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BY

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OUR ECONOMIC DILEMMA

I have been asked to discuss the economic dilemma that confronts us today. Actually there are many economic dilemmas, and time will not permit me to examine all of them. Recently, when I appeared at a Congressional hearing to discuss inflation, I made this statement which reflects some of the economic dilemma:

> "Each one wants the benefits of inflation for himself, but he wants the others to pay for them.
>
> The farmer wants a floor under his prices, but he does not want a ceiling.
>
> The real-estate people, the building-materials people, want easy credit so that they can readily dispose of, at inflated prices, the homes and materials they have to sell. But they certainly resist having any excess-profits taxes in order that the Government might recapture some of the profits that are thus made.
>
> Labor has always wanted price control, but they have vigorously resisted wage control.
>
> The bankers want higher interest rates, but they do not want the Federal banking agencies to have increased power over the expansion of credit.
>
> You know the familiar pattern. And now, after 3 years, you have been called together to consider this problem which has been with the Congress constantly, and the American public constantly, and there has been little or no willingness to face up to it, realistically, either by the public or by the Congress, or by the Administration.
>
> This situation has gone so far that to stop the inflationary development could well bring about a deflationary development."

While nearly everyone has been fully conscious of inflation in our economy, there has been no general agreement or widespread understanding among the people as to why prices have risen. Some criticize organized labor for successfully demanding higher wages. Others point to the raising of prices by business and the resultant excessive profits, to the high prices of agricultural products, or to the activities of speculators in commodities and real estate. Government expenditures, high taxes, and many other things are singled out for blame. Such factors, to be sure, all have their relevance to inflation. But some of these are only symptoms or effects of inflation, and not causes. Others are merely relatively minor factors that could never, in themselves, have developed an inflationary situation such as we have had.

Excessive money supply the basic cause of inflation.

The vital force, that has been generating inflation in this country, has been the excessively large money supply which was created by war financing. At the end of the war, demand deposits and currency held by the buying public were about three times their prewar volume. In addition, businesses and individuals increased their holdings of United States

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Government securities about 75 billion dollars. While the wartime money growth was underway, prices were held in check by a comprehensive harness of controls, including allocations, construction permits, rationing, price and wage controls and high levels of taxation, including excess profits taxes and the like. The fundamental economic adjustment, which we have faced in the postwar period, has been to grow up to this much larger money supply, that is, to bring about a more normal balance between the supply of goods and services available to the public and the expanded supply of money.

For this postwar adjustment to have been accomplished with a minimum of inflation two things should have been done. First, some reduction should have been made in the money supply in the hands of the public. Second, the wartime harness of controls on the economy should have been retained until the full flow of peacetime production had been restored and some of the most urgent of the deferred demand had been satisfied.

But we did neither of these things. True, an attempt was made to cut the money supply by reversing the wartime process of money creation through a Government budgetary surplus. Money was withdrawn from the people by taxation and by the sale of savings and other bonds, and these funds were largely used to retire Government debt held by the banks. From mid-1946 to mid-1948, Treasury operations had the effect of reducing the money supply in the hands of the public by 11 billion dollars. But, notwithstanding these Treasury operations, that money supply was materially expanded. The contraction resulting from the Treasury cash surplus was more than offset by the very rapid and large expansion of bank loans and investments other than Government securities and by the gold inflow.

The war-time harness of controls was quickly abandoned by the Administration immediately after the war, largely at the behest of organized pressure groups. The failure to reduce the volume of money and to retain, during the transition period, the harness of direct controls, to which I referred, has resulted in the inflationary situation about which everyone has talked so much and done so little.

Remedies for inflation

One way to combat inflation is to produce a greatly expanded volume of goods and services. This is a remedy we often hear proposed. It would be a gratifying way out indeed. But any realistic appraisal of the inflation problem will reveal that no such pleasant solution has been possible or is in immediate prospect. Our overall production is currently at record levels, with maximum utilization of our manpower and of many basic materials, notably steel. While further increases in production will certainly come with increases in productivity of our men and machines, it cannot come overnight. We cannot count on that as a solution to our present situation.

