CONFIDENTIAL MEMORANDUM January 2, 1951

To: Board of Governors

From: Messrs. Riefler, Thomas, Young, and Youngdahl

Subject: Federal Reserve staff comments on draft of policy section of Council of Economic Adviser's Annual Economic Review.

Attached herewith for the Board's consideration and review is a copy of proposed staff comment on "Credit and Debt Management" section of the draft Annual Economic Review of the Council of Economic Advisers. The draft of this part of the Council's review was transmitted for Federal Reserve staff comment on Friday, December 29, 1950, with the request that our comments and suggestions be returned to the Council by Tuesday afternoon, January 2, 1951.

Attachment

January 2, 1951

COMMENTS ON PART III OF THE
COUNCIL OF ECONOMIC ADVISERS
ANNUAL ECONOMIC REVIEW

General Comments on the Credit
and Debt Management Section

Under present circumstances, any Council statement on this subject runs the risk of being too specific. Actually, the nature and size of the mobilization financing task is only beginning to become clear and the major lines of decision for national financial policy are still in a formative stage. Our general suggestion as to this section of the Council's report is, therefore, that it should be modified to provide a more comprehensive and critical analysis of the problem of financial mobilization and eventual demobilization against the background of lessons taught by war financing experience during and after World Wars I and II. An indication of the type of treatment which we have in mind may be inferred from the following paragraphs.

(1) In carrying out its necessary national defense program, the Government must not be handicapped at any stage by inadequate financial resources.

(2) To minimize inflationary pressures arising out of the defense effort and also to attain utmost economy in the use of physical and manpower resources, the Government should make every effort to obtain the maximum amount of financing through taxation and private savings, leaving a minimum amount of financing to be obtained through sales of Government securities to the banks. This responsibility is doubly heavy under present circumstances because of the extreme liquidity of the economy and because

social security, pension and welfare funds, together with liquid asset holdings, constitute a far larger reserve for future contingencies and old age than existed prior to World Wars I and II.

(3) Needed funds not made available through taxation and savings will have to be provided by the banking system.

(4) Financing experience of World Wars I and II shows that the Government, through the facilities of the Federal Reserve System, has the technical ability and authority to obtain any amount of funds that may be needed to finance an emergency and at the same time to establish and maintain any level of interest rates on Government securities it may choose, provided it is willing to create money without limit.

(5) Previous experience has also demonstrated that with an adequate harness of direct controls which drastically curtail the availability of consumer goods, especially durable items, private consumption can be curbed and private savings greatly increased. World War II experience further proved that direct controls can be an efficient restraint on private investment. Altogether, an approximate balance between aggregate savings and investment was achieved in this way during World War II without excessive price inflation. There was, however, a very large increase in the total money supply, much of it in idle holdings, and also a very large expansion in holdings of Government securities which holders considered as liquid assets convertible into other uses whenever opportunity presented itself.

(6) Adherence during World War II to a level and structure of interest rates that was (a) low, (b) sharply inclined, and (c) rigid, resulted in an undue preference for the holding of cash instead of Government securities, with the effect that an unnecessarily large expansion in

the money supply occurred. The pattern of interest rates maintained actually promoted the shifting of securities from savers to banks and ultimately to the Federal Reserve. It, therefore, increased the money supply much more than war financing exigencies actually required.

(7) In the postwar period, after the removal of direct controls, the continuance of pegged interest rates made marketable Government securities the equivalent of cash at the option of the investor. With investment returns in private areas offering an attractive margin above supported yields on Government securities and with no penalty and usually profits on sales of Government securities, institutional investors and banks were encouraged to shift from holdings of Government securities into private forms of debt. This accentuated postwar credit and monetary expansion. In other words, it caused more postwar inflation than otherwise would have occurred.

(8) Experience both in World War I and World War II shows that the building up of backlog demands during the period of acute shortages and the large accumulation of wartime savings, together with high profit expectations tend to express themselves in the postwar period in large dissavings by individual holders. A significant part of the savings funds of individuals and business invested during a war emergency in Government securities will not remain in such forms if interest rates are pegged. Artificial rigidity of interest rates in such a period permits the free use, without penalty, of past savings invested in marketable securities. The nonmarketable savings bond of World War II was designed to provide a built-in penalty in its redemption schedule and hence to restrain postwar dissavings.

