Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 6, 1951

To Board of Governors

Subject:

From Governor Powell

In accordance with the understanding at the meeting of the Board on February 1, the attached draft statement has been prepared setting forth the current monetary problem and a program for meeting it.

Attachment

STRICTLY CONFIDENTIAL February 5, 1951

At the outset, the Board of Governors wishes to state that the Federal Reserve System will use its powers to assure that an ample supply of funds is available at all times to meet the Treasury's borrowing requirements. The issue today is not one of the ability of the Treasury to raise funds, nor is it one of the impairment of the Government credit. The issue today is purely whether the Federal Reserve will reluctantly feed inflation or operate to curb it. The Federal Reserve aims are to use its powers fully to facilitate the financing of the defense effort and at the same time to restrain inflation.

Today's inflationary threat is not solely due to mounting defense expenditures but to an important extent to mounting civilian expenditures financed directly or indirectly by unrestrained sale of Government securities to the Federal Reserve. As governors of the Federal Reserve System it is our duty to present to Congress the urgent necessity that we be freed to use our powers to combat further erosion of the purchasing power of the American dollar.

Federal Reserve powers can be used to fight inflation without interfering with an adequate flow of funds to the Treasury. The use of these powers is essential to maintain investor confidence in the Government's credit. We believe that the prime essential for the maintenance of the Government's credit is the pursuance of policies which will assure investors in Government securities that the purchasing power of the principal and interest of their investment will be maintained.

The current situation

The facts of the current economic situation are well known. The defense demand for goods is being piled on top of a tremendous civilian demand that has been whetted by the threat of scarcity of goods and further price increases. In addition to consumer demand, industry is attempting to stock itself against the day of shortages. The phenomenal use of bank credit in financing the movement of agricultural products and increases in other business inventories this past fall has made possible the inflationary rise in commodity prices and the higher cost of living. Ominously, bank credit continues to expand indicating that new loans are exceeding repayments by last autumn's seasonal borrowers.

In the scramble for goods, buyers have had four sources of funds -- first, current incomes; second, accumulated cash; third, conversion of semi-liquid savings, particularly Government securities, into cash; and fourth, an amazingly unlimited access to credit. As a result not only has the money supply of the country increased but the turnover of money has accelerated. Thus, there has been a double-barrelled impact on commodity and other prices.

Fears of further inflation are deep-seated and are spreading. The man on the street is coming to feel that he should put his savings into investments that will protect him against further declines in the value of the dollar. The current rise in the stock market is fostered by a desire to convert dollars into equities. The rush to buy houses and farms, reported from all parts of the United States, is still another inflationary symptom. Foreign countries are drawing on their dollar assets to buy gold.

Weapons against inflation

The weapons of defense against the mounting inflation are well known. First and most important is more taxation. No one should object to dipping into his pockets to pay taxes to finance the defense effort necessary to make this country strong and secure. This money taken out of our pockets ceases to be available for competitive spending, which merely drives up both the cost of defense and the cost of living. The defense program is not too big to be paid for by taxation. It should not be paid for with borrowed money. Borrowing supplies the civilian public with more income to spend than there are goods available. It also increases the supply of money and other liquid assets.

The second defense against inflation is economy and restraint in spending by national, State, and local governments, by businesses and by individuals. Postponable projects should be postponed. New social programs by governments should not be started. Existing programs should be placed on a "pay-as-you-go" basis.

The third weapon against inflation has to do with liquid savings. Further use of past accumulations of savings for spending must be discouraged. People must be encouraged to increase their current saving and to invest their savings in ways that are not inflationary, particularly in Government bonds. Nothing discourages savings more than fear that inflation will eat away their value. The first step, therefore, is for the Government to convince the public that it means business in its fight against inflation by adopting pay-as-you-go taxes and by stopping the inflationary increase in our supply of money. With confidence thus reestablished, the savings habit can be further encouraged by making the various forms of savings more

attractive. This can be done by giving them a higher rate of return. Life insurance companies, savings banks, building and loan associations, and other savings institutions, in turn, must be induced to maintain an increasing portion of their funds in Government securities.

Another type of saving is the kind people do when goods are unavailable. This is very unstable saving which is likely to break out into spending in many areas at any time. Such savings certainly cannot safely be relied on to carry the main burden of an anti-inflation program. To the extent that they materialize, every effort should be made to tie them up with an attractive savings bond.

The fourth weapon of defense against inflation is to stop the increase in the volume of credit. As for bank credit, the customary way to do this is to limit the supply of reserves available to the banking system through restrictive open-market operations and higher discount rates. The Federal Reserve has had to lay aside these techniques in carrying out the policy of maintaining prices of Government securities. Banks, insurance companies, and other large holders of Government securities have been heavy sellers of those securities to obtain funds for use in making loans and investments. Since the Korean outbreak there have been more sellers than buyers for Government securities, the Federal Reserve Open Market Committee has been a steady buyer to support the prices of all issues and the longest-term issues above par. Since the payment for these bonds is in effect by a cashier's check drawn on a Federal Reserve Bank, the collection of the check adds to the reserve account of some member bank. Thus, Government securities -- short or long-term -- are potential bank reserves which provide commercial banks with loanable funds at the beck and call of the market. In the last half of 1950 the Federal Reserve bought 2.5 billion dollars of Government securities and bank reserves were sharply increased, all at a time when bank credit should have been closely limited.

