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WHAT ABOUT MONEY AND CREDIT?[1]

by

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The economic situation in which we find ourselves today is indeed difficult. Instead of the happy security we hoped to enjoy after the war, we are beset with fears, confusions, and discouragement. We are dangerously close to a process of turning around and heading back in the direction from which we just came.

During the past winter we were making noticeable headway in the fight against inflation. Although the underlying economic situation continued to be basically inflationary, there were signs that the pressures of an undersupply of goods and an oversupply of money were undergoing gradual, cumulative abatement.

On the side of production, the output of goods was not only holding up at maximum levels, but in some areas was catching up with demand. Crop prospects in the world at large were encouraging, and the fall in the prices of foods and other agricultural products was a desirable, corrective readjustment. The program of world aid recovery, then under consideration, seemed to hold promise of providing an effective basis on which to reestablish lasting peace.

Recent Monetary Developments

On the monetary side, fiscal and monetary policies were having significant restrictive effects. The money supply, though still excessive, was being sharply reduced by the Treasury's seasonal surplus of tax receipts over expenditures and by accelerated retirement of public debt held by the Federal Reserve Banks and commercial banks. There had been some rise in interest rates during the fall and early winter in response to tightening credit conditions. At that juncture, the Government bank supervisory authorities launched efforts to discourage further expansion of bank credit, and these efforts were strongly reinforced by a nationwide program of voluntary restraint by the banking fraternity. Finally, the credit situation was affected restrictively by successive Federal Reserve actions: first, the lowering of support levels for Government security prices at the end of December; second, the rise in discount rates early in January; and third, the moderate increase in reserve requirements for banks in New York and Chicago in February.

Despite a large inflow of gold, a heavy seasonal return of currency from circulation, and large sales of Government securities by nonbank investors to the Federal Reserve during winter months, fiscal and monetary operations kept bank reserves under unslackened restraint. Federal Reserve holdings of Government securities fell by about one and a half billion dollars. The combined effect of fiscal and monetary operations, too, was to reduce the total money supply by nearly 4 billions. Considering all of the circumstances, this was a notable anti-inflationary accomplishment.

Government Budget Outlook

In view of these salutary developments, it came to be widely hoped that inflationary pressures were finally under control and that taxes could be safely reduced. The response of Congress to this belief was a general reduction, taking away about 5 billion dollars per annum from the revenue of the Government and adding this sum to the annual purchasing power of the public. The effect of this action was to eliminate any further budgetary surplus and any anti-inflationary restraint the surplus might have had on bank credit expansion, while at the same time unleashing new inflationary pressures through larger purchasing power.

While Congress was acting upon a tax program and a program of world aid, the international situation commenced to display alarming portents—especially in Czechoslovakia and in Berlin. These portents put an entirely new face on our international position. They produced a program of renewed military preparation that promises before it is completed to add billions to the Federal budget. In undertaking such a preparedness program, we must remember that our recently enacted program of world aid for the coming year is only a part of a larger program covering several years. It is, so

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to speak, a first instalment. I wish to underscore this fact. It means that we are adding expanded military preparedness on top of an already heavy budgetary load. We may shortly be confronted by budgetary deficits; in fact, we may have some budget deficit as early as this coming fiscal year. And this is only the beginning of developments for which no terminal point, as a matter of stark realism, can now be set.

The elimination of the Government's budgetary surplus and the prospect of imminent budgetary deficits strike the economy before the fight against postwar inflation has been decisively won. Prices of many products are still very high in comparison with prewar and wartime levels, and many commodity and service prices, including wages, are still advancing. The total money supply, while reduced from last fall, continues redundant in relation to the output of goods, and the public's 250 billion dollar stock of available purchasing power—currency, bank deposits, and Government securities—remains excessively large. Sustained high levels of production and employment, which are likely, will generate high levels of consumer income, but supplies of goods for final consumption must be diminished by amounts required for foreign aid, for military preparedness, and for domestic capital maintenance and expansion.

