

STAFF MEMORANDUM

THE PROBLEM OF CONTROLLING CREDIT EXPANSION WITHOUT SERIOUS INJURY TO THE MANAGEMENT OF THE PUBLIC DEBT

Introduction

The following discussion begins with a statement of the logic of traditional general credit restriction to combat inflation. Then we discuss the changed conditions which make such restriction ineffective under present conditions as a means of curbing excessive loan expansion to business, and which convert it into a specific attack on the Government bond market. We next examine the alleged anti-inflationary effects of a moderate rise in interest rates. Then we consider the dangers under present conditions of a vigorous and indiscriminating restrictive credit policy. Finally, we summarize the main requirements of sound private and public credit in the present situation and examine various possible measures whereby these requirements may be met.

I - The Logic of Traditional General
Credit Restriction to Combat Inflation

The present demand of the Federal Reserve authorities and other persons for an indiscriminating restrictive credit policy to combat inflation is in keeping with a long tradition. It was a sound tradition in the circumstances in which it arose. But a method of control that was well enough adapted to a banking system in which the bulk of bank assets consisted of business loans cannot be effectively or safely applied without modification to one in which the bulk of bank assets consists of Government securities.

The logic of a traditional general restrictive credit policy can be simply summarized as follows:

Inflation is caused by excessive spending relative to the output of the goods and services desired by the public. Although an excessive volume of spending can develop without additions to the supply of money, it is powerfully stimulated by such additions, and it can be checked and reversed by reductions in the money supply. This is particularly true of bank deposits created by bank loans. Such deposits are promptly spent because the borrowers pay interest for them and are therefore anxious to employ them fully. If bank loans can be stopped from expanding or be actually reduced, the total volume of private spending will almost certainly be curtailed.

During 1950, the expansion in loans of all commercial banks in the United States amounted to \$9.7 billion. Their loans to business expanded \$5 billion and their real estate and consumer loans each expanded by about \$2.5 billion. The net increase in the money supply of the country during the year was \$6.4 billion. A part of the growth in the money supply due to the rise in bank loans was offset by a reduction in bank holdings of securities and other factors.

Unless the creation of new money via bank lending is limited, we cannot halt the march of inflation by increasing taxes. By itself, an increase in taxation is one of the most effective means of combating inflation, since it directly reduces private spending power. But the effect of a given increase in taxes is largely or wholly destroyed if an equal amount of new spending power is permitted to be created through bank loans.

The traditional method of stopping or reversing an expansion in the aggregate volume of bank loans and bank deposits is to reduce the lending power of the commercial banks. This has already been done in part by raising the required reserves of member banks, which account for about 4/5ths of total bank deposits, but we have virtually reached the statutory limit in this direction. Another step already taken has been to raise the discount rates at which the Federal Reserve banks are prepared to rediscount business and agricultural paper previously discounted by member banks for their

customers and at which the Reserve banks will make direct loans to member banks. This has the effect of making it more expensive for member banks to obtain additional reserves by rediscounting or borrowing at the Reserve banks. But its practical influence is small because rediscounting and borrowing are no longer the principal methods whereby member banks obtain additional reserves. Instead, they nowadays sell Government securities to the Reserve banks. Since the member banks own about \$52 billion of Treasury securities, they have a virtually unlimited source of additional reserves as long as the Reserve banks remain ready to buy Government securities at prices the banks will accept. And each dollar of additional reserves obtained by the member banks as a whole enables them to expand their loans and investments by about \$6.

Apart from moral suasion, which has already been attempted by means of public pronouncements and letters urging loan restriction, the only substantial remaining tool available to the Reserve System under present law is to stop adding to their holdings of Government securities on net balance or actually to reduce these holdings. When the member banks can no longer obtain new reserves by selling Government securities to the Reserve banks, they will be unable to increase the total volume of their deposits. And if the member banks or their customers buy securities sold by the Reserve banks, they will lose reserves of

approximately the same amounts, they will be forced to reduce the volume of their deposits by about six times the loss in their reserves. They will reduce their deposit liabilities by presenting maturing Treasury securities for redemption without replacing them, by failing to renew a portion of maturing loans, and by selling securities to the nonbank public. In this way, the expansion in the country's money supply will be brought to halt or reversed; and this source of inflationary spending will be eliminated.

The halting or reversal of the growth of member bank lending power would be accompanied by a rise in interest rates. It is contended by most, though not by all, advocates of tighter money that such a rise will exert additional anti-inflationary effects. We shall discuss these presently.

II - Changed Conditions Which Make A
General Restrictive Credit Policy
A Specific Attack on the Government
Bond Market and Only a Weak and In-
direct Attack on Excessive Business
Loan Expansion.

Restrictive Credit Policy Formerly Operated
Directly Upon Bank Loans to Business

The prescription of tight money and an accompanying rise of interest rates as an effective means of combating inflation arose abroad and in this country at a time when the bulk of the assets of commercial banks consisted of customer loans and other short-term business paper. In 1914, the marketable securities of all the commercial banks in the United States amounted to less than 22 percent of their earning assets. Most of their holdings consisted of loans to business enterprises. These were generally so staggered that some of them fell due every business day. Under these conditions, the banks could reduce the total volume of bank credit merely by making new loans or extending old ones in smaller amounts than those maturing. When the banks lost reserves, they did not have to sell large quantities of marketable securities. The borrowers whose notes were maturing provided an automatic market at par for their own notes.

