THE PROBLEM OF POST-WAR MONETARY POLICY

In my previous lecture I dealt in very broad terms with the subject of contemporary monetary policy in relation to economic stability. Today, I have planned a more specific approach. I propose to discuss the problems of monetary policy as they have developed in the context of our post-war experience to date.

Since the end of the war, monetary policy has had to cope with more or less continuous inflation. Effective demand, until recently, has consistently exceeded the available supply of goods largely because spending from current income has been substantially supplemented by drafts on accumulated liquid savings and by rapid expansion of private credit. This condition of excessive demand has inevitably placed an upward pressure on prices. Advancing prices accompanied by expanding money income, leading to further price increases, is the spiraling process of inflation with which we are now all too familiar. As a result, between mid-1946 when price controls were initially terminated, and August 1948, wholesale prices rose 50 per cent, consumer prices 31 per cent and total personal incomes expanded by 24 per cent.

Basically, our post-war inflation is the product of our wartime financial policies. The war cost around 320 billion dollars. This huge volume of expenditures was financed in part out of our current income, tapped through taxation and sales of securities to the public; and in part through expansion of the money supply brought about by borrowing from the banking system.

Purely from the point of view of monetary stabilization, taxation is, of course, the ideal method by which to finance a war. When taxes are imposed, the spending power of the public is reduced by the amount the Government's is increased, and current expansionary pressures are thereby held to a minimum. Also, and perhaps more significantly for our problems, taxation does not add to the "liquidity" of the economy, since the taxpayer receives in exchange only a tax receipt which he cannot convert into spending power either in the present or the future.

Borrowing from the nonbank public shares with taxation the advantage of absorbing current spending power, but has quite opposite liquidity implications. The loss of spending power involved in lending to the Government is not permanent as with taxation, but may be reclaimed by the lenders at a future date. In other words, unlike taxation, issuance of Government securities to the public results in an expansion of the economy's stock of liquid assets.

Borrowing from the banking system is an outright inflationary method of financing war expenditures. It absorbs no current income, but instead produces an immediate expansion of the money supply. Furthermore, as matters have turned out, it leaves the banking system in possession of assets that can, when the opportunity arises, be readily converted into reserve funds to back a multiple expansion of private credit.
It was not reasonable to expect our expenditures for war to be financed entirely through taxation. There are serious obstacles, essentially non-monetary in nature, that place a definite upper limit to the tax burden that can be imposed even in wartime. As the tax burden grows, particularly when it grows rapidly, the interrelated problems of administrative feasibility, equity, and incentives become increasingly difficult to handle. More safeguards against widespread evasion and its generally demoralizing effects have to be devised. Numerous special adjustments are required to maintain a general consistency with the community's standards of fairness, without which no tax system can long survive as an effective instrument of policy. And, finally, a rapid stepping up of the tax bill may, at least in the short run, have adverse effects on effort incentives and thereby interfere with achieving a maximum wartime output.

Just where that upper limit of taxation is, cannot be determined exactly, but it is safe to say that we fell short of it by much too wide a margin. Less than one-half of the funds raised by the Treasury between the middle of 1940 and the end of 1945 came from tax sources.

Further, not only did we rely much too heavily on borrowing, but on borrowing of the most inflationary kind. Of the total amount borrowed by the Treasury from mid-1940 to the end of 1945 more than two-fifths came from the banking system including commercial banks, Federal Reserve Banks and mutual savings banks. Thus, in our war finance we made the twofold mistake of taxing too little and borrowing from the banking system too much.

As a consequence, then, of our wartime financial policies we entered the postwar period with an economy characterized by an excessive degree of liquidity. Government securities held by commercial banks—their highly liquid secondary reserves—grew from 17 billion in June 1940 to 91 billion by December 1945. They constituted the bulk of total bank loans and investments. It is estimated that over the war period the stock of liquid assets—currency, bank deposits, and Government securities—held by individuals and businesses including insurance companies, increased approximately threefold while over the same period the gross national product only about doubled.

