

September 11, 1950

M E M O R A N D U M

In the evening of August 18, about an hour after the Secretary of the Treasury announced an offering of 13-month 1-1/4% notes in exchange for maturing obligations on September 15 and October 1, the Federal Reserve Board announced its decision to raise the discount rate from 1-1/2% to 1-3/4%.

On the following Monday morning it was plainly indicated by the Federal Reserve that it would be profitable for holders of the "rights" to the new issue to sell them to the Federal Reserve rather than to exchange them for the 1-1/4% note. Sale of the "rights" to the Federal Reserve on the first day amounted to \$819 million and heavy purchases have continued daily since then until at the close of business on September 8, they amounted to \$7,098 million. As one writer said, "The Reserve Board undersold the Treasury on its own securities."

Since then a number of financial writers who favor an increase in interest rates have had a field day commending the Federal Reserve for its action and criticizing the Treasury. The Federal Reserve action has been described as a practical means of counteracting inflationary member banks' lending and it has been suggested that the Treasury's action was based upon political expediency, being motivated by a desire to continue a policy of cheap money. Virtually no effort was made to further public understanding of the Treasury's problem and point of view.

The Secretary of the Treasury has been frequently commended by the committees representing the American Bankers Association, Mutual Savings Banks, and Insurance Companies for the skillful manner in which he has managed the public debt since the war.

The action of the Federal Reserve has been described as a "declaration of independence," as if this of itself is a great virtue. Many persons seem to overlook the fact that when the Federal Reserve System was established in 1913, conditions were considerably different from those which exist today. The public debt was little more than \$1 billion and the Government's expenditures were less than \$3/4 billion, which is equivalent to about a week of present day money requirements. The Federal Budget was practically in balance. The financing and refunding problems of the Secretary of the Treasury were relatively infinitesimal.

As a result of two world wars and a major depression, the public debt of the United States Government today is approximately \$257 billion. This is about half of the total public indebtedness. The management of this huge public debt is a major responsibility of the Secretary of the Treasury. Many regard it as his greatest responsibility.

In managing the public debt the Secretary of the Treasury must determine not only the amount of funds to be raised to finance the Government's vast activities, but he also must determine the types of securities to be offered and the rates of interest at which the offerings shall be made. These are statutory responsibilities and call for the exercise of judgment.

In determining the types of securities to be issued, the terms of the offerings, and the rates of interest to be paid, the Secretary takes into consideration the economic forces which are at play or may be in the offing.

The decisions of the Secretary of the Treasury with respect to types of securities to be offered and their terms, including rates of interest to be paid, undoubtedly have an important effect upon the activities of the Federal Reserve Board in the field of money and credit. But so do many other fiscal operations of the Government have effect on money and credit problems of the Federal Reserve, notably taxation and expenditures. If, as seems to be contended, the Federal Reserve should determine the interest rates to be paid on Government obligations, it might also be contended that the Federal Reserve's jurisdiction should also be extended to a supervision of Federal Budget.

Aside from the fact that the laws enacted by the Congress impose upon the Secretary of the Treasury the duty of fixing the terms of public offerings (subject under certain conditions to approval of the President) the amount of interest paid is part and parcel of the Federal Budget. Therefore this item is of concern not only to the Secretary of the Treasury but also to the President. The annual interest cost is now about \$5,625,000,000 which is about an eighth of the total Federal Budget. For every dollar of additional interest that must be paid, the Secretary must raise an additional dollar either through taxation or by borrowing.

It is erroneous to conclude, as is frequently inferred, that the Treasury's principal or only objective is to reduce the interest cost in disregard of other factors. The Treasury recognizes as clearly as anyone else that the rate of interest paid on Government obligations is an important element to consider in a program to combat inflationary forces. The effect of fiscal policies, however, must be weighed against other factors. On the other hand the Treasury wants to see that the people get a return for the money the Government spends. The additional cost to the public Treasury resulting from an increase in the interest rate is a determinable matter but the return is impossible to measure. It is a general assertion that the benefits, through reduced prices, would outweigh the additional cost. Not only is it impossible to weigh these benefits but it is also impossible to determine their distribution among the citizens.

Some financial writers have interpreted the present situation as a battle between two Government agencies for power. Although no useful public service is served by discussing the subject on this plane it may be worth noting that the actions of the Secretary of the Treasury, of which a number could be mentioned, provide no reasonable basis for any such assertions. What the Secretary of the Treasury has sought in public debt management is cooperation, consideration, and due recognition of his responsibility for financing the Government's operations and of refunding the huge war debt.

Some of the statements indicate that the interest rate on the Treasury's offering is "unrealistic" and imply that the September 15 financing can be successful only through the support of the Federal Reserve System. Actually, the Federal Reserve created the situation which makes such support necessary. Through its power to issue currency and conduct open market operations in Government securities the Federal Reserve is in a position either to assist in the sale of a Treasury offering or to bring about its failure. In this connection it is interesting to note that the notes which are issued by the Federal Reserve Banks are by law "obligations of the United States." This fact is so stated on the face of the notes. Federal Reserve notes are not backed solely by the assets of the Federal Reserve Banks; they are backed by the credit of the United States. The power to issue currency, plus the power to buy and sell Government securities in the market, provides the Federal Reserve System with an effective weapon which it can hold over the head of the Secretary of the Treasury.

