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ALTERNATIVE METHODS OF MONETARY EXPANSION

An expansion in the circulating medium may come about by a variety of means. In addition to the problems raised by the increase in circulation itself, therefore, there are further problems relating to the advantages or disadvantages of the methods used to produce the expansion. In the case of some of these possible methods the issue is sufficiently current, or recurrent, to warrant further examination. It may be remarked at the outset that the following analysis of the characteristics of different methods of financing, all of which are expansionist, does not imply an endorsement of any one of them.

Borrowing from Banks vs. the Issue of "Greenbacks"

At times like the present, proposals invariably appear for reducing the costs of war by dispensing with the payment of interest. In its more sophisticated form the argument runs along the following lines: if it is possible to borrow from banks at interest and let them manufacture non-interest-bearing debt in the form of demand deposits which serve as circulating medium, why should not the government manufacture circulating non-interest-bearing debt—such as greenbacks—directly, thus saving the cost of the interest charge? In view of the persistence of the question, it is worth examining a few of the possible consequences should the government issue a large quantity of greenbacks instead of borrowing a similar amount from banks.

In the case of Treasury borrowing from banks, demand deposits are customarily created and placed at the disposal of the government. If the government were to issue greenbacks and place the newly printed currency to the credit of its deposit accounts, the effect would likewise be to expand deposits but the banks would have added cash instead of bonds to their assets. If, on the other hand, the government were to pay out the greenbacks directly, the recipients of these payments might use the bulk of the proceeds to expand their deposit balances with banks. This would be in keeping with the custom of making the largest share of payments by check, a long-established preference which the issue of additional paper money would no necessarily alter. Thus the final composition of the circulating medium might be much the same whether the initial expansion took the form of deposits or currency.

It might, perhaps, be supposed that the greenbacks would remain in circulation and would circulate at a greater speed than a similar volume of demand deposits. This is by no means certain. In the first place, the greenbacks, as has been remarked, might chiefly enter into use not as currency but as the source of additional deposits; and in the second place, currency ordinarily circulates more slowly than deposits. Nor would the entire issue necessarily be a net addition: a part of the greenbacks might simply take the place of the expansion of Federal Reserve notes that is occurring under present methods of financing.

The issue of paper money, then, might serve to expand demand deposits in much the same way as is now being done by direct Treasury borrowing from banks. Why is it generally believed that the former would be so much more inflationary than the latter? The reasons most commonly advanced are that the issue of greenbacks would destroy public confidence and contribute to further inflation by, for example, interfering with the sale of war savings bonds, stimulating panic buying, and fostering political abuses of all sorts. The exact inflationary effects of any printing of paper cannot be told in advance, for the reason that mass behavior is highly unpredictable at any given time.

A further reason for believing that the issue of paper money would be more inflationary than the direct borrowing from the banks, while less familiar than the other, rests on the difference in the effect of the two methods of expansion upon the position of bank assets in general and bank reserves in particular. If the issue of greenbacks served to expand deposits, reserves would be increased by an approximately equal amount so that the ratio of reserves to deposits would rise. In other words, excess reserves would be greatly expanded. Borrowing from banks, by expanding deposits but not reserves, has just the opposite tendency; excess reserves are decreased.

The potentialities present in such a situation may be illustrated by supposing that instead of borrowing $18 billion from member banks in the year following Pearl Harbor, the government had issued $18 billion of greenbacks. Let us assume that $4 billion of this took the place of the expansion that occurred in Federal Reserve notes in circulation. If we assume, in accordance with the reasoning suggested above, that all the remainder were used to expand demand deposits, this would mean that member bank reserves would have increased by $14 billion instead of by $758 million as was actually the case. Under these circumstances the Reserve authorities would have faced a problem not of having to create more credit, but of having to absorb a vastly increased supply of credit. In December 1942 excess reserves would have come to $14.6 billion. Such a huge volume of excess reserves could be highly disruptive of conditions in the money market and seriously inflationary in its possibilities.

Borrow-and-Buy vs. Direct Borrowing from Banks

A more pressing issue exists in connection with the way in which bank credit is brought into play in the purchase of government securities. During the last war extensive use was made of private borrowing from banks as a means of obtaining funds with which to subscribe to government bonds, the bonds themselves serving as security for the loans.[24] This resulted in the creation of demand deposits payable to individuals and turned over by them to the government. Present policies of war financing result in the creation of deposits which are placed directly at the disposal of the government.

Following the last war the policy of borrow-and-buy came into thoroughgoing disrepute. Rightly or wrongly, it was given a considerable share of responsibility for the rise in prices that occurred at that time. So completely was it discredited that no great effort has been made to revive it in the present emergency. The principal objection advanced against borrow-and-buy was that it involved an increase in circulating medium in the form of bank deposits.[25] The validity of this objection may be challenged at the present time when the alternative, borrowing directly from banks, is similarly expansionist in character.

A given amount of borrowing from banks will presumably result in the same increase in bank credit under either method of financing; the inflationary tendency at the time of borrowing may therefore be assumed to be the same. With borrow-and-buy, however, the participation of the public would be broadened and the net obligation on securities so acquired would tend ultimately to be transferred from the banks to the public. This would operate to contract the volume of deposits as loans secured in this way were paid off. In effect, the policy of borrow-and-buy would permit individuals to pay for bonds out of income on an instalment basis.

