ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

In making its thirty-second annual report, as required by law, the Board of Governors of the Federal Reserve System takes the first opportunity afforded, since the end of hostilities, to present to the Congress a general appraisal of the war's effects upon the country's monetary situation, viewed from the standpoint of the responsibilities which Congress has placed upon the System and the System's statutory powers to discharge these responsibilities.

It is the Board's belief that the implicit, predominant purpose of Federal Reserve policy is to contribute, in so far as the limitations of monetary and credit policy permit, to an economic environment favorable to the highest possible degree of sustained production and employment. Traditionally this over-all policy has been followed by easing credit conditions when deflationary factors prevailed and, conversely, by restrictive measures when inflationary forces threatened.

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.

Accordingly, the Board takes this occasion to review Government financing operations of the war years and at present as they have affected the country's banking and credit situation, and to outline, in general terms, some of the alternative measures to which the appropriate committees of the Congress may wish to give detailed consideration at the proper time, in determining by what means monetary and credit responsibilities should be discharged.

MONETARY SITUATION AS A RESULT OF WAR

Between June 30, 1940, on the eve of the defense program, and the end of 1945, the Government raised approximately 380 billion dollars. Of this, 153 billion dollars came from taxes, or about 40 per cent. The remainder, 228 billion, or about 60 per cent, was raised by borrowing, that is, by increasing the public debt. Of the total borrowed, 133 billion, or about 60 per cent of the borrowing, came from selling Government securities to investors other than commercial banks and the Federal Reserve Banks. Approximately 95 billion dollars, or 40 per cent, of the borrowing, was raised by selling Government securities to the commercial banking system.

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It is important to any appraisal of monetary and credit conditions, to understand that borrowing from the banking system, whether by Government or by others, creates an equivalent addition to the country's monetary supply. Borrowing from individuals, business concerns, insurance companies, or other sources, except the banking system, represents the investment of existing savings. 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 nonbank investors, it relied upon the banks and thus created new supplies of money.

As a consequence, the country's money supply, as measured by demand deposits and currency in circulation, more than tripled, increasing from 40 billion dollars in June 1940 to 127 billion at the end of 1945. Time deposits nearly doubled in the same period and now amount to about 50 billion dollars. In addition, the general public (exclusive of banks, Government trust funds, insurance companies, and other financial institutions) has about 100 billion dollars of Government securities, eight times as much as in June of 1940.

From the monetary standpoint, it is necessary to take into account, not only these existing liquid assets, but also the amount of current income flowing from production and employment. All of these items compose an inflationary potential, at a time when the supply of goods and services available for purchase with existing funds and currently produced income is far from adequate to meet current demand, on which is superimposed an unprecedented backlog of demand accumulated in the war years. The extent to which funds available to the public, including business, will compete for the existing supply of goods and services depends upon many factors. It depends, among other things, upon the continuance and effectiveness of price controls, upon credit restraints and other devices for dealing with inflationary effects, and upon public psychology and behavior, which in turn are influenced by expectations as to the trend of prices and the volume of production. Public confidence that the purchasing power of savings and current earnings will be maintained depends primarily on the determination of Congress and of administrative officials to hold inflationary forces in check and to reduce them, wherever possible, until the country's unrivaled capacity to produce has had every opportunity to bring about a reasonable balance between the factors of supply and demand.

It is axiomatic that inflationary dangers exist when the supply of money in the hands of people who seek to spend it greatly exceeds the volume of goods and services available. The more the money supply exceeds the volume of goods, the greater the inflationary pressures will be. There can be no doubt that the country's money supply, several times greater now than ever before, is and will continue for an indefinite time to be much in excess of available goods. Under such conditions, with the heavy drains of war financing no longer existing, public policy calls for vigorous attack on the basic causes of inflationary pressures. This, in turn, requires that the Government stop and reverse, if possible, the process whereby it has created bank credit. It is all the more imperative that the Government reverse this process as the commercial banking system resumes its

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peacetime function of supplying credit to private sources whose borrowing will itself create additional funds.

The Government has, in fact, been reversing its creation of money by drawing on its surplus cash balance to pay off Government debt, primarily that held by the banks. As long as this use of the Treasury's cash balance continues, the effect will be anti-inflationary and altogether salutary at this time. However, if the policy of paying off Government debt is to continue, as it should until such time as deflationary and not inflationary pressures threaten economic stability, it will be essential to have not only a balanced budget but as great a surplus of receipts over expenditures as is possible without neglecting necessary governmental functions. Accordingly, further general reduction of taxes should be avoided and prudent economy should be effected in governmental operations.

