To Mr. Eccles

From Mr. Edmiston

ANALYSIS OF ALTERNATE METHODS FOR HANDLING UNEMPLOYMENT RESERVES

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In the large volume of writing about unemployment insurance schemes of various types it is rather surprising that there has been relatively little attention paid to the question of how the reserves are to be handled and what effects upon the economic system might be expected from different uses of the reserve funds. There are three types of proposed schemes for handling reserves, which will be discussed below.

Investment of Reserves in Government Securities.

In the first place, the reserves might be invested in securities, particularly in Government securities, as these provide the maximum safety and availability and probably for political reasons would be the only type of securities in which the funds can be invested under any compulsory unemployment insurance plan that requires the fund to be handled by some Governmental agency whether it be the National Government or the Governments of the several States.

If Government securities are to be used for investment of reserves the handling of the fund requires considerable management. In a period of increasing business activity it is to be expected that payments would normally be coming into the fund at a faster rate than benefits are being made. If this excess amount were used to purchase Government securities the funds would go into the hands of the holders of these securities who sold them to the trustees of the fund. These individuals or institutions would then be able to use the funds as they saw fit. They would probably either purchase other securities, purchase commodities or leave deposits in the hands of banks. As the original payments into the fund came as a result of the sale of some of the above types of assets the net effect from these operations would entail no change at all upon the volume of bank deposits or purchasing power if no other factors entered into the picture.

If, on the other hand, the source of the original payments into the reserve fund came as a result of an expansion of bank credit, indicating the prospect of greater profits and an increase in business activity so that bankers were willing to advance new funds and were able to do so, either because they had previously accumulated excess reserves or were willing to borrow at the Federal Reserve, the operations of the reserve fund by purchase of Governments would provide no check whatsoever to this expansion of bank credit.

In fact it has been argued by some that by purchasing Governments the price of those securities would be kept high with the tendency to provide ease in the money market, thus the general level of interest rates would be kept down, providing an impetus to further expansion of bank credit as the cost of credit to entrepreneurs would be low, thereby increasing the spread between selling prices and costs and consequently increasing the margin of profits.

The reason why the inflationary aspects of the use of unemployment reserves in a period of accumulation is looked upon by many as dangerous is because of the growing lack of confidence in the ability and the willingness of the Federal Reserve authorities to apply sufficient check to credit expansion and to exert control over the speculative use of bank credit. This is a real problem as I have pointed out in previous memos and danger is undoubtedly present under the existing organization of the Reserve system. However, it seems to me that the situation should be reformed directly by changing the set-up of the Federal Reserve System rather than by superimposing an unemployment reserve scheme which attempts incidentally to correct the abuses that now exist in the agency of credit control.

Such a plan of handling reserves has exactly the same effect on securities markets as the customary Treasury operations of retiring bonds which mature or become callable during periods when reserves exceed expenditures. The only difference is that operations in Government securities would be somewhat greater when the unemployment reserve fund is added to the normal Treasury operations.

In a depression period the problem is more difficult. In mild depressions the tendency in the past has been for Governments to strengthen from the levels at which they were quoted in the later stages of the previous boom, with its attendant high interest rates. Thus if the volume of liquidation from the reserve fund's holdings of Governments is not too great there would be no loss or difficulty in selling out securities.

However, if the depression deepens, heavy sales of Governments would tend to have unfortunate aspects. In a time of general deflation of bank credit, declining business activity, and falling prices, to have Government credit weekened unnecessarily is unfortunate because it has repercussions throughout the whole financial and economic system.

If Government securities tumble in price the bond market generally has the tendency to follow suit. With a weak bond market new corporate issues become impractical and refunding is handicapped. Corporations with maturities approaching try to get liquid and to accumulate cash. They lower standards of maintenance and delay necessary repairs. These actions result in decreased employment and purchases which tend to accumulate over the economic system as a whole. Commodity markets feel the effects, contraction of bank credit ensues and a cycle of deflation is engendered. This process continually makes government securities harder to liquidate without severe losses as time goes on.

In order to preserve Government credit and to halt deflation generally it is important to have the close cooperation of the Federal Reserve System. If the Federal puts new funds out by purchasing the bonds that the trustees of the unemployment reserves find it necessary to sell, the price of Governments can be maintained and the unemployment reserve fund will show no appreciable losses.

The funds find their way into commercial banks almost immediately (assuming hoarding of currency and gold exports do not take place) with the result that banking stress is eased and pressure for continued deflation lessened as reserve balances are built up. Again, the fact should be mentioned that early action by the Reserve system is essential before depression psychology sets in and deflation has been carried to such lengths that even large excess reserves do not provide an incentive to new lending by the banks of the country.

<u>Holding the Reserves as Deposits in the Banking System</u>

A suggestion has been made in some quarters that instead of investing the unemployment reserve funds in securities they be placed ~~xxxxxx~~ in the commercial banks of the country as demand deposits. The individuals who advocate this course are generally those who have very little faith in the effectiveness of control measures which might be taken by the Federal Reserve and therefore want to connect a form of monetary and credit management with the handling of unemployment reserves.

The effect of this type of operation is that it would sterilize certain bank deposits at the time when there is likely to be excessive credit expansion, and on the other hand would provide for a shift of funds from inactive to active accounts in a period of depression.

In periods of expanding business activity the payments which the fund trustees receive would be placed in the commercial banks to remain there simply as idle deposit accounts that would not be checked against. These funds have been received from accounts which presumably have been active previously, and would continue to be so if not disturbed. Thus, there would be a decreasing of the velocity of circulation of bank deposits by the operations of the reserve fund and to this extent the incipient boom is undermined. It remains true of course that there can be an expansion of bank credit provided the bank reserves allow it and conditions are favorable. These new funds that are created in the banking system might have a very rapid velocity so that in total amount debits to individual deposits might increase at a rapid rate.

