
FRBSF WEEKLY LETTER

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Adjusting the Focus

Inflations seldom get out of hand during wartime, but the danger carries over after peace comes and a war weary people, tired of wartime controls and restraints, are eager to throw them off. This is just the time when it may be fatal to relax prematurely the control of war-engendered inflationary forces.

So warned Marriner Eccles, Chairman of the Board of Governors, in testimony before the Senate Banking and Currency Committee in 1944 — a year before the end of World War II. This *Letter* discusses the problems experienced by the nation's economy in converting from wartime to peacetime production, including the difficulties faced by monetary policy.

Brave new world

Contrary to widespread expectations, the conversion to a civilian economy proceeded with considerable zip. A 60 percent drop in federal government outlays between 1945 and 1947, an initial drop in industrial production in 1946 of about 15 percent, and rapid demobilization of the armed forces, which more than doubled unemployment to 2.4 million (or 4 percent of the labor force), did not slow it down.

The public had tripled its holdings of liquid assets during the War, and these assets, which were available to support a strong demand repressed by wartime controls, were partly responsible for a post-war surge in consumer spending and private investment. The surge resulted in a rise in *employment* of 5 million and a rise in *nominal* output of 10 percent between 1945 and 1947. However, because of a 30 percent increase in prices over the same period, real (inflation-adjusted) output *declined* by over 20 percent.

Inflation was fed in part by pent-up demand (and supporting liquidity), and in part by wage increases that averaged 15-20 percent over 1946-47. In 1946, 116 million man-days were lost through wage-related strikes — four times the previous record in 1937. Material allocation controls and rationing had been eliminated shortly after the war ended, taxes reduced, and the excess profits tax also eliminated. Wage and price controls were abolished in the spring of 1946, and prices rose sharply.

Fed Chairman Eccles had protested the elimination of controls and reduction of taxes so soon after the war to no avail. In subsequent testimony before Congress on the inflationary potential of "our enormous money supply," he noted that progress had been made in limiting the money supply's further growth through a sharp reduction in government spending and borrowing.

However, the net reduction in the outstanding debt (\$22 billion between 1945 and 1947), accomplished by drawing on the Treasury's balances, actually contributed to a further, albeit slower, increase in the private money supply. This increase in the money supply took place in spite of a modest net reduction (\$2 billion) in the Fed's holdings of U.S. government securities which exerted a tightening effect on bank reserves. Moreover, the funds which banks received from redeeming over \$20 billion in *their* holdings of government securities gave them the means to expand their lending.

Engine of inflation

The Federal Reserve system was thus confronted by a dilemma much like that it faced at the end of World War I. To facilitate the Treasury's operations, it could continue to support the Treasury's bond price and rate "pegging" policy — as the Treasury insisted, or it could allow more flexibility in the interest rate structure (i.e., higher yields) to gain better control over money and credit. The former would increase inflationary pressures, while the latter would increase the Treasury's financing costs and inflict losses on holders of government securities, who had been urged to buy them at lower rates to help finance the war.

Following the passage in 1946 of the landmark Employment Act, the situation became increasingly anomalous. This Act declared it to be the "continuing policy" of the federal government "to promote maximum employment, production and purchasing power." The Board of Governors strongly endorsed the legislation as consistent with Chairman Eccles earlier but unheeded recommendations in 1935, but resisted efforts to endorse more specific criteria or objectives for monetary policy on the grounds that the latter "calls at all times for the weighing

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of a great many different factors and the attaching of the same factors at different times."

Pressures to continue supporting the Treasury's policy proved not only to inhibit efforts to control inflation, but, as it turned out, also to hamper the System's ability to deal with a recession in 1949. As private demands for credit slackened that year, banks purchased government securities and thereby put upward pressure on securities' prices and downward pressure on their yields. Maintaining the pattern of yields compelled the System to sell government securities — a process which absorbed reserves and exerted a contractionary effect on the economy.