It has been suggested that the opportunity to borrow in order to buy might reduce the incentive to save in order to buy; but during the last war it was maintained that the effect of borrowing to buy was to make people work harder and save more, because savings were pledged and invested before they were accumulated. In fact, it was said that the public tended to overestimate the amount they could save and thereafter were under strong pressure to fulfill the commitments they had made in a rush of patriotic enthusiasm.

Thus, there are inflationary dangers associated with both a borrow-and-buy program and the policy of direct borrowing from banks. Likewise the methods employed to hold inflation within bounds—taxation, borrowing out of income, rationing, price controls—would presumably be equally effective, or ineffective, against credit inflation originating in borrow-and-buy.

[24] In addition to credit extended in this way, a considerably larger total was advanced to industry directly from 1917 to 1919 than was provided by loans on the collateral of government bonds.

[25] Further aspects of the problem, which bear particularly on bank operations, will be treated in a later study in this series.

Treasury Borrowing from Federal Reserve Banks

At various times in recent months the proposal has been advanced to allow the Treasury to borrow directly from the Federal Reserve Banks. In support of this suggestion it was argued that necessary financial operations could be carried through at smaller cost and with less disturbance to the market. In opposition, the proposal was condemned as virtually on a par with the issue of paper currency, with extreme inflation as its inevitable consequence. When the issue came before Congress the Federal Reserve Banks were given authority under certain conditions to lend directly to the Treasury up to a total of $5 billion.

It needs to be be observed that this method of financing, like that now followed, would lead to a growth of commercial bank deposits as the Treasury disbursed the credits established with the Federal Reserve Banks. It would have the additional effect, however, of increasing member bank reserves. The same result of loading the Reserve Banks with government securities, which opponents of the proposal feared, could be brought about by Federal Reserve purchases in the open market. To suppose that this would be practicable in the one situation and not in the other requires the arbitrary assumption that the Reserve authorities would be subservient to the Treasury if purchases were direct, and independent if they had to be made in the open market.

Direct borrowing from the Reserve Banks would resemble the issue of paper money in that both the reserves and the deposits of member banks would be increased, leading to a marked expansion in excess reserves. It would be more inflationary than borrowing from commercial banks since the latter method, although it increases deposits, also reduces excess reserves.[26]

A further objection advanced by opponents of the proposal was that direct sale prevents a market testing of particular issues. The advocates of the proposal, however, question whether any effective testing of government credit is possible under wartime controls.

It may be remarked in summary that methods of monetary expansion cannot be evaluated solely in terms of the volume of circulating medium, the reserve position of banks, or other quantitative factors. To a great many people, the possibility that a departure from familiar methods of financing might destroy public confidence or lead to political abuse appears more menacing than any purely quantitative consideration. Nor is this judgment

26 As was pointed out earlier, reserves can hardly be considered a serious check on deposit expansion under wartime conditions. See the annual report of the Bank for International Settlements for 1941-42, pp. 13-14. On the basis chiefly of European experience, this report classifies borrowing from the central bank as the most inflationary method of war finance.

appreciably altered by a recognition that existing methods may themselves be highly expansionist. The importance customarily attached to subjective interpretations helps to explain why the quantitative factors mentioned above have generally been given so little emphasis.

MONETARY EXPANSION AND THE PROBLEM OF INFLATION[27]

A sudden and pronounced increase in the volume of circulating medium always gives rise to the fear of inflation. It has become customary to discuss the problem of inflation in the present war, however, not in terms of the quantity of money but of incomes and expenditures, or more especially, of consumer incomes in relation to the supply of consumer goods and services. The explanation, briefly, is that enlarged expenditures by the government lead to an expansion of incomes but, because they are directed toward the production of war materials, do not lead to a corresponding increase in the supply of goods and services available for purchases by the public. The result is the emergence of a so-called inflationary gap, an excess of potential demand over potential supply. The former is represented by consumer income and the latter by consumer goods and services available at the prevailing level of prices.

The Bases of Inflation

The question here is how the growth of circulating medium is related to this familiar explanation of the causes of inflation. The relationship would seem to rest principally on two considerations. In the first place, when funds disbursed by the government are obtained by borrowing newly created deposits from banks, there is no offsetting reduction in total means of payment at the disposal of the public. Consequently expenditures by the public are presumably larger than they would be if the government had acquired the sums it spends by taxation or borrowing out of income. In the second place, the increase in total circulating medium maintains the stream of income and expenditure in an inflated condition through subsequent exchanges. Thus the expansionist effect persists: the continued growth of circulating medium contributes to a sustained rise in income.

It is often implied that taxation or borrowing from the public will reduce

[27] Note by Clarence Heer, Director: For the benefit of those readers who are not acquainted with the plan of this series, it should be emphasized that this paper is primarily a study of war-time changes in the volume of currency and deposits and their relation to the problem of inflation. This restriction in scope is partly because of limitations of space and partly because plans call for the treatment elsewhere of other aspects of the problem of war finance. Any appearance of over-emphasis or omission that may result from this arbitrary division of subject matter will, it is hoped, be remedied through the publication of other papers in the series.