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BY

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It is ten years since I had the privilege of meeting with you at a bank management conference of the New England Council. The Axis cloud was then just beginning to blacken the skies over Europe and the Orient. Few were aware of its ominous portent. We were still struggling up from the deepest depression in our economic history. A decade ago most bankers and businessmen were worried about the Federal debt, the unbalanced budget and the danger of inflation. The gross national debt had reached nearly 34 billion dollars.

No one then could have foreseen the events of the next decade. After the most devastating of all wars, we find ourselves today with a gross national debt of 265 billion dollars, or nearly eight times as much as it was ten years ago. Today, we no longer have a great slack of unemployment. We do have accumulated wants and needs beyond all past experience. The backlog of savings, available to individuals and business in the form of currency, bank deposits and Government securities, is from three to four times as great as in 1936, and current income payments are running at a rate of about 170 billion dollars a year, or more than double the highest prewar peaks of 1929 and 1940. The inflationary potential thus continues to be great -- and war-time controls intended to keep the flood of money in check until production could catch up with demand have been largely abandoned.

If we are to avoid going through a painful period of readjustment of distortions in the wage-price structure, we must now rely primarily upon self-imposed restraint on the part of powerful conflicting groups in management and business, in labor and in agriculture. Responsibility for maintaining orderly economic progress, which will prevent a further inflationary development that would inevitably be followed by a decline has now largely shifted from Government to labor and management.

The unity of purpose, which enabled us to achieve a miracle of production for war and thus to hasten the victory, is gone, and with it public support of the direct controls over materials, wages, profits and prices that prudent policy in the national interest seemed to require while inflationary forces were still dominant. Fiscal policy and scattered credit controls are about all that remain to the Government as protective measures but these, too, are beset by increasing controversy and are likewise dependent upon majority will.

Popular revulsion against direct controls and other restraints, of course, is natural in the aftermath of war. Certainly freedom of expression and the interplay of the point of view of manifold social and economic groups is the life blood of a progressive democracy. But this democratic freedom should not be a license for special interest groups to seek their own ends without regard for the public good. This spirit of unenlightened self-interest has increasingly pervaded our national life since the end of the war. If we are to make our economic and political system function successfully we must find means of settling conflicts of interest by lawful and peaceful democratic processes, without disrupting economic stability and progress.

We see examples of conflicting interests on all sides. For instance, most cattlemen object to control of livestock prices, but want the Government to stop a railroad or coal strike if it threatens to interfere with distribution of their products; most farmers oppose ceilings on the prices of their products, but want price floors; in general, labor unions object to wage controls, but want the Government to control prices; most businessmen favor curbs on wages but not on profits; bankers want the Government to balance the budget, but many also advocate higher interest rates on the public debt ostensibly to combat inflation. And so it goes.

We must recognize the fact more than ever in this highly industrialized, interdependent age that one sector of the economy cannot gain in the long run at the expense of another. Prosperous economic conditions which will benefit all groups can be secured only if the requirements of the economy as a whole are considered. Past experience has demonstrated that the maintenance of stable and prosperous conditions can not be assured by exclusive reliance upon the free play of market forces. The Government, as the collective agent of all of us, must be, in effect, the umpire between contending pressure groups, deciding important issues on the basis of what is in the interest of the country as a whole. It is a question of the degree of Governmental action and intervention. For my part, I want as little as possible -- but I want enough to minimize destructive economic conflict, and protect our national interests.

We have only to look at the world about us today to realize that there are, broadly speaking, three general types of economic order -- communism, socialism which, in greater or lesser degree, prevails in England and throughout western Europe, and the democratic capitalism which we want to preserve in this country. The challenge to our system can and must be met by providing a sustained high level of production and employment. Otherwise, we shall inevitably drift towards more and more Government intervention and controls until our system has been replaced by something akin to the other two -- not because our people deliberately choose it but because they would be likely to consider it the only alternative to widespread economic distress and social disorder under our own system.

