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#### MONEY AND CREDIT TODAY

You know, of course, that this is a must for me, and a happy one. I was born here; lived here; and worked here until 1933. I was on the faculty of DePaul's College of Commerce practically from its beginning. Here I learned a little something about Building and Loan and about banking. When I left here, I was Comptroller of this city. And today's occasion has a combination of all these elements. That's why I accepted your invitation without hesitation, in spite of the demands made upon our time in Washington in our fight to preserve economic balance at a time most vital to our national interest.

It has long been my conviction--based, of course, upon my training and experience here--that each of us must know not only our political, but also our economic system in order to make it work effectively in the interest of the greatest number; that is, in the public interest and therefore for our national welfare. Our economic system works best when the greatest number understand how it works and why. It follows also that the better we understand it the easier it is to correct any imperfections. In our country, the people decide what they want and how they want it.

For 17 years I have tried to the best of my ability to explain the working of our system of money and credit. I have tried to show how the Federal Reserve seeks to maintain the purchasing power of the dollar, using the instruments of monetary policy given to the Federal Reserve by the Congress. I have tried to make my audience understand the concepts so familiar to you: the discount rate, which determines the price to be paid by the banks for advances from the Federal Reserve; the open market operations, which influence the quotations at which Government securities are bought and sold; the reserve requirements, which determine the deposits to be kept by the banks with the Federal Reserve; and more recently also the selective credit controls, which influence credit conditions for purchasing and holding securities, for purchasing automobiles and other goods on the instalment plan, and for constructing private homes.

For the past few months much has been said and done about credit restraint in our fight against inflation. However, you and I know that credit measures must not be our only defense. Our first reliance must be placed upon adequate fiscal measures. Second, priorities and allocations become necessary whenever commodities needed for our rearmament program are scarce. The Government's policy, as the President has emphasized, is to rely upon credit and fiscal measures to hold the line and diminish the need for direct controls such as price and wage freezes and consumer rationing.

Late in August at the University of Wisconsin and again late in September in New York before the American Bankers Association, I had occasion to discuss the principles involved in money and credit policy and its relationship to fiscal policy. I shall try today to confine myself to the principal points made on those two occasions.

Fiscal and credit measures both aim to reestablish the proper balance between consumer demand and the available supply of goods. This balance is threatened from two directions: on the demand side, by rising incomes resulting from the increased activities of our defense industries; on the supply side, by the diversion of labor and materials from civilian to military use. We believe that it is essential to prevent over-expansion of the supply of money. Fiscal and credit measures get at the basic causes of inflationary pressures by curbing excessive growth of the money supply. Direct controls, on the other hand, deal with the effects. They serve to contain inflationary forces so long as the controls are effectively enforced. Not only do they deal with effects rather than causes, but they distort wage and price relations and thereby interfere with the efficient working of the market mechanism on which our economy is based. In a free market, a change in prices brings about an increase or a reduction in production according to changing consumers' demand; if such a change in price is made impossible by direct controls, the consumers lose their influence on the decision of the producers. More important still, direct controls are characteristic of a regimented society which is wholly alien to our ideas. They are measures of last resort, inevitable in the case of a total war, but, in my opinion, avoidable in the present situation.

#### The Role of Monetary and Fiscal Policy in General

Monetary and fiscal policies must always go together because an inflationary rise in money incomes usually stems from two sources: an excess of Government expenditures over Government revenues (in other words, a budget deficit); or an excess of private investment over private savings (in other words, an over-expansion of private credit). Fiscal policy aims to keep the budget in balance; monetary policy aims to keep the system of private credit in balance. Should fiscal policy fail in its duty, monetary policy would have to restrict private credit sharply in order to counterbalance the Government deficit. Similarly, should monetary policy fail in its endeavors, fiscal policy would have to create a huge Government surplus in order to counterbalance the over-expansion of private credit. For this reason, the question can never be whether monetary or fiscal policies are to be used, but only how monetary and fiscal policies can best be coordinated.

