

Speech delivered before
Third Annual Federal Reserve Forum
Nicollet Hotel, Minneapolis, Minnesota
October 11, 1948

OUR FEDERAL RESERVE POLICY TODAY

Introduction

Our inflation is an offspring of the war. During the war, resources had to be diverted from the production of goods and services for civilians and turned to the production of military necessities. But the fact that goods were not available did not mean that the demand for them automatically dissolved. Unsatisfied wants accumulated, awaiting the return of peace and prosperity. Today the impact of those accumulated wants is still being felt in almost every sector of our economy.

But the most important aspect of the war from the point of view of explaining the present inflation is the way in which it was financed. Fundamentally the Government had two sources upon which to draw for its funds: (1) the pocketbooks of individuals and business firms which it could reach through taxation or borrowing; (2) the resources of the banking system.

Taxation is, of course, a noninflationary form of finance. When taxes are imposed, the spending power of the public is reduced by the amount that the Government's is increased. No expansion in the total spending power of the community takes place. The taxpayer receives in exchange only a tax receipt, which he cannot use to make purchases in the market, either in the present or in the future.

No government has ever succeeded in financing the total cost of war through taxation, and ours was no exception. It is estimated that less than half of the total funds raised by the Treasury from the middle of 1940 to the end of 1945 came from taxes. Now, there are serious practical obstacles that place a definite upper limit to the tax burden that can be imposed in wartime without hampering the war effort itself. Just where that limit is cannot be determined exactly. But it is certain that we didn't reach it. We should have done better, and had we used taxation more during the war, inflation would not be the problem that it is today.

Another noninflationary type of finance, at least while war is going on, consists in borrowing from the nonbank public. Since in purchasing a Government security the individual gives over a portion of his current spending power to the Government, borrowing from the nonbank public is in one aspect similar to taxation. It has a basic difference from taxation, however, which is all important for the postwar period. Holding a Government security is the next best thing to holding money, so far as a reservoir of purchasing power is concerned. This means that the loss of spending power involved in lending to the Government was not permanent, as with taxation, and that the power could be reclaimed in the future pretty much at the lender's demand. We have been seeing the effects of this potentiality since the war's end. Thus, while borrowing instead of taxing helped to relieve current pressures during the war, it was storing up pressure trouble for the postwar era.

An outright inflationary way to finance a war is through borrowing from the commercial banking system. When commercial banks lend to the Government, which they do by means of security purchases, bank deposits are created and placed at the disposal of the Treasury. During the war this deposit creation typically took the form of additions to the Treasury. During the war this deposit creation typically took the form of additions to the Treasury's war loan accounts. Thus, by borrowing from the banks, the Government increased its spending power through an expansion of credit and the money supply. There was not, as was the case for taxation and borrowing from the nonbank public, an offsetting reduction in the spending power of the rest of the community. And when the Government spent the funds it acquired from the banks, a general rise of money incomes took place. With no commensurate increase in the supply of goods and services upon which the community could spend the higher incomes, the result was an intensification of the upward pressure on prices.

In this process of wartime borrowing from the banks, trouble was also being stored up for the postwar era.

Support of Government Securities

As you know, the pivotal wartime policy of the Federal Reserve was the maintenance of the longer-term interest rate structure at approximately the level existing at the beginning of the war. As was generally known at that time, this policy was intended to serve several purposes: to forestall delay by investors in purchasing securities, who might otherwise have awaited higher interest rates as during World War I; to keep down interest cost on the Government's war debt; and to prevent an undue growth in bank and other investors' earnings from their holdings of public debt, issued to fight a victorious war.

Another important purpose of the policy was to facilitate necessary bank purchases of Government securities. For though it was generally recognized as desirable that the balance of expenditures not covered by taxes should be borrowed out of the people's savings, it was also recognized that as a practical fact the Treasury would rely on the commercial banking system for a fairly substantial portion of its funds. The Federal Reserve accepted as an over-riding obligation the necessity of assuring the availability of whatever funds the Government needed for the prosecution of war, even though it was constantly stressing the importance of sales of securities to the public rather than the banks. About one-fourth of the total funds raised by the Treasury during the war came from the banking system. This was clearly excessive, even in view of any practical difficulties of wartime finance. As the Board of Governors pointed out in its 32nd Annual Report to Congress, in the interest of a successful financing of a victorious war we committed the double error in our wartime finance of taxing too little and expanding bank credit too much.

