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Monthly Letter on
Economic Conditions
Government Finance

New York, December, 1947

General Business Conditions

THE proposals for combatting inflation, made by President Truman in his message to Congress November 17, have opened a debate of momentous importance for the business outlook in this country. After asking Congress to provide interim aid promptly for France, Italy and Austria, and promising recommendations shortly for the long-range European recovery program, Mr. Truman turned to the "alarming degree of inflation," and devoted the bulk of his message to the situation and requests for new legislative action. He noted the high levels of farm and industrial production, but pointed to the rise in prices and the cost of living, which he described as inviting catastrophe. He suggested three types of measures to deal with the problem: one, to relieve monetary pressures; two, to channel scarce goods into the most essential uses; three, to deal directly with specific high prices.

Within these categories Mr. Truman made ten specific proposals. The first was to restore consumer credit controls, and "to restrain the creation of inflationary bank credit". However, the President offered no program to accomplish the latter purpose; and when Chairman Eccles of the Federal Reserve Board brought forth a proposal Secretary of the Treasury Snyder promptly announced that he was against it, which leaves Administration policy in the dark. Mr. Truman went on to ask for authority to regulate speculative trading on the commodity exchanges. He requested extension and strengthening of export controls, of rent controls and of power to allocate transportation facilities and scarce commodities, including control over inventories of the latter. He asked additional authority for the Department of Agriculture, not spelled out in detail but designed to save grain in animal feeding and to help increase production of food in foreign countries.

Finally, in the most important and controversial of his proposals, he asked Congress to authorize selective consumer rationing on products in short supply which basically affect the cost of living, selective price ceilings on products in short supply which basically affect the cost of living or industrial production, and such wage ceilings as are essential to maintain the price ceilings.

Causes and Symptoms of Inflation

There is no dispute as to the existence of inflation and the danger to the economy, but there is endless disagreement as to what should be done about it. The fundamental question raised by the President's suggestions is whether the country is to attack inflation by dealing with its causes, or by attempting to suppress its symptoms. If the former, many things will have to be done upon which the message did not touch. If the latter, the pressures which are pushing up prices will not be abated, but only diverted from some areas into others.

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Of President Truman's proposals only the first – relating to the credit situation – is aimed at causes. We discuss the banking situation and the proposal to restrain inflationary bank credit in an article on a later page of this Letter. What concerns us here is the fact that the President did not improve the occasion to discuss other causes of inflation. He did not mention the fiscal and monetary policies of the Government, an omission which may leave the impression that there is no call to do anything in those fields. But the Government is not only by far the greatest spender in the country. It is also a lender and guarantor of loans by others on an enormous scale. These loans and guarantees have contributed steadily to the credit inflation.

Federal tax policy restricts saving and discourages accumulation of capital; the end result, in a time of immense need for capital, is greater use of bank credit. Moreover, Treasury policy, and the Treasury view of what Federal Reserve policy should be, have been major obstacles to the earlier exercise of existing powers to discourage credit expansion. Subsidies, soldiers' bonuses, and support of certain farm prices have helped keep the inflation rolling. An effective program, going to the roots of the problem, would have to consider all these aspects.

Mr. Eccles's Analysis

Mr. Marriner S. Eccles, chairman of the Federal Reserve Board, in a statement before the Joint Committee on the Economic Report November 25, presented a more comprehensive analysis of the causes of inflation and ways to deal with them. Mr. Eccles called for decreased government spending, with as big a budget surplus as possible, and in general adoption of an anti-inflationary fiscal policy. Particularly he called for stricter appraisals and less liberal credit terms under the Veterans Administration, the Federal Housing Administration and the Home Loan Bank programs of housing finance. He testified that the easy terms available on housing loans constitute "possibly the most inflationary factor in the present situation", and said that Congress should reconsider the entire program.

This statement may cause many people to consider Mr. Eccles indifferent to the needs of veterans and others for housing. But to point out the part played by housing credit in inflation is neither discriminatory nor a sign of callousness. It is only giving one of the important inflationary influences the recognition due it. What is brought out by the statement is that easy terms on housing loans are expanding them to an unsound extent, creating demand for materials and labor beyond the country's capacity to supply, driving housing costs and prices upward, and leaving purchasers with thin equities in their property. Mr. Eccles expects a wave of foreclosures to follow.

The contribution to "boom and bust" is apparent. In carrying out even socially desirable programs, the cost has to be considered at some point, and costs are doubly excessive when not only housing programs but public and private expenditures of almost every kind are contributing to inflation. The families who need housing may think their needs are paramount, but they also have an interest along with everyone else in sound finance and in economic stability. They will be among the greatest sufferers if the bubble is blown larger and then bursts.

Wage and Productivity Factors

An anti-inflation program which deals with causes must also take account of the power of government to influence the policies of people through example and leadership. Mr. Eccles took the occasion to make proposals outside the field of money and credit. He said, "Nothing could be more effective than increased productivity of labor and longer hours of work by everyone." He asked business to hold the price line. He called for suspension of future demands for wage increases. In this he went beyond President Truman, who in his message asked for power to control wages as an adjunct to price controls, and when essential to maintain necessary price ceilings.