A general restrictive credit policy under these conditions operated primarily as a selective restriction on loans to business and on the bank deposits and currency of business enterprises. A contraction of bank credit of this character could

not proceed far without critically reducing the money supply of the business community. This was particularly true prior to 1914 because it was then the fashion of business enterprises to finance a far greater proportion of their working capital requirements through bank loans than it is today. Even a moderate contraction of bank credit or the mere slowing up of the expansion, therefore, hit directly at a particularly active and strategic sector of the country's money supply, and commonly forced a contraction of business spending. High interest rates as such did not achieve this; a curb on the availability of bank credit was necessary to achieve it.

It Would Now Operate Mainly Against
Government Securities

But see how different the banking situation is today. At the end of June, 1950, loans of all kinds of all the insured commercial banks in the United States constituted only 37 percent of their earning assets. More than a quarter of their loans, moreover, consisted of real estate loans, which are akin in some respects to securities, though less liquid. The total of their commercial and agricultural loans was only 16 percent of their earning assets. Nearly two-thirds of their earning assets consisted of securities, mainly Federal government obligations.

The change in the institutional situation of banking means this: Whereas formerly a general tight money policy operated directly and immediately to restrict loans to business enterprises, today a general tight money policy means a specific attack upon the Government bond market, and only an indirect and weak attack on business loan expansion.

In order to achieve a reduction of 6 or 7 billion dollars of business loans, the weapon of a general restrictive credit policy would first have to wade through billions of dollars of Government securities owned by the commercial banks. These banks now hold nearly \$4 billion of Treasury bills, some of which mature every week and all of which mature within 13 weeks. If the Federal Reserve System sought to curb business loan expansion by refusing to add to their holdings of Government securities, the commercial banks could continue to obtain funds to expand their business loans merely by not replacing their maturing Treasury bills as they matured. Further, the commercial banks hold about \$18 billion of Treasury notes, most of which mature within a year. They hold large amounts of other Federal obligations with near-term maturities, from which they could obtain funds for continued loan expansion as these securities mature, without selling them in the open market. Besides waiting for their short-term holdings to mature, and some of them would mature every week, the banks could get additional funds by selling Government securities in the open market.

Capital Losses Unlikely to Prevent Substitution
of Business Loans for Treasury Securities
in Bank Portfolios

It is argued by some that the rise in interest rates which would accompany a tighter money policy by the Reserve System would cause such declines in the market prices of Government securities that the banks would be restrained from selling them because of the capital losses many of them would sustain and because the yields would be more attractive. But a moderate rise in interest rates would cause only small changes in the prices of short-term Government securities. For example, a 1-1/2%, one-year Treasury note would still sell above 99 if the short-term rate of interest went up from 1-1/2 to 2-1/2%. If a bank has a good commercial borrower at 3-1/2 or 4%, it is not likely to be deterred from selling its Treasury notes at 99 in order to obtain the funds for the new loan. Moreover, as previously noted, the banks own large amounts of early maturing Treasury securities which they could turn in to the Treasury for cash upon maturity without loss. Further, the higher yields on Treasury notes would not necessarily make their retention by the banks attractive if equal or greater increases took place in the yields obtainable from business loans. Experience tells us that such increases would undoubtedly take place.

In short, a moderate tightening of the money markets under present conditions will not provide an effective curb on business loan expansion because of the extremely large cushion of short-term Government securities owned by the banks, securities that they could sell or allow to mature in order to obtain funds for continued expansion of their loans.

Little Restriction on Lending by
Other Financial Institutions

We have indicated that a general restrictive credit policy by the Federal Reserve System would have to go a long way -- become more than moderate -- before it could seriously limit the expansion of banks loans to business. It would have even less, if any, effect upon the loan expansion of other financial institutions.

The big life insurance companies, for example, function as capital banks. They gather the idle cash and current savings of millions of small savers and lend them out to business enterprises and individuals who make active use of them. The excess of premium and interest receipts over policy redemptions and operating disbursements of the life insurance companies is now running at around \$4 billion a year, enabling them to make this volume of funds available annually for investment spending, mainly by borrowers. It is well known that the big insurance companies now compete actively with commercial banks for many business loans,

and that they provide an important fraction of the total long-term loans for industrial plant expansion and residential and other construction. The mutual savings banks, Home Loan banks, savings and loan associations, fire and casualty insurance companies, and other financial institutions also provide large sums each month for new investment spending.

Such loans do not nominally add to the supply of money, but they are no less effective in financing increased spending. They activate the idle cash and current savings of millions of small savers. If inflation is to be fought effectively through credit weapons, non-bank lending must also be restricted. The small contribution to this end offered by an indiscriminating restrictive credit policy would be that achieved through the influence of higher interest rates, the feeble effects of which we discuss in the next section.

