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THE CHANGED SITUATION
IN
OUR MONETARY AND CREDIT PROBLEMS TODAY

Since the days when I was active in the operations of building and loan associations, many changes have taken place--changes in the number and size and activities of building and loan associations, and changes in the operation of our economy and the organization of our society. The problems which confront the central banking authorities with which I have been associated are also reflected in the problems with which you have to cope.

In 1914 the United States was a debtor nation; a substantial part of national development had been and was being financed abroad. We were in the process of shifting from a predominantly agricultural nation to a predominantly industrial and urban nation. Our conventional patterns of finance drew no distinction between the fiscal position of Government and that of individuals and businesses.

There were about 6,600 organizations of the type we think of as building and loan or savings and loan associations, as compared with about 6,000 today. These associations, through the thrift and saving of their members, had accumulated total assets of 1,360 million dollars, as compared with about 11 billion dollars today. At the same time, there were about 26,000 commercial banks with total deposits of about 17 billion dollars, compared with about 14,000 banks today with deposits of 140 billion dollars. The Federal debt was only 1 billion dollars. Today it is 254 billion.

Our pre-World War I economy was a composite of regional economies. Perhaps the heart of our central banking problem at that stage of the country's development was to reconcile the monetary and credit needs of major regions and to maintain a balance between these needs. It was largely with this end in view that the Federal Reserve System was established. At that time there did not seem to be any necessity for separate provision to balance special needs of the various regions for mortgage credit.

When the Federal Reserve Act was revised substantially two decades later, between 1933 and 1935, the nation had become a great creditor country internationally and a great industrial economy domestically. Our monetary and credit problem had changed from the problem of distributing funds among regions--which had been solved fairly well--to the problem of controlling the total supply of money and equating this supply to various national uses. In addition, the economy had gone through a great war, two great "booms", and two great "busts". The war, the "booms", and the "busts" were national in ramification. While regional differences in economic organization still existed, the reality of regional interdependence was a more fully demonstrated fact than every before in our history. During these two decades there were indications that traditional methods of mortgage financing were not completely adequate. We had the notable

experiment with various kinds of mortgage bonds, mortgage participations, and "guaranteed" mortgages, and we had the notable failure of traditional mortgage financing methods in the Florida "boom" and crash.

Our great "bust" of 1929 had been particularly severe and its aftermath was widespread bankruptcy, unemployment, and poverty. The economy's critical problem of that period was "idle men, idle machines, idle money". It was determined to solve the problem on a national basis. Fiscal policy and central banking policy became, more directly than formerly, the instruments of national economic policy. Many new agencies were created to complement these two major instruments of national policy. In mortgage credit, the Federal Home Loan Bank System was given the form we know today, and provision was made for chartering Federal savings and loan associations. The Home Owners' Loan Corporation was formed to take over "slow" mortgages and strengthen lending institutions, and the Federal Savings and Loan Insurance Corporation was established to insure share accounts in building and loan and savings and loan associations. At the same time, under the Federal Housing Administration, the program of mortgage insurance was inaugurated, and this program made use of much of the experience with mortgage credit which had been acquired by building and loan associations in their many decades of operation.

Once more we find ourselves in a new period. We have again gone through a great and devastating war. The war has changed our position in international affairs, and we find ourselves overwhelmingly a creditor.

The balance of power between capital and labor is different from what it was in 1914 or 1935, and is still changing. The relationship between creditor and debtor has also changed, in important part because better financial arrangements and techniques have been worked out. Banks make one kind of arrangement with farmers for the repayment of loans and a different kind of arrangement with manufacturing concerns, each arrangement calculated to fit the operations of the borrowers. Relatively little mortgage credit is extended today for the short periods of one, three, or five years which used to be "conventional". Most mortgage lenders have adopted the practice of writing long-term amortized loans which building and loan associations were pioneering in 1914.

The Government is no longer merely another borrower in the market. It is by far the largest borrower. The Federal debt accounts for nearly three-fifths of the entire indebtedness of the country, and interest on the debt is a major item in the Federal budget, amounting to more than 5 billion dollars a year. In this situation, special arrangements have had to be made for selling and managing the public debt. The Treasury and the Federal Reserve work closely together in issuing, retiring, and refunding the debt. This greatly increased importance of the public debt is one of the major factors in the present inflation.

Why has this increase in the public debt contributed so strongly to inflation? If we understand this point, we shall understand why some of the problems of the Federal Reserve System are so difficult to handle.