From the point of view of the problem of postwar inflation control, the chief consequence of the policy of maintaining the interest structure on the Government debt is that it has seriously impaired the capacity of the Federal Reserve to perform at this time its chief central banking

function: namely, the control of expansion of bank credit and the money supply.

Expansion of bank credit requires, of course, that banks have access to an expanding volume of reserves. Consequently, in exercising control over the total volume of money and credit, traditional Federal Reserve policies have had as their focal point the reserve position of member banks. Through changes in the rediscount rate banks were to be encouraged in, or discouraged from, borrowing, from the Reserve System to obtain additional reserves. Through changes in reserve requirements the Reserve System was to influence the volume of credit that member banks were able to extend on the basis of any given amount of reserves. Through its open market operations the System was to be able to bring about expansion or contraction in the volume of reserves itself -- though always of course within amounts set by the criterion of orderly security market conditions.

Now, with the Federal Reserve committed to supporting the market, Government securities in commercial banks are essentially potential legal reserves. Banks can always count on liquidating their holdings of Government securities, in order to obtain reserves for credit expansion.

Furthermore -- and this is a point that I think has been frequently overlooked in discussing the problem of credit control in the current situation -- so long as a support policy is in force, the Government security holdings of financial institutions other than banks must also be classified as part of the potential reserve base for credit expansion. When these institutions sell Government securities to obtain funds for loans to private borrowers, the effects may be exactly the same as when commercial banks sell securities to make private loans. In the absence of other buyers the securities must be absorbed by the Federal Reserve under the support program. When the proceeds of the sale are then added to the institution's bank account the legal reserves of the bank receiving the deposit as well as its deposits are increased. In other words the behavior of nonbank lending institutions can be a factor that seriously aggravates the problem of credit control.

As the portfolios of Government securities of member banks themselves continued to swell throughout the war, so, in a sense, their reserve position became stronger and stronger, and they became more and more insulated from any restraining influence by the System. Except for its psychological impact, the rediscount rate lost much of its effectiveness as an instrument of control, since banks could generally adjust their reserve position by sales of securities and not by borrowing from the Reserve Banks. From 1941 forward, reserve requirements had been raised to the prevailing legal maximum for country and reserve city banks, and the increases still remaining for central reserve cities were not large. In any event, moderate increases in reserve requirements were not likely to be very effective, since banks on the whole could meet the higher requirements fairly readily by selling Government securities. Finally, the policy of support precluded the possibility of refusal by the System to supply banks with reserves at their volition when they offered Government securities for sale. Open market policy as an instrument of restraint was rendered essentially inoperative.

Money and Credit Supply

As a result, then, of our methods of wartime finance, the nation's money supply and the national debt experienced a tremendous growth. Between December 1939 and December 1945, currency and bank deposits in the hands of the public increased from 63 billion to 151 billion. The increase in the gross national debt, other than that held by agencies and trust funds of the Federal Government itself, amounted to 210 billion. Of this increase nearly 115 billion, or 55 per cent, was held by nonbank investors; approximately 75 billion, or 35 per cent, went into the portfolios of commercial banks; and the remainder into the holdings of the Federal Reserve Banks.

Thus the stage was set for postwar inflation. First, there was a generally pent-up demand that would take several years to satisfy, even with the economy operating at full capacity. Second, there was a huge volume of liquid assets held by individuals and business firms which could be drawn on to make demands effective in the market place.

And third, though by no means third in importance, there was the banking system, and other financial institutions as well, capable of providing a huge supplementary flow of spending power through credit expansion, and well insulated under existing powers from any restraining influence by the Federal Reserve. For it was clear that the policy of System support of the Government securities market, inhibiting though it was, could not be abandoned or suspended at the termination of hostilities. The public debt had grown to tremendous proportions during the war -- five times its prewar peak. Its interest level had become integrated into our whole asset and liability structure. Aside from any considerations as to increased interest cost on the public debt, withdrawal of support might well have a disastrous impact on our whole financial system. Perhaps never again, or at least not for a long time could public debt management be permitted to recede from its position as a prime preoccupation of Federal Reserve policy.

Well, I do not need to remind any of you here tonight that on that well-set stage a very vigorously acted-out play took place and is still taking place. The plot has been simple: an upward spiral of wages, profits and prices. The only element of suspense has been, where will they stop? And the great concern of us all has been, what is to be the sequel? A leveling off into enduring prosperity is the great hope; deflation and unemployment the great fear.

