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bonds, and the feature that bears most closely upon problems of money supply and price movements, has to do with the effect of their ultimate repayment, whether by early redemption or otherwise. Much of the recent literature on fiscal policy and particularly on deficit financing assumes that an expansion in government debt tends to be inflationary and a reduction to be deflationary. Some writers have gone so far as to conclude that any substantial reduction in national debt is virtually precluded because of the deflationary consequences that could be expected to follow. This reasoning is based on two principal assumptions, first, that repayment of debt held by the banks would tend toward the destruction of demand deposits and, secondly, that it would restrict consumer expenditures. In the case of war savings bonds, which are held chiefly by people in the lower-income brackets, neither of these assumptions can be accepted as valid. Discharge of these obligations would entail no destruction of demand deposits, such as would follow payment of debt held by banks; and a transfer of funds, such as would occur if they were paid out of taxation, would largely be to individuals with a high propensity to consume so that the effect would probably be expansionist.[33] With respect to war savings bonds, then, there is considerably less danger than has frequently been alleged that a postwar reduction of government debt would exert a depressive influence. It might, in fact, have the opposite effect. The spenders-for-recovery and the orthodox budget-balancers may be able, through the medium of war savings bonds, to meet on common ground.

In this respect war savings bonds closely resemble the assets accumulated under a system of compulsory savings. One of the principal arguments advanced in support of compulsory savings is that they would provide a back-log of potential purchasing power for use in the event of a postwar decline in business. The same end may be served by war savings bonds.

IN CONCLUSION

The increase in circulating medium that has occurred in recent years raises questions as to the future of Federal Reserve policy.[34] The growth in circulation means that the Reserve System, in pursuing policies designed to influence the volume of credit, would have to conduct operations on a much larger scale in order to effect the same relative change in bank credit outstanding. If in the meantime changes had been introduced in reserve require-

33 Because of the relatively high propensity to consume of holders of war savings bonds, the general effect of their redemption is likely to be expansionist under any circumstances. If the funds for redemption were obtained by new borrowing from banks the effect would be especially so.

34 The effects of the war on the Federal Reserve System will be discussed in detail in a companion study in this series.

ments or larger excess reserves had become customary, the difference in scale of operations would not necessarily be proportionate, however, to the growth that has occurred in circulating medium.

At the same time, recent changes in bank portfolios have impaired the effectiveness of some of the most familiar instruments of credit policy. This is particularly apparent with respect to the possibility of restricting credit by the sale of securities in the open market. The magnitude of their holdings of government securities renders banks very sensitive to any decline in security prices. The possibility that sales by the Federal Reserve might, under certain conditions, depress the value of government securities (and thereby weaken confidence in banks or even precipitate a panicky unloading of bonds by banks) may appear sufficiently serious to deter the Reserve Banks from making extended use of open market sales in the future.

The importance of this consideration is heightened by the fact that Federal Reserve Banks have likewise acquired large amounts of government obligations. At the end of 1942 government obligations constituted 93 percent of the portfolio of the Reserve Banks. At the end of 1918, on the other hand, they represented only 13 percent, while bills discounted or purchased amounted to 87 percent.[35] With assets of the latter type, contraction of credit can be exerted without the same depressing effect on bond prices that might accompany the sale of long-term securities in the open market.

The existence of excess reserves during recent years complicated the problem of credit control by the Federal Reserve. While excess reserves have not entirely disappeared, the practical problem since the spring of 1942 has not been to combat an excess, but to provide additional reserves as needed to facilitate the Treasury's program of war financing. Despite the temporary respite thus afforded, it is not to be assumed that the problem of excess reserves has been permanently solved.

The increased volume of currency in circulation in recent years has been largely influenced by developments associated with the war effort, such as the expansion of defense industries, the growth of armed forces, and restrictions on durable consumer goods. With a return of economic life to peacetime channels, a reversal of these influences is to be anticipated. Unless counteracting forces come into play the result would presumably be a retirement of some of the currency now in circulation. At one time such a movement of currency would have been offset, in part at least, by the repayment of member bank indebtedness to the Reserve Bank, but today such indebtedness is of negligible proportions. Barring a further large ex-

[35] The policy of not holding government bonds was concurred in by the Treasury as the following statement from the Annual Report of the Secretary of the Treasury for 1919 (p. 101) indicates: "The Federal Reserve Banks . . . very properly abstained from directly investing their funds in Government war securities."

pansion in bank credit, therefore, a return flow of currency would have a tendency to cause a renewed growth of excess reserves.

