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An Address given before the 55th Annual Meeting of Group Two of the
Pennsylvania Bankers Association
held at the Bellevue-Stratford Hotel, Philadelphia, Pennsylvania
By Aubrey G. Lanston, President of Aubrey G. Lanston & Co. Inc.
On February 12, 1951

THE TREASURY-FEDERAL RESERVE DISPUTE

I would like to talk to you this morning about the differing convictions of the Treasury and the Federal Reserve, because these involve questions of policy that are of great importance to our economy and, therefore, to you as bankers. Public opinion is being brought to bear on the impasse that exists, and it is being marshalled through statements that oversimplify the points at issue. It would be unfortunate, as we see it, if too many people accepted the thought that, if the Federal Reserve were freed of its compulsion to buy Treasury securities at fixed prices, the Federal could necessarily exercise a deflationary influence. Nor should we accept the generality that preys upon our love for tradition, namely, that the Federal Reserve was created as a supreme court of finance and that it would be a sacrilege if it were interfered with in any way.

Let me tell you at the outset where we stand on these matters. We believe it is most desirable that the Federal become more free than it has been in the past decade to follow a restrictive credit policy at times when this is needed. We agree with those who say that Treasury domination of Federal Reserve credit policy is dangerous. We do not go along, however, with the sophomoric contention that the Federal Reserve should be omnipotent or that it should be free to assume an attitude that might be described as "the Treasury be damned". There is much appeal in the thought advanced by Mr. Russell Leffingwell that the Treasury and the Federal Reserve be equal partners. On such a plane each can act to restrain the other or to goad the other as the case may be.

The question of domination or partnership is important largely as a matter of who holds the final say. The real problem involves many technical phases of debt and credit management and the need for a continuing understanding of investor psychology. Perhaps the outstanding problem in the technical field is whether 2 1/2% Treasury bonds need be supported forever at par or better. We have long been of the firm belief that par support should not be a permanent practice. At the same time we are equally firm in our belief that we cannot depart from such a practice overnight, particularly in an atmosphere of contention between the Federal Reserve and the Treasury. We also believe that if the two partners in money and debt management are so far apart in their convictions that agreement can be reached only by literally hitting one of the two of them over the head, the public cannot be blamed if it loses confidence in both, and in the dollar, and in Treasury securities.

We are inclined to place a great deal of weight on the importance of the state of mind of the investor and on the degree in which this must be considered in the management of both debt and credit.

The open-market operation is the principal instrument with which the Federal may affect the amount, availability, and cost of money. We know quite well how readily the Federal can expand the amount and can increase the availability of credit by the purchase of securities in the market.

We believe that some misconception exists as to the ability of the Federal to contract credit by the sale of Treasury securities. Success in this regard depends upon the Treasury's cash position. If the Treasury is operating with a substantial cash surplus, the Federal can contract reserve credit by selling securities in the market or by redeeming obligations as they mature.

If the Treasury does not have a cash surplus, attempts by the Federal to sell in the market cannot contract credit against the will of the market and may only expand the amount of credit in use.

At the present time the Treasury faces a deficit, and the prospect of the Treasury attaining a surplus seems remote. Therefore, in future open-market operations the Federal will be unable to contract credit to any appreciable extent by sales of Treasury securities on balance.

Perhaps this is why we are confronted with the demand that the Federal Reserve be restored to the independence conceived for it thirty-seven years ago. Such independence would permit of an attempt to reduce the inflation problem by denying credit to the market, with the obvious result that a sharp upward trend in interest rates would follow. In the meanwhile the Federal Reserve creates, on occasion, a situation where there is no market for Treasury securities.

This brings us to the second phase of open-market operation, namely, the techniques employed by the Federal that would produce a trend toward higher interest rates. One can be certain that if the Federal were free to precipitate, directly or indirectly, a sharp upward trend in interest rates and if it were determined to use this mechanism to the necessary extent, it could stop the present inflation spiral. But once this had been accomplished, or during the process, another series of chain reactions would be started, such that the resultant inflation potential would cause our present problem to be dwarfed by comparison.