Necessary as it is that Government policy be firmly anti-inflationary at this juncture, the rapid attainment of full and sustained production far overshadows all other economic considerations. As production is disrupted, whether by strikes or other causes, a series of interrelated and dangerous economic consequences inevitably results. On the one hand, supply is diminished relative to demand. On the other hand, demand is increased in so far as the public, anticipating rising prices, strives to purchase whatever can be obtained at whatever prices are asked or tolerated. Black markets, inventory accumulation, speculation, particularly in fields not covered by price controls, such as securities and real estate, are thus fostered. These are the customary symptoms of an inflationary spiral, which can end only in collapse and deflation. When that stage is reached, diminished incomes cause a sharp decline in Government revenues, leading to an unbalanced budget and a deficit which has to be financed chiefly by creation of more bank credit.

It is this chain of causation that has to be prevented, first of all, by full and sustained production and, second, by having the Government discontinue its creation of bank credit and reduce as rapidly as possible its debt. Even under the most favorable auspices, of maintaining high levels of taxation and of careful economy, the process of reducing the redundant money supply will be slow and gradual. It may be offset, not only by creation of bank credit to finance necessary private production, but by creation of bank credit that finances speculation in existing assets, whether commodities, real estate, securities, or Government bonds.

The creation of unnecessary bank credit by the commercial banking system is the particular concern of those charged with monetary responsibilities. It can not be a matter of indifference that at present the country's central banking mechanism lacks appropriate means, that may be needed, to restrain unnecessary creation of bank credit through continued acquisition of Government or other securities by the commercial banks. So long as the Government is able, whether out of its surplus cash balance as at present, or out of a future budgetary surplus, to pay off its debt held by the commercial banking system, a restraining influence is exerted.

Nevertheless this restraint may not suffice because of circumstances which are

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the heritage of war financing. One of these is the Reserve Board's assurance to the Treasury that the rate of ⅞ per cent on one-year certificates will be maintained, if necessary, through open market operations. This means in practice that the Federal Reserve stands ready to purchase short-term Government securities in the open market in order to prevent short-term interest rates from rising above the level the Government is now paying. This assurance is necessary from the standpoint of the Government's financing operations, and was given because the Board does not favor a higher level of interest rates than the Government is now paying.

This policy makes it possible, however, in the absence of effective restraints, for commercial banks to sell short-term, lower-yield Government securities to the Reserve System and thus acquire reserves which, on the present basis of reserve requirements, can support a sixfold expansion of member bank credit. To the extent that commercial banks use these reserves, either for their own account or in loans to customers, for the purpose of purchasing longer-term, higher-yield Government bonds or other securities, the money supply can thereby be increased on the volition of the banks irrespective of national monetary policy and without control such as exists in other principal countries.

There remain outside of the banks approximately 20 billion dollars of Treasury bonds which are eligible for bank purchase. An additional 34 billion, now ineligible for banks to purchase, will become eligible during the next 15 years. Thus, even though the Federal budget is balanced and Government debt continues to be paid down, there will be some 55 billion dollars of Treasury bonds that could be acquired by the commercial banks, in the absence of effective restraint. Commercial banks hold some 20 billion dollars of certificates and, at least theoretically, could by selling less than half of these certificates to the Reserve System obtain enough reserves, on a six-to-one ratio, to absorb all of this 55 billion dollars of Government bonds. This is wholly aside from what other loans and investments banks could make on the basis of the potential reserves available.

It is this possible further monetization of the public debt which may need to be subjected to more definite restraint, if monetary policy is to be effective and, indeed, if the commercial banks themselves are not to induce a further lowering of the interest rate structure. This in turn would reduce the earnings of banks from sources other than their Government bond portfolios. Furthermore, such continued, uncontrolled monetization of the debt and the consequent decline in interest rates would further accentuate speculative inflationary forces in all capital assets. Constant downward pressure on interest rates arising not from the accumulation of savings but from the creation of unnecessary bank credit is not desirable under inflationary conditions.

Excessive competition for and the consequent bidding up of market prices of outstanding longer-term Government securities makes for private speculative profits but not for a saving to the Government. Continued declines in the rate structure bear most adversely upon the many millions of the country's savers, upon insurance companies, savings banks, endowments, trust funds, and pensions.

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Instead of a further monetization of the debt by the commercial banking system, public policy at this time would be well served if the banks were to sell some of their longer-term holdings to nonbank investors and if bank holdings of the debt were more concentrated in short-term securities which bear low rates of interest. Bank earnings in general reached a higher level in 1945 than at any previous time as a result of profits and earnings from Government securities. While the peak of receipts from this source has probably been reached, it would be preferable if bank earnings were derived increasingly from private lending and other operations in response to necessary community requirements, and if less reliance were placed upon earnings from Government securities.

