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FISCAL AND CREDIT POLICIES IN PRESENT EMERGENCY

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File

The sudden outbreak of war in Korea has called for a reappraisal of American economic developments and economic policies of the Government. Increased Government expenditures for military purposes are being injected into an economy already showing signs of bulging at its production and price seams. The impact of these new defense expenditures on all aspects of the economic situation under these conditions will go far beyond what the figures of 10 or 20 billion dollars by themselves suggest. Unless incisive offsetting Government action is taken, substantial inflation seems inevitable.

The United States cannot successfully discharge its great responsibilities of world leadership, it cannot fulfill its function as an arsenal for the United Nations, unless we maintain the strength and integrity of our domestic economy. It is as imperative to maintain our economic strength as it is to provide for our military strength. Without the one, we cannot have the other. Inflation at home can be as deadly an enemy as the armed enemy abroad. We have to assure success on both fronts. Both require sacrifices of all of us.

The Nature of the Problem

In the broadest aspects, the objectives of economic policy are three-fold: (1) to assure that the military program obtains the goods and manpower needed to accomplish the task assumed; (2) to finance the increased Government expenditures in a way which will avoid or diminish the possibilities of inflation both <u>during and after</u> the emergency; and (3) to curtail or restrain private spending and investment, as well as nonmilitary expenditures of Federal, State, and local governments, to the extent necessary not only to assure essential supplies to the military but also to reduce the current and future possibilities of inflation.

Attainment of these objectives is essential to the maintenance of a sound economy. In determining policies directed toward them, the principal aspects of the current situation and of possible future developments to be taken into consideration are the following:

(1) The economy is already operating at close to capacity and the leeway for further expansion is limited. This situation is in sharp contrast to that existing in 1940 and 1941 when the previous defense program was commenced. In addition, holdings of money and other liquid assets by businesses and individuals are much greater relative to the national product than in 1940 and, together with existing potentials for credit expansion and growing current incomes, could provide the basis for a substantial increase in the volume of private spending and investment.

(2) The presently announced increase in the military program taken alone could be met by the economy with little change in the volume of goods and services available to the civilian sector of the economy. In particular areas expansion of capacity or contraction of consumption will be needed. A considerable expansion of the military program beyond what has yet been indicated would drastically change the situation.

(3) The major problem of economic policy <u>for the immediate future</u>, irrespective of the size of the military program and the rate of increase of expenditures, will be <u>to curtail overall civilian spending</u>. The increase in incomes resulting from the expanded military program, the diversion of

goods to that program, and the various stimuli given to private spending by the psychological and other factors incidental to such a development will not only result in increased consumption and investment but also in speculative commitments. Inflationary pressures now already powerful will snowball.

(a) Businesses and individuals have been put on notice that they are insured against depression for some time to come. The general caution which tempered the postwar inflation cannot safely be relied on for the years immediately ahead.

(b) Businesses and individuals have been educated by recent experience regarding inflation If a price rise becomes general, they can be expected to move quickly to spend vast amounts of liquid funds in an attempt to protect themselves against future declines in the value of the dollar. Some are already doing so.

(c) Prices will be under upward pressure from the cost side (aside from other pressures from increased demand). The increased cost of living and the larger profits, together with high employment and the attraction of labor into defense industries, will stimulate wage demands and some wage increases. In addition, labor costs per unit will tend to rise as overtime payments are required and as less efficient marginal workers are reemployed in an effort to maintain or expand production.

(d) The actual cash expenditures by the Government for increased military supplies will not be the measure of productive resources tied up in this work. Higher incomes will also be generated and scarce resources used up as work proceeds on producing planes, tanks, and guns and providing additional capacity even before actual payments are made by the Government.

(e) Speculative buying and investment activities can be readily financed either by available liquid assets or by borrowing from banks and other lending agencies.

