Speech delivered before
School of Banking, University of Wisconsin
Madison, Wisconsin
August 31, 1951

MONETARY AND FISCAL POLICY IN A REARMAMENT PERIOD

When I talked at the School of Banking a year ago, it was just two months after the outbreak of hostilities in Korea. At that time we were faced with sharply increased inflationary pressures. The Government was embarking on a large-scale program of rearmament. In anticipation of possible resulting shortages and higher prices, consumer and businessmen were already rushing into the market to buy. To do this, they were borrowing heavily and making free use of the large volume of liquid assets accumulated during the war and of current high and rising incomes. Production was increasing but not fast enough to meet increased demands and prices were rising rapidly, especially raw material prices. This was the way things stood when I outlined to this School my ideas about the best way to deal with the situation.

The Program Outlined Last August

Under the circumstances, with prospects of continued or growing inflationary pressures, a coordinated program of fiscal, debt management, monetary and credit policies and a system of selective priorities and allocations of strategic materials seemed to me essential. Arguing that fiscal measures must play an important role in limiting incomes available for spending, I advocated increases in personal and corporate income tax rates and imposition of selective excise taxes and taxes on war profits and speculation.

I urged Government debt management policies designed to tap available investment funds as far as possible with a concerted effort to sell nonmarketable bonds and tax savings notes to individuals, businesses, and nonbank financial institutions. Such a program would absorb money that would otherwise be spent on current consumption or new private investment and also would reduce the volume of Government financing through banks, which is highly inflationary.

Monetary and credit controls, it seemed to me, should be broad in scope and should include effective curbs on consumer and real estate credit as well as general measures to curb the availability of credit to all types of borrowers. The Federal Reserve had already raised the discount rate from 1-1/2 to 1-3/4 per cent. The Board of Governors and the Open Market Committee had issued a joint statement indicating that both bodies were prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market. The Board, in cooperation with the other Federal and State bank supervisory authorities, had issued a statement urging that banks and all other institutions engaged in extending credit exercise special care in their lending and investment activities. Rapid credit expansion was continuing, however, and I called attention to the possible need for further

action, including the imposition of selective controls and the more restrictive use of one or more of the Federal Reserve System's general instruments of credit control, namely open market operations, changes in the discount rate and changes in bank reserve requirements. Should these measures prove inadequate, Congress might well need to consider the desirability of authorizing additional powers over bank credit expansion in the form of supplementary reserve requirements.

Monetary and Fiscal Measures Taken Since Last August

Today we may well ask what the record of the past year has been and what now lies ahead. As you know, the program of controls provided for in the Defense Production Act passed early in September last year and in an accompanying tax measure was a rather broad one, including direct controls over prices, wages, and materials use as well as controls of mortgage and consumer credit. The direct controls were used to only a limited extent until after the Chinese intervention and throughout the year great reliance has been placed on fiscal and monetary actions to check inflationary developments. As a result largely of the various fiscal, monetary and other measures taken, of increased production, and of changed consumer attitudes, the inflationary spiral was checked this spring, at least for the time being. Since then, despite rising defense expenditures, prices in wholesale markets, especially for raw materials, have declined and prices at the consumer level have shown little further rise. Now what action specifically has been taken in this year in the fiscal and monetary and credit fields to help check inflation?

In the field of selective credit regulation, Regulation W was imposed in September and strengthened in October to check the rapid growth in instalment credit and also to limit demand for consumer durable goods made from scarce materials. The rapid growth in instalment credit was stopped and the volume of such credit outstanding is now less than it was last September. In October a new type of selective control was initiated with the adoption, with the concurrence of the Housing Administrator, of Regulation X, specifying minimum down payments and maximum maturities on mortgage loans to finance the purchase of new houses. Later this was extended to loans on new apartments and some types of nonresidential buildings. Initially, the effectiveness of this regulation was limited by the large volume of commitments made previously. Since this spring, however, as these commitments were being used up, and as the amount of funds available for investment was being limited by more general measures, the availability of mortgage credit was being reduced and the volume of new residential building being started was at a much lower rate than a year earlier. July housing starts totalled 86,000 as compared with 144,000 in July 1950 and 96,000 in July 1949.

