FRBSF Weekly Letter

April 4, 1986

"Any Bonds Today?"

Any bonds today?
Bonds of Freedom, that's what I'm selling,
Any bonds today?
Scrape up the most you can, here comes the freedom man,
Asking you to buy a share of freedom today.

The words and music were by Irving Berlin, a gift to Treasury Secretary Henry J. Morgenthau who copyrighted the ballad on behalf of the Treasury early in 1941 for use as the official theme song of the National Defense Savings Program. As events already had begun to demonstrate, the defense buildup in response to darkening war clouds abroad would shape the nation's economy in the decade of the 1940s.

This *Letter* discusses the impact of war-related activities leading up to and following Pearl Harbor — a period that little more than one-quarter of today's population is old enough to remember — and how they influenced monetary policy and the Federal Reserve System.

While the storm clouds gather . . .

In 1935, Army Chief of Staff MacArthur warned that successive cutbacks had weakened the nation's defense capabilities "below the danger line." Between 1935 and 1939, defense spending rose slowly to $1.4 billion, or 16 percent of federal budget outlays. In January 1939, eight months before the German and Soviet invasion of Poland and the official start of World War II in Europe, President Roosevelt gave a special message to the Congress in which he asked for a $500 million appropriation for national defense, including $100 million to commence stockpiling strategic materials. Over vocal opposition, his request was granted at mid-year.

War broke out in Europe in September, and in the ensuing two years prior to Pearl Harbor, efforts to make America the "Arsenal of Democracy" rapidly gained momentum. During the German breakthrough in France in May 1940, FDR noted the "swift and shocking developments" with a "new element — air navigation — which steps up the speed of possible attack to 250 to 300 miles a hour." He called the nation to gear up to produce 50,000 planes a year (during the previous year production had doubled to 12,000 planes), and also requested and received a $900 million appropriation to modernize the armed forces.

While *Life* magazine (at 10 cents a copy) queried "Will the U.S. mobilize its industrial might in time?", FDR established an Advisory Commission on National Defense under the direction of Ford production manager William S. Knudsen. The Commission would develop plans to mobilize all areas of production in the nation's economy — a task that eventually was to be implemented by at least two dozen major agencies charged with responsibilities ranging from resource allocation to production and price control. Through the twelve Federal Reserve Banks, field programs were established to contact and advise small businesses of the procedures for obtaining government defense contracts.

"Arms for the love of America"

In July, FDR requested and received a $5 billion appropriation primarily for a "two ocean navy." (One key Senator called the request "outrageous.") At his urging, Congress also passed legislation authorizing an embargo on the export of "basic war materials." Early in 1941, Congress passed the "Lend Lease" bill, which granted an initial $7 billion appropriation to finance the sale, lease or transfer of "any defense article" to "any country whose defense was deemed vital to the United States."

The rapidity of the defense buildup was such that defense spending accounted for one-half of the $25 billion rise in GNP in 1941. It was by far the major contributor to the 4.7 million rise in employment between 1939 and 1941, and the attendant drop in the unemployment rate from 17 to 10 percent. The latter was aided by adoption of the first peacetime Selective Service, which tripled the armed forces to 1.6 million just prior to Pearl Harbor. (Enacted in August 1940, the draft was renewed a year later by only a one vote margin in the House of Representatives.) In 1941, virtually all of the nearly 3 million net increase in civilian jobs occurred in defense industries and on the federal government's payroll.

Our daily bread

The expansion in employment was accompanied by an appreciable rise in hourly earnings and the length of the workweek. Average hourly pay in manufacturing rose to 73 cents in 1941 from 63 cents in 1939, the workweek to 41 hours from 38, and weekly earnings to $29.93 from $23.94. (The minimum wage in covered industries was 30 cents an hour.) The construction industry led the pay scales at $1.01 an hour ($35 a week), while retail trade logged 50 cents an hour — $24.42 a week or about $1,250 a year. Non-salaried doctors earned an average of $5,100 in 1941, lawyers, $4,800, and employees of the Federal Reserve System, $1,740 — less than what they earned in 1929 and 1933.