All in all, the outlook for a serious inflationary spiral is foreboding. Such an inflation would cause great hardship to many groups of our people. It would diminish incentives and misdirect tremendous amounts of effort into nonproductive areas. To prevent inflation is a matter of critical importance and urgency.

(4) Private credit expansion, which has already been substantial this year, is likely to be accelerated. This would provide the monetary means for an inflationary spiral. Banks, insurance companies and other lenders can readily obtain funds for new lending by selling low-yield Government securities. If the Federal Reserve should purchase these securities to maintain stable rates in the market, there would be an increase in bank reserves which provide the basis for multiple credit expansion. Strong credit demands will undoubtedly continue in the housing field, for purchases of consumer durable goods, and for expansion of business inventories. Widespread demand for bank credit to finance speculative commitments of various sorts is also to be expected.

(5) The immediate need is for a well constructed, ably and firmly administered set of fiscal and monetary controls. Such controls are always preferable to direct ones if they can do the job. They are always needed to back up direct controls if inflation is to be avoided. At their best, direct controls do not prevent inflation so much as postpone some of its impact.

Fiscal and monetary controls involve less infringement upon individual freedom and choice, do not dispense with the price system as a guide to civilian production, are less difficult to administer, are less costly, and are more readily relaxed or otherwise adjusted flexibly to changing situations, thus creating fewer post-emergency problems. It will be necessary, however, for such controls to be applied wisely and courageously in a manner that will be genuinely restrictive. Their administration could not be painless.

Scope of Fiscal and Credit Policies

This is the time to resolve to finance the national defense program as far as humanly possible on a pay-as-you-go basis. Nothing could be as effective in combating and preventing inflation as taxes high enough to absorb surplus money competing for scarce goods. In retrospect, the gravest mistake we made in financing World War II, and the mistake which left the deepest mark on the American economy, was failure to tax enough. This failure left us with a huge burden of Government debt and tremendous potentialities for inflation. As a consequence, we experienced great difficulty in maintaining economic stability in the postwar period.

After taxation, the least inflationary method of Government finance is for the Treasury to confine its borrowing as much as possible to the current savings of the public and to avoid as far as it can borrowing from banks. Current savings of individuals and businesses would be sufficient to provide the Treasury with a substantial source of funds, particularly if limitations are placed on extension of housing and other investment not essential for the military program. Choice of securities offered to raise these funds is especially important.

The most important immediate task of credit policy is to curtail private credit for nonessential purposes. It will take time for a tax program to become effective. In the meantime, the only weapon at our command is restriction of private nonessential credit extension. In fact, it will be necessary to maintain a more effective set of restraints on private credit extension than has been undertaken in recent years.

The task of restraining private credit extension is much more difficult under existing conditions than it was in previous periods. The large volume of liquid assets, including cash and Government securities, held by banks, other lending institutions, businesses and individuals constitute a large block of funds available for other uses.

Particular fiscal and monetary measures that might be considered for use in the present emergency will now be discussed more fully.

Taxation

In the present emergency, the most important measure in the fiscal and credit area is to assure a volume of Federal Government revenue that exceeds expenditures. This will require a substantial increase in taxes and rigid economy in the less essential functions of Government. Some cuts in expenditures, such as those in connection with the agricultural commodity support program, housing, and unemployment should come automatically. Others will be necessary and will require courageous action.

In considering an expanded tax program to finance increased defense expenditures, the following guides or principles are suggested:

(1) It is highly important to curb purchasing power throughout the private sectors of the economy.

(2) Purchases of certain civilian goods need especially to be curtailed to help prevent military procurement from creating price spirals in these areas.

(3) The tax program should hit war profiteering and speculative activity.

Financing the expanded military budget should not be limited to taxation of wealthy individuals and business enterprises. An across-the-board increase in income tax rates, including those on individuals in the lower and middle income tax brackets, is absolutely essential if income available for the purchase of goods and services is to be brought into line with the supply of such goods and services without price spirals.

