

THE CURRENT INFLATION PROBLEM—CAUSES AND CONTROLS*

by

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Mr. Chairman and Members of the Committee: In appearing before you today I wish to make clear that I am speaking for the Board of Governors of the Federal Reserve System, an agency of Congress, and I am not undertaking to speak for the Administration or the Presidents of the 12 Federal Reserve Banks.

You have requested me to testify, I take it, as to what might be done in the monetary and credit field to deal with inflationary forces, which have already gone so far as to cause very serious maladjustments within the economy. Correction is overdue. The longer it is postponed, the more severe will be the inevitable reaction.

I am sure this Committee recognizes that a great many factors and forces contributed to the inflationary problem and that there is no easy, simple, or single remedy. We are already in the advanced stages of this disease. It is no longer a question of preventing it, but of moderating so far as possible its ultimate ravages.

At best, monetary and credit policy can have only a supplemental influence in any effective treatment of either inflation or deflation. In considering what can be done so far as monetary and credit action is concerned, it is necessary to make a correct diagnosis of the multiple causes of the situation with which we are now confronted.

What is inflation? It is the condition which exists when effective demand exceeds the overall supply of goods and services. Potential overall demand always exceeds supply. What is lacking in deflation is effective demand. We are witnessing effective demand today when individuals and businesses, together with State and local governments, as well as the Federal Government, generally have money which they are trying to spend, bidding for an insufficient supply of goods and services. This effective purchasing power is composed of past savings, current income, or future credit. The savings were largely accumulated during the war years in the form of currency, bank deposits and Government securities.

At the end of 1946, individuals and businesses held about 223 billion dollars of such liquid savings, or more than three times the prewar total. Similarly, current national income is at an all-time

high level. It is running at a rate of 200 billions a year, or about two and a half times the total for 1940, the highest year prior to the war. It is due to a record high agricultural income, high wages of organized labor and other workers, but not all of them, and unprecedented business profits. This is augmented by a readily available supply of excessively easy credit for consumers' goods of all kinds, for housing, for short- and long-term business loans, for State and municipal expenditures, and for foreign credits and grants. The notable exception is loans to buy listed stocks, which are sharply restricted by the Board's margin requirements.

In the face of these large and expanding demands, production is practically at capacity and further growth will necessarily be slow. The physical volume of output of manufactured goods and minerals in 1947 has averaged 186 per cent of the 1935-39 average. Current output is about one-fifth below the wartime level, largely because of the reduction in weekly working hours. Agricultural output in physical terms has continued for the past three years at record levels of about a third above the maximum of any prewar year. This volume reflects general favorable weather and further growth can hardly be expected. Construction of all kinds, including residential building, is close to any previous peacetime peak. Expansion in building is now being retarded by shortages of essential labor and materials. Railroad transportation is limited by the shortages of railroad cars and other equipment. Employment is at very high levels with acute shortages in many fields and with a minimum of unemployment.

The source of the present inflation is war financing and the enormous Federal deficits incurred in preparation for and prosecution of global war. During the six-year period, June 30, 1940 through June 30, 1946, the Government raised about 398 billion dollars, but only 176 billion dollars; or 44 per cent came from taxes. The remainder of 222 billions, or about 56 per cent, was raised by borrowing. And of this total which was borrowed, approximately 90 billion dollars, or 23 per cent of total needs, was raised by selling Government securities to the commercial banking system, including those purchased by the Federal Reserve Banks.

* Statement by Chairman Eccles before the Joint Committee on the Economic Report, Special Session of Congress, Nov. 25, 1947.

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As the Reserve Board stated in its 1945 Annual Report to Congress, it is important to bear in mind that borrowing from the banking system, whether by the Government or by others, creates an equivalent addition to the country's money supply. To the extent that the Government did not finance its war program by taxation, it was obliged to borrow, and to the extent that it did not borrow from non-bank investors, it relied upon the banks and thus created new supplies of money. The Federal Reserve by purchasing Government securities, supplied the commercial banks with reserves needed as a basis for the increased money supply.

