

CURRENT BANKING MONETARY AND FISCAL POLICIES
Summary of an address by Marriner Eccles, Member,
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THE PROBLEM of financing the present rearmament program is chiefly a problem of how to transfer productive facilities from the civilian economy and their peacetime uses to the procurement of the necessary war materials. This problem today with its danger of inflation is far more difficult than it was during World War II. Inflation is primarily a problem of the supply of money and its rate of turnover compared with the amount of things available to be bought with that money. If more money is available for spending than there are goods available to be bought with it, the effect of the excessive money supply is an increase in the price of goods. At the beginning of World War II this country had a large amount of idle productive facilities. Consequently, the principal effect of the increase in spending which came with the war was to increase the production of goods and services without causing large price increases.

The situation today is entirely different. Productive facilities are being used to capacity and it is not now possible to produce significant additional quantities of goods. Whereas in the period of World War II large additions to the stock of war goods could be made simply by fuller utilization of our productive facilities, now these goods can be made available for the rearmament program only by transferring productive facilities away from the output of civilian or peacetime goods. It is basically a problem of transferring productive facilities from civilian to military uses. This transfer cannot be made simply by increased government expenditures. An effort to do so would develop serious inflationary pressures. The only way to make the transfer in such a manner as to avoid inflationary pressures is by taxation. In order to transfer the productive facilities from civilian to military uses the spending power of the civilian economy must be reduced by taxation and that purchasing power transferred to the government for the purpose of employing the resources released by reduction of civilian spending power.

The inflation experienced by this country in recent years has been the direct result of the failure of Congress during World War II to levy sufficiently heavy taxes. During the period of World War II when Congress appropriated more money than was available to the government through taxation, the funds had to be acquired by borrowing. To the extent that this borrowing was from individuals and other nonbank lenders the effects were not immediately inflationary because there was no immediate effect on the money supply. Savers by buying bonds had less money to spend and thereby reduced their demands on the nation's productive facilities. The funds thus acquired by the government could be used to direct the productive facilities into war uses.

Every effort was made during the war to avoid bank borrowing and to place the government bonds in the hands of savers. However, it was necessary to sell large quantities of bonds to the banks of the country when it became

impossible to finance the total deficit through nonbank borrowing and when the taxes voted by Congress were inadequate to cover war expenditures. The effect of bank borrowing is to increase the amount of money in the country. When a bank buys a bond it adds the purchase price of the bond to the deposit of the United States Government and when the government spends that deposit it adds to the nation's money supply by increasing the amount of bank deposits owned by the general public. Except for purchases of gold by the government, such increases in bank loans either to the government or to private borrowers represent the only means whereby the money supply of the nation can be increased. The new loans give rise to new money in the form of demand deposits and these deposits remain in existence until the loans are repaid. As a result of such bank borrowing this country had approximately a 300 percent increase in its money supply during the period of World War II. This resulted directly from bank borrowing during the war period.

When the war was over the damage had been done. All this increased purchasing power was available to be poured into the market whenever the public chose to increase its spending. Price controls during the war period did not prevent the building up of this inflationary fund but simply postponed its normal effect. At the end of the war when price controls were prematurely removed this increased purchasing power was released into the market and had its normal effect in causing substantial price increases throughout the economy. In addition to the inflationary pressures resulting from the war-expanded money supply, further inflationary pressure resulted, during the postwar period, from expansion of bank credit. During the postwar period in spite of balanced government budgets, or even large surpluses in most years, the inflation continued. Thus we see that a balanced budget alone does not insure against inflation and that it is possible to have inflation even with government surpluses. The important thing is to prevent increases in the money supply which are in excess of things available to be purchased. During the postwar period in spite of a balanced budget the money supply was increased faster than goods became available, largely because of the expansion of bank credit. Bank credit was expanded and increased the nation's money supply faster, on balance, than the annual government surpluses were able to reduce it. A balanced budget alone is not enough, excessive credit expansion must be controlled too.

Because of difficulties arising out of the war debt legacy, monetary policy has been seriously handicapped in its control of credit. With the huge government debt since the war it has been necessary for the Treasury to carry out large and almost continuous refunding operations. To support and facilitate this the Federal Reserve System has supported the government bond market. Even in the absence of refunding operations it has been necessary for the Federal Reserve System to exercise some measure of support in order to maintain orderly conditions in the bond market. The proper role of the Reserve banks in this connection should not be rigid support of the bond market at excessively high prices. This means perhaps artificially low interest rates and discourages the holding of government bonds. It may encourage the selling of these bonds by investors who wish to take advantage of better interest opportunities in other loan fields. When the Federal Reserve banks stand ready to give rigid support to the bond market at very high prices and low interest rates the effect is to make marketable government bonds the equivalent of cash. It means that all of the banks of the country which hold these bonds have access to Federal Reserve funds to an extent limited only by the amount of marketable bonds

in their portfolios. As a result the Federal Reserve banks have no real control over the volume of credit in the country. The banks can always convert their bonds into reserves at the Federal Reserve bank, and use these reserves as a basis for additional loans.

