BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MATERIAL PROPOSED FOR INCLUSION IN
STATE OF UNION MESSAGE OR PRESIDENT'S ECONOMIC REPORT

Since the end of hostilities, great progress has been made in repairing the most acute damage of the war; in revival of agriculture throughout the world, in restoration of production and of transport in western Europe, and in reconversion and expansion of plant capacity in this country. Much remains to be done. The world outside our borders is not yet restored to the point where exceptional measures of foreign aid are no longer required. Within this country, despite the phenomenal record of postwar production, serious deficiencies inherited from the war still exist. To these have been added new distortions that have developed during the postwar period, largely as a by-product of postwar inflation.

We have by no means arrived at a situation where we can regard the future with complacency, even when current inflationary pressures are under control. During the past three and one-half years, in the effort to alleviate a tragic shortage in housing facilities, more money has been made available to finance the purchase of houses than there were houses to buy. As a result, the prices of houses and the costs of building have increased much more rapidly than the money wages of most of the population. Many low-income families, in order to satisfy their need for homes, have incurred mortgage debt that places an excessive burden on their future income.

Although the total increase in money income since the war has kept pace with the rising cost of living, increased incomes have been unevenly distributed. Some groups in the population have been in a position to increase their incomes, in many cases more rapidly than living costs. These increases, to the extent they were not accompanied by higher productivity, have raised costs and prices and thus accelerated the upward spiral of inflation. Other groups, large in the aggregate, have had little or no increase. The aged and others living on savings and fixed incomes have suffered drastic reductions in purchasing power. Distortions such as these greatly aggravate the problem of long-run stability. Housing and other durable goods, though they may be purchased with the aid of credit, must ultimately be paid for out of income. A long continuance of high levels of production, particularly of durable goods and building, requires that costs remain in line with the incomes of the great mass of the people and not simply those segments of the population whose incomes have had a more than average increase.

For a sustained prosperity, it is essential that credit conditions remain sound and that overindebtedness be avoided. It is also essential that we do not, in this period of extraordinary activity, so far anticipate our future capital needs, private as well as public, as to leave no backlogs to draw upon when the current phase of reconversion is over.

It would be possible to achieve a form of temporary stability at the present general level of prices that would conceal serious undercurrents of weakness. If we should undertake to achieve stability by the prop of credit expansion, whether bank or otherwise, then we would be storing up trouble. We would be jeopardizing the future if we were to rely upon expenditures in excess of current savings to finance heavy new borrowing by businesses, substantial buying on credit by consumers, large mortgage expansion at present high construction costs, and large State and local expenditures for public works. We should refrain, in a time of inflationary pressures, from resort to stimulants appropriate for counteracting deflationary forces.

It is of paramount importance to avoid Federal deficits when, as now, production, employment, and incomes are at higher levels than ever before. The most effective way to deal with the basic cause of inflation is by means of a substantial budgetary surplus which can be used to reduce public debt.

During the early part of 1948, the major restraining influence was due to the large excess of Federal Government cash receipts over expenditures, amounting to nearly 9 billion dollars. This made possible retirement of public debt held by Federal Reserve Banks and thereby reduced the excessive money supply. During the past year, increased military and foreign aid expenditures were authorized. At the same time Congress reduced taxes. As a result, the budgetary surplus, which had been a most important anti-inflationary factor, disappeared. It is essential that it be restored and that any material increase in Federal expenditures in the next fiscal year be at least offset by increased taxation.

A vigorous fiscal policy should be supplemented by corresponding monetary measures. Adequate means should be provided so 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.

FURTHER MEASURES OF RESTRAINT

The problem of restraining inflation and of promoting sound credit conditions can be dealt with through many channels of Governmental policy. In addition to restricting the availability of credit and increasing taxes in order to curtail buying power, rigid economy and postponement of all nonessential expenditures are necessary. Allocations may be used to distribute scarce materials and direct price and wage controls can be invoked to hold down the upward spiral of costs, but such measures do not remove the basic causes of inflation.