Prospective Bank Credit Expansion

These conditions present a picture of continuing inflationary pressures. They also add up to a strong possibility that the financing needs of the Federal Government, together with those of business, State and local governments, home owners, and consumers, will exceed the supply of available savings. This possibility implies a large demand for financing through the banks, repeating the type of bank credit development which occurred last year. Renewed expansion of bank credit and money could only result in accentuating our inflationary pressures.

The commercial banks could readily accommodate any amount of demand for further bank credit expansion. In all likelihood, bank reserves will be increased somewhat by an inflow of gold from foreign sources, and also by such purchases of Government securities from nonbank investors as the Federal Reserve may make for the purpose of maintaining an orderly market. Finally, commercial banks, though obliged to sell some Government securities in recent months, still hold about 66 billions of such investments, which are readily convertible at the discretion of banks into reserves. And as reserves from these various sources expand, they make possible, for the banking system as a whole, a six-to-one inflationary expansion of bank credit and deposits.

Faced with these prospects, further bank credit expansion, which will add to our existing superfluity of money and liquid assets, will be very difficult to keep in check. We must probably resign ourselves to some credit expansion; we should certainly take every precaution, however, to keep it within the bounds of the essential. I suggest as a criterion of what is essential the expansion of bank credit required by our current program of national preparedness and world aid. This means, of course, priority for the bank financing of production related to these programs and also for the financing of any Government deficits that may result. It means, too, a rigorous avoidance of bank credit expansion for nonessential production, for speculation, and for consumption purposes.

Measures for Monetary Restraint

There is no simple or single way of accomplishing this task. It will have to be accomplished in a combination of ways—by general credit controls and in particular areas by selective controls. Moreover, credit controls alone cannot do the entire job. Banking and monetary policies will need to supplement fiscal and other national policies—including, if necessary, direct economic controls. I speak, however, only of the factors lying in the field of money and credit; they are not the most potent but they are essential.

The responsibility of the Federal Reserve System in this situation is to conserve the nation's credit resources in the interest of the longer-run stability of our democratic capitalism. In view of this responsibility, the System will be obliged to use its influence to restrain unnecessary credit expansion. Its capacity to fulfill this responsibility is necessarily circumscribed, in part as a result of statutory authority, and in part as a result of the nature of our banking system.

Applicability of Interest Rate Policy

Taking these limitations into account, there are two lines of general credit policy open to the System. The first of these alternatives, which is entirely within the System's existing statutory authority, is to permit a general rise in the level of interest rates. Such a program would have a threefold purpose: first, to strengthen the incentive for savings; second, to meet increased financing needs; and, third, to discourage nonessential borrowing. It is a program that would conform in major respects to the traditional precepts of "orthodox" finance.

Yet it is a program that should not be accepted without careful consideration; for the effect of rising interest rates varies and may be the opposite at one time of what it is at another. Thus the initial effect of rising rates may be to encourage economic activity and they may not become restrictive till an alarmingly high level has been reached. They are first taken as harbingers of rising prices and active business. Under inflationary conditions, especially, rising rates would put businesses under a strong inducement to undertake expansion programs before rates and costs went still higher; and they would hardly become deterrent until they had become extremely high. They would impel consumers to avoid higher prices in the future by making credit purchases in the present. They would draw out savings now held in bank deposits or in savings bonds and add them to the volume of credit. But they would not discourage Government borrowing, for the Government borrows not because rates are low but because appropriations and tax legislation make borrowing necessary.

Still further aspects of a policy of higher interest rate levels are the primary effects of such a policy upon the market prices of Government bonds and the secondary effects of lowered price levels for Government bonds upon the soundness and the functioning of financial institutions. It is one thing to contemplate higher interest rates on a public debt of 25 billion dollars, such as we had at the end of World War I; it is another thing to contemplate higher interest rates when public debt amounts to 253 billion and exceeds the total of all private and other debt by nearly 50 per cent. We have also to keep in mind that marketable public debt alone amounts to 162 billion, or approximately 75 per cent more than the value of all listed stocks and non-Government bonds.