The great growth in the monetary importance of non-bank credit institutions has been recognized increasingly in this country and abroad. The Board of Governors of the Federal Reserve System has sought and obtained selective credit controls over some areas of non-bank lending. It obtained control over stock margin requirements under the SEC legislation of 1934. It obtained temporary control of consumer credit (its Regulation W) during World War II, and this control was recently renewed by Congress and is again in effect. Last fall it sought

and obtained considerable power over construction loans (its Regulation X). There is little doubt that it would like some control over the lending and investing activities of insurance companies and other non-bank financial institutions. These movements in the direction of specific or qualitative controls over credit in various fields clearly indicate that the Federal Reserve System is aware of the inadequacy and inappropriateness, for some purposes, of an indiscriminating general credit curtailment policy.

The business community and the public are also far more insulated against restrictive banking action than they formerly were. Whereas most of their money supply formerly arose from short-term debts to banks -- a fact which made them sensitive to banking policies -- most of it is now owned by them free of any direct short-term debts to the banks. In addition, they now own billions of dollars of marketable or redeemable Government securities, whereas they formerly held only small amounts of such assets. In June 1926, the loans, including real estate loans, of all commercial banks amounted to 114 percent of the total of their adjusted demand deposits and of the currency in circulation outside of banks; by the end of 1950, they constituted only 45 percent. At the end of 1950, individuals held more than \$200 billion of liquid assets, as compared with less than \$20 billion in the middle of 1914; and corporations held some \$48 billion, as against approximately \$1 billion in 1914 (liquid

assets being defined as currency, demand deposits, savings accounts in commercial and mutual savings banks, savings and loan associations, postal savings, and holdings of Federal Government securities).

During the calendar year 1950, the gross expenditures of business corporations for plant and equipment, additions to inventories, and increases in net receivables, amounted to about \$28 billion. About seven-tenths of the \$28 billion they used in these ways came directly from their retained earnings and depreciation allowances. About \$4 billion came from new issues of securities; and only about \$3.5 billion came from increases in bank loans and in mortgages bought by banks and other lenders.

III - Small if Any Anti-Inflationary Effects Can
Be Expected from Moderate Increases in
Interest Rates.

Higher interest rates are said to exert anti-inflationary effects in several ways. Let us examine each of them briefly:

(1) They discourage borrowing and the accompanying spending by making it more costly.

Few persons nowadays attach much importance to moderate increases in interest rates as a deterrent to short-term borrowing by business enterprises. The gross profit margins in manufacture and trade are sufficiently wide to swamp the influence of moderate changes in interest costs. A department store that borrows \$100,000 for 3 months to buy goods to retail for \$160,000 would find that a rise from 3 to 6 percent in its interest rate would raise the cost of the goods by only \$750.

Increases in long-term rates should logically be more influential, but even here the records show that changes in expected volume of business and in expected income are so much more important than the cost of borrowed money that actual borrowing and construction have generally been at their peak in times of high interest rates and have been smaller when interest rates were lower.

(2) The declines in the prices of Government securities occasioned by the rise in interest rates would discourage commercial banks from selling them because of the capital losses they would sustain; hence, they would be deterred from expanding their

business loans with the proceeds of sales of Government securities. We discussed this contention a few pages back.

(3) At higher yields, Treasury securities would attract new savings flowing to insurance companies and other institutional investors against the competition of new private investment opportunities. Private investment spending would thereby be reduced. To the extent that the securities so purchased came from the portfolios of commercial banks, the volume of bank deposits would also be reduced.

Whether current savings can be diverted to Treasury securities in materially greater amounts would seem to depend more upon whether a sufficient volume of attractive private investment outlets continues to be available for such funds than upon a rise in interest rates. If private investment spending were seriously curtailed by direct controls or by shortages of materials and labor, current accessions to institutional funds would have no other place to go than into Government securities. This was the situation during World War II. If, on the other hand, residential mortgage financing and new corporate bond issues continue to be available in adequate amounts, a rise in the yields of Treasury obligations would be accompanied by as great or greater increases in the yields obtainable from high grade private investments. This has occurred consistently in the past when yields on Treasury securities have risen.

Too many persons appear to assume that the yields of the private obligations would stay put if those of Treasury securities rose. The average yield of the Treasury's index of high grade corporate bonds at the end of November, 1950 was 2.66 per cent. Does anyone suppose that these corporate bonds would remain at this yield if long-term Treasury bonds came to command 2-3/4 or 3 per cent? Treasury securities possess certain characteristics not shared by other investments, or shared by them in much lesser degree, such as freedom from risk of insolvency of the debtor, easy acceptability as security in legal connections, unexcelled marketability, etc. The market could be expected to continue to appraise these relative advantages at a substantial figure and to offer lower prices for investments lacking them. In short, if the yields on Treasury obligations rose, those on high grade corporates would rise as much or more. Some funds that would otherwise go into new private investments would no doubt be attracted to Government securities by a rise in their yields, but the equal or greater rise in the returns offered by private obligations would continue to make them attractive for new investment.

(4) Higher interest rates would stimulate additional saving.