The February National City Bank letter offered a comment that was of great interest to us in this connection. It was directed primarily to the defense effort, but it applies equally to those phases of credit and debt management that have precipitated the Federal-Treasury dispute. The National City Bank noted that during most of the time since Korea, people have been uncertain as to the extent of the requirements of defense and what was expected of them. The Bank went on to say that little authentic information had been available on the size of the defense program, and it admitted that, although such uncertainties may have been unavoidable, the lack of a firm basis for calculations left the way open for uninformed opinions, speculation, and extreme statements both public and private. The comment closed with the following quotation, "Undoubtedly there has been 'inflation by publicity', which has fostered a contagious state of alarm and scare buying".

We believe that the drawn-out public discussion over the clash between a fixed interest rate and credit control, a discussion in which Federal Reserve officials have taken a long lead, has contributed importantly to the expansion of bank credit.

How much weight should be given by the Federal to the impact of its credit policies on holders of Treasury securities such as businesses and individuals? For an idea we might turn to an estimate of the so-called inflationary gap that was recently made by a noted Federal Reserve economist. He said that the gap during the next year could be as much as \$20 billion and will stem from a contraction of \$10 billion in the goods available for civilian purchase and an increase of a like amount in consumer and business income. He cautions that the estimate is premised on (1) no further price or wage increases, (2) no substantial credit expansion, (3) no further tax increases, and (4) a consideration of particular potency to our discussion -- namely, no large use of available liquid assets. He then points out that individuals and businesses hold \$175 billion of bank deposits and currency and \$90 billion of Treasury securities, a large part of which are redeemable on demand or have short maturities. The total is \$266 billion. The question, therefore, is whether attempts by the Federal to reduce the size of the inflation gap will suggest that some portion of the \$90 billion of these Treasury securities be sold or whether such investors thereby will be encouraged to increase their holdings.

The Federal Reserve, as a special guardian of the purchasing power of the dollar, also must keep in mind that some \$100 billion of Treasury securities rest in the portfolios of commercial banks, savings banks, insurance companies, and the like, and that such investors hold additional billions of other marketable securities, the value of which would be affected, along with their Treasury securities, should a sharply increasing trend in interest rates occur.

Managers of these portfolios, such as yourselves, are concerned with the decreasing purchasing power of the dollar, but you also take into consideration in the management of your portfolio the dollar prices that your security investments command in the market. Many of the decisions that you make with respect to the purchase, sale, or retention of these securities are based upon changes in market values. Collectively these decisions of yours, influenced as they must be by the Federal Reserve's policies, will bear importantly on whether individuals and businesses prefer to acquire additional securities or are inspired to bring their liquid assets into play in a manner that will heighten our inflation.

Thus, the Federal is quite correct in saying that it must protect the purchasing power of the dollar, but the Treasury is also on sound ground when it says that investor confidence in Treasury securities should not be impaired by unexpected sharp fluctuations in the dollar prices of its securities. These two statements are the crux of the dispute.

Now let us digress for a moment in order to examine the weight that should be given to the Board's contention that it has a responsibility for credit that it is not able to discharge. There is nothing new about this. The Federal Reserve was charged just as fully in this connection nine years ago as it is today. Yet nine years ago, as a consequence of the war emergency, the Federal agreed to underwrite a pattern of rates for Treasury wartime financing. The Federal had no option, because the Treasury faced an unprecedented deficit, the money had to be raised, and there was nothing else to do.

Since the Treasury again faces a deficit, is there any better way to resolve matters than to bring about an agreement between the Treasury and the Federal in the technical area of interest rates and support techniques?

Nine years ago when the Federal accepted the responsibility of protecting the prices of Treasury securities, the Secretary of the Treasury would have accepted a support price that was fractionally below par. When I say this I am not making an assumption. The choice of par, as a precise figure, was made by the Federal, and with the passage of time most Treasury security investors have come to believe that whenever "the cards were down", neither the Treasury nor the Federal would elect to drop the support price of the 2 1/2% bonds below that figure.

Indeed, you will recall that by the time we had to face up to the inflationary problems of 1947 and 1948 a leading official of the Federal proclaimed that failure to support Treasury 2 1/2% bonds at par would lead to a catastrophic condition. We repeat that we firmly believe that we need to get away from par support, and we believe that a program should have been and could have been worked out long before this. A period of national emergency and of bitter dispute between the Treasury and the Federal, however, is not a propitious moment to engage in drastic changes or to withdraw support.