With most other inflation curbs gone, attention -- and criticism -- will no doubt be centered more and more on fiscal and credit matters which affect about the only area left where some restraint may be exercised by the Government. Criticism has been aimed particularly at three points: 1. At the Reserve System's support of the 7/8'ths rate on Treasury certificates; 2. At the Board's fixing of margin requirements at 100 per cent; and, 3. At continuation of the Executive Order under which the Board has regulated consumer credit. Let me discuss these three subjects briefly.

1. Government Financing

Various bankers, dealers, insurance companies and others have recommended an increase in short-term interest rates as a means of combating inflation. As the Board pointed out in its Annual Report for 1945, there is no reason to suppose that even if the short-term rate were increased to as high as $1\frac{1}{4}$ th per cent, 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 cannot be rapidly reduced -- and in fact can only be continuously reduced by having a budgetary cash surplus sufficient to continue the program of debt retirement. This can come either from taxes or from the sale on balance of nonmarketable bonds to the public, using the proceeds to pay off bank-held debt. The other, and by far the most important basic cause, is the insufficiency of production as yet in relation to the existing money supply.

Since most of the short-term debt, outside of the Reserve System, is held by the banks, an increase in the short-term rate would add to bank earnings, which are still at very high levels due to Government bond holdings. It would add to the cost of carrying the public debt. It would not reduce the existing money supply. It would add nothing to production -- the basic need of the hour -- nor would it reduce consumption. It would have no real bearing as an anti-inflationary factor. We have been witnessing a rapid rise in business, consumer and mortgage credit. It is hardly reasonable to suppose that short-term rates on Government securities could be increased sufficiently to deter this private borrowing.

As for increasing the short-term rate with the idea of discouraging further monetization of the debt by the banks, it should be emphasized that the Treasury's debt retirement program has been an effective means of accomplishing this desirable objective, and postponing need for more direct measures such as the Board outlined in its report as possible alternatives for Congress to consider.

It has been argued that a flexible policy permitting some increase in short-term rates would introduce uncertainties into the market; which would discourage banks from shifting into longer-term issues. The fact is that there could be very little uncertainty as to short-term rates in view of the large volume of securities that mature monthly. If a policy were adopted permitting short-term rates to rise without setting an upper limit, the Treasury would have difficulty in refunding its maturities, since banks and other investors would be likely to withhold funds awaiting even higher rates. The question then is not whether the short-term rate should be pegged at $\frac{7}{8}$ per cent or permitted to fluctuate up and down, but whether it should be pegged at 1 per cent, $1\frac{1}{4}$ per cent or $1\frac{1}{2}$ per cent, or some other level. There is no natural level. If short-term rates

were permitted to rise sharply there would also be pressure to drive long-term rates up. This would jeopardize the savings bond sales program and cause wholesale redemptions.

There has been much discussion about the issuance of long-term, 2-1/2 per cent marketable securities not eligible for banks. It has been said that such an issue would be anti-inflationary because it would absorb savings which could be used to retire bank debt. Some of the arguments that might be made against putting out such an issue at this time are that it would increase bank credit and insurance companies and savings banks would not only use accumulated funds for such investment but in addition would sell bank-eligible issues to banks in order to raise funds with which to subscribe, or would borrow from banks. Such issues would not serve to increase savings of individuals who are the most important group from the inflation standpoint. Series E, F, and G Savings Bonds already offer attractive investment outlets to this group.

If it should appear desirable in the future to provide an additional investment outlet for funds of insurance companies and savings banks it would be preferable to do this through the offering of long-term nonmarketable securities, the yield on which would be 2-1/2 per cent if held to maturity. This would avoid the danger of future additions to long-term holdings of banks and it would protect the Treasury against investors who buy long-term securities for short-term holding, thus getting 2-1/2 per cent, plus the premium as maturity is reached, on what in effect is demand money so long as the 2-1/2 per cent rate is maintained. In my opinion this long-term rate should not be permitted to go up, and, if need be, the market must be supported by the Federal Reserve. Otherwise the cost of carrying the public debt would be increased, many outstanding savings bonds yielding lower rates would be cashed in and the funds invested in the higher-yield market issues, and heavy losses would be incurred by holders of outstanding market bonds. Confidence in the stability of the Government bond market would vanish. If long-term nonmarketable issues were offered, it might be necessary to limit subscriptions under some formula which would provide only for the investment of accumulated funds and prevent switching from present holdings, particularly the bank eligibles.

