William McChesney Martin, Jr., Papers

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Working Document

STRICTLY CONFIDENTIAL

WORKING DOCUMENT ON TREASURY POSITION IN CURRENT EMERGENCY

The responsibility for the sound conduct of the Nation's finances is a very grave one. Since the earliest days of our history, this responsibility has been placed with the Secretary of the Treasury. But the problems involved are not the problems of the Treasury alone. They are not the problems of the Congress alone. They are the problems of every citizen of the Nation.

Here is the situation with which we are now confronted. We have today a public debt amounting to over $250 billion. Not long ago we were worrying about a debt which might reach $50 billion. We did not know how the country would be able to stand such a debt. We did not know how it would affect the solvency of the Government. We did not know how it could be managed without disrupting the financial life of the Nation.

But our public debt today is more than five times that figure. It is the most important single factor in our financial structure. It represents one-half of all the debt obligations in the country. Mortgages, State and municipal securities, corporate bonds, other private obligations -- all of them added together only equal the sum total of the present debt of the Government.

Life insurance companies now own over $13 billion of Federal Government securities -- about one-fifth of their total assets. Mutual savings banks own $11 billion -- about one-half of their total assets. Nonfinancial corporations own $20 billion, or nearly 15 percent of their current assets. Individuals own $67 billion of Federal securities of all kinds -- representing approximately one-third of their total liquid assets of more than $200 billion. Commercial banks hold more than $61 billion -- representing approximately one-half of their earning assets.

Before World War II, the situation was entirely different. Financial institutions and business concerns had much more of their invested funds in private obligations. Only a very small proportion of our individual citizens were owners of the securities of their Government.

As a result of World War II financing, the public debt became the predominant factor in the financial life of the Nation. The size, the importance, and the wide distribution of the debt are new facts to all of us. They create new problems. They place tremendous new responsibilities on the Secretary of the Treasury who is charged by law with the sound management of the Nation's finances. And under present conditions of international crisis and rising inflationary pressures, both the problems and the responsibilities are enormously increased.

Throughout the postwar period, the public debt remained the single most important influence in the financial life of the Nation. But it has not been a disruptive factor. The problems involved in managing a public debt of over $250 billion are unprecedented. (But they have been successfully solved.) During the postwar period, the debt has been managed in such a way as to ease the problems of reconversion and promote our return to peacetime business at the highest level of production and employment in history.

How was this accomplished? It was accomplished by means of maintaining stability in the market for Federal Government securities and by spreading the debt as widely as possible among the people of the Nation -- at the same time that bank holdings of Federal securities were being reduced.

The Treasury has been eminently successful in achieving these objectives. There has been no more dynamic period in our entire industrial history than the past five years. There has been no similar period in which such a large volume of long-range programs for increasing productive capacity and for

modernizing existing plant and operations were put into effect. Stability in the financial markets was essential to these programs. But the maintenance of stability did not require absolute inflexibility in interest rates. As the economy itself began to function smoothly at a new high level of activity and trade, more flexibility in the Treasury debt management program was achieved by allowing short-term interest rates to increase gradually. Moreover, there have been times during the postwar period when keeping the market stable has meant strong actions to keep prices from going too high. The Federal Reserve System has had to sell Government securities and the Treasury has sold issues held by the trust accounts to keep prices down. Federal securities were in great demand. They were considered very attractive. With the outbreak of the crisis in Korea, however, the considerations calling for a high degree of stability in the Government security market once more became all important.

Likewise, the Treasury achieved great success in its program for increasing the proportion of Federal securities in the hands of nonbank investors and reducing bank holdings of Government obligations. In the last half of 1950, the holdings of nonbank owners reached a new postwar peak, while bank holdings, correspondingly, fell to a new low for the postwar period. This shift in ownership is of the greatest significance at the present time, since it acts directly on the money supply by reducing the inflationary potential of bank assets.

The Treasury's success in achieving these important objectives of debt management -- a stable and orderly market situation, a wide distribution of securities among nonbank owners -- could not have been realized if our people had not had full confidence in the ability of the Government to manage the debt without disturbance to the economy. It could not have been realized if the citizens of the Nation had not had full confidence in Government securities. But they did have confidence -- a confidence based on performance.

Today, with the enormously increased financial requirements of the defense program before us, it is more important than ever before that people hold on to the Government securities which they now own. It is more important than ever before that they add to these holdings as their funds permit them to do so.

One of the obvious things that has to be done if we want people to hold on to an investment already made is to stabilize the price. During the present emergency, we must eliminate the fear that the owner or prospective buyer of an obligation of the Government is going to be penalized immediately by having the market price of his investment drop. Nobody who has any choice wants to hold on to a commodity that is going down -- that is being priced lower all the time. (It doesn't take a financial expert to figure that out.) It is part of ordinary, everyday experience.

Let us make no mistake about it -- forcing up the interest rates on Federal Government securities means forcing down the price. It means slicing off a part of the investment which every owner of a marketable security has made in the obligations of the Government. It means that owners of demand obligations, such as savings bonds, may decide it is prudent to cash in their bonds -- to get their money out. There is little inducement to hold a fixed income obligation, such as savings bonds, when the owners of other Government securities are getting increasingly higher returns.

Let me emphasize that word -- increasingly. It is the trend that matters. A given interest rate is unattractive -- it will cause investors to shy away -- if the price trend of the market is down. The same rate can appear attractive if investors believe that next week, or next month, it won't be very different.

A bond market that is undergoing a major decline -- that is being subjected to rumors and forecasts of further declines -- cannot be a confident market. There will be many sellers. There will be a lot of people on the side lines. But who will want to buy?

Let me repeat again -- nobody wants a commodity that is going down in price. It is imperative that we keep the securities of the Federal Government attractive to owners and purchasers. It is imperative, therefore, that we keep the prices of these securities stable. We must avoid every action which holds the risk of starting a rumor, a belief, or a fear that investment in Federal securities is not a good investment -- now or in the future.

These considerations are urgent at all times. With a Federal debt of over $250 billion, interwoven throughout the financial fabric of the Nation, there is no period when we can afford to raise doubts as to the wisdom or prudence of an investment in Federal Government securities. Under presant circumstances, however, when the money must be forthcoming for a greatly enlarged defense program, the considerations calling for a stable and confident situation throughout the whole broad structure of the public debt are magnified many times.

Because of the uncertainties of the international situation, we cannot foresee the full extent of the financial demands which may be made upon the Government. We know only that they will be very large. The Congress has already acted to increase the revenues of the Government. Further measures for a greatly enlarged revenue program are now being deliberated. But our military spending is already rising at a rate which will result in a budget deficit of several billion dollars by the last quarter of this fiscal year.

To the extent that additional revenue is not at hand to cover all of the Government's needs, we shall have to borrow. We shall have to increase our already large public debt.

Under any circumstances which we can foresee, there appears to be no possibility for some time to come of reducing the outstanding debt of the Government. This means that maturing obligations which come due must be refunded. Every holder of a maturing issue -- like every holder of a demand obligation, such as savings bonds -- may, of course, obtain cash for his securities if he so desires. But the money to pay him will, in turn, have to be borrowed from someone else. During the remainder of this calendar year, for example, over $50 billion of marketable securities alone must be refunded. This in itself is a tremendous financing operation. It is as much as all the private refunding in this country in the past 25 years.

The Government needs every dollar of nonbank money represented by these securities. It needs a full 100 percent reinvestment, and where possible, more than 100 percent. But this it cannot achieve without full confidence of the holders of the maturing obligations and of investors generally in the desirability and the wisdom of continuing their investment in securities of the Government.

These are considerations of such weight that they cannot be overemphasized. Questions and doubts as to the wisdom of investing in securities of the Government would lead to conditions of financial chaos. If these questions and doubts persisted to the point where important numbers of Federal security owners attempted to liquidate their holdings, irreparable harm would be done to the entire financial structure of the Nation.

The course which the Federal Reserve has been purauing during the present period of international crisis involves precisely this risk. The Federal Reserve has carried on a policy which has resulted in lowering substantially the prices of outstanding issues of Government securities. The stated purpose of this program is to check credit expansion by reducing incentives to sell Federal securities and by increasing incentives to hold on to them or to buy new ones. This the Federal Reserve means to accomplish by the price and interest rate route. It has pulled down prices -- and told the market that prices will go still lower. It has thereby raised interest rates -- and given notice that the rates will go still higher.

First and foremost, this program is dangerous because it takes the grave risk of upsetting the debt structure of the country; not only the debt structure of the Government itself, but the private debt structure as well. This would involve all of the difficulties which have already been discussed. It would very shortly involve a mass refunding of all Federal Government securities, nonmarketable as well as marketable, on the basis of higher rates. As already noted, refundings now come to about $50 billion a year. The Federal Reserve action has already started a chain of events which could well result in a $250 billion refunding. No Federal securities would be exempt, not even those held by the trust funds, since a large part of these require an interest rate tied by law to the average interest rate on the public debt.

A mass refunding would drive many Federal security holders out of the market for good. Others would stay on the side lines for an indefinite period. The confusion and chaos which this would cause seem unthinkable to us now, after many years of placid and orderly conditions in the Federal security market

as a consequence of successful debt management. But complete disruption of the debt structure, with all that would entail, is not by any means beyond the realm of possibility. It can happen. The failure of the two important refundings of the Government since last June, as a result of the Federal Reserve actions, shows that it might, in fact, happen very swiftly.

The experience of other nations shows us that no one can predict exactly what final occurrence -- possibly small in itself -- will start a full-scale retreat from Government securities when conditions of uncertainty and confusion have been prolonged for some time. A flight from Government securities -- which would bring with it a flight from the currency of the country -- would, of course, cause a rampant inflation of a type never before experienced in this country.

Why should we take such a risk; why should we even consider actions which might impair the credit of the Government of the United States? Even if the expansion of bank credit could be completely stopped by this method, it still does not seem rational or reasonable to use this weapon, at this time, in view of the risks which it involves. We know that it is possible to maintain the Government bond market at a level permitting new issues to be offered at no change in interest rates. "Support" operations are not needed when investors are fully confident of a stable market situation. Why, then, should we use a weapon which lowers the price of the outstanding securities of the Government, seriously unsettles the Government bond market, and raises doubts which, if not quieted, could impair the Government credit?

The great risks involved are thus the first consideration which must be weighed in judging the appropriateness of the Federal Reserve policy. But it is important to note, in the second place, that even if bank credit expansion were completely restricted, the battle against inflation would not necessarily have been won in whole or in part. The present inflation is not fed only by bank credit expansion -- by an increasing volume of demand deposits. During the years since the end of World War II, there have, at times, been advances in prices when there has been no expansion in bank credit and

currency holdings; in other words, when there has been no expansion in the money supply of the country. There have been other periods when the price level stood still or declined, although the money supply was expanding.

Why then should we use changes in the interest rate at all to combat inflation?

The stock answer to this question is that, in times of inflationary pressures, we must use all of the weapons at our disposal. Such an answer cannot be called anything but irresponsible, however, when it is used to justify measures which have the distinct possibility of doing more harm than good.

But now let us come to the possibilities for good. Surprisingly enough, in view of the vehemence with which the Federal Reserve has clung to its position, we find that these possibilities shrink to the vanishing point under the cold light of facts. It has not been proved that a higher price for credit is an effective measure in restraining bank loan expansion and in fighting inflation. The evidence, on the contrary, is all on the other side.

The record of recent months clearly shows that the Federal Reserve policy, implemented by means of higher interest rates, has had no perceptible effect on credit expansion. Total loans of all commercial banks expanded nearly $8 billion in the last six months of 1950 -- an increase of a magnitude which has never been equalled in this country. We have had other -- and more extreme -- examples of attempts to control bank credit expansion by interest rate increases in the past history of our country. In the 1919-1920 inflationary period, rates on short-term Treasury issues were run up sharply until they reached nearly 6 percent; and the rate on call-money went as high as 30 percent. In 1929, rates on short-term Treasury issues were run up to

above 5 percent; and the call-money rate went to 20 percent. Yet, bank credit expansion was not effectively checked until we had the market crashes with which all of us are familiar.

It is perfectly clear to all of us, when we stop to think about it, that higher interest rates in a dynamic period such as the present actually may result in spurring on the banks to make more loans. Higher rates on Governments mean that private lenders can boost the rates which they charge their customers. They can make more money. This is the best possible incentive to making more loans, at a time when there is no lack of borrowers seeking funds.

And this has been the situation since last June. Every businessman knows that controls are about to become tighter, that many essential materials for nondefense products are about to dry up, that plant expansion may soon be greatly restricted. A jump in the price of credit, under these circumstances, will not deter many borrowers. In particular, it will not deter those who need credit the least -- the inventory hoarders, the speculators, the producers of soon-to-be-scarce consumer goods. They will try to borrow anyhow -- and the lenders will get a windfall profit.

Whether Federal Reserve policy has actually stimulated private borrowing during the period since Korea, or whether it has merely coincided with a credit expansion brought about by other forces, can never be decisively determined. But there is one result of Federal Reserve actions which can be fully demonstrated. That is the effect which these actions have had on the stability of the Government security market and on confidence in the credit of the United States. The Government security market has been seriously unsettled; and the resulting fear has restrained investors from purchasing

or holding on to Government obligations. The actions of the Federal Reserve System also have brought about two failures in Treasury refunding operations -- an occurrence of such great significance that it warrants a full discussion later in this statement. Finally, the confusion and fear with respect to the prices and yields of Government securities may even have weakened the appeal of savings bonds. During the last part of 1950, there was a noticeable decrease in the sales of the larger denomination savings bonds and an increase in redemptions of these denominations, which are ordinarily bought by the more "sophisticated" investors.