During the war, the Government spent more than twice as much as it collected in taxes, making up the difference by borrowing. Producers--workers, farmers, and business organizations--were paid for all the

production of the economy, but the taxes they paid were less than half the money spent by the Government for the goods and services needed to win the war. Producers, as consumers, therefore, were left with more money to spend or save than the value of the goods and services they could buy. To some extent, they used these excess funds to bid up prices, but because we were at war, and because some goods, such as automobiles, were not available, controls were effective in spreading the supply of goods and services and restraining price increases. People, therefore, saved. Some of the savings were in currency, some in bank deposits, and some in other liquid assets, particularly Government securities.

The country's aggregate money supply, as measured by currency in circulation and privately-held demand, time, and savings deposits, is two and a half times as large as at the beginning of the defense program, about 170 billion dollars, compared with 66 billion in June 1940. In addition, the general public, outside of banks, insurance companies, and Government agencies, increased its holdings of Government securities to 105 billion dollars, or nearly seven times as much as in June of 1940. These Government securities in the hands of the public are practically the equivalent of money because they are readily convertible into cash. In sum total, this stock of purchasing power available to buy the current output of goods and services amounts to almost 275 billion dollars, compared with a stock of about 80 billion in 1940.

Most of this expansion in the money supply and liquid assets in the hands of the public occurred during the World War II period. However, further expansion has taken place over the postwar period, and in recent months the expansion has shown marked signs of acceleration. This recent acceleration of expansion largely resulted from very active bank lending to businesses and individuals.

Since the war, the economy has been operating very close to capacity and the general public has shown a pronounced disposition to enjoy all the things that were in short supply during the war, from shirts and socks to automobiles and houses. People have been willing to spend their current incomes and dip into some of their accumulated savings. They have also supplemented these funds by borrowing from banks and other lenders, and by buying on installment credit. As a result of these strong demands for goods and services--demands in excess of supplies--prices have risen, and we have had inflation. As long as the volume of goods and services available, valued at current prices, remains less than the amount of money being spent, inflation will persist. This condition, in fact, is the essence of inflation.

Two other factors are adding to inflationary forces. First, the addition of productive facilities to the economy is going on at a rapid pace. Second, we have a large export surplus. On the first, producers are paid now for turning out machinery and building warehouses, factories, and houses, and, on the second, producers are paid for making the goods which are being shipped abroad. But goods and services to match these incomes will be turned out by the machinery and buildings only over a period of years, and it will also take some years for us to receive goods and services from abroad in payment for our exports financed through loans.

Both expansion of productive capacity and the export surplus have resulted in additions to the money supply through the creation of credit, and by the use of funds previously held idle. An additional source of increased money supply has been payment in gold for some of our exports of goods.

This brings me to the problem which confronts the banking authorities and about which the Federal Reserve Board is deeply concerned, for it shows clearly the changes which have taken place in the tasks of the Federal Reserve System.

Taken as a whole, the commercial banking system is fundamentally a mechanism for creating money--for allowing borrowers to spend money which no one has saved. This is in contrast to other types of lending--lending such as your institutions, or savings banks, or insurance companies, or individuals do--which is a matter of transferring savings from those who have them but do not wish to spend them to those who do wish to spend them.

Limits are set to the amount of credit banks can create by the legal requirements that they must hold cash reserves to the extent of some proportion of their deposits--which are themselves largely the result of loans and investments. Banks which are members of the Federal Reserve System, which hold 85 per cent of all commercial bank deposits in this country, must hold their reserves as deposits with the Federal Reserve Banks, and no income is derived from these reserves. On the average, required reserves amount to about one-sixth of commercial bank deposits. For every dollar of reserves, credit can expand sixfold.

Reserves are the heart of commercial banking, and control over commercial bank credit has traditionally been exercised by control of these reserves. Three techniques have been used to exercise this control: (1) varying the rediscount rate, or the rate of interest at which member commercial banks may borrow from the Reserve Banks; (2) open market operations; or the buying and selling of Government securities by the Reserve System; and (3) varying the level of reserve requirements, that is, the amounts which member banks deposit with Federal Reserve Banks as legally required reserves.

Two of these techniques for controlling bank reserves--discount rates and open market operations--are not so effective as they once were, while the third--varying the level of reserve requirements--was exhausted under present law as a restraining weapon early in the recent war, except for a relatively small percentage in central reserve cities--New York and Chicago. The present limited effectiveness of available credit control technique is due almost entirely to the size and wide distribution of the public debt largely inherited from the war. Commercial banks now hold 70 billion dollars of Government securities, an amount equal to about 50 per cent of their total demand and time deposits, which they can sell in order to obtain additional reserves without borrowing from the Reserve Banks.