The Congress has acted wisely in increasing our income taxes so as to raise tax receipts in accordance with the rise in our defense expenditures, and it probably will have to raise taxes further to keep pace with further rises in expenditures. However, these fiscal measures will at best finance the cost of our Government on a pay-as-we-go basis and avoid the inflationary consequences of heavy deficits. They do not deal with the equally formidable problem of expanding private credit. In other words, it accomplishes nothing in the battle against inflation if we can replace with borrowed dollars the dollars that are taxed out of our pockets.

The recent sharp rise in economic activity, which began several months before the attack on South Korea and is greatly accelerated by our military expenditures, has been based on a rapid expansion of bank credit. Between June and September 1950, commercial banks increased their loans by about 4 billion dollars; bank holdings of corporate and municipal securities as well as real estate and instalment credit from nonbank sources, also rose substantially. Credit expansion has been greater in this period than in any other peacetime period of the same length. Monetary policy has thus a great opportunity, but an equally great responsibility.

The task of monetary and credit policy is clear: its purpose is to reduce the availability of bank reserves. You know that under our system of fractional reserves, the banks can use every dollar kept on deposit with the Federal Reserve for extending six or seven dollars of credits. The difficulties of that task are very great. Aside from the economic limitations upon the various anti-inflationary measures available to us, we certainly cannot ignore psychological factors. In spite of the constant improvement in our statistical techniques, it is very hard to foresee the reactions of thousands of banks, firms, and individuals to changes in interest rates, liquidity, or consumer, real estate, and stock exchange credit regulations. Groups that are most directly affected by any of our actions frequently try to persuade us that our measures are overly harsh. Other critics contend that we are not going far enough. We must proceed judiciously and with caution, trying to avoid unnecessary hardships; but we must be prepared to amend promptly any regulation if it proves either inadequate or inappropriate for the economic conditions with which we are trying to deal.

### Monetary Policies in Foreign Countries

As I said recently at the University of Florida Business Conference, it is interesting to observe that we are not alone in attempting to cope with our present problems through monetary policies in preference to direct controls. Indeed, in many countries of the Western World the first response to the renewed inflationary dangers caused by rearmament and rising world prices has been resort to measures of monetary policy. The significance of this development is heightened by the fact that monetary policy is now being rehabilitated precisely in those countries of Western and Northern Europe which in the postwar period have relied primarily on direct controls (of investment, of prices, and of consumption) to curb inflation.

The reasons for this comeback are evident: In the first place, countries which have recently succeeded in freeing themselves from direct controls that were becoming increasingly inefficient are extremely reluctant to resume these controls. Governments are likely to look around for anything that may enable them to avoid reimposition of controls--for anything, if it holds promise of doing at least part of the stabilization job!

Secondly, the prestige of monetary policy has increased gradually over the past few years. In France, credit restrictions and the imposition of reserve requirements played a considerable part in arresting postwar inflation which had driven price levels 20 times above prewar. In Belgium, immediately after World War II and in Germany in 1948 the

monetary reform worked miracles in reviving production and in restoring incentives. Monetary policy has chalked up significant successes in recent years--a situation far different from that prevailing at the outbreak of the second World War when governments looked back over a period during which the record of monetary policy was none too impressive.

Finally, and possibly more important, the current situation differs in many essential respects from that which confronted the Western World during the second World War. At that time it was essential to make a maximum effort in the shortest possible time. The determination of governments not to have their efforts "too little and too late" was almost measured by their willingness to impose all kinds of controls on their economy. While the danger of inflation was taken seriously, the magnitude of the necessary effort appeared to call for comprehensive direct controls rather than reliance on the fiscal and credit measures. It was thought that incentives to work would suffer if the war was financed entirely by taxation; that people would be more willing to work if taxes were held down somewhat even though they could not spend the extra money they had until after the end of the war. These wartime savings were largely responsible for our postwar inflation.