The impact of the rapid defense buildup on economic activity was particularly evident in the Twelfth District where employment and total personal income increased by about 23 percent and 40 percent respectively between 1939 and 1941, including a 34 percent rise in per capita income to $974 — 22 percent above the national average.

At the same time, prices in 1941 were very low — about one-eighth today's level as measured by the Consumer Price Index. A good apartment in San Francisco could be rented for $30-$60 a month and a new home purchased for $5,500, including 10 percent down and monthly payments of $36. A five cent fare on public transportation would convey a discriminating palate to any one of a number of good Italian restaurants for a 65-75 cent six-course dinner. To cap the evening out, 25 cents would provide admission to a downtown theater showing "The Maltese Falcon" or "International Squadron" ("Starring, in his most important role by far — Ronald Reagan.")

The economics of Armageddon

But while prices generally were low by today's standards, they also were increasing — consumer prices rose by 10 percent and commodity prices by 18 percent during the two years 1940-41. Concerned over this development and the inflationary potential of both the burgeoning defense program and the large reservoir of liquidity that lay dormant in the excess reserves of the banking system (over $6 billion, or almost one-half of member banks' total reserves), the Board of Governors and the Reserve Banks submitted a special joint report to the Congress in December 1940 embracing three principal recommendations.

They urged that (1) government expenditures, including the defense program, be financed with *existing* deposits rather than new bank deposits created through open-market purchases, (2) a progressively larger portion of defense and other expenditures be financed with taxes, and (3) the budget be balanced as the economy approached full utilization of its capacity.

In fact, at President Roosevelt's urging, the Congress raised personal and business taxes rather stiffly in 1940 and 1941. The raise included imposition of an excess profits tax "so the few don't gain at the expense of the many . . . and so no one will be enriched by the national rearmament effort." Nevertheless, while the increase in taxes raised revenues to $9 billion in 1941 (and $15 billion in FY 1942), they still failed to cover the rise in expenditures.

As a result, borrowing and the outstanding public debt rose substantially — the latter reaching about $64 billion at the end of 1941 from $48 billion in 1939, of which $2.3 billion was held by the Fed. (In their capacities as fiscal agents for the Treasury, the Reserve Banks played a major role in the bond sales campaigns, as they did during World War I. But as an anti-inflationary move, they reduced their own holdings of Governments by $200 million over this period.)

The nation's banks acquired about $5 billion and businesses and the general public the remaining $11 billion, including Defense savings bonds and stamps. Defense bonds carried an annual yield of 3½ percent when held to maturity — substantially more than the prevailing 2 percent yield on long-term governments, the 1/10th of one percent yield on Treasury Bills, and the 2½ percent on savings deposits.

Supporting the Treasury

To help restrain mounting inflationary pressures in the months before Pearl Harbor, the government imposed price ceilings on many key materials, and the Fed raised reserve requirements to the maximum limits permitted by law. The Fed also implemented Congressional authorization to impose controls on consumer credit, requiring a minimum down payment of 30 percent and maximum maturity of 18 months on big ticket items. (At that time consumer installment debt totaled $6 billion, compared with $545 billion today.)

Following America's entry into the war on December 7, the Board of Governors reaffirmed its policy of "assuring that an ample supply of funds was available at all banks for financing the war effort." In short, much as it had during World War I — except that this time the initiative for a support policy *originated* with the Fed, not the Treasury — the Fed agreed to "peg" (support) the prices of government securities by purchasing them from banks and security dealers whenever necessary to keep their prices (and yields) from fluctuating beyond a very limited range.

From 1941 through 1945 (the war ended in August), an $80 billion net increase in government outlays (to $93 billion) was by far the major factor contributing to a $87 billion, four-year rise in GNP (to $213 billion). Altogether, the government raised about $350 billion during the war years to pay the salaries of the nearly 12 million members of the Armed Forces and to cover the cost of producing the materials and tools they needed to do their job.