The peg must be removed

We have lived with this problem for many years and we have reviewed it from every angle. We reluctantly conclude that the only genuine and workable restraint on further inflation resulting from the creation of more money is to free the Federal Reserve System from the shackles of pegged interest rates. This can be done without shock if it is part of a comprehensive approach to the financial problems now facing us.

We must stop maintaining a phoney market for Government securities. We must make it necessary for would-be sellers of Government securities to find buyers other than the Federal Reserve. This would mean offering higher yielding securities into which existing holders can convert and permitting market prices and yields to adjust to levels where the public is willing to hold the securities. This does not mean that interest rates would skyrocket. Small adjustments would have considerable effect, particularly in the case of the long-term rate. The United States is a high-savings economy with abundant funds available for investment in Government securities. Investors, however, must have confidence that prices of these securities genuinely reflect supply and demand forces. They cannot have such confidence if prices are artificially pegged by operations which require expansion of the money supply and which inevitably result in depreciation of the purchasing power of the dollars stored in the securities.

A fundamental difficulty in maintaining the 2-1/2 per cent long-term rate is that it is too low a rate to meet the needs of a big sector of American financial institutions. The bulk of the accumulated reserves of insurance companies are from contracts with policyholders which are written on a basis that requires a yield on investments of 3 per cent or more. Obviously these companies cannot hold a large part of their investment

portfolio in 2-1/2 per cent securities but must seek other avenues of investment to meet their contractual obligations. Even for policies written on a 2-1/2 per cent rate, the gross return on investments must average about 2-3/4 per cent to cover operating costs. The United States Government itself has accepted a 3 per cent yield in setting up the national service life insurance fund, the Civil Service retirement fund, and the railroad retirement account. In the case of savings bonds, yields have since the war become less attractive in comparison with other outlets for savings.

The net result of too low yields on Government bonds is to divert savings into other forms of investment which at the present time are inflationary since they provide funds for spending at a time when more spending is undesirable. Not only are holders of Government securities tending to sell them but the Federal Reserve has been obliged to supply more and more credit in support of Treasury refunding operations. As a result, more bank reserves are being created and the growth of bank credit at low rates of interest is stimulated. These low rates of interest facilitate undesirable uses of bank credit during this period of shortages of goods. Prices and yields on outstanding securities should be permitted to adjust to levels where they would rest on their own bottoms.

A constructive program

The Treasury should issue securities at rates and on terms which would be attractive enough so that investors would acquire them willingly and hold them in the future. To avoid undue transitional shocks, existing Government bonds should be convertible into the new issues.

A 3 per cent, 30 or 35 year bond for nonbank investors would most likely meet these conditions. Similarly, an instalment-retirement nonmarketable bond at 2-3/4 per cent for a final maturity of about 30 years (average maturity of about 20 years), and with conditional redeemability before maturity, would no doubt find a ready market. All this could be done without any undue shock to the money market if presently outstanding Treasury bonds were made convertible into the new higher-yielding bonds.

It should be understood that the Federal Reserve had no commitment to keep Government issues at par in the future. Federal Reserve support should not be given when inflationary pressures are strong except at a figure which would require the holder to make some sacrifice to get his money before maturity. For example, most institutional investors would be reluctant to sell Government bonds to buy private bonds or mortgates if they had to make a sacrifice on the switch equal to a full year's interest on the new investment.

With the Federal Reserve System freed from its present strait jacket of maintaining an unrealistic pattern of interest rates and the market supplied with securities at coupon rates satisfactory to institutional holders, the Federal Reserve Open Market Committee would no longer be required to purchase Government securities on an unlimited basis and thus to pump funds into the reserve pool. The Committee would continue to purchase securities in moderate amounts when necessary to maintain an orderly market, but not for the purpose of maintaining any particular bond at a price pegged above par.

By restricting the creation of new bank reserves through open-market operations, the Federal Reserve discount rate policy would become effective. Banks would soon exhaust their excess reserves and would have

to decide whether further credit expansion would warrant borrowing from the Federal Reserve Banks. The American banking tradition of reluctance to borrow would again become a powerful restraining factor. With banks having fewer funds to lend, the terms of credit would be tighter, banks would be more restrictive and selective in their lending, and borrowers would be more conservative in their use of funds. In other words, a more normal and healthy restraint of credit greatly to be desired at this time would be forthcoming.

As for savings bonds, no special problem would arise from the change in policy. They are not subject to market fluctuations and can be converted into cash at the wish of the holder. If some of them were exchanged for the new issues that would not be objectionable. The savings bonds which are approaching maturity have a yield for the last few years of higher than 3 per cent so that these holders would not be likely to exchange their bonds. An increase on the yield offered on new savings bonds would make them more attractive to investors and would draw in more funds.