These are the controlling factors in the opposition of the Treasury to increases in interest rates on Government securities.

There is, however, another sure effect of the Federal Reserve actions in raising interest rates which cannot be ignored. That is the increase in Government expenditures which will be required if the Government is forced to pay higher interest rates on new issues of Government securities. The Treasury is often quoted as being only concerned with this one aspect of increased interest rates. That, of course, is not the case. Nevertheless, it is the Treasury's responsibility to recommend fiscal policy which will use the taxpayers' money wisely. There is never any defense for needless increases in taxes. To use the taxpayers' money to pay for further increases in the interest cost of the public debt in an ineffectual attempt to control inflation is clearly unjustifiable.

It is helpful in understanding the effects of the Federal Reserve actions in raising interest rates on Government securities to review the specific occurrences in the Government security market since the invasion of the Republic of Korea. Let us take up that record now.

Immediately following the outbreak of hostilities in Korea, the Secretary of the Treasury took the position that our first line of defense on the financial front was a stable and confident situation in the market for United States Government securities. The considerations which led him to this view are evident. From that time forward, our defense needs were paramount. They would have to be financed. We should have to live with our large public debt for a long time. We might have to increase it. Confidence in Federal securities had to be maintained. Stability was now not only desirable; it was vital to a successful defense financing program.

On Monday, June 26, Secretary Snyder requested the Fiscal Assistant Secretary of the Treasury to convey to the Open Market Committee of the Federal Reserve System the feeling of the Secretary that "everything possible should be done to maintain a basically strong position in the Government bond market during the present period of international disturbance."

On July 17, Secretary Snyder wrote at some length to Chairman McCabe of the Board of Governors of the Federal Reserve System, restating his feeling that stability in the Government bond market was of paramount importance because of the disturbed international situation and explaining the reasons in some detail. In this letter, he also stated that it was imperative that every financing operation of the Government be carried through to a successful conclusion.

On many occasions since then -- both publicly and privately, and directly to Chairman McCabe and other officials of the Federal Reserve System -- Secretary Snyder restated his conviction that stability in the Government security market is required.

Officials of the Federal Reserve System have not agreed that the situation calls for stability in the Government bond market. The System has ignored, in its actions, the fact that the Secretary of the Treasury, as chief fiscal officer of the Nation, has grave responsibilities with respect to the management of the outstanding obligations of the Government of the United States. The System has made it clear that, in its opinion, it has complete right to disregard entirely the wishes of the Secretary of the Treasury and of the President in managing the Government security market.

Although discussions of the differences between the viewpoints of the Treasury and the Federal Reserve on stability in the Government security market almost always start with the actions of August 18, the Federal Reserve -- right from the beginning of the outbreak of the conflict in Korea -- acted in a manner which unsettled the Government security market. Despite the requests of the Secretary of the Treasury for a program which would promote confidence in the Government's financial position, the Open Market Committee did not stop its program of weakening the market for Government securities by continuously putting pressure on long-term bonds. In the period from June 27 through August 18, the System sold $1.1 billion of long bonds in 38 trading days. The market reaction to this operation was a rising tide of doubt and questioning as to whether the 2-1/2 percent rate on long-term issues was going to be continued.

The decision of the Secretary of the Treasury to maintain the 1-1/4 percent rate on the two issues of 13-month Treasury notes offered in exchange for the $13-1/2 billion of Treasury bonds and certificates of indebtedness maturing on September 15 and October 1 was no surprise to the Federal Reserve. This offering -- which, in accordance with the laws of the United States,

had the approval of the President -- was in line with the Treasury's policy of maintaining stability in the Government security market.

The terms of the issues announced on August 18 were identical with the terms of the issues offered in connection with refunding the certificates of indebtedness which had matured on June 1 and on July 1. Furthermore, the terms of the new issues were in line with the market on the day of the refunding announcements. It is of very great importance to note, also, that the terms of the new issues met the needs of the market at that time. This the Treasury is always careful to do, and indeed must do, if it is to be fully successful in attracting the largest possible amount of nonbank funds into Federal securities. When long-term funds are fully committed, and short-term funds are available, it is the short-term needs which must be met. This was the situation in August. Short-term securities were, accordingly, offered.

Despite all of these facts and the careful evaluation of the situation which the new issues reflected, the Federal Reserve, at the opening of trading on Monday, August 21, immediately proceeded to run up the rates on short-term securities -- that is, mark down the prices of these issues -- to levels wholly inconsistent with the rate on the refunding offering of the Treasury.

There has been a great deal of emphasis on the fact that the Federal Reserve had to purchase a large portion of the maturing issues in the September-October refunding operation in order to prevent the Treasury from having to pay off almost the entire maturities in cash. What has never been made clear is that this so-called "support" would not have been required if the Federal Reserve had not changed the market on the first trading day after

the financing announcement. It bears repeating that the refunding issues were priced in line with the market and met the investment needs of the market at the time. As in previous refundings, a large proportion of the maturing issues would undoubtedly have been presented for exchange if the Federal Reserve had not immediately changed the market pattern of yields on outstanding securities. The Open Market Committee accomplished this by lowering the prices at which it sold Government securities from its portfolio, thereby giving purchasers of outstanding issues a higher rate of return than they would receive on the new issues offered by the Government.

This increased doubts as to the future of the entire rate structure -- and it started a stampede to the side lines, as far as the holders of the maturing issues were concerned. Obviously, most of them did not choose to exchange their holdings for the new issues. A great many did their own refunding through the process of selling the maturing issues to the Federal Reserve System and buying back outstanding issues which were more favorably priced. Most of the remaining holders either sold their securities to the Federal Reserve and retained the cash, or turned in the maturing issues to the Treasury for cash. When it was all over, the figures showed that less than 6 percent of the refunded issues were exchanged for the new issues by private holders. This was a measure of the extent to which the Federal Reserve had demolished the Government securities market and caused a virtually complete failure in an important refunding operation of the Government. The action taken by the Federal Reserve with respect to this refunding, it should be emphasized, was unprecedented in Government financing experience. Moreover, it was undertaken in connection with a refunding operation of great market significance, amounting to $13-1/2 billion.

I have noted that the September-October refunding was approved by the President before its announcement. When it became apparent that the actions

of the Federal Reserve System were threatening to cause a failure in the refunding operation, President Truman -- personally and by letter -- requested Chairman McCabe to see that the actions of the Federal Reserve System were consistent with maintaining confidence in the credit of the United States and stability in the Government security market. The President was assured that this would be done. In the weeks that followed, nevertheless, the Federal Reserve continued to push up rates on Government securities.

While these events were taking place, it was necessary for the Treasury to undertake another refunding offering. The terms of the refunding of $8 billion of certificates of indebtedness and bonds maturing in December 1950 and January 1951 were announced on November 22. Because of the actions of the Federal Reserve in the intervening period, an interest rate higher than the rate in August had to be offered in order to price the new issue in line with the market. Holders of the December-January maturing issues were, accordingly, offered 5-year Treasury notes drawing interest at the rate of 1-3/4 percent per year. The new issue was in accord with the Federal Reserve recommendation to the Treasury; and Mr. McCabe assured Secretary Snyder of the full cooperation of the System in the refunding operation.

The announcement was made on November 22. The following day was Thanksgiving; so that Friday, November 24, was the first trading day after the announcement was made. On that day, the Federal Reserve permitted the market to go off sharply; and further unsettled market psychology by dropping the price on the Victory Loan 2-1/2's by 2/32 during the day. This latter action was of particular significance because this issue is the bellwether of the long-term bond market. It has a particularly sharp impact, therefore, on market psychology.

As a result of the continued uncertainty with respect to the price and yield outlook created in the minds of Government security owners, the exchange experience in the December-January refunding operation -- while considerably improved over September-October -- was still far from satisfactory. Only 51 percent of the maturing issues were turned in to the Treasury by private holders for the new issues. Moreover, the cash redemption experience was only slightly better than in September-October. Cash redemptions amounted to 14-1/2 percent of the total of the maturing issues; in the previous operation they had amounted to 17-1/2 percent. This compares with an average on offerings of this type of a little over 5 percent in recent years.

In addition to unsettling the Government security market by sharp mark-downs in the prices of outstanding Government issues, the Federal Reserve System continuously instigated rumors of further increases of rates on Government securities. This type of thing led to further doubt and confusion as to where the Federal Reserve System intended to take the Government market.

This "planned confusion," as it was called by one market commentator, was supposed to make banks hold on to their Government securities and refrain from expanding loans. What actually happened was entirely different. There was so much confusion and unsettlement in the market that investors were restrained by fear from holding on to Government securities. In other words, conditions requiring "support" operations were worked up by the Federal Reserve. The Federal Reserve portfolio of Government securities increased by nearly $2-1/2 billion between June 30 and December 31 -- the opposite of the effect the Federal Reserve actions were intended to have. This was the real meaning and the real result of the so-called support operations of that period.

Although there was some pressure on the long end of the Government market, the events which have just been described affected primarily the short- and medium-term issues of Government securities. However, early in January, Mr. McCabe and Mr. Sproul -- President of the Federal Reserve Bank of New York -- outlined to the Secretary of the Treasury a program which would involve a complete reorientation of debt management policy. They proposed a program of further increases in interest rates, particularly in the long-term area. They also urged higher interest rates on savings bonds.

Secretary Snyder decided, under these circumstances, and in view of the large financing operations coming up within a few months, that the time had come to settle for the duration of the emergency the matter of the rate on long-term Government bonds. Decisions on Federal Government financing were, of course, the responsibility of the Secretary, assigned to him by law. They were responsibilities which could not be delegated. Accordingly, Secretary Snyder met with President Truman and with Chairman McCabe to discuss the entire defense financing program. At this time it was agreed that market stability was essential and that, therefore, the 2-1/2 percent rate on long-term Government bonds would be continued and that refunding and new-money issues should be financed within the pattern of that rate. This was immediately prior to the speech which Secretary Snyder made on January 18, before the New York Board of Trade, announcing this policy.

In the course of this speech, the Secretary outlined in some detail the considerations which had led to his decision on continuing the 2-1/2 percent rate. The 2-1/2 percent rate, he noted, is a fair and equitable one -- to the Government, which is borrowing the money; to the purchaser of Government bonds, who is lending the money; and to the taxpayer, who has to pay the interest on the money borrowed.

The Secretary pointed out that the 2-1/2 percent rate of interest on long-term Government securities has become an integral part of the financial structure of the country. During the past 10 years, it has become a most important influencing factor in financial policy throughout the Nation. It is a foremost consideration in the financial policies of our insurance companies, our mutual savings banks, our commercial banks, and even in the financial decisions made by private business concerns and individuals throughout the country. It is the single most important factor in the bond markets -- Government, corporate, and municipal.

As an example of the way in which the 2-1/2 percent rate has been woven into the financial fabric of the Nation, the Secretary noted that the guaranteed interest provisions of new life insurance policies during the past decade have been brought into conformity with that rate. In consequence, about 85 percent of the new life insurance premiums received by insurance companies at the present time are on policies written at interest rates of 2-1/2 percent, or less. Mutual savings banks, likewise, have tied their current interest rate on funds of depositors to the Government rate.

It is important not to miss one other highly significant fact with respect to the 2-1/2 percent rate. The existence of this rate has coincided with a period of unprecedented growth and prosperity for the financial institutions of the Nation. There is now $100 billion more life insurance in force than there was a decade ago. The deposits in mutual savings banks are twice as large as before World War II. Earnings of banks and life insurance companies, moreover, are more than double those of 10 years ago. Financial institutions of every kind, in fact, are enjoying the most profitable period in their history. It is clear, therefore, that the existence of the 2-1/2 percent

rate has been in no way stifling to the financial life of the Nation. It has, on the contrary, provided the necessary financial stability for a growing economy and at the same time made possible earnings which are not only fully adequate, but richly rewarding to the financial institutions of the country.

Despite the weight of evidence bearing on the wisdom of Secretary Snyder's decision to continue the 2-1/2 percent rate -- and despite Chairman McCabe's agreement with the Treasury policy before the Secretary's announcement -- officials of the System launched a public attack on the policy immediately following its announcement. The attack has been carried on with vigor since that time. Mr. Sproul and Mr. Eccles, in particular, have strongly criticized the announced program. Moreover, the Federal Reserve has continued since January 18 to put pressure on the long-term bond market. On January 29, the Open Market Committee again reduced its buying price on Victory Loan 2-1/2's. It was at this juncture that President Truman asked the Open Market Committee to meet with him, so that he could impress upon the Committee the need for stability in the Government bond market and confidence in the credit of the United States as long as the emergency lasts; and request that they govern their actions accordingly. As is well known, the Federal Reserve subsequently gave out information to the press indicating that the Open Market Committee intended to follow its own course and disregard the request of the President.

For a full understanding of the program which has been pursued by the Federal Reserve since last June, it is important to note the source of the Federal Reserve's power -- of its ability to act contrary to the established financial policies of the Government.

In an act passed during the first session of the First Congress of the United States, the Secretary of the Treasury was given full responsibility for

the conduct of the Nation's finances. This responsibility has remained with him since that time. The instruments which enable the Federal Reserve System to assume an important part of this responsibility itself and to dictate the financial policies of the Government have fallen into its hands accidentally. They are the direct result of the great changes in our economy and in our financial life brought about by the increase in the public debt -- with an accompanying increase in the Government security holdings of the Federal Reserve System.