This greatly increased ratio of liquid assets to the value of the national product reflected in part a considerable restraint on the part of consumers and business concerns who, for economic as well as patriotic reasons, were willing to accumulate liquid reserves rather than bid for the scarce supply of goods that were available during the war. And, of course, the high "liquidity ratio" that developed over the war reflected the fact that we had generally effective direct controls on prices and materials.

Combined with a heavy backlog of unsatisfied real demands, this high degree of liquidity meant that strong inflationary pressures would inevitably develop, particularly if the wartime controls were prematurely removed.

But our wartime policy of heavy reliance on borrowing held yet another implication for the problem of stabilization in the post-war world. Our national debt grew during the war to a peak of 275 billion dollars, a figure of astronomical proportions by prewar standards. Its ownership was
widely distributed and its interest pattern had become integrated into the whole asset and liability structure of our economy. Confidence in the market value of the public debt was almost synonymous with a stable financial organization.

Clearly, no realistic conception of the problem of postwar stabilization could afford to ignore these facts about the public debt. Yet to take them into account, enormously complicated the role that monetary policy was called upon to play in our postwar economy. For it meant that no measures could be undertaken to control an expansion of credit and the money supply that were inconsistent with the objective of maintaining an orderly and stable market for government securities at all times.

Now, I do not want at this time to cover again the pros and cons of the support policy that the System has followed since the end of the war. Suffice it to say that as I have understood the arguments set forth by serious critics, they have always seemed to be very uncertain as to just what the consequences of suspending supports would be. And in view of the uncertain effects of such an action and the compensating advantages which confidence in the stability of Government security prices has had, it seems to me that the decision to adhere to the support program has been necessary and wise.

Nevertheless, it is true that for the Reserve System to fulfill the role of residual buyer in the Government securities market placed severe limitations on the usefulness of traditionally powerful techniques for controlling the volume of credit and deposit expansion. As a residual buyer the Federal Reserve System became a source of reserve funds which commercial banks could tap at their own volition by offering Government securities for sale. Banks also received additional reserve funds involuntarily whenever nonbank investors sold securities to the Reserve Banks. And with a fractional reserve banking system, each dollar of reserve funds provides the basis for a manifold expansion of private credit and the money supply.

Moreover, because of the abundant security holdings that the banking system acquired through the processes of war finance, commercial banks no longer had extensive need for borrowing funds from the Federal Reserve Banks. Adjustments of reserve positions could be achieved instead through security sales in the supported market. As a result, except for whatever psychological impact it might have, the rediscount rate lost its effectiveness as an instrument of credit control.

Finally, sales from their holdings of Government securities offered an easy means by which banks could offset in some measure pressure that might be brought to bear on their reserve position through a rise in reserve requirements. In consequence, relatively small changes in reserve requirements could not be relied on to have severely restrictive effect. And while larger variations in requirements could be an effective weapon, they have not been available to the Federal Reserve during most of the post-war period because of practical exhaustion of statutory discretion on the upward side.

Thus, under the circumstances that have existed during most of the period since the close of the war, the traditional instruments available
to the Federal Reserve for influencing money and credit developments in this country were either ineffective, inoperative, or near exhaustion. Meanwhile, the volume of credit extended to private borrowers during this period underwent a considerable expansion. From the end of 1915 to the end of 1918, commercial and industrial loans of all insured commercial banks almost doubled, which represented an absolute increase of approximately 9 billion dollars. Agricultural loans of these banks rose by 1-1/2 billion over the same period, while real estate loans increased by approximately 6 billion. Finally, the increase for the period in the consumer loan category of insured banks amounted to almost 4-1/2 billion dollars.

I do not mean to suggest that our post-war monetary policy has been a failure. There have been significant elements of restraint, without which the situation would have been decidedly worse.

The most important factor of restraint in the post-war period has been the Treasury cash surplus. For the calendar years 1916, 1917, and 1918, Treasury receipts from taxes and other sources exceeded cash outlays by a total of about 14 billion dollars. This surplus has exerted a powerfully contractive effect directly on the expenditure-income stream and on the supply of credit and money. Without it the upward pressure on prices would unquestionably have been more severe.