Cost to the Treasury

Under this program the Treasury would save money on its total budget. The benefits from holding down the cost of defense and the cost of living would far exceed the additional interest cost to the Treasury. The Treasury interest bill is currently 5.8 billion dollars. If all of the 60 billion dollars of securities maturing in 1951 were refunded at coupon rates as much as 1/2 of 1 per cent higher than the rates they now bear, the additional interest cost to the Treasury would amount to 300 million dollars of which at least one-third would be returned to the

Treasury in higher taxes. To the extent that outstanding bonds are converted into new higher rate issues, the added cost would be correspondingly increased. It is hardly likely that the total additional interest cost would exceed one billion dollars a year, of which a substantial portion would be recovered in taxes.

This increase in Government expenditures would be negligible compared with the additional cost to the Government that would result from a further rise in commodity prices under a policy of holding down interest rates. The increase in commodity prices over the past year has been close to 10 per cent. With the Government about to spend 60 billion dollars for goods and services, another 10 per cent increase in prices would cost the Treasury 6 billion dollars a year, to say nothing of the tremendous increase in the cost of living to the American public.

Substitute devices fall short

Numerous devices have been suggested for restricting the growth of inflationary bank credit while continuing the practice of pegging Government securities. All of these devices have very serious limitations.

Foreign countries have experimented with a number of them. There is nothing in the experience of foreign countries to justify an expectation that these devices can spare an economy from the inflationary consequences of rate pegging. The lessons of foreign experience in this respect are summarized briefly in Appendix A.

The most drastic of the devices suggested to meet our current credit emergency is to enforce a ceiling on loans and investments -- other than United States Government securities -- to apply to all lending institutions. Such a ceiling at best is a crude and temporary expedient. It

would postpone the need for a more fundamental solution but would not avoid it.

A less drastic but also less effective proposal is that the Federal Reserve be granted special emergency authority to impose supplementary reserve requirements on commercial banks. Plans along this line have been carefully explored by the Federal Reserve System but by themselves they all fall short of the mark. These plans and their advantages and drawbacks are reviewed briefly in Appendix B.

The plan which might most effectively restrain expansion of bank credit would provide supplemental reserve requirements on the increase (from some base amount) in loans and investments other than United States Government securities. The plan itself would not deter or prevent nonbank financial institutions from selling Government securities in order to acquire other higher-yield investments, and thus under current pegging policies to expand commercial bank reserves. Flexibility in interest rates combined with debt management policies appropriate to such rates would still be necessary, or statutory authority would be needed to require nonbank financial institutions to hold a specified portfolio of Government securities.

A much discussed device is the security reserve requirement that commercial banks hold a certain proportion of their deposits in short-term Government securities. This plan would attempt to curb credit expansion by tying up some of the liquid asset holdings of banks and by restricting their ability to sell Government securities in order to acquire other assets. In view of the large holdings of Government securities that banks now have, the percentage requirements would need to be very large for the plan to be effective. Moreover, its effectiveness could be readily undermined by the Treasury through expansion in the amount of short-term issues

outstanding either through refunding operations or increases in the public debt. In any event, nothing in the plan removes the need for flexibility in yields and prices of marketable Government securities held by nonbank investors.

Selective credit controls

Selective credit restraints, such as the Reserve System's regulation of stock market credit, consumer credit, and real estate construction credit, are sometimes talked about as if they offered a desirable alternative to general credit control measures and to flexibility in interest rates in an inflationary period such as the present. Selective credit controls are useful supplements to general credit weapons but they are not substitutes. They are applicable only to limited areas where credit is used for well defined purposes and where the terms and conditions of credit extended are customarily related to the purpose of the loan. These selective credit instruments affect the demand for, rather than the supply of, credit.

We have looked into the possibility both of tightening existing restrictions and of significantly extending the range of selective credit controls. Our conclusion is that a further tightening of existing regulations may be necessary but that extension of the range of these controls is impractical.

Statutory responsibilities

Under the Federal Reserve Act, the Federal Open Market Committee is directed to use its powers for the accommodation of commerce and business and with a view to the general credit situation. The background and meaning of this directive is made clear in the legislative history of the Federal Reserve Act and its amendments, together with established practice and experience of central banks throughout the world, and the great body of

literature in this field. All of these sources make it evident that Federal Reserve powers are designed to provide the basic money and credit needed by a progressive economy in a way that will moderate economic instability.

Because of the long history throughout the world of abuse by governments of the power to issue money for their own uses, central banks have been set up as institutions separate from treasuries. There have been, however, either in law or in practice varying degrees of coordination with treasuries. Under the Federal Reserve Act, as amended in 1935, the Federal Reserve System is established as an agency responsible to Congress and is not subordinate to the Treasury. In view of the importance of the public debt in the financial structure of the United States, there has developed a need for effective coordination of debt management policies with monetary and credit policies. Practices with respect to such coordination are described in the reply made by the Chairman of the Federal Reserve Board to the questionnaire of the Congressional Subcommittee on Monetary, Credit, and Fiscal Policies in November 1949.

The Federal Reserve Act specifically prohibits the Federal Open Market Committee from purchasing securities directly from the Treasury except to a limited extent. Established practice, as well as legislative history, indicates that this exception is to take care of temporary operating needs of the Treasury without unnecessary disturbance to the money market. It is not to be used to finance the Treasury for extended periods. The Federal Reserve has power to purchase Government securities in the market and it has followed the practice, particularly in periods

of growing or large public debt, of conducting its operations so as to facilitate Treasury finance. These operations have been deemed to be in accord with the statutory authority of the Federal Reserve Act.