The traditional open market operation to reduce excess bank reserves is for the Federal Reserve System to sell Government securities, thus drawing down private deposits at commercial banks. In turn, this

draws down the reserves of commercial banks by reducing their deposits with the Federal Reserve Banks.

Here, however, we come up against the problem of management of our huge public debt of 254 billion dollars. If the Reserve System were to sell enough Government securities to reduce bank reserves and curb credit expansion, it would involve great dangers for the entire economy. To make possible this volume of sales, the prices of Government securities would have to be permitted to decline. With a marketable public debt held by investors other than the Federal Reserve Banks amounting to 143 billion dollars, no one can say how great this decline in prices would have to be. As prices declined because of Federal Reserve sales, investors would suffer capital losses and in turn would be encouraged to sell their holdings while their losses were still small, and these sales would further drive prices downward. In brief, Federal Reserve open market operation to reduce bank reserves might lead to a disruptive decline in Government security prices, which might spread to the prices of other securities. This is a risk too serious to contemplate.

Traditional open market policy would also have serious consequences for the Treasury. As prices of bonds decline, their yield, or effective interest rate, rises, and, if Government securities were to fall seriously, all future Treasury financing would have to be done at higher interest rates, thus raising the cost of servicing the Government debt. Also, in such a market, the price at which the Treasury and other borrowers could sell securities would be altogether uncertain, and this uncertainty would interfere with the orderly management of the public debt as well as the orderly financing of private corporate investment programs.

The Federal Reserve System through its open market and discount policy in close cooperation with the Treasury, has already recognized that interest rates have undergone an upward readjustment, probably in response to temporary forces. It has recognized this, first, by lowering the support price (increasing the yield) on short-term Government securities, and second, by lowering the support price on long-term obligations (with assurance, however, that support of the lowered levels would be aggressive and continued for the foreseeable future), and third, by the increase in discount rates from 1 to 1-1/4 per cent. It seems much better to us to permit interest rate changes in this manner than to leave the economy's marketable debt to find its own interest level in a free market, dominated by Government securities.

It should be apparent from what I have said that the most important change in the problem facing the central banking authorities is the greatly increased influence of the public debt in our monetary and fiscal affairs. After the First World War the public debt (26 billion dollars) could be looked on as merely another set of obligations--to be allowed to find their own price level in a completely free market. This policy, which was in line with traditional attitudes, resulted in large losses to many individuals and businesses, but these consequences were not nearly as serious as those which would result from a similar policy now. The public debt today is a factor to be reckoned with in all public and private decisions. Both its size and its wide distribution have given it great leverage in monetary policy and economic conditions. Moreover, the fact that the Treasury, unlike other borrowers, must constantly refinance

its debt makes stability of the market for the public debt particularly crucial.

The increased importance of the public debt is also a factor in another situation which has received relatively less attention in public discussion. This is the shift which has taken place from the hands of the banking and fiscal authorities of a significant part of the control over the supply of money. I have already mentioned the primary difference between bank credit and credit extended by other lenders--namely, that nonbank lenders lend only savings which have been accumulated by savers, while banks also make available to borrowers funds created by the 6 to 1 expansion of deposits to which I have referred above.

It has been customary and, in the main, correct, to say that loans made by nonbank lenders add nothing to the money supply. Today this is no longer true. Before we can say whether a loan by, for example, an insurance company or a savings bank or a savings and loan association adds to the money supply or not we must know where these funds were obtained.

Take an insurance company for example. In the first place, of course, the insurance company obtained the funds from its policyholders in the form of insurance reserves on policies--that is, policyholders' savings. In this sense the funds were saved by the policyolders. But this is not the full answer. If the insurance company had these funds invested in Government securities, and, in order to make a loan, it sold these securities indirectly to the Federal Reserve Banks, it added to the money supply, or at least to the potential money supply. Such an addition to the money supply results because when a nonbank investor sells Government securities, their prices tend to fall, and if prices threaten to fall too far, the Reserve System buys in order to preserve a relatively stable and orderly market for these issues. This increases private deposits at commercial banks, and the deposits of commercial banks at the Federal Reserve Banks, thus increasing bank reserves, and the capacity of the banks to lend. The effect, in other words, may be just as inflationary as if commercial banks had sold the securities. The insurance companies, the savings banks, and the savings and loan associations are apostles of thrift and foes of inflation and yet by selling Government securities to add to their currently available funds for investment they are contributing to inflationary pressures.