In the absence of severe shortages of desired consumption goods, the savings of individuals are primarily responsive to the level of their incomes and to the prevailing standards of consumption and saving. They are not highly responsive to increases

in interest rates. Few housewives are likely to forego the purchase of an electric refrigerator because the yield obtainable from Savings Bonds rises from 2.9 to 3-1/2 or 4 per cent. In fact, a rise in interest rates would reduce some important kinds of saving. The net premiums payable on life insurance policies, which account for a substantial volume of individual savings, would become smaller. So also would the annual amounts of savings required to accumulate a given capital sum or a given annuity. Economists possess no factual knowledge of the responsiveness of total savings to changes in interest rates. They do not even know the direction of the response -- that is, whether more tends to be saved at higher or at lower interest rates.

(5) Many bank depositors would be induced by the higher interest rates to convert their deposits into securities purchased from the banks, thereby reducing the disposition of the purchasers to spend, and reducing the total of bank deposits.

This may well be the tendency, but no evidence exists to indicate that the actual effect would be large. An uncertain fraction of bank deposits is regarded by their owners as a prized form of property, fixed in dollar value and instantly available, but not destined for spending under ordinary circumstances. The owners set greater store on the absolute safety and availability of their principal than upon yield. If they did not, they would already have invested their deposits in Government securities. Moreover, even if an appreciable amount of such deposits were invested into Government securities, the anti-inflationary effect would be

negligible, for the deposits themselves are regarded by these owners as a form of investment, not available for spending.

Another portion consists of funds held temporarily to meet corporate and individual tax liabilities or contemplated expenditures. Because of the high level of tax liabilities in recent years, substantial deposits are accumulated to meet them. Principally for this reason, business corporations already constitute a good market for short-term Treasury obligations; they hold about \$9 billion of Tax Notes alone; and a rise in yields might attract a somewhat larger volume of funds. But no significant anti-inflationary result is achieved when idle deposits held for tax payments are converted into Treasury securities. A rise in interest rates would give an unsought bonus to present holders of securities, without reducing the spending of those who would be induced by the higher rates to convert additional such deposits into Treasury securities.

Perhaps the largest portion of bank deposits consists of those used for transactions purchases. It is possible that higher interest rates would attract some of these into Government securities, but no one could confidently say that the amount would be large. The anti-inflationary effect of such conversion as did occur would be offset to an unknown and perhaps substantial

extent because the remaining deposit balances would be used more actively. The annual rate of turnover of bank deposits has increased materially in recent years but is still far below the rate in 1929 and prior years. Small anti-inflationary results are achieved by a sale of Government securities to individuals and business enterprises who regard these securities as close substitutes for cash, as freely available for spending.

IV - Dangerous Possibilities of an Undiscriminating Restrictive Credit Policy

We have hitherto assumed for purposes of discussion that a general restrictive credit policy could be kept moderate in its impacts. In particular, we assumed that non-bank investors would readily absorb the Government securities liquidated by the banks or offered by the Treasury to refund bank-held maturing obligations. This is by no means likely.

The mistaken assumption is commonly made that the non-bank market for Government and other high grade securities is highly responsive to small change in interest rates. The Treasury's extensive experience and that of investment banking houses clearly indicates otherwise. Let us see why.

1. Non-bank institutional investors cannot buy large amounts suddenly.

The biggest investors in marketable Government and other high grade securities are institutions - insurance companies, commercial and savings banks, trustees, pension funds and business corporations holding Government securities for temporary investment, either in anticipation of corporate tax liabilities or contemplated expenditures.

On December 31, 1950, of the \$218 billion of the United States government obligations, direct and indirect, held

outside of government agencies, the commercial banks and Federal Reserve banks held a total of \$82 billion, the mutual savings banks and insurance companies \$30 billion, business corporations \$19 billion, other institutional accounts, including brokers and dealers, \$11 billion, and state and local governments \$5 billion. This left \$67 billion in the hands of individuals; and \$50 billion of their holdings was in the form of savings bonds and only \$17 billion in the form of marketable securities.

The non-bank institutional investors secure their funds day by day through the receipt of premium payments, deposits, dividends, interest, rents, and profits; and they usually invest them rather promptly at the going rates, as the receipts come in. They rarely hold large amounts of idle cash. Hence they cannot enlarge their purchases of Government securities greatly in any short space of time except by liquidating other investments. But the principal market for other high grade investments is amongst themselves and the banks. As a group the non-bank investors cannot procure new funds for buying Governments by selling other investments to one another. The funds obtained in this way by the sellers among them must be given up by the buyers.

Moreover, as we have previously noted, the yields on other high grade investments will also rise if the yields on

Treasury securities increase. Attempts to liquidate these competing high grade investments by those desiring to switch to governments will drive down their prices, push up their yields, and thereby tend to maintain their relative attractiveness as against Treasury securities.

Any substantial volume of additional Government securities can be sold to institutional investors in a short space of time only if new investment outlets for their incoming funds, such as new corporate bond issues and residential mortgages, are greatly reduced, as they were during World War II. Over a longer period, an increase in the public's savings in the form of life insurance premiums, savings deposits, and the like, will add to the investment resources of the institutional investors, but no large increase can be expected in any short space of time.