As a result, the country's money supply, as measured by privately held demand deposits and currency in circulation, increased more than two and one-half times, rising from less than 40 billion dollars in June of 1940 to 106 billions at the end of June 1946. In the same period, time or savings deposits nearly doubled. In addition, the general public, outside of banks, insurance companies, and Government agencies, accumulated or increased holdings of Government securities to 100 billion dollars, or nearly seven times as much as in June of 1940. These Government securities in the hands of the public are the equivalent of money because they are readily convertible into cash.

It should be strongly emphasized that the banking system was the instrument, and not the instigator, of this swollen money supply. The bankers performed a vital service in the financing of the war and particularly in the sale and distribution of savings bonds and of other Government securities.

If it were possible to finance a great war entirely by taxation there would, of course, be no increase in the public debt. Or if it were possible to do the financing by a combination of taxation and borrowing outside of the banking system, there would be no increase in the money supply. In retrospect, we can see that we could have and probably should have taxed more and borrowed more from non-bank investors and less from the banking system. 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.

In order to enable the banks to purchase Government securities essential to the financing of the war, the Federal Reserve System maintained easy money conditions and made Federal Reserve credit and reserves readily available to the banks. The vast money supply thus created was held in check by an elaborate harness of controls consisting, among other things, of allocations of

scarce materials, construction permits, price and wage ceilings, rationing, and the excess profits tax. When the harness of controls was prematurely removed and no effective substitute was devised to hold back the flood of effective demand, it was apparent, or at least it should have been apparent, that a sharp rise in prices was inevitable.

As a result, the economy was caught in a dangerous wage-price-profit-credit spiral, acutely intensified by short farm crops abroad, and reduced corn and cotton crops at home. Critical conditions abroad, in part resulting from our rising prices, impose upon us obligations which must be met even though they add to our inflationary difficulties.

It would be blindly and foolishly optimistic to believe that the spiral of inflation can continue through further general wage, price and profit increases and further overall expansion of credit without ultimate serious deflation. The longer the necessary readjustment is delayed, the longer it will take to reach a stable condition of employment and production. The most serious maladjustments are evidenced by the increasing numbers of our people whose incomes do not keep pace with the rising cost of living. They are being priced out of the market for housing and many other things, and in countless instances their savings and credit have already been exhausted. The higher prices rise and credit expands, the greater the subsequent liquidation and downward pressure on prices is bound to be. As the November letter of the National City Bank of New York correctly states, "Rapidly accumulating debt is both a cause and a consequence of the inflationary pressures, for in a wage-price spiral, business constantly needs more and more money to keep going and this leads to the incurrence of more and more debt by business and more and more spending by the individual. To check this kind of spiralling—which is to the ultimate benefit of no one and to the injury of all—is not simple."

The problem we all face now is what can be done at this late stage, if necessary, to curb further inflationary developments. As a practical matter, we cannot now put back the elaborate harness of wartime controls, and it seems that we are left only with the choice of certain curbs or restraints selectively applied at some of the more critical points of danger.

In the absence of a comprehensive scheme of controls we must continue to put our main reliance on fiscal policy, which is by far the

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most effective way to deal with the demand side of the equation, while we do everything possible to maintain and increase production. We should have the largest possible budgetary surplus while the inflation danger exists. And this means taking from the public in taxes money that otherwise would continue in the spending stream. It means rigid Government economy. It means deferment of all expenditures, Federal, State, or local, to the greatest extent consistent with public obligations at home and abroad. Using the budgetary surplus to pay off bank-held public debt as it becomes due will reduce the money supply by an equivalent amount. This is a reversal of the process by which the money supply was expanded. In an inflationary boom such as we are experiencing the Government should pay off as much of its debt as possible.

Public debt cannot be reduced during deflation. Budgetary deficits, not surpluses, are an inevitable consequence of serious deflation. Tax reduction would be appropriate after deflation sets in, not during an inflationary period. If a reduction of taxes at this time would, in fact, call forth more production, then it would be justified. Today we still have acute scarcities of labor and materials. Adding to existing buying power either by tax reduction or aggregate expansion of credit can only have the effect of bidding up the prices paid for both labor and materials. If conditions were reversed and we had idle labor and a surplus of materials and productive facilities coupled with a shortage of capital and insufficient purchasing power, then reductions in taxes, particularly those which would stimulate mass buying power, would be in order.

