Open mkt 4/10/41

FEDERAL RESERVE POLICY AND THE DEFENSE PROGRAM

The Reserve System desires to assist by every means in its power in promoting the national defense program. It recognizes that the economic measures appropriate to this end are not solely or even mainly monetary and that what is needed is a program of cooperation among the governmental agencies involved. What part can the Reserve System most usefully play in such a program?

In a defense program, as in war, there are special reasons for not relying upon a general monetary control such as might seem appropriate in dealing with peace-time expansion of economic activity. A general monetary control, through bank reserves and the quantity of money, is aimed at interest rates and is designed to affect the cost and availability of funds for investment, which in turn affects the volume of national income, output and employment. But in war or in defense there is the special circumstance that the government is and must be the principal borrower, and that the success of the defense effort rests essentially upon the success of the financing program. The possible dangers which might arise from an excessive money supply or from low interest rates must be weighed against the necessity of ensuring the success of the government's financial program upon which the military expenditures depend. Faced with this dilemma, nations are compelled to consider alternative methods of preventing ordinary consumption and investment from weakening the military effort and bringing on the general inflation which would logically follow if neither monetary nor other restrictive measures were adopted. It is no accident that other countries, democracies like England and Canada as well as Germany, have subordinated general monetary controls to other types of control and are pursuing a program of combining low interest rates and ample bank reserves with fiscal measures and more specific controls designed to prevent inflation. This in general is the type of program upon which this country has embarked, though it is as yet in an earlier stage of development, and we are entirely in accord with it.

There are, however, two ways in which the Reserve System can render effective assistance in the present circumstances. It can cooperate with the Treasury in formulating and carrying out the financial program and it can in cooperation with other agencies help to develop special forms of monetary control.

With respect to the financial program we are entirely in sympathy with the Treasury's desire to finance as large a part of the defense expenditures as possible through taxation. Such a course would be in keeping with the sound monetary principle of meeting military expenditures so far as possible out of current income rather than newly created bank deposits. But it is recognized that the need for borrowing will be substantial. According to the Board's most recent estimates, the amount to be borrowed from April, 1941 to July 1, 1942, after allowing for estimated tax revenue including new taxes and for savings bonds, is about $11 billion (including direct and guaranteed financing), or at the rate of $8 to $9 billion a year.

We are fully in accord with the Treasury's desire to finance as much of its borrowing as possible from non-bank investors, and it may well be that the receipts under the savings bond program recently announced will exceed during the fifteen months period the $2.5 billion allowed for in our estimate. We believe that the borrowing program can be greatly simplified and the appeal to savings made stronger by adopting a pattern of bond issues which could be repeated from time to time at unvarying rates of interest attractive to non-bank investors, but without excluding the banks. The recent 2 1/2 per cent issue would fit well into such a pattern and there may be needed in addition a longer bond at 2 3/4 per cent. Such a pattern, especially if accompanied by a statement of the probable needs to the end of the next fiscal year, would go far to remove any expectation that the financing is to be done at rising rates, which in turn would provide assurance that potential investors would not hold back their funds. But in view of the magnitude of the amount to be borrowed and the uncertainties as to the volume of savings available for government securities, we believe it would be unwise at the present time to risk any impairment of the bank market for such securities either by actual reduction of excess reserves or by the adoption of the reserve "ceiling plan".

With such a program, Treasury financing through the next fiscal year should not present major difficulties. But we believe it would be very desirable to develop some more regular and continuous procedure of consultation and cooperation between the Reserve System and the Treasury than now exists both to insure the success of the financing program and to avoid in every way possible its having any inflationary effects. The subject matter of the consultations could include the formulation of the program; joint investigations by both research staffs on fiscal needs, both taxation and borrowing, and the monetary considerations which should govern the division between these two types of financing, consideration of how the physical facilities of the Reserve System can best be used to facilitate the distribution of securities and to perform other services for the defense program; the extent to which and the means by which the Reserve System should assist in maintaining orderly conditions in the government security market; the extent to which and the circumstances under which it might be desirable to make use of the Keynes compulsory savings plan which has now been adopted in modified form by the British Government; and the exploration of the special forms of monetary control referred to earlier in this memorandum.

As already stated, the dilemma which we face in a war or a defense program is that if we impose a general monetary control we create special difficulties for the Treasury, but if we do not impose such a control we run the risk of stimulating an inflation through low interest rates and an excessive supply of money. The reason in such circumstances why nations have learned to prefer other anti-inflationary measures than the monetary, and in this war have even gone so far as to combine them frankly with an easy money policy, is not merely that such a program facilitates Treasury financing, important as that is, but that it is also much the more effective method of safeguarding against inflation. Historically, there is no proof that if inflation is not prevented by more direct control measures or by wise fiscal policy, it will or can be prevented by a general monetary control. But there are special forms of monetary control which go more directly to the heart of the problem, and far from interfering with Treasury financing may positively assist it. One such measure would be the rationing of the private capital market. Such a policy, as practiced in Germany or England, is intended to prevent private investment from competing with military needs for savings or bank funds, but as yet no such problem appears to have developed in this country. Another and more pressing problem is the competition of durable consumer goods with the needs of the defense industries. In this area there appear to be important opportunities for cooperation between the monetary authority and other agencies of government. The machinery of price controls, priorities and rationing may well prove ineffective unless accompanied by monetary measures designed to control expenditures on durable goods. The two areas in which this problem seems now most in need of study with a view to action are the field of instalment credit for automobiles and other durable consumer goods and the field of residential housing.

April 10, 1941