This brief reference to the economic problems confronting us during the last war serves to point out the considerable differences between now and then. Today, we are facing an indefinite period of defense during which our non-civilian expenditures are expected to mount gradually, but not to attain the very large percentage of national income that they attained during the recent war. In addition, the period during which we shall have to carry defense expenditures on a substantial scale is not one of short emergency, but may extend over a long period of years. The case for direct controls is thus far weaker today than it was during the second World War. Direct controls work best over a short period; they become increasingly inefficient and cause more and more economic distortions as the years go by.

#### Recent Monetary Policy Actions in the United States

The policy of the Federal Reserve in the present emergency has been guided by these principles. We have used many of the older weapons of monetary policy and have been given a few new ones. We have raised the discount rate. We have engaged in open market operations designed to reduce the availability of bank reserves created by the sale of Government securities to the Federal Reserve, and these operations have necessitated a very moderate increase in short-term interest rates. Jointly with other agencies entrusted with the supervision and regulation of private credit institutions, we have formally appealed to the banks not to expand credit for purposes inconsistent with our defense program.

In addition, we have taken important measures under the Defense Production Act, recently passed by the Congress. We have promulgated Regulation V, setting up a program of guaranteed loans for defense production, patterned after the so-called V-Loan Program of the Second World War. On the restrictive side, we have issued Regulation W, dealing with consumer instalment credit, and Regulation X, dealing with real estate credit for new construction of one and two-family houses. Since the original restrictions of consumer credit did not prove sufficiently effective, we have tightened Regulation W by an amendment. We are fully aware of the fact

that Regulation W tends to reduce the demand for automobiles and other goods, and that Regulation X tends to reduce the demand for new homes. That is exactly what these regulations should do if they are to accomplish their purpose. Labor and materials which hitherto have gone into automobiles, television sets, and new homes must be released for use by the defense industries. This shift can be accomplished most efficiently if some people are induced to forego the purchase of automobiles, television sets, or homes, by being confronted with less attractive credit terms. If supply were reduced before demand, say, by a Government decree forcing producers to cut production, an artificial scarcity would be created. In consequence, prices would rise rapidly and it would be highly profitable for producers to evade the decree. The Government would then be confronted with the difficult task of enforcing the cutback in the face of strong resistance by both producers and consumers. If demand is reduced, however, producers will curtail output in proportion, and the shift to defense orders can be accomplished without a rise in prices and, more important, without the need of enforcing direct controls which defy the market situation by an attempt to keep inflation suppressed but not removed.

### Conclusions

Quite recently some observers have expressed the opinion that the measures taken so far may have sufficed to break the momentum of inflation. Construction activity has indeed slackened and some prices have declined from their summer peaks. I am afraid, however, that such a view would be overoptimistic. Many prices continue to edge upward, and in view of the wage increases recently won by labor, further price rises may be expected. Profits are soaring, and despite the recent tax increase personal incomes after taxes are generally higher than before the start of the Korean war. Moreover, the defense program is expanding and business is developing more and more ambitious plans for investment. For these reasons I do not believe that the inflationary threat will subside without continued efforts on the part of the fiscal and monetary authorities.

I cannot discuss here any of the directions in which we may wish to move in the future. But it may perhaps be useful to point out that neither our actions nor any of our proposals for dealing with inflationary dangers would imply nearly as great infringement of our economic freedoms as would the reimposition, on a large scale, of direct controls which are the only alternative to effective fiscal and credit measures.

Naturally, we will determine our policies in the light of the requirements of our own economic situation. This time we are fortunate in having the benefit of extensive experience with the various measures of combating inflation which have been tried both here and in many of the countries that are united with us in a common cause.

From time to time the Federal Reserve reports to Congress on the policy actions taken and the reasons for those actions. That is not only essential to our system of Government, but helpful in making a realistic appraisal of the effects of actions taken, or not taken, under our public responsibility and with the powers granted by Congress to meet that responsibility.