The additional cost to the Government of a higher interest rate program is another matter requiring thoughtful consideration, since a maturing debt of 50 billion dollars this year and 100 billion in five years would have to be refunded at higher rates. This aspect of the interest rate problem has a further implication. The Treasury might become a borrower at the higher interest levels. This would raise the knotty question of equity with regard to present holders of Government securities. The program of financing participation in World War II, in contrast to that of World War I, was geared to avoidance of this problem by adherence to a stable pattern and level of interest rates.

These considerations with respect to the general level of interest rates do not mean that the existing structure of interest rates should remain rigid. Long-term interest rates reflect conditions in the capital market—the supply of savings relative to the demand for investment. Short-term interest rates are more largely determined by liquidity preferences and other more transient money market factors. To the extent possible without raising long-term rates, short-term rates may be permitted more flexibility than they have had in recent years. In particular, short-term and discount rates somewhat higher than those now prevailing may help to encourage investment in short-term Government securities by banks and other holders of liquid funds and reduce the amounts that need to be bought by the Federal Reserve. Such a policy may be helpful in avoiding creation of additional bank reserves.

Proposals for Higher Required Reserves

In the light of these considerations, I think you will agree that there are fairly clear practical limitations on the use of interest rate policy to restrain further growth in bank reserves and accompanying bank credit expansion. This leads me to the second alternative, namely, an increase in the reserve requirements of all commercial banks. This alternative would require legislation granting additional authority to the Reserve System. The System still has unused power to increase the reserve requirements of member banks in New York and Chicago, but the leverage to be exerted through this authority

would be relatively minor in relation to the problem that the banking system confronts. What is needed is a more general authority which would apply, as a matter of equity as well as economics, to all commercial banks. To this end, the Federal Reserve Board has recently recommended to the Congress that authority of a two-fold character be provided.

In the first place, the authority should make it possible for the System to impose on all commercial banks a primary reserve requirement up to 10 per cent of aggregate demand deposits and 4 per cent of aggregate time deposits, in addition to present requirements. If desired, the authority could be graduated by class of bank. This measure would give the Reserve System authority to increase total reserve requirements by a maximum of about 12 billion dollars. It would enable the System, over the next few years, to absorb and sterilize the credit expansion potential occasioned by gold inflows and by Federal Reserve purchases of Government securities from nonbank investors.

In the second place, the recommended legislation would enable the System to impose on all commercial banks, under proper safeguards, a special reserve requirement up to 25 per cent of aggregate demand deposits and 10 per cent of time deposits. This may be preferably described as an optional reserve requirement, because the special reserve could be held, at the option of the individual bank, in specified cash assets or in certain marketable short-term Government securities.

It seems to me at this time that perhaps the most desirable arrangement would be to package together the optional reserve plan and the proposal for authority to increase primary reserves made by the Board to Congress in April. Provision might be made both for the optional reserve and for an increase in primary reserves as proposed, with the general limitation that the total increase in required reserves that might be applied by the two types of authority taken together could not exceed 25 per cent of aggregate demand deposits and 10 per cent of aggregate time deposits.

At the special session of Congress last fall when the Board was asked to say what might be done in the monetary and credit field to deal with inflationary forces, its response was to recommend consideration of the special reserve plan. The proposal attracted considerable attention, much of which was adverse. It was objected that the situation was not yet serious enough to warrant such a measure, and that the Board already had enough power anyway. As to the timing, the Board proposal was not that the power be granted for instant application but that its use be authorized when necessary. The mere existence of such an authority would have some effect, of course, for most bankers had rather act on their own initiative than wait for a regulation to tell them what to do. Moreover to wait till a situation is desperate before recommending appropriate legislation is scarcely what one would call statesmanship. As for the adequacy of Board powers, I think the point is whether the present powers are applicable. The power to raise reserve requirements in New York and Chicago, for example—which the Board could do—is not very helpful when the problem largely lies elsewhere. Moreover, it is impracticable to exhaust powers before the moment of their greatest effectiveness and unfortunate to have to exhaust them without some power in reserve. Finally, the Board was not seeking power but was responding to a request for suggestions at a time which was not of its own making or choice.

