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### ANTI-INFLATION BATTLE REPORT

I can only report on certain phases of this battle. As I see it, any report on our battle at home against inflation should begin with a broad consideration of its background. We know that international tensions have mounted steadily over the past three years. The Korean war is only the most recent of a series of crises. Korea, however, established the intention of the United States to support United Nations policy with force. It also brought to light inadequacies in our defense establishment in relation to our diplomatic and moral commitments to the free world. As a result, we are now greatly expanding our defensive power.

The international situation continues tense. Potential trouble spots are scattered throughout the world. In these circumstances, we must maintain a vigorous and integrated foreign policy consistent with the aims of the United Nations. This means for an indefinite time a much larger defense establishment than we have ever known in peacetime to meet our international commitments and to secure our own defense.

We do not know, at this time, how much an adequate defense program may ultimately cost. Nevertheless, actions already taken clearly indicate that present and forthcoming programs will exert a heavy strain on our economy and that we must gear our economic policy to the new situation. The President has stated that the size of the armed forces will double from the pre-Korean level of 1.5 million to 3 million men. Congress has appropriated an additional 17 billion dollars for defense, military aid abroad, and an expanded stockpiling program. In men and dollars, this more than doubles the pre-Korean defense program, and indications are that further supplements may be needed.

The new situation has serious implications for economic stability. Great pressures are placed on our capacity to produce and our price structure is put under severe strain.

#### Economic Impact of the Defense Program

Even before Korea business and consumer demands were very high. Output of goods and services was at record levels both in terms of physical volume and expenditures. Unemployment was relatively low. In many key industries, output was at or close to capacity and further output depended on new additions to plant and equipment.

Now a greatly expanded defense program has been superimposed upon these large civilian demands. As the defense program accelerates total output will also rise with the increase in capacity, productivity, the length of the work week, and employment. Total production, in fact, may expand by as much as 8 or 9 per cent over the next year, but it is not likely to rise as rapidly as the takings of the defense program. While total supplies of commodities and services available to civilians may

show little change, or even increase somewhat, over the coming 12 months, in some areas, especially metal-using industries and residential construction, supplies may be sharply curtailed.

The attainment of such an increase in over-all production would exert severe strains upon our available supply of labor as well as on industrial capacity and supplies of scarce materials. It would seem conservative to estimate manpower requirements for defense production and the armed forces at 8 million persons by the end of 1951, or about one-eighth of the labor force of 65 million. This allows for 5 million workers in defense activities, about 3 million more than at present, and an increase in the armed services to a total of 3 million men. Since unemployment is now at low levels, the additional workers will have to come mainly from a greater than normal expansion in the labor force and transfers in employment from civilian to defense activities. If in the next year the labor force increases by 1.5 million instead of the normal 600,000, it would still be necessary to shift some 2 or 3 million workers away from production of civilian goods. In addition, it is likely that the work week will also have to be increased further.

As long as we are obliged to maintain a garrison economy, the volume of goods and services available to civilians will be limited by the size of defense programs relative to our ability to increase production. Much of our national strength in the past has arisen out of our capacity to expand our production and at progressively lower cost per unit in terms of manhours employed. This has been the result of rapid technological progress, intensive use of capital equipment, unique managerial genius, and a trained and intelligent labor force. The survival of our democratic way of life depends in no small measure on our ability to maintain and possibly improve our past record in this area. This means that technological research must continue to have a high priority. Modern war is a war of technology as well as of men.

Increased production, however, will not be enough by itself to avert inflationary dangers as defense programs expand. The nature of the problem may be indicated by illustrative figures. Let's say that total gross national product in terms of third quarter 1950 prices might be increased by 25 billion dollars, or almost 9 per cent from the third quarter of 1950 to the third quarter of 1951. But if, for example, defense takings account for 20 billion dollars of the total increase, then only 5 billion dollars would be left for additional private civilian and regular Government expenditures. Meanwhile, private incomes before taxes would be increased by 25 billion dollars. These rising incomes, unless drained off by a pay-as-we-go fiscal policy, will result in rising demands which cannot be satisfied and which will exert strong pressure on prices. Unless restrained, price advances under such circumstances will breed further price increases in an inflationary spiral.

The inflationary potential is further aggravated by the fact that both businessmen and consumers can increase their expenditures by reducing holdings of liquid assets and by making use of credit. These demands are in addition to those arising out of incomes earned through current production. Furthermore, as prices rise, incentives become stronger for shifting out of cash or its equivalent into real assets, that is, people buy goods and invest, and demand for credit becomes more urgent.