A proposal to suspend wage increases is a far cry from past government pronouncements on wages, going back to Mr. Truman's radio address and executive order of October 30, 1945. In that address, made when his economic advisers were predicting that deflation and unemployment would follow the curtailment of war spending, he said, "Wage increases are therefore imperative – to cushion the shock to our workers, to sustain adequate purchasing power and to raise the national income."

The history of the government intervention in wage negotiations which followed is too lengthy for repetition. But the record is clear that the effect was to extend and enlarge the wage increases. Costs and prices were forced up, in the familiar inflation spiral. Higher costs and prices required business to borrow more from banks, expanding the money supply. What Mr. Eccles now asks is that further extension of this spiral be avoided, and that costs be brought down by greater productivity.

Mr. Eccles deserves great credit for his courage, as a public official, in stressing so many po-

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litically unpalatable, although fundamental, aspects of the inflation problem. It is idle to expect that inflation can be checked and stability established without dealing with causes and cutting off the pressure on prices at its source.

The Place of Speculation

President Truman's request for the regulation of speculation on the commodity exchanges, which is point number two on his program, implies a belief that such speculation, in the grain markets especially, has been a significant factor in the inflation.

Commodity speculation on the organized exchanges is recognized by society and by the law as serving an economic function, in which respect it differs from gambling. The late Justice Holmes in a famous dictum once described speculation as the "self-adjustment of society to the probable". One way in which this adjustment comes about is that speculators looking forward may cause price movements to occur earlier than otherwise, with resulting earlier effect on production and consumption. Speculators exaggerate price movements, but in the long run their influence cancels out because every buyer in due course must be a seller.

If speculators this year are assailed for causing the rise in wheat to occur earlier than it might otherwise have done, they may as an offset claim credit for encouraging economy in the use of wheat, particularly as feed for animals, earlier than it would otherwise have appeared. No effective device for restricting the feeding of wheat except a high price relative to the price of the animal and of other foods has been discovered. This observation bears also on another of President Truman's points, namely, to "authorize measures which will induce the marketing of livestock and poultry at weights and grades that represent the most efficient utilization of grain". Secretary of Agriculture Anderson was questioned about this at hearings before the Joint Committee, and he stated that in his considered judgment the way to halt the fattening of livestock is to let grain prices find the level where feeders are priced out of the grain markets sufficiently to reduce slaughter weights.

Allocations and Controls

Three of President Truman's proposals, having to do with allocation of transportation and scarce commodities and with export controls, may be described as intended to ameliorate the effects of excessive demand by asserting priorities for certain urgent needs. The Harriman Committee, which examined the requirements for the European recovery program, recommended the extension of export controls and of power to allocate transportation. The Administration now has both powers, but they expire February 29, 1948. Probably the recommendations for their renewal will have wider support than almost any of the President's other proposals.

There are good arguments both for and against commodity allocations. People accept the need to establish priority when there is congestion, and a few commodities are still under allocation, carrying over from wartime. However, allocations of scarce materials proved extremely difficult to design and administer during the war, when they were vitally necessary, and might be even more difficult to operate on any considerable scale now. On the other hand, allocations by the industries themselves, while imperfect, have not worked badly, even without the degree of cooperation which an arbiter like Secretary Harriman, for example, could doubtless obtain.

Price Controls and Rationing

The President's request for power to restore price control on a selective basis is based on the statement that it may be necessary "to check adverse forces at particular trouble spots" and "to enable us to stamp out profiteering and speculation". Rationing would be for protection against "unfair distribution".

It may be enlightening for those who are persuaded that rationing and price control are now good, although only one year ago they were considered bad even by President Truman himself, to examine the table which follows. This table shows in the first column the OPA ceiling prices of various foods at retail in New York City in the Summer of 1946, and in the second column a report on black market prices, also in New York, compiled and published regularly by the New York Sun at the same time. The third column is the current retail price, as reported by the City Department of Markets, November 26, 1947. We do not suppose the Sun would claim absolute accuracy for its report, since black market sellers

		N. Y. Sun's Figures		Dept. of
		OPA Ceiling	Black Market Price Range	Markets for week ended Nov. 26, 1947
Butter	Pound	$.67	$.95	$.85– .97
Sirloin steak	"	$.40–.46	$.95–1.25	.69–1.00
Rib roast of beef	"	.32–.36	.90–1.10	.59– .85
Leg of lamb	"	.38–.45	.90–1.10	.55– .69
Pork chops	"	.31–.40	.85– .90	.63– .79
Loin of pork	"	.33–.36	.80–1.00	.53– .69
Whole smoked ham	"	.35	1.00	.53– .65
Sliced bacon	"	.42–.43	.75–1.00	.82–1.00
Roasting chicken	"	.51	.65– .80	.49– .65
Fowl	"	.44	.60– .70	.37– .53
Eggs, large, grade A	doz.	.55	none	.75– .97
Apples (table)	pound	.13½–.14½	"	.08– .21
Snap beans	"	.17–.19	"	.19– .39
Lemons	"	.10–.13½	"	.10– .19
California oranges	"	.11–.14	"	.09– .15
Bananas	"	.10–.12	"	.13– .19
Amer. cheddar cheese	"	.43–.48	.60– .65	.49– .69

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asked widely varying prices, but we have checked the figures with people familiar with conditions at that time and are convinced that they are substantially representative. It will be seen that in most of the meats, where important black markets existed, current prices are below rather than above the black market prices and generally by a substantial margin.