If I were to outline a program to meet the situation with which we are now faced, I would list the following steps to deal with the causes rather than with the effects of inflationary pressures. They are listed in what I consider their order of importance.

1. Increased productivity both at home and abroad. Production is the ultimate solution for inflation. Nothing could be more effective than increased productivity of labor and longer hours of work by everyone. In short, if all who are engaged in producing goods and essential services were to work more, and save more, and spend less, the unbalanced relationship between demand and supply would most effectively be corrected and prices would come down.

2. Suspension of future demands for wage increases, especially those of organized labor where the increases have been greatest, is necessary if the present unbalanced relationship is to be corrected without severe deflation. Business profits after taxes are more than double what they were in any prewar year and almost double the profits in any war year, and therefore business should hold prices down or should reduce them, in accordance with what would be reasonable earnings.

3. A fiscal policy to produce the largest possible surplus to be used to pay off bank-held Government debt and thus reduce the money supply. This means the greatest possible economy in all Government expenditures. It means more adequate financial support of the tax collection machinery of the Government to prevent tax evasion. It means no general decrease in tax rates at this time. It should also mean the elimination of the agricultural price support program unless price ceilings are reimposed.

4. Legislation giving the Federal Reserve System such authority as may be necessary to restrict further overall expansion of bank credit. The need for this authority would be less if Congress authorized other anti-inflationary measures such as restoration of consumer instalment credit restrictions and if stricter appraisals and less liberal credit terms were applied under the Veterans' Administration, the FHA, and the Home Loan Bank programs of housing finance.

5. Continuation and expansion of the Treasury's Savings Bond campaign, with adequate financial support by Congress. Funds so raised have a two-fold effect. It removes these funds from the spending stream and makes them available to pay off bank-held debt, thus reducing the money supply.

Other actions have been proposed which, however, deal with the effects rather than the causes. Allocations, construction permits, price and wage ceilings, commodity margin requirements, instalment credit regulation, export and rent controls, and similar devices are all in the category of curbs rather than cures. Where they can be applied as a practical matter and enforced, they can be useful, but they do not go to the sources of the problem.

I should like to summarize what the Federal Reserve Board believes might be done in the monetary and credit field. In its 1945 and 1946 Annual Reports to Congress the Federal Reserve Board described the situation in which those with responsibility for monetary policy find themselves

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as a consequence of the war. As the Board stated in the 1945 report:

"In common with other nations whose energies were devoted primarily to winning the victory, the United States had no choice, under the exigencies of a global war, except to use monetary powers in furtherance of essential war financing and not as an anti-inflationary weapon. There has been a widespread assumption that, with the coming of peace, such statutory powers as the Reserve System possesses should be exerted in the traditional way against the heavy inflationary forces at present confronting the country. The Board believes that such an assumption does not take sufficiently into account either the inherent limitations of the System's existing statutory powers, under present-day conditions, or the inevitable repercussions on the economy generally and on the Government's financing operations in particular of an exercise of such existing powers to the degree necessary to be an effective anti-inflationary influence."

Of late the Federal Reserve System has been increasingly criticized for not adequately using its existing statutory powers to restrain bank credit expansion. It is very important, therefore, that the Congress understand what those powers are and why the Board does not believe they can be used to deal with the credit problem, and why we suggested in the 1945 and 1946 reports, and suggest now, that Congress consider providing other authority that may be necessary to cope with the situation. We did not then and we do not now seek power, but we feel that we would be remiss, as an agency of Congress, if we failed to report the situation as we see it and to propose alternative means of dealing with it inasmuch as we feel that our existing powers are insufficient.

The Reserve System has always had broad powers to influence the supply and cost of bank credit. Through open market operations, that is, buying and selling of Government securities, the System either gives reserves to the banks or absorbs reserves. Reserves are the foundation on which bank credit is built. If banks have no reserves they cannot lend. But they can obtain reserves when they borrow from the Federal Reserve Banks or sell Government securities to the Reserve Banks. And the banking system automatically receives reserves through gold acquisitions, and also when the Federal Reserve Banks buy Government securities from nonbank investors. The Reserve System can restrain banks from borrowing by raising the discount rate sufficiently

high to make the borrowing unprofitable. It could refuse to buy Government securities and shut off that source of reserves. It has no powers to deal with reserves arising from gold acquisitions.