Encounter . . . and accord

Early in 1950, System efforts to regain a substantial degree of "independence" in the conduct of monetary policy received support from the Congressional Joint Economic Committee (JEC). However, the policy of supporting the Treasury was strongly endorsed by President Truman, who had refused to re-appoint Marriner Eccles Chairman of the Federal Reserve when his term expired in 1948 (Eccles stayed on as a Board member until July 1951).

Late in 1950, Truman wrote a letter to Board Chairman Thomas McCabe expressing his dismay over an article in a New York newspaper which claimed the Board was undercutting Treasury financing operations. The President claimed that the Korean War's financing requirements necessitated stability in the government securities market. Truman subsequently called the Federal Open Market Committee — the Fed's chief monetary policymaking body — to a meeting at the White House, after which he issued a press release stating that the Fed had "pledged its support . . . to maintain the stability of long-term governments as long as the (Korean War) emergency lasts."

In a letter to the President a few days later designed to clarify *its* intent, the FOMC made four points: (1) the System would do all in its power to maintain confidence in government securities and the dollar; (2) the control of bank reserves was essential to this objective; (3) that charges that the FOMC favored high interest rates "confuse the issue" — its real objective being more effective control over the creation of money; and (4) the System would try to work out an agreement with the Treasury both to safeguard confidence in outstanding government

securities and to protect the purchasing power of the dollar.

Finally, on March 4, 1951, the System and the Treasury signed an "Accord" in which the System agreed to maintain an "orderly market" in government securities, but without a commitment to support them *at par*. The "Accord" represented a milestone in that it enabled the System, for the first time since the mid-thirties, to regulate bank reserves and the money supply effectively, and to exercise independence from strong political pressure — in this case pressure from the Executive branch — in conducting monetary policy.

The Korean War . . .

The military buildup which accompanied the Korean War boosted government expenditures sharply, but taxes were increased, and, as a result, budget deficits in FY 1951-53 (the year the war ended) aggregated only \$4 billion. On balance, the Fed acquired \$6 billion of government securities during the period while commercial banks and the public together made comparable net reductions in their holdings.

To help restrain inflationary pressures, discount rates and reserve requirements were increased (as in World War II, the Reserve Banks again arranged and administered guarantees for war production loans under a reactivated "V" loan program), and the System again administered Congressionally mandated controls over consumer and (for the first time) real estate credit. After an initial jump of about 6 percent in the six months following the outbreak of the war, the Consumer Price Index rose by only an additional 6 percent over the next two-and-a-half years, and, significantly, did not spurt following the end of the war.

. . . and Viet Nam

Growth continued in an environment characterized by general price stability until the beginning of the Viet Nam buildup in the mid-1960s. In fact, over the two decades of the 50's and 60's, industrial production almost tripled and real GNP more than doubled (averaging annual increases of 5 percent). Employment rose by 20 million (or over 30 percent) and helped boost aggregate personal income by over 250 percent.

Moreover, due to the relatively low rate of inflation — consumer prices rose at an average annual rate of only 2.6 percent during the two decades — most of the gains were "real." That

is, per capita income *after* inflation rose by 61 percent. Stability in financial markets also was evident in a low level of interest rates: the prime rate did not hit 5 percent; mortgage rates, 6 percent; and the Fed's discount rate, 4 percent, until the mid-1960s. Treasury Bill rates didn't reach 5-6 percent until the end of the 1960s, under pressure from sharply rising government expenditures in support of the war in Viet Nam and the Great Society.

Adjusting the focus

From the mid-fifties until 1960, the Fed generally followed a policy of purchasing and selling "bills only" to influence bank reserves. That is, open market operations essentially were limited to the buying and selling of short-term T-bills to minimize the effects on the prices and yields of longer term securities. In the process, various concepts of reserves came to be used as operating targets, including "non-borrowed" and "free" reserves, and terms such as "active ease," "ease," "neutrality," and "restraint" were used to describe policy — all of which focused, in essence, on interest rates rather than the money supply.