Expenditures not only by the Federal Government but also by State and local governments should be confined to absolute essentials. Every possible outlay should be postponed until demand for labor and materials slackens. At such a time, these expenditures would have a sustaining instead of an inflationary influence.

During the past year the American Bankers Association has undertaken an organized campaign to discourage banks from extending credits of a recognizable inflationary character. These efforts have had a desirable influence in slackening the rate of bank credit expansion. A similar cooperative effort among all groups of lenders, including those outside the banking field, might also be helpful in the longer-term capital market.

Voluntary efforts of this nature should be encouraged as a supplement to, but not as a substitute for, necessary Governmental measures of restraint.

Public debt management.-- It is of primary importance to have a budgetary surplus sufficient to permit retirement of a substantial part of the public debt. There have been heavy drafts on wartime savings, invested in public-debt securities, to finance current expenditures. The inflationary effects of these withdrawals should be counterbalanced by public-debt retirement.

The Treasury has a problem of refunding large amounts of maturing obligations and of maintaining a balanced debt structure. Maturities amount to over 50 billion dollars each year and the average maturity of the outstanding debt is steadily shortening. It is necessary that the debt be managed in a manner that will not only encourage nonbank investors to buy and hold Government securities as long-term investments but will also reduce the amount of Government securities held by the banking system. In order to encourage the holding of Government bonds by investors, confidence in the stability of bond prices must be maintained. Policies regarding the management of the public debt should be guided by these considerations.

Federal Reserve support of Government bond prices.-- Stability of bond prices has been maintained. In supporting this market the Federal Reserve Banks increased their holdings of Treasury bonds by more than 10 billion dollars during the twelve months ending in November.

Whereas in the earlier postwar years Federal Reserve purchases were largely from banks wishing funds to expand other types of credit, during the past year the bulk of purchases has been of long-term bonds held by insurance companies and other nonbank investors. The magnitude of sales by these investors reflects the heavy demand for investment funds. These withdrawals from past accumulations of funds for current expenditures add heavily to inflationary pressures.

The policy of purchasing Treasury bonds in order to maintain stability in the bond market has confronted the Federal Reserve System with a serious dilemma. These purchases not only increase the supply of money currently available but also supply the banking system with additional reserves on which bank credit can be pyramided. The Reserve System has endeavored to prevent the reserves thus created, as well as additional reserves arising from gold inflow, from becoming the basis for a further multiple expansion of bank credit. With this purpose in view, two sets of measures have been adopted, one dealing with short-term interest rates, the other with reserve requirements. Although these measures alone can not arrest inflation, they exert a desirable restraint.

Increase in short-term interest rates.-- Interest rates on short-term Government securities have been permitted to rise somewhat from the very low levels maintained during the war and early postwar years. Banks and other holders of liquid funds were thereby encouraged to purchase and hold short-term securities. As a result, Federal Reserve Banks reduced their holdings of short-term securities by almost the same amount as their purchases of bonds, thus preventing a corresponding expansion in bank reserves.

The effectiveness of this measure depends upon the willingness of banks and others to hold short-term securities rather than to put their available funds to other uses. The situation calls for flexibility in the short-term money market.

Higher reserve requirements.-- In order to immobilize newly-created reserves, the Board of Governors of the Federal Reserve System raised the reserve requirements of member banks. Increases for banks in New York and Chicago (Central Reserve Cities) were made during the first half of 1948 under unused authority in the Federal Reserve Act, and in September requirements were increased for all member banks under authority of legislation passed by the Congress in August. The combined actions immobilized about 3 billion dollars of additional bank reserves. This authority expires June 30, 1949. Increases made under it would be cancelled automatically at that time. The Congress should reconsider the whole problem of bank reserves and provide authority covering the entire banking system adequate to meet the changing needs of the economy.

Regulation of consumer instalment credit.-- Consumer instalment credit, which is an important source of expansion in buying power, was also brought back under regulation through power granted by the Congress in August. This power likewise expires on June 30, 1949. It should be continued in order to exert a stabilizing influence on this highly fluctuating type of credit.