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OUR MONETARY PROBLEMS

The monetary problems that we face today are largely a heritage of the most tremendous war financing in history. This financing was successful because we all worked together to win the war as quickly and as effectively as possible.

Now that the war is won, we need to work together again--this time, to win our fight against the immediate danger of inflation. Countless millions of Americans have loyally supported the home front battle against the inflationary forces generated by the war. It would be tragic to lose this battle at the eleventh hour by prematurely abolishing essential price controls and the other remaining protective measures, irksome though many of them may be and eager as we all are to be rid of such restraints as soon as we can safely do so. If we were to permit inflation to demoralize our economy now it would place in jeopardy our justifiably high hopes for establishing an enduring prosperity at home. And a prosperous America is essential to a lasting peace abroad.

A solution of our monetary problems is a part of winning that fight against inflation. I should like to touch on some of these monetary matters tonight.

At the outset we should admit that we can not solve our monetary problems with some simple single device, with some single action, or for all time. We must move cautiously, not abruptly, and we must take the problems as they come--as objectively as we can. That is the economic and politic thing to do. There can be no easy nor quick way.

We do not live and work in a vacuum. We live and work in an active day-to-day economy under a free enterprise system, which we propose to preserve under our form of Government. This Government, like our economy, has many parts, and these parts have many departments and divisions in which responsibilities are not always exact and precise. Solutions to national economic problems do not lie in any one single part, department, or division, nor in any one segment of our economy. The solutions should not result in favor of any single group or groups of our people. The solutions of our monetary problems must be considered with one fundamental aim--economic stability at a high level of production and employment. That goal can not be reached through monetary and credit measures alone, but it can not be achieved without appropriate monetary and credit measures.

In peace time, as has been said often before, the primary objective of Federal Reserve policy is to provide monetary and credit conditions favorable to sustained sound economic activity in commerce, industry, and agriculture. In war time this objective continued to be of great importance but it was influenced by the special requirements imposed by military necessity. In reconversion from war to peace, it is influenced by

the special requirements imposed by the accumulated demands for goods here and abroad, the short supply of certain goods, the large purchasing power in the hands of the public, and the interest cost on the extraordinarily large public debt--all resulting from the war. The primary problem, therefore, is to meet the accumulated demands for goods, needed both at home and abroad, through an expansion of production that will achieve as rapidly as possible a better balance between supply and demand without, at the same time, causing a rapid inflationary rise in prices that would end in deflationary collapse.

It is important to note right here that inflation increases the cost of Government as prices rise sharply. The increased cost would likely continue during the subsequent collapse as the Government would need to make expenditures for recovery and relief.

To fight inflation we need to encourage continued savings by the public on a substantial scale. The savings bond program is, therefore, vitally important and deserving of support. We should exert every effort to insure the balancing of our budget. Hence we should not reduce taxes further in the coming year and should hold Government expenditures to the minimum.

On the monetary side, as you are aware, individuals and businesses have accumulated huge amounts of liquid assets which are held in the form of currency, bank deposits, and readily convertible Government securities. The public, even after paying greatly increased war-time taxes, had a large excess of income relative to the supply of goods and services available for purchase. If the public had spent a larger part of this excess income, the result would have been a ruinous inflation.

Notwithstanding the fact that taxes were increased heavily and that tax receipts of 153 billion dollars comprised about 40 per cent of all funds raised during the war period, the public debt rose from less than 50 billion dollars before the war to a peak of approximately 278 billion.

This increase in debt inevitably added tremendously to the liquid assets of the public. Liquid assets--that is, currency, bank deposits, and Government securities--held by individuals and businesses, exclusive of financial institutions, rose from about 80 billion dollars at the time we entered the war to approximately 225 billion at the end of 1945--an increase of some 145 billion dollars. This is an inflationary potential that dwarfs anything in our past.

As you know, it has been the policy of the Government to sell the largest practicable amount of its securities to investors other than commercial banks and to induce these nonbank investors to hold their securities. The purpose has been to channel as much as possible to the current income and idle funds of nonbank investors from the purchase of scarce goods and services to investment in Government securities. This, in turn, has retarded the increase in bank deposits and thereby limited the amount of funds that were in readily spendable form for purchasing goods and services, either during the war or afterward. You are familiar with the devices used to implement this policy--war loan drives, payroll savings plans, and issues of Government securities whose ownership was general restricted to nonbank investors.

In spite of this, a large part of the Government securities went to the banks.