Why, then, doesn't the System simply make the discount rate prohibitive and at the same time refuse to buy any more Government securities? Let me say that if the Congress disagrees with us and feels, as do some bankers and insurance company executives, that we should more fully use existing powers, we would welcome such an expression from the Congress. In that case, there would be no need to consider any alternative powers. On the other hand, if Congress agrees that our existing powers are not appropriate under present circumstances, full consideration should be given to any proposal that would help to meet the situation.

First, let us consider what the effect would be of raising the discount rate by itself. Actually, the effect would be negligible, except for possible psychological reaction, because as long as the System stands ready to buy Government securities in the open market, banks can obtain reserves at will by selling such securities out of their portfolios. Suppose, then, that the System refused to buy the securities—and that is the heart of the matter—what would the consequences be? Bear in mind that the total interest-bearing debt of the Government is 256 billion dollars, more than five times what it was before the war. The public debt at the beginning of 1940 was about one-fifth of the total public and private debt of the country, whereas at the present time it is nearly two-thirds of the entire indebtedness of the country. About one-third of the total Government debt is short-term marketable debt and would need to be refunded into higher-rate securities. This would raise the cost to the Government, and therefore to the taxpayers, of carrying the public debt. Already the nation's tax bill for interest cost is approximately 5 billion dollars or nearly one-seventh of the total Federal budget.

Just how high would interest rates have to rise to deter business and individuals from borrowing from banks? Higher interest rates do not deter the lender. Rising interest rates are like rising prices. At some point they do deter the borrower or the buyer. They do not deter the lender or the seller. I doubt if anybody knows how high interest rates, especially short-term rates, would have to rise to discourage borrowers. Certainly the rates would have to be substantially above the present relatively low levels. Bank customers, particularly business, with seemingly insatiable markets awaiting their

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products, are hardly to be deterred by one or two points of increase in bank interest rates.

The additional costs to the Government in carrying the public debt would be difficult to estimate, but they would amount to billions a year over a period of time. If that were the only consequence, it might be argued that the extra cost to the Government would be justified because inflationary borrowings would cease.

However, this is only one aspect of the matter. In the process of leaving Government securities to the free play of variable forces in the market, the Treasury would be confronted with a continuing puzzle in all of its constantly recurrent refunding operations. It could not tell from day to day at what price it could sell its securities. It would be entirely at the mercy of uncontrolled factors in the market, if, indeed, conditions did not become so confused and chaotic as to demoralize completely any refunding operations.

I recently saw a prediction by a very keen bond market analyst that failure of the Reserve System to support the $2\frac{1}{2}$ per cent rate on marketable Government bonds would lead to a wholesale liquidation of all Government bonds, including the non-marketable E, F and G bonds. He declared that it would be the most dramatically inflationary move that could be made at this time, the repercussions of which would be, as he put it, so catastrophic as to make present fears appear as one raindrop in a storm. That is strong language. Nobody can say with certainty that it is too exaggerated.

In any case, I think it is fairly clear that withdrawing support from the Government securities market and letting interest rates rise on Government securities would not increase the power of the Federal Reserve System to offset increases in bank reserves from gold acquisitions. Sales of System holdings of Government securities for this purpose would have to compete with private credit demands. Private borrowers might outbid us for these reserves. There would be no certain level of security prices or interest rates at which we could dispose of enough Government securities to offset gold imports.

On the other hand, we have to recognize what would happen if we follow the present course of policy in order to maintain the public's confidence in Government credit and avoid any unnecessary increase in the interest cost to the Government for carrying the public debt. Commercial banks currently hold about 70 billion dollars of Government securities. This sum is about 50 per cent of their total deposits. If they should sell half of

these securities and the Federal Reserve System, in providing an ultimate market, should buy them, the banks would acquire an equivalent volume of new reserves. On the basis of these reserves, the banks could expand credit by about six times, or by more than 200 billion dollars. This is nearly double the present amount of demand deposits and currency. While it is unlikely that the banks would dispose of so large a proportion of their holdings, it nevertheless is a measure of the potential bank credit expansion that can occur if the banks are left with complete freedom to convert their Government security holdings into reserves at will.