Under existing statutory authority, the Treasury has authority to determine the amounts, timing, and terms of securities issued. The Treasury, however, does not have any authority to require that investors or the Federal Reserve purchase its issues at any particular price. This means that prices, yields, and terms must conform to conditions prevailing in the market at the time of issue.

Federal Reserve open-market operations can establish conditions in the market favorable to borrowing by the Treasury through the creation of new money. This is possible because Federal Reserve purchases of securities supply funds to banks and other investors which in turn may be used to buy other securities from the Treasury. In fact, Federal Reserve purchases supply reserves to banks which can be used as the basis for a manifold expansion of bank assets. It was by means of operations of this nature that World War II was financed at such low rates of interest.

Open-market operations of the Federal Reserve System directed primarily toward aiding Treasury finance can be highly inflationary. It would be an evasion of the purposes of the Act, therefore, for the Committee to purchase securities solely for the purpose of assuring that the Treasury can raise funds on whatever terms the Treasury may wish, if such financing is considered by the Committee to be undesirable from the standpoint of the general credit situation and the needs of commerce and business.

The membership and organization of the Federal Open Market Committee have been set up to assure careful consideration of the various aspects of the American economy in determining its policies and to avoid domination by any particular interests. It is composed of the seven members of the Board of Governors, who are appointed by the President and approved by the Senate, and of five representatives of the twelve Federal Reserve Banks elected by the directors of those banks. Two-thirds of these directors are elected by member banks, one-third drawn from the banking community, and one-third from commerce and business. The remaining third are appointed by the Board of Governors. In actual practice, the Reserve Bank members of the Committee have always been Reserve Bank Presidents who are elected by the directors of their respective Banks and approved by the Board of Governors. Thus, while the banks of the country have an indirect influence in the selection of a minority of the members of the Federal Open Market Committee, the Committee as a whole represents the broad interests of the public in general. It is clear that the responsibility of the Committee is to conduct its operations for the benefit of the entire economy.

Concluding statement

It is our conviction that the United States must adopt an effective program for restraining the expansion of credit. If it continues to leave the flood gates of bank credit wide open, even though it controls prices and wages directly and succeeds in maintaining a balanced budget, further inflation will be inevitable. We have only to look at our own and foreign experience in the early postwar years to know that this will happen again. For the United States, the strongest country in the world, consciously to permit itself to drift in this direction would indeed be a shameful record of monetary irresponsibility.

APPENDIX A

Lessons of Foreign Experience

Recent foreign experience with interest rate policy and with security reserve requirements yields a number of lessons:

1. Under postwar conditions of high employment attempts of monetary authorities to peg or to lower interest rates have reinforced inflationary pressures and have contributed to balance of payments difficulties.

2. No country that has imposed security reserve requirements has, for that reason, considered it either possible or desirable to peg long-term interest rates.

3. Security reserve requirements were imposed by foreign countries not as a substitute for flexibility in the short-term interest rates, but, on the contrary, to make central bank discount rates (and changes thereof) effective as instruments of monetary control.

4. Even the most stringent reserve requirements are unable to prevent an inflation originating outside the banking system.

The following discussion briefly illustrates these lessons.

I. Under postwar conditions of high employment attempts of monetary authorities to peg or to lower interest rates have reinforced inflationary pressures and have contributed to balance of payments difficulties.

