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ANALYSIS OF THE MONETARY AND ECONOMIC ASPECTS OF CONGRESSMAN GOLDSBOROUGH'S RETAIL CREDIT BILL H. R. 7188 AND AMENDMENTS

Congressman Goldsborough's new proposal is quite different from the usual monetary authority plans for controlling booms and depressions which he and others have advocated in the past. The principal feature of his latest bill, introduced last May and on which hearings were held last summer and this year, is the scheme for increasing purchasing power in a recession by offering discounts on consumer purchases at retail. The theory is that the resulting increased volume of retail sales would quickly work back through industry and restore capacity operations in all lines. Admittedly an increase in business and consumer spending is necessary to promote business expansion, but Mr. Goldsborough's scheme to achieve this aim is oversimplified, inequitable, and subject to many administrative and technical difficulties.

Brief description of the proposal

A Federal Credit Commission is established whose primary duty is the determination of a retail discount rate to apply on all purchases of consumers. This discount rate shall be fixed each month by the Commission at the percentage of idle productive capacity to total capacity which exists at the time. The rate shall be set by the bill at 15 percent until such time as the Commission otherwise determines, and it shall not change more than 5 percent a month. No discount is to be granted if the productive capacity of the country is employed up to 85 percent, so that if any discount rate is proclaimed, it can never be less than 15 percent.

When the plan has been placed in operation, consumers will go to the stores and buy things in the usual manner at prevailing prices, less the discount at the

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rate determined by the Commission. If the rate were 15 percent, for example, a $100 article would cost $85 and the consumer would pay $85 in cash and sign a voucher, supplied by the Secretary of the Treasury, for $15. The retail merchant would therefore receive $85 in cash and $15 in warrants or vouchers. These vouchers, however, could be deposited at his bank along with the cash and the retailer would have the opportunity to check against the full deposit of $100.

The next step is that the Secretary of the Treasury would issue a special kind of currency to be known as interbank currency notes equal to the amount of the voucher which the bank receives from the retailer. These notes bear no interest and would be available as backing for deposits created by the voucher. The notes would also be available for interbank settlements and for payment of Federal taxes owed by the banks, but they would not be available to be paid out to the public. They would not, however, serve as reserves for a multiple expansion of bank credit.

The idea is that no inflation can occur so long as no more notes are issued than are necessary to bring up the activity of the country to full capacity and the notes cannot be used as reserves for credit expansion. Moreover, if the Commission should find that an inflation is under way, it could request the Secretary of the Treasury to recall a part of the notes and the banks would be required to contract their outstanding credit accordingly. In order that the banks would not suffer an immediate loss through recall of the notes, an amendment to the bill provides that they shall be held in trust for the banks by the Treasury and returned when authorized by the Federal Credit Commission. In the meantime, however, they could not be used to settle clearing balances, to count as reserves, or to pay off deposits in case of liquidation of a bank. Authority is given the Secretary of the Treasury to issue ten billions of notes to begin with.

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The bill states that the proposal is not to interfere with the Board of Governors in any way or with the Federal Reserve System, which shall continue to have their present normal powers and duties. In fact, the Board is given the added power to raise reserve requirements to 100 percent, as a further means of controlling a possible inflation in the future.

General criticisms of the proposal

1. Effectiveness as a recovery measure. - In the first place the economic validity of the underlying philosophy of the proposal is open to question. It is questionable, for example, that sufficient stimulation could be supplied by giving discounts on retail sales in a recession to guarantee that all forms of industrial activity would rise to capacity. It is characteristic of a period of severe business recession that the production of perishable consumers' goods declines much less rapidly and less substantially than does the production of producers' goods and durable consumers' goods. In these circumstances, there is no assurance that the incomes of the working classes through shorter hours and loss of jobs would not be falling at such a rapid rate that even though retail discounts were given the total volume of spending would continue to decline. Moreover, many persons who have incomes available for consumption expenditures might decide to curtail purchases in a period of recession, even though prices were falling and a retail discount were proclaimed, because they may expect that prices will fall further and a larger discount will be given in the future. In the meantime, however, they would spend only enough to cover the chief necessities and would allow their surplus income plus the money saved on such purchases by the discount to pile up in the form of idle balances or perhaps use part of them to reduce indebtedness at banks and elsewhere.

2. Inequity of benefits provided by the plan. - A second important objection is that the method of giving benefits under this plan discriminates against

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the low income classes of the community. In order to obtain a subsidy from the retail discount, it would be necessary for the purchaser to have sufficient funds or be able to borrow the amount required to cover the difference between the list price of the articles purchased and the retail discount. This means that the benefits would increase in accordance with the volume of retail purchases and the principal benefits would therefore accrue to the higher income groups. Those persons who have lost their jobs through the decline in production and, hence, have been deprived of their current sources of income would not be able to benefit by the retail discount or would do so on a greatly reduced scale. This is a form of discrimination that could not very well be justified from the standpoint of public policy. The present system of direct relief and work relief is predicated on giving assistance to those persons who are unemployed and are therefore dependent upon public sources for their livelihood. It should be noted that it is this class which spends practically its entire income for consumers' goods.

