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 present 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 pursuing 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 the 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.