The first comprehensive critique by the System in which the term "money supply" and its various measures and functions were used, including its influence on national output and economic activity, was prepared for the JEC in 1952. However, William McChesney Martin, who had become Chairman in 1951, consistently argued that "no single index or single combination of factors can serve as a continuing, infallible guide (to monetary policy)."

Subsequently (in 1964), Milton Friedman urged that the FOMC be subject to a "legislated rule . . . which specifies that the quantity of money shall grow at a steady rate from week to week, month to month and year to year," on the grounds that knowledge of the economy and of the effects of System actions on it simply were imperfect. However, the System reaffirmed a stance in favor of discretionary and flexible operating procedures for much the same reason: that imperfect knowledge made policy formulation by rule or formula ineffective.

From the time of the Fed-Treasury "Accord" in 1951 to the end of the 60's, growth in the money supply (M1) averaged less than 4 percent

a year — an achievement which clearly contributed to the relatively low average annual rate of inflation. During the late sixties, the FOMC moved in the direction of using the Fed funds rate (the rate charged by banks to each other for borrowing excess reserves) rather than member banks' nonborrowed or free reserves as its operating target. In the face of rising demand pressures, including pressures on the credit markets exerted by the expanding borrowing needs of the federal government (outlays reached \$178 billion in 1968, accompanied by a record peacetime deficit of \$25 billion), efforts to keep the Fed funds rate within its FY target by supplying more reserves resulted in faster growth in the money supply.

Supported by a 60 percent increase in the System's open-market portfolio from 1965-69 and a 30 percent increase in member bank reserves, increases in various measures of the money supply during this period ranged from 27 to 41 percent. In the context of slowing productivity and rapidly rising wages, prices and interest rates were moving up at an accelerating pace by the end of the decade.

A look back . . . and ahead

A memorandum prepared by economists at the San Francisco Fed in 1968 reviewed earlier in-house debates and warned of the potentially dire economic consequences of policies designed to accommodate *both* "guns and butter," especially in the absence of a substantial increase in taxes. The Board of Governors noted in its 1969 *Annual Report* that moves to restrain money growth during that year (when consumer prices rose 6 percent) were necessitated by "deeply rooted expectations of continuing inflation." Efforts at monetary restraint were aided that year by a small (\$3 billion) surplus in the federal government's budget.

Fiscal year 1969's \$3 billion surplus, however, gave way to an uninterrupted succession of deficits over the next seventeen years, which were to dwarf everything that had preceded them in the nation's 194-year history. A future *Letter* will discuss developments affecting monetary policy and the nation's economy in the turbulent decade of the 1970s.

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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.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from 4/3/85	
	Outstanding 4/2/86	from 3/26/86	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	202,349	1,632	11,833	6.2
Loans and Leases ^{1 6}	183,873	1,658	11,424	6.6
Commercial and Industrial	53,187	752	27	0.0
Real estate	66,562	90	3,919	6.2
Loans to Individuals	38,931	— 46	5,620	16.8
Leases	5,643	— 8	283	5.2
U.S. Treasury and Agency Securities ²	10,600	32	— 553	— 4.9
Other Securities ²	7,876	— 58	961	13.8
Total Deposits	205,244	5,922	7,143	3.6
Demand Deposits	51,565	4,855	4,174	8.8
Demand Deposits Adjusted ³	34,514	2,466	4,682	15.6
Other Transaction Balances ⁴	16,249	1,045	2,121	15.0
Total Non-Transaction Balances ⁶	137,431	23	851	0.6
Money Market Deposit				
Accounts—Total	46,396	493	2,369	5.3
Time Deposits in Amounts of				
\$100,000 or more	37,199	— 550	— 1,743	— 4.4
Other Liabilities for Borrowed Money ⁵	27,341	777	8,027	41.5
Two Week Averages of Daily Figures	Period ended 3/24/86	Period ended 3/10/86		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (—)	135	22		
Borrowings	10	30		
Net free reserves (+)/Net borrowed(—)	125	— 8		

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