It is often said that the basic cause of inflation is the Government deficit and the resulting borrowing from banks that creates new money. This is essentially true, but the results of that situation now exist and they can not be eliminated overnight. No country has ever been able to impose sufficient taxes to finance a war without borrowing or creating new money in the form of bank deposits. Now that the war is over, the deficit has practically disappeared; it is no longer necessary to create this new money by borrowing to finance the Government. Nevertheless, the money created during the war still exists and might be expanded through further transfers to the banks of Government securities already in the market. Until those funds are firmly invested or until our economy has grown up to them, they are potential inflationary tinder.

These funds, in addition to current incomes that result from current production of goods and services, are available for spending or investment in other assets. Thus the potential spending power can continue far in excess of the current flow of goods and services even though production should increase considerably. Expanding production would not prevent or check inflation, if the public should attempt to spend its accumulated savings as well as current income. Nor can these accumulated liquid assets be substantially reduced except by debt retirement--at best a slow process. We can hope that they will remain firmly held until they can be gradually invested in peace-time pursuits. In the meantime, controls of various sorts over goods in limited supply and over prices will continue to be necessary.

Although this background is familiar to you, it is so vital to any discussion of our monetary problems that it bears repeating.

In the monetary field the responsible authorities face a difficult though not impossible dilemma. Under the existing structure of interest rates, with its wide spread between short-term and long-term rates, there is an incentive for both commercial banks and nonbank investors to shift their holdings from short-term to longer-term securities. By this means they can obtain both the higher yield on the longer-term securities and the profit that accrues as each issue, with the passage of time, automatically becomes shorter and consequently declines in yield and increases in price. For this reason there generally has been a supply of short-term securities in the market and a demand for longer-term securities. The Federal Reserve is continuing, as it did during the war period, to support present short-term rates by purchasing all of the short-term securities that are offered in the market at those rates. On the other hand, the Federal Reserve can not supply the market demand for longer-term securities, because it has already virtually exhausted its portfolio of these issues.

The result is that, so long as holders of Government securities want to shift from short-term to longer-term securities, Federal Reserve holdings increase. This increases member bank reserve balances at the Federal Reserve Banks. On the basis of these increased reserve balances, commercial banks as a group can expand credit for whatever purpose they choose by six times the increase in reserve balances at the Federal

Reserve Banks. The expansion averages six times the increase in reserve balances because on the average a given amount of reserve balances will support six times that amount of deposits. Expressed the other way around, present reserve requirements for the various reserve classes of banks are at levels that equal, on the average for all member banks, one-sixth of net demand deposits. To summarize, so long as present short-term rates can be maintained only by Federal Reserve purchases, there is an inducement for bank credit to expand further. This increased bank credit is available to the public for spending in addition to their current income.

You may ask, quite properly, at this point: "Why not use the methods that the Federal Reserve has employed in the past? Why should not the Federal Reserve discontinue buying Government securities? Would not this top the further expansion of bank credit? If the Federal Reserve discontinued buying securities, would not this make it more difficult and more costly for nonbank investors to raise funds by selling Government securities, by borrowing from banks, or, as in the case of corporations, for example, by the issuance of their own new securities?"

I think the answer to these questions is that the present situation is entirely different from anything in the past. The difference lies in the large public debt, the large interest cost of that debt, the large profits that commercial banks as a whole receive from Government securities, and the large holdings of Government securities by nonbank investors.

If the Federal Reserve discontinued buying the securities, short-term interest rates would no doubt increase. This, in turn, would increase the interest cost of the debt to the Treasury as maturing short-term issues were refunded at higher short-term rates. The importance of this interest cost is shown by the fact that, as a result of the war-time expansion of the debt, it has increased fivefold from a billion dollars a year to about five billion a year. Who pays this interest cost? The taxpayer. As you know, the public and the Government are in no mood to increase the cost of servicing our tremendous public debt.

An increase in interest rates also would unnecessarily add to the profits of commerical banks. The importance of this consideration is shown by the fact that, as a result of war-time purchases of Government securities, commercial bank profits have more than doubled. You may say that, since an increase in bank profits was of no concern to the Government in the past, it should be of no concern now. I believe, however, that the difference lies in the fact that in the past bank profits came principally from the public in the form of business loans, corporate securities, and like assets. At present, however, a considerable part comes from the Government, which in the last analysis means you and me as taxpayers. More important still is the continuation of our free enterprise system, and increasing the profits of commercial banks at this time at the expense of the taxpayer is not a good way to preserve the system of free enterprise--or, to be more specific, to preserve our private banking system.