Public acceptance of such an increase in individual income taxes would be considerably aided if groups that are known for their ability to avoid income taxes were subject to closer scrutiny and enforcement. The plugging of other tax loopholes, including certain tax free exemptions, would also improve the receptivity of the general public for higher income taxes as well as substantially increase revenues.

Use of selective excise taxes should also be expanded to divert private purchasing from critical sectors as well as for purchase of nonessential products and services that utilize scarce labor. Without such taxes or other controls, expenditures in these areas would be restricted only through higher prices with resulting higher business (windfall) profits. This would contribute to the development of an inflationary spiral. With an excise tax this money flows directly into the Treasury. Consideration should be given to levying excises as temporary measures with a definite expiration date related to the immediate and prospective situation.

Not only should there be a well conceived contract renegotiation policy applicable to business corporations handling military contracts, but all business corporations should share in carrying the burden of the increased tax program. A program of corporate tax increases designed for a relatively short emergency would place considerable reliance on an excess profits tax. The basic weakness of such a tax is the incentive given to nonessential and other cost increasing expenditures, which invite the very situation that the anti-inflation program is intended to prevent. New excess profits tax legislation should discourage extravagance resulting from unlimited allowance for nonessential expenditures, and may need to be accompanied by wage controls in order to restrain excessive wage and salary increases. Such cost increases, if left unrestricted, would divert funds into the spending stream and defeat the purposes of the anti-inflationary program.

If the emergency is likely to be of long duration, it would be preferable to raise normal and surtax rates on corporations as well as to adjust individual income taxes, rather than continue indefinitely a system of heavy excess profits taxes.

Government Borrowing from Nonbank Investors

Even if Government expenditures were fully covered by taxation, it would be highly desirable under present and prospective conditions for the Treasury to obtain as large a volume of excess investment funds as possible by borrowing from real savings. Every effort should be made to sell bonds to the public, including individuals, corporations, and nonbank financial institutions, thus absorbing money that would otherwise be spent on current consumption or new private investment. Such a program would not only absorb redundant funds but also make it possible to reduce the volume of securities held by banks, which would be a further anti-inflationary influence.

The success of a defense bond financing program should not be judged in terms of the dollar amount of bonds sold. The program should be judged mainly by the extent to which purchasing power is really diverted from the public to the Federal Government. It should have the effect of curtailing current purchases of goods and services. If new bonds are sold to investors who in turn sell existing holdings to banks, the major purpose is not accomplished.

In order best to accomplish this purpose, the program of borrowing from nonbank investors should vary somewhat from that followed during the last war. The main aspects of a program that might give most effective results would be as follows:

(1) Efforts to sell Series E, F, and G bonds to individuals should be continued and intensified. These funds come directly from individuals and the bonds are of a nature that discourages their liquidation, although permitting redemption at some penalty.

(2) Sales of savings notes, which are largely purchased by corporations, should be pressed.

(3) Continuous (or tap) offering should be made of a nonmarketable, redeemable 2-1/2 per cent bond to nonbank investors (perhaps with limited purchases permitted by banks in relation to savings deposits). The maturity of the bond, the scale of redemption values, and limitations upon purchases would be determined in the light of market conditions. This bond should be continuously available in the same manner as Series E, F, and G bonds. Purchases might be limited in accordance with the accumulation of new funds available to investors, in order to discourage buying by sale of outstanding securities to the banks. Opening up of Series G bonds to institutional investors on a similar limited basis might be considered instead of offering a new type of bond.

Such an issue would offer a means of tapping current savings as they become available. With limitations on mortgage credit and perhaps on other types of private and public financing, and with appropriate selling efforts, these bonds should attract a substantial amount of funds.