Rising prices raise material costs and stimulate wage increases. With high employment, tightening pressures upon manpower supplies, rising living costs, and expanding profits, workers are in a position to ask for higher wages. At the same time, employers must bid actively for labor by offering extra inducements to workers. Advancing profits tend to lower resistance to wage increases. With demand strong, business is able to raise selling prices to cover additional expenses. Thus, higher prices lead to higher wages, incomes, costs, and expenditures, and to higher prices again.

Developments in the third quarter of 1950 illustrated the nature of the inflation process. Defense expenditures rose only very moderately. Nevertheless, prices, incomes, and expenditures advanced very sharply. Incentives for accumulating inventory were very strong. Business revised sharply upward its plans for investment in plant and equipment. Consumers engaged in a buying spree of commodities which might eventually be in short supply. Consumer holdings of liquid assets were reduced and bank credit, reflecting especially loans to business and to individual buyers of consumer durable goods and houses, expanded at record rates. These developments were based primarily on changed expectations. A higher price, cost, wage, income, and credit structure was built into the economy even before the real pressures of the defense program on our available resources were felt.

### The Economic Prospect

What is the economic situation in prospect? It is not one of all-out warfare expected to last for a limited period of time. Rather, what we may face is a condition of Government expenditures which are expected to be high but below wartime levels for a number of years in the future.

In such a situation, direct controls like price and wage controls and rationing are both less necessary and less workable than in a period of all-out warfare. On the other hand, sopping up the excess purchasing power through taxes and monetary measures is much more feasible than under conditions of all-out warfare. Certainly as long as consumer durable goods are available in anything like the volume we can still expect, the task of allocating them among us would be exceedingly difficult. Furthermore, the longer direct controls are continued, the more difficult their administration becomes and the more likely it is that controlled prices will develop serious economic distortions as conditions of production change in the different industries.

Steps have to be taken, of course, to conserve and allocate certain strategic materials which are in scarce supply. But a harness of direct controls, including controls at the retail level, should be accepted only if needed as a last resort. In any case, even if direct controls should be adopted, it will be necessary constantly to mop up excessive funds so that the controls themselves will not become a sham while inflationary processes find their real expression in black markets and concealed transactions.

To say that we face an extended period of more or less chronic inflationary pressures does not mean that we face a period of progressive deterioration in the purchasing power of the dollar. It does mean that fighting inflationary dangers will be our continuing problem. It doesn't

mean that we need to lose that fight. But fighting inflation cannot be painless. If we are to do it successfully, with or without a comprehensive harness of direct controls, we must accept the financial measures which are necessary to do the job.

It should be recognized that the prospect of an extended battle of fighting inflationary trends does not imply that business trends will follow a steady upward course. A garrison economy will have many difficult problems of balance in production, prices, and employment. Unbalanced conditions may develop which can only be corrected by temporary setback of activity. A continuing danger will be that of speculative excesses, which from time to time could go much too far. We could then even witness the spectacle of deflationary reversal at a time when underlying forces were on the whole inflationary. History of inflationary periods is filled with examples of that kind of economic development.

### The Task of Monetary Policy in Fighting Inflation

A dynamic economy requires enough money to permit a level of production which is compatible with a high level of employment. If, however, the amount of money in the economy is far in excess of available supplies of civilian goods, the saver may lose faith in the future purchasing power of his dollar. It is the task of monetary policy to see that the money supply is adequate for a fully functioning economy but not so large as to cause inflation with all its misdirection of human effort and other productive resources and its inequitable redistribution of real income and real wealth.

In the long run, an expanding money supply is required by an expanding economy with an increasing working population, increasing capital investment, and increasing productivity per worker. Our banking system has done a splendid job of supplying the financial resources to keep pace with our increased production.

But to keep the economy on an even keel from month to month and year to year requires constant vigilance. There are always incipient movements in the economy which, if allowed to develop, might result in run-away inflation or deflation. Whatever the initial cause of such developments, actions by the Federal Reserve can serve as an important offset. If a general price swing is caught early, it may take little to restore the economy to an even keel. It is much easier to check an inflationary or deflationary movement before it has become cumulative and before one-sided anticipations of business and consumers have begun to reinforce it.

It is just these incipient movements which monetary policy is best adapted to attack. Monetary policy is flexible. It can be applied rapidly, it can be applied gradually in experimental doses, and it can be easily reversed.