This table should refresh memories as to the conditions which existed in the last months of the OPA. Only a part of the meat supply, of course, was sold at the black market prices listed, but it was a large enough part to make the OPA ceilings thoroughly nominal and unrepresentative. Moreover, according to studies made at the time, even meat sold nominally at the ceilings through regular channels was actually costing the consumer 15 to 30 per cent above ceilings due to misrepresentation of quality, refusal to trim normally, etc. The price paid did not cover the full cost of the meat to the consumer, since as a taxpayer he supplied a subsidy averaging around 5c a pound. Finally, the majority of people, who never patronized or saw a black market, did not get much meat.

These figures, so far as they go, supply evidence that the purported 40 per cent increase in retail food prices since the middle of 1946 – referred to by President Truman – is a thoroughly unrealistic calculation. They also provide a reminder of conditions which existed previously under controls, and which would doubtless exist again. Black markets were not the only evils under price control and rationing. Price differences between various markets resulted in diversion of supplies, and valuable products were wasted in black market slaughtering. The law-abiding people were the sufferers from the inevitable inequities.

President Truman said November 9, 1946, in directing the abandonment of controls over wages and prices, "I am convinced that the time has come when these controls can serve no useful purpose. I am indeed convinced that their continuance would do the nation's economy more harm than good." Admitting that prices of some commodities still in relatively short supply would rise sharply when controls were removed, he made this statement: "The law of supply and demand operating in the market place will from now on serve the people better than would continued regulation of prices by the Government."

It is difficult to believe that, having been ended in effect by the people themselves, the system if restored now would work any better than it did then. Even selective price controls would do nothing to weaken the inflationary pressures themselves but could only try to bottle them up. The pressures could be expected to break out in other directions – partly in pushing up prices of alternative foods or other goods, and undoubtedly to a great extent in black markets, the profits of which would go to violators of the law. Reestablishment of the vast organization needed to administer and enforce a new OPA, even of limited powers, can be looked upon only with dread.

Controlling Bank Credit

The President, in proposing various lines of attack on inflation to the special session of Congress, suggested that "some restraint should be placed on inflationary bank credit," although he did not specify – beyond a recommendation that consumer credit controls be reinstated – what means should be chosen.

The first step in this direction was taken a week later when bank supervisory authorities, in a joint statement urging banks to exercise "extreme caution" in their lending policies, spelled out the thought the President may have had in mind. Excerpts from this statement follow:

> Our country is experiencing a boom of dangerous proportions. The volume of bank credit has been greatly inflated in response to the needs for financing the war effort. Domestic and foreign demands for goods and services are exerting a strong upward pressure on prices in spite of the high volume of our physical production.
>
> The demands would be inflationary without any further increase in the use of bank credit, but the demand is being steadily increased through continued rapid expansion in bank loans, in addition to other factors outside the control of the banking system.
>
> The Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Executive Committee of the National Association of Supervisors of State Banks are unanimously of the view that present conditions require the bankers of the country to exercise extreme caution in their lending policies. It is at times such as these that bad loans are made and future losses become inevitable.
>
> It is recognized that a continued flow of bank credit is necessary for the production and distribution of goods and services. The banks of the country have adequately met this important need in the reconversion period.
>
> Under existing conditions, however, the banks should curtail all loans either to individuals or businesses for speculation in real estate, commodities or securities. They should guard against the over-extension of consumer credit and should not relax the terms of instalment financing.
>
> As far as possible extension of bank credit under existing conditions should be confined to financing that will help production rather than merely increase consumer demand.

These are all words of sound advice and they deserve careful attention not only by the banks

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subject to the supervision of the authorities sponsoring the statement, but also by lending institutions generally. All the banks of the country which are members of the Federal Deposit Insurance Corporation, and that means 13,400 out of 14,000, are examined thoroughly once or twice a year by Federal examiners who are thus in a position to warn the directors of each bank of any unsafe or speculative loans or investments they find. If these examiners and the management of the banks have in mind the danger set forth in the foregoing statement it will be helpful towards avoiding the boom-bust pattern which this country has so often experienced.

The problem of credit inflation, however, goes beyond this. It is the main responsibility of bank management and bank examiners to see that banks make only *good* loans, that will be repaid. Even if all loans are good there could still be overexpansion of credit which would be inflationary.

It was to this broader problem that Secretary of the Treasury Snyder and Chairman Eccles of the Federal Reserve System have addressed themselves in recent appearances before Congressional committees.

Mr. Eccles's Views

Testifying before a Joint Congressional Committee November 25, Chairman Eccles of the Board of Governors of the Federal Reserve System disclosed his views as to how the battle against high prices should be waged. "At best", he said, "monetary and credit policy can have only a supplemental influence in any effective treatment of either inflation or deflation". Citing "war financing and the enormous Federal deficits" as "the source of the present inflation", he stated that "we are suffering the consequences today of an excessively swollen money supply which neither the bankers individually nor government authorities have adequate means at present of controlling". The economy thus is "caught in a dangerous wage-price-profit-credit spiral, acutely intensified by short farm crops abroad, and reduced corn and cotton crops at home". Mr. Eccles's suggestions for dealing with the causes of inflation other than credit are discussed earlier in this Letter.