In periods of depression, on the other hand, it is normal to find a slackening in the turnover of bank deposits as many corporations and individuals find themselves without suitable channels to use their money and therefore they simply hold them as idle deposit accounts in the hands of the banks. In such a period the benefit payments from the reserve fund would be increasing, and hence the former sterilized deposits would now become active, as the benefit payments would be made to individuals who would put the funds to use immediately by purchasing necessary goods and services. Of course only one turnover of the funds is all that can be guaranteed, because the funds might then go into the hands of individuals and corporations who would have no pressing use for the funds and in view of depressed conditions would prefer to allow them to remain idle.

This method of simply placing reserves in commercial banks, therefore, does have some merit in tending to stabilize the business cycle. However, it seems to me to be going outside of their proper field of activity for trustees of an unemployment insurance fund to be attempting credit management, even though in this case, there would be no descretionary action on their part as they would simply be following the specific mandates of the legislative branch of the Government. Personally, I am a believer in having one agency held responsible for maintaining sound credit conditions and having absolute control over the credit and monetary base. These powers of management should in no way be confused or hampered by the operations of any unemployment insurance fund.

Placing Unemployment Reserves in the Federal Reserve Banks

A third method of handling unemployment insurance reserves is to have the funds placed as deposits in the Federal Reserve banks by the trustees of the fund. The proponents of such a plan are even more pessimistic about the effectiveness of Reserve authorities in controlling the credit situation than those who advocate the previous plan. They take the attitude that the Federal Reserve system by its very composition finds itself unable to prevent an excessive expansion of bank credit during periods of increasing business activity. Therefore, they propose that in periods when funds are piling up in the unemployment reserves there should be an immediate withdrawal from banks and the funds placed as deposits in the Federal Reserve Banks. Thus, the reserve balances of member banks would be immediately drawn down, and in order to replace them, the banks would either have to contract credit, thereby decreasing deposits and hence the amount of reserves required, or would have to borrow from the Federal Reserve. This situation would mean a tightening of credit, a tightening of money rates and therefore an effective check to further credit expansion.

It may be that contraction at such a time would have too great an effect in checking a desirable increase in legitimate business activity. If this was deemed to be true then the Federal Reserve authorities could counteract the effects of the operations of the unemployment reserve fund by lowering rediscount rates and purchasing Government securities, thus replacing funds in the market and making accommodations cheaper. In other words, it is a reversal of the normal operations of the Federal Reserve Board in controling the situation during a boom period. The view is taken however that the Reserve authorities are too lax in placing checks to unwise credit expansion and therefore it is better to have pressure applied on them to ease conditions in a boom, with the main reliance for keeping market conditions tight placed upon the automatic operations of the unemployment reserve fund.

The reverse situation would appear in a time of depression. As benefit payments from the unemployment reserve fund exceeded current receipts the trustees would simply draw checks upon the Federal Reserve banks, thereby placing funds in the hands of member banks relieving the pressure of liquidation, building up excess reserves, tending to make market rates low, and credit conditions easy. All of which would be desirable in such a period. Furthermore, the funds would be placed immediately in the hands of spenders and thus in addition to there being created an absolute increase in the volume of purchasing power there would be every expectation that this purchasing power would be used immediately in the commodity markets of the country.

While it is true that in a depression period the fund if operated in this way would be very beneficial to business immediately, there is no guarantee that funds would stay in circulation. It is quite possible that the individuals who receive the funds after the first turnover would simply be willing to maintain unused deposit balances in the hands of commercial banks, thereby effectively sterilizing the funds from future circulation. Also, it is not beyond the realm of possibility as definitely shown in the present depression that the mere existence of excessive reserves provides no one incentive for banks to lend when conditions in the business world make the prospect of profits unfavorable.

It is true that this plan of handling unemployment reserves has some merit when we consider that the operations of the Federal Reserve Board have left much to be desired in the past. But this plan goes too far to the other extreme and I would definitely be opposed to it. In the first place, here again the duties of trustees of an unemployment reserve fund are combined with powers for monetary and credit control. I think this is an unwarranted assumption of powers which should only be placed in the hands of an especially designated and qualified body. Even worse in its probable effects is the method which this plan sets up of specifically directing the trustees of the unemployment reserve fund to deposit at the Federal Reserve in a period of increasing business activity. I am not one who argues for a passive attitude on the part of the body charged with credit control and recognize that an unwise expansion of bank credit leads to greater difficulties later on. However, it is important to realize that credit expansion in itself is not an evil. Growing business activity must be supplied with new funds if employment and production are to be maintained. I fear that the automatic drawing down of member bank reserves in such a period would be too severe and that in spite of compensatory action by the Federal Reserve banks, it would check desirable increases of production and business activity. Moreover, there would be too large a shift from week to week of reserve balances and it would be expecting too much of the central banking authority to maintain sound credit conditions when the volume of member bank reserves is shifting at such a rapid and unpredictable rate.

Thus, while the aims of this plan are commendable in that they seek to prevent excessive expansion of bank credit in boom periods and also attempt to prevent serious contraction of credit by automatically forcing funds out into the market and into the hands of spenders in a period of depression, the methods which the plan employs to attain these ends are too drastic and would probably tend to introduce instability into the economic system to a greater degree than the stabilizing influence which they exert. The cure is in effect worse than the disease.