There can be no assurance that the process of shifting from the shorter- to the longer-term Government securities will be discontinued unless the shorter-term rates should rise to the point where the shifting would no longer be profitable—and this would be undesirable because it would increase the cost to the Government of carrying the public debt. Unless some adequate restraint could be exercised as to the amount and kind of Government securities that commercial banks may hold in relation to their demand deposits, the issuance of additional long-term securities to the market could result in a continued monetization of the debt, even though the securities were made ineligible for bank purchase. For there would be nothing to prevent the sale of existing eligible securities to the banks and the use of the proceeds to purchase the new issues. Even though the funds thus obtained by the Government were used to pay off short-term maturing debt held largely by the banks, there would be nothing to prevent the banks from replacing, through market purchases, enough of the eligible securities to equal the amount paid off. Under such circumstances, nothing would be gained towards reducing the money supply.

If the Federal debt occupied the relatively subordinate place in the economy that it held even up to 1940, the problems of debt management would be far simpler and the question of increasing the cost of carrying the debt would manifestly be of less significance. However, the Federal public debt at the end of 1945 had reached 280 billion dollars, or nearly six times what it was five years before. Whereas it was equal to about one-fourth of the entire debt of the country in 1940, by the end of 1945 it was nearly two-thirds, as is shown on the chart on page 6. Interest on the Federal public debt amounted to less than a billion dollars for the fiscal year 1939. It rose to 3.6 billion dollars for the fiscal year 1945, and according to budget estimates it will be 4.8 billion for the fiscal year 1946 and 5 billion for the fiscal year 1947. As a result of this fivefold increase, it has become the largest single item in the budget aside from expenditures for national defense, and exceeds by 800 million dollars estimated expenditures for veterans' pensions and benefits for the fiscal year 1947. In view of the large amount of short-term debt that will need to be refunded in the next few years, each full percentage point of increase in the level of interest rates would add up to a billion dollars a year to the nation's tax bill.

Proposals, therefore, for increasing interest rates, as an anti-inflationary in-

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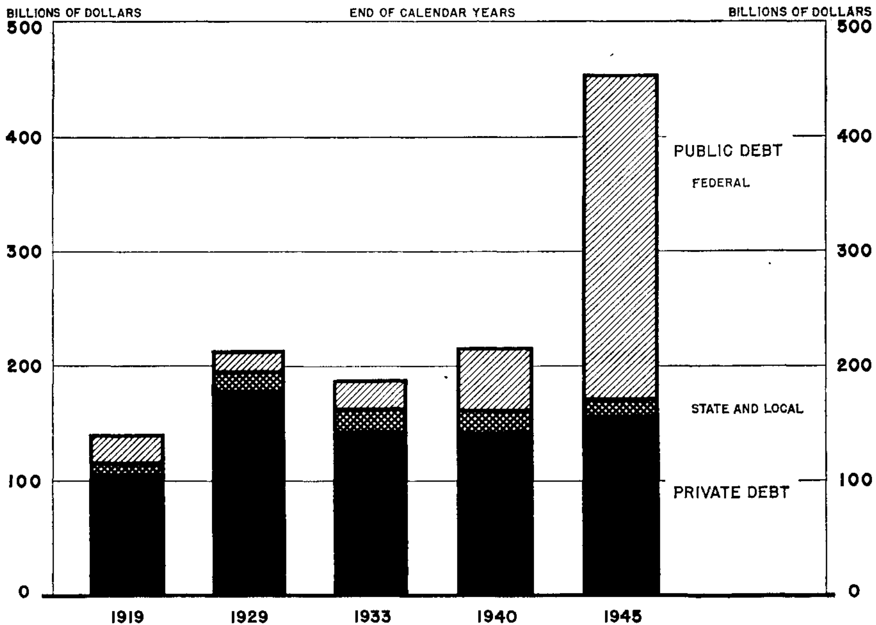
fluence, raise more formidable questions affecting the Federal budget, the levels of taxation, and the amounts paid on the debt to the banking system than was the case only a few years ago. In all principal nations the trend of rates paid by the Government has been downward rather than upward, notwithstanding the presence of comparable, war-created inflationary pressures. In other countries, Governments have been better able to exercise effective control over the amounts of Government securities purchased by banks and over the rates paid to banks for this financing.



Such comparisons would perhaps be unwarranted were it not for the fact that proposals have been publicly put forth in the United States suggesting that further debt monetization might be prevented through voluntary agreements on the part of the commercial banks of this country such as are entered into in some other countries. Such a solution for the problem would be far preferable to statutory regulations if it offered a reasonably assured prospect of success. The differences between the situation in the United States and in other countries arise because there are more than 14,000 commercial banks in the United States, operating under highly competitive conditions, and with three Federal and forty-eight State bank supervisory agencies. In England and Canada, the countries usually cited in connection with voluntary agreements, competitive and other conditions are entirely dissimilar. Each of these countries has but one bank supervisory authority. There are but ten chartered banks in Canada, while

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in England about a dozen banks do most of the banking business. It is a relatively simple matter to bring about voluntary agreements among so few banks and to obtain equitable observance, but in view of the different situation prevailing in the United States it would be impossible to enter into or to enforce similar agreements.