However, only about 38 percent of revenues, or $135 billion, was raised through taxes (Form 1040 was introduced in 1941 and tax withholding through payroll deductions, in 1943). The remaining 61 percent ($215 billion) was raised through borrowing and increasing the gross public debt by this amount to $279 billion. One hundred and five billion dollars of the borrowing — about one half — represented sales of bonds to private investors *other* than commercial banks, and $70 billion, sales to banks. The Fed acquired $22 billion of government securities in the market in connection with its support or "pegging" policy, and the remaining $18 billion was acquired by government agencies and trust funds. Government securities accounted for all but $4 billion of the $73 billion net increase in total commercial bank loans and investments during the war.

In 1942, the Chairman of the House Banking Committee, Congressman Wright Patman, (D-Texas), urged that the government finance its expenditures simply by printing new money rather than by borrowing, in order to save the interest costs on a rising debt. Fed Chairman Eccles replied that there "was no escape from the truth that someone must pay for everything" and that while, ideally, taxes rather than borrowings should finance more of the war cost, the inflation that would result from printing money rather than tapping savings to the greatest extent possible would be a "disaster."

"The March of Time"

The policy of substantially monetizing the Treasury's huge borrowing requirements resulted in a more than doubling of the money supply during the war (and a near tripling from the time of the defense buildup early in 1940), together with a tripling in the volume of liquid assets accumulated by the public. (Individuals alone effected a fivefold increase in their holdings of government securities.)

The impact on *prices* of the huge increase in liquidity was muted during the war by the imposition of rationing and comprehensive wage and (except for securities and real estate) price controls, but prices still rose by 24 percent. A month after the war ended, an article in the *Federal Reserve Bulletin* noted that "the holding of these liquid assets by business and individuals in such large volume constitutes a new factor, one not present in the previous period. The manner and extent to which (they) will significantly affect the functioning of the postwar economy is difficult to determine in advance. They could lead to inflationary developments if there is a rush to purchase scarce goods before production increases or if there is a wave of speculation . . . (but) they can also have a stabilizing influence on the economy through providing funds for individuals and bankers to use during recession periods."

As events shortly were to prove, *both* assessments were correct. And four more years were to pass before the System was able to pursue a monetary policy "independent" of the Treasury. The problems that the System faced in attempting to adjust its policy focus in the "Brave New World" following the end of World War II will be the subject of a future *Letter*.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/12/86	Change from 3/5/86	Change from 3/13/85 Dollar	
Loans, Leases and Investments[1] [2]	201,779	− 518	12,581	6.6
Loans and Leases[1] [6]	182,880	− 504	11,347	6.6
Commercial and Industrial	52,805	− 272	− 312	− 0.5
Real estate	66,271	− 80	3,854	6.1
Loans to Individuals	38,506	60	5,562	16.8
Leases	5,570	− 79	241	4.5
U.S. Treasury and Agency Securities[2]	10,840	58	135	1.2
Other Securities[2]	8,059	− 72	1,098	15.7
Total Deposits	200,714	−1,749	7,114	3.6
Demand Deposits	47,695	−1,932	3,586	8.1
Demand Deposits Adjusted[3]	32,539	− 120	3,525	12.1
Other Transaction Balances[4]	15,382	− 258	2,101	15.8
Total Non-Transaction Balances[6]	137,637	441	1,427	1.0
Money Market Deposit Accounts—Total	45,959	132	2,007	4.5
Time Deposits in Amounts of $100,000 or more	37,823	187	− 1,160	− 2.9
Other Liabilities for Borrowed Money[5]	25,599	146	6,632	34.9

Two Week Averages of Daily Figures	Period ended 3/10/86	Period ended 2/24/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	22	71
Borrowings	30	191
Net free reserves (+)/Net borrowed(−)	− 8	− 119

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change