The only other way to strike at the core of the inflation situation is to reduce the flow of spending for goods and services. We must

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stop increasing the volume of money and, in fact, we should reduce it. We should encourage people to save and we should discourage any expenditures for consumption or capital goods that can be deferred, and particularly such as is done by the use of credit. However, it is not right for the Government to advocate this, unless it will take whatever steps are required to protect the purchasing power of the dollar.

Since mid-1946, a date which might be taken as the end of the period of physical transition from war to a peace economy, we have had an increase, and not a decrease, in the money supply in the hands of the public. Demand deposits increased by 3 billion dollars and time deposits by 6 billion. Currency has decreased 1 billion. The total has increased by 8 billion dollars. This increase has been due to gold inflow, net selling by nonbank investors of Government securities to banks, principally the Reserve Banks, and an expansion of commercial bank credit to businesses, real estate owners, consumers and public bodies. Of these, commercial bank credit expansion has been the largest. As I have said before, the expansion of deposits would have been greater had it not been for the use of the Treasury surplus to retire securities held by banks.

If we are merely to stop a further increase in the money supply, we must not only stop, but must reverse, the expansion of bank credit. The reason being that gold production amounts to nearly a billion dollars a year, and we may expect to get most of it. This not only directly increases our bank deposits by a corresponding amount, but also adds to the volume of bank reserves which can be used as a basis for further multiple credit expansion. I commend to your attention the recent statement by Mr. Russell Leffingwell regarding the question of gold and its proper use.

I am fully aware of some of the difficulties which may be involved in a policy of credit restraint in making that policy effective in stopping inflation. The rate of use or velocity of existing money has, as you know, been low in recent years as compared with previous experience, particularly in the twenties. This low velocity has been the result, in large part, of the cheapness as well as of the abundant supply of money and credit.

Tightening bank credit and raising money rates tends to activate the existing supply of money. Investment institutions, such as savings and loan associations and savings banks, raise the rates they pay on savings deposits in order to induce holders of cash to make their funds available for investment. Commercial banks also raise their time deposit rates and other borrowers offer higher rates for money. Idle pools of deposits are thereby drawn into the spending stream. Attracted by the higher rates on other investments, some savings bond owners might be induced to cash their bonds, and purchases of new bonds would be discouraged. Sales of marketable Government bonds to the Reserve Banks are also encouraged.

In other words, to the extent that credit restriction or contraction increases velocity, its effectiveness is impaired. This does not

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mean that, should the inflation continue, it would be futile to restrict bank credit. What it does mean is, that in a highly inflationary situation, with increasing velocity, restriction may not be enough. In such circumstances it might require a contraction of the money supply to overcome the inflationary effect of the increased velocity.

Bank credit restraint

As I have stated earlier, we are confronted with an economic dilemma. We have in fact some very unpleasant alternatives. One of these is to do nothing at all, even though inflationary pressures continue. Another is to adopt a strong policy of monetary restraint. A prerequisite for dealing successfully with monetary problems under inflationary conditions, however, is the adoption of fiscal policy which would insure a balanced budget or, preferably, a budgetary surplus so long as inflationary pressures continue. However, if fiscal policy should result in substantial deficit financing, it would not be possible to adopt a restrictive monetary policy under existing powers.

Monetary policy under present day circumstances must be reinforced by a fiscal policy and a debt management program consistent with it. In other words, fiscal and monetary policy should go hand in hand.

Our fiscal position in recent years has been favorable to credit restraint and has been a major factor checking monetary expansion. A further Government surplus, however, is not now in prospect. We have had a 5 billion dollar cut in taxes. Expenditures are up about 5 billion dollars for military purposes and foreign aid. So the Government surplus, heretofore the principal monetary bulwark restraining inflation, has disappeared. Indications are that defense expenditures will be further materially increased. If there is no corresponding increase in taxes or reduction in other Government expenses, there will be a budget deficit which would add to our present inflation problems. This would be most unfortunate and should not be permitted to happen.