Furthermore, if the reasons for supporting outstanding Treasury bonds were compelling in 1948, how do we justify ignoring similar reasons today?

The Federal has lived with its conscience for nine years. Why must it suddenly choose a war emergency and a period when the Treasury faces a deficit of unknown size to suggest that it be free to act independently?

Indeed the differences between the type of inflation that we face today and that with which we were confronted in 1947 and 1948 should leave the Federal Reserve with less rather than more reason to have precipitated these questions. During 1947 and 1948 the inflationary problem arose primarily from activity in the private economy, at a time when the Treasury had a substantial cash surplus. The present inflation has been enlarged by the prospect of controls, of shortages, and of an undefined but large defense program.

Some portion of the plant and equipment expansion necessary to the defense program is yet to be met. The money needed from outside sources must come largely from either the insurance companies or the commercial banks. At the present time great emphasis is being placed on the expansion of bank credit. Few seem to realize that under existing conditions loans granted by banks are less inflationary than the extension of an equal amount of credit by insurance companies.

Now, the Treasury security and other bond markets have remained relatively calm throughout this drawn-out Federal Reserve-Treasury dispute and its accompanying publicity. This calm is the result of a general confidence that the Treasury long-term rate of 2 1/2% will stand, and so will par support for outstanding long-term bonds. In other words the rank and file of investors do not believe that the Federal will be or will feel free, in the final analysis, to unstabilize the Treasury security market by decreasing the support prices or by withdrawing support.

My first question, therefore, is as follows: If against the contentious background of recent months, the Federal reduced its support price for Victory 2 1/2s to 100 and, at the same time, became a more-than-usually reluctant buyer of short-term Treasury securities, would investors continue to be calm or would their confidence be somewhat shaken?

Second, would a drop in the support price of 2 1/2% bonds to 100 or an increasing denial of a market to some holders of Treasury securities produce an increased volume of precautionary sales?

Third, if the Federal Reserve were to drop the support price to 99 1/2 or 99, how confident would institutional investors be that such support prices would hold?

If the Federal breaks par in support of Treasury bonds, will this be deemed, by investors, to be evidence that it has adopted a program of retreat to successively lower prices depending upon the volume of bonds offered to it?

If, to make its credit less readily available, the Federal decided to let the market decline to whatever point was necessary to dry up selling, how far would prices have to decline? Does anyone know? Can we afford to act on optimistic guesses?

Now let's go to the other side of these things. Let us assume that, to reduce the availability of credit, the Federal Reserve drops its support prices sufficiently low that it ultimately dries up any substantial selling. How many institutional investors would become buyers of Treasury securities?

We are asked to believe that more Treasury securities can be placed if the interest rate offered on them is made more "attractive". When bond prices decline interest rates become more attractive, but I have never seen a bond market that was undergoing a major decline that could be characterized as a confident one. If the bond market is caused to decline sharply while institutional investors are net sellers on balance, where are the additional buyers of these bonds going to come from?

We believe that the important consideration is not whether interest rates become more "attractive" or whether a higher level of rates is brought about. It is the trend of rates that is important. As bankers, you may agree that there is a tendency to feel more "loaned-up" when the outlook is for higher rates of interest than is the case if the outlook is for lower ones. The same thing is true with respect to bond buyers. A given rate is unattractive if the trend of the market is down, but the same rate can appear attractive if the price trend is stable or rising.

Please do not misunderstand. We are not an advocate of low interest rates. We would have much preferred a Treasury decision calling for a long-term 2 3/4% bond or a long-term 2 1/2% bond at a discount to yield 2.70% or 2.75%. Both of these would have been possible without disturbing the stability of outstanding bonds if the Treasury and the Federal had evidenced an ability to resolve their differences.

We have been told that market conditions have clearly shown that the Treasury has insisted upon interest rates that are "too low". In justification, our attention is called to the natural forces of supply and demand as they appear in the market and to the amount of Treasury securities that the Federal has been forced to acquire. The market for Treasury securities during the past year has been made almost entirely by the Federal Reserve, and the market has looked, most of the time, the way the Federal open-market operations caused it to look.