New Powers Recommended

In his statement to the Congressional committee Mr. Eccles went on to describe how the Federal Reserve open market operations add to or take away bank reserves and thus can be used to restrain bank credit expansion. These operations, however, he explained, affect the Government's cost of borrowing, since the Government must compete for available funds with other borrowers.

He then brought out, for the renewed consideration of Congress, a plan whereby the Federal Reserve System might be authorized to impose a second set of reserve requirements, on top of those now in force, for the nation's banks. He felt that this scheme, a modified version of the "certificate reserve" proposal, would "divorce the market for private debt from the market for government securities."

Some of the pitfalls in this proposal, which was one among three requests for additional powers contained in the Board of Governors' Annual Report for 1945, were discussed in the July, 1946 issue of this bank's Monthly Letter. In the present version, banks would be required to hold cash or short-term government securities of up to 25 per cent against demand deposits and up to 10 per cent against time or savings deposits. These "special reserves" would be separate from the regular reserves of 14 or 20 per cent (depending on the location of the bank) against demand deposits and 6 per cent against time or savings deposits. The regular or primary reserve requirement (which applies to all member banks of the Federal Reserve System) is met by carrying the amounts stipulated by law on deposit with the Federal Reserve Banks. The proposed special or secondary reserve requirement (which would apply to nonmember commercial banks as well as to the members) could be carried (1) in short-term government securities; (2) as additional deposits with the Federal Reserve Banks; (3) as cash in the bank's own vault; or (4) on deposit with correspondent banks.

Need for New Powers Questioned

Secretary of the Treasury Snyder, testifying before the House Banking and Currency Committee, stated that he was "not in agreement" with the Federal Reserve Board proposal for secondary reserve requirements. Mr. Snyder felt that the measures being taken, under existing powers, to retire bank-held government securities and tighten up the credit supply are proving effective. Primarily he advocated a continuation of recent policies, plus the revival of Federal Reserve Board control over instalment buying and intensification of the Savings Bond sales program. Mr. Snyder expressed the view that consumer credit is "the most important single form" of credit extension now contributing to inflationary pressures. At the same time he disclosed that the Treasury has been studying means of "sterilizing" imports of foreign gold as an anti-inflation measure.

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On the matter of the "special" reserve requirement proposal, Secretary Snyder was blunt and to the point. "I am against it," he said, "because I don't think it will achieve the ends he (Mr. Eccles) expects." And again, later, "You have got to carefully guard against taking any action that will have a worse effect in another field— (public) debt management." Additional grounds for objection were forcefully stated in a memorandum to the Federal Reserve Board from the Federal Advisory Council, a group of leading bankers from each of the twelve Federal Reserve Districts who serve in an advisory capacity to the Reserve Board. Stating its unanimous opposition to the scheme, the Council gave the following reasons:

1. It is impractical. The operations of banks are so different, reflecting as they do adaptation to the varying needs of their communities and customers, that no percentage of short-term government security holdings can be applied fairly or practically to all banks. Any percentage high enough to offer any measure of restraint on a substantial number of banks will have disastrous effects on many other banks, compelling them to liquidate sound and necessary loans and thus actually check production. The very banks which have served the business in their communities most aggressively and helpfully would be hardest hit.
2. Such a plan would substitute the edicts of a board in Washington for the judgments of the boards of directors of 14,000 banks throughout the country as to the employment of a substantial part of the funds of their banks. This is a step towards socialization of banking.
3. As indicated earlier, the Federal Reserve System and the Treasury already possess large powers of credit control not now being fully used. Such new powers as those proposed are not necessary.

The Council took the view that "the causes of our present inflation are not in current banking policies but are found in the great wartime expansion of buying power together with unusual events and public policies since that time". Among recent inflationary causes the Council listed (1) the foreign aid program, (2) a cycle of wage increases in excess of increases in either the cost of living or productivity, (3) a shorter work week, (4) a short corn crop, (5) veterans' bonuses and relief payments, (6) agricultural price subsidies, (7) U. S. Government spending of 36 billion dollars a year, and (8) housing subsidies.

In bank loans themselves, the Council stated that it found: "... nothing to suggest that growth of loans has been an active inflationary factor. It rather appears to have been a reflection of the very high level of business activity and high prices". The dangers in the present situation, the Council indicated, are understood by bankers. "There is hardly a bank in the country which has not been warning its customers against overexpansion."

The Federal Advisory Council's memorandum dealt also with government policies that directly encourage bank credit expansion:

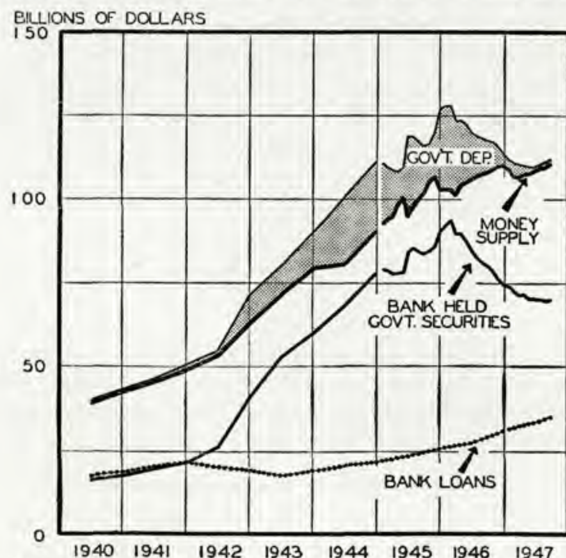
For example, an increase of nearly 4 billion dollars in the real estate loans by insured banks since the end of the war reflects directly the purchase of FHA and GI mortgages in the housing program.

