

Address of Marriner S. Eccles, Member of the Board
of Governors of the Federal Reserve System,
at a Luncheon of The Executives' Club of Chicago,
Grand Ballroom, Morrison Hotel,
Chicago, Illinois, March 2, 1951.

For release upon delivery,
Friday, March 2, 1951.

Adequate defense against Communist aggression calls for more than powerful military forces and strong allies. It also calls for sound domestic economic policies that will assure the preservation of our free democratic institutions. More specifically, it calls for the prevention of further inflation which erodes the savings of the people, impoverishes all recipients of fixed incomes, destroys incentives to productive effort, corrupts the moral fibre of the nation, and in the end destroys the very system which the defense effort is designed to protect. Defense of the free nations of the world and defense of the dollar are equally compelling.

The dollar cannot be defended for long, if at all, with a harness of direct controls - we all know what happened to its purchasing power during and after the last war. We should have no illusions about the effectiveness of such direct controls. They attack the symptoms, not the basic causes, of inflation. In the absence of adequate fiscal and monetary measures to curtail buying power in the hands of the public, imposition of direct controls for the prevention of further price increases merely postpones and delays inflation, but does not prevent it. If demands of businesses and individuals supported by money and credit had not exceeded the available supplies of goods and services, prices could not have advanced so rapidly since Korea. You cannot divert labor and material from civilian to defense production and avoid inflation unless you divert a corresponding amount of financial resources from the civilian economy.

The only way that the purchasing power of the dollar can be preserved is through a tax program that will keep the Federal cash budget in balance as long as inflationary pressures exist, and through monetary and debt management policies that will effectively regulate the expansions of bank credit in relation to the total output of goods and services. Adoption of such policies, together with the maintenance of an adequate amount of savings by the public, will bring about the necessary balance between civilian demands for, and the available supply of, goods and services. A pay-as-you-go tax program by itself is not enough to defend the purchasing power of the dollar. During 1950 the Government operated on a cash budgetary surplus; despite this, wholesale prices advanced roughly 16 per cent during the year. The inflation is due, therefore, not to Government spending more than its income, but to excessive spending by the public, a substantial part of which resulted from new money created by bank credit.

To a great extent, this expansion in bank credit was made possible by the Federal Reserve's purchase of Government securities in the market at fixed prices. Such purchases provided the commercial banking system with

reserves that formed the basis for a multiple expansion of loans and deposits. Despite the rapid increase in bank loans since Korea, and the inflationary impact of this credit on the economy, the policy of purchasing Government securities at the will of the holders at fixed prices has been continued. Such action by the Federal Reserve does not assure confidence in the credit of the Government. The credit of the Government is determined by the willingness of the public to buy and hold Government securities. A policy that results in continued monetization of the public debt in time of inflationary pressures leads to destruction of the Government's credit by depreciating the value of the dollar.

Continued support of Government securities at fixed prices, some above par, makes call money, or interest bearing currency, out of the marketable public debt. If these conditions are to prevail, there is no justification for the various issues of marketable Government securities, with their wide variation of maturities and interest rates. Why should the Government discriminate against holders of savings bonds by paying them less interest if they cash them prior to maturity, when it requires that the holders of marketable bonds be protected against any loss of principal or interest if they sell them before maturity? Why should they be called marketable when their prices are not permitted in any degree to reflect market demand?

The Federal Reserve System has been accused of seeking higher interest rates, which primarily enrich the banks and other corporate holders. The Federal Reserve is not interested in higher interest rates as such, but only as they help in curbing the sales of Government securities which add to the reserves and deposits of the banking system. In order to curb such sales of Governments, it is necessary that the market for them become more self-supporting and less dependent on Federal Reserve purchases. The incidental result of such a development, under current conditions, will be somewhat higher interest rates.

This does not mean, as has sometimes been suggested, that the Federal Reserve favors a completely free market for Government securities. The responsibility for maintaining an orderly market that will assure the continued success of Treasury financing has long been recognized and publicly proclaimed by the Federal Reserve System. Let us not confuse the issue - an orderly market, in which the demand for and supply of Government securities are permitted some freedom of action in order to determine what the real public market is, is not the same thing as maintaining a fixed pattern of rates irrespective of inflationary conditions.

If the Federal Reserve became a more reluctant buyer of Government securities, the market for such securities would in no sense get out of hand. These securities are held mainly by large institutional investors who need the income from them. I strongly believe that if the marketable securities eligible for purchase by non-bank investors bore a somewhat higher yield, such investors would be less willing to sell the securities they now own and more willing to take new or refunding issues.

While the maintenance of an orderly, as contrasted with a pegged, market may result in some increase in the interest cost to the Government, such increase would be nominal as compared with the effects of a further depreciation of the dollar. Only that portion of the debt which is refunded or converted each year would bear the higher interest rate. The additional interest cost on that portion of the public debt which may be refunded or converted during the next few years would be very small indeed compared with the added cost of inflation to the Government, if monetization of the public debt is allowed to continue. As a matter of fact, the increased interest cost on the marketable debt would be less than claimed, since the Government will collect in taxes more than half of any additional interest which it pays to holders of its securities.

We must, above all, be realistic in formulating and assessing the effectiveness of debt management policies at the present time. We are not starting with a clean slate. We must recognize the size, structure, and distribution of the public debt. There are a great many different types of Government obligations outstanding which are held by various classes of investors. Consequently, increases in yields on market bonds must not be permitted to adversely influence the very large number of savings-bond holders.

While the establishment of a freer but orderly market for Government securities is essential to curb further sales by banks and other institutional holders, the moderate changes in interest rates permissible in view of the debt structure may not prove to be a sufficient deterrent, especially in the case of banks, which largely hold short-term securities yielding from 1-1/2 to 1-3/4 per cent. In that event, Congress will have to authorize supplementary authority to increase reserve requirements or some other form of controlling reserves of commercial banks so as to limit their sales of Government securities to the Federal Reserve for the purpose of expanding their loans and investments.

So far as the disagreement between the Treasury and the Federal Reserve System is concerned, it is not a matter of personalities, but what appears to be a conflict of responsibilities. The Treasury's primary responsibility is that of financing the operations of the Government at the lowest possible cost at which it can induce the public to buy and hold its securities. The Federal Reserve System, as an independent agent responsible to Congress, is charged with the responsibility for regulating money and credit in such a way as to contribute to the maintenance of economic stability. Ordinarily there should be no conflict between the objectives of these two agencies of the Federal Government. However, a conflict has arisen during the postwar period, and particularly since Korea, over continuance of the cheap money policy of the wartime period of heavy deficit financing, despite the existence of budget surpluses and inflationary pressures since the war. These inflationary pressures have been due in large measure to credit expansion by the banks, based upon reserves obtained through the sale of Government securities to the Federal Reserve System because of its support of the Treasury's cheap money policy.

It is not the responsibility of the Federal Reserve System at a time like this to underwrite the public debt at fixed prices, but rather to do everything in its power to curb further expansion of the money supply and further depreciation in the purchasing power of the dollar. Therefore, the Federal Reserve System should not continue to support the market for all Government securities at present prices. If the Congress does not want the Federal Reserve System to carry out its present statutory responsibilities it should repeal or redefine its powers. Until such time as it does, the System has no choice under the present impact of inflationary pressures but to use its powers in a manner consistent with its responsibilities to the public as well as to the Treasury. To do otherwise, would be to fail in its public duty and would not be in the real interest of the Government. A greater degree of independence on the part of the Federal Reserve System is long overdue.