CURBS ON INFLATION — MONETARY AND FISCAL CONTROLS

(Notes on discussion by Chairman Eccles before the OWMR Advisory Council, July 30, 1946)

Inflation threatens when supplies are short of what people want to buy at prevailing prices. If prices are not to rise, three things may be done:

(1) Direct controls over prices, allocation and distribution can be used to regulate the market.

(2) More can be produced so that demand will be met.

(3) Steps can be taken to reduce demand and hence buying, public or private.

The first approach — the direct control — has been relied upon mostly so far, but will be less and less effective. The second approach — increase in production — will have to be the eventual solution, but that takes time. We must not only reach peak production but must continue it for many months until the pressure of backlog demands has worn off. In the meantime, the third approach — limitation of expenditures — is extremely important. This, I take it, is what you want me to discuss under the heading of "monetary and fiscal controls of inflation".

Monetary Controls

Monetary controls cannot be relied upon.

The most important thing to be said about monetary controls is that they are not a very powerful factor in the situation. Those who think that we can permit direct controls to deteriorate carry on a lax fiscal policy, yet worry little since, in the last resort, Federal Reserve policy will "guarantee the value of the dollar", are greatly mistaken. Monetary policy can do no such thing if other and more important policies are permitted to default. It could not stabilize the economy in the 'twenties or 'thirties and can do so much less under present conditions when the huge public debt has greatly weakened such powers of monetary controls as did exist in the earlier period. In meeting this inflation problem, there can be no major reliance on monetary policy.

How is monetary restriction supposed to check inflation?

Monetary policy, according to traditional thinking, can check inflation by (1) raising the cost of credit to would-be borrowers, thus discouraging them from going ahead with their purchases and (2) reducing the money supply, thus curtailing the funds which people have at their disposal to spend. Both these factors must be considered in the light of the present monetary setting, which is the direct outcome of war

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finance, and as they relate to the nature of existing inflation pressures.

War finance has reduced effectiveness of monetary policy.

As the result of heavy wartime borrowing and especially borrowing from the banks, the financial condition of the country has been changed drastically. In particular:

(1) The public debt has risen from 45 to nearly 270 billion.

(2) Liquid assets held by the public have increased from 100 to 250 billion.

(3) Bank holding of U. S. securities have risen from 17 to about 85 billion.

Because of these developments, the entire setting of monetary policy has been changed and, as will be shown, its effectiveness has been reduced. I shall first consider the advisability of raising interest rates; then, the possibility of curtailing the money supply.

Rise in interest rates would be costly.

With a Federal debt of 270 billion, we find that the public (Federal, State and local) debt is now twice as large as the entire private debt in the country. Interest costs on the Federal debt have risen from about 1 billion in 1940 to over 5 billion now, which is just slightly below the average Federal budget of the 'thirties. Had the war debt not been financed by a declining interest rate, this item would be still larger. The average interest charge on the debt is now about 1.9 per cent. In view of the large amount of short-term debt outstanding, a rise of only 1 percentage point in interest rates could increase the annual cost of interest service by a billion dollars in the course of 5 years.[1/] Should the average rate return to the level of the 'twenties (4 per cent) and the public debt remain at the present level, the total interest cost would eventually be 11 billion dollars per annum. It is evident from these figures that the taxpayer's cost of servicing higher interest charges might be very great. Clearly an increase in interest rates — that is, abandonment of the present policy of maintaining the rate level — should be considered only if we are sure that it will greatly help the economic situation and thus be worth its cost. I do not believe that this is the case.

1/ This is estimated as follows: The total amount of debt maturing in the course of 5 years will be 100 billion dollars. If this debt is refinanced at a rate of one per cent above what it otherwise might be refinanced at, the net result will be an increase in interest service of one billion dollars. This, of course, is different from saying that the interest service will rise from 5 to 6 billion dollars — as this statement is independent of changes in maturity. It merely argues that interest service will be one billion above what it otherwise would have been, whatever the average maturity of the debt and, hence, the overall level of rates.

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Higher interest rates would accomplish little.

If one discusses rising interest rates, one must distinguish between moderate and drastic action.

(1) A sharp rise in interest rates, quite apart from its budgetary effects, might serious unbalance the security market. Considering the large volume of marketable Government securities now outstanding, this is a risk which few would be willing to undertake. The remedy would be worse than the disease.