In 1913, when the Federal Reserve System was established, it was given permission by law to carry on transactions in the financial markets. This permission was thought of as an incidental part of its discount functions -- namely, as an incidental outgrowth of credit operations carried on between the banks and their own members. There was no thought and no possibility at that time that market operations could influence to any appreciable extent the financial policies of the Government.

For many years, such market transactions as were carried on by the System were conducted by informal groups or committees. In the middle Thirties, however, when the last major revision of the Federal Reserve Act took place, an agency for carrying on market transactions was established by law and was given full statutory authority to conduct all of the open market operations of the System. This agency was designated the Open Market Committee of the Federal Reserve System. It is made up of the seven Governors of the System, together with five of the presidents of the Reserve Banks. At that time -- as in 1913 -- there was no recognition that conditions might develop which would give this Committee the powers it now has to dominate the financial markets and to dictate the financial policies of the Government.

Between 1935 and the present time, the Federal debt has grown from $33 billion to over $250 billion. The Government security holdings of the Federal Reserve System have grown from about $2-1/2 billion to over $20 billion. Because the public debt is widely distributed among institutional, business, and individual owners throughout the Nation, the Open Market Committee need use only a small part of its current holdings to establish any price or interest rate level it chooses for the marketable securities of the Federal Government. Because of the size of the public debt, this action in turn has the effect of a depth charge. It sets up repercussions which are felt throughout the entire economy. But first and foremost, it leads to conditions which may impair the public credit. It leads to conditions which may drive the Treasury into the dangerous waters of bank financing -- including Federal Reserve bank financing.

Interest rates alone do not sell bonds. Confidence in the public credit sells them. Salesmanship sells them -- backed up by the belief of our millions of bondholders that the product they are buying is a good investment in itself and a sound instrument of public debt management. For the very good reason that the credit position of the United States Government is higher than that of any private organization or institution, the Government need never compete on interest rates with other borrowers. Raising the rates on Federal Government securities simply pushes up other rates all along the line. The Government's competitive position -- viewed solely from the standpoint of interest rates -- is unchanged by such a policy.

From every point of view, therefore, the program now being followed by the Federal Reserve is seen to be utterly futile for the purpose intended -- namely, cutting back the volume of bank credit and stemming the rise in prices. If at the same time this futile process undermines the credit of the United States, forces Federal security owners out of the market, and makes necessary refunding operations of the Government a failure, then surely it is time to call a halt to theory. It is time to recognize the essential facts in the vital problem of inflationary control, and act on the basis of these facts.

These things we must do.

First, we must have comprehensive programs for allocating scarce materials and we must take the other necessary steps for reducing the incentives to speculative projects.

Having done this, we must, second, keep the volume of private borrowing at a minimum, through measures which act at the crucial point of the borrowing relationship between the banker and his customer. Selective credit controls such as those already put into effect -- voluntary credit control programs such as those used effectively by the American Bankers Association in 1948 -- are of the greatest importance. Other measures for reducing the availability of credit to nonessential borrowers may be required.

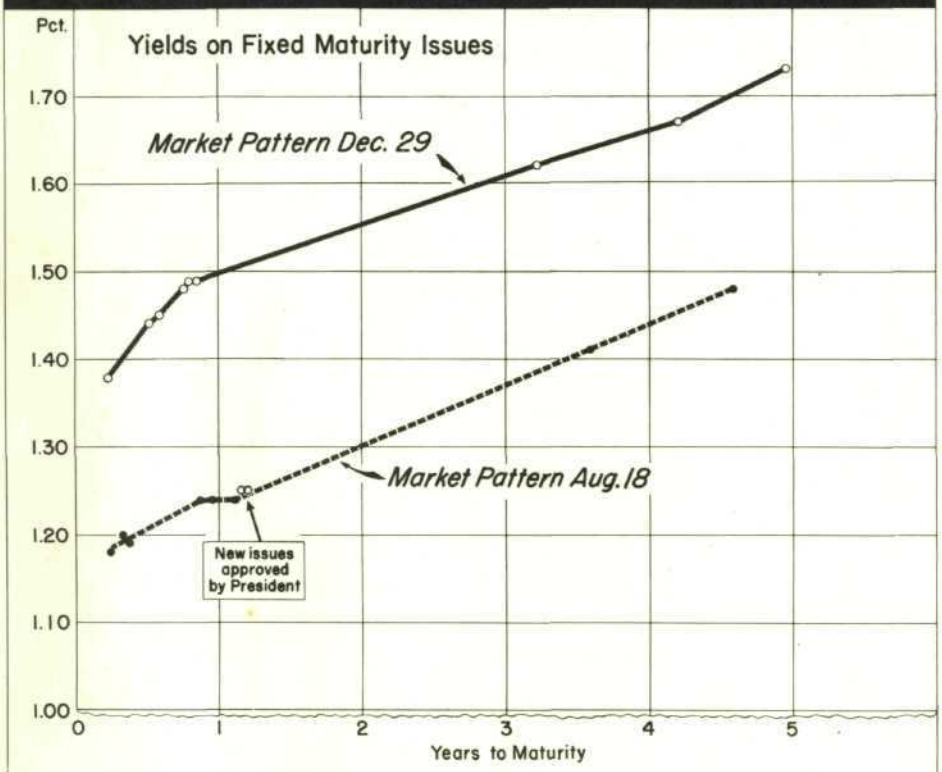
Third, we must keep the volume of public borrowing at a minimum through increasing our taxes along with our increased defense needs.

Fourth, we must manage our outstanding public debt in such a way as to keep the inflationary potential at a minimum. This means keeping the largest possible proportion of the debt in the hands of nonbank investors, and keeping the bank holdings of Federal securities at the lowest possible figure. Any

policy which leads to increasing the dependence of the Treasury on the banks and decreasing the volume of Federal securities in the hands of nonbank investors is to the highest degree inflationary. It is to the highest degree dangerous to the ability of our economy to move ahead swiftly and surely in its great task of protecting and strengthening our defenses against aggression.

Charts

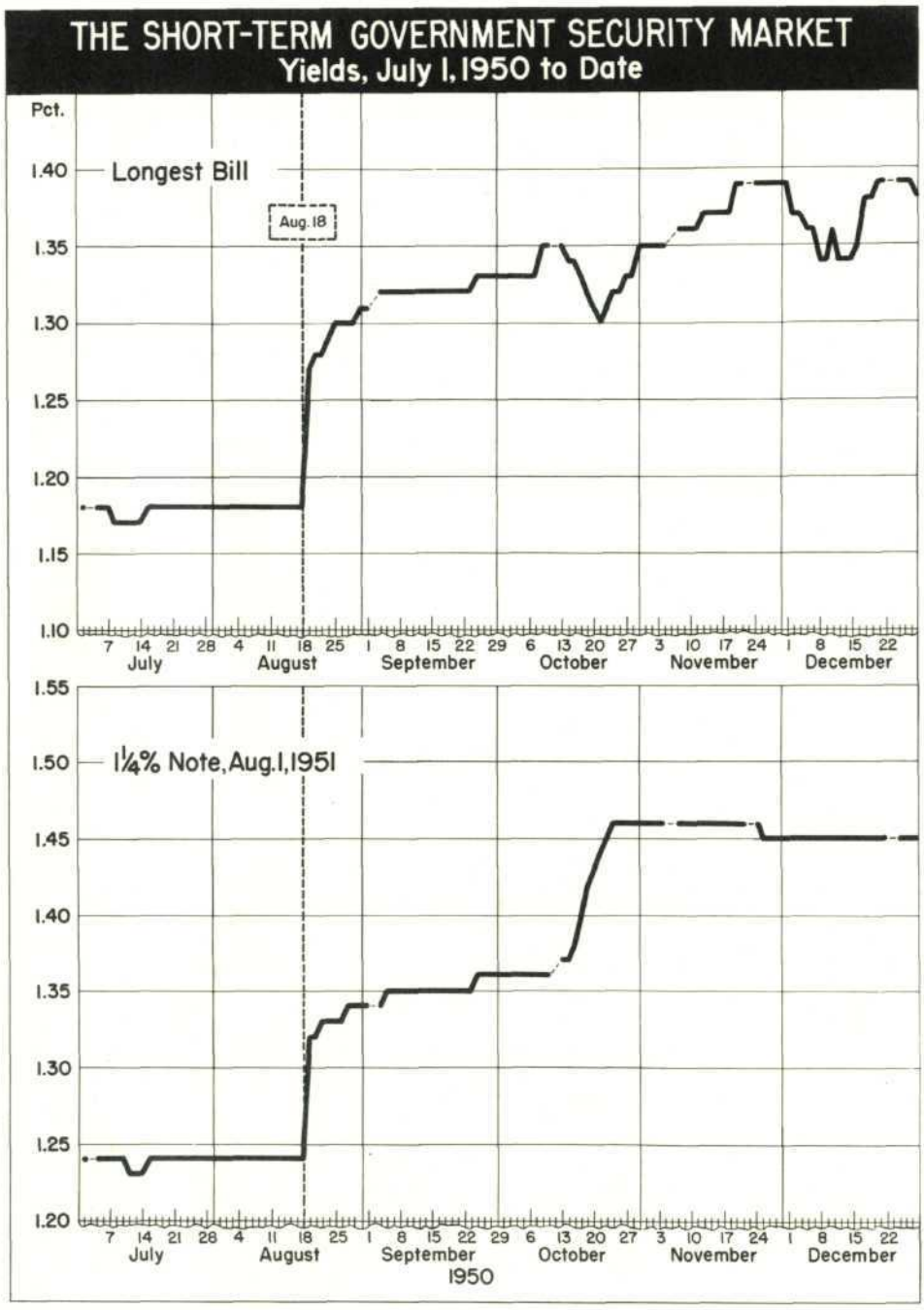
COMPARISON OF INTEREST RATE PATTERNS IN THE GOVERNMENT SECURITY MARKET, AUG. 18 AND DEC. 29, 1950