### Types of Monetary Measures

Monetary measures include actions that influence the availability and price of funds to lending institutions and actions that directly define terms of lending--such as down-payment and maturity requirements--in certain fields of credit. The former measures affect primarily supply conditions for credit, the latter mainly demand conditions.

The availability and price of funds to lending institutions are influenced by open market operations, changes in the discount rate, and changes in reserve requirements. These actions all have their major effect on bank reserve positions, although they may also immediately affect the lending ability of other groups of lenders.

Even at the risk of appearing either too elementary or on the other hand too technical, it seems appropriate to me, at this time, to define a little more clearly what is meant by bank reserves and reserve requirements. The term reserves may refer to any cash assets held by banks. For member banks of the Federal Reserve System, however, it refers generally to the deposits of commercial banks with the Federal Reserve Banks. At the present time, country, reserve city, and central reserve city banks are required to hold reserves equal to 12, 18, and 22 per cent, respectively, of their demand deposits and reserves of 5 per cent of their time deposits. Thus member banks can now have demand deposit liabilities equal to about six times their reserves. If there is a change in either the amount of reserves or the percentage reserve requirements, then the amount of deposits the reserves will support is changed. This will change correspondingly the amount of credit that banks may extend, since, as you know, when banks increase their credits they increase their deposits and when they reduce their credits they reduce deposits.

Open market operations.--Now let us consider the effect of open market operations, changes in discount rate, and changes in reserve requirements on the reserve position of banks. The Federal Reserve may at any time either purchase or sell United States Government securities. If the Federal Reserve shows a willingness to purchase Government securities at favorable prices and low yields, it encourages holders to sell them in order to secure funds to lend on more favorable terms to private borrowers. These funds thus find their way into the expenditure stream.

The sellers of securities to the Federal Reserve may or may not be commercial banks. In any case, Federal Reserve purchases will supply banks with reserves which, as I have indicated, may be the basis for multiple credit and deposit expansion. Any seller will be paid with a check on a Federal Reserve Bank. If banks are themselves the sellers of securities, then they obtain reserves directly as a result of the sales. On the other hand, if the sellers are nonbank investors--say, insurance companies--they will deposit the proceeds in banks, since the Federal Reserve Banks do not hold deposits for the general public. Thus in this case, too, banks will obtain increased reserve balances at the Federal Reserve. In either case, banks will find themselves with reserves in excess of legal requirements and will be able to increase their loans and deposits. As the deposits thus created are spent, other banks will find themselves with excess reserves. For the banking system as a whole, the increased excess reserves may form the basis for an increase of five or more times credit and deposit expansion.

It is easy to see, therefore, that if the Federal Reserve can avoid buying securities in the market it puts a powerful brake on the further expansion of bank credit. Moreover, if the System can sell securities from its portfolio it may set the stage for a multiple contraction of such credit. When the Federal Reserve shows a willingness to sell Government securities at low prices and high yields, it encourages purchasers to buy them. Bank reserves will be drawn down either because the

banks use them to purchase securities themselves or because depositors write checks on the banks to pay for securities purchased from the Federal Reserve. Unless banks as a group have started out with excess reserves, the banking system must either decrease loans and deposits by five or more times the decline in reserves or it must borrow reserve funds from the Reserve Banks. Banks do not like to be borrowers except for very temporary periods, and so they make every effort promptly to adjust their affairs and to liquidate such indebtedness. The readjustment may involve contraction of lending, sales of investments, or both types of action.

However, it is important to point out here that the Federal Reserve does not carry on open market operations only to bring about a net increase or decline in bank reserves. It may act merely to offset the effect on bank reserves of other developments, such as gold and currency movements. Furthermore, both the type of securities which are purchased and sold, and to some degree the extent of open market operations, may be determined partly by conditions in the Government security market.

Decisions to purchase or sell Treasury securities are made with primary consideration to general economic conditions. But the Federal Reserve cannot ignore conditions in the Government security market, and the vigor and scope of open market operations must always be tempered by the necessity for maintaining an orderly, functioning market.