(2) A moderate increase in interest rates would do little to check an inflationary demand for credit, if such demand should develop. If large capital gains and other profits are anticipated, a moderate increase in interest rates will be a minor factor. Moreover, the bulk of inflation pressure to date has not been based upon newly created commercial credit. On the contrary, the demand has been based on funds received as current income and on liquid assets which have been accumulated in the past. Unlike the boom of the late 'twenties, the present inflation pressures are cash financed and take the form of excessive consumers' and equipment expenditures and speculation on real estate and housing, not mainly security speculation. The control of stock market credit and of consumer credit, which may be important elements of credit expansion in a boom, is being dealt with by direct methods, which do not involve raising interest rates.

(3) Moderately higher interest rates would not reduce expenditures out of current income. Disposable income of consumers is now higher than it has been ever before and the rate of savings has fallen off sharply since the war. The rate of corporation profits after tax is also likely to surpass the wartime peak by the end of the year. If the public's ability to spend out of current income is to be reduced, the Government can do so by lowering its own expenditures (which in turn feed private incomes) or by raising taxes — and both these are matters of fiscal policy, not of credit restriction.

(4) Moderately higher interest rates, similarly, would not offset the use of funds which have already been created. Cash and deposits held by the public have increased from 70 billion before the war to about 160 billion now. These funds are so large that very extensive inflation would occur without the need for any new credit at all and, hence, quite independent of any restrictive credit policy. In addition, private holdings of Government securities amount to 90 billion, as against 25 billion before the war. Monetary policy, again, could do little to prevent the cashing in of these securities should individual and business holders wish to do so.

For these reasons, it may be concluded that an increase in interest rates would not only be costly, but that it would accomplish little in curtailing expenditures and, hence, inflation pressures.

No substantial contraction in money supply is possible.

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Nor can monetary policy do much towards reducing the existing money supply and, thus, funds available for spending. The only way in which this can be accomplished is by reducing bank holdings of Government securities (or liquidating other bank credit). For all practical purposes, this in turn can be done only through debt redemption out of budget surplus. Thus, we again find that the key to action rests with fiscal, not monetary policy.

Preventing further credit expansion.

Banking policy, at best, can aim at preventing further unnecessary increase in credit, but even this has been rendered difficult as a result of war finance which has greatly increased present and potential bank holdings of Government securities.

To illustrate:

(1) Banks have been increasingly desirous to increase their earinings by shifting from the holding of short-term securities to longer term and higher yielding issues. This has involved an altogether unnecessary increase in bank earnings. It has also resulted in further credit expansion since the banks in the process have sold their short-term securities to the Federal Reserve System which has purchased them in accord with the policy of maintaining short-term rates. Temporarily, the debt retirement program out of the Treasury's balance has been helpful in checking this shift, but sooner or later this balance will reach rock bottom. The shift into short terms will tend to be resumed as a large volume of longer term securities becomes eligible for bank holding. Over 20 billion of eligible issues now outstanding are not held by banks and 30 billion more will become eligible during the next 8 years. Conceivably, this drift could be checked by permitting the short-term rate to rise, but this would be an altogether unsatisfactory solution as it would give rise to excessive bank earnings, since banks now hold large amounts of short-term securities. Rather, the problem should be approached by establishing some direct control over the security holdings or earnings of commercial banks.

(2) A related and eventually more important difficulty arises because large holdings of Government securities endow the banks with secondary reserves which, if more attractive earning possibilities arise in the private credit field, may be transformed into legal reserves through sale to the Federal Reserve System. As the System, under the policy of maintaining the rate structure, will have to purchase these securities, Federal Reserve control over bank reserves has been greatly weakened. Some way must be formed to reestablish the System's control. Means of dealing with the problem while maintaining the prevailing level of interest rates have been suggested in the Board's Annual Report.

Limitation of Monetary Policy — Summary

Monetary restriction is no effective method of reducing demand, that is, checking inflation.

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(1) Raising interest rates greatly adds to the budget cost of debt service and — if the rise is sharp — may thereafter dislocate the security market. Against these clear-cut disadvantages, the advantages are very doubtful: A higher interest rate would not check expenditures out of current income (i.e., raise savings) or out of accumulated balances. Moreover, it would do little to reduce commercial borrowing (i.e., reduce dissaving). Consumer credit and stock market credit are more important, but they are dealt with independently.

