COMMITTEE FOR ECONOMIC DEVELOPMENT
444 Madison Avenue, New York 22, N. Y. Murray Hill 8-2063

February 8, 1951

Dear Sir:

The Research and Policy Committee of the Committee for Economic Development (CED) has expressed its views on Federal monetary and debt-management problems in several Statements on National Policy, notably "Monetary and Fiscal Policy for Greater Economic Stability", issued in December, 1948, and "Paying for Defense", November, 1950, as well as "Economic Policy for Rearmament", an August, 1950 statement by the Program Committee of the Research and Policy Committee.

For the convenience of those interested in the current public discussion of the policies of the Federal Reserve and the Treasury, pertinent excerpts from these statements are attached.

If you would like full copies of these and other CED statements for your reference files, please let me know.

Sincerely,

Wesley F. Rennie

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Executive Director

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P. S. Also attached is a list of the present members of the Research and Policy Committee.

COMMITTEE FOR ECONOMIC DEVELOPMENT

EXCERPT From "PAYING FOR DEFENSE", Statement on National Policy by the Research and Policy Committee of the Committee for Economic Development, November, 1950:

"No program to stabilize the economy and control inflation can be effective unless it includes measures for limiting the expansion in the money supply and bank credit. The purchasing power which has been reduced by heavier taxation must not be replaced through borrowing from banks. This would mean undoing with one hand what is being done by the other.

"Certainly one of the most effective available methods of limiting the expansion in the money supply and bank credit is action to make the money market, including the market for short-term Government securities, self-supporting. Such action requires flexibility in money rates, for no satisfactory way has as yet been found to restrict the availability of credit without affecting interest rates charged all borrowers, including the Government. Even small increases in money rates dissuade some banks from selling bank-eligible Government securities and induce some yield-conscious investors to buy them. Without flexibility in short-term interest rates, the Federal Reserve System is unable to follow consistent anti-inflation objectives as it is obliged to do by law.

"Relying on a self-supporting money market and permitting Federal Reserve actions to affect money rates is entirely consistent with a Government debt-management policy that is in the national interest even though it results in some temporary increase during the present defense emergency in the cost of carrying the public debt. This increase in carrying-cost is but a small fraction of the possible cost to the Treasury and to the people of this country of a substantial and a sustained rise in prices."

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EXCERPT From "ECONOMIC POLICY FOR REARMAMENT", Statement by the Program Committee of CED's Research and Policy Committee, August, 1950:

"No aspect of economic policy for mobilization is in greater danger of neglect than the management of the debt. The issues are obscured by technical complexities, which make it difficult for public opinion to come to bear on the problem. Moreover, the division of responsibility between the Treasury and the Federal Reserve tends to impede decisive action. Yet the problem is of paramount importance.

"In the present military program the cash budget should be balanced and there should be no increase in the debt. In that situation the problem is to prevent the existing debt from becoming the basis for expansion of bank credit and the money supply. But we must also prepare for the possibility that the Treasury will face large deficits, as a result of a large increase in the military program. If that happens, commitment to a pattern of interest rates or structure of debt which involves large-scale borrowing from the banks will be the surest road to inflation. Such a commitment, explicit or implicit, must be rigorously avoided in the refunding operations which lie ahead.

"Managing the Federal debt so as to minimize borrowing from banks may involve some increase in the interest burden of the debt. This is, in our opinion, a secondary consideration when compared with the danger of encouraging inflation, especially since a large part of the increased interest would be recovered by higher taxes."

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<u>In December of 1948 CED's Research and Policy Committee published a detailed study of the way in which government monetary-fiscal policy affects economic fluctuations. In this statement, "MONETARY AND FISCAL POLICY FOR GREATER ECONOMIC STABILITY", establishment of a Commission on National Monetary and Financial Policy was proposed:</u>

"The Committee recommends that a temporary commission be established to make a comprehensive study of the possibilities of improving the structure and policies of monetary, budgetary and related institutions...The monetary problem is inseparable from the problems of budgetary policy, debt management, and savings institutions...

"The commission should, we think, be established by act of Congress, in such manner that its recommendations, when arrived at, will have Congressional support and the confidence of the public. It should be non-partisan and include private as well as public members."

The Committee said areas which should be thoroughly studied by such a temporary commission include:

"a) Procedure for making and coordinating financial policy. This is a problem within the Administration, within the Congress and between the Administration and the Congress. Within the Administration the outstanding need is for correlation between the monetary functions of the Federal Reserve and the functions of the Treasury in managing the debt and the government's cash balances.