Discount rate.--Changes in the Federal Reserve Bank discount rates are the second measure available to the Federal Reserve to influence availability and price of credit in general. The discount rate is the rate at which the Federal Reserve Banks lend to member commercial banks. This measure is really a joint instrument with open market operations. This is because it is desirable to adjust discount rates in accordance with the direction of open market operations. If banks are losing reserves as a result of open market operations, it may not be desirable to permit them to replace those reserves by borrowing at the Federal Reserve Banks, at least, not without an additional penalty by way of paying an increased discount rate. This additional penalty is both a deterrent to member bank borrowing and, if borrowing is done, an incentive to repay the indebtedness at the earliest possible time. At the present time banks adjust reserves more frequently by purchasing and selling short-term Treasury securities than by borrowing from the Federal Reserve and repaying such credit. However, the terms on which banks can borrow from the Reserve Banks may be important at certain times. Furthermore, changes in the discount rate are looked to as one evidence of the opinion of the Federal Reserve regarding the general credit situation.

Reserve requirements.--Changes in reserve requirements are a third means of influencing bank reserve positions and thus the ability and willingness of banks to lend. Changes in reserve requirements do not lend themselves to flexible adjustment as do open market operations and discount rates. However, there are times when because of large Treasury borrowing needs or other special circumstances in the market, open market operations and discount changes may not be feasible on a large enough scale to bring about the desired change in bank reserve positions. Under such circumstances, an increase or decrease of reserve requirements may be appropriate. The Federal Reserve now has the power to vary requirements on demand deposits between minimums of 7, 10, and 13 per cent for country, reserve city, and central reserve city member banks, respectively, and corresponding maximums of 14,

20, and 26 per cent. In the period August 1948 to June 1949, it had authority to raise them to maximums of 18, 24, and 30 per cent.

If reserve requirements should be raised from an average of, say, 17 per cent to an average of 20 per cent, each dollar of reserves would become the basis for \$5 rather than \$6 of deposits. Unless the banks had excess reserves to begin with, they would be forced to decrease their loans and deposits correspondingly or to raise new reserve balances by selling securities. The fact that they need to sell securities or borrow imposes a penalty on banks and acts as a deterrent. Furthermore, each new dollar of reserves received would form the basis for a smaller amount of deposit and credit expansion.

Selective credit measures.--In certain fields of credit, the Federal Reserve sets the terms of lending and, as I said before, these terms directly affect the demand conditions for the affected credit. These fields are stock exchange credit, where margin requirements are set; and consumer and real estate credit, where, under emergency authority, down payment percentages and repayment periods are regulated. These fields lend themselves particularly to this type of regulation because terms of such loans can be standardized. By an increase in margin and down payment requirements and by a shortening of the period of repayment of real estate and consumer loans, some purchases are prevented. Those purchasers who are able to meet the requirements are more likely to have to cut down on other expenditures to make the larger payments both at the time of purchase and subsequently.

All of the actions of the Federal Reserve are taken under the authorization of Congress, and the Federal Reserve endeavors to keep Congress informed on the measures applied. In its Annual Report to Congress, the Federal Reserve summarizes the steps taken and the economic conditions giving rise to them. Furthermore, the members of the Board, the officials of the Federal Reserve Banks, and the System's economic advisers are always ready to go before Congress to explain the actions taken and to express their views on the economic situation.

### The Role of Fiscal and Debt Management Policy

I am not suggesting for a moment that monetary policy can operate independently of other policies, particularly tax and fiscal policy and debt management policy. For maximum effectiveness, monetary, fiscal, and debt management policies should work hand in hand.

The level of prices and of economic activity is greatly influenced by the relationship between Treasury receipts and expenditures--that is, by whether there is a surplus or a deficit. Whether Treasury securities, both new and refunding issues, are being sold to bank or to nonbank investors likewise has an important effect on the economy. A cash surplus on the part of the Treasury can be a very potent measure in combating inflation. This is particularly true if the excess of taxes over current expenditures is used to retire bank-held debt and thus to reduce the supply of money in the economy.

There are circumstances, of course, under which it is impossible for fiscal policy to serve in the desired manner. For example, high expenditures required by a defense or war emergency may be responsible for an

inflationary movement. In such a situation it may be unrealistic to expect a Treasury cash surplus.

Even when fiscal and debt management policies are fully appropriate to the economic situation, however, monetary policy still has an important part to play in maintaining economic stability. Monetary policy alone is especially designed to influence the extent of private spending with borrowed funds. Furthermore, the flexibility of monetary policy makes it a desirable part of any program for achieving economic stability. It is possible for the Federal Reserve to act while the means for increasing taxes and expenditures are being decided upon. It is possible for the change to be in much smaller steps and to be reversed if conditions change. Although debt management policy can be more flexible than taxation and expenditure policies, debt management policy is limited by the structure of the debt outstanding, as well as by a relatively narrow scope as compared with monetary measures.