Further, a substantial portion of the surplus has been used to retire debt held by the Reserve Banks. As I pointed out in my first lecture, this disposition of the surplus is the one most consistent with a policy of monetary restraint; for it results in a withdrawal of funds not only from the general income stream, but from the commercial banking system as well, thereby bringing pressure to bear on the reserve position of commercial banks. The Treasury also exerted a similar pressure on bank reserves by drawing down the deposits that had been permitted to accumulate previously in the war loan accounts of commercial banks.

Moreover, the System has vigorously used its relatively modern accessories—control over stock market credit and control over consumer installment credit. Since the end of hostilities in mid-1915, margin requirements for extensions of credit on listed securities by banks and by brokers and dealers have not been below 75 per cent, and for the year ending January 1917 were at the level of 100 per cent. Bank loans for purchasing and carrying securities other than U. S. Government securities amount to only about a billion dollars today. These loans have not increased since the war—in fact, they have declined slightly while debit balances of customers at their brokers and dealers have also decreased since the end of the war and are today actually less than their credit balances. Credit and monetary expansion in the post-war period has not been due to speculative credit in the stock market.

Regulation of consumer installment credit, in the periods it has been in force since the war, has also been an influence in restraining the increase in this type of credit. As you know, Congress, in mid-1917, terminated this authority effective November 1, 1917. Subsequently expansion in this credit went forward at a sharply increasing rate. Since September of 1918, when the regulation was reinstated on the basis of authority granted in the special session of Congress, consumer installment credit has increased only moderately, although prior to that action it had been
expanding at a rate of nearly 200 million dollars a month. Only a few days ago, as you know, the Board modified somewhat the September terms of consumer installment credit.

The System has also used carefully its influence over interest rates. To raise the cost of reserve funds to the banks, and also to encourage banks and non-bank investors to hold on to the short-term Government securities they own and to buy more rather than to unload them on 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-1917 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.

The System has applied more vigorously than the banking community has desired available statutory authority to regulate member bank reserve requirements. Prior to the legislation enacted in August, increasing member bank reserves 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 last 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 Reserve Board raised reserve requirements by 2 percentage points on demand deposits and 1-1/2 percentage points for time deposits early last fall.

Finally, the System has used its informational resources to urge upon Congress and the public the importance of restraint in credit expansion and of the need for a strong fiscal policy.

The American Bankers Association has cooperated in this program by urging bankers to practice self-restraint in their own as well as in the national interest, and some other lenders have taken a similarly enlightened view of the need for self restraint in lending.

The fact that despite a vigorous application of those powers which could be used under existing circumstances, we nevertheless experienced considerable post-war inflation has, it seems to me, one very clear implication. There is a basic need for strengthening our monetary powers.

Monetary authorities should have at their disposal at all times adequate means for checking growth of the money supply without endangering the Government's credit. To this purpose the System needs to be given authority to prevent or restrain credit expansion by an increase in reserve requirements of banks. By this authority the System could absorb or immobilize additional reserves acquired from a return flow of currency, from gold inflow, or from sales to the Reserve Banks of Government securities, either by banks or by their depositors. Furthermore, on grounds of fairness as well as on grounds of making the requirements more effective, the authority ought to be extended to all insured banks.

As a supplement to quantitative controls over bank reserve positions, selective-type controls need to be developed further to strengthen the System's influence over monetary and credit developments. Experience with
controls over stock market and consumer instalment loans has demonstrated the helpfulness of operating directly on the demand side of the credit market. The Board strongly believes in the continued usefulness of both of these controls for achieving greater economic stability, and has recommended to the Congress enactment of legislation which would replace the present temporary authority to regulate consumer instalment credit with a permanent authority.

The case for continuing regulation of consumer instalment credit merits special comment. Consumer instalment credit is directly associated with the distribution and financing of durable goods. In an advanced and rich economy such as ours, increases in our standard of living come about more and more in terms of ownership and enjoyment of a greater volume of durable goods. These goods, however, usually have a long and variable life of service. They are generally items of high unit value and not many of each are purchased in the average consumer's lifetime. Original purchases and replacements can be postponed for indefinite periods. Even if their purchase were on a strictly cash basis, demand would be unstable with changing conditions of unemployment, income and buying psychology. With unrestrained use of instalment credit financing, instability in the demand for durable goods tends to be accentuated. In periods of business expansion consumers draw heavily on their future income to swell their purchases of these goods. When a downturn sets in, instalment loans are being paid off and the payments reduce further an already inadequate volume of consumer purchasing power. By limiting or relaxing the terms of instalment credit, not to stifle its growth but to spread its growth, much can be done to space our purchases of durable goods more evenly over time. This will add to the stability of the entire economy.