Let me illustrate this by comparing two financings a year apart. First, we will go back to November 1949. When the Treasury and the Federal Reserve were discussing the terms to be set on the approaching refunding of that period, the market "looked" as though a 1 1/8% rate were no longer suitable. The Treasury, nevertheless, decided to continue with a 1 1/8% one-year rate. It also offered a 1 3/8% note with a 4 1/4 year term. This note quickly reached a premium of 11/32 above 100. Why? Because investors took the financing decision of the Treasury as an indication that the Federal has lost the fight to advance the pattern toward higher yields. Both offerings were an outstanding success.

During the months following the Federal showed, by its handling of the open market, that it had not given up the fight. Even when the Treasury, in the spring of last year, acceded to somewhat higher interest rates for shorter-term securities, the Federal appeared to be dissatisfied. At least, that is the impression gained by close observers, an impression that was more than fully justified by the open break that occurred in August of last year.

Let us now consider the latest refunding in which the offering consisted of a single issue of five-year 1 3/4% notes. The terms set by the Secretary of the Treasury were those recommended by the Federal Reserve, ones that were later characterized by the Federal as appropriate and attractive. Most market observers, and we believe the Treasury as well, were skeptical of the appropriateness and the attractiveness of a five-year obligation for corporations, who were large holders of the maturing securities. But there are grounds for believing that the Federal assured the Treasury that this refunding would be a success.

What is the record? Only about 52% of the public holdings of the maturing securities were exchanged for the new issue and held throughout the exchange period. The remaining 48% of the public holdings were sold to the Federal or redeemed for cash. This hardly could be construed as a successful exchange from the point of view of the sound objectives of debt management.

About 15% of the public holdings were redeemed for cash. This compares with a 21% cash redemption last September and October and with the more normal cash redemptions of 5% or less. The drain on the Treasury's balance resulting from these two refundings was \$3 1/2 billion.

The differences between the successful refunding of November 1949 and the unsuccessful exchange offering made in November 1950 were twofold. In the first place, it is a testimony to the deterioration in investor confidence that has been brought about by the public wrangling over differences. Second, it suggests that the Treasury is a better judge of the type of securities that investors will buy than is the Federal.

This brings to mind something that has occurred to us with increasing frequency over recent months. We have wondered whether the Governors of the Board and the other members of the Open Market Committee could possibly be too far removed from an intimate contact with the Treasury security market, that is, from the changing states of mind, the preferences, and the reactions of those whose activities create the supply and demand with which the Federal open-market operation must contend. These are details of great importance when it becomes necessary to refine the terms of Treasury offerings. We also have wondered whether an adequate exchange of technical information takes place between the Treasury and the Federal. We have wondered about these things, because if such

situations were to exist they would explain why some of the misunderstandings arise.

But let us get back to more tangible things. The apparent calmness of institutional investors will be put to a full test when the Treasury begins to refund almost \$40 billion of maturing or callable securities. The bulk of these refundings covers a span hardly longer than four months and begins this June.

Were the Treasury to experience the same percentage of cash redemptions that it suffered in the last refunding, it would have to pay out about \$6 billion. No wonder the Secretary of the Treasury believes a stable and confident Treasury security market is a prerequisite to financial mobilization.

If, therefore, the Federal Reserve were to endeavor to make credit unavailable by reducing support or by withdrawing it, what would be the attitude of holders of the maturing and callable Treasury securities?

Many have substantial forward commitments in mortgages and the like. A larger number would be offered good loans at rates substantially higher than those now prevailing. Some of these loans will be necessary to the defense program.

Would investors accept the refunding offerings to be made by the Treasury?

Or would they deem it prudent to redeem their securities in order to meet their commitments or to make loans?

If, in the final analysis, the Treasury met with no greater success in these financings than in those just past, would potential buyers of long-term Treasury bonds gain or lose in confidence?

And, wholly aside from the Treasury's cash position, if it must meet large-scale cash redemptions, from whom will it obtain the funds? From the Federal Reserve Banks? Or from the commercial banks?