(9) The program of defense emergency and war financing adopted in 1941 and followed ever since was greatly influenced by the fact that the Liberty and Victory bonds of World War I fell to a large discount in early postwar years. To prevent a repetition of this experience, the nonmarketable savings bond was adopted as a principal financing instrument for tapping the savings of lower and middle-income groups. With respect to marketable bonds, designed for large individual and institutional investors, the Federal Reserve assumed a responsibility for supporting prices.

(10) Experience following World War II shows that, in attempting to avoid the postwar difficulties of World War I financing, the second war financing program went too far in the other direction. The redemption penalty of nonmarketable bonds and the pegged prices and interest rates on marketable bonds gave a money quality to the entire public debt with grave inflationary potentialities and consequences.

(11) The Council's treatment of the current problem of mobilization finance goes a long way in recognizing the lessons learned from financing two World Wars. The question is whether it goes far enough. The Council recognizes the dangers of undue wartime liquid asset accumulation by emphasizing the importance of holding the expansion of money and Government securities to a minimum (a) by paying for the defense program with taxation, and (b) where borrowing is necessary, by getting as much money as possible from nonbank sources. The Council's treatment further recognizes that after World War II short-term securities held by banks were readily liquidated, and that even marketable long-term issues in World War II did not remain firmly lodged in investor portfolios. When direct controls were removed and private outlets for funds opened up, these securities were used to finance private

spending and particularly to support a large loan expansion by other lenders as well as banks. The Council undertakes to meet this problem in the present situation by recommending reliance on long-term nonmarketable issues for nonbank investors, institutional and individual, and a special nonmarketable issue for banks, the holding of which in some relation to deposits might be required.

(12) As stated earlier, the present financial situation differs in two major respects from that obtaining at the beginning of the two preceding war emergency periods. First, the economy is already surfeited with liquidity. This condition means that additions to the economy's over-all liquidity either from private credit expansion or from deficit financing operations will have the immediate effect of greatly intensifying current inflationary pressures and the ultimate effect of greatly increasing the postemergency inflationary threat. Second, in addition to huge accumulations of liquid assets, today's economy carries a very large load of social security, pension, and welfare liabilities. This condition implies a diminished need for additional liquidity and also immensely more serious social repercussions from a progressive loss in the purchasing power of the dollar.

(13) Before any specific program of defense finance becomes crystallized, a comprehensive and fundamental reconsideration of all aspects of the debt management problem is needed. It should be the aim of that review to incorporate all of the lessons of the past. We must recognize the very serious long-run inflationary prospects that are being opened up by the emerging situation. Not only must we induce people to save and buy Government securities now, but we must invent greater

incentives to induce individuals and institutions who put savings in Government securities during the emergency to keep them there. Established types of nonmarketable bonds may need to be modified and new forms developed, in order that the Government, in meeting future developments, will have greater freedom to influence the liquidity positions of holders.

(14) The problem of choosing an appropriate reserve requirement plan for supplementing the general central banking credit control authority during the emergency, in our judgment, hinges on a determination of what specific debt management program is to be followed. The uniform reserve plan, which the Council endorses, has nothing to do with controlling inflation but rather is concerned with the matter of the equity and technical efficiency of the reserve requirement mechanism. We see little point in raising the issue of the uniform reserve requirement proposal in connection with the defense program discussion. It is possible that any changes in reserve requirements needed in the future might move toward greater uniformity.

(15) In conclusion, our suggestion is that the Council's discussion of credit control and debt management should avoid too definite a commitment to specific devices from which retreat may be difficult and that the toning should be such that flexibility of position is retained.

Comments on the Discussion of Regulations W and X

The Council's first recommendation with respect to Regulations X and W is to the effect that the regulations not be relaxed. This might be interpreted as implying that the regulations should not be further tightened. Does the Council wish to take this position?

The paragraph (p. 62) which comments on the effects of Regulation W on low income groups could be eliminated. To the extent that the regulation is effective, it helps low income groups by its effects on prices. Also, credit to low or any income group is not a free good if its use entails a high extra cost. The recommendation as to the use of certificates of urgency in the purchase of new automobiles is clearly premature and the possibility should not be raised publicly at this time.

With respect to the discussion of adequate inducement for the construction of private rental housing in defense areas, it is suggested that the word "different" be substituted for the words "more liberal" in the last sentence of the first paragraph on page 63.