Regulations T and U have been strengthened to restrict the growth of stock market credit and to reduce the potential influence of credit in financing stock speculation.

While actions in selective credit regulation are more easily understood, actions to restrict the general availability of credit are more important. A series of such actions has been taken this year. As already noted, the discount rate was raised last summer. In January 1951

reserve requirements of member banks were raised to the upper legal limits, except for 2 percentage points at central reserve city banks. In early March announcement was made of a Treasury-Federal Reserve accord to coordinate debt management and monetary and credit policies in such a way as to assure successful financing by the Government and at the same time to minimize the monetization of the public debt. A conversion offer was made for the two longest term restricted bonds which substantially reduced the amount of marketable bonds in the market. As a result of the accord, holders of Government securities have been less disposed to sell them in order to obtain funds to make new loans to private borrowers and State and local governments. In financial markets, where short-term rates had firmed last autumn, long-term rates are now up somewhat. Perhaps most important, however, is the restoration of a considerable degree of flexibility which it is hoped will promote caution among both lenders and borrowers.

A voluntary credit restraint program has also been inaugurated in which commercial banks, investment bankers, life insurance companies, mutual savings banks and savings and loan associations are cooperating to screen their loan applications more carefully and to curb less essential credit. This program has been a further constructive measure of credit restraint. It has helped particularly in reducing the availability of credit for purposes which are not closely related to the defense effort.

Fiscal and debt management policies have had an impressive anti-inflationary effect thus far in the defense period. Actions taken last September to increase individual and corporate income taxes and last December to impose an excess profits tax on business corporations were timely and yielded a significant volume of new revenue. Despite a rise in defense expenditures, including foreign aid, from an annual rate of 17 billion in the second quarter of 1950 to 35 billion in the second quarter of this year, Government revenues have generally kept pace with increasing outlays. This is a real achievement even though it has been made possible partly by the sharply increased incomes growing out of inflationary developments.

Recent refunding and new financing operations of the Treasury have been very successful. The success has been due to the offering of securities that have been attractive to investors, and to general investor confidence in the Government securities market. The recent August refunding of over 5 billion dollars of securities was accomplished with an exceptionally small proportion of cash redemptions, and since early July the Treasury has been able to raise almost a billion and a half dollars of new money through increased sales of Treasury bills, with very small purchases by banks and practically none by the Federal Reserve.

Current and Prospective Economic Situation

So much for the record of the past year. Now what about the future? What are the prospects for increases in inflationary pressures and what action should be taken to check any further inflationary developments? Before any attempt is made to answer these questions, it is essential to look briefly at the current economic situation.

Since early spring, there has been a marked diminution of inflationary pressures. Prices of basic commodities are down 17 per cent and wholesale prices generally are down 4 per cent from peaks of earlier this year. Consumer prices have shown little change. The rate of credit expansion has moderated and recent increases in commercial loans of banks have been about seasonal in amount.

Consumer demands for many goods are sharply below earlier extraordinarily high levels and consumer expenditures as a whole are below their usual relationship to disposable income. This shift in consumer buying came about as fears of shortages were reduced. Consumer holdings of durable goods have increased and distributors have ample supplies for the time being.

With industrial production at very high levels and with private demands on the whole reduced, business inventories have risen sharply. The book value of inventories at all stages of production and distribution at the end of June was up to 70 billion dollars. This was an increase of 30 per cent over a year ago, with less than half of this rise reflecting higher prices. The prospect of large crops this year, and particularly for a bumper cotton crop has been another important factor in price declines from peak levels. New construction, allowing for usual seasonal movement, has declined somewhat since March, reflecting primarily the reduction in residential building.

While the situation in recent months has not been as tight as it was earlier, the importance for the future of such easing as has occurred should not be over-emphasized. In the third quarter, the gross national product will probably be as large as it was in the second quarter, when it reached an all-time high annual rate of 326 billion dollars. Personal income in June, at an annual rate of over 250 billion dollars, was 15 per cent higher than a year ago and was still rising, although at a less rapid pace than earlier. Consumer prices in July were at their peak, 9 per cent above June 1950. Wholesale prices now are 12 per cent higher than in mid-June 1950. Wage rates are continuing to rise, tending to increase incomes and the cost of doing business.

