

15 per cent
November 18, 1940

EASY MONEY

Decline in Money Rates

Money rates are at an extraordinarily low level. As is shown by the attached table, rates on various classes of loans and open-market investments declined substantially between 1929 and 1936 and declined somewhat further since then. The most drastic declines have been in short-term open-market rates. Rates on Treasury bills and Treasury notes have approached zero and in certain periods these obligations have been selling at negative rates. Yields on bonds of all kinds have also declined. Rates on commercial loans by banks in leading cities, which were exceptionally high in 1929, dropped abruptly between that year and 1936. Further declines have not been reported since that time, but many loans to well-established customers are being made at rates lower than those reported. All kinds of real estate loans have also declined in yield, but are still at levels that are relatively not low.

Problems Raised by Low Rates

For Endowments

For some time past the lower returns on first-class investments have constituted an acute problem for all kinds of endowed and fiduciary institutions. Insurance companies have difficulty in finding what they consider satisfactory investments; beneficiaries of trust funds have had their incomes seriously curtailed, and universities and other institutions of learning, as well as charitable foundations and all kinds of other endowed organizations, have had difficulties in meeting their budgets. Some

of the adjustments that have been made to the lower level of returns on investments are a necessary recognition of the fact that the economic position of the country has radically changed. From a debtor country it has become a creditor country. Instead of having a limited supply of reserve money it has a great abundance of reserve funds. Rates which were normal a decade or two ago would be clearly out of line with present-day conditions. The great increase in available capital has radically changed the relationship between the supply and the demand for long-term funds, and capital may well find it necessary to be satisfied with a lower return than was to be expected at a time when the country was still experiencing a scarcity of investment funds. The fundamental adjustment has now been made, however, and further declines endanger the functioning of the capitalistic system, a fundamental principle of which is that invested capital is entitled to a reasonable return.

For Banks.

There has been a good deal of criticism of easy money by banks which have viewed with apprehension the disturbance of the rate structure to which they have been accustomed. Nevertheless, it should be recognized that the readjustment downward of certain rates which have been too high was necessary, particularly in reducing the cost of money to local borrowers in smaller cities and in rural districts. It is also true that, as a result of availability of Government securities, of the decline in losses and the increase in recoveries of items previously written off, together with reduced

payments of interest on deposits, banks have had reasonably good earnings in recent years. Further declines of the higher long-term rates, however, and continuance of excessively low rates on large loans and open-market investments makes the problem a serious one for the banks.

Inflationary Danger

Aside from the point of view of the lenders as to returns on their money, the very low level of interest rates now prevailing may contribute to unhealthy inflationary developments if they should get started. The situation is a very different one from the period of deflation when abundance of funds at as reasonable rates as possible was a means of combating the downward spiral. With business and employment increasing, with the prospect of a broad and rapid recovery, the possibility must be faced that the availability of funds at excessively low rates would tend to encourage unsound expansion.

Reasons for Low Rates

In the light of these circumstances, a careful review of the reasons for the excessively low rates and of System policy in relation to it is appropriate, with a view to formulation of a policy for the immediate future and for the longer range.

The System's so-called "easy money" policy in the last ten or eleven years may be reviewed from several angles. The term "easy money" has four different meanings which are not always clearly distinguished.

It is sometimes used in describing efforts to combat deflation, sometimes

in referring to the reduction of money rates, at other times it refers to a policy of providing abundant funds for lenders, and still another meaning is one that has reference to the possibilities of inflation. The System's policy in general has been directed primarily towards the furnishing of abundant funds, without special reference to money rates.

In the four years from 1929 to 1933 the System was combating deflation. During that period a rapid decline in money rates was encouraged by System policy. With the exception of a brief period in the autumn of 1931, after England went off gold, the System pursued a policy of easing credit conditions and adding to the volume of available funds. This was for the purpose of helping to arrest the violent deflation which was under way. The System reduced its discount rates and made large purchases of Government securities. Most of the funds released by the System, however, did not increase member bank reserves, but merely helped the banks to meet the foreign demand for gold, and the domestic demand for currency for hoarding, and at the same time to reduce the member banks' indebtedness to the Federal Reserve Banks. It was a period of tight not easy money in which the Federal Reserve System was attempting to moderate existing bad conditions.

By the autumn of 1933 the banks had reduced their indebtedness to the Federal Reserve Banks to a small amount, gold and currency had begun to pour back into the banking system, and funds began to accumulate in the form of excess reserves. In November 1933 member banks had \$800,000,000 of reserves in excess of

requirements. Since that time the System has not added in the net to its portfolio, but on the contrary has substantially reduced it. The continuous growth of member bank reserves from 1933 to 1940 has been due chiefly to the inflow of gold from abroad and to a lesser degree to silver purchases by the Government. The banks have been out of debt and all the funds added to reserves have helped to support the growing volume of deposits and to build up an extraordinary volume of excess reserves.

The excess reserves, therefore, are attributable chiefly to the gold inflow. As is well known, much of the gold has come as the result of an export balance of trade. We have sold more goods than we have purchased. As a creditor nation to which payments are constantly being made from abroad on interest and principal of indebtedness, we would have to have an import balance of commodity trade if we do not wish to be recipients of gold. Our tariff policy, which was conceived at a time when this was a debtor nation, is not adapted to our new condition and its continuance has contributed in so small measure to the inflow of gold. Much the greater part of gold, however, has come not in settlement of commodity trade balances, but in the form of capital seeking asylum from disturbed conditions abroad.