The Reconstruction Finance Corporation is encouraging bank lending by guaranteeing risky loans . . .

In this period the Government, through various agencies, has been making loans that the banks refrained from making because of their speculative nature. The Reserve System itself is asking for more power to guarantee loans on the presumption that bank lending is too cautious.

Some Facts About Bank Credit

In appraising the responsibility of bank lending for the inflationary situation, it is necessary to take a look at the facts of bank credit expansion. Changes in bank credit outstanding, together with changes in the national gold stock, sum up into changes in the "money supply"— currency holdings and checking account deposits. The money supply is a barometer of spending power in the hands of the public. As the accompanying chart brings out, the expansion in bank loans, while steady, accounts for only a minor part of the rise in the money supply. The main factor is the vast amount of government securities pumped into the Federal Reserve and commercial banks to help finance the war. We are still feeling the effects of the great amounts of



COMMERCIAL BANK CREDIT AND THE MONEY SUPPLY. (Semi-annual plottings June 1940 - December 1944; monthly plottings January 1945 - September 1947, except for Bank Loans which are plotted on call dates through December 1946 with monthly estimates from January - September 1947.) Sources: Bank-held Govt. Securities — Treasury Department estimates. Bank Loans, Money Supply, and Govt. Deposits — Federal Reserve figures. Money Supply represents demand deposits adjusted held by the public plus currency outside banks.

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money poured out during the war which people could not spend because the goods were not available to buy. Now the goods are available and people are bidding against each other for them, and not infrequently also against the government procurement agencies.

Commercial bank holdings of government securities declined sharply last year, as the chart shows, by the use of excess cash balances accumulated by the Treasury in the Victory Loan drive to redeem debt. The money supply in the hands of the public was somewhat increased, as a part of the government securities redeemed were held by the public. Bank-held Governments and the money supply were brought down together early this year when heavy surplus revenues were applied to retirement of bank-held debt. The same thing presumably will happen in the big tax collection months early next year. Meanwhile, with the rise in bank loans and dollars realized by foreigners through the sale of gold, the money supply is back up to or a little beyond the $110 billion postwar peak of last December.

But, if we take seasonal influences into account, the major significance of the money supply line is that it has been holding relatively even when it should have been going down.

Composition of Bank Loans

Secondly, before venturing to "crack down" on bank lending it is essential to look into the composition of bank loans and examine the changes. The following table gives the main loan and investment items, as well as deposit data, for banks in leading cities which report their figures to the Reserve Banks every week. During the war many of the loans were against government securities. These were cut about an even billion in the year ended November 19. Loans for financing speculation in stocks, tightly regulated, have not been an important factor in the credit picture for a number of years. A good part of the reduced security loan figure represents loans to carry new securities in process of distribution.

Selected Balance Sheet Items, Weekly Reporting Member Banks in Leading Cities

(In Billions of Dollars)

ASSETS	Nov. 19, 1947	Change since Nov. 20, 1946
Total loans	22.9	+3.7
Commercial, industrial and agricultural loans	*14.2*	*+3.0*
Security loans	*1.8*	*—1.1*
Real estate loans	*3.4*	*+1.0*
Other loans	*3.5*	*+ .8*
U. S. Government securities	37.8	—5.3
Other securities	4.2	+ .3
Total loans and investments	64.9	—1.8
LIABILITIES		
Demand deposits adjusted	47.6	+1.2
Time deposits except Government	14.5	+ .6
U. S. Government deposits	1.1	—2.7

On the other hand, banks have returned to their prewar business of granting commercial loans. These loans, classified in the official statistics as "commercial, industrial and agricultural," are showing their accustomed responses to seasonal influences, for example as crops come to market. At the same time, there is a rise over the corresponding period of a year ago of $3 billion. The explanation for this is primarily the substantial increases in wages and material prices which add to the working capital requirements of business. These must be met to keep production flowing.

Real estate loans are expanding, with the encouragement of Federal Housing Administration guarantees, providing money principally for home and apartment building. The category of "other loans" has been expanding with the much ncreased availability of classes of merchandise which many customers are accustomed to finance on the instalment plan.

Points of Agreement

The uncompromising exception taken by the Federal Advisory Council to Mr. Eccles's proposal for new powers, and variations of emphasis on other points, should not be allowed to obscure the important areas of agreement:

1. The basic cause of current inflationary pressures goes back to war finance and lies primarily outside of the area of recent banking developments.
2. Government expenditures are too high and should be pared down.
3. Government credit-insuring agencies are importantly contributing to inflationary pressures by encouraging unhealthy credit expansion in the field of housing, primarily to aid veterans.
4. To a large extent expansion in bank lending has been necessary to supply working capital needed by business to maintain or increase production at rising prices.
5. Existing Federal Reserve powers have been used to good effect.

The real questions arise concerning the further use of existing powers for braking bank credit expansion as the need appears. No one questions the fact that the Federal Reserve System has an abundance of power, with $22 billion government securities held in the Federal Reserve Banks. By selling some of these securities, and by discount rate changes, The Federal Reserve can put any degree of pressure it wishes on bank reserve positions. It can sterilize the inflationary effect of the gold influx.