It has also been argued that the Treasury should refund short-term securities into longer-term debt to ease the refunding problem and avoid the demand liability on the Treasury. Compared to refunding in short-term issues, this would result in an increased interest cost and in less flexibility to the Treasury in managing the debt. Commercial bank holdings of longer-term securities and commercial bank earnings, would be relatively higher. As a matter

of fact, to the extent that private investors continue to expand their holdings of E, F and G bonds, and the proceeds are applied to retiring maturing bank-held debt, the result is a refunding of short into long-term holdings. This accomplishes the desirable objective of shifting the debt out of the banks and into the hands of the general public. Also to the extent that the Treasury has a cash surplus -- and it may possibly be \$4 to \$6 billions in the first half of 1947 -- it can likewise be used largely to reduce short-term bank-held debt.

With commercial banks holding 75 billion dollars of Government securities out of a total marketable debt of 182 billion, a large amount of the debt should be in short-term issues. Monthly refundings create no problem. The argument that the Treasury is now faced with a large volume of demand obligations is not persuasive.

Under present conditions, the entire debt is in effect a demand obligation since the Federal Reserve assures the Treasury at all times of a ready market for its offerings on a basis of 7/8'ths per cent on the certificates and 2-1/2 per cent on the longest bonds. With the public debt as large as it is today -- twice the entire private debt of the country -- a free market is out of the question if that is taken to mean an unmanaged, unsupported market. The public interest requires a stable market for Government securities, and this is the responsibility of the Federal Reserve.

The Federal Reserve has worked and will continue to work in close cooperation with the Treasury. The public interest requires the closest teamwork. The Federal Reserve is in complete agreement with the Treasury's debt management program, as well as the general fiscal policy, as outlined on several occasions by Secretary Snyder.

Beginning in March, as you know, it became possible not only to meet the greatly reduced deficit without further borrowing, but to enter upon a program of debt retirement by drawing upon cash accumulated balances. Since then, and including the projected retirement of 2 billion dollars for November 1, the Treasury redeemed for cash close to 20 billions of securities. This debt retirement program has been of considerable help in checking inflationary pressures on the monetary side.

As a result of the retirement program the enormous monetary expansion which had been in process throughout the war years and which raised the money supply from 39 billion dollars in 1940 to 102 billions in February of this year has been halted and reversed.

By imposing a drain on bank reserves, the retirement program has also exerted some brake upon further expansion of bank credit. While commercial loans and consumer credit have recently

increased rapidly, security loans have declined, and, as I have indicated, the retirement program has at least temporarily discouraged further shifting by banks from short to medium and long-term Government securities.

While I would not like to see an increase in interest rates at this time, neither would I like to see a further rate reduction. The decline in the price of longer-term issues since spring and the resulting increase in yield has been altogether satisfactory as has been the general stability of security prices.

There is no need for the issuance of additional long-term marketable securities at this time, as the Government does not need new money and, as I have indicated, expects to have a cash surplus. If insurance companies, savings banks and other institutions have surplus funds there is plenty of opportunity to invest in the existing long-term issues at present favorable prices and yields. Also there is or will be an increasing opportunity to invest in mortgages and other long-term investments, including World Bank securities.

2. Margin Requirements

The credit policy of the Federal Reserve System, in all its aspects, should be adjusted to the general credit situation of the country. We are not justified, for example, in fixing margin requirements exclusively by reference to the movement of stock prices, as some people have suggested. The general credit situation must be the main criterion, and this in turn is an integral part of the general business situation. When margin requirements were fixed at 100 per cent, the general credit situation was highly inflationary because of the immense volume of purchasing power in the hands of investors and the general public. Indeed, there is plenty of cash today to drive stocks up very high, entirely without credit, if investors, let us say, had more confidence in the prospect for profits in business and industry and less uncertainty over the possibilities of further wage-price maladjustments. It can hardly be contended, with reason, that the credit gates should be opened now in the market in order to finance new productive enterprise and private employment. There was a very large volume of undigested offerings in the stock market, only a part of which was for new financing. But in any case this is not a time for encouraging new issues even for productive purposes because with the scarcity of materials and labor, it would only add to the inflationary pressure.

