	March	April	May	June	July
(1) Official	576	573	573	574	575	575	575
(2) Free	573	573	574	575	575	575	575
(3) Average	574	573	574	574	575	575	575

5. Total drawings on the Fund to July 31, 1948, by country are as follows:

ERP Countries	Quota	Drawings		
	(In millions of U.S. dollars)			
		In U.S. dollars	Other	Total
Belgium	225	33.0	--	33.0
Denmark	68	10.2	--	10.2
France	525	125.0	--	125.0
Netherlands	275	62.5	(6 a/ (6.8 b/	75.3
Norway	50	5.0	4.6 c/	9.6
Turkey	43	5.0	--	5.0
United Kingdom	1,300	300.0	--	300.0
		540.7		558.1

a/ Dollar equivalent of purchase of sterling
b/ Dollar equivalent of purchase of Belgian francs
c/ Dollar equivalent of purchase of Belgian francs

Other than ERP countries				
Chile	50	8.8	--	8.8
Ethiopia	6	.3	--	.3
India	400	44.2	--	44.2
Mexico	90	22.5	--	22.5
		75.8		75.8

6. The reichsmark currency in Western Germany was converted into the new "Deutsche Mark" at the rate of 1 new for 10 old marks. Only 60 new marks were paid out in cash, however, (40 marks immediately and 20 marks on August 20); the remainder had to be deposited in bank accounts, of which one-half was temporarily blocked. All accounts exceeding 5,000 old marks were released only after investigation of the owner's tax status. Holdings of public agencies were not converted, but public agencies (including the occupation authorities) received amounts sufficient to provide for one month's operations. The German authorities were instructed to enact legislation and impose special levies for the equalization of the burdens imposed by the currency conversion.

No official exchange rate has as yet been established for the new currency, but in foreign trade (with the exception of food imports) a factor of 30 cents per mark is used for the conversion of dollar payments and proceeds into German currency.

7. As of July 31, 1948, the Export-Import Bank had outstanding loans amounting to $2,224 millions, and undisbursed authorizations of $616 millions. This, out of a total lending authority of $3500 millions, left $660 millions of uncommitted lending authority.

8. The following table shows loans extended by the International Bank as of June 30, 1948:

	Loans authorized	Disburse-ments	Unused balance of commitment
	(Millions of U.S. dollars)		
France	250	250	
Netherlands	195	195	
Netherlands shipping companies*	12	12	
Denmark	40	16.4	23.6
Luxembourg	12	8.6	3.4
Chile	16	0	16

* $8.1 million of this loan was extended by 10 U. S. commercial banks and guaranteed by the International Bank.

(For further information on International Bank operations see Third Annual Report to be released September 29, 1948.)

9. The amounts appropriated or authorized by Congress for foreign aid for the fiscal year 1948-49 are as follows:

	(In millions of dollars)	
European Recovery Program	$ 5,055	a/
Government & Relief in Occupied Areas b/	1,300	
Revolving fund for purchase of agricultural commodities for occupied areas	150	c/
Greek-Turkish Aid	275	
China Aid	400	d/
Philippine Rehabilitation	116	
International Refugee Organization	71	
International Childrens Emergency Fund	35	

a/ $4,000 million appropriated for use from April 3, 1948, to June 30, 1949, but may be spent in period ending April 2, 1949. $55 million represents a deficiency appropriation for fiscal 1948. $1,000 million represents authorization to the Economic Cooperation Administration for extension of credits through the Export-Import Bank.

b/ For Germany, Japan, Korea, the Ryuku Islands, and a small sum for occupation costs in Austria.

c/ Credit authorization

d/ Available to April 2, 1949

10. Procurement authorizations are issued at the request of the European countries, in accordance with the fund allocations made by ECA at the beginning of each quarter to each recipient country. Total fund allocations by ECA to ERP countries for the period April 3 to September 30, 1948, amount to $2,595 million, of which $2,080 is in the form of grants, and $515 in the form of loans. The ECA has so far extended only one loan, to Iceland ($2.3 million). Loan negotiations with other ERP countries (U.K., France, Belgium, Italy, etc.) are in course and will be concluded shortly. It is quite possible that procurement authorizations will reach by September 30 a figure close to that of grant allocations ($2,080 million). Procurement authorizations on loan on the other hand, will not begin until after the signing of the loan agreements and, therefore, the total amount outstanding at the end of September - if any - will possibly be small.