This bank credit expansion potential is apart from other sources of bank reserves. Gold is now flowing into our banking system in large quantities from foreign holdings. As a result, deposits are increased and on the asset side banks gain an equal amount of reserves. Over the next year, the gold inflow is estimated at from 2 to 3 billion dollars. Multiplied by six, this would permit an expansion of bank credit of from 12 to 18 billions.

There are two other important potential sources of increased bank reserves. Nonbank investors, mainly business corporations, hold about 13 billion dollars of short-term Government securities. Businesses face increasing needs for working capital under prevailing inflationary conditions. To some extent, these needs will be met by sales of short-term Government securities, which the Reserve System may have to buy.

The second possible source of bank reserves is the 59 billions of marketable, medium- and long-term Government securities held by nonbank investors. With widening opportunities for the placement of funds in private investment at increasingly attractive yields, there is a small amount of shifting by investors of their holdings of marketable long-term Government securities. If inflation continues, this shifting will likely increase. Such sales have to be met by Federal Reserve support of the prices of marketable Government bonds so as to protect the $2\frac{1}{2}$ per cent rate on long-term issues. The result of these support operations is to increase bank reserves and thus to support further inflation.

Under present and prospective conditions, it is not only desirable but essential, in the opinion of the Treasury and of the Reserve System, that the established $2\frac{1}{2}$ per cent rate on long-term marketable Government securities be maintained.

The Federal Reserve Board has one other power that it has been criticized by some for not using. That is the power to raise the reserve

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requirements of the banks in New York and Chicago from 20 to 26 per cent of their net demand deposits. This is a relatively minor matter and does not in any way go to the heart of the problem. Any action taken would have an effect on banking conditions only in two cities in which the credit expansion, as well as deposit growth, has been relatively less than for the rest of the country.

We have given a great deal of study to this admittedly difficult and complex problem. We are convinced that the remedy of letting interest rates on Government debt go up on the theory that this would bring an end to inflationary borrowing is dubious at best, as has been demonstrated in past monetary history, notably in the 20's when high rates were unsuccessful in restraining speculation in the stock markets, real estate, or otherwise.

As was made clear in the Annual Report for 1946, we are not opposed in principle to higher interest rates if some desirable ends and the public interest can be served by such a policy. In fact, in recent months we have cooperated with the Treasury in permitting some moderate, corrective rise from wartime levels of interest rates on short-term Government securities. This adjustment was made to reduce the wide differential prevailing between short-term and long-term interest rates. Such a large differential was having the effect of encouraging banks to sell short-term securities, which the Federal Reserve bought, and to buy long-term securities in the process, thereby encouraging multiple credit expansion. The differential in rates was also exerting a strong downward pressure on yields of long-term securities. We were aware that this decline was artificially induced by investment policies of the banking system known as monetization of the public debt, and resulted in bank credit expansion. We also recognized the importance of checking the decline in long-term interest rates to protect educational, charitable, and pension funds, as well as insurance institutions, savings banks, and individuals depending upon interest for income.

The action permitting a moderate rise in short-term interest rates coincided, however, with strong demands for long-term funds, which put considerable strain on the market for corporate and municipal securities. As a consequence, these issues have been made more attractive as investments. They are thus somewhat more competitive with long-term Governments than before. We have to face this fact of the market place and be prepared to offset any shifts in investor holdings from Government

bonds to other securities. The undesirable aspect of the situation, from the standpoint of inflationary credit conditions, is that support of Government bonds adds to bank reserves. These developments indicate that a policy of permitting interest rates on short-term Government securities to rise has gone about as far as can be justified under present circumstances.

We have, therefore, been compelled to seek some better alternative than higher interest rates to restrain further bank credit expansion. We believe that one is available which will not make the Government and the taxpayer bear the added cost of the restraint, that will impose very little, if any, hardship on the banks, that will, in fact, have a compensating aspect in that the restraint imposed would increase interest rates on private borrowings without additional cost to the Government.