Some bankers have liked the special reserve plan and some have not. I have had doubts about it myself, and can sympathize with the doubts of others. Yet I know of nothing better, and the plan has advantages, I think, which have not been understood or appreciated.

Generally speaking, the optional or special reserve requirement would be capable of accomplishing the same restraints on bank credit expansion as a straight increase in primary reserve requirements, but it would be considerably less onerous to the banks. As I have just said, I sympathize with bankers who have questioned the desirability of the special reserve plan and I think I understand their misgivings. Bankers naturally resent being blamed for everything. They did not bring on the inflation and they do not like to feel that all the pressure to stop it is being put on them. In reality, of course, restraint on the extension of credit happens to be one of the effective ways of resisting inflation, and we must not forget that we are speaking about it because banking is the field of our responsibility and not because we expect everything that is done to be done in that field and nowhere else. I certainly do not wish to give the impression

that I have any patience with the tendency to take everything out on the bankers. I have a public duty to perform, but that duty is certainly not against the long-run interests of bankers. One of its aims is the protection of banking through banking itself. It is in this spirit that I should like to clarify the optional reserve plan, for perhaps our explanations have not sufficiently described the relative merits of the proposed measures.

Optional Reserve Plan

By way of preface it should be emphasized, as I noted earlier, that banks now hold 66 billion dollars of Government securities. From the standpoint of an individual bank and from the standpoint of the banking system as a whole, these securities are virtually excess reserves. That is, banks may sell Government securities in the market to obtain reserves and unless other buyers appear, the Federal Reserve System must buy them in support of orderly and stable market conditions. In the process new bank reserves are created. As a matter of fact, nearly all large banks and many medium-sized and small banks recognize this characteristic of Government securities by adjusting their reserve positions continually through purchases and sales.

Any plan to place restraint on the total volume of bank credit and the money supply must recognize the potential reserve feature of the Government securities held by banks, or for that matter, of those held by other investors. As a measure to reduce the volume of potential reserves, it is as effective to immobilize a part of these securities in the portfolios of banks as it is to require banks to sell them to the Reserve Banks in order to meet an increase in primary reserves. In fact, as a device for meeting the very special kind of situation that now confronts us, the special or optional reserve plan has certain important advantages both to banks and to the public generally.

In the first place the optional or special reserve requirement, if imposed, would leave the banks with their holdings of Government securities intact. It would make possible an increase in bank required reserves and at the same time avoid a considerable amount of banking readjustment, as well as any serious adverse effect upon bank earnings. It would simply immobilize a portion of commercial bank portfolios of Government securities and discontinue the treatment of these holdings as excess reserves, i.e., as assets equivalent to cash and available for conversion into actual reserves at the bank's discretion through sale to the Federal Reserve.

The optional or special reserve, which would strengthen the demand by banks for short-term Government securities and thus aid in the maintenance of relatively stable interest rates on Government securities, would, on the other hand, make possible some increase in interest rates on private borrowing, particularly on short-term and medium-term borrowing. Any such rise would have the same restraining effects on inflationary borrowing as higher interest rates in general might have. More importantly, the plan would put pressure on the lender to ration scarce bank credit among customers and to reduce voluntarily the bank credit available for business expansion and consumer financing.

Furthermore, if Government deficit financing again becomes necessary at some not too distant stage, the optional requirement would make it possible to tie the deposits created in deficit financing to the securities sold to the commercial banks and held as assets against the deposits. Consequently, it would be much more adaptable in coping with the problems of credit control incident to Government deficit financing than an increase in primary reserve requirements would be.