Therefore, it requires courage to differ with the Federal Reserve. In the light of what has happened, for the Federal Reserve to assume credit for supporting the Treasury in its September 15 financing is like knocking a man down and then claiming credit for lifting him up and giving his support.

Since the Treasury announced the September 15 refunding operations, the Federal Reserve System has said in effect to investors: "We have on our shelves better securities than those offered by the Treasury . . . Bring to us your 'rights' to the Treasury's offering and we will sell you better securities . . . Some of the securities we have carry the same rate of interest as those offered by the Secretary of the Treasury, but we will sell them to you at a price which will net you a better rate . . . Moreover, the Secretary of the Treasury has offered you the September notes at par, but if you will wait until after September 15 you will be able to buy them from us at a discount . . ."

The discharge of the duty imposed by law upon the Secretary of the Treasury in the fixing of terms of Treasury offerings necessarily involves a large degree of individual judgment, and whenever the element of judgment is involved it is to be expected that there may be some disagreement. In spite of contrary views as to what the rate of interest should be the decision of the Secretary of the Treasury with respect to the September 15 offering was not an unreasonable one. The effect of the Federal Reserve action is to invade the authority and responsibility imposed upon the Secretary of the Treasury. It is doubtful whether the Congress intended that the Open Market Committee use the authority of its open market operations as a means of compelling the Secretary of the Treasury to fix interest rates to suit its judgment.

In the post-war economic studies the economists of the Federal Reserve Board admitted that the critical issue is not solely or even primarily, as is sometimes argued, whether interest rates on the public debt should be stabilized or whether there should be flexibility in market rates. They stated that although stability of interest rates and bond prices might impede monetary authority, it is by no means clear that a policy of permitting fluctuations in the rates and prices of Government securities would promote stability as long as the present public debt structure is retained. They also express the view that to be effective against inflation, higher interest rates would have to result in the conversion of idle or excess monetary balances into Government securities or time deposits. In the long run, the rate of interest "probably" has a great deal of influence both on the employment and holding of money. But in the face of short-run inflationary developments of any real magnitude, "a very great increase in interest rates might be necessary to resist the conversion of Government securities into deposits."

In this connection it is interesting to note the observation of these economists that "Interest rates of 5 and 6 percent on Government securities following the last war (World War I) were not an adequate curb on credit expansion by banks and did not promote nonbanking absorption of Government securities to any significant extent."

The following excerpts from Study No. 8, issued in November of 1947, (p. 107) are worth quoting:

"Experience shows that increases in Federal Reserve discount or bill-buying rates have not always exerted effective restraint against credit expansion generated by speculative demands. Such increases would be even less effective in a situation where their primary effect would be upon prices of outstanding Government securities, rather than upon private borrowers."

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"Substantial variation in short-term interest rates, however, in view of the large volume of public debt outstanding and its broad distribution among owners, would have serious repercussions throughout the economy without exerting the same influence

upon borrowing and lending as in the past when private debt was a more important part of the total debt structure. Maintenance of substantially higher interest rates, furthermore, would raise the cost of the public debt, and widely fluctuating rates would greatly complicate the Treasury's task of refunding its large maturities. Finally, it is important to recognize that higher levels of short-term interest rates would not prevent shifting by banks, corporations, and others from the vast holdings of Government securities in order to meet private demands for credit if these demands are particularly strong or banks are competing actively for such business. In other words, while sale of short-term Government securities to purchase longer-term issues might be prevented by diminishing the existing spread between short and long-term interest rates, the higher short-term rates would not prevent sales of Government securities to expand private debt."

The economists stated that -

"If traditional Reserve System methods of influencing changes in the amount of private debt through changes in interest rates are resumed, appropriate protections will need to be established against undue instability in the market value of the vast public debt."

In connection with the problem of debt management, it would seem that the Federal Reserve should have given more consideration to the importance of maintaining a stable securities market at such a crucial time when it was not known the extent to which the Government might be required to borrow money to finance military activities. It also seems that while a great deal of claims are made for the psychological value of the increase of interest rate, such action is little more than working around the fringes of a program to combat inflation. The way to attack inflation is through direct or qualitative controls along the lines of the President's speech on Saturday night.

There is no conflict of objectives between the Secretary of the Treasury and the Federal Reserve. The Secretary of the Treasury is just as much concerned as the Federal Reserve about maintaining a stable economy and a prosperous nation. He is just as much aware of the importance of the stability of the buying power of the dollar and a sound currency system as the Federal Reserve. As a matter of

fact he has a greater direct interest and responsibility in economic stability because it is he who has to finance the operations of the Federal Government, whether the Nation is at peace or at war. He is the representative of the President of the United States, the elected representative of the people on whose shoulders rests the primary responsibility for economic stability and the general welfare.

The Secretary of the Treasury has endeavored through friendly persuasion to convince the Federal Reserve System that an increase in interest rates at this time is unnecessary, inadvisable, and not in the interest of a stable Government securities market. He has zealously avoided encroachment upon the functions of the Federal Reserve System, and has discharged his duty with a high degree of courage and discretion.