Restraints

Nevertheless, there have been a number of restraining elements in the postwar situation to date, without which matters might have been much worse. Particularly since mid-1947, Treasury fiscal and debt management policies, as well as Federal Reserve credit policies, have had as a major objective generation of restraint on monetary and credit expansion.

Perhaps most significant has been the restraining influence produced by the Treasury cash surplus. During the period between July 1947

and September 1948, receipts by the Treasury from taxes and other sources exceeded expenditures by about 10 billion dollars. This excess of receipts over expenditures has had the effect of directly reducing the spending power of the community. Further, by using the surplus substantially to retire debt held by the Reserve Banks, funds have been permanently withdrawn from the commercial banking system as well as from the public. Thus pressure has been brought to bear on the reserve position of commercial banks.

To raise the cost of reserve funds to the banks, and also to encourage the willingness of banks and nonbank investors to hold on to the securities they own rather than unload them onto the System, short-term market rates and Federal Reserve discount rates have been permitted to rise. Rates on Treasury bills have risen from $3/8$ of 1 per cent in mid-1947 to more than 1 per cent today. Yields on one-year certificates have increased from $7/8$ to $1-1/4$ per cent, while the Federal Reserve Banks have raised their discount rates from 1 to $1-1/2$ per cent.

Moderate pressure has also been brought to bear on the reserve position of member banks by increases in reserve requirements. Prior to the legislation enacted in August, this was a possible course of action only for the New York and Chicago banks, since for all other classes of banks requirements were at their legal limit. In January, and again in June of this year, the Federal Reserve Board raised by 2 percentage points the reserve requirements on net demand deposits at New York and Chicago banks. On the basis of the temporary authority granted by the Congress in August the Board raised reserve requirements by 2 percentage points on demand deposits and $1-1/2$ percentage points for time deposits. These new requirements became effective September 16 for country banks, and September 24 for central reserve and reserve city banks.

As a measure of direct restraint in an area in which credit expansion has been very rapid, the Board has reinstated controls on down payment and maturity terms of consumer installment credit. First imposed in 1941, these controls expired in November of 1947. They have been revived under the temporary authority granted the Board in the August legislation.

Today's Situation

Today the Board's responsibility for restraining the forces of inflation is perhaps greater than ever. Certainly the general situation is as volatile as it has ever been. Yet the 1948 tax reduction act, calling for an estimated reduction in revenue of around 5 billion dollars, and expanded defense and foreign aid expenditures have cut deeply into the Treasury surplus. Thereby one of the most important elements of inflation restraint in the postwar period has been removed -- though I should perhaps point out that I do not mean by this to suggest that the defense and foreign aid expenditures are the cause of the present inflation. Rather, they are today a contributing factor, no different in this respect from certain other forms of government expenditures, or from the expenditures of consumers and business firms, especially capital expenditures. No one of these expenditure components is, alone, responsible for the present inflation. But all of them together are responsible in the sense that they

add to a total of spending that is excessive in relation to the total volume of goods and services that can be made available. The even greater responsibility than that today's situation imposes may confront the central banking authorities of the United States with a very real dilemma: to seriously modify the policy of supporting the Government securities market in the interest of credit control, and thereby risk demoralization of our capital markets; or to adhere to the support policy and risk the possibility of a further serious inflation resulting from excessive expansion of bank credit.

Either horn of our dilemma would obviously be intolerable. Would escape between them be possible?

To put the matter in another way, it may be necessary to seek more efficient means of credit control than the Board now possesses -- instruments that take into account the changed environment in which central banking policy must operate today. What would be the nature of such instruments? Many proposals have been made, and I would like at this juncture to mention briefly to you some that have been given consideration.

Optional Plan

The first of these is the optional or special reserve proposal which was recommended to Congress in the Board's Annual Report for 1945 and again recommended in November of 1947 and in April 1948. Under this proposal the Board would be authorized to impose on all commercial banks, member and nonmember, a special temporary requirement that could be met, at the option of the individual bank, either in specified cash assets or certain marketable short-term Government securities. Nonmember banks were included in the proposal since it was recognized that the responsibility for curbing inflationary credit expansion should be shared by the whole banking community, and not only by members of the Federal Reserve System. It would be unfair and inequitable to do otherwise.

An important advantage of the plan is that it would immobilize a portion of each bank's holdings of short-term Government securities, and thereby cut down the reserve potential of the banking system. At the same time, however, the earning assets of the banks would not be reduced, and any consequent rise in interest rates would be limited largely to the field of private credit and would not be reflected in an increase in the cost of carrying the public debt.