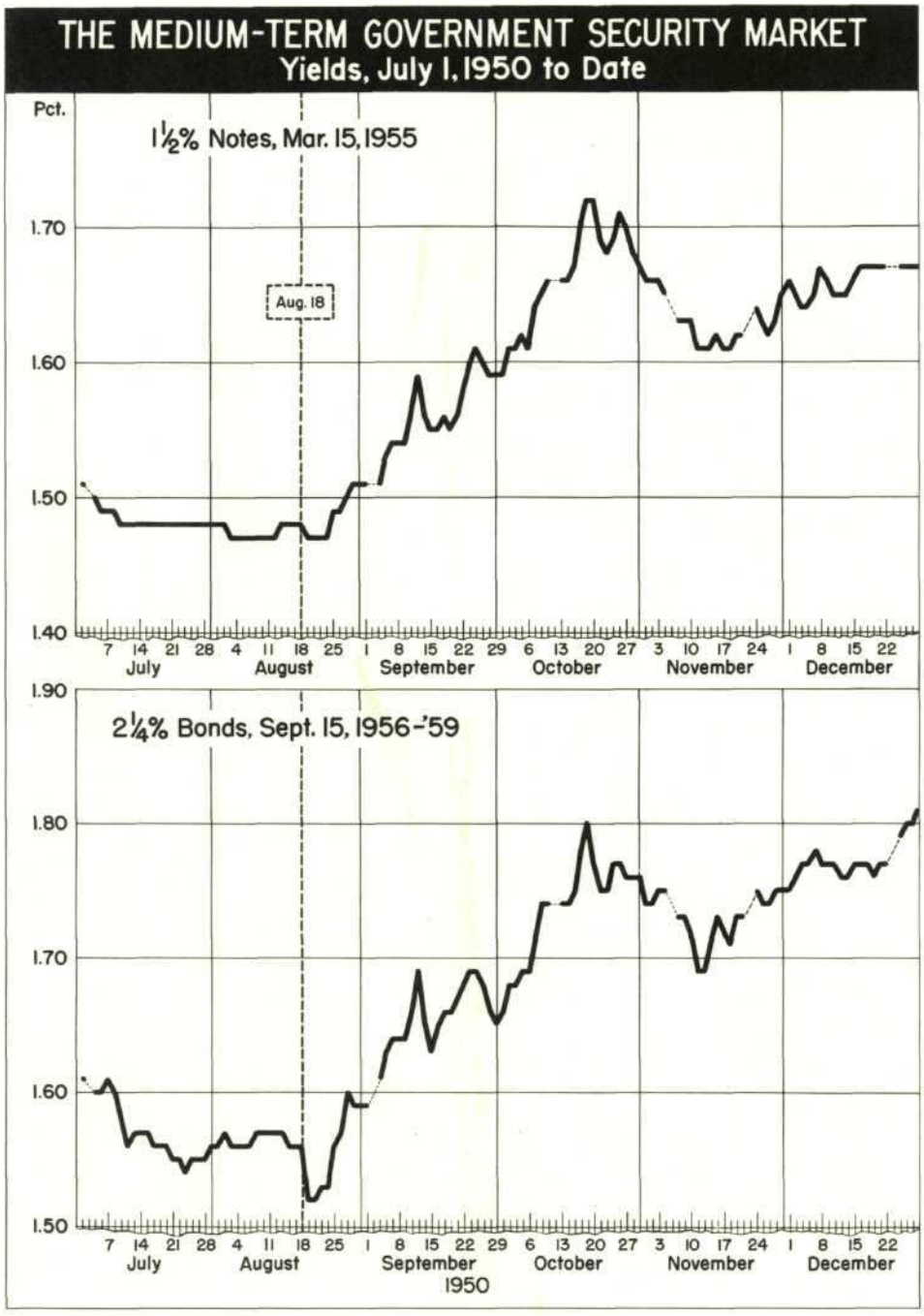


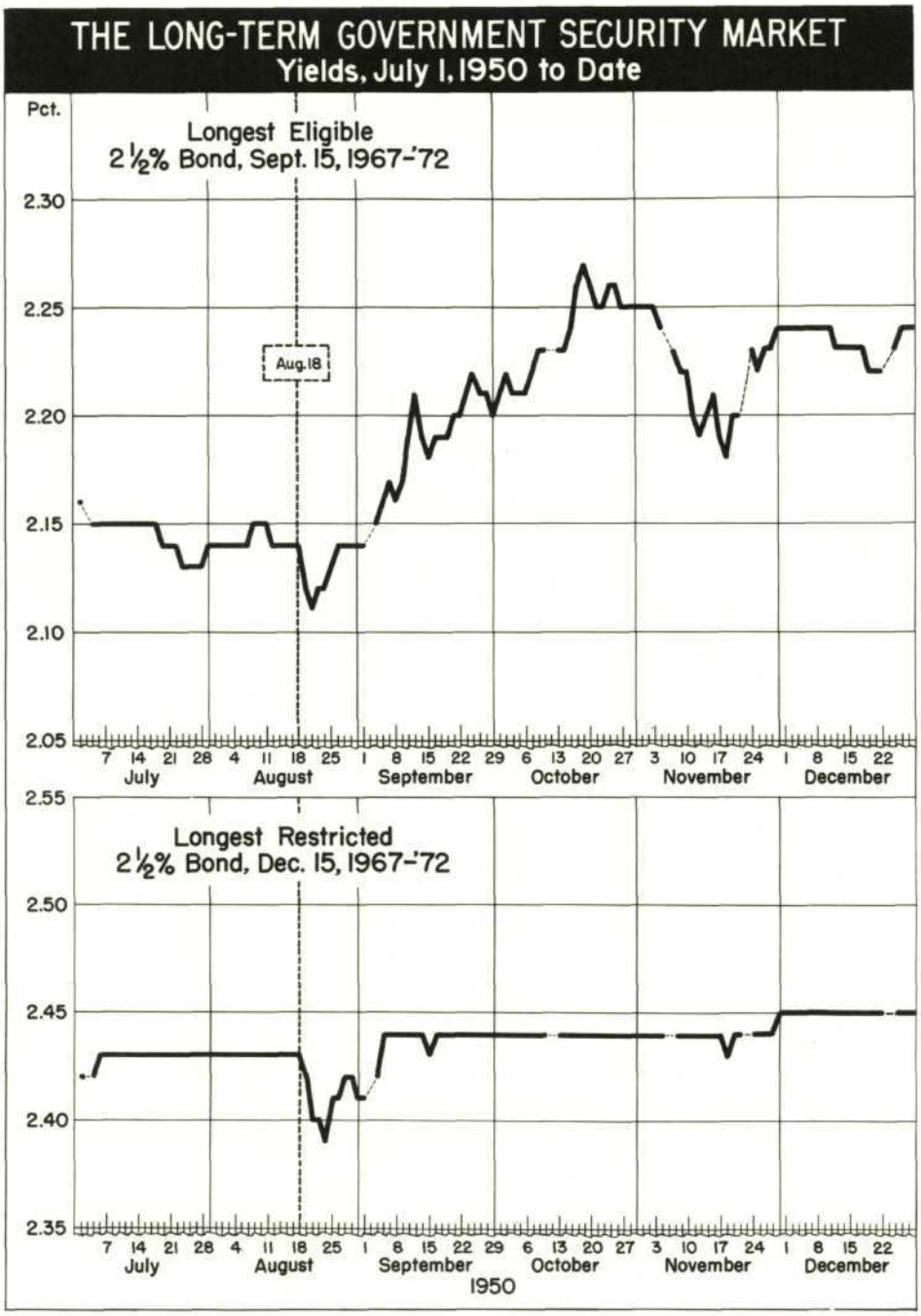
ANALYSIS OF THE PUBLIC DEBT OUTSTANDING

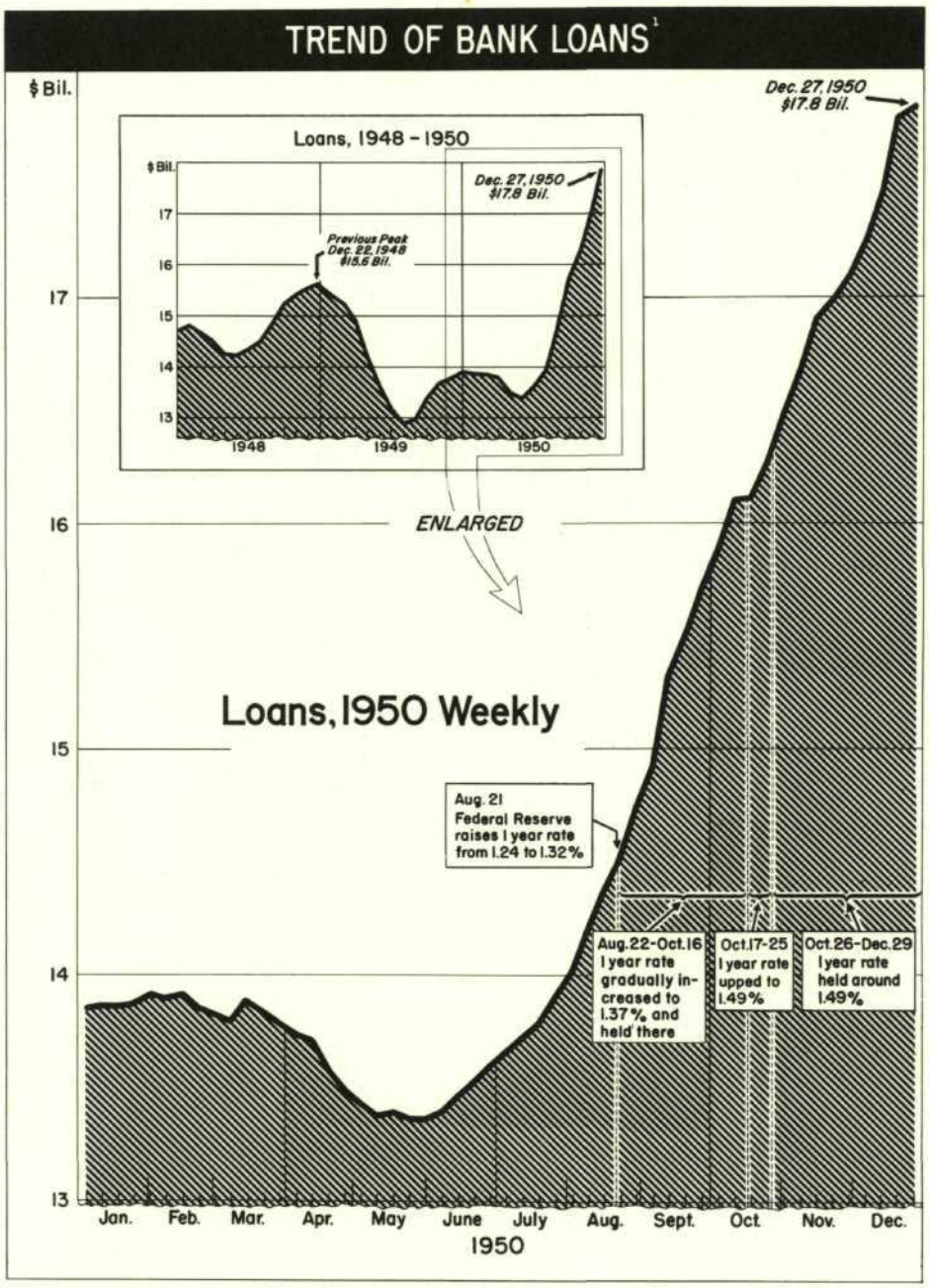
Issues most directly affected by rate changes in the short and medium term market:

Bills	$13½ Billion
Certificates and notes	44½
Bonds (under 6 years)	39½
Savings notes	8½
Total	$106 Billion
All other issues	150½
Total debt	$256½ Billion









July 17 Letter from Secretary
Snyder to Chairman McCabe

C O P Y

July 17, 1950

Dear Tom:

Thank you very much for your letter of July 12, expressing your thoughts and those of the Executive Committee of the Federal Open Market Committee with respect to new financing and the current situation in the Government bond market.

As I asked Mr. Bartelt to transmit to the Open Market Committee on June 26, I feel that everything possible should be done to maintain a basically strong position in the Government bond market during the present period of international disturbance. The firmness with which the market has withstood the impact of the events of the past three weeks is certainly a testimonial to good management. It is also the best possible evidence of the confidence which has been built up in our ability and determination to maintain a stable market for Federal securities.

I know you will agree with me that it is of the utmost importance at the present time to maintain that confidence and, in addition, to do everything possible to strengthen it. This involves, first of all, avoiding any course which would give rise to a belief that significant changes in the pattern of rates were under consideration. The operations of the Open Market Committee since the beginning of the crisis have been well adapted to this end.

As I have studied the situation, I have become convinced that present circumstances call for one further precaution which is, perhaps, of even greater importance than maintaining a good balance in current market operations. In my view, we must take extreme care to avoid introducing any factor which would run the risk of producing unsettlement in the broad market for Federal securities represented by investors throughout the Nation. It is my belief, in particular, that no new financing program should be undertaken at the present time without maximum assurance that it will be well received and can be carried through to a successful conclusion.

Our future tasks, whatever they may be, would be made very much more difficult by anything less than 100 percent success in a program for raising new money. In my judgment, we can not attain the maximum assurance of success until the outlook with respect to both the international and the domestic situations has become considerably more clarified.

At present, the defense needs which may have to be financed in the near future are not known. Our expectations as to revenues are also subject to considerable change as the situation develops. For these reasons, as you know, I recommended that the Congress postpone action on the tax bill now under consideration in the Senate Finance Committee. The same basic considerations lead to my strong belief that no new financing program whose reception is to any considerable extent unpredictable should be introduced into the market at the present time.

There are, of course, occasions which call for quick and bold action. These occasions have occurred with respect to the Federal security market and they may occur again. But every appraisal of the present situation indicates that the maintenance of stability should take priority over all other market considerations. A stable and confident situation in the market for Federal securities is our first line of defense on the financial front, no matter what may be ahead of us.

As you know, developments in the Government bond market have repercussions which fan out through the entire economy. Both the size and the wide distribution of the Federal debt are unprecedented in comparison with the situations which faced us at the start of other periods of crisis. Under these circumstances, we have an obligation of the highest order not only to maintain the finances of the Government in the soundest possible condition, but also to fulfill our responsibilities to the millions of Federal security holders throughout the Nation.

There is one further consideration which confirms my view that the present situation calls in the highest degree for caution and prudence. During the present stage of the emergency, it is vital to make use of every opportunity for assuring our citizens that those at the head of their Government have a strong and steady hand on the helm. The response of the Nation to the President's courageous action in the Korean crisis was one of the greatest demonstrations of unity that we have ever had in this country. The Nation is now waiting to learn what domestic programs may be needed in order to utilize our full strength in the interests of national defense. When these

programs are brought forward, it will take time for the public to assimilate them. In view of these facts, it is of the utmost importance that no action be taken at the present time which could be construed in any sense as anticipating proposals for defense which may later be outlined by the President.

In short, every circumstance at the present time calls for steadiness and manifest strength in the Federal security market as a primary measure of economic preparedness. That is the net of the situation as I see it. And, as you will note, I am sending my thoughts on to you just as they have occurred to me, in order to let you know the course of my thinking as events unfold.

Sincerely yours,

(signed) JOHN W. SNYDER

Secretary of the Treasury

Honorable Thomas B. McCabe
Chairman, Board of Governors of
the Federal Reserve System
Washington 25, D. C.

Board of Trade Speech

Author: Collins, Edward H.

Article Title: Economics and Finance: Mr. Snyder Outdoes Himself

Journal Title: New York Times

Date: January 22, 1951

TREASURY DEPARTMENT

Washington

The following address by Secretary Snyder before a luncheon meeting of the New York Board of Trade at the Commodore Hotel, New York, N. Y., is scheduled for delivery at 1:30 P.M., EST, Thursday, January 18, 1951, and is for release at 1:00 P. M.

We are facing critical times. It is especially vital that under the circumstances, we take every opportunity to exchange views on urgent national and international problems. Many of you members of the New York Board of Trade have at various times come down to Washington to give the Treasury Department the benefit of your judgment on measures under consideration in the area of Federal finance. Others of you have participated in such discussions through committee memberships. This exchange of views which we have had with individuals and groups of individuals -- not only in Washington, but on various occasions in almost every part of the country -- has been most valuable to the Treasury in making policy decisions.

More than three-quarters of a century ago, the founders of the New York Board of Trade set down certain important goals of cooperative effort. These were -- among others -- to provide useful information, to encourage needed legislation, to promote civic improvements, and to adjust differences and misunderstandings on an equitable basis.

The guides to action which were set down by your founders are in keeping with the doctrines of our American form of Government and our American system of free enterprise. It is in the spirit embodied in these principles that I should like to discuss with you today some of the issues which are involved in our present national task of mobilization for defense. I am grateful to the Board of Trade for affording me this opportunity to speak openly and frankly about the financial and economic problems that now confront us.

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I need not tell you that the destiny of a nation is not always decided on the battlefield -- nor even in the sometimes equally hazardous and difficult paths of diplomacy. In any national emergency, much depends upon our work in the factories and in the fields -- and the keystone of our production and economic effectiveness is the financial stability of our country.