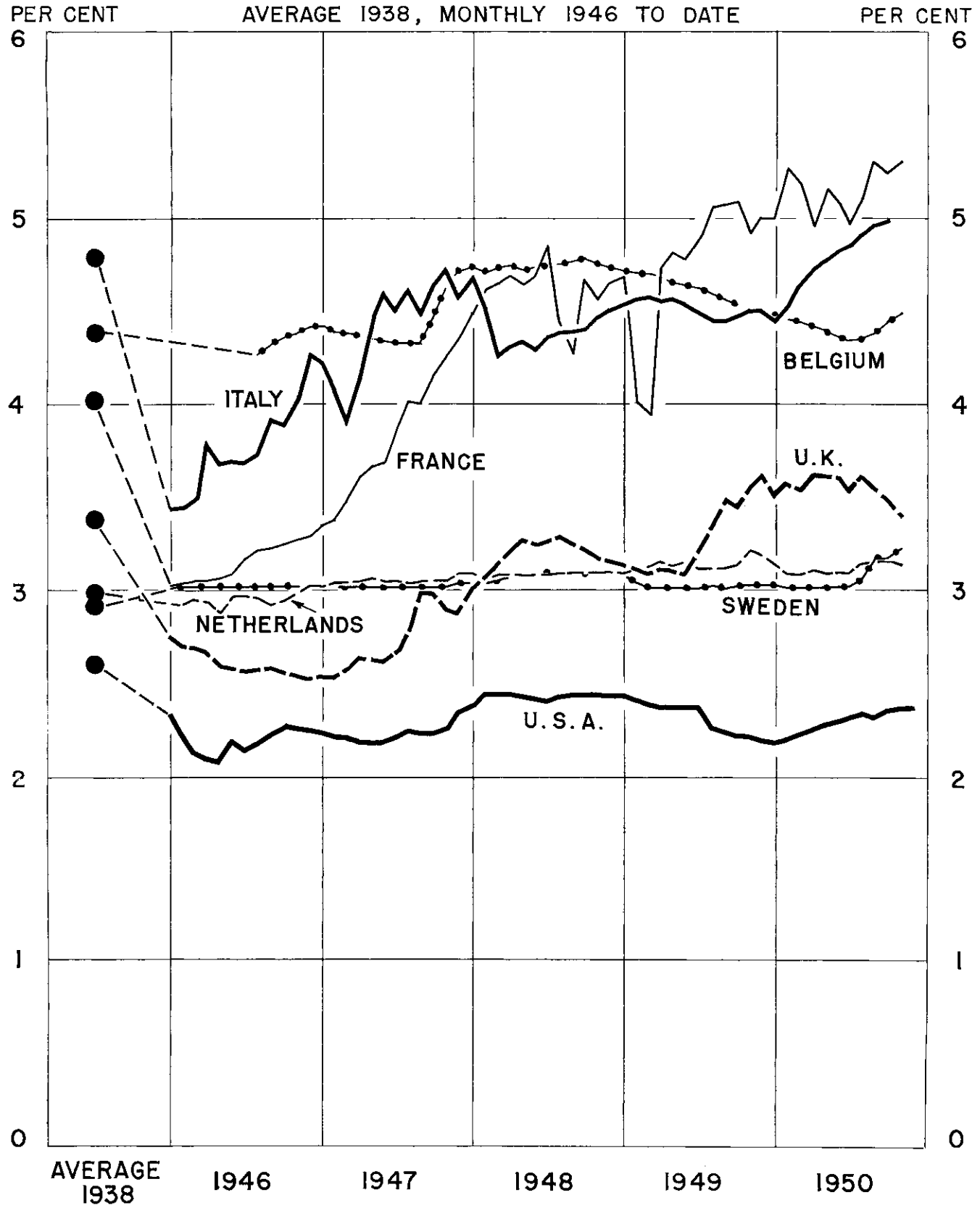
The outstanding illustration of this lesson is, of course, Dalton's "cheap money drive" of 1945-1947 in the United Kingdom. In the

belief that the existing direct controls would be able to prevent any inflationary developments, Mr. Dalton set out at the end of 1945 to drive the long-term rate of interest down from 2.9 per cent to 2-1/2 per cent (see Chart I). In the course of this experiment between January 1946 and January 1947 deposits of the London clearing banks expanded by £900 million (or 20 per cent). The Government apparently contributed to this expansion not only through borrowing from the banks, but also through direct use of funds held by its various departments for purchasing marketable securities. As is well known, Mr. Dalton scored a victory that was only momentary, and in the end a very costly one to the British economy. Direct controls were unable to stem the inflationary pressures generated by the redundancy of money. The fuel crisis brought about by the harsh 1947 winter merely exposed the fact that the British economy had become "threadbare" and hypersensitive to any shock. Moreover, the difficulties in Britain's balance of payments took on truly huge proportions.

While Mr. Dalton seems to have been puzzled by what he called the contrast between the domestic monetary ease and the balance of payments difficulties, the casual connection between these two phenomena became clear to everybody after Sir Stafford Cripps' policy of disinflation took effect. This policy relied primarily on the disinflationary effect of a budgetary surplus, but it was also characterized by a complete abandonment of Mr. Dalton's cheap money drive. Once the authorities gave up the attempt to hold the long-term rate at the 2-1/2 per cent to which it had been driven toward the end of 1946 it went rapidly beyond the point from which the cheap money drive had started, i.e., beyond 3 per cent. A further sharp

YIELDS ON LONG-TERM GOVERNMENT BONDS

U. S. AND SELECTED COUNTRIES



rise in the rate to over 3-1/2 per cent was permitted in the second half of 1949. This rise has only recently been partially reversed, largely as a result of the inflow of foreign funds.

In contrast to the long-term rate, the short-term rate in Britain has been held steady at 1/2 per cent. The Treasury is able to enforce this rate largely because of its intimate working relationship with the Bank of England and the closely knit British banking system. Britain has a special reason for keeping the short-term rate down. A large volume of foreign-held sterling balances is invested in Treasury bills and any increase in the short-term rate would result in an additional burden for the British balance of payments.

Sweden provides another instructive example of an official attempt at manipulating interest rates. The maintenance in the postwar period of the long-term rate at the level of 3 per cent contributed to a huge investment and construction boom which had almost immediate adverse repercussions on Sweden's balance of payments. Sweden's gold and foreign exchange reserves fell from nearly 3 billion kroner at the beginning of 1946 to less than 1/2 billion kroner at the end of 1947. In spite of this dangerous development the support policy was continued and required massive bond purchases by Sweden's Central Bank which, in their effect on the money supply, more than offset the gold outflow. In this fashion, the pegging at 3 per cent not only resulted in inflationary pressures and foreign exchange losses, but prevented the operation of corrective factors generally associated with such losses. It may thus be said that Sweden, which had maintained a high level of production and prosperity throughout

the war, engineered its own dollar shortage and did so to a considerable extent through the bond support policy. It may be surmised that only their country's inclusion in the European Recovery Program and the consequent receipt of dollar aid made it possible for the Swedish authorities to avoid an about-face of their monetary policy such as was effected in Britain by Sir Stafford Cripps.