Large-scale Government expenditures financed to a considerable extent by borrowing from banks has also been a factor in the decline in rates, because it has created a large volume of deposits in the hands of

the public available for investment. Government deficit financing does not increase member bank reserves, as is sometimes stated. On the contrary, it creates deposits and, therefore, increases the volume of required reserves and reduces excess reserves. It does, however, when it takes the form of borrowing from banks, create a large volume of funds in the hands of the public that presses on the investment market and tends to reduce yields on fixed interest obligations.

All these factors have greatly contributed to the building up of a supply of funds. On the other hand, the demand has not been adequate to absorb this growing supply. Bank loans have been in small volume owing to the low level of business activity. Investment has lagged behind, partly because of scarcity of opportunities and partly because of caution induced by lack of assurance of successful business operations. The situation has been one in which persons with adequate credit standing were not borrowing, while persons and institutions which wished to borrow lacked the necessary basis of credit.

A great deal has been done by the Government to relieve distressed conditions of borrowers on farms and urban homes and this has greatly improved not only the status of the borrower, but also the financial condition of the lenders. Nevertheless, the policy of Government agencies to borrow at the low rates available to the Government and re-lend to the public at what looks like very low rates to business lenders has been one of the factors depressing money rates. While the emergency refinancing has done a great deal of good from the public point of view, even in the field of Government credit agencies the time has come

when the leading policy of these organizations should be carefully reconsidered in the light of changed conditions.

Recent System Policy

The System has shown continuously an awareness of the dangers of inflation and has not been interested in low rates as such, particularly on short money.

An indication of the System's attitude toward short-term open-market rates is given by the fact that in 1939 it allowed its entire portfolio of \$500,000,000 of Treasury bills to mature in order to increase the supply of these bills available and relieve the pressure that was forcing these rates below a no-yield level.

The System has been interested in maintaining funds abundant for all legitimate enterprises at a time when business recovery has been incomplete. At the same time it has been aware of the possibilities of inflation arising from an over supply of funds. In 1935 the power to raise reserve requirements was obtained in order to absorb some of the reserves on which a further expansion could occur. The power which Congress granted to the Board in this matter was limited to doubling the reserves, and in 1936 and 1937 the System used this power to the full. In the spring of 1938 it reduced requirements by one-eighth

as a part of a general government program for dealing with deflationary developments at that time. But this reduction was of no particular consequence because the System retained the power to reabsorb the reserves thus released and because ^{desterilization} distribution and further large gold imports soon increased bank reserves to a point where the System's power was not adequate to control them. The Chairman of the Board of Governors opposed the silver purchase policy, and tried to obtain authority for discouraging the inflow of foreign capital which was the most important single cause of the growth of excess reserves. The Board has constantly pointed out to Congress and to the public the need for adequate powers for controlling reserves. Particularly in its annual report for 1938 the Board stated emphatically that it would not be in a position to discharge its responsibilities unless it were given adequate authority to deal with reserves.

Program

The important question, however, is what can and should be done now in order to prevent further declines in money rates and to increase somewhat those rates that are excessively low. It would seem that the first necessary action would be to make strong representations to Congress for obtaining additional powers over reserves. In the second place the System should recommend the discontinuance of the policy of silver purchases; thirdly, it should give careful study to the question of gold policy, particularly after active warfare stops. It would seem that for the present purchases of gold are principally from England and there would be no support for depriving England of this means of obtaining necessary

armament. After the war stops, however, the question of the gold purchase policy will have to be reconsidered in the light of world conditions as they emerge from the conflict.

The System's policy in regard to open-market operations has for some time past been one of attempting to maintain orderly conditions in the Government security market and indirectly in the entire capital market. Purchases of Government bonds during the drop in the market after the outbreak of the World War have been offset to a very large degree by sales made at times when the market has been strong and the demand for securities has exceeded the supply. Some further reduction in securities may be desirable and feasible, but it should be pointed out that if the System's earning assets fell to the point where it did not earn enough to meet its expenses, this would either diminish the System's financial independence or else make it necessary for it to discontinue or charge for many services to business which it now performs free of cost to them. So long as membership in the Federal Reserve System is optional it is doubtful whether much can be accomplished in the way of service charges without encouraging some banks to leave the System.

In the field of public finance it is clear that in present conditions everything should be done to encourage such financing as is done by borrowing to come out of savings and not through the creation of additional bank credit. This means that the System should use its influence with the Treasury in the direction of issuing long-term obligations which more generally are purchased by investors rather than short-term obligations

which are more likely to be absorbed by banks. It should encourage the issuance of savings bonds with current income coupons in order to induce small savers who wish to have current income on their savings to purchase Government bonds.

Finally, the System should consider the point at which further governmental expenditures should be met out of taxation rather than from borrowing. This should be done as soon as it becomes clear that further additions to the income stream through Government financing no longer increases the nation's real income and is beginning to result in a rise in prices. It would appear that when the national income reaches the level of 95 or 100 billion dollars it will become safe to balance the budget out of existing or newly imposed taxation. Provision for this situation should be made promptly since the formulation of tax measures is a lengthy process, and certain new taxes become fully effective only after a lapse of more than a year from the time the laws are passed. The System should be prepared to make its views on this subject known to the Congress.