Today our Nation is in a state of emergency. For the second time within less than a decade, we are being called upon to marshall our great military strength to resist the forces of aggression which seek to destroy us. Very serious days are ahead of us. The varnish of Soviet pretense to peace has worn off. Soviet imperialism is threatening the structure of world security. We have no time for illusions. We must be alert -- we must be fully aware of the peril -- and we must know wherein the hazard lies.

The danger we face is all the more menacing because of the sinister nature of the campaign which the aggressors are waging. This campaign is typical in most respects of all the campaigns of imperialist dictators, but the Soviets have added some stratagems of their own.

The Moscow plan is one of arousing hatreds -- nationality against nationality, class against class, creed against creed -- to bring about mutual destruction of those peoples on whom they cannot count to play the Moscow game. Here in America, the Communistaggressors, through their agents and propagandists, seek to stir up suspicion and strife among us -- and so to create disunity.

It is their theory that if a democracy is subjected to enough of their propaganda of confusion, its people will be unable to act swiftly and confidently if attacked. A first step which we must take in defense against such strategy, obviously, is to see through the smokescreen of propaganda, to expose their lies, and to meet their threats with a solid front of strength which is at once spiritual, economic and military.

Determined efforts and concentrated energy are needed to gain this goal. Yet, at the same time, we must maintain the basic stability and productivity of our domestic economy.

Public policies today, in every area of domestic endeavor -- fiscal and otherwise -- must be so designed as to strengthen the sinews of our productive power. We must plan in such a way as to avoid any measures -- however well adapted they may seem to a specific purpose -- which would undermine the ability of the American economy to meet the tremendous demands which are being made upon it.

The Secretary of the Treasury has far-reaching responsibilities in the formulation of fiscal policy to meet the financing needs of our Government. To fulfill these responsibilities adequately, it is necessary to have the counsel and aid of the most able financial and economic minds of our country. The successful merging of revenue measures and borrowing programs in such a way as to make the most effective contribution to the productive power of the Nation is one of the most difficult and most important problems on the domestic front.

One of the most serious threats to the strength of our defense economy is undoubtedly inflation. And it is a threat which could develop into disaster.

The essence of inflation is the uncontrolled spiraling of prices and wages. There have been manifestations of this economic disease in every period of war or defense effort of this country and of all countries. Our defense program today presents the same hazard.

The effects of pronounced price instability are diffused in many directions. One of the most dangerous results is that mobilization itself is handicapped through both direct and indirect influences. Far-reaching inequities arise from the inflationary process in the uneven distribution of income and profits. The defense burden is inequitably distributed among groups and communities by inflation. We lose productive efficiency. Inflation feeds the very fires of controversy.

To keep inflation in check, then, is the first need in our defense undertaking. As we transfer a great portion of our productive power from civilian to military output, and so reduce the supply of civilian goods, we must put brakes on the purchasing power of consumers. This means that a substantial part of both business and personal incomes must be diverted from the consumer markets. The alternative of allowing prices to move higher and higher would vitally damage the defense effort.

Without question a most effective over-all fiscal measure for avoiding the evils of deficit financing, and thereby combating an inflationary spiral in prices is a revenue system which enables the Government to pay its current bills out of current income. No one welcomes heavy taxes. But in a time of unprecedented national danger like the present, I am certain that all groups of our population will soon realize that very much higher taxes -- for themselves, as well as for others -- are a necessary defense measure.

While adequate revenues are an essential safeguard against the development of inflationary tendencies, they cannot do the job alone. Measures for allocating essential materials have been adopted in order to assure priority for our military needs without increasing the strain on the price structure. Selective credit controls such as those embodied in the Defense Production Act passed by the Congress last Sept. ~~July~~ are also of definite help. Other measures of demonstrated effectiveness in curbing inflationary tendencies, such as price and wage controls, are under consideration and will assuredly be adopted soon.

You will note that I have not included the use of fractional increases in interest rates on Government securities as one of the measures of effectively controlling inflation. The Treasury is convinced that there is no tangible evidence that a policy of credit rationing by means of small increases in the interest rates on Government borrowed funds has had a real or genuine effect in cutting down the volume of private borrowing and in retarding inflationary pressures. The delusion that fractional changes in interest rates can be effective in fighting inflation must be dispelled from our minds.

In the absence of new legislation, the Federal deficit will amount to $16.5 billion in the fiscal year 1952.

This deficit is a result largely of our defense requirements. In non-defense spending, as the President has noted, the only major new public works projects included in the Budget are those directly necessary to the defense effort. Construction of many public works projects now under way has been substantially curtailed. Many other activities have been abbreviated.

The revenue requirements which the defense situation demands need no comment. These requirements can be met without damage to the economy if our citizens have mutual willingness to make the necessary sacrifices.

Along with adequate revenues and specific controls required for curbing price and wage rises, there is a weapon of great importance available to us for keeping inflationary forces under control. That is a debt management program which is directed toward placing the largest possible proportion of Federal securities in the hands of nonbank investors -- individuals, insurance companies, mutual savings banks, and other investors outside the banking system -- and reducing the proportion of Federal securities held by commercial banks and Federal Reserve Banks.

This program is a powerful weapon in combating inflation. There seems to be a lack of sufficient public knowledge or understanding of what the Treasury has achieved in this area during the postwar period. It should be pointed out, therefore, that as a result of specific Treasury debt management policies, holdings of Government securities by private non-bank investors have increased substantially since the end of the war, and have reached an all-time peak during the last half of the calendar year 1950. This activity has been accompanied by a decline in the holdings of the commercial banking system, which reached new postwar lows during the last half of 1950. Three years ago the public debt was the same as it is now. But the Government security holdings of the commercial banking system have dropped nearly $10 billion; and approximately $4 billion of this reduction took place during 1950.

The importance of this anti-inflationary accomplishment can not be overestimated. This reduction in the money supply of the country holds particular significance at the present time when it is vitally important to the well-being of the economy that the inflationary potential of commercial bank assets be kept at a minimum.

There are two other important matters relating to debt management policy which hold particular interest at the present time and which have been given extensive consideration in the financial community and elsewhere in recent months. The first is the place of savings bonds in the Government financing picture, and the actions that will be taken to refund maturing "E" bonds. The second is the rate of interest that the Treasury is going to pay on long-term Government bonds in refunding and new borrowing programs. I want to take up each of these two questions in turn.

A moment ago, I stated that an important anti-inflationary action could be accomplished by placing the largest possible proportion of Federal securities in the hands of non-bank investors. As part of the Treasury Department's endeavor toward this end, the Savings Bond Program has been of outstanding value. It has been both dramatic and effective. It has been dramatic because it is sustained on practically a volunteer service basis. It has been effective because today, the total of outstanding Savings Bonds represents approximately 25 percent of the entire Federal debt.

It is really inspiring to know that there are about $10 billion more Savings Bonds outstanding today than there were at the end of World War II financing. The tremendous selling program involved in achieving this remarkable record is due in the main part to the volunteer efforts of individuals, business groups and all organizations who have contributed time, money, and ingenuity to the promotion and sales of Savings Bonds.

There are only about five hundred paid employees in the Savings Bond Division of the Treasury. These employees plan and coordinate the program. The real volume of the work, however, is done through the generous efforts of those volunteers who have sold Savings Bonds to over eighty-five million purchasers.

Of the $58 billion total of outstanding Savings Bonds, nearly $35 billion is in "E" Bonds. This is a noteworthy accomplishment -- for no one would have been rash enough to predict at the end of World War II hostilities that five years later there would be a $4 billion increase in the total of outstanding "E" Bonds. Most of us were sure in 1945 that there would be a heavy cashing of Savings Bonds as soon as war scarcities and restrictions were over. On the contrary, however, the "E" Bond total has gone up every year because of the organized promotion by volunteers in bringing the merits of the Savings Bond investment to the attention of the public. As a matter of fact, in the calendar year just ended, the volume of "E" Bonds outstanding rose by three-quarters of a billion dollars, notwithstanding the fact that there were increases in redemptions as a result of the scare buying immediately following the outbreak of the Korean crisis. It is interesting to observe in this connection that the redemption of "E" Bonds -- in relation to the amount outstanding -- was less percentagewise than other comparable forms of savings. So it becomes readily apparent that the Savings Bond is, in fact, a very popular form of savings.

It was this last fact that led to the conclusion on our part, after consulting with many individuals and business groups, that the Treasury should continue the Savings Bond Program after World War II as a major effort to encourage the promotion of thrift. It is this same conclusion that leads us to announce that the Treasury will continue to offer the "E" Bond, in its present form, to the public as a Defense Bond during the mobilization period. The aim now is not only to promote thrift, but to act as an anti-inflationary force and to help further distribution of the ownership of the public debt.

As you know, beginning in May of this year, a portion of the Savings Bonds bought during the war years will mature. While some of the holders of these bonds may desire to cash them upon maturity, it is our belief that the majority will desire to continue their investment in United States Savings Bonds. Therefore, the Treasury is adopting the following plan for handling the maturing bonds. The holder may have his choice of: one, accepting cash if he so

desires; two, continuing to hold the present bond with an automatic interest-bearing extension; and three, exchange his bond for a current income savings bond of Series G.

Under Option 2, the bond would be automatically extended, bearing interest at the rate of 2-1/2 percent for the first seven and one half years and interest at a rate sufficient thereafter so that the aggregate return for the 10-year extension period will be 2.9 percent compounded. The term of the extension would be limited to 10 years after maturity. The existing option of paying taxes on interest on Series E bonds currently or at maturity would be retained. Necessary Congressional legislation to authorize this option will be requested immediately. Once the plan is placed in effect, it will apply to all outstanding E bonds as they mature, and will apply by right of contract to all new Series E savings bonds that are issued.

These decisions with respect to the refunding of savings bonds and their future place in the Federal securities structure have been reached after long deliberation and extensive consultation. Among those who have given us the benefit of their thought and judgment are representatives of the Federal Reserve System, which has done such a magnificent job in facilitating the smooth functioning of the savings bond mechanism throughout the Program's entire history.

Almost a year ago, at the annual Fiscal Agency Conference held in San Francisco, various alternatives with respect to the refunding of savings bonds were fully discussed by representatives of the Federal Reserve System and the Treasury. Following that conference, other groups and individuals continued to meet with officials of the Treasury and to give time and thought to the refunding measures which would be in the best interests of both the Government and the bondholders. The program which I have outlined to you today is the result of this cooperative effort. As soon as the necessary Congressional legislation is completed, full details of the extension Savings Bonds Program will be released to the public. I believe that we have adopted a good program.

Now let us go on to the subject of interest rates. It is my view that a 2-1/2 percent rate of interest on long-term Treasury bonds is a fair and equitable rate -- to our Government which is borrowing the money, to the purchaser of Government bonds who is lending the money, and to the taxpayer who has to pay the interest on the money borrowed.

The 2-1/2 percent rate of interest on long-term Government securities is an integral part of the financial structure of our country. During the past ten years -- a period in which we fought our most costly war and made a most extensive reconversion to peacetime activities -- the 2-1/2 percent rate has become a most important influencing factor in financial policy in the country. It dominates the bond markets -- Government, corporate, and municipal. Moreover, it dominates the operations of financial institutions. Most of these have already adjusted themselves to the 2-1/2 percent rate -- and after so doing, have become more prosperous than ever before.

Most life insurance companies, for example, have changed the guaranteed interest provisions of their new policies during the past decade to conform with the 2-1/2 percent rate, so that today about 85 percent of the new life insurance premiums received by insurance companies are on policies written at interest rates of 2-1/2 percent or less. Mutual savings banks also have tied their current interest rate on funds of depositors to the Government rate.

Any increase in the 2-1/2 percent rate would, I am firmly convinced, seriously upset the existing security markets -- Government, corporate, and municipal.

We cannot allow this to happen in a time of impending crisis, with the heavy mobilization program to finance. We cannot afford the questionable luxury of tinkering with a market as delicately balanced as the Government security market. Now is no time for experimentation.

We have not hesitated to draft our youths for service on the battlefront, regardless of the personal sacrifice that might be entailed. Neither can we hesitate to marshal the financial resources of this country to the support of the mobilization program on a basis that might, in some

instances, require a degree of profit sacrifices.

In the firm belief, after long consideration, that the 2-1/2 percent long-term rate is fair and equitable to the investor, and that market stability is essential, the Treasury Department has concluded, after a joint conference with President Truman and Chairman McCabe of the Federal Reserve Board, that the refunding and new money issues will be financed within the pattern of that rate.

When I came to the Treasury in June 1946, the war had been over less than a year, and war financing had only recently been completed. I felt at that time that stability in the Government bond market during the transition period was of vital importance. As the economy became more stabilized, the Treasury used more flexibility in its debt management program by allowing short term rates to increase gradually.

Later, beginning with the crisis in Korea, however, the considerations calling for stability in the Government bond market became tremendously important. The credit of the United States Government has become the keystone upon which rests the economic structure of the world. Stability in our Government securities is essential.

I do not think that we can exaggerate when we emphasize these matters. I think they are basic to our national survival.

I have outlined for you the highlights of our financial mobilization program. I believe that with vigorous, cooperative effort, we can make it a successful one.

The democratic processes and the free institutions of our country enable us to do just that. We are a Nation of strong individuals, united in our belief in American principles and in our determination to defend them. We do not expect -- and we do not wait to be told what to think and what to do. We will not govern our actions according to decrees which represent thinking done for us by someone else. Every American citizen today is searching his mind and heart for answers to the challenge of aggression. We do this because we know that in a free Nation such as ours, decisions on matters of national import must be made by the citizens themselves.

