Memorandum

Subject: Post-War European Experience and the Interest Rate Controversy

Any one seeking positive support for the Treasury viewpoint in the present interest rate controversy will find small comfort in post-war European experience.

Without exception, every Continental country and the United Kingdom has taken monetary steps much more drastic than anything proposed by the Federal Reserve System in order to deal with the problem of internal inflation. In brief summary, European countries have taken all the steps necessary to deprive their banking systems of the power to expand reserves except with the full approval of the central authorities. They have utilized a variety of techniques to achieve this result: secondary reserve requirements of all sorts, increases in central bank rediscount rates, deliberate increases in yields on long-term government securities, and moral suasion.

A detailed, objective summary of the steps taken by each European country is contained in pp.83-95 of "General Credit Control, Debt Management, and Economic Mobilization" prepared by the Staff of the Joint Committee on the Economic Report.

The only real support for the view that the United States long-term and short-term government rate should be pegged at present levels for the duration of this emergency that can be adduced from post-war European experience is the indirect argument that there are alternative techniques, e.g., various types of secondary reserve requirements and direct selective credit controls, that not only can be used, but have been used in Europe to deprive banking systems of their power to increase reserves or create deposits without calling for any increase in the government bond rate.

If one is prepared to support the use of alternative techniques that will achieve the same results as fractional upward increases in the yield on government securities one can cite chapter and verse of European experience to show that interest rate adjustments are not essential to achieve the objective of bringing the volume of commercial credit under control. Fractional interest rate adjustments are clearly much less effective as a means of inhibiting sales of governments to the central banking system, for example, than are special reserve requirements. The European countries have, as stated above, been prepared, not only to make it impossible for the commercial banks to dispose of existing holdings of governments but also to restrict the power of the banks to use new cash deposits to create additional reserves.

One of the problems posed for the Treasury by the present controversy is the fact that fractional interest rate adjustments are so obviously of limited effectiveness. It is easy enough to demonstrate that fractional interest rate shifts would not have much effect in curtailing increases in bank reserves and bank loans. The Federal Reserve System would presumably not quarrel with this contention. But it is a weapon that is available and would doubtless have some effect. This is all that the proponents of the Federal Reserve approach need maintain in public debate and as long as advocates of the Treasury view take the extreme position that the interest rate weapon is of <u>no</u> use I do not see how they can expect much public support. The problem of the Treasury spokesmen is to demonstrate that there are other monetary and fiscal measures which can and should be put promptly into effect

and which will achieve the same anti-inflationary results but without the adverse fiscal consequences of an interest rate increase. So long as the Treasury stand is purely negative, the Federal Reserve will have all the advantages in public debate traditionally associated with those individuals and institutions who are vocally against sin and inflation and have a program for dealing with it.