Similarly with the investment resources of individuals. In the aggregate individuals cannot obtain any net increase in funds available for the purchase of Government securities by selling other assets to one another. They can secure additional funds for this purpose only through additional savings or by using previously accumulated bank deposits. We have previously noted that in the absence of severe shortages

of desired consumption and investment goods, the savings of individuals are primarily responsive to the level of their incomes and to the prevailing standards of consumption and saving. They are not highly responsive to increases in interest rates.

We are forced to conclude, therefore, that, in the absence of major obstructions to private investment and consumption spending, the banks and the Treasury could sell large amounts of Treasury securities to non-bank investors in any short space of time only by persuading depositors to buy them with previously accumulated deposit balances. We have noted the difficulties and the small anti-inflationary results to be expected in this direction. Nevertheless, something could be accomplished toward this end by vigorous public campaigns provided confidence in the stability of the Government bond market were maintained. But if we are to use increases in yields to accomplish this result, the results are bound to be either inadequate or disastrous.

If the rising yields took place as the result of selling pressure on the market by the commercial banks and Federal Reserve banks, the declining price trend of Government securities would quicken fears of further price declines. Many institutional investors who confidently purchase Government

securities today, would be moved to hold off, as they have often held off in the past during periods of declining bond prices, to await the cessation of the decline. Others would be frightened by the development of declining prices into dumping their holdings of Government securities. Many banks would doubtless join in the selling.

Who would do the buying? We have already called attention to the small capacity of the non-bank market to absorb any large volume of Treasury securities in any short space of time unless severe restrictions existed on private investment and consumption spending. And against the buying of those who would be attracted by the rising yields must be set the heavy selling of many who will hold Governments only when and because they have a stable market and serve as a good substitute for cash. Owners of idle bank deposits who might be persuaded by a vigorous publicity campaign to convert a portion of their deposits into Government securities if the market remained stable would be given a convincing reason for retaining their cash.

A concrete illustration of how the market reacts to a decline in prices of Government securities was provided by the market's behavior during the 14 months between October 1947 and December 1948. Instead of being attracted by the declining prices and rising yields, insurance companies, mutual savings banks, and savings and loan associations, as well as other non-bank

investors, sold heavily from their holdings of long-term Treasury securities. Their holdings of long-term Treasury securities were reduced by approximately \$8 billion in this period; while, on net balance, the whole amount of the sales was absorbed by the Federal Reserve Banks and Government investment agencies.

The declining movement could not be held within orderly limits without continuous and adequate support buying on the way down by the Federal Reserve or the Treasury. It is easily conceivable that the Federal Reserve System would have to purchase a greater volume of Government securities, and thereby create a greater increase in member bank reserves, to keep a decline within orderly bounds than to maintain the present pattern of interest rates.

If the declines in the prices of Government securities were allowed to proceed far, it is conceivable that a serious loss of confidence in the credit of the Treasury would result, and with it, a loss of confidence in the dollar. Already the substantial rise in commodity prices has led to fears and rumors about the soundness of our currency. The appearance of sharp discounts on Treasury securities would confirm such fears in the minds of some. And if, shortly after, the Treasury had to go to the market to raise substantial sums for rearmament deficits or all-out war, the difficulties of non-inflationary financing would have been made far more serious.

On the other hand, if the rise in yields were accomplished by a Treasury offer to refund the whole public debt at rates one-half of one percent higher at all maturities than the prevailing ones, and by a Federal Reserve assurance that the new yields would be maintained by their market support, there would be little, if any, gain in credit control. Commercial banks would continue able to expand their reserves at will by selling Treasury securities to the Reserve Banks, and the rise in yields of business loans and private securities would make it profitable for them to do so. The operation would add perhaps \$1.5 billion annually to the interest cost of the public debt. The only gain from it would be a highly conjectural one: some additional Treasury securities -- no one can say how much, and we have given reasons for believing the amount would be small -- might be purchased by non-bank investors.

Need for Credit Restriction Temporary,
But Undiscriminating Action May Have
Lasting Adverse Effects.

Our experience during World War II indicates that when the direct controls over steel and other scarce materials, and the credit controls over construction, take hold during the present

emergency, private outlets for investment spending will shrink materially. Much of the week to week receipts of savings by insurance companies, mutual savings banks and other institutional investors will then have no other place to go than into Government securities. If the Treasury is not then operating at a deficit, these investors will be ready to absorb such securities from the commercial banks and the Federal Reserve banks. The same will be true of business corporations that will be accumulating funds for future plant investment. If new houses, automobiles and other important objects of individual spending are also less available, the demand for Government securities from individuals will likewise increase. Direct control over inventory expansion by business enterprises may perhaps be necessary to curb this source of demand for bank credit; but the over-all outlook is that, before many months have elapsed, there will be a considerable increase in the demand for Government securities and a substantial reduction in the total volume of private spending.

In the light of this probability, which, however, is not a certainty, it would seem particularly unwise to sacrifice the stability and confidence of the long-term bond market for the purpose of restricting a temporary bulge in bank loans to

business. There is involved here not only the large Federal debt but the billions of dollars of long-term securities issued by public utilities, railroads, and state and local governments, as well as the interest rate structure of residential mortgage financing. It has taken a great many years to achieve the present level of long-term interest rates, which is now imbedded in the market prices of all high grade securities, but it would take only a few months of indiscriminating credit restriction to blast the chances of maintaining or soon restoring confidence in such a level. The effects of a so-called temporary rise in long-term interest rates would long outlast the occasion that led to raising them.