For achieving a condition of restraint on bank credit and monetary expansion, several proposals have been made. You are familiar with most of them, I am sure. One instrument that would be effective is authority to increase primary reserve requirements of all banks, member and nonmember alike. This is an inflexible instrument, which could be used to offset bank sales of Government securities to the Reserve Banks. It could also be used to immobilize additional bank reserves resulting from gold inflows and from System purchases of Government securities from nonbank investors, thus preventing multiple credit expansion on the basis of these reserves.

Another less onerous plan is the special or optional reserve proposal. This would immobilize a large part of bank portfolios of Treasury bills and certificates, and greatly reduce the willingness and ability of banks to lend. It could also be used to tie up new bank reserves in these

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securities. The special reserve authority would be particularly applicable to a situation of a further Government deficit that an enlarged military and foreign aid program may cause. With this authority, should it be necessary to extend bank credit to the Government, the deposits thus created could be tied to the securities issued and these securities could not provide a means of obtaining additional bank reserves upon which a multiple credit and money expansion could be based.

Even more effective as a program of credit control would be a combination of these two authorities.

The position of the banking fraternity in general, with respect to the monetary situation, is an inconsistent one. Most bankers want the System to continue the present price support for Government securities. But they oppose the System's request for any additional authority that would serve as a partial substitute for the use of traditional powers which the System is unable to use so long as it maintains the present support policy.

They even oppose the System's use of the small emergency powers to increase reserve requirements, granted last August, although these powers have been used only to absorb reserves created by the gold inflow and by the System's support purchases of Government securities from nonbank investors. It was primarily for the purpose of absorbing any additional reserves which might become available to the banking system that the authority was given. The increase in reserve requirements of member banks has approximately offset the growth in reserves from these sources since the middle of the year, and earning assets of member banks are just as large as they were at the end of June. In the meantime short-term interest rates have been permitted to rise, thus improving bank earnings from this source. Accordingly, banks as a whole have not been adversely affected, but their earnings have been improved. Further additions to the supply of reserve funds, from whatever source, would call for additional use of this authority so long as the present inflationary conditions exist. The bankers have proposed no solution of their own to this dilemma except the voluntary program, which, though commendable, has not been adequate.

It is the commonly expressed view that authority to increase reserve requirements is a blunt instrument which places too much power in the hands of the Federal Reserve Board. The increases in reserve requirements early in 1937 have been cited as an example of the dangers in the use of this power. It is claimed that the Board's action was a principal factor precipitating the recession which began in that year.

This reference to the 1937 situation, to discredit changes in reserve requirements as a credit policy instrument, needs to be examined critically. You will remember at the beginning of 1937 excess reserves of member banks were about 2 billion dollars, largely reflecting the substantial gold inflows of the time. The Board raised reserve requirements to immobilize as much of these unnecessary reserves as it could within

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its available authority, so that the more flexible power of Open Market operation could be used effectively. At the same time, the Treasury, by borrowing money to do so, was sterilizing incoming gold to prevent further expansion in reserves.

Mr. Leffingwell, in his recent article in Fortune, implies that this action made credit unavailable. Nothing could be further from the truth. Never during this period were excess reserves of member banks below 700 million dollars. Credit was not only readily available, but it continued to be exceedingly cheap. For example, rates on short-term commercial paper were not above 1 per cent; on bankers' acceptances, 1/2 of 1 per cent; on stock exchange call loans, 1 per cent; and on Treasury bills, 3/4 of 1 per cent. Rates charged by banks on average business loans continued at very low levels. Does this sound like a shortage of credit?

The forces which turned the economy down in 1937 were the rapid and excessive inventory accumulations which began in the middle of 1936 and the abrupt balancing of the Government's cash budget in 1937, following a period of substantial Federal deficits. The Board's action to increase reserves, to bring the market within reach of the System's open market powers, had nothing of substance to do with the recession that developed.

