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Chairman Eccles

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Digest of "The Impact of Business requirements on Interest Rates," by The First Boston Corporation, December 13, 1946.

BRIEF SUMMARY

The requirements of full employment without further price inflation are said to include a large expansion of bank credit to private borrowers and consequently a large increase of indebtedness of individuals; a private demand for practically all new funds available to the various investor groups; and consumer expenditures so large that savings out of disposable income (increased by a 20 per cent reduction of individual taxes) would be only half the percentage saved before the war.

With full employment, insurance companies would make small net purchases of Treasury securities obtained from other investors, but no other investor groups would be purchasers. With mild deflation, the only other investors increasing their Treasury holdings would be banks. Banks would hold more, partially because the retirement of publicly held debt would be only 4.5 billion dollars as against 28 billion with full employment. The reduction in the total debt would equal the Treasury surplus, .5 billion with mild deflation and 17.5 billion with full employment.

The retirement of 28 billion dollars of publicly held debt would prove difficult in the absence of the large short-term debt of the Treasury, which thus appears more of an asset than a liability.

Assuming full employment and only slight departures from present Treasury and Federal Reserve refunding and interest rate policy, the interest rates in 1947-1951 will on the average either remain about the same as at present except for a possible rise in the short-term rate, or, with mild deflation, will decrease slightly. If at some time in the period the certificate rate is not allowed to increase slightly or a moderate amount of new medium-term Treasury securities are not issued, interest rates will decline further "than would otherwise be the case."

A decision to raise the ceiling of the certificate rate above 1½ per cent might endanger the entire interest rate structure; and Treasury offer of any substantial amount of long-term bonds would disturb the flow of investment necessary to prosperity.

Treasury campaigns to sell securities to individuals during a virulent inflation are foredoomed to failure. If the inflation is in its formative stage, such campaigns must be limited, because a large absorption of funds would interfere with the necessary flow of savings to productive uses.

While interest rates for the period as a whole should not change substantially, there may be significant variations in the interest rates

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at different times. The current large volume of corporate new money financing, which at present results in a less than average demand for longer-term ineligible $2\frac{1}{2}$ per cent Treasury bonds, is likely to be temporary, for in a prosperous situation business largely finances itself. However, any increase in the market price of $2\frac{1}{2}$ per cent bonds after the interim period of corporate financing also seems likely to be temporary, because the rapid growth in mortgage loans and in consumer paper in the later stages of a prosperous period will absorb institutional and bank funds. With respect to medium term yields, bank investments may at first cause a tendency toward lower yields with possibly a subsequent reversal, since bank earnings are not expected to increase very much until mortgage loans expand further.

Banks may have an excessive amount of liquidity over the next few years. However, bank management is essentially conservative, so that even rapidly rising liquidity ratios should not lead to material purchases of longer-term securities if, as expected, commercial bank earnings permit increased dividend payments and additions to capital accounts. Bank earnings on Treasury securities should be at an average rate of 1.3 per cent, and amount to 25 to 30 per cent of total operating earnings.

Comment

The most striking conclusions germane to the determination of current Federal Reserve and Treasury policy are that within narrow limits banks will not attempt to increase their holdings of longer-term U. S. securities and that the present supply of long-term U. S. securities is adequate to meet the needs of institutional investors. These conclusions stem from the belief that at high levels of employment other outlets will maintain bank earnings and almost completely absorb institutional funds, so that the probability of a mild decrease in interest rates, greatly increased liquidity of banks, and shortening of Treasury maturities held by institutional investors is of no great concern. The conclusions might well be different were more than mild deflation to be assumed; and in any event there is a question whether the analysis does not rely too heavily upon private financing to insulate the U. S. security market.

Among the conditions assumed necessary for full employment during the next five years are (1) the stimulation of investment at all times to the fullest extent possible and (2) constant expansion of bank credit. These conditions sooner or later create an imbalance between productive facilities and consumer demands and bring on a situation in which individuals may not be able to repay loans out of reduced savings. The picture is probably realistic but is depressing for, as the analysis recognizes, the necessary conditions for full employment also lead to eventual depression or else to replacement of private deficit financing by Government deficit financing.

The assumption that nearly full employment can be maintained in the manner indicated without further price inflation is less realistic. Prevention of further price increases while maintaining full employment at the present price level assumes an unrealistic sensitivity of control.

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It probably is true that in our economy there can be no sharp cut in present inflated prices and profits without inducing excessive unemployment.

Many economists are very much concerned with the problems of inflation created by full employment. The unprecedented amounts of materials and capital investments required to fully employ a labor force already 30 per cent greater than prewar at an output per worker already 20 per cent greater than prewar could easily result in shortages and the danger of excessive price increases if funds in active use are too large or improperly channeled. On the other hand, there is the danger that a depression might be initiated if insufficient active funds are provided to do the job (the line taken by the First Boston, among others). The latter seems less likely at the moment because of the large volume of liquid savings of individuals and corporate reserves and retained earnings carried over from the war period and because of the large portion of the managed debt held by banks. Nevertheless, large and increasing funds in active use would be required to finance the large expansion of production with full employment and the steadily lengthening production and distribution process at inflated values.

A more detailed summary is attached.

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