One way of anticipating this possibility would be for the Federal Reserve Banks to hold chiefly short-term securities. If currency is paid into the Reserve Banks, holdings of short-term government obligations can then presumably be reduced by a corresponding amount, provided, of course, that the government either is not obliged to make new short-term loans or can obtain them from sources other than the Federal Reserve Banks. In recent months the proportion of short maturities in Federal Reserve portfolios has greatly increased. At the start of April 1942, the Federal Reserve Banks reported no Treasury bills or certificates. At the end of 1942, on the other hand, bills and certificates constituted 33 percent of total Reserve Bank holdings of government obligations and in the last week of May 1943, 56 percent. This shift in the character of Federal Reserve Bank portfolios would appear to have reduced to some extent the probable amount of future excess reserves. The running off of short-term Treasury obligations may help at some future time to facilitate adjustment to a smaller volume of circulating medium much as the repayment of member bank borrowing was once expected to do. It would do so without the same depressive effect upon the price of government bonds that might attend sales in the open market.

Probably the most important conclusion to be drawn from the analysis presented in this paper is that the methods of borrowing employed during the war will influence what the Treasury and the banks will be able to do in the postwar period. It is highly significant that borrowing by means of war savings bonds, for example, is non-inflationary while borrowing from banks tends, by bringing about an expansion of demand deposits, to be inflationary. It is also significant—and by no means as well recognized—that the repayment of these securities in the postwar period would have quite different effects. Likewise, the pattern of distribution of the federal debt as between long and short maturities, will determine what future Treasury action will prove feasible.

Moreover, the Reserve Bank policies that can be employed at all, or that can be used with reasonable chance of success, will depend on the policies—such as open market operations, lending on collateral, or changes in reserve requirements—that are adopted now. Similarly the policies followed by bankers today—whether they hold long or short maturities, whether they lend directly to the government or indirectly by means of collateral loans to customers, whether or not they lend directly to business—will influence their freedom to follow particular policies in the later period. The magnitude of their holdings of government securities is, in particular, a phenomenon of the greatest significance to both Reserve Banks and commercial banks.

Fiscal policy is construed much too narrowly if we think of it independently of the circumstances in which it is expected to operate. Not the least of these external circumstances is the volume of circulating medium. At times like the present attention is inevitably directed toward short-run effects of our financial policies. It is scarcely less important, however, to remember that the policies of today are setting the stage for the policies of tomorrow. This is true in the realm of fiscal policy; it applies also with respect to central bank policy and to the policies of individual banks. We are helping to determine today both what must be done at some future time and how it can be done.

ADDENDUM: Monetary Expansion to June 1943

At the time this paper was completed data on deposits and currency were not available in final form beyond December 1942. The purpose of the present note is to indicate the magnitude of the growth of deposits and currency during the first half of 1943. The total volume of circulating medium at the end of June 1943 may be estimated at approximately $80 billion. The increase of 46 percent during the fiscal year was equal to approximately 75 percent of the total circulating medium outstanding in June 1939.

As the following summary shows, the increase in total circulating medium in the first half of 1943 appears to have been only a little over half as great as in the preceding six months.

	Total June 30, 1943[a]	*Increase Fiscal Year*[a]	*Increase July-Dec. 1942*	*Increase Jan.-June 1943*[a]
		(in billions)		
Circulating medium	$80.0	$25.5	$16.6	$8.9
Currency	15.7	4.8	3.0	1.8
Demand deposits, adjusted	56.0	14.2	7.0	7.2
Government deposits	8.3	6.5	6.6	—0.1

[a] Estimated

Adjusted demand deposits increased about the same in each period while the increase in government deposits was exclusively in the first six months, a slight decrease occurring in the second six months. This was largely because government deposits were at a peak in December as a result of the first war