"b) Monetary Policies. What are the functions to be performed by the Federal Reserve in its actions affecting the supply of money and bank credit? By what principles should the Federal Reserve be guided in its discharge of its functions? Can any specific criteria or rules be established for the assistance of the Federal Reserve in interpreting these principles?

"c) Monetary control powers. The powers of the Federal Reserve System should be re-evaluated in the light of the growing recognition of the responsibilities of the System and the situation created by the existence of a huge Federal debt. Should the limit up to which the Federal Reserve can increase reserve requirements be raised, and in what form?..."

In "MONETARY AND FISCAL POLICY FOR GREATER STABILITY" CED's Research and Policy Committee devoted considerable attention to Federal Reserve policies. Excerpt follows:

"It is important to recognize and emphasize that economic stability is the primary objective of monetary policy. This must be recognized not only by the Federal Reserve itself but also by the public generally. For while the Federal Reserve has the power, it is necessarily influenced in the exercise of that power by public opinion and attitudes. Once priority of the stabilization goal is accepted, success in the discharge of its responsibilities will depend upon the wisdom and courage of the monetary authority. The Federal Reserve cannot be provided with rules that will tell it in detail what should be done in each of the infinite variety of conditions that may confront it. Particular applications of policy will reflect the judgment of the Federal Reserve authorities.

"In general, the Federal Reserve should act to restrict the money supply and tighten the reserve position of the banks in times of business expansion and rising prices and to expand the money supply and ease the reserve position of the banks in times of falling production and prices. The methods available to the Federal Reserve for executing such a policy are basically three; 1) purchase and sale of government securities in the open market, which affects the money supply of the public directly as well as the reserves of the banks, 2) change of the terms on which the Federal Reserve will lend to member banks, and 3) the variation of required reserve ratios within the limits established by Congress.

While these instruments may not be perfect in all respects, we believe they are sufficient for the execution of a highly beneficial stabilizing monetary policy.

"Flexibility is essential to wise monetary action. The Federal Reserve must be prepared to act promptly and to reverse itself quickly when economic conditions change. Changing monetary action need not be the sign of uncertainty and inconsistency in the monetary authority but rather of necessary adjustment to a fluctuating economy. The monetary instrument has - at least by comparison with such instruments as tax and expenditure policy - great potentialities for timely and deliberate flexibility. The process of deciding what to do need not be as time-consuming as the enactment of legislation. And the time lapse between decision making, action and effect can be relatively short.

"The monetary policy required for stabilization is bound to be unpopular with some people. Restrictive monetary action inevitably means that some prospective borrowers will not be able to get from their banks the credit that they wish or feel entitled to.

"In periods of inflation some curb on the increase of total expenditures and incomes is necessary to prevent a rapid rise in the level of prices. It will be important for the future conduct of monetary policy that this be recognized...

"The currently most important problem of monetary policy relates to action in the market for government bonds. The Federal Reserve is now supporting the prices of the longer term government bonds at slightly above par. Whenever holders of the supported bonds offer them for sale and do not find other buyers at or above the support price, the Federal Reserve Banks will buy. In buying, the Federal Reserve not only provides the sellers with cash but also provides the banking system with additional reserves as in the case of any other open-market purchase. These reserves could then be the basis for a multiple expansion of bank credit. It is precisely in inflationary conditions when the demand for credit is high that the Federal Reserve is likely to be called upon to buy in support of the market and thus to provide banks with reserves, unless the Federal Reserve is able to offset the effect of its purchases in some other way.

"The Committee recognizes the serious considerations underlying this support policy. Among these are the size of the government debt, which is now a very large part of the total debt in the country and a large part of the total assets of financial institutions. Certainly it is important to avoid unnecessary unsettlement of the capital market. However, these considerations do not supersede the priority of general economic stability as the objective of monetary policy."

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"In its decisions as to purchase and sale of government bonds, the Federal Reserve should act on the basis of its judgment from time to time as to the effect of such action on the economy as a whole. This assumes accepting continuing responsibility for maintenance of an orderly market for government bonds. It also assumes that due consideration will be given to requirements arising out of unsettled international relations. The Federal Reserve should feel free to reduce the support level unless it finds a superior alternative way of bringing about a monetary restriction if and when that is required by the objective of economic stability. It should regain the initiative in its open-market operations, rather than let the initiative remain with the market. Passive open market policy is not consistent with effective regulation of the money supply...

