Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 5, 1942

To Chairman Eccles

From Martin Krost

Subject: Proposed Statement to the Director of Economic Stabilization

Mr. Thurston just mentioned to me by telephone that you wanted to submit a statement of economic policy to the Director of Economic Stabilization within the next week or ten days. During your absence we attempted to draft such a statement embodying the ideas you had expressed to me before you left. I should be glad to send it to you if you are interested in seeing it.

MK

Suggested Instructions File

10/29/42

MEMORANDUM

To - The Director of the Office of Economic Stabilization

From - M. S. Eccles, Chairman, Board of Governors of the Federal Reserve System

(In response to the Director's request for a statement of the part played by each department or agency in the total stabilization program.)

The role of the Federal Reserve System in the present and prospective economic picture has to be viewed against the broad background of the entire economic front. The present outlook is alarming. We are losing all along this front. Only immediate and drastic action can avert disastrous consequences. Compared with our allies, notably England and Canada, or with our chief enemy, Germany, our defenses against inflationary dangers are feeble and crumbling.

We are spending more than $200 millions every day--92 per cent of it for war purposes. This is at the rate of 6 billions a month, and this is to be stepped up to 6-1/2 to 7 billions a month. Our gross national product--everything turned out by our farms, mines, factories, including services--will aggregate some $175 billions in the coming year. Not more than 70 billions of this will be available for civilian consumption. Yet, after paying taxes, the public will have available some 130 billions which could be spent for this 70 billions of goods, or 60 billions more than their worth. Unless this surplus potential spending power is drained off the markets through taxation and all forms of savings, price stabilization is doomed. Price fixing cannot hold indefinitely against such pressures.

At the present rate of progression our national debt will exceed $200 billions by December 1944, even at present price levels. At the rate we are going, about half of this increase will be represented by newly created bank funds, just as if we had turned out that much money by the printing press. Instead of financing the war by adequate taxing and borrowing from current income, that is, by utilizing effectively our existing money supply, we have been following the easy and ruinous path of going to the banks for new supplies.

Faced with the necessity of furnishing the banks with the reserves needed to finance the purchase of so large a part of the public debt, the Federal Reserve System has no choice but to be an instrument of vast inflationary potentiality. It has no powers to halt the march toward ultimate banking and credit collapse. Far from being a stabilizing influence, it is being driven by the necessities of the hour in the opposite direction. It cannot, therefore, survey its part in the economic picture for the purposes of this or any other realistic report without emphasizing as vividly as possible the dilemma in which it finds itself.

The only escape can come through adequate taxing and borrowing programs that will reduce to a minimum reliance upon creating new money to finance the war. Of the $200 millions a day which we are spending, only about one-quarter of it is being raised in taxation, while two-thirds of it is being borrowed, and of the two-thirds which is borrowed we are getting only about one-half of it from nonbank sources. The rest comes from what is the equivalent of turning the printing presses to create new money--and this notwithstanding the fact that our money supply is already large compared to that of Great Britain or Canada.

In both those countries more than half of the government expenditures

is being met by taxation, as compared with one-fourth in this country. As to borrowings, both Canada and Great Britain are getting two-thirds outside of the banking system and only one-third through the money-creating process of selling sedurities to the banks, whereas, we are borrowing approximately two-thirds from the banks and getting only one-third by anti-inflationary borrowing. In other words, both of these allies are doing twice as well as we are on the taxation front and three times as well in avoiding inflationary borrowing.

According to the Budget Bureau estimates of October 7 covering the fiscal year 1942-43, our expenditures will rise to $80 billions, of which we will collect only one-fourth in taxes, leaving nearly 60 billions to be borrowed. At the rate we have been going, about 40 billions of it will come from the banks, which means piling that much new money on top of what we already have, so that our total supply of demand deposits and currency will amount to close to $100 billions. That is almost double what we had when we entered the war. And if this swollen money supply should turn over at the rate of the existing supply has been turning over in the early part of this year, it would mean that our national income would skyrocket to some 260 billions by December of 1944 or nearly 100 billions more than the nation can produce in physical volume at present prices. There is no way in which the Reserve System can control that money supply now or in the future and, obviously, the greater it grows the more dangerous and unmanageable it becomes.

The banks should be the last resort and not a primary source of funds. Compulsory savings coupled with a pay-as-you-go plan and withholding

at the source should be our first reliance and voluntary savings secondary. While the new revenue act is a decided improvement, it still falls far short of the goals that we must reach. Instead of collecting merely 5 per cent, representing the victory tax, at the source, all or a large part of the income tax should be collected at the source before it gets into the spending stream and has an inflationary effect. Moreover, this would bring the money currently into the Treasury and avoid wholesale evasions and defaults. In addition, we urgently need the type of enforced savings that will take these funds definitely out of the spending stream until such time after the war as they can be put back into the spending stream without inflationary consequences. As it is, the billions which we are now seeking to channel into voluntary savings can be converted into cash virtually overnight to swell the rising tide of purchasing power.

Against this background as outlined above, the Reserve System is helpless except insofar as it is able to influence indirectly the shaping of policies on the fiscal and financial front that will minimize the resort to inflationary financing methods, and insofar as it can, through its direct controls over consumer credit and stock market margins, exert direct pressures on specific segments of the economy. In addition, the System, through its examiners, is discouraging the granting by banks of unnecessary loans, such as, for example, loans for the accumulation of excessive inventories and for speculative purposes. Through Regulation V, covering war production loans by the banking system under guarantees of the armed services and Maritime Commission,

the country's productive capacity is more fully utilized.

In summation, recognizing the responsibility which the Reserve System has under the law and in the public mind for contributing to economic stability, but one conclusion can be reached for the purposes of this memorandum, namely, that measures and policies beyond the System's authority and scope will have to be developed and applied promptly to avert the disastrous economic consequences of financing methods to which the necessities of the war and not the dictates of prudent finance compel the System to resort.

ET:b
10/29/42