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OUTLOOK FOR INTEREST RATES

Considering the size of the public debt and the great importance of the interest cost of servicing the debt, few, if any, would be so bold as to forecast sharp increases in interest rates over the next several years. I make no claim as a forecaster, and as a member of the Board of Governors should not place myself in that position. However, I can discuss with you some of the factors which will bear importantly upon the future cost of interest rates and some of the considerations which probably will influence public policy in this matter.

The War Situation

The demand for and the supply of loans and investments have always been the underlying factors determining the course of interest rates. During the war, the conditions of demand and supply in the security markets, as in any other sectors of the economy, were of an altogether unusual kind. From Pearl Harbor to early this year the public debt rose from 64 billion dollars to 280 billion. This enormous increase in the supply of securities was made necessary to pay for some 60 per cent of the war cost which was not covered by taxation.

At the same time, there was also a vast increase in funds available for investment in Government securities. Wages, salaries, farm incomes and profits, after allowing for deduction of income taxes rose from an annual rate of little over 90 billion dollars to a rate of well over 140 billion. As the supply of civilian goods did not increase during the war years and prices were held fairly stable, savings, and hence the demand for investments, rose sharply. As the economy moves along, these factors keep changing with it. Of the 216 billion dollar increase in the debt, over 50 per cent was absorbed by this investment demand outside the banks. The remainder was absorbed by the banking system. To adjust the combined demand for securities to the requirements of war financing, the commercial banking system, for this purpose, was supplied with the necessary reserve funds.

Thus we have for the war period a vast increase in the supply of securities, accompanied by an equally sharp rise in demand. On balance, the two factors tended to offset each other and it was possible to maintain interest rates at a fairly stable level. Rates on Government securities ranged from 3/8 per cent on 3-month Treasury bills to 2-1/2 per cent on long-term marketable bonds. In fact, during the latter part of the period there was strong market pressure for interest rates on medium-term and long-term Government securities to decline. The spread between corporate and other securities narrowed during this period as a result of the decline in yields on corporate securities; interest rates on loans also declined.

The Transition Period

With the end of the war, there was a rapid change in the financing picture. The Federal budget has tumbled from its wartime peak of annual expenditures of over 100 billion to less than 40 billion dollars. The deficit has well nigh disappeared, and by the end of the year we should begin to have a cash surplus. The increase in the debt has stopped, and due largely to the drawing down of Treasury balances it is being reduced at a considerable rate. On the supply side the situation has thus eased a great deal. The problem which was one of rapid debt expansion has become one of refunding and retirement.

On the demand side the change has been less drastic. The level of income has remained extraordinarily high. Notwithstanding strikes and other disruptions, our production record since V-E Day has belied the pessimists and surpassed most expectations. Production during the months before the coal strike was higher than ever before in times of peace. If we manage things at all well in the months ahead, finished products will be flowing to the market at an ever-increasing rate.

With incomes remaining high, the dollar volume of private savings will continue at a high level. Although it is only natural to expect that the rate of savings should decline from its wartime peak, a substantial amount of current savings will continue to be available for investment in Government securities. Individual savings are now at an annual rate of about 20 billion, as against 7 billion in 1940. The demand for Government securities, similarly, should be sustained by the existence of the huge volume of liquid funds which has been created in the course of wartime borrowing from the commercial banking system. The volume of demand deposits (adjusted) and currency alone increased from 39 billion in 1940 to 130 billion by the end of April.

But here is where the inflation problem enters the picture. Even under the most favorable prospects for full production, the supply of goods for some time is bound to remain scarce relative to demand. Inflation pressures are bound to remain strong. If we can hold them in rein, if we can avoid the vicious spiral of price and wage and price increases, there is every reason to hope that pressures will relax within a year or so. If, on the other hand, we fail to do so, if we give the investor any reason to fear that the purchasing value of his security holdings is threatened by upward spiralling prices, the entire demand side of the security market will be most seriously threatened. Already, there is an overflow of funds into speculative investments, and capital values in many lines have reached inflationary levels. This is true especially in the real estate market, both for urban and residential real estate. The prices of low-cost houses are generally 65 per cent, and in many cases 100 per cent, over their 1940 levels. Also, there has been a steady inflow of funds into the stock market and prices during the past 12 months have increased by 30 per cent. All signs show that strong inflationary pressures will continue.

Lest this situation should get out of hand, we must use all our powers to stem inflationary forces until production has time to bring about a reasonable balance between the factors of supply and demand. Monetary policy and Federal Reserve policy has an important though secondary role to play in preventing a further increase in, and if possible in reducing the money supply at this time. This means avoidance of further increases in bank credit and, if possible, a reduction. The Treasury in this connection has embarked upon a program of retiring debt out of the large cash balances that were built up during the Victory Loan. The cash balance remains sufficiently large to continue this debt retirement program over the next several months. The securities being retired are, of course, short-term maturing issues, which are largely held by commercial banks and the Federal Reserve Banks. This will have a tightening effect upon bank reserves.