The formulation of a successful policy of financial mobilization is not easy. It must, of necessity, be one that will require sacrifices from every one of us. Let me make on thing clear. Even a short period of weakness in the financial stability of the United States could mean a generation of disaster to us and to the world.

The Communist regime knows this -- and ever since the close of the Second World War, it has sought to undermine the structure of peace and stability we have tried so patiently, and with so marked a degree of success, to help build in the free world. Red Imperialism has taken the offensive against the free world in almost every area of human cooperation where civilization might again be made secure. It has coupled with a bellicose avowal of peace the most flagrant and most insidious forms of human sabotage.

Let there be no mistake about it. We want real peace in this world. To seek this, we set up a forum in which men might work out their differences and arrange for solutions of common problems. We tried very earnestly to win an honorable peace across the council table. But the Russians have tried to make a mockery of the vital work and procedure of the United Nations. While we have tried to restore economic and financial stability to nations suffering from the ravages of war, the Soviet Union has sought to dissipate the effects of our unprecedented and successful aid to free nations and are now trying to destroy the fruits of our aid with the blight of urgent and costly need for self-defense.

As the economic and financial stability of our friends and allies in Western Europe became more certain -- Soviet Imperialism became bolder and laid down a barrage of direct and indirect assaults on the free world.

It is but a natural reaction to hope, in an emergency, that we can preserve our freedom, and save ourselves from danger, without sacrifice. Any such hope runs counter to all of human experience. Readiness to sacrifice for freedom is the first requisite of life in a free land.

I have every confidence that whatever sacrifices are required of our people to repel the aggressors will be willingly, earnestly, and confidently made.

What we face is obvious. What we must do is plain.

We shall diligently continue our efforts with free nations to help establish peace and prosperity in the world. But in the meantime, we shall face realities -- face them in the knowledge that our pride in America's past and present, and our confidence in her future, permit no passive acceptance of the dictates of a foreign aggressor.

We are going ahead with our military and our financial mobilization measures to whatever extent the unfolding disclosures of Communist intentions make necessary. In justice to ourselves and to all other believers in freedom, we can follow no other course.

oOo

Insurance Companies
and 2-1/2 percent rate

STRICTLY CONFIDENTIAL

The Life Insurance Plea for Higher Interest Rates

For many years life insurance companies have felt that the interest rate paid by the Treasury on long-term securities was too low to meet their needs. Five years ago there was a vigorous campaign conducted by the life insurance business for higher interest rates. At that time life insurance companies felt that they had done their patriotic duty in supporting the large Treasury financing operations during the war on a 2-1/2% basis and now that war financing was drawing to a close the Treasury should give serious consideration to raising the interest rate. They claimed that there were three harmful results of the 2-1/2% rate on the life insurance business: (1) that the lowness of the rate increased the cost of life insurance, (2) that it threatened their solvency, and (3) that it increased the cost of living and hence decreased the value of life insurance to its holders. But then the large volume of private mortgage and corporate financing began to open up, the rate of earnings of life insurance started to rise, and the campaign lessened in intensity.

At the present time a new cycle of protest appears to be in the making, stemming in part at least in the statement by Mr. Thomas Parkinson two weeks ago in which he argued that as far as the life insurance companies' government portfolios were concerned "their interest needs -- indeed, their very solvency -- call for a minimum rate of 3%."

We have examined the position of the life insurance industry in some detail and have come to the conclusion that the life companies are currently in excellent condition. They do not seem to have been affected adversely by a period of approximately 10 years of Treasury long-term issues at 2-1/2% and it does not seem likely to expect that they would be affected seriously if that rate is continued.

The fact that the amount of life insurance in force in the United States today is 50% larger than it was 5 years ago and is twice as large as it was 10 years ago is just one evidence of the current strength of the life insurance industry. Life insurance is a product

which is popular, a product which has been selling well year after year and promises to do so far many years ahead.

Assets of life insurance companies have also doubled during the last 10 years and their surplus funds are currently almost 2-1/2 times as large as they were in 1940. This tremendous expansion in the life insurance business during the last decade has taken place despite the fact that the going rate on long-term government securities has remained at 2-1/2% for the entire period. It has taken place despite the fact that each successive year through 1947 showed a decline in the average rate of return on life insurance investments. This decline did not impair the solvency of the life insurance companies, it was reflected for the most part in the increased cost of insurance to policyholders. As a result dividends (which are really a return of premium) tended to become a smaller proportion of total premiums year after year, falling from 11-1/2% in 1940 to something like 8-1/2% at the present time.

It does not appear that life insurance companies have suffered at the expense of other savings institutions as a result of this increased cost of insurance. During the last five years savings of individuals in the form of private insurance increased by over 40%, as compared with increases for mutual savings bank deposits of 30%, 20% for savings accounts in commercial banks, and a 15% increase in savings bonds held by individuals. Only the percentage increase in savings and loan shares is in excess of that for insurance. In terms of total investment individuals now have an equity in private insurance that exceeds $60 billion, a figure almost as large as individual holdings of Federal securities, or individual holdings of all forms of savings accounts in mutual savings banks, commercial banks, savings and loan associations, and Postal Savings.

If the low level of the interest rate on governments were a factor pushing life insurance companies toward insolvency one would expect that the first place where that would be evident would be in the stock market performance of the stock insurance companies, which account for about one-fifth of the life insurance assets in the country. Typically these companies have gross premiums on their nonparticipating policies which are lower than those of the participating policies of mutual companies, so that they do not have the recourse of cutting down or eliminating dividends to policyholders.

We have taken a look, therefore, at the record of the stocks for three of the largest stock companies, Travelers, Aetna Life and Connecticut General, to test the general market appraisal of these

insurance company stocks. These three companies hold about one-third of the assets of all stock companies. Travelers and Aetna Life also do a fire and casualty business which contributes materially to their profits although upwards of 85% of the assets of both companies are currently in their life insurance departments. The business of Connecticut General is entirely life, health and accident insurance.

From 1940 to 1945, when the 2-1/2% Government rate first became firmly established, there was a dearth of private investments available to life companies. Nevertheless, all three of these companies showed increases in stock prices which either approximated or exceeded the averages on Dow-Jones industrials as a whole. Since 1945, quotations on these three stocks have continued to rise at a rate well in excess of the increase in the industrial averages.

During this same decade, there has been a steady increase in dividends to stockholders in each of these three companies. Cash dividends paid by Travelers Insurance Company amounted to $3.2 million in 1940, $3.6 million in 1945, and $5.6 million in 1950. For Aetna Life, the 1940 figure was $2.1 million; in 1945, it was $2.2 million; and in 1950, $4.5 million. The increase in dividends with regard to Connecticut General is even more striking; they rose from $0.2 million in 1940 to $0.4 million in 1945 and $0.9 million in 1950. These impressive market and dividend records are indicative of the financial strength of the stock companies.

The ability of life insurance companies to keep strong financially in spite of a declining rate of interest on invested funds stems from two factors. A large part of insurance in force today was written on the assumption of interest rates of 3% or better. The deficiency of actual interest earnings as compared with the rates at which these earlier policies were written is more than offset by the fact that the average American is now living longer than he used to. Up until rather recently, life insurance policies were typically written on the basis of the American Experience Tables based on mortality experience long since out of date. This resulted in the insurance companies having a significant margin in which they could absorb a decline in interest earnings.

During the last few years, insurance companies have moved away from the American Experience Tables and are now typically using the Commissioners Standard Ordinary Table as a more up-to-date basis. At the same time, however, insurance is now being written at much lower rates. On the basis of most recent data available, it appears that of the 49 companies accounting for about 90% of the total life insurance assets in the country, 41 are writing their new insurance with interest rate assumptions ranging from 2 to 2-1/2%. Of the remaining 8 companies, 6 sell only nonparticipating insurance, which may be at a slightly higher guaranteed rate to offset the fact that dividends are not paid on such policies. The comparison

of the present interest rates at which new insurance is being written with comparable rates as recently as five years ago is rather striking. At that time 40 of the 49 companies were writing their insurance on an interest rate assumption of 3% or better.

It would appear, therefore, that the life insurance industry has over the course of the last decade become adjusted to the existence of a 2-1/2% rate on governments. The problem has perhaps seemed less acute to them during the last two or three years because they have seen their average rate of earnings on invested funds growing slightly from 2.88% in 1947 to something like 3.05-3.10% at the present time, with the increase reflecting the growing importance of private investments and the declining importance of governments in their portfolios.

What the life insurance companies seem to fear at the present time is that the defense expansion program will seriously curtail the volume of new private investments appearing on the market and that they will again be in a position of relying more heavily on governments and again their average rate of earnings will begin to fall. It does not seem likely, however, that the rate will change much in 1951. With new plant and equipment expenditures likely to continue close to their all time highs there will still be a significant volume of new corporate issues on the market. It is true that the increase in mortgage debt in 1951 will undoubtedly fall considerably below the rise in 1950. Nevertheless, it still seems logical to assume that life insurance companies will find an outlet for most of their funds in 1951 in other than government securities. Life insurance companies have already adjusted by and large to the existence of the 2-1/2% rate, however, as we have noted above. Even if the average rate on earnings should fall off slightly in the next year or two, the solvency of the companies is not threatened.

There are two other important questions, in addition to the problem of life insurance solvency, which should be answered: (1) Who pays the cost of increased interest rates as against who receives the benefits, and (2) do higher interest rates stimulate saving and help alleviate inflationary pressures.

Life insurance companies often emphasize the widespread distribution of life insurance ownership in the country, thereby giving the impression that trends in interest rates would be an important factor in connection with the policies of many millions of Americans. It is true that there are many millions of Americans involved, but it should be remembered that the rate of interest really has no effect on term insurance and group life insurance and very little effect on the cost of industrial insurance (since reserves built up against these types of policies are either non-existent or very small). It does have a considerable effect on the cost of whole life policies and is a major factor in the cost of endowments and annuities. It is probably true, therefore, that the interest rate is of real importance to a relatively small number of large policyholders with

above average incomes. If insurance companies (and other investors as well) should receive higher interest rates in the future a large share of the burden should fall directly on the taxpayers of the country, as Federal, State, and local government debt costs are increased. Most of the rest would fall directly on home owners and renters, on public utility and railroad ratepayers and on consumers generally. It would appear, therefore, that the cost of an interest rate rise would be far more widespread than the benefits.

The insurance companies also argue that the use of a higher rate of interest would encourage savings. It is doubtful if it can be proved that individuals would save more at higher rates of interest than at lower rates, particularly when one is talking in terms of a differential as small as 1/2%. In general the volume of saving at any given time is much more a function of such factors as the (1) size of the Government deficit, (2) the relative ability or inability of business to finance its own capital expenditures through retained profits and reserves, and (3) the consumption and thrift habits of the large body of savers. These are the primary factors, while small changes in the rate of interest are secondary.

You may be interested in the two attached tables on (1) some of the important figures on the financial status of life insurance companies and (2) the data on the net rate of interest earned on life insurance invested funds.

Net Rates of Interest Earned on
Life Insurance Invested Funds
1925-1950

1925	5.11%
1930	5.05
1935	3.70
1940	3.45
1941	3.41
1942	3.40
1943	3.29
1944	3.19
1945	3.07
1946	2.92
1947	2.88
1948	2.96
1949	3.04
1950 e	3.05-3.10

Office of the Secretary of the Treasury,
Office of the Technical Staff. Jan. 12, 1951

Source: Institute of Life Insurance.
e Estimated by Treasury.

Financial Status of Life Insurance Companies
December 31, 1935-1950

(In billions of dollars)

	Assets			% in	Surplus	Insurance
	Governments	Other	Total	governments	funds	in force
Amounts outstanding December 31:						
1935	2.9	20.3	23.2	13%	1.8	101
1940	5.9	24.9	30.8	19%	2.2	118
1945	20.9	23.9	44.8	47%	3.7	156
1950 e	13.5	50.5	64.0	21%	5.3	234
Dollar change during 5 year period:						
1935-1940	+2.9	+4.6	+7.6		+.5	+17
1940-1945	+15.0	-1.0	+14.0		+1.5	+38
1945-1950 e	-7.4	+26.6	+19.2		+1.6	+78
% Change during each 5-year period:						
1935-1940	+101%	+23%	+33%		-27%	+17%
1940-1945	+254%	-4%	+45%		+65%	+32%
1945-1950 e	-35%	+111%	+43%		+43%	+50%

Office of the Secretary of the Treasury, Office of the Technical Staff. January 12, 1951.

Source: Life Insurance Institute and Spectator Year Book.
e Estimated.

Chronology of Events Relating to Government Security Market

STRICTLY CONFIDENTIAL

CHRONOLOGY OF EVENTS RELATING TO THE GOVERNMENT SECURITY MARKET

1. June 25 -- The Republic of Korea is invaded.

2. June 26 -- Secretary Snyder conveys to the Open Market Committee through the Fiscal Assistant Secretary his feeling that "Everything possible should be done to maintain a basically strong position in the Government bond market during the present period of international disturbance."

3. June 27 to July 17 -- Federal Reserve ignores the Secretary and continues to sell long bonds in the market. In 13 trading days, the Federal Reserve sells over $300 million of long-term bonds.

4. July 12 -- McCabe writes the Secretary that, instead of stability, continued pressure should be placed on the Government security market in order to reduce bank credit.

5. July 17 -- Secretary replies to McCabe, calling again for stability in the Government bond market and explaining his reasons therefor at some length. (Copy attached.)