(4) So far as possible, sales of marketable securities should be limited, and large-scale loan drives of the kind used during the war should be avoided. Vigorous selling campaigns inevitably encourage a certain amount of free-riding (oversubscription in order to sell later at a profit) and result in substantial switching from existing holdings to new issues. Such practices are profitable to subscribers and cannot be entirely prevented so long as short-term rates are lower than long-term rates. Since the securities sold by subscribers would be largely bought by banks, the indirect effect of these practices is to increase bank credit.

Continuous offering of a long-term nonmarketable bond of the type proposed would help accomplish certain desirable purposes. (1) It would always be on tap to absorb investment funds as they become available; (b) it would establish a level of long-term interest rates at a sustainable basis reasonably related to rates on outstanding bonds; and (c) it would provide, both for the emergency period and for later years, a security that would discourage widespread liquidation such as occurred in 1947 and 1948 with upsetting effects on the economy. The bond would be redeemable but at some loss of interest, which would provide an inducement to hold; also, demands for redemption would not be reflected in market prices of outstanding securities. No other type of issue would contribute so greatly to stability in the long-term market, and lighten so materially the burden of the Federal Reserve System in its open market operations, both during and after the war emergency.

Two objections have been raised to nonmarketable issues of this sort: One is that they are not popular with large financial investors, who naturally would prefer to be able to sell their bonds on a supported market when they wish without loss. Their ability to make such sales, however, would require continuous support operations which exert highly inflationary effects at times when prevention of inflation is most essential. The second objection is that such securities present at all times a potential demand obligation upon the Treasury of indeterminable magnitude. Because of the penalty involved, however, redemption of nonmarketable obligations is less likely to occur than is the sale of marketable securities.

Limitations on Bank Credit Expansion

In a situation where inducements for expansion and speculation are substantial, where capacity for expansion is limited, where the bulk of economic decisions continue to be privately motivated, and where new and adequate taxes have not yet become effective, vigorous measures of restraint on private credit extension constitute the most important instrument immediately available for holding the line against an inflationary price spiral. As previously pointed out, however, that task is necessarily complicated by the large volume of public debt outstanding, which makes it possible not only for individuals, businesses, and financial institutions to obtain needed funds by liquidation of Government securities but also for banks to obtain reserves needed for credit expansion in a similar manner. The various means available for restraint on credit expansion are as follows:

(1) Selective Credit Instruments -- Some types of credit can be restrained by Government regulation imposing conditions as to the nature of the credit advanced. The outstanding examples are margin requirements on security loans, maturity and down-payment requirements on consumer instalment credit and payment limitations on other types of consumer credit, and various types of requirements as to real estate credit. These are important supplementary instruments but they cannot by themselves be relied upon to meet the present anti-inflation problem.

Expanding credit in the housing field during recent years has been greatly stimulated by Governmental policies and is currently very inflationary in character. Current construction activity and the expansion of mortgage credit as well as the outstanding volume of such credit are at the highest level of all times. Recent action by the President to reduce Governmental stimulants is an important step toward curtailment in this field, but additional action will be required. The authority requested in the proposed "Defense Production Act of 1950" would provide the means for applying further restraints and this authority is necessary.

Authority to regulate consumer credit, including particularly instalment credit, is provided for in legislation before Congress. Under that authority restrictions could be imposed on new extensions of such credit. Previous experience with regulation of consumer credit indicates the procedures for accomplishing this purpose.

Present laws and regulations as to margin requirements appear adequate to deal with any situation which may arise. Margin requirements, which are now 50 per cent of the current value of stocks held as collateral, are moderately restrictive. The present authority is adequate to restrain credit in this area if speculative developments in the stock market should require more restraint.

Selective controls are not suitable to most other types of credit, such as loans to businesses and farmers to provide working capital or carry inventories because specific rules as to repayment are not generally applicable. Expansion of these credits, as well as of those subject to selective regulation, can be restrained to an important degree through the voluntary cooperation of banks and other lenders, through bank supervisory policy applied cooperatively by the State and Federal authorities, and through the use of general credit instruments which limit the supply of reserves available to banks.