I do not want to seem in any way to disparage either the need for

the existence of a healthy commercial banking system or the excellent job that commercial banks did for their country during the war. Commercial banks were an important factor in selling Government securities to nonbank investors. Also, they purchased the Government securities that the Treasury was unable to sell to nonbank investors. They performed many other valuable functions in the war effort. Always--in war or in peace--they are vital, useful institutions and as such they must earn sufficient profits to maintain their existence. Also, in exceptional circumstances, some individual banks or groups of banks have not participated in the general increase in profits but banks in general do not need to obtain higher rates of interest on Government securities to maintain their existence.

There is a third reason for avoiding a rise in short-term interest rates, in addition to the effect on the interest cost of the debt and on commercial bank profits. It is said that a rise in short-term rates might result in liquidation of present holdings of Government securities by nonbank investors. If this were to reach large proportions of a flight from Government securities, it would have inflationary consequences. After interest rates have been prevented from increasing for four years, the first break in the dike might possibly bring on a flood. For my part, I do not believe that this would be the result, but the possibility at least indicates that we should proceed with caution, and there are those who stress this point.

On the other hand, there is the long-run danger that lies in the fact, well known to you, that as commercial banks purchase medium-term bonds from nonbank investors and the nonbank investors in turn bid against each other for long-term bonds not available to commercial banks for purchase, yields on these bonds decrease. A decline in long-term yield tends to result in such attractive premiums that holders of long-term bonds other than institutional investors are tempted to sell them at those premiums, with profit, and to seek other employment for their funds. The result is that the funds tend to shift to other markets--first to high grade corporate bonds depressing their yields to the point where they become unattractive, then into lower-grade bonds, stocks, real estate, etc., bidding up their prices and tending to accentuate speculation in such investments. A decline in long-term yields tends to reduce the income of insurance companies, savings banks, and endowed institutions, which hold a large part of the savings of the public and perform essential public services. It seems to me, therefore, that lower interest rates, especially at this time, would not be desirable.

What I have been saying up to this point seems altogether negative. There is something, however, on the positive side. Most important is the state of the Federal budget. In the first quarter of this year, the Treasury had a small surplus of tax and other receipts over Government expenditures. Receipts were larger and expenditures had been reduced more rapidly than had been expected. The budget is close to a balance on an annual basis. As long as inflationary pressures continue, however, there is no justification for further tax reductions and Government expenditures should be held to the minimum of public needs. I believe that budgetary surpluses to retire public debt should be the order of the day.

The favorable trend in the budget means that the Government deficit is not nearly so large as it was and that there has been a reduction in the excess of the public's income over the available supply of goods and services. In addition, it means that the Government debt will not continue to increase.

In fact, the Government debt has already started to decrease because the Treasury very wisely has been retiring maturing and called securities by using part of the large cash balance not needed for current expenditures. Since the cash balance is still large, the Treasury is in a position to continue to retire debt. Since banks held a large proportion of the maturing and called issues, the result is a substantial reduction in bank credit. From March 1 through May 1, 1946, the Treasury retired a total of 6.4 billion dollars of certificates, notes, and bonds. Of this amount commercial banks held somewhat over 4 billion dollars and Federal Reserve banks 1.2 billion.

Another new factor that may retard the monetization of our public debt is that the yields on the medium-term bonds that commercial banks have been eager to purchase have declined to 1-3/8 per cent, compared with 2 per cent only a little over a year ago. The spread between these bonds and the 7/8 per cent certificates consequently has been reduced from 1-1/8 per cent to 1/2 per cent. The type of switching that leads to further expansion of bank credit is not nearly so profitable as it was formerly. Finally the debt retirement has reduced commercial bank holdings of the shortest-term securities and consequently has lengthened the average maturity of their portfolios. This also tends to make them a little hesitant to extend their maturities further by selling certificates and purchasing medium-term bonds. In fact, during recent weeks commercial banks seem to have been shortening rather than lengthening the maturities of their Government securities.

In any event, because of this combination of circumstances, the situation looks much more favorable than it did a few months ago or at the time you invited me to speak here. The demand deposits of individuals and businesses have stopped expanding, and the total of bank loans and investments has actually declined. Total loans and investments by weekly reporting member banks declined from 68 billion dollars in February to 65.5 billion dollars on April 17. Whether this is a temporary phenomenon or a major change, I would not undertake to say, but I hope it is a major change.