6. July 17 to August 10 -- Federal Reserve continues to put pressure on Government security market, selling $600 million of long-term bonds in 18 trading days.

7. August 10 -- McCabe and Rouse meet with the Secretary. McCabe expounds on problem of preventing inflation. Talks about higher discount and short-term interest rates, and further pressure on the long-term market. Secretary reiterates the necessity for stability in the Government security market during international crisis. McCabe requests another conference to discuss the matter with the Secretary further, and this is set for August 18.

8. August 10 through August 18 -- Federal Reserve continues pressure on long-term bond market, selling $145 million of long bonds in 7 trading days.

9. August 18 -- McCabe and Sproul meet with the Secretary, not for the purpose of discussing interest rates as indicated on August 10, but to tell him that the Federal Reserve has decided to raise the discount rate by 1/4 of 1 percent, and to tighten rates in the short-term market generally. The Secretary tells them that his views on stability remain unchanged and that he cannot, therefore, go along with the Federal Reserve. The Secretary announces the September-October refunding, as approved by the President. McCabe checks the proposed discount rate increase with the President, who tells him that he doesn't want Government security rates raised. Federal Reserve, nevertheless, goes forward with its program and announces change in the discount rate.

10. August 21 -- Federal Reserve raises interest rates in the entire short-term Government security market. Billions of dollars of Government securities go to a discount in the first half hour of trading.

11. August 24 -- Secretary informs President of the situation in the market. President talks to McCabe about it and sends him a letter calling for the maintenance of confidence in the credit of the United States and stability in the Government security market. McCabe returns the letter to the President, assuring him, however, that his request will be carried out.

12. October 2 -- McCabe and Sproul meet with the Secretary and advise him that they are going to raise short-term rates further. (The one-year rate had already been raised from a 1-1/4 percent to a 1-3/8 percent basis.) This is confirmed by letter on October 16. This letter assures the Secretary, however, that "these actions will not affect the maintenance of the 2-1/2 percent rate for the outstanding longest term Government bonds."

13. October 17 - Federal Reserve starts to raise yields on short-term Treasury issues further. One-year rate rises to nearly 1-1/2 percent within a few days.

14. October 26 - Meeting at the White House between the President, Secretary Snyder, and Chairman McCabe. McCabe finally agrees to prevent short-term rates from going up further and, "for the present," to maintain the one-year rate at 1-1/2 percent. This is confirmed by letter on October 30.

15. November 17 - McCabe gives Secretary the Federal Reserve views on December-January financing, proposing a five-year, 1-3/4 percent note. Secretary agrees to go along with McCabe so long as the financing can be done within the pattern of 1-1/2 percent on one-year securities and 2-1/2 percent on long bonds.

16. November 24 - Federal Reserve allows market to go off sharply as result of November 22 announcement of December-January financing. Unsettles market psychology further by dropping price on Victory Loan issue 2/32 during the day.

17. December 1 - Secretary Snyder sees the President and tells him about developments in the market. The President calls McCabe, discusses the matter with him and tells him that he is relying on the Federal Reserve to carry out the commitment to keep the market stabilized.

18. December 19 - McCabe advises the Secretary that the Board has further measures for credit control in mind, specifically, raising reserve requirements and increasing margin requirements on securities. The Secretary tells McCabe he doesn't think these moves will do much toward controlling credit and makes it clear to McCabe that he wants stability in interest rates. McCabe assures the Secretary that he does not have further interest rate changes on Government securities in mind.

19. December 26 - Federal Reserve reduces the price of the Victory Loan issue from 100-23/32 to 100-22/32. This unsettles the market and causes much conversation as to whether the Government really proposes to maintain the 2-1/2 percent rate.

20. December 28 - McCabe advises the Secretary that the Federal Reserve has taken action to raise reserve requirements; tells the Secretary further that the Federal Reserve proposes to reduce the buying price on Victory Loan 2-1/2s, allowing them to go down 1/32 a day. He mentions a floor of 100-8/32 and then suggests a range of between 100-4/32 and 100-8/32 for this issue. The Secretary tells McCabe he wants stability maintained in the long-term market.

21. January 3 -- The Secretary meets with McCabe and Sproul, who outline a program which would involve a complete reorientation of debt management policy. They propose a program of higher interest rates, particularly in the long-term area. They also want higher interest rates on savings bonds.

22. January 17 -- Joint conference between the President, the Secretary, and McCabe to discuss the defense financing program, at which time it is agreed that market stability is essential and that, therefore, the 2-1/2 percent rate on long-term Government bonds shall be maintained, and that refunding and new money issues will be financed within the pattern of that rate.

23. January 18 -- Secretary's speech before the New York Board of Trade announcing a policy of market stability and stating that during the defense period refunding and new-money issues will be financed within the pattern of the 2-1/2 percent rate.

24. January 22 -- Sproul makes a speech before the New York State Bankers Association, attacking Secretary Snyder's statement on defense financing and market stability policy.

25. January 25 ---Eccles testifies before the Joint Committee on the Economic Report and strongly criticizes Treasury financing policy.

26. January 29 - Federal Reserve reduces the buying price on Victory Loan 2-1/2s to 100-21/32. In order to assure market stability, Secretary authorizes the Federal Reserve, as fiscal agents, to purchase this issue for the account of the Postal Savings System at 100-22/32 -- the price that had existed up to 2:00 p.m. on this day.

27. January 30 - Federal Reserve fails to cooperate with Treasury action. Terminates open-market purchases of Victory Loan 2-1/2s and buys $33 million of this issue for Postal Savings account.

28. January 31 - Open Market Committee meets with the President in accordance with his request of the previous day.

29. February 1 -- The White House releases a statement on the January 31 meeting, which says that the Federal Reserve Board had pledged its support to the President to maintain the stability of Government securities as long as the emergency lasts. Press Secretary Short announces that this statement is to quiet rumors of differences of opinion between the Treasury and the Federal Reserve Board.

30. February 2 -- President Truman sends letter to Chairman McCabe, thanking the Board and the Open Market Committee for their assurance that they would fully support the Treasury refinancing operation as to refunding and new issues; and would stabilize the market for Government securities and maintain it at present levels in order to assure successful financing requirements and establish in the minds of our people confidence concerning Government credit.

31. February 4 -- Eccles releases to the press his views on the meeting with the President. He disputes the assumption that the Board supports the Treasury position and, in evidence thereof, releases the Open Market Committee record of the meeting.

32. February 5 and February 6 -- There is considerable discussion on the floor of the House about the Treasury-Federal Reserve controversy -- involving primarily Representatives McCormack, Patman, and Crawford.

33. February 5 and February 6 -- The press carries a report that on February 5 the Senate Banking Committee starts an inquiry to decide whether public hearings should be held. This is followed by a press release on February 6 that Senator Robertson has closed the door on any public hearings, stating that neither

agency wishes to usurp the functions of the other and that he thinks the matter is going to be adjusted by mutual cooperation.

34. February 8 -- McCabe and Sproul meet with the Secretary and hand the Secretary a letter in which they propose for the present to maintain long-term bonds above par with the further proviso that if substantial Reserve buying is necessary, the Secretary would be prepared to announce a new long-term higher-income bond into which he would exchange all of the outstanding issues. With respect to short-term rates, the Federal Reserve proposes to hold purchases of short-term issues to a minimum and, if bank credit demands continue, to increase short-term rates. McCabe reads to the Secretary the letter the Open Market Committee proposes to send to the President. It is in open defiance of the President's request that the market for Government securities be stabilized. The letter is dated February 7, but appears to have been delivered February 8.

35. February 8 -- The President tells his weekly news conference that he understands a majority of the Federal Reserve Board now agrees with the Government's interest rate views; and adds that he had thought all of the members of the Board supported these views, based on what the Board told him.

36. February 9 -- Senators O'Mahoney, Maybank and Robertson meet with McCabe and ask him to prevail upon the Open Market Committee to withdraw the letter written to the President; and to maintain the market at status quo until after Secretary returns from hospital. McCabe agrees to try.

Mr Martin

Credit Restriction
and Debt Management

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 undiscriminating 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 undiscriminating 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 Indirect 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 undiscriminating 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 undiscriminating 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 $8 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 or 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 indurance 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 undiscriminating 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 percent 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.

Some Background on
Present Problem

Staff Memorandum Presenting Background on the Present Problem

It has often been pointed out that the huge growth of the public debt, to the point where it is approximately one-half of all debt in the country, had made it much more important to minimize nervousness on the part of holders of Treasury securities. It must be remembered that at the time the Federal Reserve System was established there was no public debt to speak of (about $1 billion) and so the Federal Reserve was faced with no difficulties like we have today.

Perhaps the real issue between the Treasury point of view and the Federal Reserve point of view centers about this element of nervousness. Both sides recognize that there is a large body of assets in the hands of nervous holders. These holders are not always nervous, but they have a natural nervous feeling that becomes important when changes in interest rates are being discussed. For the most part, these nervous holders are not the little fellows, but on the contrary are the professional portfolio men, the smaller bank presidents, the trust fund administrators, etc. This is a very sophisticated group, by and large, and as such they are more than ever afraid that they will be caught short in some way. In other words, there is a large element of pride involved. The portfolio man is in a sense gambling against the market and wants to "look good" to his superiors and particularly his board of directors. Hence these people are apprehensive all the time that something will happen to make their decisions look bad. This is why a fractional rise in long-term interest rates, with a corresponding small drop in the price of long-term Government bonds might bring on a great wave of selling. The selling would be engendered by the fear that prices would go lower and lower and the portfolio man who sold early would

reason that he would be able to either (a) minimize his losses, or (b) make some profits by reinvesting later at lower prices.

The Federal Reserve position seems to be that it is possible to capitalize on the very fact that there is nervousness in the minds of a large body of holders of our vastly expanded public debt. It is said that this very sensitivity can be used to advantage, and that small manipulations of interest rates and bond prices may produce highly desirable changes in the monetary situation. In other words, the argument is that the growth of the debt and the nervousness of some of the holders means that the Federal has more control than ever because of the leveraged effect of its manipulations.

In any event, there is agreement on the existence of a substantial body of nervous holders. The difference in opinion lies primarily in the conclusions about how these nervous holders would react to uncertainties stemming from changes in interest rates and bond prices. The Federal Reserve position is one of confidence that small changes can produce comfortable results. The Treasury position is that small changes may produce chain reactions leading to completely unpredictable results. This is obviously a matter of judgment.

The Federal Reserve is willing to experiment and feels that if it makes a mistake it can easily correct it. The Treasury is afraid to experiment because of the volatility of public opinion and contends that it may be virtually impossible to correct mistakes. Moreover, the anti-inflationary results seem so slim relative to the size of the risks involved that the game does not seem to be worth the candle to the Treasury. In fact, the Treasury feels that there is a distinct

chance that scaring the nervous holders by manipulation could result in an intensification of inflationary pressures. This is because if people are already worried about the declining purchasing power of the dollar, will not their fears increase if they feel that savings are not safe because the financial markets themselves show heavy selling and declining prices? The natural reaction might be to say that this caps the climax and it is best to save not dollars but acquire only things.

The Federal Reserve argument for raising interest rates and lowering bond prices has shifted around from time to time. Three arguments come into peoples' minds for taking this action to stem inflation. One is that higher interest rates encourage savings. The second is that higher interest rates discourage spending with borrowed money. The third is that declining capital values on Government securities discourage lenders from selling them to raise funds to make loans. Apparently the Federal Reserve feels that the first two arguments do not have much validity now and it is the third argument which is motivating their thinking. To repeat this argument, it is that the introduction of capital losses on holdings of Government bonds will discourage banks and insurance companies from liquidating them in the market to raise funds to make loans.

This point requires critical examination. There is undoubtedly some truth in it. Yet it is hard to believe that there is a universal rule here. It depends on a great many things -- the size of the capital loss involved, the relative attractiveness of the loans to be made, the question of whether "good customers" are involved, the question of whether a future business relationship is involved, and other factors. In general, it seems hard to believe that this would be a very important factor if only fractional losses in bond values are assumed to be what is desired by the Federal Reserve.

For example, would a price of 99 on the Victory Loan 2-1/2's reduce selling on the part of insurance companies because of the capital loss feature, or would selling be increased because of the fear of further declines to come? Might not the market be deluged with selling without Federal Reserve attempt to restore order there with a new peg at 99? If this were allowed to really stick, would it have accomplished much from having it pegged at par or above? Are not the securities going to be "near-money" if there is a peg at any level? Would not alternative investments or loans appear equally attractive at any peg in view of the fact that there is always a spread between rates on Government securities and rates on private debts? The Treasury feeling, therefore, comes down to simply this -- a decline in the bond price to 99 may have too much effect and make things worse, or it may have no effect at all if the market is convinced that stability will be maintained from there on out. The Federal Reserve position would be somewhere between these two, with a feeling of confidence that things would be able to be worked out just right.

There is, of course, agreement between the Federal Reserve and the Treasury that inflationary pressures should be controlled and that the expansion of bank credit should be limited. The difference of opinion lies in the question of remedies. The Treasury is afraid of the interest rate remedy, and the Federal Reserve wants to try to use it again. In this discussion the Treasury position has not been made clear. It has seemed to be arguing for low interest rates in order to keep down budgetary interest costs. If this were the only argument, it would be

inadequate. Surely if an increase in interest rates would neatly stop the inflation, it would be a small price to pay even if it cost several billion dollars. The Treasury fear is that an increase in interest rates would have very little to do with stopping inflation or might upset the balance in the financial markets and cause more inflation and, therefore, it is not a suitable remedy. Besides which it would increase interest costs.