Recently we have had an interruption of the inflationary course. In an increasing number of areas supplies have caught up with, and in numerous lines, exceeded demand at current prices. Indicative of the changed situation are the recent declining prices, the moderate slackening of investment in producers' goods and business inventories, and the increased supplies of goods, many of which were in tight supply a year ago. Average wholesale and consumer prices have been declining from their August peaks. In fact, by mid-February average wholesale prices were slightly lower than a year ago, while consumer prices were probably very close to their levels of February 1948. Prices of farm products in mid-February were 8 per cent and foods 6 per cent below a year ago. Average prices of commodities other than farm products and foods were only 3 per cent above a year ago, and have been virtually unchanged on the average since August, with prices of most commodities in their group other than metals generally either remaining stable or drifting down. Retail sales have recently shown substantial evidence of increasing consumer resistance. When figures become finally available on department store sales for February they will probably show a decline from a year ago despite intensified merchandising efforts.

Though employment has continued at generally very high levels there have been recent declines. Claims for unemployment compensation increased more than seasonally and by mid-February they totaled about 750,000 or 45 per cent higher than a year ago.

Notwithstanding these developments I strongly emphasize the need for making the System's authority adequate to cope with inflation. I certainly
hope that there will not be further inflation. My emphasis rather re-
reflects my concern that our System at all times be equipped to cope with 
whatever monetary problems we may be facing.

The Reserve System today is far better equipped than ever before
to help offset deflationary forces should they actually develop. A major
deficiency of the banking system that has aggravated business contrac-
tions in the past—the inability of the central bank to provide adequate 
funds when needed by the market—no longer exists. The System has virtu-
ally unlimited means of supplying the market with additional reserves 
through purchase of Government securities. The Reserve Banks at present 
hold 23 billion dollars of gold certificate reserves, and, on the basis 
of existing legal gold reserve requirements, the System could more than 
double its outstanding note and deposit liabilities. Moreover, as a 
result of the liberalized lending authority provided by the Banking Act 
of 1935 advances can now be made on any assets of member banks that are 
acceptable to the Reserve Banks as security. Thus the supply of funds 
will not be undesirably restricted by the need to adhere to "eligibility" 
rules. Further, when other lenders are not available, the System em-
powered to make direct loans to business firms for working capital pur-
poses. Finally, the System can always contribute to monetary ease gener-
ally by a reduction in reserve requirements and in special areas through 
relaxing instalment credit and margin requirements.

My point, then, is that monetary policy must be as adequately fore-
armed to cope with expansive forces in the economy whenever they occur as 
it now is to counteract the forces of contraction (always bearing in mind 
that on the downside our major contribution is to create a monetary cli-
mate favorable to business expansion; the forces that generate expansion 
lie outside the realm of monetary policy alone). Only if the System is 
forearmed can we have the full advantage of the stabilizing potentiali-
ties of action in the monetary sphere—about which I have already indi-
cated my optimism. It is my conviction that monetary policy, along with 
coordinative action in the fiscal area, can contribute a great deal to 
curbing the effects of unstabilizing elements in our economic life. How-
ever, I want to emphasize again the essential role that timing will always 
play in determining the success or failure of even the best of available 
weapons. Not only must we have the power to act, but it is essential 
that our action be undertaken in the right amount at the right time.

In conclusion, I would like to say that my interest in this general 
monetary approach to economic stabilization is based not only on my op-
timism with regard to its results. My interest is also based on the con-
viction that this is a good approach for a free competitive economy. It 
calls for no great expansion of the allocative powers of Government over 
the nations's resources. It calls for no proliferation of Government 
directives—the mechanism of a regimented economy. Rather, it promises 
both economic stability—which we somehow have to achieve—and economic 
freedom—which we dare not give up.