**V - Elements of a Sound Policy for Private
and Public Credit in the Present Situation.**

The foregoing considerations suggest that the outstanding requirements of credit policy in the present situation are:

(1) Measures that will reduce private investment and consumption spending, particularly the part financed by loans, without disrupting the market for government securities.

(2) Measures that seek a more permanent adjustment of our system of bank regulation to the new importance of Treasury securities in bank portfolios;

(3) Consideration of possible additional types of Treasury securities for non-bank investors.

(1) Selective Credit Controls

In the industrial field, we have already recognized that the present emergency requires a variety of selective direct controls. We are not relying upon drastic increases in the prices of steel, copper, and other scarce materials to shut out non-essential uses of them. We know that some non-essential uses can outbid essential uses.

The same principle is applicable to credit. In the present emergency, which exists only because there is great danger of all-out war, the credit needs of the United States Government

should have a first claim upon the credit resources of the country. The amount of credit available to the Government and to the business enterprises serving its emergency needs, as well as the rates paid for this credit, should not be determined by the readiness of non-essential users of credit to outbid the Government and its suppliers.

The total amount of credit in use must be restricted to curb inflation, but the restriction should be selective. Adequate credit must be provided for suppliers of military and related goods, and for the normal requirements of essential civilian trades and industries. The amount of credit used by others should be reduced to the extent needed to avoid inflation. A few months hence, such reduction will be accomplished automatically, in considerable measure, by the direct limitations being imposed upon the availability of scarce materials for non-essential uses, and by the recent limitations upon loans for construction. But other measures are also appropriate.

(a) Qualitative Regulation of Bank Loans

(1) Voluntary Credit Controls

An immediate step, and one that requires no legislation, would be the establishment on a voluntary basis of national and local organizations of banks and other lenders for the purpose of dissuading borrowers and lenders from entering into credit transactions, except

those that would contribute to the defense effort or to essential civilian requirements. The President could give this organization prestige and moral authority by issuing an Executive Order creating it, called the Voluntary Credit Control Commission, and composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Director of the Office of Defense Mobilization, and the presidents of the American Bankers Association, the Investment Bankers Association, and the Life Insurance Association of America, as well as a representative of the savings and loan associations, to be selected by the Chairman of the Federal Home Loan Bank Board.

Such a Commission would formulate a national policy for the guidance of borrowers and lenders, describing by categories the various types of credit transactions and their relative desirability or undesirability under present conditions. It would likewise concern itself with the problem of capital expenditures, including those of State and local governments as well as corporate enterprise. The Commission would establish regional committees to help in the implementation of its program.

(2) Compulsory Credit Controls

If the voluntary program were not effective, there are two statutes under which qualitative regulation of bank loans could be undertaken -- the Emergency Banking Act of 1933 and the Trading with the Enemy Act. Under these statutes, the Secretary of the Treasury could issue a regulation requiring all commercial and

savings banks to obtain prior approvals for extensions of credit if the particular lender's aggregate of loans would thereby exceed an amount fixed in accordance with a definite formula. In guiding the administration of this regulation, the regulatory agencies would withhold approval from proposed loans not deemed necessary for defense purposes or for essential civilian requirements.

Such a use of existing authority would remove the present great deficiency in the power of the banking authorities to restrict bank lending except at the cost of grave injury to the market for Treasury securities. Through it, the authorities would be enabled to act directly against unnecessary bank lending. The curb on lending would restrict spending and the creation of additional bank deposits, and it would encourage the retention of Government securities by banks.

(b) Combination of Qualitative and Quantitative
Regulation of Bank Loans.

An alternative method that could be adopted under the same authority would require every bank to maintain a supplementary

reserve in cash or on deposit with a Federal Reserve bank of a specified percentage of the increase in the total of a bank's loans and investments, other than United States Government securities from the amount on a base date, such as January 1, 1951; except that loans in excess of the base amount might be permitted without the supplementary reserve upon express authorization of the regulatory authorities. The exemptions would be made to enable a bank to meet seasonal credit needs, the demand for defense loans, and essential civilian requirements, including, in some cases, the expanding credit needs of growing communities.

Such a provision, like the alternative above, would reduce the ability of the banking system to expand private credit for nonessential purposes and increase the attractiveness of Government securities to the banks. If the base consisted of a specified proportion of private loans and investments to deposits or total resources, instead of the amount of private loans and investments on a specified date, the plan would be somewhat less effective in curtailing undesired credit expansion because of the exemption of banks whose private loans and investments were less than the base proportion.

Either of the foregoing methods of selective restriction of bank lending would be superior because of their selectivity

to an increase in ordinary reserve requirements. For the same reason they would be superior to the adoption of what was termed a ceiling reserve plan, which would impose a 100 percent reserve requirement against all increases in the deposits of any bank. An increase in ordinary reserve requirements or the imposition of a ceiling reserve requirement would seriously reduce the capacity and disposition of the banks to own and buy Treasury securities, would reduce bank earnings, and would not operate selectively against speculative and other unnecessary lending.