(2) Monetary restriction cannot effectively reduce the existing money supply. This can only be done through budget surplus.

(3) The existence of a large debt eligible for bank investments renders existing Federal Reserve controls ineffective in preventing further credit expansion, except at the cost of higher interest rates. Steps are called for to restore such control without necessitating an increase in rates.

Government Lending

The lending policies of Government credit agencies is one area in which monetary action need and can be taken. Public agencies which extend credit directly, or guarantee or regulate credit, should be requested to do whatever they can to bring about curtailment of credit except as it may be essential to maintain or increase production. To illustrate:

(1) Recent action by the RFC which gives a blanket guarantee to all loans made by banks that would sign an agreement with the RFC will encourage banks to extend unneeded credit. This type of action is highly inflationary and quite incompatible with other Federal Reserve and Treasury policies aimed at preventing unnecessary expansion.

(2) The features of the currently pending Wagner-Taft-Ellender Bill, which provide credit for public housing through the NHA and liberlize credit terms are equally inflationary in the present situation and these aspects of the bill should, therefore, be deferred.

(3) Also, all public lending agencies should be instructed to pursue more conservative appraisal policies.

Fiscal Controls

Fiscal controls are more effective than monetary controls because they do not deal with the supply of funds but are directly concerned with the flow of expenditures. Since direct controls over specific goods have been successively abandoned or weakened, primary reliance must now be placed on the fiscal approach.

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During the deflation of the 'thirties, fiscal policy required a budget deficit, putting more purchasing power into the economy through public expenditures than was taken out through taxation. Now, under reversed conditions of inflation pressure, a budget policy is called for which will take more purchasing power out of the economy through taxation than is returned through public expenditure. A fiscal policy which brings about a substantial budget surplus is by far the most effective means left at our disposal to meet inflation pressures. Debt retirement, based on budget surplus, will not only curtail expenditures directly, but will also provide an effective method of curtailing the money supply. Theoretically, the budget surplus can be obtained in two ways — by raising taxes or cutting expenditures. Since the first approach is not very feasible politically, retrenchment of expenditures must be given first attention. Stated very briefly, the major points of a fiscal program are these:

Retrenchment of Government Expenditures

1. The expenditure outlook has deteriorated. The estimate was 35 billion, is now 40 billion or more. The increase has accrued mostly in national defense items which are nearly one-half of the budget.

2. Any substantial reduction must come in defense items. All items not immediately needed should be postponed.

3. For the purpose, a committee should be appointed and include representatives of prominent civilian groups, in order to recommend expenditure deferments of at least 5 billion dollars.

4. Also, economies should be enforced in other items:

   (a) Public works should be postponed.

   (b) The leave pay bill, if it provides for large cash payments, should be rejected.

   (c) Relief food purchases which are not needed to meet immediate shipments and distribution abroad should be deferred.

Taxation

1. The very minimum requirement is to maintain present tax rates. Talk of rate cuts is irresponsible. The rate reductions of last year meant 5 billion dollar loss of revenue. Had these not been lost and had expenditures been kept at 35 billion dollars, we might have had surplus of 10 billion. Now we may well have a deficit of 2-3 billion or more.

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2. If rate increases were feasible, it would be desirable to

    (a) Reintroduce excess profits tax

    (b) Tighten capital gains taxation.

3. The provision of the House bill on Social Security which would postpone the increase in the payroll tax rate from 1 to 2 1/2 per cent scheduled for January 1, should be rejected.

State and Local Finances

1. A conference of Governors and Mayors of major cities should be called to obtain cooperative actions on:

    (a) Postponing unnecessary expenditures, especially construction

    (b) Maintaining taxes.

Appeal to Public

(1) Having curtailed its own expenditures, the Government can appeal to the public—consumers and businesses—to do the same. Investors should be told that they will not lose by buying savings bonds even if prices should rise temporarily. If there is inflation, it is bound to collapse which will bring prices down again.

(2) Labor and industry should be called upon in cooperation to increase production as much as possible through higher productivity and increased hours. Increased production is the final solution.

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