This is not a one-way street. When the situation changes, and there is need to stimulate the use of credit for purchasing securities, it will be time to consider lowering margin requirements.

This would be a time, as it seems to me, when there will be sufficient supplies of materials and labor to justify the encouragement of new issues of corporate securities, provided there is at the same time a prospect of declining production and declining employment. The time to lower the margin requirements will be one at which, in contrast to the present time, the effect will not be to add to inflationary forces which are already strong but to combat deflationary forces in the general economy.

The stock market, after a four-year rise which increased values by 150 per cent, has now experienced a decline, bringing prices down to the level at the end of the war, or about 20 per cent below their high point of last spring. I do not consider this an alarming symptom. On the contrary, to the extent that this re-adjustment reflects a more sober appraisal of prospects and a lessening of the inflationary psychology, to the extent that it will tend to slow down the timing of not absolutely urgent capital expenditures and inventory accumulations, it will contribute to a balance in the economy.

One of the fortunate aspects of the situation has been the low level of stock market credit. Such credit now outstanding is in the general neighborhood of 1 billion dollars, as compared with something like 3 billions at the prewar peak of stock prices in 1937 and more than 12 billions at the peak in 1929. Without the existence of stringent credit regulations the speculative upward movement of prices would undoubtedly have gone much further and the subsequent price decline with a concurrent forced liquidation of credit would also have gone much further, thus making for greater instability.

Over the last 40 or 50 years, the upswings and downswings of the stock market have been a decidedly unstabilizing influence in the national economy. It was in order to reduce this unstabilizing influence, particularly as it is connected with the use of credit, that Congress in 1934 vested in the Reserve Board responsibility for fixing margin requirements on listed securities but not on unlisted securities. In the late 1920's, when there were no Federal margin requirements, the upward movement in stock prices caused them to increase by more than 200 per cent and the sharp decline in 1929 was more than twice as rapid as that which took place during recent months. The recent gyrations in the cotton market, which advanced very rapidly last summer and then slumped by nearly 20 per cent in a few days are an indication of what can be expected in speculative markets which are not subject to any effective control over the use of credit.

One of the interesting consequences of the Board's margin requirements has been an almost uninterrupted reduction since the middle of last year in the amount of stock-market credit in use, including the reduction during the period when the market was advancing -- which had never happened before. There were, to be sure, some inequities and imperfections in margin requirements as a regulatory instrument, including the failure of the law to cover non-listed securities. Congress considered the question of whether unlisted securities should also be covered by the law but concluded that it was not practical. Moreover, it is evident that control of listed securities greatly influences the use of credit and the market for unlisted securities. On the whole, the use of margin requirements can be viewed with satisfaction. Neither the long upswing that culminated last May, nor the subsequent downswing have gone to the lengths to which they would have gone if there had been no Federal margin requirements.

The general public strongly approves of this regulation. It is not to be expected that some of those in the brokerage or security business who feel that their business is adversely affected by regulation would agree with this viewpoint.

3. Consumer Credit

As for consumer credit regulation, it was, as you may recall, the seventh point in the Government's war-time program for economic stabilization. The Reserve Board did not seek the task of administering this regulation. The question of whether there should be some permanent legislation covering this important segment of credit in our economy is one for Congress to determine. The Board, having had experience with the war-time regulation aimed specifically at the inflation target, would be remiss, I think, if it failed to call the attention of Congress to the need for making a decision, one way or the other. I, for one, while I certainly do not crave taking on this additional load, feel as the Board's annual report stated that serious consideration should be given by Congress to the desirability of placing authority in some Governmental body to deal with the problem -- for undoubtedly the expansion and contraction of this type of credit have greatly accentuated economic upswings and downturns in the past. There is a very strong case to be made for moderating these excesses, so far as possible, in the consumer credit field.