Interest Cost Considerations

The objection generally given to the proposal that the Federal Reserve System might use its existing powers with greater vigor is that rates

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of interest might rise sharply and greatly increase the cost of servicing the public debt. It is natural that the Secretary of the Treasury should be concerned with rates of interest, for while the rates are contractually set for long periods of years in the case of big blocks of long-term debt, currently maturing obligations can be paid off only in part out of surplus revenues so that there are continuing problems of refunding debt. It is also natural and desirable that the Federal Reserve System should assist him in making these large operations go off smoothly. The taxpayers' concern in the matter is divided; cheap money may save him a few dollars in taxes but cost him far more than that in terms of lost purchasing power for his savings and pension rights. For the country as a whole, it can be a penny-wise, pound-foolish proposition.

The Secretary of the Treasury has not allowed cheap borrowing to distract his attention from the wisdom of placing as much of the debt as widely as possible in the hands of the people where it can serve as an attractive medium for current saving as well as a resource for personal emergency. In Congressional hearings November 25 Secretary Snyder asked additional appropriations for a huge peacetime campaign to sell Savings bonds. The Savings bonds are the most expensive securities, interest-rate-wise, that have been offered to the public in recent years, but there is general agreement that the results fully justify the cost.

The permitted rise in short-term interest rates since June presumably has already added something to the cost of carrying the public debt although the net amount must be quite negligible when account is taken of the special 90 per cent tax on Federal Reserve Bank earnings, and the high corporate and individual income tax rates. The retirement of debt, which has included some old bond issues carrying relatively high interest coupons, of course, works to reduce interest costs.

Effectiveness of Recent Policies

The surprising thing is that, in spite of easy access to additional Federal Reserve credit, the rise in private debt has been as restrained as it has. The retirement of large amounts of the short-term government debt, most notably last year, has kept the banks under some pressure. The lowering of price supports for short-term governments — the "defrosting" operation begun in July — has helped by reestablishing the market outside the banks for Treasury bills. Direct redemptions by the Treasury of government securities held in the Federal Reserve portfolio have helped. By one device or another the Federal Reserve's holdings of government securities are now running $1¼ billion under the level of a year ago. This is, under the circumstances, a noteworthy achievement.

The authorities have shown considerable versatility in approach. They have injected uncertainties into the money markets, uncertainties which reenforce the banker's caution. They have displayed greater courage and determination in dealing with the situation than many observers had expected. Not least of their accomplishments has been the breaking of the dangerous boom in long-term bond prices. Meanwhile, the loan expansion itself has filled out the loan programs of a number of institutions so that they are proceeding with increased caution.

The only limitation that exists on the further use of present powers rests on concern for the inevitable impacts on the government security market. The more tender the concern for government security prices, the more restrained use of these powers can be. The purpose of the secondary reserve requirement scheme is to freeze large amounts of low-yielding government securities in the hands of the banks so that they cannot sell them to meet loan demands.

A Dangerous Principle

This is a new and dangerous principle to introduce into the financing of the Government — of placing the citizens of the country under legal compulsion to buy its bonds. Heretofore one of the greatest protections against unsound fiscal policies in any country has been the need for selling its obligations. Compulsion has been used only by the police states. Under compulsion the Treasury could sell its securities at any rate or on any terms it wishes.

At the same time, the principle of compelling banks to hold government debt is diametrically opposite to the efforts made by the Government, during and since the war, to shift as much of the debt as possible outside the banks. Securities held by the banks cannot command a market outside the banks if they are securities whose yields are not attractive to outside investors, or, more to the point, if banks are *compelled* to retain them.

Moreover, the assumption is that the Federal Reserve Banks would themselves stand ready to take over government securities now held outside the banking system, including those held by other types of credit-granting institutions. Thus it is questionable whether Mr. Eccles really goes to the root source of the creation of money and credit. That root source is Federal Reserve credit.

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Conclusion

There is a captivating charm about controls, especially those that are new and different. It is always possible to entertain the illusion that here at last is something that may be technical perfection. A new kind of control, by definition, is one that has never failed. Also it is one that has never succeeded. The old controls, which regulate the base of the whole credit pyramid, have records of failure as they have of triumph. But these very records of experience provide the guide to go by.

The Bond Market

The downward adjustment in bond prices continued into November, bringing the increases in yields since August up to at least one-quarter per cent on corporate and municipal obligations generally. At the end of the month most sections of the market were on a steadier keel.

Increases in yields on Federal Government long-term securities over this period have averaged about one-eighth per cent. This was enough, however, to cause some concern. Many banks saw their government accounts turn from black to red. Official buying beginning around the middle of the month, when the restricted 2½ per cent bonds sold in the Victory Loan drive reached 101, steadied the entire restricted list. Treasury bonds unrestricted as to ownership, such as the various War Loan drive 2s, and the 2½s of September 1967-72, which have been selling at higher premiums over par because of the wider marketability and eligibility for bank ownership, extended their decline after the appearance of stability in the restricted issues though at a slackened rate. The same held true for the partially tax-exempt list.