(2) Open Market Operations — Under existing conditions, with the large volume of Government securities outstanding, the principal source of funds for credit extension is the sale of Government securities to the Federal Reserve. Such sales create bank reserves which can be used for multiple credit expansion. The Federal Reserve could impose definite restrictions upon the potential expansion of bank credit by limiting its purchases of securities to the amount necessary to maintain orderly conditions in the market. Under such a policy some flexibility in short-term interest

rates would be necessary. Some proponents of easy and cheap money advance the thought that it is more important for the Government to have access to unlimited Federal Reserve funds at very low interest rates than to use open market operations to combat inflation and maintain the basic strength of the American economy.

It is important to remember, furthermore, that the Government no longer issues tax-exempt securities so that some portion of what it pays out in interest is recaptured through income taxes paid by corporate and individual recipients of the interest payments. Hence, the cost to the Government of an increase in short-term rates, for example, ought to take account of what is recaptured by taxation and not be measured simply by the additional charge against the current budget.

(3) Discount Rates — In earlier years, changes in discount rates on member bank borrowing were the principal instrument of Federal Reserve policy. In recent years, the effectiveness of discount rate changes has been diminished by the very large bank holdings of Government securities which enable them to obtain needed reserves by the sale of such securities instead of by borrowing. Discount rate changes, however, still have a considerable psychological influence and are used on appropriate occasions. The discount rate at Federal Reserve Banks is now 1-1/2 per cent compared with a current market rate of 1-1/4 per cent on 1-year certificates and slightly less on 3-month Treasury bills. With this spread in rates, banks prefer to sell Government securities rather than borrow to obtain needed reserves, but a narrower spread in rates might encourage some increase in the amount of borrowing as a means of adjusting temporary shifts in bank reserve positions. Under present conditions, changes in discount rates must of necessity be

related in some degree to changes in short-term rates on Government securities.

There is a well-established, and on the whole desirable, tradition on the part of banks against continuous borrowing which results in restraint when banks are in debt. Consequently, adjustment in bank reserve positions by rediscounting is more restrictive in its effects on the credit situation than is adjustment by sales of short-term Government securities in the market. Penalties on borrowing, of course, can be varied in accordance with credit conditions by changing the discount rate.

(4) Reserve Requirements — One means of decreasing or increasing the supply of reserves available to banks as a basis for extension of credit is to change the amount of reserves that banks are required to hold with the Federal Reserve Banks. Changes in reserve requirements are particularly adapted to bringing about broad adjustments in the reserve position of member banks so that monetary policy may be carried out through the flexible instruments of open market operations and discount rates. An increase in reserve requirements can be used to absorb excess reserves that banks might hold in order to make them unavailable as a basis for further credit expansion. Its application at a time when banks do not hold excess reserves makes it necessary for banks to liquidate assets in order to obtain the additional reserves needed. Under the circumstances, the additional reserves would have to be supplied by Federal Reserve purchases of securities or advances to member banks. The restrictiveness of the action would depend in large part upon whether banks have sufficient Government securities to part with some of them and still meet their liquidity standards. The interest yield rate at which the Federal Reserve bought securities would also influence the response of the banks to the action.

One of the disadvantages of an increase in reserve requirements is its unselective application to banks. It affects all banks alike in relation to their respective deposits without regard to the nature of their assets or their current credit policies. In contrast, open market operations exert their influence indirectly through the money market without an obvious and direct effect upon individual banks. Under present law, the authority to increase reserve requirements applies only to member banks of the Federal Reserve System which, in general, are already subject to higher requirements than nonmember banks. In a critical period of inflation, it would be of less than maximum effectiveness as well as inequitable to impose higher requirements on member banks without giving consideration to some similar limitations on nonmember banks. Such limitations could take various forms and could be administered through the State bank supervisors.

