

Joint Committee on the Economic Report  
Hearings upon the 1951 Annual Economic Report  
of the President, February 2, 1951

Statement upon Monetary Policy by  
John D. Clark, Vice Chairman  
Council of Economic Advisers

The diversity of view of monetary policy which has been exhibited in recent discussion and here today is not surprising. We are now dealing with the problem in an environment which has never before been experienced.

The policies and theories developed in a period when, as Dr. Seltzer said, business loans constituted the bulk of investment of the banks. Today it exists in a situation where the banks hold billions of dollars of Government securities which, whatever price manipulation may take place, will always be liquid and can be turned into cash upon a moment's notice.

It exists in a period when great institutional lenders likewise hold billions of dollars of these liquid assets and when business itself is a source of credit far beyond any situation that existed before.

Businessmen do not have to go to banks in order to get loans before they can initiate a project even though later in the course of the project they may want to resort to banks for part of the funds.

These are new situations which have greatly upset the assumptions upon which monetary policy has been developed in the past century and a quarter. We also have the new situation of an enormous public debt which, because it has been handled successfully, seems now to be looked upon by many people as a tame domestic animal which does not hold within it the seeds of violent disturbance to the economy, and therefore we do not have to do much about it.

That is not the character of the national debt. If it is not handled prudently, if we take such action that some important offering of Government securities is a flop on the market, we will soon learn that the Government credit can be destroyed by imprudent debt management.

These are the two new situations which have to be considered in considering monetary policy today. Obviously we have an opportunity to come to different conclusions about proper monetary policy. Certainly the lessons of the past have very little to guide us in determining what we are to do in a situation which is so greatly different from that of other years.

The breadth of this diveristy of view is illustrated by a couple of statements which have been brought to the attention of the Committee. One I am not certain that you have had. It is a statement issued this week by some of the most important members of the faculty of Chicago University, of the department of economics. To show how strongly these respectable authorities support the most rigorous view of monetary policy, I want to read just a few lines:

"The price rise of the last six months could almost certainly have been largely or wholly avoided by effective monetary action."

Approaching the subject from that standpoint they come to this conclusion of what the policy should be today:

"The Federal Reserve System should at once announce that it will conduct its operations with an eye single to their effects on the supply of money and credit and on the level of prices."

In demanding "an eye single" upon one and only one objective, they exclude all idea of monetary policy being related to the problems of debt

management in this period when the public debt certainly is going to be a matter of daily concern. "It should at once begin to sell Government securities to whatever amount is necessary to bring about a contraction in the currently swollen credit base, and it should persevere in this policy to the point that the inflation is checked, even though one of its incidental effects is a rise in the interest rate on Government securities."

Last week you heard Mr. Eccles state a very simple theory of monetary policy based upon the idea of the direct relation between the volume of money—including currency and bank deposits and savings deposits—and prices.

As I undersood him, his view was that you could influence prices in either direction by changing the volume of money. That seems to be the view expressed by the Chicago economists. The simple fact is that prices in July, August and the first part of September had their most rapid price advance when there was almost no change in the volume of money, and had slowed down and there was relatively little price advance from the middle of September until the end of November when there was a very rapid increase in bank loans and in the volume of money outstanding.

That is the very reverse of the situation implied by these theories.

In 1939 the Federal Reserve Board made a very frank statement to the American people of the monetary theories held by the board. I will read a single short sentence which was repeated in that report more than once:

"The Board finds it impossible to believe that prices can be controlled by changes in the volume and cost of money."

Before you suggest that that was at a time when we were interested in bringing about price increases, and that the very general and universal

terms used by the Board at that time must be interpreted as applying only to efforts to come out of a deflationary condition, let me hurry to tell you that the illustration they used, out of experience, to justify this conclusion, was the events from 1926 to 1929 which as you may recall was not a deflationary period.

The Chairman. Was that a Board statement?

Mr. Clark. Yes, sir.

The Chairman. Not the statement of any individual members?

Mr. Clark. That was a Board statement, published in the Federal Reserve Bulletin in April 1939. The Federal Reserve position today is not so easily determined. They have not made an equally candid statement of the theories behind their operations.

As well as I have been able to ascertain the theoretical position of the Board at this time, it is this: They still hold to the view expressed in 1939 that you can not control prices by bringing about changes in the volume of money or in the cost of money, the cost of credit. They first moved into the theory of restricting availability of bank credit, which has been mentioned here today, by finding methods which will induce banks to hold their Government securities. You see it is a new problem they are dealing with, one they did not have in 1939 to any large degree. They would induce banks to hold their Government securities by giving them a better yield thereon, a policy which Professor Musgrave in his report to you--which has been published--speaks of as buying off the banks from using their credit machinery to endanger the public welfare.

The difficulty with that is, as has been pointed out by some of these

gentlemen today, that every bank in America has plenty of Government securities which it can dispose of in the market without being much concerned about these changes in yields. The banks hold a large proportion of short-terms which are not very much affected by the moderate changes in yields which you can bring about.

The Reserve Board now has a much more sophisticated theory of controlling bank credit under this condition of large bank holdings of Government liquid securities. It is that they will perhaps be able to dissuade the banker from disposing of this Government securities if he has to take a book loss thereon.

I can not quote anything officially from the Board itself on that, but this is the explanation given by Mr. Louis Brown, a director of the Federal Reserve Bank of New York, when he undertook to explain the recent policy maneuvers of the Federal Reserve System.