I refer to the second alternative proposed in the 1945 Annual Report. We recommend for consideration, as the best alternative we have been able to devise, that all commercial banks be required as a temporary measure to hold some percentage of their demand and time deposits, in addition to present reserves, in a special reserve in the form of Treasury bills, certificates and notes or cash, cash items, interbank balances, or balances with Federal Reserve Banks.

Such a requirement would be far less onerous for the banking system than any other effective method that has been suggested in the long period in which this problem has been discussed by bankers, by economists, and public officials. Manifestly, such a requirement would have to be imposed gradually, if at all, as an offset, for example, to bank reserves created by gold acquisitions and by the purchase of Government securities from nonbank investors, and also to limit the too ready availability of reserves, now enabling banks to obtain them at will. A multiple expansion of credit can be built on these reserves at a ratio of fully six dollars of lending for every dollar of reserves. We would propose that the special reserve requirement be limited by law to a maximum of 25 per cent on demand and 10 per cent on time deposits. It should be made applicable to all commercial banks. It would not be effective if applied only to member banks of the Federal Reserve System, and would be an unjustifiable discrimination.

We recognize that this proposal is no panacea, but it would be an important, available restraint, now lacking, to be applied equally to all commercial banks so that the individual banker would be in the same competitive situation he is in today.

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Over the next four months there is likely to be little need for the suggested special reserve because of the large amount of Treasury surplus funds, taken from the market through taxes, which will be available to retire bank-held public debt. This would temporarily exert pressure against bank credit expansion.

The proposed special reserve requirement has a number of important advantages over other methods of dealing with the problem of restricting the banks' expansion of credit:

1. The plan would have about the same effect in limiting credit expansion as an increase in primary reserve requirements, which was proposed as the third alternative in the 1945 Annual Report. It would enable the banks to retain the same volume of earning assets that they now hold, whereas an increase in basic reserve requirements would make it necessary for them to reduce earning assets, with adverse effects upon the earnings position of banks.

2. The ratio of potential credit expansion on a given increase in reserves would be narrowed to the extent that the special reserve was required. At the maximum requirement proposed, it would be lowered from six to one to nearly two and one-half to one.

3. It would bring about an increase in interest rates on private debt and would increase earnings of the banks from this source where rates on loans are comparatively low. It would accomplish this purpose, moreover, without increasing the interest cost on the public debt or permitting unstable prices in the Government securities market. The plan, in effect, would divorce the market for private debt from the market for Government securities.

4. The plan would not rely on higher interest rates to restrain private borrowing, but to the extent higher interest rates restrain such borrowing, the proposal would make use of the interest rate mechanism. Hence, the cost of restraining credit would be borne by private borrowers who are incurring additional debt, and not by the Government which is reducing its debt.

5. The main effect of the plan would be to reduce the availability of bank credit. This would be accomplished by putting the restraint on the lenders, that is, the banks. They would be less willing to sell Government securities in order to expand credit because the amount of such liquid assets as they held as secondary reserves could be greatly reduced by the requirement. Such an authority,

even without action being taken by the Reserve authorities, would have a very restraining influence.

6. The plan would restore use of the customary instruments of Reserve influence on bank credit expansion, namely, discount rates and open market operations. Support of these instruments by the special reserve requirement would enable the Federal Reserve to make it more difficult and costly for banks to borrow Federal Reserve funds.

7. No alterations in the banking structure, in the authority of the supervisors, in customary methods of bank operations, or in established interbank relationships would be introduced as a result of imposing the requirement.

8. The banks would be left by the plan with sufficient latitude to meet essential needs of the economy for credit, and the public would be assured of a high degree of liquidity and safety for the banking system.

Many bankers argue that this proposed requirement is unnecessary because the banks themselves have a vital interest in the conservative extension of credit, and will prevent excessive credit expansion as a matter of ordinary banking prudence. The banks, however, are confronted by a situation in which they can readily meet unlimited private credit demands and in which such demands are vigorously sustained by inflation while, at the same time, these demands are contributing to inflation. They are both a cause and effect. The banks are not in a position to refuse legitimate, sound credit demands of individual customers, and current loans, taken separately, which in the light of the customer's satisfactory credit risk, do appear to represent legitimate credit needs. But in accommodating these credit demands freely, the banks as a system are expanding bank deposits and adding to the money supply.