The gold inflows continued in such volume that by mid-1940 excess reserves were nearly 7 billion dollars. The System had no means of absorbing these excess reserves, since its holdings of Government securities were only about one-third as large. This was the case, even though reserve requirements were near the maximum levels permitted by law. In view of this situation, in December 1940, for the only time in the history of the System, the Board, the Presidents of the Federal Reserve Banks and the Federal Advisory Council submitted a joint report to Congress. This report called attention to the inadequacy of Federal Reserve powers to discharge its responsibilities. It recommended, among other things, that the System be given authority to raise reserve requirements to double the statutory maxima and to apply these requirements to all commercial banks, member as well as nonmember banks. This would mean that requirements could be raised to 12 per cent on time deposits and to 52 per cent, 40 per cent, and 28 per cent on net demand deposits for central reserve city, reserve city, and country banks, respectively. The Federal Advisory Council, the body representing the member banks, participated in the preparation of this report and unanimously favored its submission to Congress. At the present time, this Council opposes granting any additional authority to control credit expansion, although the inflationary situation is far more serious.

"Flexible" support of the Government securities market

What alternatives have been advanced to the System's proposals for restricting bank credit expansion? The principal alternative proposals relate to changes in the Federal Reserve System's policies with respect to support of the market for Government securities.

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Because of the importance in our economy of a 250 billion dollar Government debt, the Federal Reserve System has undertaken to continue its wartime task of maintaining orderly and stable conditions in the Government securities market. This program involves the purchase of Government securities by the Federal Reserve Banks whenever holders choose to sell and others are not in the market to buy at support level prices. Banks, insurance companies, and other lenders have taken advantage of this market support to sell Government securities in order to extend credit to other borrowers. As I have said before, this process creates additional amounts of bank reserves and money.

Much of the criticism of the support program for Government securities has come from insurance company executives and from officials of large banks. Specifically, the System's support activities have been criticized by Mr. Parkinson, President of the Equitable Life Assurance Society, and by Mr. Russell Leffingwell, Chairman of the Board of J. P. Morgan & Co., as well as by the privately-sponsored Committee on Public Debt Policy, which is composed principally of persons associated with large commercial banks, insurance companies, and savings institutions.

I am not entering into a debate with these critics. However, I would like to help clarify the issues.

I agree with these critics that there is too much money and that it is too easy to create additional money.

Mr. Leffingwell and I are in agreement as to the need for measures outside the private credit field. Some of my views on this were expressed extemporaneously last August before a Committee of Congress. I quote from that testimony:

> "I do believe that everything within the power of the Administration and the Congress should be done to maintain a budgetary surplus.
> I do believe that the Federal Government should do everything within its power to encourage the State to postpone every expenditure that it is possible to postpone, and set an example to the States by doing likewise.
>
> I do believe that the Federal Government should not, for what seem to me political reasons, encourage a housing program in excess of the amount of labor and materials available, and encourage further inflation thereby.
> I do believe that the Federal Government should do everything within its power to bring down food prices, by encouraging more and not less production."

As part of a program for reestablishing effective control of the money supply, there is wide agreement that further steps should be taken toward greater flexibility in short-term rates. The Federal Reserve

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System believes in, has advocated, and has taken tangible steps toward this objective. Action in this field must, of course, take into account the Treasury's problem of public debt management. I personally feel, however, that action has moved unnecessarily slowly and that further steps are needed which would permit higher and more flexible short-term rates. Any such action would be accompanied by appropriate changes in the Federal Reserve Bank discount rate.

But the principal controversy is not relative to the short-term rate. The more controversial issue is whether or not the Federal Reserve should continue maintaining the rate of 2 1/2 per cent on the longest-term Government securities.

The means for restraining monetary expansion which critics of the support program prescribe is to introduce flexibility into the long-term rate. Complete abandonment of the Government bond market by the Reserve System is not generally advocated. As Mr. Leffingwell has put it, "The peg should come out, but the Government bond market should not be abruptly left to itself." He also wrote, "The policy of supporting Government bonds when necessary, without pegging, and of maintaining an orderly market in Government bonds, would be continued until a normal market is reestablished. The authorities should, however, stop the automatic supply of money to the market to peg bond prices at par, and should let interest rates and bond prices gradually settle themselves; but not make money dear or scarce."