To the extent that high prices and low yields encourage nonbank holders to sell their bonds to the Reserve banks the effect is much the same. The sellers of the bonds will deposit the checks received from the Federal Reserve in their banks. When the banks send the checks in to the Federal Reserve for collection the Federal Reserve will add the same amount to the reserve deposits of the banks whose customers have sold the bonds. This means that bank deposits and bank reserves have both been increased by exactly the amount of bonds which were bought by the Federal Reserve. However, with an average legal reserve requirement of approximately one-sixth, only one dollar out of every six of additional reserves created by Federal Reserve bond purchases will be needed to support the additional bank deposits arising from the sale of bonds. The remaining five dollars of the new reserve is excess reserve and can be used as a basis for 30 dollars in new loans by the banks. The Federal Reserve banks by purchasing the bonds have created the excess reserve, but the banker may see only the increase in his reserves and will probably expand loans and deposits on the basis of it.

Although it is undesirable to encourage this sort of credit expansion by rigid support of bonds at high prices it would also be undesirable to have a completely free market. A great danger here would be created by the existence of the large volume of non-marketable savings bonds which are demand obligations and which the holders may cash if they choose. If the price of marketable bonds were to fall low enough, holders of savings bonds might find it possible to cash their bonds at the fixed redemption rate and buy the marketable bonds which at their low price would perhaps afford a higher yield. If a movement to cash savings bonds got started it would force the Treasury to go to the banks to get the money, thus pumping out huge quantities of cash through bank financing of the operation. This is, of course, just the opposite of what we want.

Although the inflation problem must be dealt with primarily by a balanced budget it is also necessary to find means of preventing excessive increases in the money supply through expansion of bank credit. In this situation voluntary controls have been urged. However, there is little evidence to support the belief that such voluntary cooperation alone can solve the problem. Voluntary controls have not worked in other fields and there is little reason to believe that they would work more satisfactorily in the field of banking. Banking is a competitive business and there is little doubt that most bankers will meet competition to any extent necessary. Selective loan controls recently extended are likely to be minor in effect, deterring a few borrowers but not necessarily making basic changes in the policy of lenders. Some real additional controls may become necessary.

Three possible approaches have been suggested. These would all require action by the Congress. The first is the possibility of simply increasing present reserve requirements. There has been opposition to any extension of Federal Reserve power to increase reserve requirements. However, such increased reserve requirements become necessary only as a means of

preventing credit extension on the basis of excess reserves created when the Federal Reserve banks buy government bonds in support of the bond market or to facilitate Treasury refunding. It is the Federal Reserve purchase of bonds which has created the excess reserves in the first place and it should not be considered unreasonable for the Reserve banks to have the power of preventing credit extension on the basis of such reserves. By the elimination of excess reserves through increased reserve requirements the Federal Reserve would simply be sterilizing excess reserves which its own bond operations had created. A second proposal also designed to limit credit extension is that of a special reserve requirement through which banks might be required to hold say 25 percent in short-term government securities as a special reserve against their deposits. A third proposal is that of a loan reserve whereby the banks might be required to maintain reserves against their loans thereby tending to limit the amount of loans. Whatever method is employed it may become necessary to find some additional means of controlling excessive bank credit expansion.

The basic problem is to protect the purchasing power of the dollar and with it the security of the great middle income group. If we fail to do so the very foundations of our present democratic society will be threatened with destruction and we are likely to turn to socialism. Even though we win the battle of the defense program we might still lose if we fail to control inflation and to protect the purchasing power of the dollar. Only by doing so can the foundations of our society be preserved. We must understand that there is no substitute for the sacrifices that must be made. The program must be on a pay-as-you-go basis. Without the necessary monetary and fiscal policies price and other direct controls cannot prevent inflation. They act only as a temporary dam but do not stop the building up of the inflationary forces. Direct controls deal only with the symptoms not the basic causes. They tend to sugar coat, they delay and postpone inflation but, without appropriate fiscal policies, they cannot prevent it. The future of our society depends upon following the proper policies now.

(This summary was prepared by members of the economic staff of the State College of Washington.)