In addition, a return flow of currency and gold imports, which could have been a basis for further expansion of bank credit, has been offset by a decline in Government securities held by the Federal Reserve Banks. Currency in circulation has declined by about 700 million dollars from the war-time peak of nearly 29,000 million dollars reached last December. Gold imports in this period have amounted to about 200 million dollars. The effect of these movements, which is to increase bank reserves, has been more than offset by a decline in Government securities held by the Federal Reserve Banks. As a result of the Government's debt retirement program and sales of securities in the market the Federal Reserve System's portfolio has been reduced by 2 billion dollars since the first of the year. It is now 22 billion dollars.

As I have indicated, there are serious obstacles under present day circumstances to the use of the traditional monetary powers to implement anti-inflationary policies in a way that would increase interest rates. Our Board announced last week Thursday that it "does not favor a higher level of interest rates on United States securities than the Government is now paying." The problem of exerting further pressure to arrest unnecessary and undesirable monetization of the public debt through the commercial banking system may require Congressional study and legislation.

One perhaps relatively minor but certainly desirable step was the ending of the war-time preferential discount rate of 1/2 per cent on Government securities due or callable in a year or less. This special rate was established purely as an emergency war measure to help the Treasury in the successful sale of its securites to obtain funds required to win the war. It was designed to enable commercial banks to obtain more readily the excess reserves needed to purchase Government securities that could not be sold to the public. To facilitate them in adjusting their reserve positions, and finally to encourage them to buy short-term rather than long-term securities.

This rate not only had passed its period of usefulness but had made it possible for banks to borrow at 1/2 per cent in order to purchase higher yielding Government securities. The magnitude of the possible credit expansion is several times the amount borrowed from the Federal Reserve because, as I have already explained, the bank reserves created by the additional Reserve Bank credit provide the basis for a six-fold expansion of bank credit. The preferential rate also encouraged banks to lend on Government securities at low rates, thus giving substantial profits to borrowers and encouraging speculation. Although such loans have declined from the war-time peak, they still exceed 3 billion dollars. The preferential rate has not been an important instrument of monetary policy and its elimination is merely a post-war adjustment in conformity with the Government's stabilization program.

Various other proposals concerning our monetary problems have come to my attention. For example, to stop further expansion of bank credit and a further decline in the long-term yield and to do so without increasing the interest cost of the public debt and without increasing further the already large profits of commercial banks, several suggestions have been made to require commercial banks to hold a certain minimum amount of Treasury bills and certificates, or, following the example of the Canadians, to prohibit the commercial banks from holding more than a certain maximum amount of Treasury bonds.

It has likewise been proposed by some that the required reserves of central reserve city banks be increased to 26 per cent against net demand deposits. They are now 20 per cent, the same as at reserve city banks, while so-called country banks are required to hold reserves of 14 per cent against their net demand deposits. That is the limit of our authority. It has also been proposed, therefore, that the Federal Reserve ask the Congress for some additional power to raise reserve requirements above the present maximum for each of the three classifications of member banks. It seems to me that whatever merit there may be in the various proposals that have come to my attention, one thing is

evident and that is that they deserve very careful study for, as you know, they have both advantages and disadvantages.

Sudden or drastic action with respect to our monetary situation is not advisable, economically or politically. We should move slowly, cautiously, moderately--step by step--in the monetary field, giving whatever help we can to increased production, giving whatever help we can to prevent inflation. What we do in the monetary field, while essential, is only supplemental to the larger economic influences inherent in the budget and in debt retirement, for example. Monetary and credit policies can help, but they can't do the whole economic job alone.

Forums such as this are important and necessary to widen our understanding of the economic problems of the times and to aid us in arriving at the most satisfactory solutions. Some of the problems are complex and not widely understood by the general public. I think we may justly classify the problems of debt management, of interest rates, and of monetary action through the commercial banking system as being among the most complex and least understood generally.

If you feel that I have dealt in too general terms in speaking about some of these monetary matters, I must confess that I have done so deliberately and, in part at least, in the hope of stimulating discussion rather than assuming to know the final and best answers to many of these complex problems today. We shall arrive at the right solutions by patient, open-minded study and discussion--not by dogmatism or any narrow consideration of our individual interests apart from the broader interests of the nation as a whole. By your program and your presence here, you signify your desire to hammer out the right answers on the anvil of full and free discussion. That, in essence, is democracy--and, by the same token, we shall preserve our democracy and our economic system only by such full, free, and fair discussion and debate.