3. Inflationary possibilities. - In spite of the numerous safeguards which are incorporated in the bill, Congressman Goldsborough's proposals contain a serious threat of ultimate inflation. In a period of sharp business recession, the amount of deposits created by the issuance of retail credit vouchers would be very large. On the basis of incomplete data, there is reason to believe that in 1932, for example, the amount would have totaled as much as $12,500,000,000. This increase in deposits in itself would not necessarily have led to inflationary conditions, provided the deposits were not subsequently used or that the banks contracted loans and investments and in the process destroyed an equal amount of deposits. It is not necessarily true, however, that in a period of recession loans and investments and deposits would automatically decrease and, hence, the introduction of the retail discount might lead to a substantial increase in total deposits. As time goes on, and the volume of spending increases and the activity

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of these deposits picks up, there would be the possibility that an inflationary movement could get under way in a relatively short time. In such circumstances, it would be very difficult to apply quickly measures which would force contraction and even if such measures were adopted, it would be at the risk of producing a drastic deflation.

4. Difficulty of determining potential and unutilized capacity. - A number of the practical difficulties would confront the Federal Credit Commission in determining the potential capacity and what percentage of this capacity is actually employed. On the basis of our present statistical information, this would be an almost impossible task. Certainly it would be necessary to set up elaborate and costly reporting systems, if it is to be done on a current basis as contemplated under the bill. There are also a number of theoretical questions in connection with the definition of what constitutes potential capacity for all types of productive activity which would have to be settled before the discount rate could be established with any degree of accuracy. Capacity is related to price and it would require high prices to bring old obsolete equipment into production. Before capacity production in all lines is reached, therefore, many lines would be operating at full capacity and bottlenecks would appear. Further stimulation to retail sales in such circumstances would be purely inflationary.

5. Encouragement to price raising. - Another practical problem is that there seems to be no reason why retail stores could not raise prices to absorb the discount to consumers. For example, stores could mark up a $10 article to $12.50 and inform the customer that it will only cost him $10 as usual, while the remaining $2.50 will be met by the retail discount voucher. It might be possible to establish machinery for preventing such price increases, but this would appear to be difficult because it would be hard to determine definitely

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the reason for the price increase. Price increases might be limited by effective competition, but effective competition is not complete and there could be cooperation among retailers or manufacturers to raise prices at least of certain types of articles. To the extent that the plan resulted in price advances it would fail to produce additional purchasing power.

6. Administrative problems. - There would be many problems of policing the system and a complex system of accounting and auditing would be necessary to prevent widespread fraud. Licensing of all individuals and businesses which sell any goods or services to ultimate consumers would also present many administrative difficulties.

Effect upon the banking system

The operation of the plan would seriously impair the efficiency of the banking system and would result in reduced bank earnings and possibly in severe capital losses.

1. Increased cost of bank operations. - The expansion of bank deposits for which the banks receive "interbank currency" that carries no interest would increase the expenses of banks without increasing their earning assets. Congressman Goldsborough recognizes that the handling of the retail discount vouchers by the banks for customers would entail additional expenses and therefore provides that the Federal Credit Commission shall fix the service charge to cover these expenses. It would appear from the language of the bill that this charge would be in the form of an initial deduction upon the presentation of the vouchers by the retailers. Such a charge would be entirely inadequate and would be inequitable as between individual banks. The principal expenses to the banks would be the continuing ones of handling the larger volume of deposit transactions arising from the creation of deposits against non-earning assets. When the deposits originally created by deposit of a retail credit voucher are checked against and

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transferred to other banks these banks would not be able to make a special service charge.

The most likely source of new income for the banks thus faced with decreased earnings would be to institute additional ordinary service charges for handling deposit accounts. Competition and customer resistance would limit the revenue that could be derived from this source. In any event it would be a slow process and in the transition period bank earnings would be curtailed with impairments of banking capital and probably failures in the case of numerous individual banks. The introduction of higher service charges might also have other undesirable effects which are difficult to predict and could be determined only by experience with the plan in actual operation. For example, a higher level of service charges might increase the volume of currency in circulation. This would be a backward step in view of the economy and efficiency with which business settlements are now effected through the use of checking accounts at commercial banks.

2. <u>Effect of segregation of interbank currency from other bank reserves.</u> - Many serious practical difficulties would be encountered in the segregation of the so-called interbank currency from other reserve funds of banks. The purpose of this segregation is, of course, to prevent the inflationary tendencies that would result if the new currency were allowed to count as reserves upon which a multiple expansion of bank credit could be based. The currency cannot be paid into circulation but is legal tender for making interbank settlements. In view of the fact that interbank currency counts as reserves only dollar for dollar, any adverse clearing balance would be met by use of this currency instead of regular reserves.