By using open market operations to bring about an increase in the yield--which means a decline in the market price--of the Government securities, including short terms, the banker will be persuaded not to take a book loss in selling some Governments to build up his reserve in order to make some business loan which is offered to him.

The suggestion has been made here that bankers do not think that way and do not act that way. But quite irrespective of that, I do not think that the banks of the country can possibly be put in that squeeze. The little bank that supports me when the Government is not employing me is not entirely typical in that respect, but it is not such a bad example. It is one that I happen to know about. Every week, we subscribe for

\$200,000 of bills which mature in 13 weeks. \$200,000 happens to be just 10 per cent of our required reserve.

So every week we have \$200,000 of bills maturing. All we have to do in any week to increase our reserve by 10 per cent is simply not to subscribe for new bills that week. And in three weeks we can increase our reserve by 30 per cent. The Treasury is going to continue to use these short-term securities in our total debt structure. They will always be available to the banks.

You could not possibly drop prices on the financial markets low enough--unless you are ready to completely destroy the debt structure--so that any banker is going to be under any particular difficulty of meeting requests that he make attractive loans. We are caught in this trap and we can not get out of it, by these methods. The bankers do have liquid assets which they are able to turn into reserves and you can not stop them by market manipulation.

The view of the Council upon this tough problem has been presented under two of the three groups of circumstances with which your committee has been concerned during the past year. Last February Mr. Keyserling and I, as the surviving members of the Council of Economic Advisers, in response to your request for a report upon a number of questions, including monetary policy, furnished you our views which you have published in the hearings on the 1950 Economic Report of the President.

In November we again made a report in response to the request of the staff that we contribute to this very valuable staff report that has been published within the last few days. The first time we were dealing

with problems of monetary policy in a period of peacetime inflation. We told the committee that our approach to the problem is not and can not be limited to the monetary aspect, nor to the obvious need to protect the Treasury in managing the public debt. Under the Employment Act of 1946 our approach has to be much broader to consider the total problem of stabilization and not merely the monetary problem and the debt-management problem. We are continually concerned with the problem of economic growth. We look upon the cost of capital as being no different from any other cost of production and we believe that it is always desirable to have costs of production, including the cost of capital, held at as low a point as social policy will permit or will bring about.

Therefore, we were not in favor of monetary policies that were directed to increasing the cost of capital and thereby limiting economic expansion. But in a period of inflation, under ordinary peacetime conditions, a period which is bound to come to an end either through effective policies being applied to it or through the crash which otherwise is the normal result of inflation, we think that it is entirely permissible to tighten credit.

And for that reason, ever since the Federal Reserve Board presented the proposal in 1947, we have vigorously supported the plan for a special reserve, to be held at the option of the bank in short-term Government securities.

In November the committee was considering the situation that then was dominated by the needs of the defense program following the attack in Korea, a very long term program, so far as we can tell. The one change

that we then made, and for that reason made, in our recommendation was to tell you that under the conditions following the Korean attack we looked upon the continued expansion of the economy as being far more important than it would have been in another period of inflation.

For that reason we were not in favor of tightening credit, although we did believe that it was still true that the Federal Reserve Board always should have among the tools in its armory of anti-inflationary policy, the right to establish the special reserve requirement when conditions called for such action.

Now we are in the third situation. The Chinese attack has aggravated the problem of preparedness and has accelerated the defense program. We immediately shifted from the original position we had taken that it was not necessary to have wage and price controls. Now we thought it was necessary to have wage and price controls. And a second change which that new condition makes in my mind is that if now business loans, the extension of bank credit, are creating a dangerous situation, there is no sense in trying to attack the danger by the use of the awkward, indirect, and indiscriminate control of credit. We should do with respect to credit what we are doing with respect to other sectors of the economy, and that is to apply direct control of the volume of credit.

And when it is suggested, as Mr. Eccles argues with me, that the problems of direct control of the volume of loans which banks may make is an administrative impossibility, I have to say that we certainly are wasting our time in talking about such things as controlling prices of 4,000,000 business institutions and fixing the wages of 60,000,000 workers

if the problems of controlling 14,000 banks, the institutions more subject to control than any others in our nation, is too big a job for us to handle. That is a personal view. The Council has not had occasion to pass upon it.

I say "if it is necessary to act." Last week, when the committee had an executive hearing, I stated my view that there is probably no great problem in this matter of bank credit, that the situation has already been carried into a pattern which will not only stop the increase in bank credit but will soon create a plethora of funds seeking investment.

Two days after I made that forecast to you the president of a building and loan association, in an address at one of their conventions, besought them not to establish limits upon deposits which they would accept. And the problem arose because those institutions already are finding it impossible to find outlets for savings and for new investment funds.

If you looked at the schedule that Don Woodward gave you at your hearing the first of the week you may have noticed that he came to the conclusion that in 1951, without any changes in prices, the inability of consumers to find goods to buy would mean that consumers' savings would be in excess of \$25 billion this year. What are they going to do with the money? It will not be put into houses. That is a kind of a saving or a method of saving. What are they going to do with the funds? What will be done with the funds of these corporations which are going to begin to establish reserves for these higher taxes that the President has proposed today, and which will not be payable until the beginning of next winter?

They will not let those funds lie idle in the banks. I am sticking by my forecast, Mr. Chairman, that by the middle of the year you are not only not going to have any problem of expansion of bank credit, but you are going to have such a drive upon the Government security markets by those seeking the only outlet available for their funds, that it will be absolutely impossible through any rational open market operations to prevent interest rates from going down.