Now, just what does this type of program actually contemplate? It seems to involve a continued willingness on the part of the Federal Reserve System to take Government bonds and to supply Reserve Bank credit, but at yields higher than 2 1/2 per cent. Apparently, however, the System should follow a policy of gradually easing bond prices down and yields up, but buying aggressively, if necessary, to maintain orderliness in the market.

What would be the position of a Government bond owner or a potential bond buyer under such circumstances? Would they have any confidence in the market? Holders would tend to sell and potential buyers to hold back, creating increasing downward pressure on bond prices, until substantially lower prices were reached. If yields should rise only 1/2 per cent on the longest 2 1/2 per cent bonds, their price would fall to less than 93. But in a falling bond market, with general credit demand strong, rates on other securities and loans would tend to rise at least proportionately as much. Under these conditions, can it be expected that insurance companies or savings and loan associations or other institutional investors would act materially differently with the yield on Governments at 3 per cent than they do now at 2 1/2 per cent?

Loans or investment, other than Government securities, would have as much, if not more, relative attractiveness to lenders and investors. Few, if any, borrowers would be priced out of the market for funds by

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rate increases of the size contemplated by advocates of this "flexibility" policy. Any moderate rise in long-term interest rates would not, in itself, reduce significantly the demand for money. Investing institutions, which are now switching from long-term Government bonds to private credit forms, would still be motivated to do so by a continuing margin of return between the two kinds of investment.

Thus, under the "flexible" policy, the Federal Reserve System would still be called upon to support the bond market and would thereby continue to create bank reserves. It is possible that the amount of support required under these conditions would be much greater than is now the case. Investors generally would lose confidence in the market and would rush to sell their securities before prices declined further. Money and reserves created by Federal Reserve purchases below present support prices would be just as high-powered as those created by support at existing prices, and the reserves thus made available could support nearly six times as much in bank loans.

If a program of dropping the support prices on Government bonds is to have any meaning as an anti-inflation device under conditions such as exist today, it must effectively restrict credit expansion. This means denying the market new Federal Reserve funds. Merely reducing somewhat the prices at which the System buys securities and supplies the market with funds would not alter the fundamental conditions underlying the current expansion in the money supply.

If the System were to go any part of the way down the road of withdrawing support from the 2 1/2 per cent long-term Government rate, it should be prepared to go as far as necessary to place monetary expansion under adequate restraint by this device. Interest rates, under such a policy, would need to go high enough to discourage long-term borrowers, to restrain selling of Government securities, to bring idle funds into the market for Government securities, and to increase savings. Prices of Government securities would need to drop to the point where buying would about equal selling, without significant support by the System.

No one knows how much the prices of Government bonds would drop before such a balance would be reached. No one knows, moreover, just what would be the consequences of such a policy, not only upon some of our financial institutions and upon our financial structure generally, but upon the entire economy.

Certainly we could not expect that such action would increase the sales on balance of savings bonds, of which there is over 50 billions outstanding. It could have the opposite effect of causing many holders, not understanding the action taken, to cash in their present bonds. Other savings bond holders, who are more familiar with the investment market, might see an opportunity to profit by shifting out of E, F, and G. bonds and into marketable bonds if the prices of marketable issues go low enough. Either of these developments would put the Treasury in the market for new

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funds to redeem these securities and could require that the Reserve System give up its tight money policy to assist the Treasury in meeting its obligation to savings bond owners and thus could defeat the purposes of this anti-inflation program.

A program of credit control, made effective by withdrawal of System support from the Government securities market, could lead to a serious deflation. This, indeed, is a result that the sharpest critics of the support program say they are anxious to avoid.

Inflationary role of nonbank institutional investors

Representatives of some big investing institutions have freely criticized banks for their creation of new money through bank credit expansion. They complain about the effect of inflation on the value of savings and insurance benefits.