The existing unused authority for the Board to increase requirements under the present law is limited. For banks other than central reserve city banks, which are in New York and Chicago, requirements against demand deposits can be increased by only 2 per cent and against time deposits by 1 per cent. For banks in New York and Chicago, the increase could be as much as 4 per cent on demand deposits. These banks have not shown the same increase in resources in recent years as have other banks and would be unduly penalized relative to other banks if subjected to disproportionate increases in requirements. Altogether the remaining authority to increase requirements would amount to about $2.4 billion of reserves. This small authority could be used with some degree of effectiveness under circumstances when short-term interest rates could be permitted to reflect the operation.

There are certain inequities in the existing system of reserve requirements, which are based upon the needs of situations prior to establishment of the Federal Reserve. It would be highly desirable to revise the methods of computing reserve requirements so as to relate them more specifically to types of deposits and eliminate the arbitrary classification of cities and also to permit cash holdings and to some extent inter-bank balances to count as reserves. Means for bringing about such changes have been under consideration within the Federal Reserve System for several years and a staff study on the subject was presented to the Joint Committee on the Economic Report some time ago. Since then, the System has extended its studies in consultation with the Federal Advisory Council, but these studies are not yet concluded.

(5) Supplementary Requirements -- In view of the large holdings of Government securities by banks, which can readily be liquidated to meet other types of credit demands and the difficulty of restraining such liquidation without upsetting the Government securities market, proposals have been made for immobilizing portions of the banks' holdings. It is the object of such measures to assure retention of a stable demand for short-term Government securities at relatively low rates and at the same time make it possible to restrict the availability of other types of credit.

These measures would not prevent expansion of the money supply as a result of Government financing through the banks, but would be designed to reduce its multiple effects, particularly in the post emergency period. For them to be effective, the Treasury would have to limit the eligible securities which it issues to minimum amounts required to meet the needs of the situation. It would also be necessary for the Federal Reserve System to follow a flexible open market and discount policy which would permit rates in the money market to fluctuate.

Following are the principal objections advanced against requirements of this nature:

(1) In view of the large holdings of Government securities by banks, very high requirements would be needed to exert an effective degree of restraint.

(2) Because of wide variations among banks, such requirements might seriously restrict some banks while not restricting others.

(3) They could be used as means of forcing banks to purchase Government securities.

(4) Effective restrictions could be applied if the Federal Reserve would refuse to buy, or would sell, Government securities, rather than follow the policy of buying any amounts needed to keep interest rates from rising.

Government Borrowing From Banks

As previously suggested, the increased military program as now scheduled can and should be financed through taxation with no resort to inflationary borrowing from the banking system. Vigorous fiscal action should be supplemented by Government borrowing from nonbank sources in order to absorb funds that would otherwise be spent on consumption and new private investment and to reduce the volume of Government securities held by the banks. Any borrowing from banks should be held to the irreducible minimum needed to finance the increased monetary requirements of a wartime economy.

In the case of an all out military program, every effort should be made to carry the financial burden through pay-as-you-go taxation. The most inflationary method of financing the Government's military deficit would be to borrow needed funds from the banks. Even if special methods are employed to keep down the secondary credit expansion potential of such borrowings, the method is still inflationary. Over the past few months, the Government has secured most of its new funds from banking sources, but this borrowing has been partly counterbalanced by Federal Reserve sales of long-term bonds to nonbank investors.

Experience of the last war demonstrated that it was relatively easy to sell any amount of Government securities either directly to banks or to nonbank investors who in turn sell other securities to banks, as long as the Federal Reserve bought enough securities to supply the banks with needed reserves. It also showed that the maintenance of short-term rates at a level substantially below long-term rates is a great encouragement to the shifting of Government securities, as they approach maturity, to banks and then to Federal Reserve Banks. Another situation of this sort should be avoided as it is an inducement rather than a discouragement to Government financing through the banks. Such a situation is highly inflationary in character.