In either event it would appear that banks as a whole might be forced to cope with some more or less unworkable plan such as a secondary reserve requirement, a ceiling reserve plan, higher cash reserves, or they may be told to accept Treasury certificates of deposit bearing interest at some rate such as $1/4\%$. Yet none of these devices will insure an improvement in the credit condition over what it can be if debt management is permitted to work in our favor instead of against us.

This is not a question of interest costs. Surely many would prefer higher rates, but the determining element in the equation is the maintenance of investor confidence. This requires a stable and confident Treasury security market and confidence among Treasury-security investors that they will not be subjected to some abrupt manipulation of the market, by either the Federal Reserve or the Treasury.

It seems to us important that the attitude of the institutional investor toward the market for Treasury securities may determine the confidence that business corporations and individuals have in these same securities.

To parlay the reduction in the value of the dollar by decreasing the dollar price of Treasury securities abruptly may be the worst way to deal with inflation.

In summation we suggest that the differences between the Federal and the Treasury involve questions of policy that are most important to the economy and to you. It is dangerous to accept over-simplifications, either of principle or of the technical aspects of the points at issue. Federal Reserve open-market operations designed to reduce the availability of credit cannot do so on a quantitative basis except as the Treasury is armed with a substantial cash surplus. The Treasury will soon be operating at a deficit. A substantial cash surplus is hardly a possibility. To reduce the support rendered to Treasury securities, against the present contentious background, or without warning, would be most dangerous. The withdrawal of support would be intolerable. Yet, we need to plan for its ultimate elimination. Of greater importance than an increase in interest rates, is the trend of rates. But, this is no time to attempt to control credit by starting a trend to higher rates. To do so would multiply not reduce the inflation potential. Neither the Federal nor the Treasury should be omnipotent or dominant. Each should consider itself to be an equal partner charged with responsibilities of equal weight.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 14, 1951

To Governor Eccles

Subject: Comments on Speech by

From Mr. Leach

Aubrey Lanston, February 12, 1951

At the outset, Lanston takes the position that domination by either the Federal or the Treasury would not be in the best interests of the economy, but that Leffingwell's idea of equal partnership for the two parties would be the most appealing solution. The conviction is expressed that the long drawn-out public discussion of differences of opinion has resulted in deterioration in investor confidence and thus "has contributed importantly to the expansion of bank credit."

A comparison is made between the situation which existed nine years ago and the current situation, without any mention of the extreme differences in the economic situation of the two periods, but rather with the bland conclusion that since the "Federal has lived with its conscience for nine years," why choose a war emergency and deficit financing period to cry for independence?

Lanston repeatedly states that he is neither an advocate of par support or of low interest rates. To him the "determining element in the equation is the maintenance of investor confidence." A minor change in support levels would, he asserts, more likely decrease confidence than increase it, would not reduce the amount of support necessary, in short would be completely ineffective; for the Federal to pull completely out of the market might be catastrophic, since there exist nothing but "optimistic guesses" as to how far prices might decline. He suggests that "the attitude of the institutional investor toward the market for Treasury securities may determine the confidence that business corporations and individuals have in these same securities."

There are some facts stated which simply do not bear analysis. Among these are: "We believe that some misconception exists as to the ability of the Federal to contract credit by the sale of Treasury securities. Success in this regard depends upon the Treasury's cash position. If the Treasury is operating with a substantial cash surplus, the Federal can contract reserve credit by selling securities in the market or by redeeming obligations as they mature. If the Treasury does not have a cash surplus, attempts by the Federal to sell in the market cannot contract credit against the will of the market and may only expand the amount of credit in use."

(1) This statement is obviously erroneous.

(2) With reference to expanding bank credit: "Few seem to realize that under existing conditions loans granted by banks are less inflationary than the extension of an equal amount of credit by insurance companies." If the insurance companies raised the funds to make these loans other than through the Federal Reserve, there would be no inflationary impact; only the fact that the Federal Reserve buys the insurance companies' securities, which then find their way into banking reserves makes this statement correct.

At best the statement is correct only by implication; in the form used it was highly misleading, but very apt since the talk was made to a banking rather than an insurance group.