Further, the special requirement would automatically reduce the increase in total deposits that could be supported by any new reserves the banking system might acquire. At the present time, member bank reserve requirements on the average work out to be about 17 per cent, or $1/6$, of total deposits. Thus \$100 of new reserves can support an expansion in deposits of \$600. If the special requirement were to raise total required reserves to, say, 25 per cent of total deposits, then \$100 of new reserves would permit an expansion of only \$400 in deposits. For the individual bank, the imposition of the special reserve requirement would mean that when it received a new deposit it would have to put

aside an amount to meet primary reserve requirements as it does now, and then an additional amount in the form of assets eligible to meet the special requirement. As a result, less would remain for new loans and investments.

Uniform Reserve Plan

It has also been proposed that if changes in reserve requirements should become a major instrument of credit control modifications should be made in the present system to eliminate inequities that would become more burdensome as requirements were increased. Essentially what the proposal -- termed the Uniform Reserve Plan -- calls for is the abandonment of distinctions based upon central reserve and reserve city designations, so that reserve requirements would be based solely upon classes of deposits as such, regardless of the bank's physical location. Under this plan, vault cash and interbank balances would be eligible for meeting reserve requirements.

Thus, under the Uniform Reserve Plan individual banks would no longer be placed at a disadvantage because of the arbitrary classification of the communities in which they are located, or because their business requires that they hold a larger volume of vault cash. Power to increase or decrease reserve requirements is part of this Uniform Reserve Plan which is in process of a Federal Reserve System study.

Dual Reserve Account Plan

Another plan involving a somewhat different approach to credit control policy has been named the Optional Ceiling Reserve Plan, or, alternatively and perhaps more accurately, the Dual Reserve Account Plan.

The plan calls for establishing two deposit accounts at the Federal Reserve Banks: a Reserve Account and a Clearing Account.

Each member bank would start under the plan with an amount in its Reserve Account equal to its existing reserve requirement at the time. Any excess or deficiency of reserves would be posted to the Clearing Account.

Reserve Account balances could be bought or sold among banks in the market just as Federal Reserve funds are traded now. But only the Open Market Committee, through deliberate purchase or sale of Reserve Account Deposits, would be able to affect the total of Reserve Account balances available to the banking system as a whole.

After the plan had been put into operation, the computation of Reserve Account requirements would be simple: For reserve city banks, for example, Reserve Account requirements would equal 22 per cent of net demand deposits less Clearing Account balances, plus 7-1/2 per cent of time deposits. No changes in the Reserve Account requirements would be necessary under the plan as a method of controlling credit expansion and the money supply. For this purpose, any desirable change in the Reserve Account position of the banks could be better achieved by use of the more refined method of Open Market Committee purchase or sale of Reserve Account deposits. However, the changes in requirements that would be

necessary to incorporate the advantages of the Uniform Reserve Plan could, of course, be readily adopted at any time.

All new funds received by a bank from ordinary transfers or from such sources as a return flow of currency or gold inflow from abroad, would expand only the bank's Clearing Account balance and by just the amount needed to cover the rise in deposits. Or, as a possible alternative that would protect bank earnings, new funds could be invested in a special, interest-bearing Reserve Bond. In either case there would be no excess to be used for loan expansion and further increases in deposits.

But more important, funds received as a result of System purchases of Government securities would also affect only the Clearing Account and not Reserve Account balances. Thus after the plan is installed a \$100 purchase made by the System in supporting the Government securities market would provide the basis for no more than a \$100 expansion in total deposits, and not a \$600 deposit expansion, as is the case today. The conflict between the policy of market support and the need for restraining the growth in the money supply would clearly be considerably mitigated.

Finally, the plan could be introduced without causing a single bank to undergo any transition adjustments. It would not reduce bank earnings, and while it would severely limit the amount of credit expansion that could be produced by the banking system as a whole, it would still leave individual banks free to make loans on a basis essentially similar to that which prevails today. This plan has no status in the Federal Reserve System and is being submitted here only for your study.

Conclusion

To repeat, in view of current and foreseeable conditions, it may be necessary to devise additional instruments of credit control of the kind suggested by these and other proposals. Not to do so may mean that the central banking authorities will have to default on one or the other of their major responsibilities. And, as a cost of that default, there may come new techniques of control much less compatible with the framework of our free enterprise economy.