Industrial production in August is estimated at about 218 per cent of the 1935-39 average, not far below 222 plateau of the first half of 1951. In many key industries, as iron and steel, operations continue at capacity. Nonfarm employment in June and July, seasonally adjusted, was at an all-time high of 46.6 million persons, more than 2-1/2 million above a year ago. Unemployment, at 1.9 million persons in July, was at the lowest level for any July since 1945.

In the period ahead one major development seems definitely in prospect. A further rapid increase in defense expenditures, with much of the increase in outlays for hard goods such as airplanes, tanks and the materials which go to make such end products. Expenditures for defense have more than doubled over the past year and amounted to an annual rate of over 35 billion dollars, 11 per cent of total national product, in the second quarter of 1951. A further substantial increase in such expenditures occurred in July, when they were at an annual rate of over 40 billion dollars. According to a recent report of the Council of Economic Advisers,

expenditures for national security are scheduled to rise to an annual rate of over 60 billion in the second quarter of 1952, accounting for close to 20 per cent of an expanded national product.

Meanwhile, business expenditures for plant and equipment are currently at a record rate, with the total for 1951 likely to exceed 25 billion dollars as compared to 18.6 billion in 1950. This plant expansion is now making heavy demands on scarce resources but is also steadily enlarging basic industrial capacity.

Business now is not accumulating inventories at the rate it did earlier and the resources previously devoted to building inventories may be largely available for other purposes. In some lines inventories may be reduced but, if the international situation continues as it is, many businesses will be glad to keep substantial inventories as a protection against shortages and possible further price advances. Although most goods are currently in ample supply, acute shortages of steel, copper, and aluminum and other metals persist and have resulted in a Controlled Materials Plan and in orders limiting their use for production of many consumer durable goods.

Consumer demands have been at a relatively low level in relation to current income. The period ahead is one in which international and other developments could easily -- but may not -- lead to renewed heavy consumer demands. Such demands, along with heavy business demands and rapidly rising Government outlays, would bring very great inflationary pressures which could be checked only if strong restrictive monetary and fiscal measures were taken.

Program

This brings us to the final question of policies appropriate in the period ahead. The experience of the past year, it seems to me, has shown the necessity of a broad and coordinated program of anti-inflation control such as that presented a year ago and summarized at the beginning of this statement.

As I see it, one of the most essential steps to be taken right now is to adopt new taxes which will offset, in important degree, the increased Government outlays being planned for defense. Short of total war, an economy such as ours should be able to stick to a pay-as-we-go policy. Much of current thinking about prospects is based on the assumption that a tax bill making substantial new levies will soon be passed. The sooner taxes are increased the less danger there will be of a resurgence of consumer demands. Government debt management policies to encourage widespread nonbank ownership of the public debt must be continued. We must draw on genuine savings rather than money creation to finance any excess of Government outlays over revenues.

Monetary and credit restraint measures must also continue in effect and be administered in such a way as to minimize the expansion of credit, especially for less essential purposes. This will be more difficult in view of the limitations recently imposed by the Congress on control of mortgage and consumer credit. There is evidence of some more than

seasonal increase in buying of consumer durable goods in recent weeks. Certainly developments in the field of instalment credit under the new terms will need to be watched carefully. So also will changes in mortgage lending. Even more than before, reliance will have to be put on general credit controls to restrain expansion of credit. The Voluntary Credit Restraint Program has exerted a constructive influence in this respect and should be continued in as effective form as possible.

The shift to a higher rate of personal saving this spring and summer has been an important favorable development and one which should be encouraged.

Further inflation is not inevitable. There is good evidence that the anti-inflation program, along with increased output has been effective in checking inflation. Rising production and a broad program of controls designed especially to prevent excessive demands can be effective in the period ahead. Inflation must be held in hand if the free world is to be strong and remain free.

The Government is now about to launch a nation-wide drive to encourage purchases of savings bonds, particularly through the payroll deduction plan. The maintenance of a high rate of personal saving and the making of that saving available for essential uses is of basic importance to the prevention of further inflation. Everybody can contribute directly by supporting the coming savings bond campaign.