(c) Regulation of Loans by Insurance Companies
and Other Non-Bank Lenders

Regulation of the loans of insurance companies and other large lenders is needed to supplement the regulation of bank lending. This could take place under the voluntary organization previously described. If voluntary methods proved inadequate, the authority of the Trading with the Enemy Act could be used. In this connection, it might be decided, for example, that all new loans in excess of \$100,000 or purchases of new securities in excess of \$100,000, other than United States Government obligations, might require express authorization by a designated agency. Approval would be given only to loans or purchases of securities deemed essential for the defense effort or civilian

needs. The effect would be to diminish the availability for private investment of the large current accessions to the funds of institutional investors and thereby to increase their demand for United States Government obligations.

(d) Regulation of New Capital Issues

Although the regulation of bank and other institutional lending suggested above would go far to divert new investment funds from non-essential private projects to Treasury securities, a considerable opening would still remain for the sale of new securities, both bonds and, more particularly, preferred and common stocks, to individual and corporate investors. A capital issues committee could be established, as was done during World War I, whose authorization would be required for the sale of any new issue of securities in excess of \$100,000 by corporations and state and local governments. The authorizations could be confined to issues deemed desirable in the national interest. The effect would be to divert investment funds to Treasury securities and to reduce the volume of investment spending.

(e) Contraction of Government Lending and
Loan Guarantee Operations

A significant reduction in private investment spending could be effected by administrative reduction of the volume of loans and loan guarantees made under existing governmental programs.

(2) Supplementary Bank Reserves Consisting of
Treasury Securities

The growth in bank holdings of Government securities to a level at which they constitute the greater part of the earning assets of commercial banks has created a structural change in banking to which the powers of the Federal Reserve System have not been adjusted. These powers were designed primarily for the regulation of the volume of bank credit extended to business enterprises. In consequence, as we have seen in detail in the foregoing pages, a need to restrict credit expansion to business can now operate only through disrupting the market for Government securities. The present emergency has spotlighted this anomaly but did not create it. Unless corrected, it will remain after the emergency is over.

The banks are destined willy-nilly to continue indefinitely to own a large amount of Government securities. Their holdings could be shifted to non-bank investors only over a long period of time, and only at the cost of absorbing real savings. It is a good thing to absorb savings in this way during inflationary periods, when the attempt to invest them in real goods would only add fuel to the inflation. In periods of underemployment, however, it would be wasteful and otherwise harmful to absorb fresh savings in this way.

However much we may regret the phenomenal increase from \$36 billion to \$118 billion in the volume of demand deposits and currency

since 1939, the effects^{of} a wholesale reduction would be far worse than the effects of the increase. The country has already become adjusted to most, if not all, of the increased money supply. At any rate, there seems little likelihood that shifts of Treasury securities from the banks to the non-bank public in the foreseeable future could absorb a large fraction of bank holdings of more than \$60 billions of Government securities.

In the meantime, this huge cushion of marketable Treasury obligations (1) insulates the banks against attempts by the banking authorities to regulate their loan expansion; (2) creates problems for the banking authorities in regulating the maturities of the Treasury securities the banks choose to hold; (3) creates unnecessary sensitiveness in the markets for Government securities; and (4) requires the Treasury to undertake frequent large scale refunding operations for these securities without effecting substantial changes in their ownership.

The same situation in a number of other countries has been met by requiring banks, through statute or informal agreement, to hold a certain proportion of their assets in the form of Government securities, or to refrain from reducing their holdings of Government securities without permission. A similar proposal made in its 1947 annual report to Congress by the Board of Governors of the Federal Reserve System would require banks to maintain supplementary

reserves, in the form of short-term Government securities or in cash, equal to a stated fraction of their deposit liabilities, these reserves being in addition to the primary reserves.

A variant of this proposal that appears to have some superior merits would require that the supplementary reserve consist of special Treasury Reserve Certificates. Just as Congress formerly required that national bank note currency be secured by United States bonds bearing the circulation privilege, Congress could require all banks with deposits in excess of perhaps 1 million dollars to maintain, in addition to other reserves required by federal or state regulation, reserves in the form of special Reserve Certificates equal to stated proportions of their deposit liabilities. The Reserve Certificates would bear interest at a rate determined by Congress or by formula, perhaps 1-1/2 percent, and would be payable upon the demand of any bank. Initially any bank could obtain the amount it needed in exchange for outstanding Government obligations. Afterward, the Certificates would be purchased from the Treasury at any time in the amounts needed to meet the Certificate Reserve requirements. The Certificates need not have a final maturity date, though they should be callable.

Under such an arrangement, the present reserve requirements of the Board of Governors would continue to govern credit expansion. The precise percentages that Reserve Certificates should constitute of deposits from time to time might be left to the discretion of the Reserve System within limits established by Congress, and the percentages could vary for different classes of banks and for demand as against time deposits, as is true of ordinary reserve requirements.

The principal advantages of transforming a large fraction of the bank-held portion of the public debt in this manner may be summarized as follows:

1. The Treasury would permanently fund at a low interest rate perhaps as much as one-third of all the outstanding marketable Government obligations in private hands. The result would be to remove this large fraction of the total from the category of ordinary public debt obligations and to eliminate all the refunding operations otherwise necessary for it. Although any individual bank could redeem the Reserve Certificates on demand, the Treasury would never experience a net loss of cash to the banks as a whole unless the banks themselves were experiencing a reduction in their deposits.