Another proposal, which has been more frequently advocated, is that the Reserve System discontinue its policy of maintaining the ⅞ per cent rate on Treasury certificates, and that open market operations be directed only towards maintaining the rate of 2½ per cent on the longest term bonds. This suggestion contemplates that the short-term rate would rise to a point close enough to the long-term rate to discourage commercial banks from selling short-term securities to the Reserve System and purchasing the long-term securities in the market. It is contended that an increase in the short-term rate from ⅞ to as high as 1¼ per cent would increase the cost of carrying the public debt by an estimated 200 million dollars and that this would be a small price to pay in combating inflationary dangers. However, there is no assurance that this much of an increase in the short-term rate would stop further debt monetization and even less reason to suppose that it would be of value in combating inflationary dangers which have arisen from two primary causes, neither of which would be corrected by higher rates. One cause is the volume of money already created, which can not be rapidly reduced. The other, and by far the most important basic cause, is the insufficiency of production as yet in relation to the existing money supply.

A major consequence in attempting to deal with the problem of debt monetization by increasing the general level of interest rates would be a fall in the market values of outstanding Government securities. These price declines would create difficult market problems for the Treasury in refunding its maturing and called securities. If the price declines were sharp they could have highly unfavorable repercussions on the functioning of financial institutions and if carried far enough might even weaken public confidence in such institutions.

The Board, therefore, does not believe that the problem could be met by voluntary agreement among 14,000 commercial banks or that it could be dealt with effectively by increased interest rates unless they were so high as to be a deterrent to necessary production, apart from the serious consequences to the Government security market.

If traditional interest rate policy or voluntary agreements are not appropriate or feasible, then what alternatives remain for preventing further debt monetization? Various alternatives have been suggested, some of which the Board considers too restrictive or otherwise impractical. Among the proposals which the Board believes worthy of consideration by the appropriate committees of the Congress are the measures outlined in general terms below.

One measure would be to empower the Board of Governors to place a maximum on the amounts of long-term marketable securities, both public and private, that any commercial bank may hold against its net demand deposits. This measure would serve to restrict the banks' demands for long-term Government

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securities and to strengthen their demands for short-term securities. It would not restrict the banks' ability to make loans or to purchase long-term securities against savings deposits. It would reduce, however, the existing inducement to sell short-term securities to the Reserve System, thus creating additional reserves, in order to purchase higher-yielding, long-term issues. The voluntary agreement adopted in Canada is similar to this limitation, which would be consistent with good banking practice in this country.

Another measure would be to empower the Board of Governors to require all commercial banks to hold a specified percentage of Treasury bills and certificates as secondary reserves against their net demand deposits. To aid banks in meeting this requirement, they should be permitted to hold vault cash or excess reserves in lieu of Government securities. This measure would result in stability of interest yields on short-term Government securities and, therefore, of the cost of the public debt. Like the bond portfolio limitation, it would provide a measure for regulating commercial banks' demands for short-term Government securities relative to their demands for longer-term issues. At the same time, it would leave considerable freedom for movement of interest yields on non-Government paper of short-term maturity.

Some administrative flexibility should be authorized in connection with either of these measures in order to meet differences among banks as well as to adjust to the changing needs of the economy for bank credit expansion or contraction.

A further possibility would be to grant additional power to the Board to raise reserve requirements, within some specified limit, against net demand deposits. If this authority were granted, banks should be permitted to count vault cash as reserves, and there should be provision for greater administrative flexibility in applying changes in requirements. To assure effective control, all commercial banks should be subject to the same reserve requirements. Adoption of this measure would strengthen the capacity of the Federal Reserve to prevent bank credit expansion on the basis of additional reserves obtained through gold imports or return flows of currency from circulation.

Under present conditions, however, when banks have relatively small amounts of excess reserves, increases in reserve requirements would make it necessary for banks to liquidate some of their assets. This would result in a rise in interest rates or necessitate Federal Reserve purchase of sufficient securities to provide the additional reserves. Under a continued policy of maintaining the existing level of short-term interest rates, the principal effect of an increase in reserve requirements would be a shift of Government securities from the commercial banks to the Reserve Banks.

Each of the foregoing measures would provide additional instruments for coping with emerging banking and monetary problems without increasing the cost of Government financing or upsetting the market for Government securities. The suggested measures would help to strengthen the position of the banks and at the same time would enable them to continue their normal peacetime functioning in the financing of commerce, industry, and agriculture, as well as consumers.

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