It should also be noted that banks could largely avoid having to take capital losses on securities liquidated to raise reserves in any event. They could do this by simply cashing in Treasury bills each week as they mature and by not exchanging certificates, notes, and bonds when they come due from time to time. Out of $55 billion of securities reported by commercial banks included in the Treasury Survey of Ownership, about $20 billion was due or callable within one year (October 31 figures). Another $25 billion was due or callable within from one to five years. No conceivable manipulation of interest rates and security prices could keep most banks from manufacturing new reserves at will by cashing in short term issues as they come due. The Treasury would thus be providing them with all the reserves which they wanted. Of course, the Treasury in turn would have to raise funds and it does not seem likely that the Federal Reserve could stand by and permit the Treasury to have real financing difficulties, so in the end, the Federal Reserve would probably have to step into the picture anyway. The important point here is that commercial banks hold the initiative.

The Federal Reserve ought to be given additional poweres to control bank credit. A longer run approach to this problem would be to try to

lock up the relatively free reserves in the banks represented by their holdings of Government securities. This method can be used only slowly, however, and while it might well have a place in a program at this time, it cannot, by itself, solve the present problems. There are several reasons for this which need not be gone into at this time.

There are other methods available for providing immediate assistance to the Federal Reserve in controlling bank credit. These were referred to in the President's memorandum the other day. Aside from voluntary efforts to limit credit expansion a variety of formulas could be developed to limit bank loan expansion directly. The problem would be to develop one which would limit unnecessary and undesirable expansion but would still permit expansion to the extent needed in the interests of the defense program and the necessary expansion of our basic facilities, including measures to increase the supplies of raw materials in short supply.

The conflict between the Treasury and the Federal Reserve System has been over-simplified. Actually the place of the Federal Reserve System in the field of economic controls by Government has changed sharply over the years. When the Federal Reserve was established in 1914, it constituted something like 90 percent of all of the economic functions of Government at the time. The only other measures consisted of the tariff, the anti-trust policy, and a few other programs, such as the control of railroads. Today the Federal Reserve powers have been shrunk back very sharply relative to the rest of the economic controls of Government. Now we have Government policies regarding wages, we have agricultural support programs, we have housing loans, subsidies and guarantees, and we have veterans aids of many kinds, we have a

conscious fiscal policy involving scrutiny of the economic aspects of expenditures, receipts and the deficit, we have a huge debt with many ramifications throughout the whole financial structure, and we have a whole host of physical controls exercised through Mr. Wilson and his associates. With this changed picture, it seems fair to say that the place of the Federal Reserve monetary controls has been very sharply reduced to perhaps something like 10 percent of the whole galaxy of Government economic programs.

Clearly the central bank is in a position where it needs new methods to do its original job of controlling private credit. The use of selective controls is very much to the point. They should be stepped up since they can work in close harmony with the direct controls on materials exercised by Mr. Wilson.

It seems perfectly consistent with the history of central banking to search for every new ways of doing the job. A British economist has pointed out that the post-war experience in central banking in England and the United States has been consistent with the long evolutionary processes of central banking in developing new sensitive spots to press against as the old ones lost their significance. Competent observers assert that the most effective weapon the Federal Reserve has ever used was the selective control involved in surveillance of lending policies of banks borrowing from the Federal Reserve during the 1920's. Quantitative controls do not appear to have been very successful over the life of the Federal Reserve. They have their place, of course, but the evidence of the '20's seems to be that the selective controls were the thing that really worked. At that time something between one-half and

two-thirds of member banks customarily found it necessary to borrow from the Federal Reserve banks. This put the Federal Reserve in the position of controlling credit policies of these banks since the Federal always had the right to refuse to make loans. What may be needed today is some device to restore this type of credit supervision to the Federal Reserve. The facts seem to indicate that as reserves became more plentiful in the 30's, and as Government securities became essentially free excess reserves in the 40's, the Federal Reserve lost the power to supervise the credit policies of member banks because so few of them found it necessary to borrow. There seems to be no real evidence that quantitative methods today could be used to restore the Federal Reserve's position. At least there is a strong difference of opinion about the risks and benefits which might be involved.

It also seems appropriate to ask whether the role of bank credit has not been exaggerated as a cause of the inflationary trend. As noted earlier in this memorandum, there are a great many Government programs with important economic aspects. Some of these were distinctly on the inflationary side in the whole post-war period, and steps are being taken to reduce their scope in the present emergency.

Since the Korean war began, the sharpest price increases have occurred in sensitive raw materials which, by and large, are in very short supply relative to demand. The price rises in these raw materials seem to bear only the remotest connection with monetary matters. Indeed the case may be made that these price rises would have occurred even if bank credit had remained stationary during this period. It is distinctly questionable whether rigid control of bank credit could have reduced the avid demands

for copper, lead, zinc, rubber, steel, cotton, wool, alcohol, chlorine, hides, and a host of other raw materials. Probably some inventories of businessmen would have grown less rapidly if bank credit had been curtailed, but it is another thing to say that the great demands for these items in short supply would have been abated. It should also be noted that inventories were low in the early part of 1950 following the recession fears of 1949 and businessmen would naturally need to increase their inventories as a new peacetime high in industrial production was being reached in June and as production rose still another 10 percent following the outbreak of the Korean war. It should also be noted that it would be sound public policy to run our plants at full capacity during the interim period when the military program was small and was gradually to rise to the point where it was to take a substantial part of our total output.

These points are made not to argue that the increase in credit was all desirable, but rather to point out that some of it was desirable and that the sharp increase in the price of raw materials was the greatest inflationary force and yet was not inspired by monetary policies.

Looking ahead from this point on it would seem that demands for credit may taper off from here on out. Physical controls will limit housing and capital formation generally as well as inventories. It is probable that by the end of the year lenders will find that their demands have dropped off rather substantially. At that point insurance companies will probably be net buyers of Government securities thereby eliminating the Federal Reserve problem of providing a market for these issues. Bank loans will probably level off and may even decline.

This is a reasonable prediction of what may happen, but we cannot rely completely on predictions that things will work out this way. Every step that is possible should be taken at once to limit credit expansion but great care should also be taken to avoid disturbing nervous holders of the public debt with the distinct possibility of creating something resembling a panicky flight from bonds and from the dollar. This is no time to scare people further, particularly since the credit problem can be handled by other measures and will probably be less intense a few months hence in any event.

Inflation since Korea
and Bank Loan Expansion

Inflation Since Korea and Bank Loan Expansion

Since the outbreak of hostilities in Korea on June 25, 1950 there has been a significant rise in the general price level, an increase which has been accompanied by a rapid expansion in bank loans during the last 5 months. There has been a tendency for many observers to conclude that this increase in commercial bank loans is the major cause of the price rise and that general monetary controls would have been effective either in eliminating the inflation or in reducing it to a bare minimum.

It is the purpose of this memorandum to study in some detail the inflation that took place since the Korean attack, to examine the relative importance of the various factors in the price rise, particularly the role played by private bank credit.

First of all, it is important to take a look at the nation's economic environment immediately before the Korean attack. The country had largely recovered from the 1949 inventory readjustment period. During the first half of 1950 prices had gone up slowly. The consumer price index rose by 2% during this 6 months and wholesale prices were up 4%, with farm prices heading the rise. The rise in industrial prices was less pronounced, although there was a rise in building materials and sharp rises in some metals and in rubber. The rise in prices was accompanied by an increase of more than 10% in the Federal Reserve index of industrial production during the first half of 1950 so that by the time of the Korean attack production had already exceeded the previous postwar peak reached in the fall of 1948. Inventory accumulation had begun early in the year and during the second quarter was proceeding at a substantial rate; corporate profits before taxes in the second quarter were already at an annual rate of over $37 billion. Personal income was at an

all time peak rate of $216 billion a year during the first half of 1950, swelled in part by the payment out of the Treasury of $2-1/2 billion of National Service Life Insurance dividends. The beginning of another round of wage increases and the continued expansion of employment also characterized the period. The unusually high levels of residential construction activity during the first half of 1950 played an important role in the economic events of the pre-Korea period.

This was our economy at the time of the Korean attack -- an economy which was already operating at high levels of activity. Without Korea economic activity would probably have continued to expand through the second half of the year, and with continued upward pressures on prices. With Korea, however, the situation was altered significantly.

The Korean attack served not only to stimulate inflationary factors which were either dormant or were effectively counterbalanced in the pre-Korea period; it also served to stimulate a host of new inflationary pressures. The threat of an immediate all-out war had an electrifying effect on business men and on consumers, in whose minds the memories of World War II shortages were still fresh. Business men were particularly sensitive to the situation and it did not take them long to realize that the imminence of Government stockpiling of strategic materials and the needs of military procurement were matters of critical importance to them. Speculators saw the point too, and wasted no time in taking advantage of it. It is not surprising, therefore, that the Bureau of Labor Statistics spot index of market prices for 28 key commodities rose by 12% within one month after Korea. The climb continued so that just 6 months after Korea the rise was almost 30%. The prices of industrial raw

materials led the procession, with an increase of close to 60% for the 5 months period, with foodstuffs up a little less than 25%. Among specific commodities the price of steel scrap rose by 20% in the last 5 months. Cotton was up over 30%, lead almost 50%, print cloth over 50%, shellac over 60%, cottonseed oil over 70%, rosin 80%, lard 80%, wool-tops over 105%, burlap over 105%, silk about 115%, tin 140%, rubber over 160%, and tallow 260%. There is typically a significant lag in the reflection of these prices in the overall indexes. The slower moving B.L.S. all-commodity index has, however, already gone up by more than 15% since June and there has been a rise of 5% in consumers prices through December alone.

These price increases for specific commodities are indicative of areas which responded swiftly to the changed environment after Korea. They are areas of price increases which occurred not necessarily as a result of any monetary phenomena but rather as a direct result of the anticipation of physical shortages in their impact upon thousands of individual business men. It is no wonder then that business inventories rose substantially during this period to new all time highs, despite the existence of a huge buying wave by consumers. The buying of metals is a case in point. Smelter stocks of refined copper and lead, for example, both reached peaks for the last decade during the year before Korea. By December 1950 stocks of copper had declined 77% from the peak and stocks of lead were down 64%. In addition, zinc stocks were down 90% during the calendar year 1950. The prospect of shortages was uppermost in the minds of many consumers as well and the decision as to whether to buy a new automobile loaded with extras today or to wait 6 months and either get no car at all or

have to pay 10% more for it was really no decision at all.

The primary characteristic, then, of the inflation since Korea has been an unprecedented rush for goods. Not only was price secondary in the events of the period; means of financing was often secondary too. The expansion of bank credit did contribute to the inflation, and unnecessary loans should have been curtailed. Nevertheless, much of this expansion in prices probably would have taken place without any extension of bank credit at all. During the calendar year 1950, for example, total corporate requirements for funds (exclusive of additions to inter-corporate receivables and cash and Governments) amounted to about $25 billion. This money was required to pay for expenditures on plant and equipment, on inventories, and to cover the net increase in receivables. How was this $25 billion of expansion financed? Almost $20 billion came directly from retained earnings and current depreciation allowances. Some of the balance came from new security issues. One billion dollars came from new mortgages. Only $2-1/2 billion came from expansion in the commercial and industrial loans made by banks.

Thus private bank credit only accounted for about a tenth of the 1950 needs of corporations. Had bank credit been unavailable more of the $44 billion of cash and Government securities held by these corporations would undoubtedly have been utilized. Borrowing happened to be a simpler and more comfortable avenue of approach to many corporations to meet their immediate needs. It was not necessarily the only approach. If the increase in borrowing had been cut down drastically there is no assurance that the price rises since Korea would have been much less dramatic.

Somewhat the same sort of analysis is pertinent in characterizing the consumer buying rush. The desire for acquisition of the goods was primary. The fact that there was a small rise in price may have been distasteful, but it obviously offered no effective deterrent to anyone who believed that prices were going to rise still further. The means by which the purchases were financed was in many cases of even less importance. Immediate imposition on July 1, 1950 of stringent consumer credit controls would have helped significantly. In itself, however, even that would not have been adequate.

One of the reasons why this is so relates to the $200 billion of liquid assets that individuals have at the present time, which provides a reservoir out of which vast amounts of consumer spending can take place without one iota of bank credit extension. As a matter of record the rates of turnover on demand deposits, on savings accounts in both mutual savings banks and savings and loan associations, and on savings bonds all increased during the third quarter consumer buying spurt. This turnover of liquid assets -- really the velocity of money as it is referred to traditionally -- is a factor which has a potential for inflation not generally appreciated.

Private bank credit has a somewhat less important role in the economy today as compared with years past. In contrast the role played by accumulated private savings is much greater. For example, before World War I the outstanding amount of private credit extended by commercial banks (loans plus corporate and municipal securities) was about equal to the total liquid assets of all private investors put together (individuals, corporations, and other nonbank institutions). Just before World War II -- 25 years later -- liquid

assets were three times the amount of private bank credit; now the ratio is approximately 4-1/2 times. The comparison can be put another way. In 1914 the total output of the country was about 2-1/2 times the amount of private bank credit outstanding. In 1939 it was almost 4 times and it is almost 5 times now.

This does not mean that private bank credit is of no significance any more and that we need not worry about it. Quite the contrary; strenuous efforts should be made to restrain its expansion in specific areas. It does mean, however, that private bank credit is only one of a number of factors involved in the financing of the increases in demand for goods during the last half of 1950. And it was the demand for goods which was the basic cause of the inflationary price rises, not the way in which the buying was financed.