The effect of these provisions would be highly discriminatory among individual banks. To illustrate let us assume that a bank has suffered a reserve

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deficiency through withdrawals of currency by the public or through adverse clearing balances after its interbank currency had been exhausted. When the bank attempts to restore its reserves through selling assets it would receive payment in interbank currency. It had lost reserves, however, which count as 1 to 5 against demand deposits while the interbank currency it receives counts as reserves on a dollar for dollar basis. Consequently, it would have to sell four times as many assets as the original loss before its reserves were brought back to the legal requirements.

Congressman Goldsborough partially recognized this contingency by a provision to allow the conversion of interbank currency into legal tender currency when "there is an emergency demand for currency that would lead to a dangerous forced liquidation of assets." This is an emergency power, however, that appears to be designed to protect the banking system as a whole in case of a wave of currency hoarding by the public. It apparently could not be used by individual banks which suffered currency withdrawals in the normal course of operations. Moreover, it would not help in the case cited above where a bank suffered a reserve deficiency through adverse bank clearings.

3. <u>Recall of interbank currency notes</u>. - Under the original bill the recall of the interbank currency notes would result in immediate capital losses to the banks through the Treasury acquiring a portion of their assets without reimbursing the banks. The amendment, para. (i) Title III, is designed to correct this feature which would obviously be disastrous to the banking system. While this amendment would prevent immediate insolvency of a large number of banks the recall of interbank currency would still present grave problems to many individual banks. The amendment states that the recalled notes are to be held in trust by the Treasury for the benefit of the banks, but it is difficult to see what these "benefits" are. They would not be available to the banks to pay off

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deposit or other liabilities. The whole purpose of recalling them is to reduce the reserves of the banks and force contraction of credit to prevent inflationary tendencies that are developing. It seems likely, however, that the cure would be applied too late and might prove worse than the disease and a deflationary cycle would be precipitated. When the Commission decided to recall the notes the banks would be fully expanded on the basis of their available reserves including interbank currency. Presumably, also, the interbank currency would be widely distributed among banks. Thus when the interbank currency notes are recalled it would force a large number of banks to liquidate assets at the same time. This would probably lead to dumping of securities, demoralization in the markets, and the banks would probably suffer severe losses. Its effects would be similar in this respect to the effects of an increase in reserve requirements when banks had no excess reserves. Congressman Goldsborough recognizes this possible danger and provides (sec. 301, para. f) that the banks shall promote an orderly liquidation and not use selective measures that would depreciate particular classes of securities. How such a provision could be administered and enforced presents an insoluble problem for the supervisory authorities. If liquidation under these circumstances leads to bank failures the interbank currency notes held in trust by the Treasury would not be available to meet the claims of depositors or other creditors unless released by the Federal Credit Commission.

It might be mentioned in conclusion that Congressman Goldsborough does not appear to be greatly concerned with the possible detrimental effects that the plan would have on the banking system. This is perhaps because he has not thought through how the plan would operate in practice. But also it is probably because he believes that as banks merely manufacture credit out of nothing they are not entitled to receive a return on their loans and investments. This is a basic flaw in his reasoning on all banking matters.

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Eccleston

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COORDINATION OF FISCAL, MONETARY, AND ECONOMIC POLICIES OF THE GOVERNMENT

The Board of Governors has maintained consistently that the effective discharge of the Federal Reserve System's responsibilities for monetary and credit policy are dependent upon coordination with the general economic policy being followed by the Government, the various phases of which are executed by a number of administrative agencies. Such coordination is especially needed now that the national defense program is moving into high gear and in the near future will exert an unprecedented stimulus to business activity and require a record volume of new Treasury financing. The magnitude of the program is such that in view of the underlying monetary conditions we could experience in a relatively short time the development of inflationary tendencies. These tendencies, if unchecked, would produce a rise in prices which would retard the national effort for defense and greatly increase its cost, as well as threaten the economic well-being of the general public. In order to forestall such developments, the Board feels that all agencies of the Government concerned with fiscal, monetary, and economic policies should develop machinery for more continuous exchange of views and for closer cooperation in the formulation of general policy. This is especially true with respect to fiscal and monetary policies, which are immediate responsibilities of the Federal Reserve and the Treasury.

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Although most officials would probably agree with the above position as a matter of principle, there is growing evidence that cooperation in the formulation of policy has been neglected in the recent past even more than formerly. A few specific examples of this are cited below.