"In time of inflation the Treasury should conduct its borrowing in ways that do not add to the money supply and will be least likely to draw idle funds into use; it should seek to borrow in ways that restrain private expenditures. In time of depression the Treasury should seek to borrow in ways which exercise least restraint upon private expenditure, essentially by borrowing from the banking system."

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"Monetary policy affects the supply of money held by the public and the cost and availability of funds to the public by its influence upon the supply, cost, and availability of reserves to the banks. The reserve position of the banks limits the supply of money (bank deposits and currency) and affects the amount and terms of bank lending. This effect is most powerful and visible in periods of expansion. Individuals and businesses wish to increase their expenditures for many purposes. Many of them are willing to borrow or sell securities to do so, and many of these potential borrowers meet banks' standards of creditworthiness. If bank reserves are plentiful, or if additional reserves can be obtained at low interest rates, banks will expand their loans and investments, financing part of the increased expenditure and increasing the money supply.

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"There are ways in which a business expansion or inflation could occur without an increase of the money supply. If holders of money are willing to reduce their holdings, either to increase their own expenditure or to lend to others who will increase expenditures, there can be general expansion without a rise in the money supply. The rate of money turnover would increase, while the quantity of money would remain constant and the money value of incomes and production would rise. However, expansion is not likely to go so fast or so far if the money supply is prevented from rising as it would if banks are able to increase their assets and deposits. For with a constant money supply, as incomes rise individuals and businesses find themselves holding less and less money in relation to their incomes and transactions, they feel short of cash in relation to possible needs for cash and so they become less willing to spend or lend. While inflation is possible without an increase of the money supply, inflation is much more likely to occur or to proceed farther if money increases rapidly. All the great inflations have been accompanied or preceded by large expansions of the money supply."

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"The Federal Reserve Act created a mechanism that can deliberately, as a matter of public policy, provide the banks with additional reserves...The Federal Reserve can refrain from providing additional reserves when credit expansion is undesirable, and can reduce reserves or increase reserve requirements when contraction is appropriate. All of these powers can be exercised only within limits set by law, limits which have been gradually broadened since the system was established...

"The Federal Reserve System now operates essentially as follows: Banks that are members of the Federal Reserve System (member banks have 80% of all bank deposits) are required to keep reserves equal to a certain percentage of their deposits in the form of deposits with the Federal Reserve Bank of their region. The required reserve ratios are set by the Board of Governors of the Federal Reserve System within a range established by Congress. If banks have no more reserves than are required by their existing deposits, they cannot expand their assets or their deposits; if their reserves are deficient, they must contract their assets and deposits unless they can obtain more reserves. Since the reserves required are a fraction of the deposits, the amount of deposit contraction required by a deficiency of reserves is not the amount of the deficiency but a multiple of the deficiency. When banks have more reserves than are required, i.e., have excess reserves, they can expand by a multiple of the excess, but do not have to. Banks may obtain additional reserves by borrowing from the Federal Reserve, on terms prescribed by the Federal Reserve. Thus the Federal Reserve, by lending reserves to the member banks, may prevent a deficiency of reserves from causing a contraction of bank credit; by lending reserves, it may also permit an expansion of bank credit.

"The Federal Reserve also can, on its own initiative, increase the reserves of the banking system by purchase of Federal Government securities in the open market. The seller of the securities will receive in payment a Federal Reserve Bank check. The seller will deposit the check with a member bank which in turn deposits it with a Federal Reserve Bank, thus increasing the member banks' reserve balances. By reducing its loans or by selling Federal securities the Federal Reserve can reduce the reserves held by the member banks. And by virtue of its authority to modify the required reserve ratios the Federal Reserve can create a shortage or excess of reserves by raising or lowering the requirements without changing the supply of reserves.

"Thus the Federal Reserve is able to tighten the banks' reserve position, stopping expansion or forcing contraction. The Reserve can loosen the banks' reserve position, permitting, but not forcing, bank credit expansion. Not only is the Federal Reserve in a position to do these things; it is always doing them one way or another, actively or passively. It is either buying governments or not, selling or not, lending to banks or reducing its loans. Whatever the Federal Reserve is doing or refraining from doing in this field reflects a decision and has an influence upon the banking situation."

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CED RESEARCH AND POLICY COMMITTEE