II. No country that has imposed security reserve requirements has, for that reason, considered it either possible or desirable to peg long-term interest rates.

The principal countries in which security, or rather combined cash and security, reserve requirements were instituted in the postwar period are, in chronological order, Belgium, Italy, and France. In all these countries there was considerable concern about banks expanding private loans by selling or by failing to renew their holdings of short-term government securities. The purpose of the requirements was to prevent the banks from doing this. They had little or no relation to the long-term rate of interest, since traditionally the commercial banks of these countries hold only small amounts of long-term securities.

In all three countries the authorities can and to intervene in the capital market through manipulation of the large funds available to them by virtue of the centralization of savings deposits in publicly owned institutions, but interventions have generally been confined to steadying operations and to "conditioning" of the market on the eve of new issues. The high cost of long-term borrowing prevailing in France, Italy, and Belgium has naturally been a cause for concern, but it has been accepted as a lesser

evil as compared with the disastrous resumption of inflation which might well have resulted from any attempt to lower yields through central bank purchases.

III. Security reserve requirements were imposed by foreign countries not as a substitute for flexibility in short-term interest rates but, on the contrary, to make central bank discount rates (and changes thereof) effective as instruments of monetary control.

As was pointed out above, the principal objective of security reserve requirements in France, Belgium and Italy--and lately also in Sweden and the Netherlands--was to prevent banks from expanding private lending through monetization of their holdings of short-term government securities. This of course did not mean that a bank that was fully "loaned up" had to stop all further lending operations; but it did mean that the banks were forced to borrow from the central bank and could obtain fresh funds only on the latter's terms. Thus, far from being substitutes for the action of short-term rates, the security reserve requirements had the effect--and the purpose--of making discount rates set by the central bank effective. This analysis is conclusively supported by the fact that short-term rates remained flexible in all three countries after the imposition of the reserve requirements (see Chart II).

IV. Even the most stringent reserve requirements are unable to prevent an inflation originating outside of the banking system.

Australia provides the clearest illustration for this lesson. Through the special accounts technique, Australian regulations required banks to set aside reserves to be held in special accounts at the Commonwealth

Bank against any increase in deposits after 1941. The reserve ratio was 100 per cent during the war and was reduced to about 45 per cent after July 1948. Inflation in Australia has been substantial. This development must be traced primarily to a series of factors which have characterized the Australian economy over the past few years and against which the special accounts control technique was powerless: large-scale immigration and investment programs, booming world prices for major export commodities, and the massive inflow of foreign capital for both investment and speculation.

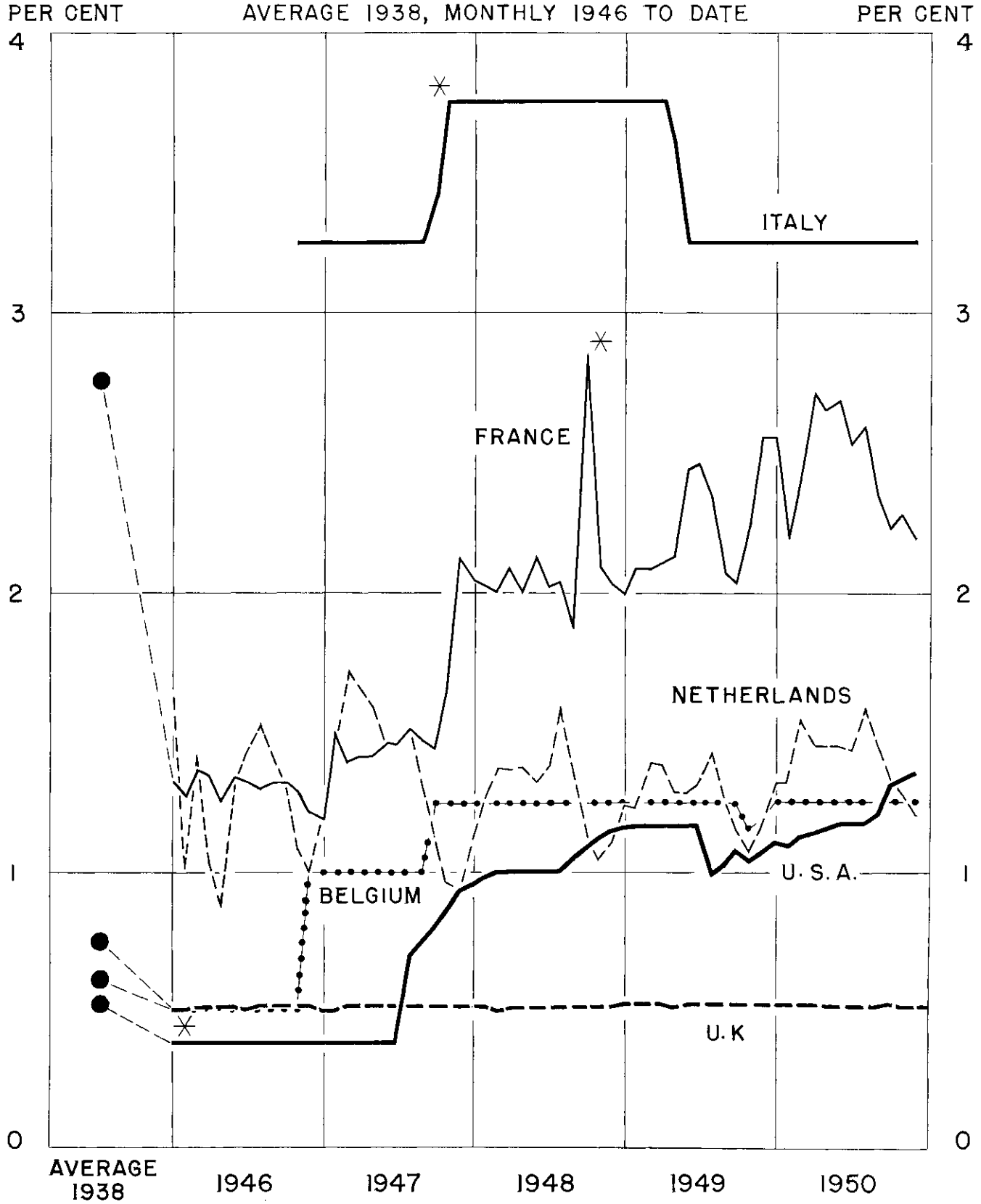
Postscript on lessons of foreign experience