Lastly, the optional or special reserve authority would restore flexibility and effectiveness to the customary instruments of Federal Reserve policy, i.e., open market operations and discount rates. In the traditional sense of their use for credit control purposes, these instruments have become largely unusable because of the dominance of public debt in the credit situation.

Criticism has been made of the special reserve plan that it would be too restrictive and again that it would not be restrictive enough. Yet as a device for meeting the serious problems of excessive credit expansion the special reserve could be used with greater precision and with less danger of adverse reaction than could an increase in primary requirements, since the special reserve, as I said before, would involve fewer banking adjustments. Moreover, safeguards against too rapid application of the requirements are an integral part of the plan.

It has been said that the special reserve would not be restrictive enough because immobilization of short-term Government securities would still per-

mit banks to sell longer-term securities to obtain reserves. It is of course true that the plan would leave banks largely free to do this. Banks would be deterred from doing this, however, because they would be sacrificing a higher-yielding security, possibly at a book loss. Further, since their short-term securities would be immobilized as special reserves, banks in practice would need to hold at least a portion of their long-term Government securities as secondary operating reserves. Should banks sell long-term securities, moreover, buyers other than the Reserve Banks might be attracted by these higher-yielding issues, thus avoiding the creation of new bank reserves through Reserve Bank purchases.

Some have criticized the special reserve plan because banks might need to sell higher-yielding bonds to obtain sufficient short-term securities to meet requirements. The resulting loss in earnings, it has been said, might cause banks to reach out for more risky, high-interest loans and investments, with consequent expansion in private bank credit and impairment of the condition of our banks. I believe this criticism does less than justice to the good common sense of the average banker as well as to the effectiveness of our bank supervisory agencies. It also does not take into account possible higher interest rates on sound private credit, and the increase in bank earnings from this source.

It is worth mention that a special reserve requirement, like an increase in primary requirements, would reduce the ratio of multiple deposit expansion that could be built on new reserves that banks might acquire from whatever source.

Supplementary Measures of Credit Restraint

My remarks thus far have been concerned with the major means of restraining redundant credit expansion. But there are also other measures supplementary to general credit policy which should be restrictive in particular credit areas and therefore helpful in controlling the aggregate volume of bank credit. I refer to the areas of stock market credit, consumer credit, and housing mortgage credit.

Credit to finance the purchase or carrying of listed stocks has been restrained up to the present by the Federal Reserve Board's regulation of margin requirements; and in view of the dangerous inflationary possibilities of the immediate future, it would be a grave mistake, in my judgment, to ease those requirements at this time.

Regulation of down payments and maturities in the field of consumer instalment credit is also needed, in my opinion. Re-establishment of this control would help to dampen consumer demand, especially for durable goods, financed on time-payment plans. This would help to curb further inflationary growth in consumer expenditures and to reduce the competition for available supplies of basic materials and manpower, on which the national defense and world aid programs must draw heavily. An auxiliary effect of this restraint would be some increase of savings, encouragement of which may be put down as an essential element of any program to fight inflation in the period ahead.

The third area that I mentioned where selective credit control might be used to advantage is mortgage credit for housing, which for some time now has been one of the most inflationary factors in the current situation. Since early last winter, there have been mounting complaints—mainly from the building industry and veterans organizations—that residential mortgage credit is becoming tighter. Partly in response to these complaints, consideration is being given by Congress to legislation designed to reverse this situation. You are perhaps familiar with the proposals under consideration. They are, first, to continue on an unsound basis the mortgage insurance program under Title VI of the National Housing Act; second, to create a Government financed secondary market for mortgages already underwritten by the Government; and third, to relax lending conditions under Titles I and II of the National Housing Act. However, I am glad to say that, in this proposed legislation, some relevant economic facts have been faced; permissive interest rates on guaranteed and insured mortgages have been placed one-half per cent higher, and the pernicious "necessary current cost" cost formula for appraisal has been replaced by a "value" formula.