### Monetary-Fiscal Measures Already Applied

A number of important actions in the monetary and fiscal area have already been taken to combat the present inflationary situation by curbing private expenditures. One of the most important has been the increase in individual income taxes, by which some of the excessive purchasing power is being absorbed. This tax increase is a proper beginning, but further increases will be necessary. There is no reason under present circumstances why tax increases should not keep pace with increases in expenditures, so that a balanced budget will be obtained. Considerations of economic stability certainly demand that Government receipts at least equal expenditures. With present income levels, we can and we must cover by taxation the level of expenditures anticipated for the next few years.

But even if we should have a balanced budget monetary and credit measures are not automatically eliminated. Some of the taxes will be paid with funds which would otherwise have been saved rather than spent, while Government expenditures will all find their way into the expenditure stream. Furthermore, there will be increased private expenditures for plant expansion which will swell the total expenditure stream. These additions to expenditures must be offset by monetary and credit measures. To the extent that the budget is not balanced, however, monetary measures become much more important. Some steps have already been taken in the application of monetary and credit restraints, and others may prove necessary in the future.

With a view to limiting the availability of credit and affecting its cost, the Federal Reserve Banks increased their discount rate from 1-1/2 to 1-3/4 per cent in August. As a result of the System's anti-inflationary open market operations, interest rates in the market rose, with yields on short and intermediate-term Government securities up generally about 1/4 of 1 per cent since the middle of August.

Steps also have been taken to control the granting of consumer and real estate credit directly by the establishment of minimum down payment requirements and maximum terms to maturity under authority of the Defense Production Act of 1950. Effective September 18, the Federal Reserve issued Regulation W setting minimum down payment and maximum maturity for consumer credit. As revised on October 16, it provides for minimum down



payments of one-third on automobile purchases, 25 per cent on household appliances, and 15 per cent on furniture, and sets the maximum period for repayment generally at 15 months. Effective October 12, the Federal Reserve issued Regulation X defining the terms of real estate credit of private lenders. At the same time, the terms for Federal Housing Administration and Veterans Administration loans were tightened. Minimum down payments now range from 5 per cent on houses for veterans costing under \$5,000 to 50 per cent on houses for nonveterans costing over \$24,250. On a \$9,000 house, the minimum down payment is set at about 11 per cent for veterans and 21 per cent for nonveterans. The maximum time for repayment is generally 20 years.

Over the period ahead fewer cars and other durable items and fewer new homes can be built if our defense needs are to be met. Regulations on consumer and real estate credit are designed to bring demand for consumer durable goods and housing into line with the necessary lower levels of production of civilian goods. If these credit controls were not in effect, other devices would have to be developed for accomplishing the same result or we would have spiraling prices, crippled war production, and black or gray markets.

Monetary expansion also can be kept down by appropriate debt management policy. At the present time the economic situation calls for sales of securities to nonbank investors. Should new borrowing be needed under present circumstances, the funds should be obtained if possible outside the banking system. As much refunding as possible should be done through sales to nonbank investors. The offering of securities which are attractive to such investors as insurance companies will decrease their willingness to make business and real estate loans and to purchase corporate and local government securities. At the same time, it will decrease the necessity for the sale of Government securities to banks with accompanying monetary expansion. A beginning has been made in this direction through the opening up this Fall of more Series F and G savings bonds to institutional investors.

### Summary

Steps taken to combat inflation are not painless for consumers. Taxes are not painless. Neither are the restrictions on purchases involved in the regulation of credit. But taxes and credit measures are much more equitable than inflation itself. They are also much more compatible with our free enterprise economy than are price and wage controls and rationing. They leave a maximum amount of freedom for market processes to operate. They stabilize the general price level by influencing the total amount of expenditures. At the same time, they leave prices of individual items free to fluctuate in accordance with changes in demand and supply. Through the pricing mechanism, goods are still distributed to purchasers with the strongest demand and manpower and materials are attracted to the production of goods for which demand is greatest in relation to supply.

It is too early to judge the effects of the various indirect measures which have been taken to combat inflation. If the steps which have been taken thus far prove to be insufficient, then further measures must be taken promptly. It seems clear that taxes will need to be increased substantially before many months. Additional monetary and credit actions

may also be needed and for this purpose it may become necessary to request additional authority of Congress in order to restrict the availability of reserves on which multiple expansion of bank credit can be based. As the future unfolds we will know more fully what measures will be required to meet it and we must be prepared to obtain authority for and to apply necessary measures. With resolute and timely action we can win the battle against inflation and keep our economy free.