Yields on Selected Securities

	Nov. 30 1946	Aug. 31 1947	Oct. 31 1947	Nov. 28 1947
Long-Term Corporate				
Aaa corporate bonds†	2.60%	2.56%	2.72%	2.82%
Baa corporate bonds†	3.19	3.18	3.40	3.48
High grade preferred stocks*	3.73	3.71	3.96	4.00
Long-Term Government				
High grade municipal bonds*	1.87	1.92	2.08	2.25
Victory Loan 2½s, Dec., 1967-72	2.37	2.31	2.39	2.43
Bank eligible 2½s, Sept., 1967-72	2.20	2.10	2.17	2.29
Part. tax-exempt 2¾s, Dec., 1960-65	1.62	1.48	1.58	1.72
Intermediate and Short-Term Government				
December 1952-54 2s	1.58	1.38	1.54	1.61
September 1950-52 2s	1.37	1.21	1.38	1.43
9-12 months certificates	0.84	0.84	0.97	1.00
3-months Treasury bills	0.38	0.75	0.87	0.94

Sources: *Standard & Poor's Corporation. †Moody's Investors Service.

Prices of seasoned bond issues of State and local Governments, which are fully exempt from income taxes, declined further in November as municipal dealers raised offering yields in order to move undigested issues. On proposed new offerings, municipalities in a few cases rejected all bids and postponed their projects, because of higher interest rates. In the November elections voters authorized the issuance of more than $1 billion in State, city, and county bonds including $700 million to finance bonus payments to war veterans in the two States of New York and Ohio. The market's behavior thus reflected, among other considerations, the prospect of continuing large additions to the supply of tax-exempts.

In the corporate bond sector, prices again worked lower but this process did not prevent the successful consummation of numerous new financing projects.

Support for Long-Term Treasuries

The official support for the long-term Treasuries, revealed in a $163 million increase in the "over five years" category of the Federal Reserve open market portfolio, closed a period of eighteen months when official concern and countermeasures were directed toward the persistent tendency of long-term Treasuries to *rise* under the pressure of the large amounts of loanable or investible funds held by the banks and other financial institutions.

From April to September, to help hold prices down, $1,800 million public marketable bonds held by Federal agencies and trust funds were put on the market. In October $870 million of a new issue of non-marketable Treasury bonds were sold to savings institutions. The mopping up of investment funds in this way, as well as unexpectedly heavy demands for mortgage money, credit needs of business, and borrowings by State and local governmental units, set the stage for the setback in bond prices.

Basically, of course, the former buoyancy of long-term bond prices was a symptom of the artificial supports for short-term government paper which discouraged holdings of Treasury bills and certificates and put financial institutions under incessant pressure to lengthen out their portfolios to obtain adequate returns on their money. Thus the decline in bond prices also represented a "delayed action" response to the decision of the Federal Reserve and Treasury authorities to allow short-term interest rates to rise, narrowing the spread between short and long rates by gradually retracting Federal Reserve support levels for Treasury bills, certificates and notes.

The margins between 1 or 1⅛ per cent on short-term paper and 2½ per cent on the long-term Treasuries remain wider than normal, but the two changes of a higher short-term rate and unsettlement in longer issues have about re-

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moved the inducement for banks to shift from short to long.

To the non-banker these changes may seem both technical and minute but they represent substantial progress in the infinitely puzzling problem the Treasury and the Reserve System have faced in managing the huge public debt. The problem has been to keep prices reasonably stable without constantly pumping money into the market and so encouraging inflation. The unfreezing and lifting of the short-term rate has eased the problem at least somewhat.

A Blueprint for European Aid

The report of the President's Committee on Foreign Aid, otherwise known as the Harriman Committee, rendered last month, presents a carefully prepared blueprint on European aid by nineteen leading citizens in industry, commerce, finance, labor, and education under the chairmanship of the Secretary of Commerce. It is one of a series of reports that have been brought out since last Summer in developing the Marshall proposal.

First, in September, came the 16-nation report by the Paris committee of experts, setting forth the "requirements" of Europe for aid. Originally, as will doubtless be recalled, the 16-nation Paris committee came up with an estimated dollar deficit with the western hemisphere for the four years 1948-51 of $29 billion. This caused such a shock that the calculations were refigured and pared to $22 billion by assuming (a) a gradual decline in the cost of European imports over the period, (b) that some of the goods wanted would not be available, and (c) that there would be a more rapid reopening of trade with eastern Europe and Asia. It was also assumed that about $3 billion of the deficit might be financed through the International Bank of Reconstruction and Development or other credit operations, and suggested that an additional $3 billion might perhaps be taken care of through transfers of dollars earned in trade outside the western hemisphere. By these calculations the estimated amount of the uncovered dollar deficit with the American continent was pulled down to about $16 billion.

It was with these figures that the Harriman Committee went to work.

Basic Principles of Foreign Aid

While accepting the premise that American aid to Europe is called for, not alone on economic and moral grounds, but also for "strategic and political" reasons in this world of "two conflicting ideologies," the Committee indulges in some plain speaking as to the practical limits upon American aid and the responsibility of Europe for self-help.

Declaring that "we believe that the future of western Europe lies very much in its own hands," the Committee points out that the sixteen nations, and western Germany, comprise over 275,000,000 men and women, possessing great agricultural and industrial resources. Even in its present depressed state, the production of this area is vastly greater than any aid which this country can provide. Such aid must be viewed not as a means of supporting Europe, but "as a spark which can fire the engine."