From the beginning of 1946 through October of this year, the banking system as a whole has increased its loans and investments—other than Treasury obligations—by an estimated 12 billion dollars. This has added a like amount to the money supply, which, together with gold acquisitions, is largely responsible for an increase in privately held deposits of 14 billion dollars.

Reconversion of the economy from war to peace required aggressive bank financing of agriculture, commerce, and industry in order to facilitate the earliest possible attainment of peacetime activity on a much higher level than prevailed before the war. Some of this bank credit expansion for private purposes, therefore, was justified. High levels of peacetime activity have long since been attained,

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however; yet, bank credit expansion is continuing and in recent months has gained rapid momentum.

None of us likes restraints. I am sympathetic with the bankers who resent seeming to be singled out for a special restraint on their wares, which are loans and investments. To the uninformed, it might appear that the banking system has been or is now to blame for the oversupply of money. This is not the case.

Instinctively and naturally, bankers do not relish restrictions on their activities any more than labor likes wage controls, or agriculture likes price ceilings. We realize that the special reserve proposal which we consider the best alternative, after considering all of the circumstances, will be very strongly resisted by those bankers who fear that it points accusingly at them, or that it is more regimentation, more bureaucratic reaching for power, or an encroachment on State rights, or an opening wedge to force nonmember banks into the Reserve System. All these things have been said to us privately or publicly—and we can only say that if a better alternative can be devised, we would welcome it.

The Board recommends that the administration of the special reserve plan be placed in the Federal Open Market Committee, whose members, in addition to the Reserve Board, are five presidents of the Federal Reserve Banks. This should help to remove some of the misgivings of bankers.

The opposition of some very prominent bankers to any new power for the Federal Reserve is expressed in a statement which they have asked me to submit for the record. It is a statement of the Federal Advisory Council, composed of twelve bankers, one from each Federal Reserve district. Often we agree. In this case they unitedly oppose the remedy we advocate. They contend that banks are not indulging in inflationary expansion of credit; that, therefore, the problem should be attacked on other fronts, and that no legislation is required on the banking front. They differ with us also in unanimously opposing reinstatement of installment credit regulation.

I am sure the Council's views reflect the opinion of a great many bankers, who are entirely sincere in the belief that the loans they are extending are safe, deserving risks necessary to sustain full production. That conviction, honestly held, is unhappily characteristic of boom psychology. In 1920, or in the latter part of that decade, bankers would have made the same replies that they give today if asked whether they thought the loans

they were making should not be made. A short time later they were trying desperately to liquidate some of these loans. The individual banker is judging by standards applying to the individual borrower and risk.

The Reserve Board, the Congress, and all responsible for public policy must necessarily approach the whole problem from a different standpoint. The question we must ask is whether any further expansion in the aggregate amount of credit is desirable or dangerous. If it, in fact, calls forth more production it will be desirable. If it only permits one borrower to bid against another would-be buyer for scarce goods and thus adds to upward pressures on prices, it is dangerous. It is our best judgment that overall expansion of the money supply at this time is inflationary and dangerous.

It is unfortunate, I think, that banking leaders oppose protective measures against inflationary forces arising in the credit field. They seem to forget that in order to assist in war financing, the Government provided the banking system with additional reserves which enabled the banks to buy Government securities; that this created new deposits in the banks; and that banks have also had the benefit of interest received on the Government securities they have held and will continue to hold for an indefinite period. They object even to a temporary limitation on the *further* use of these funds as a basis for loans to private borrowers, which would in turn create more and more deposits. The Government has an obligation and a duty to step in at this time of national danger to say to the banks, "We are not proposing to deprive you of benefits you have already derived and will continue to derive from the vast increase in bank deposits resulting from your purchases of Government securities, but we do say that you should be willing to accept a reasonable limitation on using a war-created situation to multiply private loans in peacetime when they serve to intensify inflationary pressures."

To sum up, the proposed special reserve requirement is only a part, though a necessary part, of any effective anti-inflationary program. As I have indicated, action on other fronts, by far the most important of which is fiscal policy, is necessary to the success of that program. And the need for action on the monetary and credit front would be reduced to the extent that needed action is taken on other fronts.