In the light of all these considerations, the Federal Reserve Board has recommended to Congress the adoption of a plan which we feel would restore some of the powers over the money supply which have been lost because of the great increase in the public debt. Very simply, this plan involves a temporary increase in reserves which all banks would be required to hold, except that instead of being legally required to add to their cash reserves, banks would be permitted to hold certain income-producing assets, namely short-term Government obligations.

We could, of course, ask Congress to raise the limits to which required cash reserves may be increased, but it now appears to the Board that to increase required cash reserves by this means far enough to be relatively certain of bank credit restriction, that will be required, would mean reducing the earnings of banks below expenses and a reasonable return on capital. This, however, in my opinion, may become an

alternative to the special reserve plan proposed by the Board.

We recognize that the Board's proposal is no cure-all and that it would only deal with a part of the inflationary problem. But the proposed measure would constitute an important, available restraint, which is now lacking, on bank credit expansion in the present inflationary situation.

There is likely to be little need for the suggested special reserve during the next three months because of the large amount of Treasury surplus funds, taken from the market through taxes, which will be available to retire bank-held public debt. This will temporarily exert pressure against bank credit expansion. If inflationary bank credit expansion continues after this period, however, and if further Treasury surpluses are foregone in favor of tax reduction, the need for restraining pressure will be urgent. It is better to have power to deal with the situation when it develops rather than to have it provided, if at all, too late to be used.

The urgency for the Federal Reserve Board's proposal, or some other proposal to curb credit expansion, will be especially great if we relax our current fiscal policy while inflationary dangers exist. Fiscal policy is by far the most effective way to deal with the demand side of inflation just as production and particularly more production per man hour is the most effective way to deal with it on the supply side. This means rigid Government economy and deferment of all deferable expenditures. It also means as large a surplus of tax receipts as possible so that dollars are removed from the spending stream and used to retire public debt held by the Federal Reserve System. This takes dollars out of the money supply by an equivalent amount and is a reversal of the wartime process by which the money supply was expanded. The classical precept of sound finance that debt should be paid off in boom times has peculiar virtue in the case of a public debt the size of ours, so much of which is held by the banking system.

There is still another side to the credit picture.

As you know, curbing of inflationary pressures cannot be accomplished by monetary and fiscal policy alone. Among other necessary measures are appropriate private decisions. You, for example, must ask yourselves whether, as a group, you are extending mortgage credit on a sound basis--credit which will stand up in whatever storms are ahead of us. In this connection, I commend to your attention, as well as to the attention of all bankers, the program formulated several weeks ago by the American Bankers Association, and the joint statement on "Bank Credit Policy During the Inflation", issued November 24, 1947, by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Executive Committee of the National Association of Supervisors of State Banks.

As you can see, I have so far spoken almost entirely about a fairly technical side of the inflation problem which confronts the monetary and fiscal authorities, that is, about how the supply of money is being increased. Another, and just as important, problem is how this large and increasing supply of money is being used. Here, again, developments

have removed a substantial measure of control over bank lending from the hands of the banking authorities.

Banking authorities have always exercised some measure of influence over the kind of loans and investments made by banks as well as over the total volume of their credit. Such influence has been exercised by way of statutory prohibitions or limitations, by way of varied privileges of access to Federal Reserve credit, and by way of bank supervision. Statutory prohibitions and limitations have generally been quite inflexible. Federal Reserve influence on the kind of lending done by member banks has usually been accomplished, therefore, by keeping informed as to the credit policies followed by member banks and limiting the access to Reserve Bank credit of those member banks found to be following unsound policies. Bank examination policy is also adapted, in cooperation with other supervisory authorities, to changing conditions.

Developments over the past fifteen years, particularly in Government programs, have modified the effectiveness of the powers of the central banking authorities. This modification is particularly marked in the case of real estate loans. It would be rather difficult, for example, for the Federal Reserve Board to say that banks with large mortgage loan portfolios shall be denied the right to borrow at the Reserve Banks--even if rediscounting had any significance today--when a large part of bank real estate loans are guaranteed by the Federal Government, either in whole or in part. Similarly, in these conditions, a bank examiner might have some difficulty in convincing bankers to reduce the volume of their guaranteed real estate loans or to establish additional reserves against them.

It is probably not correct to say that restraint or encouragement of credit expansion through central bank credit and supervisory policies ever exercised a decisive influence on the lending activities of nonbank lenders. It would be equally incorrect, however, to say that such policies in the past exercised no influence. Central banking policy gradually came to exert a broad influence over national credit conditions and the prudent nonbank lender took these conditions carefully into account in shaping his own lending program. But since the middle thirties, financial developments, particularly those of wartime, have tended to reduce the influence of central banking policy. In addition, the link between important sectors of the credit market has been weakened at several points.