Clearly, it is necessary to guard against any mechanical application of foreign experience to a country in which economic conditions may be quite different. Sometimes, however, it has been argued that foreign experience is wholly irrelevant to problems of monetary policy in the United States because of the extraordinarily large size and wide distribution of the public debt in this country.

It is easy to show that this argument does not hold. While, in absolute terms, the U. S. public debt far outdistances that of any other foreign country, a comparison of the various national debts with national income or money supply statistics reveals that, in relative terms, the problems raised by the size of the public debt can be no greater in the United States than in a number of advanced industrial countries such as the United Kingdom, Canada, the Netherlands, and Australia (see attached table). The only statistically assertainable fact about the comparative distribution of major public debts is the distribution between bank and nonbank holders. In this respect, the position of the United States is

SHORT-TERM MONEY RATES

U. S. AND SELECTED COUNTRIES



✳ DATE OF IMPOSITION OF COMBINED CASH AND SECURITY RESERVE REQUIREMENTS.

comparable to the position of an even larger number of foreign countries than is the case with respect to the size of the debt.

Also of interest is the fact that in foreign countries the large size of the debt has sometimes been adduced as an argument against support policies. Thus, in the United Kingdom, whose debt in relation to national income and money supply is approximately twice that of the United States, it has been argued with considerable force that it was impossible and dangerous to peg the long-term rate precisely because of the huge volume of outstanding securities and the consequent danger of inflation in case of large central bank purchases.

Importance of the Public Debt in the
Economic and Financial Structure of Selected Countries
(Percentage ratios at the end of 1949)

Country	Public debt 1/ to national income	Public debt 2/ to money supply	Interest on debt to budgetary revenue	Commercial bank-held debt to total com. bank assets	Bank-held debt to total debt 1/
United Kingdom	208	408	14	48	27
Netherlands	123	205	15	55	34
Australia	116	211	11	15	41
Canada	108	275	17	36	36
United States	100	179	14	43	45
Belgium	53	79	14	47	42
Sweden	46	120	6	12	45
Italy	30	65	8	15	37
France	30	62	4	20	47
Denmark	18	48	5	8	50

1/ Exclusive of non-interest-bearing and intra-governmental debt.

2/ Exclusive, in addition, of central-bank-held debt.

APPENDIX B

BRIEF REVIEW OF PRINCIPAL PLANS FOR ADDITIONAL AUTHORITY OVER BANK RESERVE REQUIREMENTS

The main proposals that have been advanced in recent years to increase Federal Reserve authority over bank reserve requirements are: (1) increased authority over primary reserves, (2) the special reserve plan, (3) a ceiling reserve plan, and (4) a loan expansion reserve plan. These proposals are described briefly below.

All of these proposals would have to be applied to nonmember, as well as to member, banks or they would be inequitable and would tend to drive banks out of the Federal Reserve System. None of these supplementary reserve proposals would remove the need for permitting some flexibility in interest rates. Also, none of them would curb the credit expansion of financial institutions other than commercial banks. That important problem would still have to be handled through appropriate debt management and flexible interest rate policies, or by some statutory measure to require these institutions to hold a certain proportion of their assets in Government securities.

A. Increased Authority over Primary Reserves

I. The Plan

Under this plan the Federal Reserve would be given additional authority to increase existing primary reserves of banks up to, say, double the present legal maxima.

II. Advantages of the Plan

1. It would reduce bank liquidity and discourage further expansion of loans.

2. It would reduce the multiple expansion potential of bank reserves.

3. The mere existence of the additional authority would be a psychological deterrent to further expansion of bank credit and encourage them to hold larger amounts of secondary reserves in the form of short-term Government securities.