(3) A section is devoted to the contribution to deteriorating investor confidence which has resulted from O. M. C. manipulations of the market. A comparison is made of the financings in November 1949 and 1950; the former a combination of a $4\frac{1}{4}$ year $1\frac{3}{8}$ per cent note and a $1\frac{1}{8}$ per cent certificate were an "outstanding success", but the offering of the five year $1\frac{3}{4}$ per cent note ("recommended by the Federal Reserve") a year later could hardly "be construed as successful from the point of view of debt management." The differences between the two exchanges: "In the first place, it is a testimony to the deterioration in investor confidence that has been brought about by the public wrangling over differences. Second, it suggests that the Treasury is a better judge of the type of securities that investors will buy than is the Federal." He then suggests that the Board of Governors and the O. M. C. may be "too far removed from intimate contact with the Treasury security market", and that an "inadequate exchange of technical information takes place between the Federal and the Treasury." This attack falls somewhat short of being factual. In the November 1949 refunding, the $1\frac{3}{8}$ per cent note was an unqualified success, the total cash redemption being 4.5 per cent and no purchases being made by the Federal; however, the $1\frac{1}{8}$ per cent certificates met with a 5.7 per cent cash redemption plus Federal purchases during the exchange period of an additional 4.8 per cent, or an effective cash redemption by the investing public of 10.5 per cent. While the figures in the most recent exchange reveal nearly a 48 per cent total of cash redemptions plus Federal purchases, this fails to take into account the sales by the Federal to corporate holders of short term issues which they did want to hold. This type of switching was envisioned and was felt to be preferable to putting out a short maturity which would compound the already over-sized refunding problem which the Treasury has arranged for itself over the last half of 1951.

 AW

LOS ANGELES STATE COLLEGE OF APPLIED ARTS AND SCIENCES

855 North Vermont Avenue • Los Angeles 29, California

March 1, 1951

Governor Marriner S. Eccles,
Board of Governors,
Federal Reserve System,
Washington, D. C.

Dear Governor Eccles:

The undersigned members of the Division of Business and Economics of Los Angeles State College unanimously wish to commend you and your colleagues for the position you have taken relative to monetary policy. We believe that at this time economic strength lies in curtailing the easy money policy so long followed by the Treasury.

Russell L. Chrysler

Russell L. Chrysler,
Associate Professor.

Maurice Dance

Maurice Dance,
Assistant Professor.

Sib O. Hansen

Sib O. Hansen,
Assistant Professor.

Bernard L. Hoyt

Bernard L. Hoyt,
Lecturer.

Leonard G. Mathy

Leonard G. Mathy,
Associate Professor.

Dewitt C. Watson

Dewitt C. Watson,
Associate Professor.

William T. Wilson

William T. Wilson,
Assistant Professor.

Sincerely,

William H. Bright

William H. Bright,
Instructor.

George N. Francis

George N. Francis,
Assistant Professor.

Frank J. Hill

Frank J. Hill,
Associate Professor.

Rodney F. Luther

Rodney F. Luther,
Associate Professor.

Frank S. Wilson

Frank S. Wilson,
Assistant Professor.

John C. Norby

John C. Norby,
Assistant Professor.

Floyd R. Simpson

Floyd R. Simpson,
Professor and Chairman.

March 8, 1951

Mr. Floyd R. Simpson,
Professor and Chairman,
Division of Business and Economics,
Los Angeles State College,
855 North Vermont Avenue,
Los Angeles 29, California.

Dear Professor Simpson:

I deeply appreciate the recent expression of confidence on the part of you and your colleagues at Los Angeles State College concerning the position I have taken with respect to monetary policies.

I have been both surprised and pleased with the wide-spread and intelligent discussion in the public press of the basic issues involved in combatting inflation. The many letters that I have received from people in all walks of life indicate that the public is deeply concerned about the inflationary problem and is taking a real interest in the various attempts to find a workable solution to the problem. This is indeed a most encouraging sign so far as the preservation of our free democratic capitalistic economy is concerned.

I am enclosing several copies of a statement which I gave to the press on the occasion of a speech which I delivered in Chicago recently, and which I think may be of interest to you and the members of your staff.

Very truly yours,

M. S. Eccles

Enclosures