But some of these institutions are helping to create the very inflation about which they complain. They are helping to reduce the purchasing power of money by extending credit to real estate owners, to businesses and to state and local governments in amounts which exceed funds available from repayment of debt or the current flow of savings into their institutions. They are able to do this by selling to the Reserve Banks Government securities they purchased to help finance the war. The Reserve Banks have to buy them, unless we are prepared to take the dangerous road of withdrawal of support that I have just described. There would be no objection to their selling if there were a deflation situation, or if there were a market at present levels outside the banking system.

I suspect that some of those who are most vocal in advocating a drop in support prices have a very special interest in lower prices on long-term securities. It would be interesting and enlightening in this connection, I suspect, if we could see the maturity composition of their Government security portfolios. We might find that they have few long-term securities, having never bought any or having previously sold at premiums what they did have.

There needs to be greater recognition on the part of our large nonbank institutional investors that commercial banks are not the only institutions which are expected to act in the public interest to maintain monetary stability. Insurance companies and other holders of the savings of the people have that responsibility as well. If they are unwilling to recognize and to meet their public responsibilities, then it would be necessary to include them, as well as banks, in a legislative program of adequate monetary and credit control.

In conclusion.

I should like to emphasize that further inflation is not inevitable. There are some soft spots in the economy. In quite a number

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of important areas production has been cut back as supply has overtaken demand at existing prices. Large crops have pressed down the prices of a number of agricultural commodities to support levels, which, by the way, in my opinion are altogether too high and run counter to an anti-inflation program. There is also some evidence that private construction may be declining. Inventories generally are at an all-time high, and pressures for their reduction are increasing. The need for credit control would be greatly lessened or temporarily disappear if deflationary factors should increase in importance.

Our economic objective should be to stabilize our economy at high levels of employment and production. It is easier to achieve this stability if we have a stable price level, than if we have falling or rapidly rising prices. A stable price level, however, has come to be taken by some almost as a guarantee of long-run economic stability. I think it is appropriate to inject a few words of caution on this point.

We may achieve a form of temporary stability in the present general level of prices that could be taken to indicate that all was well, but that might hide a serious undercurrent of weakness. If we achieve a stability at the existing level of prices by the prop of a further sizable credit expansion, whether bank or otherwise, then I say we are storing up real trouble. We are borrowing against the future if, to hold the economy at present prices, we need heavy new borrowing by businesses, substantial buying on credit by consumers, large mortgage expansion at present high construction costs, and large state and local expenditures for public works. This would also be true if we permit a large Federal deficit. It would be better to bring about a more balanced situation now by having a downward adjustment in prices, even at the cost of some slackening in our present level of economic activity. I say this because I believe we should not, to sustain the present price level, use the cushions that should be available to ease the next recession. If we do this, we shall be multiplying our problems in the time to come.

But if, in spite of some deflationary aspects in our economy, inflation continues or if prices are held at present levels by a further overall credit expansion, then effective monetary and fiscal control would be essential. I feel that Congress should deal realistically with this problem at the coming session, no matter how unpleasant the task may be.

If credit growth continues, or if velocity of existing money increases significantly, and if no additional authority over bank credit growth is given to the System by Congress, or if because of the activities of nonbank investors further inflation cannot be stopped by such additional powers, then the authorities would have to face an unpleasant dilemma. Either they must permit further inflation to develop, or they will have to adopt the full use of traditional methods of credit control. Only in this event would it be necessary to follow the extremely risky course of letting prices and interest rates on Government securities go to the

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point where there will be a balance between buyers and sellers in the market, without significant Federal Reserve support.

I desire to say in conclusion that I am fully conscious of the enormity of the world difficulties which affect our every domestic problem; that any fiscal, monetary, or credit program designed to establish economic stability at home may be entirely upset by expanding military and world aid programs without terminal point as to either time or amount; that the alternative is to bring about a condition of world peace at an early date, even at the risk of war.

I agree with Mr. Churchill, when he recently said:

> "The Western nations will be far more likely to reach a lasting settlement without bloodshed if they formulate their just demand while they have the atomic power and before the Russian Communists have got it too."

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