In the case of mortgage credit, for example, where this change is most pronounced, programs and practices instituted since 1932 have resulted in almost complete separation of this field of lending from general credit policy. Even mortgage lending by commercial banks has been largely sheltered from the influence of general credit conditions. Loans underwritten by the Federal Housing Administration and the Veterans Administration are obviously difficult to discourage by ordinary techniques of bank credit control when they are being encouraged on social grounds by other agencies.

Your own organizations, the savings and loan associations, are adding to the problems of restraining inflationary credit developments, again largely because of Federal programs developed since the passage of the original Federal Home Loan Bank Act in 1932. Let me say here that I

would not argue for one moment in favor of returning the savings and loan business to the conditions that existed before that date. Then, there were no effective restraints on savings and loan lending except the volume of capital available to associations, and you suffered severely as a consequence. There was no effective means for transferring funds from areas of oversupply to areas of scarcity, and developments in real estate were uneven as a result. There was not sufficient protection for shareholders against either mismanagement or unfavorable economic conditions--and many investors lost heavily through no fault of their own.

The savings and loan system has been strengthened to perform its functions, and that is a good thing. We must face the fact, however, that this very strengthening of the system has made it independent of national credit policy, in a way it never was before. Funds are attracted to a savings and loan association as much by the insurance of share accounts as by an association's reputation for being a sound, well-managed institution. The right of borrowing from the Home Loan Banks makes it possible for associations to make more real estate loans in a community than there are savings in the community available for real estate lending. The capacity of the Home Loan Bank System to borrow in the general money market makes it possible to channel the funds available for investment in institutions sponsored by the Federal Government into the particular field of real estate. All of these conditions, among others, have given savings and loan lending a degree of independence it never had in the days when the only resources of an association were the investments of its shareholders and depositors and loans from commercial banks.

Let me emphasize that the present condition is much sounder than the earlier condition. Home mortgage credit, accounting as it does for almost a fifth of all private debt, is important enough in the economy to warrant special facilities operating under special legislation. Just because it is so important, however, its general policies need to be related to and integrated with broad national policy in the credit and fiscal areas. Mortgage credit can, and does, add to inflationary pressures at a time like the present. I know you realize that credit is needed to finance the construction of houses, and you are making more and more of your loans for this purpose. You are also aware that credit extended for the construction of more houses than can be built with the materials and labor available drives prices upward and I am sure you are limiting your lending in such a way as to minimize these price pressures. As experienced business men, you know not to lend money to Tom Jones just so that he can pay more for a house than Harry Smith can afford, because that is the way bad loans are made, and bad loans seem to have a way of staying on the books longer than good loans.

And now let me summarize and conclude my remarks on this occasion.

Important changes have taken place in the structure of our economy and in the organization of our society. As a result, central banking and fiscal policies have lost a large part of the influence they once exerted over the supply of money. The credit and monetary control thus lost has not been placed in other hands, but has been diffused throughout all financial sectors. At the same time, national influence over the use to which the money supply is put--never as strong as control of the supply

itself--has been weakened, partly by these same forces, partly also by the independence which particular credit programs have had because they are specially sanctioned and encouraged by the Government for social reasons.

The Reserve Board has recommended adoption of a special reserve plan which it believes would restore a desirable degree of control over the money supply. I suggest that the reconstruction and strengthening of policy controls over the use to which the credit supply is put also requires careful and conscientious study. I do not suggest that we keep reaching out for more power and more controls, but I am aware of the fact that in honestly and sincerely seeking to promote economic stability at a high level, new effective techniques may perhaps be devised to meet the changing situation. For many years the Board has been able to control the flow of bank credit into the securities market, and during the war it was given the task of regulating consumer credit. The Board has recently asked Congress to renew this power, at least so far as installment credit is concerned.

It is possible that central banking policy will find the instruments necessary to perform its tasks under the new conditions which we face in a combination of traditional controls over the supply of money and selective controls over the use to which credit is put. If this be so, cooperation will be necessary between the central banking authorities and other agencies. For example, the mortgage credit field may be one in which such cooperation will be fruitful. At any rate, this is a question that you and we should be studying at this time, both separately and jointly.

The problems which monetary and credit policy must face today are different from those of a few years ago. On our success in finding ways to deal with these problems will depend in no small measure our success in reaching the goal of sustained prosperity.