The Federal Reserve System also has announced the discontinuance of the war-time preferential discount rate of 1/2 per cent on short-term Government securities. At the same time the Board stated thatit does not favor a higher level of interest rates on U. S. Government securities than the Government is now paying. Assurances have been given that the rate of 7/8 per cent on one year certificates would be maintained. In practice that means that the Federal Reserve from time to time needs to purchase short-term securities in the market in order to prevent short-term interest rates from rising above the level that the Government is now paying. Medium-term and long-term rates are below the coupon levels that the Government is now paying and consequently do not need support. As the Federal Reserve purchases short-term securities in the market the reserve balances increase and commercial banks generally can expand credit by several times the amount of the increase in reserve balances. Since an expansion of bank credit is dangerous at this time of inflationary pressures, some method should be devised to stop this expansion. The orthodox methods of influencing the level of bank credit cannot be used, however, because they would no doubt result in a higher level of short-term interest rates. Some new instrument of credit policy, therefore, is needed.

Several methods have been proposed and are being carefully studied. Some would directly or indirectly increase commercial bank demand for short-term securities, either by requiring commercial banks to hold secondary reserves in the form of these securities or by limiting the amount of bonds that they may hold. Another would offset Federal Reserve purchases of short-term securities by increasing the reserve requirements of member banks. These plans have disadvantages as well as advantages. None of them should be put into effect until we are sure that the advantages clearly outweigh the disadvantages. Congressional study and action is a prerequisite.

In the meantime, retirement of Government debt is anti-expansionary. As long as this retirement continues, the problem of bank credit expansion becomes less urgent. This gives us a breathing spell in which to study the problem. The development of a substantial budget surplus would go a long way toward solving this problem, because it would permit the Treasury to continue to reduce the Government debt. While I hope that the inflationary problem on the monetary side can be solved without the need for employing any new method that would restrict the operations of commercial banks, I believe that the prudent course would be to develop a new method of influencing bank credit and have it ready for use if the need for it should arise. Prudence, caution, and proper timing are of the essence.

The Longer-Run Outlook

Over the longer run, developments defy prediction. Assuming a high level of business activity, which we are all striving for, savings banks, insurance companies and other savings institutions will have a substantial accumulation of funds to invest. Over the war period these funds have found outlet in Government securities, and since the Government is now embarking upon a debt retirement program, this source for investments will not be available. The funds of these institutions, therefore, will exert strong pressure on market yields of existing Government issues, and will force a lowering of the long-term rate unless the demand for long-term funds by corporations, the mortgage lending field, the World Bank, the Export-Import Bank and others offset those pressures. It may be desirable in this connection to devise special long-term nonnegotiable Government issues, somewhat similar to the F and G bonds which will attract these institutional funds. In view of the backlog of demand for goods both at home and abroad, and in view of the demand for housing, I would venture an opinion that while there may be periods of fluctuations, the demand and supply factors might be approximately in balance at the present level of interest rates.

Conclusions

So far, we have dealt with some of the conditions of demand and supply by which interest rates are determined. It remains to be emphasized that these conditions do not represent a set of natural forces which are beyond our reach or influence. On the contrary. Debt and credit policy have a very direct bearing on these conditions. The authorities in charge of debt and credit policy have a very direct responsibility for them. This was obvious during the war when the vastly increased supply of securities was balanced by a controlled increase of bank credit available for such investment. Because of this policy, which assured that securities not sold outside the banking system would be absorbed by bank purchases, it was possible to finance the war debt at a low interest rate. Now the problem is to prevent further additions to bank holdings of securities and hence to the country's money supply, and if possible to reduce them. We must do so without raising the taxpayer's interest bill. While the problems have changed, they have not become simpler. The importance of a wise credit and debt policy has been greatly increased by the wartime debt expansion.

An intelligent opinion concerning the outlook for interest rates, therefore, involves the use of judgment as to the net effect on interest rates of many policy problems that are confronting the Government's authorities at the present time and of many crosscurrents and unpredictable factors in the demand and supply aspect of the problem. The only conclusion of which we may be reasonably sure at this time is that rates on short-term Government securities are not likely to rise, and as long as short-term rates stay down, it is unlikely that long-term rates will increase to any significant degree. Some of the wartime factors bringing about declines in long-term rates no longer exist, but others remain. It may be necessary to adopt new measures to avoid a further decline in long-term rates. With this exception therefore, I think it hazardous to venture an opinion. I would be inclined to agree with the prevailing opinion that long-term interest rates over the next six months to a year would be less likely to increase than to remain stable.