In carrying forward an aid program, the Committee would make it "a condition of continued assistance that the participating countries take all practicable steps to achieve the production and monetary goals which they have set for themselves in the Paris report." Production "must expand well above prewar levels." Likewise, "an effective restoration of the purchasing power of money is essential to the resumption of ordered economic life."

To be sure, not all of this can be accomplished without "substantial injections of American aid." But "failure (on the part of European countries) to make genuine efforts to accomplish these results would call for cessation of further assistance."

On Needs and Capacities

One result of the Harriman Committee's examination was to find that the sixteen countries at Paris had been over-sanguine as to the goods that are likely to be available in the United States for export. Looking carefully into each of the commodities, the Committee found, for example, that we just do not have two million tons of steel scrap to send abroad each year; that the Paris estimates assume our sending abroad in four years three or four billion dollars worth of food more than we are likely to have. Petroleum requirements were regarded as unlikely to be met, and other tight situations were indicated as follows:

> The situation is much the same in regard to most of the items of machinery and equipment the European countries need. In the middle of the agricultural boom, the demand of American farmers for farm machinery is well beyond the capacity of the industry. As to mining machinery, coal output is at a high rate and American mine operators are buying as much machinery as they can obtain. Heavy electrical equipment of all kinds is perhaps the tightest industrial item of all. The story is much the same for certain of the basic raw materials.

Also, some of the Paris requirements were held to be larger than these countries could probably

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digest in four years. It was the judgment of the Committee, moreover, that the Paris experts were optimistic in their estimates of what these sixteen countries could produce and export; that they may have been optimistic in their assumption that the prices of goods they imported would decline, and also about the convertibility into dollars of currencies they may earn by exporting goods to the East.

A $12 to $17 Billion Program

It was out of a composite of all these statistical and economic judgments that the Harriman Committee made its estimate that the foreign aid program would cost the United States Government about $5.75 billion for the first year, and between $12 and $17 billion for the whole four-year program. This is a substantial reduction from the estimates of the Paris experts.

By fixing such a broad range the Committee showed its realization that figures of this kind are very uncertain indeed. In fact, the Committee stated definitely that no one was wise enough to determine at the present time just what the program would cost us for the next four years. "The Committee," it said, "cannot emphasize too strongly that any aid extended to Europe must be on a year-to-year basis. It must be subject to constant, vigilant review of the Congress."

With these considerations in mind, the Committee decided upon a method by which the mandate to determine what could be "safely and wisely" sent abroad would be passed on to operating bodies to make that decision from year to year when the evidence was more reliable. This embraced the following:

1. That the Congress would decide *each year* how much it should appropriate for food, fuel, and fertilizer to send abroad.

2. That requests for industrial equipment should be referred to the International Bank, which was established for the purpose of examining capital projects and making loans which after careful scrutiny present reasonable prospect for repayment.

3. That in the middle area of raw materials and shorter-term projects, the organization and well-tested capacity of the Export-Import Bank be used, but with special appropriations to be made by the Congress from year to year to cover the needs which prove to be sound.

4. That an overall agency be created to administer the food, fuel, and fertilizer program, to supervise the raw material program, and to maintain contact with the European countries and with our domestic situation so as to recommend to the Congress from time to time how much aid may safely and wisely be extended. Within the Congressional appropriations, this agency would be empowered to administer aid in relation to the progress European countries make in carrying out their own commitments as to production, financial stabilization, and mutual cooperation.

Foreign Aid and the Budget

Finally, there is the question of foreign aid and the budget.

The Committee believes that, in view of the present inflationary tendencies, "the cost to the Government of the foreign aid program must be met out of taxes, not by borrowing." On this the report was emphatic. "The funds must be provided within a balanced budget." Not only that. "It is of great importance that the budget should show better than a balance, and there should be a surplus left over to retire debt."

Can this be done? The Harriman Committee thinks so. Nor did the Committee — contrary to some press reports — rule out the possibility of some tax reduction despite Marshall plan expenditures. What the Committee said was this —

> Fortunately, under present circumstances this country should be able to meet essential requirements of a European aid program within a balanced budget, leaving something over for debt retirement and tax adjustment.

How the Committee arrived at this conclusion will be of interest:

> In August the President estimated that the government budget for the current fiscal year ending next June 30 would show a surplus of $4.7 billion. This estimate included expenditures of $4.3 billion for international affairs out of appropriations already made, but it included no estimates for additional amounts which might be appropriated under the Marshall program. This budget estimate has proved to be conservative.
>
> Thus it would be possible to add $2.5 billion to the expenditures for foreign aid in the current fiscal year and still leave a substantial surplus, provided that expenditures in other directions are not increased. Such an addition would bring the total estimated expenditure for foreign and international affairs aid in this fiscal year to about $6.8 billion.

Conceding the hazards of projecting the level of government receipts beyond the current fiscal year, the report argues that domestic expenditure should show some further reduction as wartime organizations and obligations are liquidated; also that the requirements for foreign aid, with any reasonable screening, should be less than the total for the current fiscal year.

Hence the conclusion that, "with government economy at home, and with a continuance of a high level of business activity, we should be able to finance a reasonable foreign aid program well within the limits of a balanced budget."

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