2. The Reserve Banks would regain a considerable measure of control over direct bank lending because the individual commercial bank could no longer obtain funds for loan expansion through the liquidation of its governments except in the greatly reduced measure in which it would continue to own ordinary marketable Treasury obligations; yet the earnings of the commercial banks would not be reduced by the added reserve requirements.

3. The threat of sporadic waves of large-scale selling of governments by the banks and the accompanying threat to the stability of interest rates and the supply of money would be greatly reduced. The ability and disposition of the commercial banks to cushion the bond market against waves of selling by other investors and to perform their traditional services in the distribution of Treasury securities would be renewed and reinforced; for the banks would possess only a small fraction of their present holdings of marketable governments. On the other hand, for the same reason, the impact of a restrictive credit policy by the Reserve system would not be as concentrated upon the government bond market as under present arrangements.

4. The commercial banks would be relieved of all worry over the future course of interest rates and bond prices so far as the bulk of their assets is concerned. With perhaps 50 to 65 per cent of their earning assets no longer subject to price risks,

as well as perhaps 25 percent more in the form of cash, the liquidity and safety of the individual banks and the system as a whole would be enormously increased. The effect would be tantamount to a huge increase in banking capital. In consequence, the ability and disposition of banks to assume ordinary risks in lending would be enhanced. On the other hand, the larger aggregate reserve requirements would promote a stability in the volume of deposits approaching that of a 100 percent reserve system.

5. Increases or reductions in bank holdings of government securities would be better regulated with deliberate regard for their effects upon the country's volume of bank deposits and rate of spending, instead of being permitted to occur in response to other influences without regard to their monetary effects. The Certificate Reserve plan would also have definite advantages in making further additions to the public debt, if they should occur, more manageable within substantially our present institutional arrangements. A permanent market at a low interest rate would be assured for that part of the increase in debt which was to be absorbed by the commercial banking system. The Reserve Certificate requirements against bank deposits would merely be raised as needed from time to time and the additional Reserve Certificates sold to the banks. If it were decided to finance additional deficits by the sale of securities directly to the Reserve banks instead of to the commercial banks, similar certificates could be issued, with

ordinary reserve requirements being raised to offset the expansion that would result in member bank reserves.^{1/}

^{1/} Shifts of deposits between banks would result in no change in the amount of Reserve Certificates outstanding. Bank A, which gained \$100 of deposits, would meet the Certificate Reserve Requirement by buying \$50 of Reserve Certificates from the Treasury at the next settlement date (and would meet its ordinary reserve requirement by depositing \$20 with its Federal Reserve bank). Bank B, which had lost the \$100 of deposits, would be required to turn in \$50 of Reserve Certificates for redemption on the same settlement date (and would also have its ordinary reserve requirement reduced by \$20).

An increase in the ordinary reserves of the member banks as a whole, which could be brought about by an increase in Federal Reserve credit, gold imports, or a return of currency from circulation, among other means, would be capable of producing the same multiple expansion of member bank credit as is the case today, but one-half of the expansion would have to take the form of increased holdings of Reserve Certificates (assuming a 50 percent Certificate Reserve requirement). Thus, if a customer of Bank A sold \$100 of marketable securities to a Reserve bank, and deposited the proceeds with Bank A, the latter's reserves and deposits would each be increased by \$100. Bank A would be required to keep about \$20 of its new funds as ordinary lawful reserves and to purchase \$50 of additional Reserve Certificates from the Treasury, leaving it \$30 free for loans and other investments. The \$30 it so uses plus the \$50 paid to the Treasury, which the latter would use to retire an equal amount of its other obligations, would find their way into the reserves of other banks to serve in similar manner as the basis for deposit expansion, until a total of approximately \$500 of new member bank deposits had been erected on the basis of the \$100 of reserves created by the Reserve bank purchase of securities (the 5 to 1 ratio being the result of the 20 percent average ordinary reserve requirement).

(3) Continuing Emphasis on Compartmentalizing
the Public Debt

With the public debt at its present size, excessive market activity in Treasury securities is always potentially dangerous. It is desirable, therefore, to increase the nonmarketable proportion and to tailor some of these and marketable securities more closely to the needs of particular investor groups in order to encourage retention.

The Certificate Reserve plan would, of course, automatically compartmentalize, as well as remove from the market, a very sizeable fraction of the public debt. The E, F, and G bonds serve well to the same result. Liberalizing the limits on annual purchases of the F and G series, and perhaps extending their maturities, might attract additional funds into them.

By consultation with insurance companies and managers of pension funds, it may be possible to devise special variants of the nonmarketable bonds that would have exceptional appeal to these investors.

It is desirable to explore the possibilities of using variable interest-coupon marketable bonds -- the coupon being for perhaps 1-1/2 percent during the first few years, then 2 percent, then 2-1/2 or 3 percent or more in subsequent years, with the overall yield from issue date to final maturity at about 2-1/2 percent.