We are not at all sure that mortgage credit is getting tighter in any real sense. Financial institutions, including commercial banks, are still making mortgage loans at a substantial rate. Mortgage premiums, bonuses, and fees offered by lenders are lower or have disappeared, but loans are being placed. Borrowers are having a harder time getting 100 per cent or 90 per cent loans, but there is no sound economic reason why they should ever have had such loans. If recent anti-inflationary monetary and fiscal policies have been tightening resi-

dential mortgage credit somewhat, that seems to me all to the good, and, considering the inflationary conditions that prevail in the housing market, entirely consistent with the objectives of those policies. There is no such thing as an effective program of over-all credit restraint that avoids restrictive effects in particular areas which have large financial importance, such as residential mortgage credit.

Even without a strongly inflationary outlook for domestic economic developments, there would be very good reason for reconsidering and moderating any new program for the encouragement of mortgage lending. With such an outlook, the need for reconsideration is urgent. It would be better if we abandoned the program altogether, but at the least any further special encouragement of mortgage credit should be limited to rental housing. We shall not succeed in overcoming the housing shortage by increasing the competitive pressures on scarce supplies of materials and construction labor. What is needed is a continuing effort to keep the volume of mortgage credit from pressing too powerfully against these important supplies.

The sale of savings bonds offers a positive check on inflation that approaches the problem from a different angle. It withdraws money from the spending stream, thus reducing the pressure of buyers on a scanty supply of goods, and it substitutes private investment in Government securities for bank investment, thus reducing the volume of bank credit and of bank deposits.

Lastly, an over-all restrictive credit policy will need to be supplemented by vigilant watchfulness on the part of the supervisory authorities and by voluntary self-restraint on the part of individual bankers. We believe that supervisory policy should vigorously maintain the soundness of credit extension by individual banks, and we have actively cooperated with the American Bankers Association in its nationwide program of fostering banker-self-restraint. But the banks may expect continuing strong credit demands from businesses and individuals, and they are not in a position to refuse the sound credit demands of individual customers in good credit standing. I think that banks can fairly be asked to adhere strictly to conservative lending standards, and I believe that banks universally will respond to such requests. But I do not believe that they can extend credit competitively, as they must, in the interests of their local communities, and at the same time refrain from redundant credit expansion on a national basis—especially with the basic factors present that are now stimulating credit expansion.

Financial Strength Essential

Before closing, I should like to stress the fact that there is such a thing as a prudent, sound financial course for an entire economy. We are compelled by circumstances beyond our control to undertake commitments for world recovery and peace that no one till very recently would have anticipated. These commitments come at a time of full utilization of our manpower and resources, of heavy current and deferred peacetime demand by our own people, and of recent action to reduce our heavy burden of Federal taxes. There is no financial sleight-of-hand by which we can carry the unavoidable burden of our national program and still avoid further serious inflation. We must raise from the public the money that has to be spent and there must be some restriction on domestic demand for goods financed through bank credit.

These matters I have put before you are matters that it is the duty of the Board to bring not only to the attention of Congress but also to the attention of bankers and the public at large. Furthermore, it is our duty to do so in sufficient time to allow Congressional and public discussion and debate. And furthermore the powers the Board requires in the discharge of its responsibilities must first be granted by Congress in sufficient time for their exercise to be effective. Powers granted too late serve no particular good.

I hope the suggestions we are offering will not be greeted with the hackneyed comment that the Federal Reserve merely wants more power. To make that comment is to beg the question. The Federal Reserve System was set up nearly thirty-five years ago to exercise certain authorized functions in the public good. The world has not stood still since then, and presumably it will not stand still in the near future. We have had two great wars in that time, the magnitude of business operations has grown, and new forces have arisen. These developments make it necessary to adapt and enlarge the powers that changed conditions have rendered inadequate. I leave to your consideration the question what should be done about it.