1. Treasury financing policy. Although representatives of the Federal Reserve System meet with the Secretary of the Treasury and his staff prior to each Treasury financing, the discussions at these meetings are often confined to pricing and other technical aspects in connection with a type of financing which has already been decided upon and perhaps tentatively announced in the press. In view of the major financing operations required for the defense program, it appears desirable that more consultation should be had in formulating a general financing program, with a careful determination of the general objectives to be achieved and a detailed consideration of all possible types of issues that might be used to carry out these objectives. At any particular financing meeting appropriate issues can then be selected which will conform with the general financing program in so far as is practicable in the light of the market conditions existing at the time.

The Board feels that it is peculiarly fitted to advise the Treasury in this respect. It devotes its entire time to the consideration of monetary and credit conditions which involves the continuous study of business developments and Government fiscal

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operations. Moreover, the Board is in constant touch with all developments in the Government security market.

2. Consultation with outside "experts". It has long been the practice of the Treasury, when it is confronted with any new problem, to call in outside "experts" for consultation. According to the press, the Secretary of the Treasury recently conferred with Professors Jacob Viner of the University of Chicago and Roswell Magill of Columbia University on "the types of new securities to be issued and the methods of marketing". It is difficult to see how people in academic life can give much practical advice on these questions which involve continued and intimate knowledge of conditions in the Government security market and in investment markets generally.

Considerations of an even more serious nature, however, arise when outside "experts" with an intimate knowledge of market conditions are brought in as was the case at the time of the outbreak of war when the Secretary employed Mr. Randolph Burgess of the National City Bank, Mr. Earle Bailey of the Tricontinental Corporation, and Mr. Tom K. Smith of the Boatmen's National Bank of St. Louis. Men of this type often make recommendations which are prejudiced in favor of the private interest which they represent. In addition, while connected with the Government on a temporary basis, they have access to confidential information on prospective Treasury plans as well as on Treasury and Federal Reserve current operations in the market, knowledge of which would provide their institutions with invaluable tips on investment policy. The individual himself may be scrupulously

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honest in seeking to avoid the divulging of any confidential information, but may inadvertently let things slip which may be used by his business associates as guides to market operations. In this connection, it may be observed that a large New York City institution, with which one of the Treasury's outside "experts" was a high official, purchased a substantial amount ($16,000,000) of Treasury bonds close to the lows of the market in late September and early October 1939. This action may have been a pure coincidence, because it has been the policy of this institution to buy Governments on the scale down when prices decline and to liquidate part of its holdings on any substantial price advances.

Regardless of whether there has been any misuse of confidential information which must necessarily be made available to such advisors, the Treasury remains subject to criticism when it employes men like this on a temporary basis because of the obvious possibilities in the situation and also because of the conflicts between private and public interests which inevitably exist in the formulation of financing policies.

3. Secretary Morgenthau's comments to the press on the Federal Reserve report. At his press conference on January 9 the Secretary asserted that a "substantial and unwarranted decline" in the prices of Government bonds had been caused by the Federal Reserve System's special report to Congress on monetary conditions and indicated that he would oppose at least certain aspects of the Board's

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proposals "if Congress takes the matter seriously". The Secretary was fully advised about this report long in advance of its publication and gave no prior indication that he would publicly express such an attitude toward it.

At the time of the Secretary's statement the long-term Government bond market had reacted slightly over two points since the issuance of the Federal Reserve report, but it was still higher than at any time prior to the election last November. In fact, the yield on the longest bonds outstanding was only about 2.17 per cent as compared with the all-time low yield of 2.03 per cent reached early last December. In connection with the Secretary's recent assertion that Government bonds had suffered a "substantial and unwarranted decline", it is interesting to recall that this longest bond issue was selling at about 109 1/4 as compared with less than par in September 1939 when the Secretary and his outside banking advisors were urging the Federal Reserve to withdraw its support from the Government bond market. It was our view at that time that speculative forces had driven prices of Government securities to unreasonably low levels in view of underlying conditions, and we did not wish to see the development of panicky liquidation that further speculative price declines might have engendered. Moreover, we did not wish to see the shrewd market speculators and the trading banks have the opportunity to acquire bonds at "bargain" prices.

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4. Foreign loans of gold from the Stabilization Fund. Although a member of the Board's staff was invited to sit in on certain Treasury conferences at which were discussed some of the technical details of recent foreign loans, the Board was not consulted on the broad question of the policy of using Stabilization Fund gold for this purpose. Use of this gold directly increases bank reserves and consequently affects the domestic monetary situation. Two such loans already announced, to China and Argentina, involve the use of $100,000,000 gold from the Stabilization Fund, but no disbursements on either loan have yet been made.

5. Bank holding company bill. The new bank holding company bill under Treasury auspices was introduced without any consultation with or even advance notice to the Board of Governors. This action cannot be justified in view of the fact that this was exclusively a banking matter and the Federal Reserve is the only Government banking agency which has had any experience in the administration of bank holding company legislation.

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