4. It would be relatively simple to administer.

III. Drawbacks of the Plan

1. Since banks would sell Government securities, of which they are large holders to obtain most of their additionally required balances, the authority might have to be very large to assure effectiveness. It is not possible to know in advance how much reduction in banks' liquid assets would be needed to be restrictive.

2. It would deprive banks of earning assets, and would reduce their profits and their ability to augment their capital.

3. It would be too sweeping in its application and would be inequitable for individual banks, since it would apply with equal weight to banks extending excessive credit and to those not doing so.

4. It might force banks to seek additional loans and to sell more low rate Government securities to compensate for the loss of earnings resulting from the higher reserve requirements, thus defeating its purpose.

5. It would be resisted by bankers, particularly small bankers, who would feel that it would be an infringement on their freedom to conduct their own businesses and a confiscation of their earning assets.

B. The Special Reserve Plan

I. The Plan

This proposal would require banks to hold supplementary reserves, in the form of either short-term Government securities or cash, equal to a given proportion of their demand deposits. This supplementary requirement would be in addition to their existing primary reserve requirements.

II. Advantages of the Plan

1. If the requirements were made high enough, this plan would prevent banks from disposing of their existing holdings of short-term Government securities to obtain funds for making additional loans.

2. It would make increased required reserves less expensive to banks.

3. It would affect most severely those banks having the largest portfolios of loans and investments in other than U. S. Government securities.

4. It would enable the Treasury to borrow at low rates from banks.

5. It could be used to keep down bank earnings on Government securities in case large amounts of securities had to be sold to banks.

6. It would be relatively simple to apply and would not prevent banks from lending for essential needs.

III. Drawbacks of the Plan

1. The plan could be undermined by Treasury financing and refunding policies. Consequently, certain changes in present debt management policies would be essential to make it effective. These would include: (a) limitation on the issuance of reserve eligible securities, (b) refunding operations that would not create more and more reserve eligible securities, and (c) flexible interest rates on other marketable Government securities so that they would not require Federal Reserve support.

2. It would require relatively large special reserve requirements (as much as 35 to 40 per cent of demand deposits) in order to assure effectiveness.

3. Banks in the aggregate still would hold substantial amounts of medium Government securities which they could use to finance a loan expansion. If additional reserve funds are made available to banks through Federal Reserve support purchases of Government bonds from banks or other investors, these reserves could still be the basis for a multiple expansion of bank credit and the money supply.

4. There would be some rather serious transitional difficulties for individual banks, for short-term Government securities are not held in the same proportions by all banks.

C. A Ceiling Reserve Plan

I. The Plan

This plan would require a 100 per cent reserve against any increase in deposits after some date. The most recent version of the ceiling reserve plan has been called the "dual reserve account" plan. Additional reserves under this plan would go into a "clearing account" and could be invested in special securities issued by the Federal Reserve.

II. Advantages of the Plan

1. This plan would halt the multiple expansion of credit on the basis of any new reserves acquired by the banking system.

2. It would have few transitional difficulties for individual banks.

3. It would have distinct advantages in a period of large-scale defense or wartime deficit spending because it would make it possible for the Government to finance necessary bank borrowing through the Reserve Banks without allowing commercial banks to use the pressures thus created to expand their loans to private borrowers.

III. Drawbacks of the Plan

1. Although multiple expansion of loans would not be possible, it would not prevent banks from selling their existing holdings of Government securities to obtain funds for making additional loans.

2. It would prevent growing banks, particularly in growing communities such as defense areas, from increasing their loans and maintaining the same structure of assets as other banks.

3. It is a complex plan that would be difficult to administer.

4. Strong pressures would arise to extend Government lending activities to provide credit to borrowers unable to obtain funds from their local banks.

D. The Loan Expansion Reserve Plan

I. The Plan

This plan provides for a supplementary reserve equal to a specified percentage of the increase in a bank's loan assets from a base amount. (Loan assets would be defined to include all loans and investments other than United States Government securities. The Federal Reserve would be given authority to set the reserve ratio up to a maximum of 100 per cent of the increase in such loan assets.

II. Advantages of the Plan

1. It would effectively reduce the ability of the banking system to grant credit to businesses, consumers, and State and local governments. At the same time, it would be highly selective, having little or no effect on banks that did not expand their loan assets.

2. It would permit reserve requirements to be increased or decreased with a minimum of inequities and transitional hardships for individual banks.

3. It would permit private interest rates to be more responsive to changes in the demand for credit.

4. It would give banks an incentive to hold on to their Government securities, and would reduce their willingness to dispose of such securities in order to expand their loan assets.

III. Drawbacks of the Plan

1. It might, unless specifically exempted, restrict essential credit such as defense loans, whether guaranteed or not.

2. It would interfere somewhat with the growth of banks in expanding communities, such as in defense areas, and possibly encourage a greater concentration of banking.

3. It might not provide sufficient flexibility for meeting seasonal credit needs in all communities.

4. It would give an even more preferred investment status to Government debt, an excessive volume of which greatly aggravates our current inflation problem.