It could be accomplished, in my opinion, by focusing regulation primarily on the major durable goods customarily sold on the installment plan. They compose the great dollar bulk of consumer

credit. It has been felt for some time by the Reserve Board that the present regulation could be greatly improved administratively by focusing it on the major durables, eliminating the major part of single payment loans and charge accounts, from its scope, together with the soft goods and less important durables that were included when the regulation was originally drawn as an anti-inflationary device in war-time.

The Board for some time has been studying the advisability of thus revising the existing regulation with a view to making it administratively more workable. It is felt that this can be done without a material weakening of its effectiveness as a restraining influence at this time. When inflationary pressures have passed, it would need to be revised further, assuming that Congress decides to retain it as a permanent instrument of credit regulation.

It is important, of course, to bear in mind that these selective controls, relating to listed stocks and consumer credit, can at best play only a relatively minor role in assuring stability in our economic life. Likewise, monetary policy is even more limited in its influence under present day conditions than ever before. Overshadowing all of these aspects of Governmental policy are national, fiscal and budgetary measures, together with other broad policies relating to business, labor and agriculture. Not even the most ardent advocate of laissez-faire would propose that we abandon all Government regulations. It is, let me say again, a question of degree -- of doing through the medium of Government what needs to be done to contribute to economic stability and progress -- and doing no more than that.

Since this is a banking group, I have sought to cover three specific questions in which you have a particular interest. In conclusion, I would like to turn for a moment to the general economic situation as I see it at this time. Speaking recently at the National Outlook Conference of the Department of Agriculture, I undertook to assess in a general way the good and bad aspects of our current situation. Without recounting that appraisal of favorable and unfavorable factors, I will merely quote the conclusions that I think should be drawn from them:

"The situation calls for a budgetary surplus and continued debt retirement; Continued efforts should be made to reduce public expenditures. Taxes should not be further reduced under present conditions. It is desirable to increase tax revenues, without increasing tax rates, by increasing the national income as a result of greater productivity. Such an increase in the national income, together with decreased Federal expenditures, will bring about a budgetary surplus which will make possible tax reductions later on.

"Speaking of the general credit situation, there is no reason under present conditions for reducing margin requirements on stock market trading or for relaxing consumer credit restraints on durable consumer goods in short supply. Credit should be provided for productive purposes, but not for speculation. Nor is there justification for increasing interest rates which would greatly complicate the Government's problem of managing the public debt and increase the cost of carrying it, without the offsetting advantage of preventing inflation.

"At best, Government price or credit controls can only be a stopgap, and fiscal policy can deal only with the money side of the inflation problem. The overwhelmingly vital need now is for more work and more goods -- for increased productivity. Whether we are to have a stable economic progress depends fundamentally now on the industrial front, on labor and management, on increasing output by increasing efficiency, eliminating bottlenecks and restrictive rules and practices, including those in the construction industry, and by avoiding strikes and shutdowns. We all know that in our interdependent economy a strike in one key industry paralyzes others -- strikes even by a comparatively few workers in plants that supply others can throw many thousands out of work.

"More work and more goods are the basic cures for inflation. That is the only way in which labor can keep the gains from the pay increases it has received. It is the only way to safeguard the purchasing power of all wages and savings. Further wage increases for the same amount of work and output would serve only to intensify the upward pressure on prices. Increased wages that result in increased prices are self-defeating. It will be far better to hold prices down and increase productivity -- to increase real wages -- than to have further wage and price increases that would finally result in public resistance. For this, in turn, would upset business calculations, and all long-term commitments, thereby precipitating a recession, the severity of which would depend mainly on how long it would take to correct the distortions and maladjustments. Only by keeping prices down and maintaining the buying power of wages and savings can we have a higher standard of living.

"We have all the tangible elements of sustained prosperity -- manpower, raw materials, money supply, coupled with a vast backlog of needs and wants. The intangibles, still needed, include self-restraint, enlightened self-interest, the will and wisdom to translate the tangibles into a lasting, higher standard of living."